

Hands-Off Options

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INTRODUCTION

Executive compensation long has attracted considerable interest from investors, academics, regulators, and the media. It received increased attention in the wake of the Enron and other corporate governance scandals that erupted at the beginning of the century. Hundreds of firms were found to have engaged in various forms of earnings manipulation that, ultimately, destroyed tens of billions of dollars of social value.¹ Much of this earnings manipulation was linked to executives' pay arrangements, such as their ability to time the unwinding of their equity incentives.²

The scandals eventually led to some of the most important corporate governance reforms in decades, most notably the Sarbanes-Oxley Act ("SOX").³ These reforms were intended to improve corporate governance, including executive pay arrangements. In fact, SOX and accompanying reforms appear to have had some positive effects on compensation practices. For example, SOX's disclosure requirements seem to have reduced substantially the amount of option grant backdating.⁴

However, these reforms did little to address one of the most important defects plaguing executive compensation arrangements: managers' ability to time the *disposition* of equity incentives. Executives retain significant discretion over when they sell shares, including stock received via exercise of their options. The freedom to sell substantial amounts of stock over a short period gives rise to two types of problems. First, executives can use inside information to determine when to sell large amounts of shares. Second, whatever an

1. The collapse of Enron alone was estimated to have destroyed \$30 billion of social value. See Michael C. Jensen, *Agency Costs of Overvalued Equity*, FIN. MGMT., Spring 2005, at 5, 10-11 (concluding that Enron executives' efforts in making their business appear to be worth \$70 billion ultimately destroyed a business actually worth about \$30 billion).

2. See *infra* Part I.A.

3. Sarbanes-Oxley Act of 2002, Pub. L. No. 107-204, 116 Stat. 745 (codified in scattered sections of 11, 15, 18, 28, and 29 U.S.C.).

4. Jesse M. Fried, *Option Backdating and Its Implications*, 65 WASH. & LEE L. REV. (forthcoming 2008) (describing studies showing a decrease in the amount of backdating following enactment of SOX). Even after SOX, however, thousands of companies continued to backdate option grants and exercises to inflate and camouflage executive pay. *Id.*

executive's motive for selling, the sale of a large block of stock gives the executive an incentive to inflate the short-term stock price to boost his trading profits.

Executives' use of inside information and price manipulation to boost their trading profits hurts public investors. Each extra dollar pocketed by managers comes at the expense of public shareholders. More importantly, executives' ability to sell on inside information and inflate the short-term stock price before unwinding can reduce the size of the total corporate pie by distorting managers' operational decisions *ex ante*. The indirect costs to public investors of such distortions are likely to be far larger than the value directly captured by executives.

This Article suggests that firms use what I call "hands-off" options—options that are cashed out according to a fixed, gradual, and pre-announced schedule.⁵ By removing executives' control over the timing of unwinding, such options would make it impossible for executives to sell on inside information. And by making each sale relatively small, hands-off options would sharply decrease executives' incentive to manipulate the stock price around dispositions.⁶

This Article explains that hands-off options would create such benefits at little cost to executives or shareholders. They will neither impose much burden on executives, nor lead to an undesirable reduction in managerial shareholdings. Indeed, hands-off options could be structured to increase the amount of equity held by managers, further boosting managers' incentive to generate shareholder value.⁷

5. Although I use the term "hands-off options" throughout, the same arrangement could (and should) be used for restricted stock.

6. This Article builds on earlier work of mine that analyzed the problem arising from executives' ability to time the unwinding of their equity incentives and advocated requiring executives to disclose their trades in advance. See Jesse M. Fried, *Reducing the Profitability of Corporate Insider Trading Through Pretrading Disclosure*, 71 S. CAL. L. REV. 303, 306 (1998) [hereinafter Fried, *Pretrading Disclosure*] (proposing and analyzing a rule that would require insiders to make public their intended trade prior to trading); Jesse M. Fried, *Advance Disclosure of Managers' Stock Trades: A Proposal to Improve Executive Compensation*, ECONOMISTS' VOICE, Oct. 2006, <http://www.bepress.com/ev/vol3/iss8/art7/> (same). Such an approach, I showed, would substantially reduce (but not eliminate) managers' ability to trade on inside information. The hands-off approach, in contrast, would make it impossible for executives to make insider trading profits while selling their shares. See *infra* Part II.B.1.

7. In addition to ensuring that executives retain a desirable amount of equity, hands-off options might yield several other collateral benefits. For example, they would encourage managers to focus on running the business rather than timing their trades. They would also reduce arbitrary differences in executives' payoffs due to transaction timing luck, increasing pay equity within the management team. In this Article, however, I focus only on hands-off options' ability to both prevent information-driven selling and reduce managers' incentive to manipulate the stock price prior to selling.

Although hands-off options are likely to benefit the public shareholders of most firms, boards and executives may well be reluctant to adopt such an arrangement. Executives' ability to sell on inside information and inflate the stock price around stock sales provides them with hidden compensation—something that they are in no hurry to give up. And because directors tend to favor executives over shareholders on compensation-related matters, boards are unlikely to insist on an arrangement strongly opposed by management unless they are pressured to do so.⁸ Thus, institutional investors should strongly urge firms to adopt hands-off options.

Regulators could assist by making a small change to compensation disclosure rules. In particular, the Securities and Exchange Commission ("SEC") could require that firms giving managers broad freedom to unwind their equity incentives explain how this arrangement best serves shareholders. The difficulty of justifying such discretion may make some boards more receptive to shareholder pressure to adopt hands-off options.

The Article is organized as follows. Part I shows that managers are able to sell on inside information and inflate the stock price before unwinding their equity incentives. It also describes the costs of such insider selling and price manipulation. Part II explains how hands-off options would reduce these costs without burdening executives or undermining their incentive to create shareholder value. It also suggests how firms can be encouraged to adopt such options. A conclusion follows.

