ISSN 1936-5349 (print)
ISSN 1936-5357 (online)

HARVARD

JOHN M. OLIN CENTER FOR LAW, ECONOMICS, AND BUSINESS
FELLOWS' DISCUSSION PAPER SERIES

STOCK OWNERSHIP POLICIES – RHETORIC AND REALITY

Nitzan Shilon

Discussion Paper No. 49

02/2013

Harvard Law School
Cambridge, MA 02138

This paper is also a discussion paper of the
John M. Olin Center's Program on Corporate Governance

STOCK OWNERSHIP POLICIES – RHETORIC AND REALITY

*Nitzan Shilon**

* S.J.D. candidate, Harvard Law School. I am grateful to my S.J.D. supervisors, Lucian Bebchuk and Jesse Fried. I am also grateful for comments from John Coates, Louis Kaplow, Ted Neustadt, Holger Spamann and participants at the 2012 Canadian Law and Economics Association conference, the 2012 European Law and Economics Association conference, the 2011 Harvard Law School's Law and Economics Seminar, the Harvard Law School Corporate Lunch Forum and the Harvard Law School SJD Colloquium. Ben Jaffe provided excellent research assistance. I would also like to acknowledge support from the Harvard Law School John M. Olin Center for Law, Economics, and Business, and to thank Equilar, an executive compensation research firm, for providing complimentary use of their reports.

<u>Abstract</u>

In the aftermath of the 2008-2009 financial crisis, shareholders have pressed U.S. firms to adopt Stock Ownership Policies ("SOPs"), which require senior executives and directors to hold a certain dollar value of their firms' stock for the long-term. Firms have universally responded by adopting these policies and citing them as a key tool in their mitigation of risk. On the basis of a study of the 2010 SOPs as applied to CEOs in S&P 500 firms, I conclude that current SOPs are extremely ineffective, as they typically allow CEOs to unload virtually all of their vested stock. Moreover, SOP ineffectiveness is camouflaged in firms' public filings. The finding that current SOPs are both extremely ineffective and camouflaged is troubling because it shows that firms can hide the incentives that managers may still have to take inappropriate risks and to run their firms for the short-term. The lack of transparency further prevents investors, firms, public officials and governance reformers from conducting an informed dialogue on how SOPs should be designed. To remedy this flaw, I propose a regulatory reform to make SOPs transparent.

Keywords: executive compensation, executive pay, equity-based compensation, restricted shares, options, risk-taking, long-term, retention, unloading, hedging.
JEL Classification: G32, G38, K22

TABLE OF CONTENTS

INTRODUCTION

In the aftermath of the 2008-2009 financial crisis, regulators, firms, investors and practitioners around the world have been trying to ensure that executive pay arrangements in public firms discourage managers from taking excessive risks and pursuing short-term gains.[1] In particular, shareholders have pushed firms to adopt Stock Ownership Policies ("SOPs"), which require senior executives and directors to hold a minimum dollar value of their firms' stock until retirement, and in some cases thereafter. Leading public officials have emphasized the importance of these policies,[2] proxy-voting firms have rewarded firms for adopting these policies[3] and the business sector has accepted the need for SOPs.[4] Therefore, firms have widely adopted SOPs, reaching an all-time high of 96% prevalence among Mega Cap S&P 500 firms in 2010.[5]

SOPs involve very high stakes. First, firms commonly cite these policies as a key tool to mitigate their risk and to encourage long-term value maximization.[6] Second, SOPs

---

[1] The recent Basel II amendment requires banking regulators at the international level to monitor compensation structures with a view to decoupling compensation from short-term profits. *See* BASEL COMM. BANK. SUPERVISION, ENHANCEMENTS TO THE BASEL II FRAMEWORK, 25-27 (2009). The G-20 leaders are committed to implementing international standards to discourage excessive risk-taking. *See* G-20 MINISTRES AND CENT. BANK GOVERNERS, LEADERS' STATEMENT: THE PITTSBURGH SUMMIT 2 (2009) (preamble 17), *available at* http://www.pittsburghsummit.gov/documents/organization/129853.pdf. The UK has already implemented requirements to establish remuneration policies that promote effective risk management. *See* FIN. SERVS. AUTH., REFORMING REMUNERATION PRACTICES IN FINANCIAL SERVICES app. 1 (2009), *available at* http://www.fsa.gov.uk/pubs/policy/ps09_15.pdf. Other countries have been moving in this direction as well. *See, e.g.*, SWISS FIN. MKT. SUPERVISORY AUTH. (FINMA), REMUNERATION SYSTEMS: MINIMUM STANDARDS FOR REMUNERATION SYSTEMS OF FINANCIAL INSTITUTIONS 6-7 (2010), *available at* http://www.finma.ch/e/regulierung/Documents/finma-rs-2010-01-e.pdf (requiring simple, transparent, long-term-based remuneration schemes, independent control over the implementation of these schemes, and the structuring of remuneration to enhance risk awareness).

[2] *See* Press Release, U.S. Department of the Treasury, Statement by Treasury Secretary Tim Geithner on Compensation (June 10, 2009), *available at* http://www.treasury.gov/press-center/press-releases/Pages/tg163.aspx (last visited September 24, 2012) (declaring that "compensation should be structured to account for the time horizon of risks"); *also see* Ben S. Bernanke, Chairmen, Fed. Reserve, Speech at the Independent Community Bankers of America's National Convention and Techworld: *The Financial Crisis and Community Banking* (Mar. 20, 2009), *available at* http://www.federalreserve.gov/newsevents/speech/bernanke20090320a.htm#fn3 (last visited September 24, 2012) (declaring "poorly designed compensation policies can create perverse incentives … Management compensation policies should be aligned with the long-term prudential interests of the institution, be tied to the risks being borne by the organization … and avoid short-term payments for transactions with long-term horizons").

[3] *See* Institutional Shareholder Services Inc., *Governance Risk Indicators 2.0 Technical Document*, (Mar. 6, 2012) *available at* http://www.issgovernance.com/grid/technical_document.

[4] *See* Lloyd C. Blankfein, *Do Not Destroy the Essential Catalyst of Risk*, FIN. TIMES, Feb. 9, 2009, at 13 (declaring "an individual's performance should be evaluated over time so as to avoid excessive risk-taking").

[5] *See* Frederic W. Cook & Co., Inc., *Executive Stock Ownership Policies – Trends and Developments*, (Sep. 13, 2010), at 1.

[6] *See* Press Release, Equilar, Long-Term Performance Compensation Is Most Popular Risk-Management Strategy (April 21, 2010), *available at* http://www.equilar.com/company/press-release/press-release-2010/index.php.

set rules that widely apply to stock-based compensation, which is by far the most significant component of executive pay today. The boom in incentive pay that started in the 1990's pushed stock-based compensation so high that today the median Chief Executive Officers ("CEO") of an S&P 500 firm earns some two thirds of her total pay in this form,[7] and stock-based compensation of the top-five executives in public firms amounts to some 7% of total earnings of these firms.[8]

This Article is the first academic endeavor to discuss the transparency and effectiveness of SOPs. Based on statistical analysis of quantitative and qualitative data disclosed on S&P 500 firms' proxy statements,[9] I show that current SOPs, as applied to CEOs, are extremely ineffective. These policies typically allow CEOs to immediately unload virtually all of their vested stock.[10] For example, John J. Donahoe, eBay CEO, may sell all of his over $16 million worth of eBay's vested stock, in line with eBay's ineffective SOP. Similarly, the freshly resigned CEO of Best Buy, Brian Dunn, was allowed to unload all of his vested Best Buy stock and still comply with its SOP.

The ineffectiveness of current SOPs is a function of their design. Commonly, SOPs allow managers to count their unvested stock – stock that they do not own yet[11] - to satisfy their SOP requirements. Counting unvested stock, in most cases, renders these policies completely ineffective. Also, SOPs typically set their target stock-holding thresholds as low as 60% of a single year's total compensation. Finally, these policies usually allow CEOs to wait 5 years before they have to attain the required stock thresholds and do not specify sanctions.

The extreme ineffectiveness of current SOPs disqualifies them from fulfilling the important goals they are held to attain or to affect executives' incentives. Yet, I do not aim to prove that the extreme ineffectiveness of current SOPs is necessarily inadequate. There is no one-size-fit-all for SOPs, and there are other rules that limit executive ability to unload their firms' stock. However, most top executives engage in massive selling of

---

[7] *See* Equilar Inc. *2012 Executive Compensation outlook Report Extended*, (Feb. 2012), at 13 (reporting that in 2011 the median S&P 500 CEO was paid a total compensation of some $8.7m, while her stock-based compensation amounted to some $5.5m).

[8] *Id*; *also see* Lucian A. Bebchuk & Yaniv Grinstein, *The Growth of Executive Pay*, 21 OXFORD REV. ECON. POL'Y 283 (2005) (reporting that the ratio of the aggregate top-five compensation to the aggregate earnings of public firms increased from 5% in 1993-1995 to about 10% in 2001-2003).

