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Equity Compensation for Long-Term Results

By Lucian Bebchuk and Jesse Fried

Treasury Secretary Timothy Geithner announced on Wednesday the Obama administration's strong belief in tying executive compensation to long-term company performance. The regulations issued that day direct the new "compensation czar" to ensure that financial firms receiving "exceptional assistance" from the government don't "reward employees for short-term or temporary increase in value." Companies not covered by regulations are also currently seeking to tighten the link between pay and long-term performance. The question is how this could best be done.

With respect to equity compensation – a central component of modern executive pay arrangements – companies should prevent executives from cashing out vested grants of options and shares for a fixed number of years. But companies should avoid arrangements that block executives from cashing out options and shares until the executive's retirement, or any other event that is at least partly under that person's control.

Grants of equity incentives – options and restricted shares – usually vest gradually over a period of time. A specific number of options or shares vest each year, and the vesting schedule provides executives with incentives to remain with the company. Once options and shares vest, however, executives typically have unrestricted freedom to cash them out, and executives often liquidate them quickly after vesting.

The ability to cash out large amounts of equity-based compensation has provided executives with powerful incentives to seek short-term stock gains even when doing so involves excessive risk-taking. This short-termism problem, which was first highlighted in a book we published five years ago, "Pay without Performance," has become widely recognized in the aftermath of the crisis – including by business leaders such as Goldman's Lloyd Blankfein in a Financial Times op-ed.

The short-term distortions can be addressed by separating the time that options and restricted shares can be cashed out from the time that they vest. As soon as an executive has completed an additional year at her firm, the restricted options or shares that were promised as compensation for that year's work should vest, and they should belong to the executive even if the executive immediately leaves the firm. But the executive should be allowed to cash them out only down the road. This would tie the executive's payoffs to long-term shareholder value.

Some experts have called, including at Thursday's hearing at the Financial Services Committee of the House of Representatives, for permitting executives to cash out shares and options only upon retirement from the firm. Shareholder proposals have also been urging companies to adopt such "hold-till-retirement" requirements. Such requirements, however, would be the wrong way to go.

Hold-till-retirement requirements provide executives with counter-productive incentives to leave the firm in order to cash out accumulated options and shares and diversify risks. Perversely, the incentive to leave will be strongest for executives who have served successfully for a long time and whose accumulated options and shares will thus have an especially large value. Rather than supplying retention incentives, equity compensation with hold-till-retirement requirements would have the opposite effect.

A similar distortion arises under any arrangement tying the freedom to cash out to an event that is at least partly under an executive's control. Following the requirement adopted by Congress in February as part of the stimulus bill, Treasury's new regulations mandate that TARP recipients preclude executives from cashing out granted shares before TARP funds are repaid. To the extent that TARP recipients adopt the regulations' minimum restrictions on cashing out, executives would have incentives to return TARP funding even when they shouldn't be doing so.

To avoid the above problems, the period during which vested equity incentives may not be cashed out should be fixed. For example, when an executive's options or shares vest, one-fifth of them could become unblocked, and the executive would subsequently be free to cash them out, in each of the subsequent five years. Because the blocking period would be fixed, the executive's actions wouldn't be distorted by a desire to accelerate the cashing out of equity incentives. And as long as the executive is working for the firm and options and shares continue to vest, the executive would always have an incentive to care about the company's performance several years down the road.

The devil, as is often the case, is in the details. Well-designed blocking periods can do a great deal to curtail the perverse incentives that we have seen – and to provide executives with desirable incentives to enhance the long-term value of their firms and shareholders.

Lucian Bebchuk is professor of law, economics and finance and director of the program on corporate governance at Harvard Law School. Jesse Fried is professor of law at Berkeley's Boalt Hall and co-director of its Center for Law, Business, and the Economy. This piece is based on Mr. Bebchuk's testimony at the House Financial Services committee on Thursday and their forthcoming white paper, "Equity Compensation for Long-Term Performance."

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