I. INFORMED SELLING AND PRICE MANIPULATION

This Part explains that existing compensation arrangements enable executives to sell on inside information and manipulate the stock price around their sales, both of which impose costs on public shareholders. Section A describes the evidence that managers use inside information to time their stock sales and often inflate the short-term stock price before selling to boost their trading profits. Section B explains why existing legal arrangements have failed to prevent executives from trading on inside information (including their knowledge that the firm is manipulating the stock price). Section C details the costs to shareholders when managers sell on inside

8. See LUCIAN BEBCHUK & JESSE FRIED, *PAY WITHOUT PERFORMANCE* 23-44 (2004) (describing the factors that lead directors to favor executives over shareholders when determining executive compensation).

information and inflate the stock price before disposing of their shares.

A. *The Evidence*

Executives commonly receive a large fraction of their compensation in the form of stock options and restricted stock. After the equity vests, executives are generally free to choose when to cash it out. They can sell large amounts of stock at once or over a short period. As we will see, executives frequently use inside information to time these sales, and they often manipulate information to boost the stock price before selling.

1. Selling on Inside Information

Since academics began studying executives' trades over thirty years ago, they have found an overwhelming amount of evidence that executives use inside information to time their sales, selling before bad news emerges and the stock price declines.⁹ For example, executives tend to exercise their options and sell the underlying stock before earnings deteriorate and the price of the stock underperforms the market.¹⁰ These studies help explain the body of evidence indicating that managers make considerable abnormal profits—that is, higher than market returns—when trading in their own firms' stock.¹¹

The last decade has provided many dramatic examples of insiders unloading shares before their firms' stock prices plunged. A study published by *Fortune* in September 2002 examined executive trading in the shares of publicly held firms that had reached a market capitalization of at least \$400 million and whose shares subsequently had fallen at least seventy-five percent.¹² The firms were ranked by the amount of executive sales.¹³ At the top twenty-five firms, 466

9. See Fried, *Pretrading Disclosure*, *supra* note 6, at 317-20, for a survey of the literature through 1998.

10. See Jennifer N. Carpenter & Barbara Remmers, *Executive Stock Option Exercises and Inside Information*, 74 J. BUS. 513, 531-32 (2001) (finding that top managers at small firms time the exercise of their options based on inside information); Bin Ke, Steven Huddart & Kathy Petroni, *What Insiders Know About Future Earnings and How They Use It: Evidence from Insider Trades*, 35 J. ACCT. & ECON. 315, 342-43 (2003) (finding that insiders time their trades well in advance of negative news in order to avoid the appearance of trading on inside information).

11. Fried, *Pretrading Disclosure*, *supra* note 6, at 322-23; H. NEJAT SEYHUN, INVESTMENT INTELLIGENCE FROM INSIDER TRADING 63 (MIT Press 1998).

12. Mark Gimein, *You Bought, They Sold*, FORTUNE, Sept. 2, 2002, at 64.

13. *Id.*

executives collectively sold \$23 billion before their stocks plummeted.¹⁴

2. Price Manipulation Around Sales

Whether or not insiders' stock sales are motivated by inside information, insiders have an incentive to manipulate information to boost the stock price before selling. In fact, many studies have found a connection between the level of insider selling and earnings manipulation—both legal and illegal. For example, firms in which annual option exercises are particularly high tend to have higher discretionary accruals (and therefore higher reported earnings) in those years and lower discretionary accruals and earnings in the subsequent two years.¹⁵ And firms that fraudulently misstate their earnings have a higher level of selling activity—measured by number of transactions, number of shares sold, or the dollar amount of shares sold.¹⁶

Again, it is not difficult to find dramatic examples of the link between price manipulation and insider selling from the last decade. For example, Gary Winnick, the CEO of Global Crossing, sold more than \$700 million worth of shares in the year before the firm filed for bankruptcy, while the company was allegedly inflating sales revenues.¹⁷ Qwest insiders sold more than \$2 billion of stock while

14. *Id.*

15. See Eli Bartov & Partha Mohanram, *Private Information, Earnings Manipulations, and Executive Stock-Option Exercises*, 79 ACCT. REV. 889 (2004). See also Steven Huddart & Henock Louis, *Stock Returns, Earnings Management, and Insider Selling During the 1990s Stock Market Bubble* 32 (June 26, 2006) (unpublished manuscript, on file with Vanderbilt Law Review), available at http://papers.ssrn.com/sol3/papers.cfm?abstract_id=912214 (reporting that managers tend to inflate earnings more before high levels of insider selling).

16. Scott L. Summers & John T. Sweeney, *Fraudulently Misstated Financial Statements and Insider Trading: An Empirical Analysis*, 73 ACCT. REV. 131, 144 (1998). See also Messod D. Beneish, *Incentives and Penalties Related to Earnings Overstatements that Violate GAAP*, 74 ACCT. REV. 425, 454 (1999) (finding that managers of firms whose earnings were overstated tended to sell at a high rate before the overstatements were corrected); Natasha Burns & Simi Kedia, *The Impact of Performance-Based Compensation on Misreporting*, 79 J. FIN. ECON. 35, 63 (2006) (finding that top managers of firms that experienced accounting irregularities and were subsequently subject to SEC enforcement actions had exercised their options in the preceding period at a higher rate than top managers of other firms); Shane A. Johnson, Harley E. Ryan & Yisong S. Tian, *Managerial Incentives and Corporate Fraud: The Sources of the Incentives* Matter 25 (Nov. 8, 2007) (unpublished manuscript, on file with Vanderbilt Law Review), available at http://papers.ssrn.com/sol3/papers.cfm?abstract_id=395960 (finding that executives at firms that commit fraud exercise significantly larger fractions of their vested options than other executives).