[9] The S&P 500 stock market index, maintained by Standard & Poor's, comprises 500 large-cap American companies covering about 75% of the American equity market by capitalization. A proxy statement is a statement required of a firm when soliciting shareholder votes. This statement is filed with the U.S. Securities and Exchange Commission in advance of the annual meeting and is useful in assessing how management is paid and in assessing potential conflict-of-interest issues with auditors.

[10] Vesting periods define when managers "earn" their stock options or restricted stock. Vesting periods in the United States are usually 3–5 years for executives, but shorter for Board members. Typically, each year the executive earns her pro-rate amount of her equity grant. For example, when an executive is granted 300 restricted stock with a 3-year vesting schedule, she will typically own 100 of which after one year, another 100 stock after 2 years, and the remainder 100 stock after 3 years. SOPs define the post-vesting stock holding requirements.

[11] *Id.*

their firms' stock,[12] and shareholders cannot count on any of the various rules and policies to prevent executives from taking full advantage of their freedom to unload their shares. Managers' freedom to unload their stock is so entrenched that the September 4, 2012 announcement of Facebook co-founder and CEO, Mark Zuckerberg, that he would keep his Facebook stock for at least the next year sent Facebook stock price 5% higher.[13]

Furthermore, and of more concern to me, firms camouflage the extreme ineffectiveness of their SOPs in their public filings. First, SOPs fail to disclose critical information to investors. For example, firms never disclose how much stock their SOPs allow their CEOs to unload. Also, firms commonly do not disclose some critical terms of their SOPs, such as their counting policies, phase-in periods or sanctions, and the framing of some other critical SOP terms is obscure. Second, when critical terms are disclosed, their functioning is not salient. For example, SOPs fail to indicate the effect of counting unvested stock or stock hedging[14] on the effectiveness of their SOPs.

The ability of firms to disguise the ineffectiveness of their SOPs is inadequate. It hides the incentives that managers may still have to seek short-term gains and to take excessive risks. It also prevents investors, firms, public officials and governance reformers from ensuring that SOPs serve the important goals they are held to attain.

To remedy the flaws associated with the camouflage of SOP ineffectiveness, I propose a regulatory reform to make SOPs transparent. In particular, I propose to reform the rules governing public firms' filings with the U.S. Securities and Exchange Commission (the "SEC") pursuant to Regulation S-K.[15] I offer specific quantitative measures to gauge SOP bottom-line effectiveness, as well as shining light on certain qualitative measures that tend to significantly affect the potency of SOPs. When SOPs are transparent, both boards and shareholders, assisted by proxy advisors, executive compensation advisors and practitioners, are expected to act on this information and improve current SOPs.

This Article continues as follows. Chapter I explains the importance of SOPs for managerial incentives to maximize long-term shareholder value and to avoid taking excessive risks. Chapter II describes the recent wave of SOP adoptions and the

---

[12] *See* Tomislav Ladika, *Do Firms Replenish Executives' Incentives after Equity Sales?* (June 11, 2012) (unpublished manuscript), http://papers.ssrn.com/sol3/papers.cfm?abstract_id=2024334 (reporting that most top executives at S&P 1500 firms sell equity at least once, with the median sale equals to 15% of the executive's total holdings in the firm).

[13] *See* Sam Gustin, *Facebook Blame-Game: Who's at Fault for IPO Debacle?,* BUS. TIME, Sep. 6, 2012, http://business.time.com/2012/09/06/facebook-blame-game-whos-at-fault-for-ipo-debacle/ (reporting that Facebook announced on September 4, 2012, that Zuckerberg will not sell any of his shares for one year. That move sent the company's stock price 5% higher the day after, but it still remains nearly 50% below the IPO price).

[14] A hedge is an investment position intended to offset potential losses/gains that may be incurred by a companion investment. When CEOs hedge their stock holdings against their SOP stock investment, they can nullify their SOPs.

[15] Regulation S-K is a prescribed regulation under the U.S. Securities Act of 1933 that lays out reporting requirements for various SEC filings used by public companies.

widespread pressure that led to it. Chapter III discusses my methodology for studying current SOPs in S&P 500 firms. Chapter IV turns to describe the prevalence, declared goals, framework and structure of current SOPs. Chapter V provides evidence for the extreme ineffectiveness of current SOPs, while Chapter VI analyzes the camouflaging of such ineffectiveness. Chapter VII puts forward my proposal to fix the camouflage of SOP ineffectiveness by making these policies transparent. It also explains why greater transparency is expected to improve current SOPs. Chapter VIII concludes.

I. THE IMPORTANCE OF STOCK OWNERSHIP POLICIES ("SOPS")

In most large American corporations, ownership is separate from control.[16] This happens when managers run corporations most of whose shares they do not own. When managers-agents own little stock in the firm and shareholders-principals are too dispersed to force managers to maximize firm value, "agency costs" are created and corporate assets may be abused to benefit managers at shareholder expense[17]. Such managerial benefits may include perquisite-taking and inducing of too little effort (a.k.a. "shirking"). They may also involve the pursuit of non-value-maximizing objectives, such as making excessive acquisitions (a.k.a. "empire building"), excessive sales growth, and taking an excessive care of employee welfare. When the time-horizon of managers' stock holding and their access to inside information are different from those of long-term shareholders, they may be tempted to take excessive risks and to pursue short-term gains.

The importance of SOPs lies in their potential to minimize managerial agency costs, curbing excessive risk-taking and increasing managerial incentives to maximize long-term firm value. Past efforts to make managers hold their firms' stock for the long-term led boards to turn stock-based compensation into what is today the biggest component of executive compensation at large, publicly traded U.S. firms. Effective SOPs aim to translate the surge in stock-based compensation into a surge in long-term managerial stock holdings, in order to make managers' interests aligned better with those of long-term shareholders. This policy, in turn, should discourage managers from pursuing short-term gains, from excessive risk-taking and from diverting resources to their private benefit.

A. SOPs assist in aligning managerial interests with those of shareholders

Managerial agency costs can be significantly reduced if divergences from shareholder interests are limited by establishing appropriate incentives for managers. In particular, SOPs converge managers' interests with those of shareholders by requiring managers to hold sufficient amount of their firms stock.[18] The theory is that as their stakes rise, managers pay a larger share of the costs associated with their non-value-

[16] *See* ADOLF A. BERLE & GARDINER C. MEANS, JR., THE MODERN CORPORATION AND PRIVATE PROPERTY (Macmillan, New York, 1932).

[17] *Agency relationship* is a contract under which the principal/s engage another person/s (the agent/s) to perform some service on their behalf, which involves delegating some decision-making authority to the agent/s. *See* Michael C. Jensen & William H. Meckling, *Theory of the Firm: Managerial Behavior, Agency Costs and Ownership Structure,* 3 J. FIN. ECON. 305 (1976).

[18] *Id.*

maximizing acts. Thus they are less likely to squander corporate wealth and are more likely to work harder to increase firm value. A series of empirical studies show that executives who hold more stock are significantly better stewards for shareholders, both in maximizing shareholder value and in generating higher operating income.[19]

During the 1990s stock-based compensation spread at explosive rates in the United States, and compensation committees routinely justified this surge as having the goal of increasing managerial stock ownership. Between 1992 and 2000, the average inflation-adjusted compensation of S&P 500 CEOs more than quadrupled, climbing from $3.5 million to $14.7 million, and was fueled primarily by an increase in the use of stock options.[20] The ratio of the top-five executives' aggregate pay to public firms' aggregate earnings increased from 5% in 1993-1995 to some 10% in 2001-2003.[21] Institutional investors and shareholder activists have tolerated and even encouraged the surge in executive pay, believing that managerial ownership may reduce agency problems.

Stock-based compensation increased as well in the 2000's and became the biggest component of executive compensation at large, publicly traded U.S. firms today. For the median S&P 500 CEO in 2011, stock-based compensation, namely stock options and restricted stock, was worth $5.5million, almost two-thirds of her $8.7million total compensation.[22]

Warren Buffett, business magnate, investor, and philanthropist, has recently showed by self-example the importance he attributes to significant managerial ownership. In his sizable 2008 Goldman Sachs and GE investments, Buffet required that those companies' executives have their own wealth tied up to the company's stock price and conditioned his investment committing them not to sell more than 10% of their stock

---

[19] *See* Robert Tumarkin, *How Much Do CEO Incentives Matter?* (July 11, 2010) (unpublished manuscript), http://ssrn.com/abstract=1711504 (presented at the 23rd Australasian Finance and Banking Conference) (reporting that for the mean incentive level, Tobin's q increases by 10.0% compared to that of counterfactual firms that lack CEO incentive compensation). A similar empirical conclusion has been recently reported by Bhagat and Tookes with regards to the positive effect that actual directorial equity holding has over future operating performance. *See* Sanjai Bhagat & Heather Tookes, *Voluntary and Mandatory Skin in the Game: Understanding Outside Directors' Stock Holdings*, 17 THE EUR. J. FIN. 1 (2011).

