

Reforming Executive Compensation: Focusing and Committing to the Long-term

Sanjai Bhagat
University of Colorado at Boulder
and

Roberta Romano
Yale University, NBER

CORPORATE DIRECTORS FORUM
San Diego, CA

The Great Debate: "Does the Market Reward Good Governance?
Do Governance Ratings Matter?"

May 6, 2009

1



2



Proposal to Reform Executive Compensation

Executive incentive compensation plans should consist only of

- restricted stock, and
- restricted stock options,

restricted in the sense that the shares cannot be sold or the option cannot be exercised for a period of at least two to four years after the executive's resignation or last day in office.

Proposal will provide superior incentives compared to unrestricted stock and option plans for executives to manage corporations in investors' longer-term interest, and

diminish their incentives to
make public statements,
manage earnings, or
accept undue levels of risk,

for the sake of short-term price appreciation.

5

Caveats - 1

If executives are required to hold the restricted shares and options, then they would most likely be **under-diversified**.

Problem: Lowers the risk-adjusted expected return for the executive.

Solution: Grant additional (restricted) shares and options to the executive.

- Prohibition against engaging in derivative transactions, such as equity swaps, or borrowing arrangements, that hedge payoff from restricted shares/options.

6

Caveats - 2

Lack of **liquidity** of executive's compensation.

Median CEO tenure: About 5 years.

CEO can expect to wait about seven to nine years before being allowed to sell shares or exercise options.

This parallels time frame of realization of significant portion of private equity general partner's profits (carried interest realized toward end of partnership life, usually seven to ten years) .

Solution: Higher limit on tax-deductible cash compensation of, say, \$2 million.



7

Caveats – 3

Tax liability from receiving such restricted shares and options.

Solution: Executive allowed to sell enough shares (and/or exercise enough options) to pay those additional taxes.



8

Why not require relative performance – that is, adjust for industry/market movements?

- Executive compensation should be simple and transparent:
Questions about industry/market adjustments.
- Can lead to perverse outcomes:
CEO gets \$50 million compensation when shareholders lose \$100 billion! e.g., Ford.



9

Will this encourage early departures?

- Yes.
- Reputational effect on managers of too frequent resignations.
- In our proposal, managers are allowed cash compensation of up to \$2 million.
 - Is \$2 million annually “enough”?
 - What is the annual compensation of some other very talented professionals, e.g., medical surgeons?



10

Conclusion

Our proposal,
allowing only restricted stock and options as incentive
compensation
will provide superior incentives for executives to manage
corporations in investors' long-term interest
while avoiding the perverse incentives of both an artificial cap on
compensation and of unrestricted stock and option compensation
plans.