17. Henny Sender & Rebecca Blumenstein, *Questioning the Books: Global Crossing Creditors Review Sales, Swaps*, WALL ST. J., Feb. 25, 2002, at A6.

they were overstating revenues.¹⁸ Shortly thereafter, Qwest stock fell more than ninety-five percent.¹⁹ Qwest's CEO, Joseph Nacchio, was eventually charged with violating the insider trading laws.²⁰

Partly in response to the widespread practice of earnings manipulation, Congress adopted SOX.²¹ One of the principal aims of SOX was to increase the accuracy of financial reporting. Among other things, SOX created a new government oversight board for the accounting industry and attempted to improve internal controls.²²

While SOX may have reduced somewhat insiders' ability to misreport earnings, it certainly has not eliminated that ability. In 2006, four years into the post-SOX era, the number of earnings restatements filed by public companies reached an all-time record: 1876.²³ Thus, SOX does not appear to have prevented managers from misreporting.²⁴

Moreover, SOX fails to reach one of the most harmful forms of earnings manipulation: "real earnings management," the practice of making business decisions for the purpose of boosting short-term accounting results rather than maximizing the size of the corporate pie. For example, executives can prop up short-term earnings by postponing desirable investments, or by accelerating revenue-generating transactions that would create more long-term value if they were delayed.

Because real earnings management does not violate the accounting rules as long as all transactions are reflected properly in a

18. William S. Lerach, *Plundering America: How American Investors Got Taken for Trillions by Corporate Insiders*, 8 STAN. J.L. BUS. & FIN. 69, 103 (2002).

19. *Id.*

20. Dionne Searcey et al., *Qwest's Nacchio Is Found Guilty in Trading Case; Ex-CEO's Conviction on 19 of 42 Counts Adds to Government's Wins*, WALL ST. J., Apr. 20, 2007, at A1.

21. Sarbanes-Oxley Act of 2002, Pub. L. No. 107-204, 116 Stat. 745 (codified in scattered sections of 11, 15, 18, 28, and 29 U.S.C.).

22. Roberta S. Karmel, *Realizing the Dream of William O. Douglas—The Securities Exchange Commission Takes Charge of Corporate Governance*, 30 DEL. J. CORP. L. 79, 113-17 (2005).

23. David Reilly, *Restatements Still Bedevil Firms—Overall Total Hits a Record as Big Companies Improve; Backdating's Messy Wake*, WALL ST. J., Feb 12, 2007 at C7.

24. Section 304 of SOX requires the CEO and CFO of a firm forced to restate earnings to return to the firm any bonus or other incentive- or equity-based compensation received within twelve months of the misleading financial statement, or any profits realized from the sale of stock during that period. Sarbanes-Oxley Act of 2002 § 304, 15 U.S.C. § 7243 (Supp. II 2002). Thus, some may have hoped that SOX would reduce not only executives' ability to manipulate earnings, but also their incentive to do so. However, this "clawback" provision applies only in special circumstances involving "misconduct," and it has been invoked mainly in cases where executives were criminally convicted of fraud. See Jerry W. Markham, *Regulating Excessive Executive Compensation—Why Bother?* 2 J. BUS. & TECH. L. 277, 299 (2007). Thus, Section 304 is unlikely to deter misreporting in run-of-the-mill cases not involving criminal fraud.

firm's financial statements, SOX cannot prevent or deter it. Indeed, such manipulation appears to have increased after SOX.²⁵ Thus, we can expect executives who sell large blocks of stock to continue manipulating the stock price around these sales—through both misreporting and real earnings management—to increase their trading profits.

B. The Limitations of Existing Restrictions on Insider Trading

Executives are able to sell shares in their firms while aware of inside information (including, in some cases, the knowledge that they are inflating the short-term stock price) because of inherent limitations in the federal securities laws governing insider trading, as well as the porosity of the voluntary insider trading restrictions adopted by firms. This Section describes the limitations of the three main constraints on insider trading: (1) the prohibition on insider trading (Rule 10b-5); (2) SOX's stock-trading disclosure requirements; and (3) firms' and executives' voluntary restrictions on insider trading.

1. Insider Trading Laws

The primary mechanism for regulating insider trading is the duty to "disclose or abstain," which arises under Rule 10b-5 of the 1934 Act.²⁶ Under this duty, a person possessing material nonpublic information must disclose the information to, or abstain from trading with, certain counterparties.²⁷ In particular, this duty arises when the counterparty is entitled to know the information because of a fiduciary duty or a similar relationship of trust and confidence between them.²⁸ The rule applies to executives selling their corporation's shares because they are considered to owe a fiduciary duty to the firm's public shareholders.²⁹

25. Daniel A. Cohen, Aisyesha Dey & Thomas Z. Lys, *Real and Accrual-Based Earnings Management in the Pre- and Post-Sarbanes Oxley Periods*, ACCT. REV. (forthcoming 2008) (manuscript at 29), available at http://papers.ssrn.com/sol3/papers.cfm?abstract_id=813088.

26. *Chiarella v. United States*, 445 U.S. 222, 227 (1980). Executives' trading is also subject to Section 16(b), the short-swing profit rule, but this rule cannot substantially reduce executives' ability to trade on inside information. Fried, *Pretrading Disclosure*, *supra* note 6, at 343.

27. See *Chiarella*, 445 U.S. at 230-31, 233 (describing the circumstances under which Rule 10b-5 creates a duty to disclose or abstain from trading when in possession of nonpublic information).

28. *Id.* at 230-31.

29. See DONALD C. LANGEVOORT, INSIDER TRADING REGULATION 72 (1989) (noting the "long legal history of imposing fiduciary obligations of loyalty and care on those who control the day-to-day activities of the corporation").