[20] *See* Brian Hall & Kevin Murphy, *The Trouble with Stock Option*, 17 J. ECON. PERS. 51 (2003).

[21] *See* Bebchuk & Grinstein, *supra* note 8.

[22] The median CEO's non-stock-based incentives are typically short-term, amount to $2.2million and include annual bonus and non stock-based incentive plan compensation. The median CEO also earned $1million as base salary and other compensation of $0.1million. *See* Equilar Inc. *supra* note 7, at 13.
A stock option (or a call option) grants executives the right, but not the obligation, to buy their firm's stock from the company at a certain time (the expiration date) for a certain price (the strike price). Restricted stock refers to stock of a company that is not fully transferable until certain conditions have been met. Typically, the conditions that allow the shares to be transferred are continued employment during a period of time, upon which they vest. However, those restrictions can also be some sort of performance condition, such as the company reaching earnings per share goals or financial targets.

until the earlier of three years or the termination of Buffett's investment.[23] Many people believe that Buffett's focus on aligning the interests of Goldman's senior executives with his own by imposing significant managerial stock holdings should serve as a wake-up call to both firms and investors in the aftermath of the recent financial crisis.[24]

Similarly, Facebook shareholders have made it clear that they value managerial ownership and see it as a sign of commitment to their company. Despite being stressed-out about the company's tanking stock price and torrent of criticism, Facebook shareholders sent the company's stock price 5% higher in response to the September 4, 2012 announcement of Mark Zuckerberg, co-founder and CEO, that he would keep his Facebook stock for at least the next year.[25]

B. SOPs discourage managers from pursuing short-term gains

By requiring managers to hold their firms' stock for the long-term, SOPs discourage managers from seeking short-term gains. Managers who are allowed to sell enough stock quickly might take actions that would boost the stock price in the short-run even if they would certainly destroy value in the long-term. Such actions may include distorted investment decisions,[26] real earning management,[27] earning manipulation,[28]

---

[23] Messrs. Blankfein, Cohn and Viniar each have agreed that, with certain exceptions, until the earlier of October 1, 2011 and the date of redemption of all of our 10% Cumulative Perpetual Preferred Stock Series.

[24] *See* "*Hold Through Retirement": Maximizing the Benefits of Equity Awards While Minimizing Inappropriate Risk Taking*, THE CORPORATE EXECUTIVE (Executive Press, Inc. San Francisco CA), Nov.-Dec. 2008, at 1.

[25] *Supra note* 13.

[26] *See* Simia Kedia & Thomas Philippon, *The Economics of fraudulent Accounting*, 22 REV. FIN. STUD. 2169, 2195 (2009) (reporting evidence that firms engaged in fraudulent accounting to boost short-term price also hire and invest too much, distorting the allocation of real sources); also see Christopher Polk & Pablo Sapienza, *The Stock Market and Corporate Investment: A Test of Catering Theory*, 22 REV. FIN. STUD. 187, 187 (2009) (finding that managers with a short-term horizon engage in high abnormal investments and suffer subsequently from low stock returns, and that this phenomenon is more severe in firms with higher R&D intensity or share turnover).

[27] *Real earning management* is the strategic timing of investment, sales, expenditures and financing decisions to influence short-term accounting results and the short-term stock price at the expense of long-term economics value. *See* Francois Degeorge, Jayendu Patel & Richard Zeckhauser, *Earnings Management to Exceed Thresholds,* 72(1) J. BUS., 1, 2-3 (1999). For example, short-term managers increase the frequency of short-term retail-level marketing actions (price discounts, feature advertisements, and aisle displays) at the expense of long-term brand equity investment, such as television advertisement, to influence the timing of consumers' purchases to manage reported earnings. *See* Craig J. Chapman & Thomas J. Steenburgh, *An Investigation of Earnings Management through Marketing Actions,* (July 2010) (unpublished manuscript), http://papers.ssrn.com/sol3/papers.cfm?abstract_id=930738 (last visited November 10, 2012). Real earning management neither violates the securities laws nor is prohibited by corporate law. *See*, e.g., *Kamin v. American Express*, 383 N.Y.S.2d 807, 811 (N.Y. Sup. Ct. 1976), *aff'd,* 387 N.Y.S.2d 993 (N.Y. App. Div. 1976) (ruling that directors are allowed to deliberately cause their firm to pay extra taxes so the firm could report higher short-term earnings); Franklin Gevurtz, *Earning Management and the Business Judgment Rule: An Essay on Recent Corporate Scandals*, 30 WM. MITCHELL L. REV. 1261, 1277 (2004) (noting that although *Kamin* was decided in a New York court, most state courts are expected to follow this approach).

making certain public statements or performing other acts of "window dressing".[29]

At any given time, the short-term incentives of the manager will depend on the fraction of stock-based instruments she can freely unload in the near future, as opposed to her stock that is tied up for the long-term. When the manager is allowed to sell enough stock quickly, she might take actions that boost the stock price in the short-run even if they might hurt long-term reputation and performance.

SOPs should assist in tying executive pay to long-term performance. Federal Reserve Chair, Ben Bernanke, stressed that this is necessary in order to avoid rewarding managers with short-term payments for transactions with long-term horizons.[30] SOPs should achieve this outcome, as the vast majority of managerial stock holdings come from their stock-based pay awards rather than from stock that was purchased in the open markets.

C. SOPs assist in curbing managerial incentives to take excessive risks

By requiring managers to hold their firms' stock for the long-term, SOPs do not allow managers to sell their stock quickly. Managers who are allowed to sell their stock quickly have incentives to enter into transactions that will inefficiently elevate their firm risk so they can take more advantage of their inside information to pocket profits from greater stock movements.

Consider a transaction that will boost a firm's stock price in the future from $40 to $60 if succeeds, but would tank the stock price from $40 to $20 if fails. There is a 50% probability for either a success or a failure. Such a transaction significantly elevates the firm's risk but does not create any value for shareholders. Managers who are allowed to sell their stock quickly might be interested to take on this project, as they may be able to take advantage of their inside information and sell their stock quickly if the project is expected to fail (or buy new stock if the project is expected to succeed) before market

---

[28] *Earning manipulation* is the practice of discretionary accounting of decisions and outcomes already realized. *See* Degeorge, Patel & Zeckhauser, *supra* note 27, at 3. Earning manipulation can either be legal, so it does not violate GAAP (Generally Accepted Accounting Principles), or illegal. Fannie Mae, for example, illegally manipulated its quarterly earnings so its executives could pocket higher bonuses from 1998 to 2004. Reworking its accounting has cost Fannie Mae some $1 billion. *See* Marcy Gordon, *Wall St. Applauds Fannie Mae Restatement,* CHI. TRIB., Dec. 7, 2006, at 3.

[29] When CEO's ownership of stock options increases, a company is more likely to be involved in financial misreporting. However, CEO's ownership of other compensation components, such as restricted stock or long-term incentive payouts, is not associated with higher propensity to misreport. *See* Natasha Burns & Simi Kedia, *The Impact of Performance-based Compensation on Misreporting,* 79 J. FIN. ECON. 35, 63 (2006).

[30] *See* Ben S. Bernanke, *supra* note 2.

price changes.[31] In support of this view, a recent study suggests that incentives created by managerial freedom to unload large fractions of stock-based incentives played a role with risk-taking decisions of the top-five executives at Bear Stearns and Lehman Brothers during the years preceding the firms' meltdown.[32]

D. Low costs of SOPs and the insufficiency of other tools that can prevent managers from a quick stock unwinding

In reality, SOPs impose low costs. SOPs could potentially impose liquidity costs on managers that need more cash in hand. Second, SOPs might force managers to hold undiversified personal securities portfolios and hence be exposed to unnecessary idiosyncratic risk.[33] Finally, SOPs could incentivize managers to be excessively conservative to their shareholders' taste.[34] However, the high level of overall executive pay and, hence, the high level of CEO wealth, alleviates concerns that effective SOPs would have imposed significant liquidity costs or costs associated with excessive conservatism or risk aversion. Moreover, the evidence provided in Chapter V suggests that current SOPs are extremely ineffective, and therefore, current SOP impose low costs.

Adopting SOPs is cheaper than imposing longer stock vesting schedules while maintaining a very similar effect of tying pay to long-term performance.[35] Longer vesting schedules extend the period in which options or restricted stock does not belong to the manager. Conversely, SOPs, by requiring managers to hold their already vested stock for the long-term, merely limits managers' ability to sell stock they already own. Therefore,

---

[31] *See* Vidhi Chhaochharia, Tao Chen & Rik Sen, *Stocking up for good times: The information content of CEO's voluntary holdings*, (August 2012) (unpublished manuscript), http://moya.bus.miami.edu/~vchhaochharia/dokuwiki/doku.php?id=working_papers (last visited September 28, 2012) (reporting that CEOs have private information about future stock price performance and they generally use that to choose their stock exposure levels to the firm).

