How to Tie Equity Pay to Long-Term Performance

Harvard Business Review
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June 24, 2009

It's all very well to say, as do other participants in this debate, that companies must tie equity compensation to long-term shareholder value. The devil is in the details. A good plan should address effectively two problems: executives' tendency to quickly liquidate large amounts of their equity compensation, and their ability to "game" the timing of equity awards and the cashing out of such awards.

Executives' ability to benefit from short-term stock gains, even when they are subsequently reversed, encourages them to seek such gains--even when doing so involves excessive risk-taking. This problem, first highlighted in our book "Pay without Performance," has become widely recognized in the aftermath of the 2008-2009 financial crisis--including by such business leaders as Goldman's Lloyd Blankfein.

To address those issues, we propose the following (we develop these arguments in detail in a forthcoming white paper, "Equity Compensation for Long-term Performance"):

>> **Firms should separate the time when options and restricted shares can be cashed out from the time when 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--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.

It is important, however, to avoid arrangements--advocated by some compensation reformers and shareholder proposals--that prevent executives from cashing out equity incentives until retirement. Rather than providing retention incentives, such arrangements would perversely give effective executives an incentive to leave. To avoid such perverse incentives, executives should be prohibited form cashing out vested equity incentives for a fixed number of years.

For example, when an executive's options or shares vest, one-fifth of them could become "unblocked," meaning that the executive would 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.

>> **Compensation should also be structured to avoid providing executives with incentives to engage to manipulate equity grants or the stock price.** At the front end, CEOs currently can often use inside information to time grants in a way that will be beneficial to them. In particular, equity can be granted shortly before good news is expected to emerge. This practice of informed

grant-timing, called "springloading," turns out to be remarkably widespread. To reduce springloading, the timing of equity awards to executives should not be discretionary. Such grants should be made only on pre-specified dates.

At the back end, firms should limit the extent to which the payoff from stock sales depends on a single stock price. Instead, the payoff should be based on the average stock price over a significant period. For example, an executive wishing to unload unblocked equity would be permitted to sell the shares in the market, but only gradually according to a pre-specified, automatic plan. Such an approach would make it more difficult for executives to profit from using inside information to time their stock sales, as well as reduce executives' incentives to manipulate the short-term stock price prior to unwinding.

To further reduce executives' ability to sell on inside information, executives wishing to sell stock either through the immediate or gradual cash-out approach should be required to disclose their intended unwinding in advance. Alternatively, firms could adopt a "hands-off' approach to equity dispositions that leave the executive no discretion over when her equity is cashed out; this approach would not only reduce executives' ability to use inside information to boost their sale profits but eliminate it altogether.

Firms seeking to improve their equity compensation would do well to follow these principles, and investors should encourage firms to do so. These principles could also be useful for regulators of financial firms as they seek to develop standards that such firms should follow to avoid excessive incentives to take risks.