However, there are two limitations to Rule 10b-5's ability to prevent executives from trading on inside information. The first relates to the legal definition of "materiality." Rule 10b-5 prohibits trading on inside information only if the information is "material."³⁰ In *SEC v. Texas Gulf Sulphur Co.*, the Second Circuit held that material facts are those to which a "reasonable man would attach importance . . . in determining [whether to buy or sell shares]."³¹ In interpreting the term "material" under a related statute, the Supreme Court provided a similar definition.³²

Because a reasonable investor presumably would consider important any information that could be used to increase his trading profits, this language might suggest that any information that insiders could use to increase their trading profits would be legally material. However, the Supreme Court also held that information does not become legally material merely because an insider can earn profits trading on it.³³ In practice, lower courts have been reluctant to find information material unless it concerns a "bombshell event"³⁴—such as the definite existence of a takeover offer—whose announcement causes the stock price to move sharply.³⁵ Thus, the high threshold of materiality used by the courts enables insiders to profit legally by trading on many types of valuable private information.³⁶

The second limitation on Rule 10b-5's ability to prevent executives from trading on inside information is that the rule is

30. 17 C.F.R. § 240.10b-5(b) (2006).

31. 401 F.2d 833, 849 (2d Cir. 1968) (quoting *List v. Fashion Park, Inc.*, 340 F.2d 457, 462 (2d Cir. 1965)).

32. *TSC Indus., Inc. v. Northway, Inc.*, 426 U.S. 438, 449 (1976) (holding that under Rule 14a-9, the general antifraud provisions of the SEC's proxy rules, "an omitted fact is material if there is a substantial likelihood that a reasonable shareholder would consider it important in deciding how to vote").

33. *Basic v. Levinson*, 485 U.S. 224, 240 n.18 (1988) (citing *Pavlidis v. New England Patriots Football Club, Inc.*, 737 F.2d 1227, 1231 (1st Cir. 1984)).

34. See Dennis W. Carlton & Daniel R. Fischel, *The Regulation of Insider Trading*, 35 STAN. L. REV. 857, 886-87 (1983) (arguing that Rule 10b-5 applies only in cases involving "bombshell events" and thus has a "minimal impact on insiders' behavior").

35. Consider the case of *SEC v. Hoover*, 903 F. Supp. 1135 (S.D. Tex. 1995). An insider of a company that had publicly projected a decline in earnings of 10% sold the stock after learning that the estimate of the decline in earnings had been revised downward to 10-12%. *Id.* at 1138. Shortly thereafter, the company announced that it expected an earnings decline of 12-15%, causing the price to fall 20%. *Id.* Although (as this case shows) even a small adjustment in earnings estimates can cause a price change of large magnitude, the court granted summary judgment for the insider on the ground that the SEC could not prove that the information on which the insider traded was material. *Id.* at 1148.

36. Carlton & Fischel, *supra* note 34 (citing as an example of valuable but not legally material information preliminary technological reports indicating costs will be higher than expected).

difficult to enforce. Although the penalty for violating Rule 10b-5 can be quite severe, there are many situations where the probability of apprehension and punishment is very low.³⁷ Corporate insiders engage in hundreds of thousands of trades each year, any of which could be motivated by material inside information in violation of Rule 10b-5. However, the SEC has limited resources, most of which are not allocated to policing insider trading.³⁸ Thus, the SEC can investigate only a tiny percentage of insider stock sales.³⁹ The evidence that corporate insiders are not always deterred from trading on material inside information is that sometimes executives are caught having done so.

2. Sarbanes-Oxley Reporting Requirements

Before SOX, Section 16(a) of the 1934 Act required executives to report most of their trades by the tenth day of the following month, enabling them to wait as many as forty days before reporting these trades.⁴⁰ SOX amended Section 16(a) to require executives to report a trade to the SEC by the end of the second business day following the transaction.⁴¹

This two-day disclosure requirement will alert the market to the possibility that managers are selling while aware of bad news (for example, that short-term earnings are being inflated). If the trades are suspiciously large or otherwise unusual, investors may intensify their scrutiny of the firm, in some cases causing the stock price to drop. This stock price adjustment, in turn, will reduce managers' profits from any sales after the price drop.

However, SOX's disclosure rules enable managers to profit from selling on inside information for two reasons. First, an executive still can sell secretly for two days before revealing her trades. Any adjustment in the stock price that occurs after the disclosure of these trades will not diminish the insider trading profits reaped by the

37. See Henry G. Manne, *Insider Trading and Property Rights in New Information*, 4 CATO J. 933, 937 (1985) (noting that the "ability to detect [insider trading] will always be difficult, and when the gains that can be realized from the practice, discounted by the risk of being apprehended, are compared to the potential costs, many people will have the incentive to trade on inside information").

38. Greg Steinmetz & Cacilie Rohwedder, *SAP Insider Probe Points to Reforms Needed in Germany*, WALL ST. J., May 8, 1997, at A18 (citing the SEC as stating that only 10% of its activities involve insider trading investigations).

39. Fried, *Pretrading Disclosure*, *supra* note 6, at 332.

40. Securities Exchange Act of 1934 § 16(a), 15 U.S.C. § 78p(a) (2000). Certain trades did not have to be reported until 45 days after the end of the year.

41. Sarbanes-Oxley Act of 2002 § 403(a), 15 U.S.C. § 78p(a)(2)(C) (Supp. II 2002).

executive before the announcement. Second, markets cannot process immediately and accurately the information contained in insiders' trading announcements.⁴² Indeed, stocks traded by insiders show abnormal returns for *months* after the announcement of the trade.⁴³ Thus, any price adjustment that takes place after an insider's first announced sale is unlikely to wipe out her insider trading profits from subsequent transactions. Not surprisingly, executives have continued to make profits selling on inside information after the enactment of SOX.⁴⁴

3. Voluntary Restrictions on Insider Trading

Firms and executives voluntarily have adopted two types of restrictions on unwinding that somewhat reduce managers' ability to trade on inside information: (1) trading windows and (2) so-called "10b5-1" plans. However, these arrangements are quite porous, leaving executives with substantial ability to use inside information to time their trades and inflate the stock price before selling. Indeed, as I will explain, the use of 10b5-1 plans may have exacerbated the problem of insider trading.

a. Trading Windows

In the 1980s, Congress adopted various laws that held a firm liable if an employee engaged in illegal insider trading and the firm had not taken reasonable steps to prevent such trading.⁴⁵ To reduce the risk of liability, many firms adopted "trading windows" to restrict the times when a manager can sell or buy shares.⁴⁶ One common approach, for example, is to permit managers to trade only during the

42. See Fried, *Pretrading Disclosure*, *supra* note 6, at 360 (noting that prices do not fully adjust to reflect the information contained in trading reports after they are made public).