[32] *See* Lucian A. Bebchuk, Alma Cohen & Holger Spamann, *The Wages of Failure: Executive Compensation at Bear Stearns and Lehman 2000-2008*, 27 YALE J. ON REG. 257 (2010) (stating that the top-five executive teams of Bear Sterns and Lehman Brothers cashed out large amounts of stock selling and cash bonus during the 2000-2008 period, the years that led to the credit crisis). However, there is disagreement among commentators on whether poor incentives contributed to the recent crisis, as discussed in footnote 46.

[33] For example, the Capital Asset Pricing Model predicts that optimal diversification of risk should be measured relative to a comprehensive "market portfolio" that includes all traded financial assets as well as human capital and other assets. Therefore, managers, who have their human capital invested in the firm, should hold a small fraction of their financial portfolio in their firm's stock. See William F. Sharpe, *Capital Asset Prices: A Theory of Market Equilibrium under Conditions of Risk*, 19(3) J. FIN. 425 (1964).

[34] One of the rationales for stock-based compensation and especially option compensation is to make risk-averse managers more likely to take in risks, so their incentives will be better aligned with typically risk-neutral shareholders.

[35] Stock vesting policies limit managers' ability to unload their stock-based incentives by defining when managers "earn" their stock options or restricted stock. Vesting periods in the United States are usually 3–5 years for executives, but they are shorter for Board members. Typically, each year the executive earns her pro-rate amount of her equity grant. For example, when an executive is granted 300 restricted stock with a 3-year vesting schedule, she will typically own 100 of which after one year, another 100 stock after 2 years, and the entire 300 stock after 3 years.

both tools require managers to hold on to their stock. However, imposing longer vesting periods is more costly than adopting SOPs. The extra costs come from the extra risk that managers bear as a result of delaying receipt of ownership rights over their stock or stock options.[36] These extra costs may be rolled over to shareholders.

Adopting SOPs and incurring their costs would have been unnecessary had there been other tools that effectively incentivized or required managers to hold their firms' stock for the long-term. Most importantly, institutional shareholders and directors are able to exert informal pressure to hinder executives' stock unwinding.[37] There is evidence that institutional shareholders convey their views on executive compensation to selected boards of directors privately.[38] Institutions also use informal negotiations, backed by the threat to force a shareholder vote, as a method of prying concessions out of companies.[39]

Other mechanisms could have incentivized or required managers to hold their firms' stock for the long-term as well. First, the financial literature documents a significant group of CEOs who are persistent in being over confident and making losses from consistently choosing to hold on to their firms' stock options.[40] Second, insider trading rules practically limit managerial unwinding of their firms' stock to pre-determined short "trading windows" following the release of quarterly earnings. Alternatively, insider trading rules limit managerial unwinding of their stock to plans created in advance, when the executive was not in possession of material nonpublic information.[41] Third, federal tax rules encourage executives to defer the receipt of their restricted stock or to exercise their stock options.[42] Finally, Section 16(b) of the Securities and Exchange Act requires disgorgement of "short swing" profits realized by an insider from any purchase and sale of her firm's securities within six months.[43]

[36] This extra risk is particularly relevant when the manager anticipates leaving the firm or when the firm anticipates affecting a merger or a sale. In these cases, managers run the risk of losing their unvested stock or stock options. Conversely, managers will certainly keep their vested stock, which are subject to SOPs.

[37] *See* Bernard S. Black, *Agents Watching Agents: The Promise of Institutional Investor Voice,* 39 UCLA L. REV. 811 (1992).

[38] See James E. Heard, *Executive Compensation: Perspective of the Institutional Investor*, 63 U. CIN. L. REV. 749, 761 (1995).

[39] Joshua A. Kreinberg, *Reaching Beyond Performance Compensation in Attempts to Own the Corporate Executive*, 45 DUKE L.J. 138, 167 (1995) (noting that large private investors, such as Kirk Kerkorian, and their influence on the operations of some of America's largest corporations offer examples of investor power short of any vote or sale of stock). Now, when shareholders are entitled to a non-binding "Say on Pay" vote on executive compensation, they have more leverage to informally negotiate with management.

[40] *See* Ulrike Malmendier & Geoff Tate, *CEO Overconfidence and Corporate Investment*, 60 J. FIN. 2661, 2670 (2005).

[41] See Jesse M. Fried, *Hands-Off Options,* 61 VAND. L. REV. 453, 463 (2011).

[42] For restricted stock, tax payments are deferred to the date of selling the shares if the executive filed a Section 83(b) election with the IRS within 30 days of the grant date. For incentive stock options, taxes are deferred until the stock is ultimately sold, and the tax rate is reduced from short-term capital gains rate of 28% to 39.6% to long-term capital gains of 20% if the executive holds the shares for at least a year after the exercise date and two years after the grant date of the stock option.

[43] *See* 15 U.S.C. § 78p(b) (1970).

However, the existing mechanisms are not enough to be counted on to prevent executives from quick stock unloading. Consider David Zucker, Midway Games CEO. Between December 19, 2006 and January 6, 2007 Zucker sold a total of 650,000 Midway Games stock for $12.9 million. Between mid December 2006 and late February 2007, Midway Games stock lost almost 60% of its value.[44] Unfortunately, Zucker is not alone. In a study of executive trading in over 1200 firms during a five-year period ending in January 2006, Alan Jagolinzer found that insiders regularly sell on inside information and beat the market by 6%.[45]

Even when senior executives do not have such inside information, they engage in massive stock selling.[46] A recent study suggests that most top executives at S&P 1500 firms sell equity at least once, with the median sale equal to 15% of the executive's total holdings of firm stock.[47] Moreover, executives typically exercise their stock options years before they expire, and almost all of the shares acquired through option exercises are immediately sold.[48] Finally, Bebchuk, Cohen and Spamann provide evidence that the top executive teams of Bear Stearns and Lehman Brothers derived cash flows of about $1.1 billion and $850 million respectively from stock sales during 2000-2008.[49]

II. THE WAVE OF SOP ADOPTIONS

During the 1990's, the tectonic change in stock-based compensation did not translate into a significant increase in managerial ownership among higher-compensation managers.[50] Higher-compensation managers negated the lion's share of the effect of their incentive compensation by selling the stock that they were granted. In particular, when executives exercised options to acquire stock, nearly all of this stock was sold. Executives were allowed to do so partially because SOP adoptions lagged behind the boom in incentive pay. Only 35% among top 250 companies disclosed SOPs in 2001.[51]

---

[44] 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.

[45] *See* Alan D. Jagolinzer, *Sec Rule 10b5-1 and Insiders' Strategic Trade,* 55 MGMT. SCI. 224, 232 (2009).

[46] *See* Bebchuk et al., *supra* note 32.

[47] *See* Ladika, *supra* note 12.

[48] *See* LUCIAN BEBCHUK & JESSE FRIED, PAY WITHOUT PERFORMANCE: THE UNFULFILLED PROMISE OF EXECUTIVE COMPENSATION 176-77 (Harvard University Press, 2004) (noting studies that demonstrate executives' widespread freedom to unwind early and executives' tendency to exercise their options and sell the underlying shares well before the options' expiration).

[49] *See* Bebchuk et al., *supra* note 32, at 272. In response, Fahlenbrach and Stulz suggest that Bank CEOs did not reduce their holdings of shares in anticipation of the crisis or during the crisis. However, even Fahlenbrach and Stulz do not deny consistent and comprehensive selling by executives of their own firm equity. See Rüdiger Fahlenbrach & René M. Stulz, *Bank CEO incentives and the credit crisis,* 99 J. FIN. ECON. 11 (2011) (stating that bank performance during the recent credit crisis is not related to CEO incentives before the crisis).

[50] *See* Eli Ofek & David Yermack, *Taking Stock: Equity-Based Compensation and the Evolution of Managerial Ownership*, 55 J. FIN.1367 (2000).

[51] *See* Frederic W. Cook & Co., Inc, *Stock Ownership Policies – Prevalence and Design of Executive and Director Ownership Policies Among the Top 250 Companies,* (September 2003).

The corporate scandals of 2001 and 2002 emphasized the importance of SOPs. For example, former Enron President Jeffery Skilling, who was convicted of multiple federal felony charges relating to Enron's financial collapse and who is now serving a 24-year, four-month prison sentence, unexpectedly resigned on August 14, 2001, four months before Enron declared bankruptcy, and soon sold large blocks of his Enron stock.[52]

These corporate scandals and the increased investor attention that followed served as a catalyst for additional companies to adopt SOPs.[53] This impetus, coupled with SEC requirements increasing transparency of compensation disclosure, led to a surge in the number of formal SOPs in 2002. Specifically, 49% of the top 250 companies disclosed formal SOPs for their executives in 2002, representing a 35% increase from 2001.[54] This trend continued and in 2005 already 69.7% of these companies disclosed SOPs.[55]

Despite disagreements about the causes of the recent financial crisis,[56] the aftermath of the 2008-2009 financial crisis sparked unprecedented shareholder pressure to require companies to adopt SOPs, backed by the influential advisory power of the Institutional Shareholder Services ("ISS"). Hence, SOPs became virtually universal with a 95% prevalence rate among Fortune 100 companies in 2010.[57]

A. Post-crisis shareholder pressure to adopt SOPs, backed by ISS support

In the aftermath of the 2008-2009 financial crisis, institutional shareholders pushed public firms to adopt SOPs. In 2010, the California Public Employees' Retirement System ("CalPERS"), the largest public pension fund in the United States, declared that it believes that SOPs should be adopted universally.[58] Following this belief, CalPERS and other shareholders took a proactive approach and submitted numerous Stockholder Proposals, urging their companies to adopt stringent SOPs.[59]

---

[52] *See* Richard Oppel jr., *Former Head of Enron Denies Wrongdoing*, N.Y. TIMES, Dec. 12, 2001, Sec. C, P. 1, Col. 2.

