Harvard's Bebchuk Urges More Shareholder Control of Executive Pay

Investment Advisor
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Standard pay arrangements reward executives for short-term gains and generate incentives for them to take excessive risks and trade off long-term stock performance, says an in-depth Harvard study on how to tie compensation to shareholder value.

"The standard narrative assumed that the executives of [Bear Stearns and Lehman Brothers] saw their own wealth wiped out together with the firms when the firms melted down," said one of the study's authors, Lucian Bebchuk, a Harvard Law School professor and director of the school's program on corporate governance, in a Tuesday, June 15, webinar about the study's findings.

However, the top-five executive teams of Bear Stearns and Lehman Brothers derived cash flows of about $1.4 billion and $1 billion, respectively, from cash bonuses and equity sales from 2000 to 2008, a webinar PowerPoint states.

"We find that the standard narrative is in fact incorrect," Bebchuk said. "That narrative led to the inference that the risk-taking by those firms might have been the product of mistaken judgment or misperceptions or hubris, but it could not have been motivated by perverse pay incentives because the executives' personal wealth was largely wiped out."

In the past few years, Bebchuk has gained a reputation for being an unwelcome guest at the executive compensation party. His calls for reform include limiting executive control over the date that stock awards are granted, creating anti-hedging policies that prevent executives from betting against their own companies, and increasing the government's role in giving shareholders the tools to change pay structure.

Sponsored by New York-based nonprofit the IRRC Institute, the Executive Compensation Research Series includes these three published reports:

1) *The Wages of Failure: Executive Compensation at Bear Stearns & Lehman 2000-2008*
2) *Paying for Long-Term Performance*
3) *Regulating Bankers' Pay*

The IRRC Institute was established with the proceeds from the sale of the Investor Responsibility Research Center to Institutional Shareholder Services (now RiskMetrics) in 2006. This predecessor organization was founded in 1972 and was designed to provide impartial information on corporate governance and social responsibility.

The reports' authors hope that their framework of analysis and prescriptions will be used by firms, compensation experts, investors, policymakers, and regulators in their efforts to improve executive compensation.

The first report concludes that the top executives at Lehman and Bear were able to cash out large amounts of performance-based compensation, both from bonuses and from share sale, during the years preceding Bear and Lehman's collapse. "This cashed-out performance-based compensation was large enough to make up the losses on the executives' initial holdings in the beginning of the period," the report states.

The second report concludes that since the financial crisis of 2008-2009, there is a growing recognition among firms, investors, and public officials that equity-based compensation awarded to the top executives of public firms should be tied to long-term results and that rewards for short-term gains that may prove illusory can produce substantial distortions.

"Managers should be blocked from cashing out the equity for a specified period of time after vesting. Firms should avoid retirement-based holding requirements that could distort executives' decision to retire, as well as undermine their incentive to focus on long-term value as they approach retirement. Instead, equity-based awards should be subject to grant-based and aggregate limitations on unwinding," the second report states.

It also stresses the importance of adopting prohibitions on hedging and derivative transactions that can undermine the beneficial incentive effects of long-term equity-based plans.

"There is a need for robust anti-hedging policies," Bebchuk said during the webinar. "If you don't have such policies in place, the danger is that executives can enter into hedging and derivative transactions that can undo the effect of equity incentives. There is empirical evidence that executives do often enter into such transactions, and this is partly motivated by insider information."

If firms merely adopt a limitation on unwinding, it would lead to greater incentives to enter into hedging and derivatives transactions, Bebchuk added. The answer, he said, is for companies to adopt an anti-hedging provision that would prohibit executives from engaging in any transaction that might allow them to gain from declines in the company's stock. "This may be a case where one size largely does fit all. All companies should have this provision in place," Bebchuk said.

Finally, the third report says that incentives encouraging bank executives to take excessive risks still exist and that corporate governance reforms aimed at tightening the link between compensation structures and shareholder interests cannot eliminate them.

This is where government reform must step in, the report's authors conclude: "Monitoring and regulating bank executives' compensation—along the lines we have put forward—can constitute a valuable component of financial regulation and can complement nicely the monitoring and regulation of banks' investment, lending, and capital decisions."