43. See, e.g., H. Nejat Seyhun, *Insiders' Profits, Costs of Trading, and Market Efficiency*, 16 J. FIN. ECON. 189, 198 tbl.2 (1986) (showing abnormal stock price over a 300-day period following insider trades).

44. See Alan D. Jagolinzer, SEC Rule 10b5-1 and Insiders' Strategic Trade 2 (Sept. 17, 2007) (unpublished manuscript, on file with Vanderbilt Law Review), available at http://papers.ssrn.com/sol3/papers.cfm?abstract_id=541502 (showing that insider trades after SOX continue to be followed by abnormal stock price movements).

45. See generally Alan M. Weinberger, *Preventing Insider Trading Violations: A Survey of Corporate Compliance Programs*, 18 SEC. REG. L.J. 180, 182-83 (1990) (discussing the Insider Trading and Securities Fraud Enforcement Act of 1988).

46. J.C. Bettis, J.L. Coles & M.L. Lemmon, *Corporate Policies Restricting Trading by Insiders*, 57 J. FIN. ECON. 191, 192 (2000).

two- or three-week period after quarterly earnings have been released.⁴⁷

Trading windows reduce executives' insider trading profits by hampering their ability to time their trades to exploit anticipated stock price changes.⁴⁸ In particular, insiders cannot trade profitably on information that (a) they learn after a window period closes and (b) emerges and becomes incorporated into the stock price before the start of the next window period.⁴⁹

However, trading windows cannot prevent executives from profiting from inside information they possess while a trading window is open. In fact, insiders often trade heavily up to six months ahead of major announcements, which suggests that they may well be aware of important information during any given trading window.⁵⁰ Not surprisingly, there is evidence that executives buy and sell on inside information when trading windows are open.⁵¹

Trading windows also fail to prevent insiders from inflating the stock price immediately before unloading large numbers of shares or reduce their incentive to engage in such conduct. If executives expect to sell considerable amounts of stock during an upcoming trading window, they have a strong incentive to manipulate earnings or engage in real earnings management before that window opens. Thus, trading windows do little to address either the use of inside information to time sales or the practice of manipulating the stock price before selling.

b. 10b5-1 Plans

In 2000, the SEC created a new "safe harbor" from Rule 10b-5 liability for insiders selling or buying company shares under certain conditions. Under this safe harbor, found in Rule 10b5-1, an executive is permitted to trade while in possession of material nonpublic information if the transaction is effected according to a plan created at

47. See, e.g., Bridget O'Brian, *Insider Selling of a Stock Headed South May Mean Others Should Also Bail Out*, WALL ST. J., July 17, 1996, at C14 (describing how Micro Warehouse, Inc. only allows executives to trade five days after earnings are released); Joseph B. White & Alexandra Peers, *GM Executives Sold Stock Prior to Sharp Drop in Price*, WALL ST. J., Oct. 2, 1991, at C1 (explaining that GM executives can trade only during four annual ten day window periods after the release of corporate earnings).

48. Fried, *Pretrading Disclosure*, *supra* note 6, at 346.

49. *Id.*

50. *Id.* (citations omitted).

51. *Id.*

a time when the executive was not in possession of material nonpublic information.⁵² Many executives have used such plans to sell shares.⁵³

In principle, a Rule 10b5-1 compliant plan should prevent an insider from using material inside information to time her sales. However, deterring an insider from using material inside information to set up a Rule 10b5-1 plan is very difficult. Executives often have inside information bearing on the price of the firm's stock months before it emerges. It would be hard to prove that a particular insider had material inside information when she entered into a plan months before the information became public. Such an insider knows she is unlikely to be caught and convicted and is therefore likely to be undeterred from using material inside information to enter a Rule 10b5-1 plan.

Moreover, as I explained earlier, the "materiality" threshold is quite high. Insiders thus can enter legally into these plans based on sub-material, but still important, information. Even if regulators are able to prove that the executive created the plan with such information, the executive cannot be sanctioned. The combination of these limitations—the difficulty of detection and the high threshold of materiality—will make it hard to prevent insiders from using 10b5-1 plans to trade on valuable inside information.

And like trading windows, Rule 10b5-1 plans do not prevent executives from manipulating the stock price around their sales or reduce their incentive to do so. Executives who have scheduled large sales under these plans have every reason to boost the short-term stock price, through manipulating earnings or otherwise, to get a higher price for their stock.

Consider the case of Midway Games CEO David Zucker. Zucker set up a 10b5-1 plan in December 2006 as the firm's board, in response to various problems at the company, approved a plan to take a significant charge to earnings and lay off workers.⁵⁴ Pursuant to the plan, Zucker sold 50,000 shares every trading day between December 19, 2006, and January 6, 2007, unloading a total of 650,000 shares for \$12.9 million.⁵⁵ Between mid December and late February, the stock

52. 17 C.F.R. § 240.10b5-1(c) (2006); Jesse M. Fried, *Insider Abstention*, 113 YALE L.J. 455, 487 (2003).

53. See Dionne Searcey & Kara Scannell, *SEC Now Takes a Hard Look at Insiders' Regular Sales*, WALL ST. J., Apr. 4, 2007, at C1 (reporting that executives voluntarily reported selling \$8.5 billion worth of stock through such plans in 2006).

54. Jane Sasseen, *A Closer Look at Trades by Top Brass; Some Execs May Be Abusing an SEC 'Safe Harbor' Rule on Insider Stock Sales*, BUS. WK., Nov. 13, 2006, at 40.