[53] *See* Frederic W. Cook & Co. *supra* note 51, at 1.

[54] *Id*.

[55] Equilar Inc., *2007 Executive Stock Ownership Guidelines Report*, (Feb. 2007), at 9. Whereas only 2.8% of top 250 companies who disclosed SOPs in 2001 reported that their SOPs were new or amended in 2001, in 2004 things were dramatically different: 25.5% of companies who disclosed SOPs in that year reported that their policies were new or amended in 2004. *See Executive Compensation Trends*, EQUILAR INC. RES. NEWSL. Oct. 2005, at 3.

[56] *See* discussion in Chapter V, Part A, Section 2.

[57] *See* Frederic W. Cook & Co., Inc., *Executive Stock Ownership Policies – Trends and Developments*, (Sep. 13, 2010) at 1.

[58] *See* California Public Employees' Retirement System, *Global Principles of Accountable Corporate Governance*, (Jan. 4, 2010) at 61 (stating that it "believes equity ownership guidelines and holding requirements should be an integral component of company's equity plan and overall compensation philosophy").

[59] *See*, for example, Dow Chemical Co., Proxy Statement (Schedule 14A) at 42 (Mar. 31, 2010) (a Stockholders Proposal, pursuant to Section 14a-8 to the Securities and Exchange Act of 1934, pushing Dow Chemicals to adopt a policy requiring that senior executives retain at least 75% of net after-tax shares

Among institutional shareholders, the American Federation of Labor and Congress of Industrial Organizations (the "AFL-CIO") has been particularly active in filing Stockholder Proposals encouraging companies to adopt SOPs. It has filed proposals to adopt SOPs in a handful of TARP companies, including Citigroup, JPMorgan Chase, and Bank of New York Mellon.[60]

ISS supported institutional investors' pressure and on March 10, 2010 debuted its new corporate governance risk assessment method, named "Governance Risk Indicators" ("GRId"),[61] rewarding firms that adopt SOPs.[62] In GRId, 4 out of 28 compensation questions that apply to U.S. firms evaluate SOPs. Companies failing to disclose or explicitly saying they will not disclose their SOPs score the lowest in this category.[63] [64]

ISS has supported shareholder pressure to adopt SOPs not only by scoring firms higher on its GRId for disclosing SOPs, but also by adopting voting advisory guidelines that favor firms that have SOPs. First, ISS advised shareholders to vote for Stockholder Proposals pushing companies to adopt SOPs.[65] Second, in its 2011 and 2012 proxy voting summary guidelines, ISS urged shareholders to consider robust SOPs when casting their

---

acquired through equity compensation programs until two years following the termination of their employment).

[60] *See* Citigroup Inc., Proxy Statement (Schedule 14A) at 130 (Mar. 12, 2010); *also see* JPMorgan Chase & Co., Proxy Statement (Schedule 14A) at 40 (Mar. 31, 2010); *also see* Bank of New York Mellon Corp., Proxy Statement (Schedule 14A) at 79 (Mar. 15, 2010).

[61] GRId is intended to allow investors to assess their firms' level of corporate governance risk. *See* Institutional Shareholder Services Inc., *Governance Risk Indicators 2.0 Technical Document*, (Mar. 6, 2012) *available at* http://www.issgovernance.com/grid/technical_document.

[62] Scores are based on each company's score relative to what ISS views as "best practice" in the relevant global market. Answers are converted into numerical values based on a grading system determined by ISS with the results converted into overall scores and levels of concern (e.g., low, medium and high) in each of four areas. Generally, GRId's scoring for a question will be based on a scale of "-5" to "5" with "0" a neutral score. Scores are then normalized on a 100 point scale (e.g., 0 to 100). The score for each of the four categories, including the remuneration category, is then reported as a level of concern (high, medium or low).

[63] Question 142 on GRId evaluates whether an SOP is "robust, standard, substandard," or not disclosed. Companies are deemed to have robust SOPs when their policy requires at least six times base salary, and they would score a 3. Policies are considered standard when their base salary multiple is between three and six times, and would score a zero. Substandard CEO SOPs are those having below three times salary, and would score -3. Companies failing to disclose, or explicitly saying they will not disclose their CEO SOPs, would score a -5. This important question weights 3.25% of the overall U.S. firms' remuneration category score. Question 143 evaluates directors SOPs in a similar way, using lower base salary multiples.

[64] Questions 134 and 135 evaluate the post-vesting holding periods for stock options and for restricted shares, respectively (for executives). GRId evaluation is based on a formula, with a two-year holding period or more scoring the maximum points. These two questions weight altogether 4.8% of the overall U.S. firms' remuneration category score.

[65] *See* RiskMetrics Group Inc., *2010 U.S. Proxy Voting Summary Guidelines*, at 51-52 (Feb. 25, 2010) *available at* http://www.issgovernance.com/files/RMG_2010_US_SummaryGuidelines20100225.pdf.

votes on "Say on Pay".[66] In particular, ISS encouraged shareholders to consider robust SOPs as an important factor that mitigates the impact of risky pay incentives.

ISS is the world's leading provider of proxy voting and corporate governance services[67] and its support of shareholder pressure to adopt SOPs is expected to have a significant impact. For example, its "Against" voting recommendation on "Say on Pay" in 2012 resulted in a significantly reduced level of shareholder support of 65% versus 95% support in executive pay arrangements for firms fortunate enough to receive a "For" ISS recommendation.[68] Consequently, companies often tailor their policies to meet ISS guidelines and firms lobby for ISS support to fend off shareholder proposals.[69]

B. The business sector accepts the importance of SOPs

Leading business people and prominent pro-business organizations have all publicly accepted the need for SOPs. In January 2010, Goldman Sach's CEO, Lloyd Blankfein, emphasized the importance of this issue in front of the House Committee on Financial Services.[70] He declared that senior executive officers should be required to retain the bulk of the stock they receive until they retire, and stock delivery schedules should continue to apply after the individual has left the firm. Blankfein's proposal was implemented by Goldman Sachs as well as by other leading investment banks.[71] These policies, as I explain in Chapter V, are significantly more effective than most SOPs of other firms.

---

[66] *See* Institutional Shareholder Services Inc., *2012 U.S. Proxy Voting Summary Guidelines*, (January 31, 2012) *available at* http://www.issgovernance.com/policy/2012/policy_information; also see Institutional Shareholder Services Inc., *2011 U.S. Proxy Voting Summary Guidelines*, (January 27, 2012) *available at* http://www.issgovernance.com/policy/2011/policy_information.

[67] ISS serves more than 1,700 institutional and corporate clients and provides objective voting recommendations for more than 33,000 companies across 115 markets worldwide. See INSTITUTIONAL SHAREHOLDER SERVICES INC., http://www.issgovernance.com/about (last visited September 30, 2012).

[68] *See* John D. England, *Say on Pay Soul Searching Required at Proxy Advisory Firms*, Pay Governance (June 2012), at 1-2.

[69] The relentless efforts that HP's former CEO, Carli Fiorina has made to gain the ISS support in the HP Compaq merger demonstrates the decisive importance of the ISS. *See* Pui-Wing Tam & Gary McWilliams, *H-P Garners Major Endorsement Deal— ISS Advisory Firm Backs Acquisition of Compaq*, WALL ST. J., Mar. 6, 2002, at A3 (reporting that "many money-management firms take ISS's reports into account before voting in a proxy battle").

[70] *See Official Transcript - First Public Hearing of the Financial Crisis Inquiry Commission, Before the H. Comm. on Financial Services, 111th Cong.* (January 13, 2010) (Statement of Lloyd C. Blankfein, CEO, The Goldman Sach's Group Inc.).

[71] Goldman Sachs' 2010 SOP requires that "Each of our CEO, CFO, COO and Vice Chairmen (collectively, Senior Executives) (or, in certain cases, estate planning entities established by such persons) is required by our Shareholders' Agreement, for so long as he holds such position, to retain sole beneficial ownership of a number of shares of Common Stock equal to at least 75% of the shares he has received under our SIP since becoming a Senior Executive (not including any shares received in connection with Goldman Sachs' initial public offering and less allowances for the payment of any option exercise price and taxes). All of our Senior Executives are in compliance with this requirement." This policy is separate from and in addition to Warren Buffet's requirements in this regard discussed above. *See* The Goldman Sach's Group, Inc., Proxy Statement (Schedule 14A) at 23 (Apr. 13, 2010).

