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Pay Cap Debate

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Critics of the administration's proposed guidelines on executive compensation say they are a dangerous intrusion into corporate boards' authority and would make it difficult for financial firms to fill executive positions. These criticisms are unwarranted. If anything, the guidelines are too modest and should be tightened.

Concern that the guidelines would undermine firms' ability to attract or retain executives has been fueled by media coverage stressing the $500,000 cap on salaries. But salaries commonly represent a small fraction of total executive pay, and firms will be free to increase performance-based compensation to make up for any salary reduction.

Companies falling under the guidelines retain the ability to provide large compensation when necessary. The guidelines don't impose any cap on the total pay; they only influence its form.

Indeed, firms which get taxpayer funds under "generally available government programs" -- which likely will constitute the lion's share of firms receiving government capital -- will be permitted to provide unlimited compensation in *any* form they choose provided they disclose it and allow shareholders to have advisory "say on pay" votes on the firm's pay policy. Even firms that receive "exceptional assistance" (such as provided to AIG or Citibank in the past) will be permitted to compensate executives with unlimited amounts in restricted shares that can be cashed out after the government is paid back.

This is not excessive government meddling. As a major provider of capital to firms receiving exceptional assistance, the government has a legitimate investment interest in executives' being properly incentivized. The proposed guidelines are a rather modest intervention relative to the control rights that private investors providing so much capital would likely seek.

Furthermore, this modest intervention can significantly improve incentives and performance. In a 2004 book and prior articles, Jesse Fried and I warned that common executive pay practices produce perverse incentives to focus on short-term results. To the extent that such incentives have contributed to the current crisis -- as has now come to be widely suspected -- the adverse consequences have been dire indeed.

Executives' ability to profit from early dumping of their equity-based compensation onto the market can impose large costs on investors. To protect its investments in firms receiving exceptional assistance, the government is warranted in restricting their freedom to unload their restricted shares quickly, before the government is repaid.

For executives to view any number of restricted shares that cannot be quickly unloaded as inadequate compensation, they must believe the firm will likely fail to repay the government, and that the restricted shares will lose their value if not cashed out beforehand. In such circumstances, the firm should be immediately taken over by the government or otherwise reorganized. It should not continue operating with a structure under which executives may be retained only if allowed to cash out before things fall apart.

After a period of public comment, the Obama administration will finalize the guidelines for firms receiving capital under general programs. I believe the final version should impose tighter restrictions, at least for firms receiving a substantial capital infusion from the government.

While the proposed guidelines seek to encourage companies participating in general programs to use restricted stock, they do not limit how quickly such restricted shares may be unloaded. This should be changed. To provide incentives to focus on long-term results, executives should be precluded from unloading restricted shares for a specified period, say three years, after they vest.

The proposed guidelines also make it too easy for firms participating in general programs to opt out of the restricted stock requirement and compensate executives in whatever form they choose. Companies that opt out only need to adopt "say on pay" votes.

While such votes may be a good governance arrangement for public firms in general, they are merely advisory and, moreover, take place in the year after compensation is awarded. Furthermore, and importantly, because the government can be expected to hold investment rights (such as preferred shares) that are senior to those of common stockholders, these stockholders may prefer executive pay arrangements that would induce more risk-taking and short-termism than would be in the interest of the government as an investor.

In short, the guidelines are a useful step in the right direction. To ensure that executives of firms receiving government capital are well incentivized, however, the administration should use the comment period to significantly tighten them.

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