55. *Id.*

lost almost sixty percent of its value.⁵⁶ Zucker was not the only Midway executive who decided to sell shares in December 2006. Three other managers set up 10b5-1 plans and sold stock at the same time, two of whom also created their plans shortly before the restructuring announcement.⁵⁷ It is not clear whether the information Zucker and the executives traded on was material. It is clear, however, that they profited from using 10b5-1 plans to sell on inside information.

Zucker's story is not an anomaly. In a study of executive trading in over 1200 firms during a five-year period ending in January 2006 (which includes several years after Sarbanes-Oxley had been in effect), Alan Jagolinzer found that insiders regularly use 10b5-1 plans to sell on inside information.⁵⁸ In fact, he found that executives using 10b5-1 plans were more likely to sell on valuable inside information than executives not using such plans.⁵⁹ Jagolinzer's study suggests that 10b5-1 does not prevent insiders from trading on inside information. Indeed, it suggests the opposite: insiders seeking to sell on inside information set up 10b5-1 plans to do so, perhaps to camouflage their informed trading from shareholders or to reduce the risk of legal liability. Thus, Rule 10b5-1 actually may increase executives' propensity to sell on inside information.

C. Costs to Shareholders

We have just seen that inherent limitations in both the federal securities laws governing insider trading and the voluntary insider trading restrictions adopted by firms enable managers to sell on inside information and boost the stock price before selling their shares. This Section describes the resulting costs to public shareholders.

1. Diversion of Value

To begin, the profits made by executives using inside information to time their sales or inflating the stock price before selling their shares directly reduce public shareholders' returns. Each dollar reaped by insiders comes at investors' expense. In another article, I calculated that such trading puts at least several billion dollars into the pockets of executives each year.⁶⁰

56. *Id.*

57. *Id.*

58. Jagolinzer, *supra* note 44, at 13, 19.

59. *Id.* at 13 and accompanying tables.

60. Fried, *Pretrading Disclosure*, *supra* note 6, at 323.

One might argue that these profits are just another form of compensation. In principle, boards could reduce other components of executives' compensation arrangements for every dollar of insider trading profits made. Indeed, some commentators have made this very claim.⁶¹

But insider trading profits and gains from manipulating the short-term stock price are peculiar types of pay. They are tied to executives' informational advantage and their ability to control the flow of information to the market, not to their contribution to long-term shareholder value. Permitting managers to make such gains is an inefficient way to reward them for performance. Indeed, as I explain below, these profits provide executives with incentives to take steps that may reduce shareholder value.

In any event, shareholders—the owners of the corporation—have little way of knowing the extent of managers' insider trading and price manipulation profits. These profits do not show up in any of the firm's publicly disclosed accounting information or in compensation figures. As a result, they generally are well camouflaged from investors except in notorious cases—those where large sales of stock immediately precede dramatic declines in the stock price. Even the board may have little sense of the magnitude of these profits. Thus, it is unlikely that insider trading and price-manipulation profits are offset by reductions in other elements of executives' compensation.

2. Weakening and Distortion of Incentives

In addition to diverting value directly from public investors, insiders' ability to sell on bad news and manipulate the stock price before selling also undermines, and in some cases perverts, the desirable incentive effects of compensation arrangements. Huge executive compensation packages are justified as necessary to motivate managers to generate shareholder value.⁶² Permitting executives to sell on bad news (or at an inflated price) reduces the financial payoff differential between good and poor performance, thereby weakening managers' incentive to increase shareholder value.⁶³

61. See, e.g., Carlton & Fischel, *supra* note 34, at 881 n.80 (arguing that shareholders end up paying managers the same compensation whether or not insider trading profits are part of the compensation package).

62. See Lucian A. Bebchuk & Jesse M. Fried, *Pay Without Performance: Overview of the Issues*, 30 J. CORP. L. 647, 664 (2005) (discussing the view that executives should be paid more to increase their incentive to generate shareholder value).

63. See *id.* at 665.

Furthermore, manipulating information to boost the stock price can create perverse incentives. Executives who are free to unload large amounts of shares may seek to raise short-term stock prices by running the firm in a way that improves short-term results at the expense of long-term value.⁶⁴ They also may have incentives to choose less transparent projects, or to reduce the transparency of existing projects, because the lack of transparency enables them to profit more from their freedom to unload their holdings.⁶⁵

The costs to long-term shareholders of such distortions can be considerable. The manipulation of earnings by Enron executives destroyed a business with an estimated \$30 billion of social value.⁶⁶ And this was just a single company.

Even the out-of-pocket costs of price manipulation are far from trivial. For example, firms that restated their financial statements following SEC allegations of accounting fraud from 1996 through 2002 collectively paid an extra \$320 million in taxes as a result of overstating their earnings by \$3.36 billion,⁶⁷ which enabled managers to sell their shares at a higher price. And Fannie Mae incurred over \$1 billion in expenses cleaning up its books after giving its executives a compensation arrangement that encouraged them to manipulate earnings.⁶⁸

II. THE HANDS-OFF APPROACH

As we have seen, executives' freedom to unwind their equity incentives can impose substantial costs on shareholders. To reduce these costs, this Part suggests that firms use what I call "hands-off" options. Section A describes the hands-off approach. Section B explains how hands-off options would eliminate managers' ability to

64. See Fried, *Pretrading Disclosure*, *supra* note 6, at 362 (explaining how executives' ability to profit from short-term stock price fluctuations can reduce long-term value).

65. See Oren Bar-Gill & Lucian Arye Bebchuk, *The Costs of Permitting Managers to Sell Shares 2* (Oct. 2003) (unpublished manuscript, on file with Vanderbilt Law Review), available at http://www.law.harvard.edu/programs/olin_center/corporate_governance/papers/03.Bar-Gill.Bebchuk.cost-permitting.pdf (presenting a formal model showing why managers who are free to unload their stock have an incentive to make information unobservable to the market).