Business leaders' calls for the adoption of SOPs in the aftermath of the 2008-2009 financial crisis followed earlier public recommendations of prominent pro-business organizations. The most powerful business lobby in America, The Business Roundtable, has identified SOPs as a "best practice"[72] and recommended that these policies be designed to encourage executives and directors to maximize the long-term success of their firms.[73]

The Aspen Principles and The Conference Board[74] have publicly supported SOPs as well. The Aspen Principles, endorsed by the largest business groups including the Chamber of Commerce,[75] The Business Roundtable and the Council of Institutional Investors, urge for adoption of stringent SOPs.[76] Similarly, The Conference Board[77] has stated that SOPs' long-term focus may help in preventing stock price manipulation and other undesirable short-term decisions.[78]

III. METHODOLOGY FOR STUDYING SOPS IN S&P 500 COMPANIES

I now turn to test the effectiveness and transparency of current SOPs. I do so based on empirical analysis of all 500 firms included in the S&P 500 index. I survey current SOPs to the extent they apply to the leader of the executive team, the CEO. I choose to focus on the CEO because she is typically the most powerful figure within the top executive team, capturing the highest pay slice and having the strongest impact on the value, performance and behavior of the public firm.[79] Naturally, current SOPs apply the most stringent requirements on CEOs relative to the other members of the executive team or the non-employee directors.

I obtained most of my data by collecting the most recent information posted on the SEC website by all S&P 500 firms as of August 4, 2010. Regulation S-K, item 402

---

[72] *See* THE BUS. ROUNDTABLE, EXECUTIVE COMPENSATION: PRINCIPLES AND COMMENTARY (NOV. 2003).

[73] *See* CFA CTR. FOR FIN. MKT. INTEGRITY/ BUS. ROUNDTABLE INST. FOR CORP. ETHICS, BREAKING THE SHORT-TERM CYCLE, DISCUSSION AND RECOMMENDATIONS ON HOW CORPORATE LEADERS, ASSET MANAGERS, INVESTORS AND ANALYSTS CAN REFOCUS ON LONG-TERM VALUE (2006) (recommending that companies require executive and directors to hold meaningful amount of stock so it "makes it economically material to the individual that a company succeed in the long-term").

[74] The conference Board is a non-partisan business membership and research group.

[75] The United States Chamber of Commerce (USCC) is an American lobbying group representing the interests of many businesses and trade associations.

[76] *See* THE ASPEN INST., LONG-TERM VALUE CREATION: GUIDING PRINCIPLES FOR CORPORATIONS AND INVESTORS (JUN. 2007) (stating that "senior executives hold a significant portion of their equity-based compensation for a period beyond their tenure").

[77] The conference Board is a non-partisan business membership and research group.

[78] *See* THE CONFERENCE BOARD, COMMISSION ON PUBLIC TRUST AND PRIVATE ENTERPRISE: FINDINGS AND RECOMMENDATIONS 11 (2003) (stating that SOPs "may help prevent companies from artificially propping up stock prices over the short-term to cash out options and making other potentially negative short-term decisions").

[79] *See* Lucian A. Bebchuk, Martijn Cremers & Urs C. Peyer, *CEO Centrality* (NBER Discussion Paper No. 13701, 2007) http://www.nber.org/papers/w13701 (last visited September 30, 2012).

requires disclosure, in "Compensation Discussion and Analysis Chapter" of firms' proxy statements[80], of SOP objectives[81] as well as a general description of the policy, including applicable amounts and forms of ownership.[82] [83] The elements I collected for each SOP are: declared goals, target threshold, counting policy, phase-in period, actual holdings, and sanctions for violating the policy. I recorded CEO actual holdings from the "Common Stock and Total Stock-Based Holdings" table of each proxy statement, counting only those stock-based holdings recognized by the counting policy of each SOP.

I also relied on some data outside of the S&P 500 Firms proxy statements. For example, I collected available data from firms' websites whenever those firms' proxy statements missed some relevant information. Also, I recorded share prices from Google Finance and determined CEO tenure for each firm using data I obtained on Compustat Execucomp. All this data is recorded as of August 4, 2010 as well.

I converted each SOP target threshold into a base salary multiple, when necessary, by dividing the target threshold monetary value by the most recent CEO base salary, as disclosed on the firm's proxy statement. For companies that employ holding periods, I included the stock subject to holding periods as if this stock is part of the company's SOP.[84] I also coded each counting policy according to its counting of the following parameters: vested stock, vested options, deferred compensation, unvested stock, and unvested options.

Finally, I calculated the percentage of vested equity that each SOP allows its CEO to unwind by applying this formula: (vested equity – target threshold) + min (target threshold, unvested equity that can be counted for satisfying the SOP).

IV. THE CURRENT DESIGN OF SOPS

---

[80] Treas. Reg. § 229.402(b)(2)(xiii) (2006).

[81] Item 402(b)(1) requires that: "The discussion shall describe… (i) the objective of the registrant's compensation programs; (ii) what the compensation programs is designed to reward". *See* Treas. Reg. § 229.402(b)(1)(2006).

[82] Item 402(b)(2) states that: "..[E]xamples of such information may include, in a given case, among other things, the following: ..(xiii) The registrant's equity or other security ownership requirements or guidelines (specifying applicable amounts and forms of ownership)". *See* Treas. Reg. § 229.402(b)(2)(2006).

[83] Despite its approach against regulating substantive SOP provisions, the federal government imposed strict SOPs for all Troubled Asset Relief Program (TARP) recipients. The government is a significant stakeholder in TARP firms and the Treasury regulations preclude TARP recipient executives from cashing out any vested stock before TARP funds are repaid. *See* The Emergency Economic Stabilization Act of 2008, 12 U.S.C. § 5221(b)(3)(D) (2012). Furthermore, Kenneth Feinberg, the Special Master for TARP Executive Compensation, was instructed to focus on tying pay to long-term performance for TARP companies. *See* The Emergency Economic Stabilization Act of 2008, 12 U.S.C. § 5221(2012).

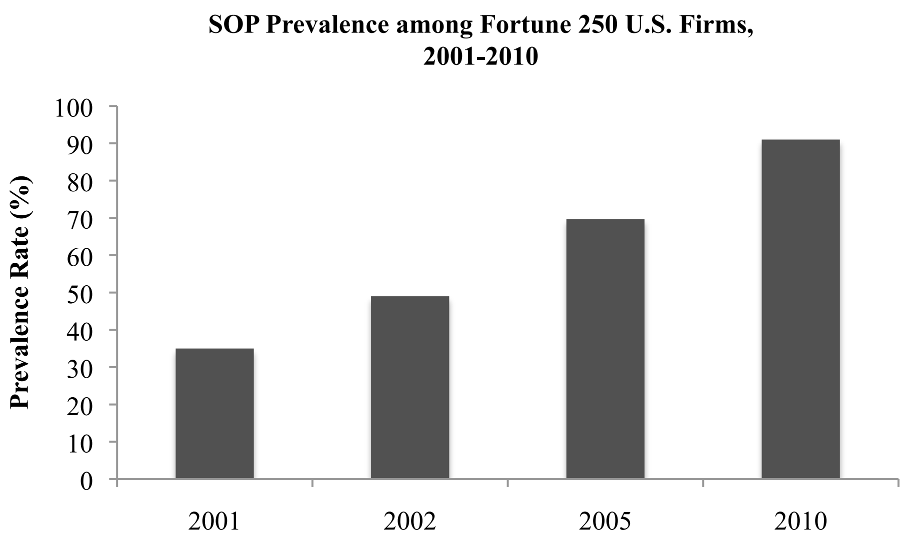
[84] By doing that, I make SOPs look stricter than what they really are. The reason is that holding periods typically require executives to hold their stock just for a few years post-vesting, as opposed to SOPs that typically require CEOs to hold their stock for their entire tenure with their firms. I choose to use this method to conclude that the ineffectiveness of current SOPs is at least as severe as I report.

Before analyzing the ineffectiveness of current SOPs, it is important to understand the way these policies are designed. I choose to focus on the main four factors pertinent to SOP design: prevalence, declared goals, general framework and structure.

A. Prevalence

In the aftermath of the 2008-2009 crisis, SOPs became virtually universal. The formal pressure I describe, and the increased attention from investors that followed, served as a catalyst for additional companies to adopt SOPs. This impetus, coupled with the popular outrage with executive compensation in general, has led to a surge in the number of formal SOPs. In 2010 SOPs reached an all-time high of 96% among Mega Cap S&P 500 companies, some 91% among Fortune 250 firms and some 85% among all S&P 500 firms.[85] This overwhelming adoption of SOPs is a dramatic increase from its 69.7% prevalence rate in 2005, 49% in 2002, and 35% in 2001, among Fortune 250 companies.[86] The evolution in SOP prevalence is summarized in Figure I below.

Figure 1: SOP Prevalence among Fortune 250 U.S. Firms, 2001-2010



[85] The prevalence rate I report is consistent with the 95% prevalence rate for SOPs among Fortune 100 companies reported by Frederic W. Cook &Co., Inc in 2010. *See* Frederic W. Cook & Co., Inc., *Executive Stock Ownership Policies – Trends and Developments*, (Sep. 13, 2010) at 1.

[86] *See*, for example: (i) Equilar Inc., *2007 Executive Stock Ownership Guidelines Report*, (Feb. 2007) at 9; (ii) Press Release, Equilar Inc., Over 80 Percent of Fortune 250 Companies Use Executive Stock Ownership Guidelines (July 28, 2010), *available at* http://www.equilar.com/company/press-release/press-release-2010/index.php (last visited September 27, 2012); and (iii) Frederic W. Cook & Co., Inc, *Stock Ownership Policies – Prevalence and Design of Executive and Director Ownership Policies Among the Top 250 Companies*, (September 2003).

B. Declared Goals

Firms have declared ambitious goals for their SOPs. They have generally communicated these goals in two ways. First, they have disclosed them in prominent sections of their proxy statements. Second, firms have included their SOPs in their new mandatory reporting of risk management strategies.

Firms have communicated the main objectives of their SOPs in the "Compensation Management Discussion and Analysis" Chapter of their proxy statements.[87] The two main objectives that firms chose to emphasize regarding their SOPs are: (i) to discourage inappropriate risk-taking related to the company's business,[88] and (ii) to align managerial interests with long-term shareholders and encourage growth in stockholder value.[89] The 2010 proxy statement of Limited Brands, Inc. summarizes the commonly declared SOPs objectives:

> In addition to aligning the interests of our executive officers with those of our stockholders, the share ownership guidelines promote a long-term focus and discourage inappropriate risk-taking.[90]

SOPs have become the single most cited policy that firms disclose for their mitigation of risk. In 2010 the SEC required companies, for the first time, to discuss the level of risk inherent in their compensation programs within their proxy statement. Having SOPs was the most commonly cited policy (60% in proxy filings of 100 companies with yearly revenues of $12.5 billion or greater),[91] more than strategies that are directly designed to discourage undue risk, such as the balance of short-term and long-term incentives compensation, or policies like excess-pay clawbacks[92] and hedging

---

[87] Firms have typically placed it in the leading paragraph of a separate heading, titled "Share Ownership Guidelines". Regulation S-K Item 402(b)(1) requires firms to disclose their SOPs' objectives: "The discussion shall describe… (i) the objective of the registrant's compensation programs; (ii) what the compensation programs is designed to reward." *Supra* note 81.

[88] *See*, for example, Cabot Oil & Gas Corp., Proxy Statement (Schedule 14A) (Mar. 23, 2010); *see also* Family Dollar Stores, Inc., Proxy Statement (Schedule 14A) at 25 (Dec. 11, 2009).

[89] *See*, for example, (i) CA Inc., Proxy Statement (Schedule 14A) at 39 (June 8, 2010); (ii) Family Dollar Stores, Inc., Proxy Statement (Schedule 14A) at 25 (Dec. 11, 2009); (iii) Marsh & McLennan Co., Proxy Statement (Schedule 14A) at 41 (Mar. 30, 2010); and (iv) First Horizon National Corp., Proxy Statement (Schedule 14A), at 53 (Mar. 16, 2010).

[90] *See* Limited Brands Inc., Proxy Statement (Schedule 14A) at 21 (Apr. 7, 2010).

[91] *See* Press Release, Equilar Inc., Long-Term Performance Compensation Is Most Popular Risk-Management Strategy (Apr. 21, 2010), *available at* http://www.equilar.com/company/press-release/press-release-2010/index.php (last visited September 27, 2012) (reporting that tying compensation to long-term performance was the most commonly cited strategy (72% in proxy filings of 100 companies with yearly revenues of $12.5 billion or greater), with almost 60% citing their SOPs as a key element in their mitigation of risk).

[92] Fifty-nine percent of 100 major companies' disclosures cite their SOPs as part of their risk strategy, but only 50% and 56% of these firms, respectively, cite the use of clawbacks and the balance of short-term and long-term incentives as part of their risk strategy. *See* Press Release, Equilar Inc., Long-Term Performance Compensation Is Most Popular Risk-Management Strategy (Apr. 21, 2010), *available at*

prohibition. The latter policies seemed important enough to the Dodd-Frank regulators that they imposed mandatory clawbacks and mandatory disclosure of hedging policies in all publicly traded firms. In contrast, the Dodd-Frank regulators avoided from regulating SOPs.

C. General framework

I find that virtually all current SOPs use a framework that calls senior executive officers and all non-employee directors to maintain a minimum ownership of their firm's stock as long as they serve in their current positions[93]. Only a small minority of SOPs (such as retention or holding period policies) requires executives to constantly hold new shares.

In particular, only some 4% of policies require holding periods, according to which, once the general ownership guidelines are satisfied, the executive officer or director is further expected, for an additional period ranging from 6 months to ten years, to retain a certain percentage of all additional stock realized through the exercise of stock options and the vesting of restricted stock units and performance awards.

Notably, less than 2% of SOPs (8 policies), mostly financial firms, including Goldman Sacks and JP Morgan, employ a stock retention approach for their SOPs.[94] Stock retention policies do not use ownership thresholds, but rather require executive officers and directors to retain until retirement, and in some cases thereafter, a certain percentage of the shares they receive from stock-based awards, after deduction for option exercise costs and taxes. This percentage ranges from 50% to 75%. Goldman Sachs, JP Morgan, Citigroup, and Morgan Stanley all use a 75% retention rate.

D. Structure

A typical SOP framework contains three elements. First, it specifies the policy's target ownership threshold. Second, its counting policy describes the type of stock that is counted to satisfy the target ownership threshold. Finally, a phase-in period states the number of years the executive has to attain her required stock threshold.

---

http://www.equilar.com/company/press-release/press-release-2010/index.php (last visited September 27, 2012).

[93] A detailed SOP is described in Johnson & Johnson's 2010 proxy statement: "[T]he Chairman/CEO is required to directly or indirectly own Company Common Stock equal in value to five times his or her annual salary... Stock ownership for the purpose of these guidelines does not include shares underlying stock options. Individuals subject to these guidelines are required to achieve the relevant ownership threshold within five years after first becoming subject to the guidelines. If an individual becomes subject to a higher ownership threshold due to promotion or increase in base salary, that individual will be expected to meet the higher ownership threshold within three years ". *See* Johnson and Johnson, Proxy Statement (Schedule 14A) at 42 (Mar. 17, 2010).

[94] I find another three non-financial firms that employ a pure retention policy: The Clorox Company, E*TRADE Financial Corporation, and United States Steel Corporation.

1. Target ownership threshold

SOPs' target ownership threshold defines the minimum amount or value of company stock the executive or director should own. All SOPs disclose their target ownership threshold. For more than 80% of SOPs, such threshold is set at a value equal to at least a certain multiple of the CEO's base annual salary.[95] Much less commonly, in some 13% of the policies, the target ownership is specified as a fixed number of shares, while only 4% of the policies are framed as a combination of the two. The remainder of SOPs includes retention policies and holding periods I discussed earlier. These policies do not state target ownership thresholds. Instead, their requirements are ongoing and apply to all stock-based compensation the executive or director may be granted, regardless of her stock holdings at that time.

In order to describe the distribution of target ownership thresholds, I collected data on all policies that use a base salary multiple method. Also, I converted all policies' target thresholds that use a fixed number of stock into a base salary multiple equivalent value.[96] Finally, I set an equivalent target ownership threshold for retention policies and holding periods.[97] When necessary, I rounded the multiples to their closets integer. The resulting distribution is summarized in Figure II below.[98]

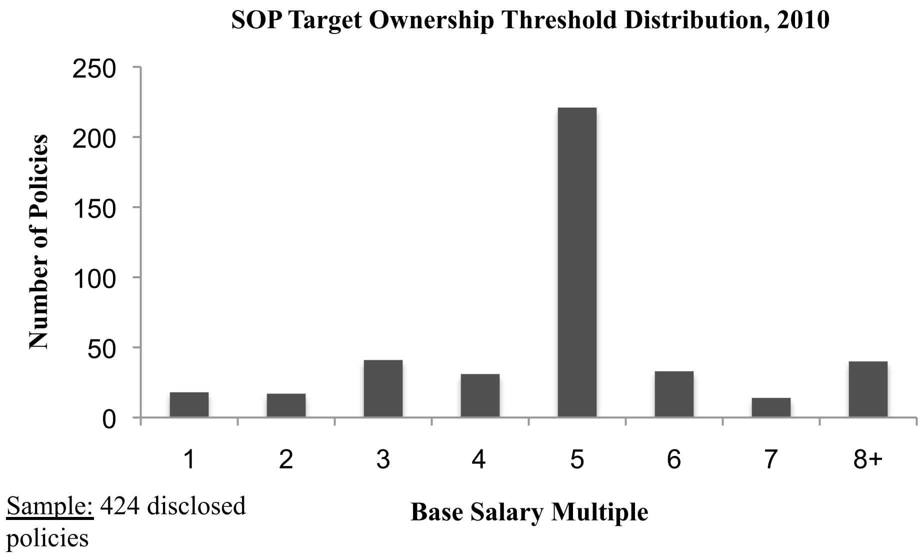
Figure 2: SOP Target Ownership Threshold Distribution

[95] Target ownership threshold for non-employee directors is specified as a multiple of their regular annual cash retainer.