66. Jensen, *supra* note 1.

67. Merle Erickson, Michelle Hanlon & Edward L. Maydew, *How Much Will Firms Pay for Earnings That Do Not Exist? Evidence of Taxes Paid on Allegedly Fraudulent Earnings*, 79 ACCT. REV. 387, 406 (2004).

68. *Fannie Mae's Profit Slashed: Restatement Erases \$6.3 Billion After Accounting Scandal*, CHI. TRIB., Dec. 7, 2006, at 3; see Lucian A. Bebchuk & Jesse M. Fried, *Executive Compensation at Fannie Mae: A Case Study of Perverse Incentives, Nonperformance Pay, and Camouflage*, 30 J. CORP. L. 807, 809-12 (2005) (explaining how the structure of Fannie Mae's compensation arrangements gave executives an incentive to inflate earnings).

sell on inside information and substantially reduce their incentive to manipulate the short-term stock price before selling. Section C shows that the possible costs of hands-off options would be low. Section D suggests how firms could be encouraged to adopt such options.

A. Description

Currently, executives have considerable freedom to determine when to unwind their vested options and stock. A hands-off plan would eliminate such discretion by automatically cashing out these incentives according to a schedule announced at the time the options or restricted shares are granted.

Consider the following example. Suppose that CEO of ABC Corporation receives one million options that will all vest on January 1, 2010. On granting the options, ABC announces that it will cash out five percent of CEO's options on the first trading day of January 2010 and each of the following nineteen months, until all the options are liquidated.⁶⁹ On each of these cash-out dates, CEO would receive the difference between the options' exercise price and the closing stock price. If the options are underwater—that is, if the exercise price is below the cash-out date stock price—they would expire as worthless.

The cashing-out schedule could be made more complex. ABC could impose a longer holding period after vesting. For example, ABC could require CEO to hold all the options for several years after vesting before they gradually are cashed out. ABC also could use a non-linear schedule, rather than one that, as in the above example, cashes out the same number of options each period. The important elements of the hands-off approach are (1) the executive does not control the timing of unwinding; and (2) each sale cashes out a relatively small fraction of the original option grant.

B. Effect on Insider Selling and Price Manipulation

A hands-off plan would eliminate executives' ability to sell on inside information and radically reduce their incentive to inflate the stock price before selling.

69. As I explain in more detail below, the benefits of hands-off options could be enhanced by scheduling the "cash-out" dates to overlap with the firm's scheduled option grant dates.

1. Insider Selling

Hands-off options leave executives no discretion as to when their equity is cashed out. As a result, executives compensated with such options could not use inside information to decide when to sell. Hands-off options thus would eliminate all the insider trading profits that executives make in connection with stock sales. No other arrangement would be more effective at reducing executives' insider trading profits.

2. Price Manipulation Around Sales

We saw that executives can control not only the timing of stock sales, but also the flow of information around these sales, including earnings information.⁷⁰ Thus, even managers who are unable to determine when they unwind can make extra profits at the expense of public shareholders. In particular, before unloading their shares, executives can use both earnings manipulation and real earnings management to boost the short-term stock price, potentially reducing long-term shareholder value.⁷¹

Managers compensated with hands-off options still could manipulate information around stock sales. However, they would have much less incentive to do so. Each sale would involve only a relatively small number of shares, reducing the *benefit* from inflating the stock price around any given disposition date. Moreover, to the extent that the cash-out schedule extends into the future and the price-boosting manipulation would reduce long-term shareholder value, the *cost* of such a strategy would be higher. In particular, manipulating the short-term stock price to increase today's payout will reduce expected payouts on future dates.

The incentive to manipulate information around cash-out dates could be reduced further by scheduling cash outs to occur on days when the executive receives fresh option grants. Most options are granted at the money, with the exercise price set to the market price. If cash-out dates coincide with grant dates for new at-the-money options, an executive inflating the stock price to increase profits from unwinding her old options will boost the exercise price of the new options being granted the same day, reducing their value. Thus, the net benefit of inflating the stock price would be even smaller.⁷²

70. See *supra* Part I.A.2.

71. See *supra* Part I.C.2.

72. Executives will often manipulate information around option grant dates to lower the exercise price of their at-the-money options. BEBCHUK & FRIED, *supra* note 8, at 163-64.

C. Costs

This Section considers two potential costs of hands-off options: that they may (1) impose an excessive burden on executives and (2) undesirably reduce executive equity holdings. It explains why neither of these costs is likely to be significant. Indeed, hands-off options could be used to ensure that executives always hold a sufficient amount of equity, providing an additional benefit.

1. Burden on Executives

Hands-off options force executives to hold equity in their firms for a specified duration. The hands-off approach may thus be seen as imposing undesirable liquidity and diversification costs on managers. But neither liquidity nor diversification considerations suggest that executives need as much control over the timing of their equity transactions as they currently enjoy.

a. Liquidity Costs

Hands-off options will reduce executives' ability to raise cash as quickly as they can now, potentially imposing liquidity costs on managers. However, executives with multi-million dollar pay packages should be able to satisfy their legitimate liquidity needs through a combination of scheduled equity cash outs and their salary, bonus, and long-term incentive plan payouts. Unusually large liquidity needs could be met by designing a shorter cash-out schedule. Satisfying the liquidity needs of executives does not require giving them unfettered discretion over the unwinding of their equity incentives.

b. Diversification Costs

Executives are likely to hold large amounts of their own firm's stock, exposing them to considerable firm-specific risk. To reduce the riskiness of their portfolio, executives may prefer to sell some of this stock and invest the money elsewhere. By forcing executives to hold equity in their firms for a specified period, hands-off options may

Scheduling cash-out dates to coincide with option grant dates can thus provide another benefit. To the extent an executive takes steps to lower the stock price so as to boost the value of new option grants, she reduces the profits from the cashing out of her old options. Thus, scheduling cash-out dates to coincide with option grant dates would reduce not only executives' incentives to inflate the stock price around dispositions, but also their incentive to depress the stock price around grant dates.

impose additional risk-bearing costs on executives. Indeed, excessive equity holdings could make executives too cautious in their decisionmaking, harming shareholders.

But such diversification concerns, like executives' liquidity needs, could be reflected in the design of the hands-off arrangement. If in a particular case the risk-bearing costs were considered exceptionally large, the unwinding of the manager's equity could occur more quickly. There is no reason to assume that risk-bearing considerations necessitate giving executives full control over the timing of their equity sales.

2. Reduction in Executive Equity Ownership?

As discussed above, requiring executives to retain equity in the firm can impose liquidity and diversification costs on the executives. However, having managers hold more equity can also yield benefits by increasing managers' incentive to generate shareholder value. The value-maximizing amount of managerial equity retention, which for expositional convenience I will call "X," depends on the tradeoff between these costs and benefits. By definition, moving executive equity holdings closer to X increases value.

To the extent that hands-off options increase managers' equity holdings, they may thus provide a third benefit (in addition to (1) eliminating managers' ability to engage in insider trading and (2) reducing their incentive to manipulate the stock price before selling). In particular, when executives otherwise would hold less than X equity, hands-off options may bring managers' equity ownership closer to X.

However, there could be other scenarios in which a hands-off arrangement undesirably moves the executive's level of equity ownership further away from X. For example, an executive holding less than X equity may believe that the stock is underpriced on a particular cash-out date. If she could choose whether to unwind her equity on that date, she might elect to hold rather than sell it. Under a hands-off plan, however, some of her equity would be cashed out automatically, leaving her with less equity than she otherwise would hold. In such a case, hands-off options may undermine the executive's subsequent incentive to generate shareholder value.

But hands-off options are unlikely to undesirably reduce executive equity holdings. If the board identifies the desired level of executive equity ownership *ex ante*, it can design the hands-off option plan to ensure that the executive always retains that amount of equity. And should changing circumstances make the optimal level of

equity ownership higher than had been expected, the board can arrange for the executive to acquire additional equity (by, for example, reducing her cash compensation and issuing her more hands-off options).

Moreover, even if in some scenarios a hands-off plan moves an executive's equity holdings further away from X, the expected cost associated with these scenarios must be weighed against the expected benefit associated with the scenarios in which the plan brings the executive's equity ownership closer to X (along with the benefits, in all scenarios, of preventing the executive from selling on inside information and of substantially reducing the incentive to engage in price manipulation around her stock sales). There is no reason to think that giving executives full discretion over the unwinding of their vested equity incentives is likely, on average, to lead to more desirable levels of equity holdings.

D. Going Forward

The benefits of hands-off options are likely to substantially exceed the costs in many (if not all) firms. Interestingly, at least one firm has adopted a compensation plan that embodies much of the hands-off approach. In 2007, Level 3 Communications filed a compensation plan with the SEC under which executives' options are cash-settled according to a pre-disclosed gradual schedule.⁷³ To reduce further managers' incentives to manipulate the stock price around settlement dates, the cash-out dates coincide with grant dates for new options.

Unfortunately, most boards are reluctant to adopt shareholder-serving pay arrangements that are inconvenient for, and thus opposed by, executives.⁷⁴ Thus, we cannot expect most boards to follow Level 3's lead and adopt hands-off options—unless they are pressured by shareholders to do so.

To that end, institutional investors should strongly encourage firms to adopt some version of hands-off options. Institutional investors routinely share their views about executive compensation arrangements with boards and management, and there is evidence that such pressure affects the amount and performance sensitivity of

73. Level 3 Communications, Definitive Proxy Statement (Form Def 14A), at 19 (filed Apr. 18, 2007), available at <http://vlt.client.shareholder.com/sec.cfm?DocType=Proxy> (at "DEF 14A" heading, select "Definitive Proxy Statement").

74. See Bebchuk & Fried, *supra* note 62, at 659 (arguing that directors often do not conduct compensation arrangements at arm's-length because they are ineffectual, influenced by management, or inadequately motivated to insist on shareholder-serving compensation).

managerial pay.⁷⁵ Shareholders seeking to tie managerial pay more closely to performance—and thereby improve executives' incentives—thus may find it worthwhile to put hands-off options on the agenda.

The SEC could assist by requiring firms to describe, in the compensation disclosure and analysis section of their annual proxy statements, the arrangements governing the unwinding of executives' equity incentives. In particular, firms not using hands-off options could be asked to explain why shareholders are served best by giving executives discretion over the timing of their stock sales. The difficulty of explaining why managers should have such freedom in unwinding their equity incentives may make some firms more susceptible to shareholder pressure to adopt hands-off options. Even if a firm fails to adopt such options, this disclosure requirement would help concentrate directors' attention on a major problem with executive compensation.

CONCLUSION

Despite recent reforms, public company executives still use inside information to time their stock sales, and they often inflate the stock price before selling. Such manipulations, which secretly boost executive pay, can impose large costs on shareholders. This Article has suggested that executives' equity incentives be cashed out according to a pre-specified, gradual schedule. It has shown that such a mechanism would reduce substantially the costs associated with current equity arrangements while imposing little burden on executives.

Because this hands-off approach would reduce executives' ability to boost their pay under shareholders' radar screens, managers are likely to resist its adoption. Boards, in turn, may be reluctant to insist on a hands-off arrangement in the face of managers' objections. Thus, institutional investors—who in the past have had some success in improving executive pay arrangements—should strongly encourage firms to adopt the hands-off approach. The SEC could lend a hand by requiring non-adopting firms to explain why they believe it is in shareholders' interest to allow executives to control the timing of their stock sales and sell large amounts of stock over short periods. At the very least, such a disclosure requirement would focus boards' attention on a significant flaw in current equity-based pay arrangements.

75. Jay C. Hartzell & Laura Starks, *Institutional Investors and Executive Compensation*, 58 J. FIN. 2351, 2352-53 (2003).