[96] The method I use to convert the fixed number of stock requirement into a base salary multiple is as follows: I multiply fixed number of stock requirement by the company's stock price on August 4, 2010, as posted on Google Finance. Then I divide the result by the CEO's base salary as disclosed on each firm's most recent proxy statement as of August 4, 2010.

[97] For retention policies and holding periods, I calculate the number of stock the executive should retain for all equity awards granted by August 4, 2010. Then I follow the methodology I apply for fixed number of shares policies described above to obtain the policy's base salary multiple equivalent.

[98] Relatively few firms reduce their base salary multiple or totally waive their SOP for executives that reach the age of 60 or 62. I do not adjust the multiples accordingly, as I do not want my analysis to depend on the identity of the CEO. To be sure, such adjustment would have been quite insignificant.



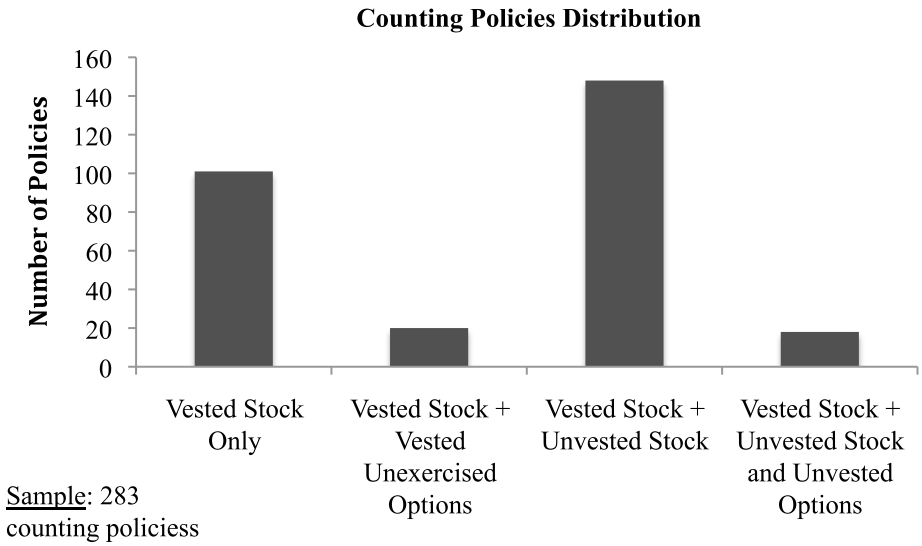
The distribution of SOP base salary multiples is centrally condensed at the 5 times multiple. Just above half of policies use this multiple, while the second most common multiple is shared by the 3 times and more than 8 times multiples. Each of these multiples shares slightly less than 10% of the distribution. While the more than 8 times multiple is driven by retention and holding period policies, all remaining multiples are driven by the standard base salary multiple method policies. Overall, the distribution on both sides of the 5 times multiple is quite even, with less than 20% more density in the lower tail.

2. Counting policy

The second element of a typical SOP defines the type of equity securities that may be counted toward meeting the policies' target ownership threshold. Types of equity securities are varied, and thus, the potential variation across counting policies is significant. Specifically, counting policies may recognize: common stock (vested or unvested/restricted), stock options (vested, unvested, exercised, or unexercised), stock in deferred compensation accounts, stock in 401 (k) plans, stock in trusts, stock owned by immediate family members, and other less common types of stock holdings. I coded all disclosed counting policies by the type of stock they allow to count.

Some one third of policies do not disclose their counting policies. Policies adopted by Cisco, Colgate-Palmolive and Adobe merely state the general term "shares" or "common stock" for their counting policies. Below is the distribution of SOPs that disclosed their counting policies:

Figure 3: SOP Counting Policies Distribution



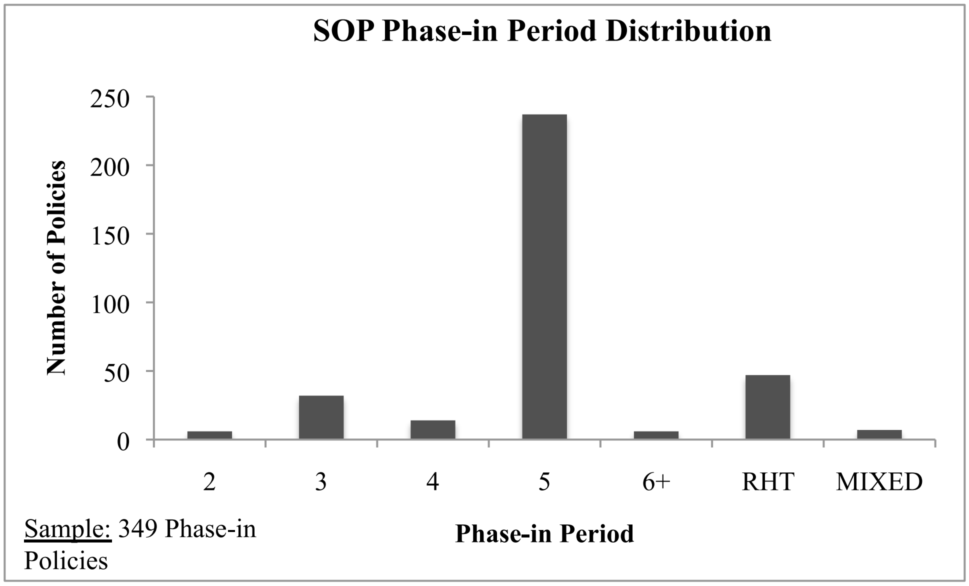
Counting unvested stock for the purpose of satisfying SOPs' target threshold merely replicates the requirements already set up by stock vesting schedules. Nonetheless, some 58% of SOPs allow the counting of unvested stock. Only some one third of SOPs recognize only vested stock. I will discuss the implications of SOPs counting of unvested stock in chapter V.

3. Phase-in period

Finally, an SOP typically describes a phase-in period provision, which states the length of time allowed to the executive or director to attain her target stock threshold. Disclosure of phase-in periods is at a rate of 82%. This rate is significantly higher than the 67% disclosure rate of counting policies, but lower than the 100% disclosure rate of target ownership thresholds. Among the firms that fail to disclose their phase-in policies are Google, Chevron, Chesapeake Energy, Comcast, and Expedia.

Phase-in policies generally use one of two methods, or a combination of them. The first method utilizes the "fixed number of years" approach, which states the number of years in which the executive or director must attain her policy's stock threshold. The other approach guides executives and directors to retain a certain minimum percentage of their stock-based awards, after deduction for option exercise costs and taxes, until they attain the required level of stock ownership. I call these policies "retain until you hit your target threshold", or "RHT". I aggregated data of all disclosed phase-in policies, and their distribution is summarized in Figure IV below:

Figure 4: SOP Phase-in Period Distribution



Some 85% of phase-in policies utilize the "fixed number of years" approach, whereas 13% of policies guide their executives to comply with their SOPs according to an RHT approach. Only 2% of policies invoke an RHT approach on top of their "fixed number of years" approach.

Among the "fixed number of years" policies, slightly more than 80% allow their executives to wait five years before they have to attain their SOPs' target ownership thresholds. Another some 10% of policies allow only three years for this purpose. The remaining 9% is equally distributed around a four-year period.

RHT policies' retention rates range from 25% to a 100%, with almost half of them (21 policies) requiring a 100% retention rate.[99] One of these firms is Dun & Bradstreet Corp:

> All executives covered by our stock ownership guidelines are expected to retain 100% of net shares resulting from equity compensation awards and shares otherwise acquired by them outright until the stock ownership guideline is achieved.[100]

V. SOP INEFFECTIVENESS

In this Chapter, I draw on the structural analysis of the previous Chapter to show that current SOPs are highly ineffective. In particular, SOPs generally allow CEOs to sell the vast majority of their vested stock and bear rare and ineffective sanctions. The

[99] The distribution of the remainder 26 RHT policies rates is as follows: 7 policies require a 75% rate, 9 policies require a 50% rate, 2 policies require a 30% rate and another 8 policies require a 25% retention rate.

[100] *See* Dun & Bradstreet Corp., Proxy Statement (Schedule 14A) at 35 (Mar. 25, 2010).

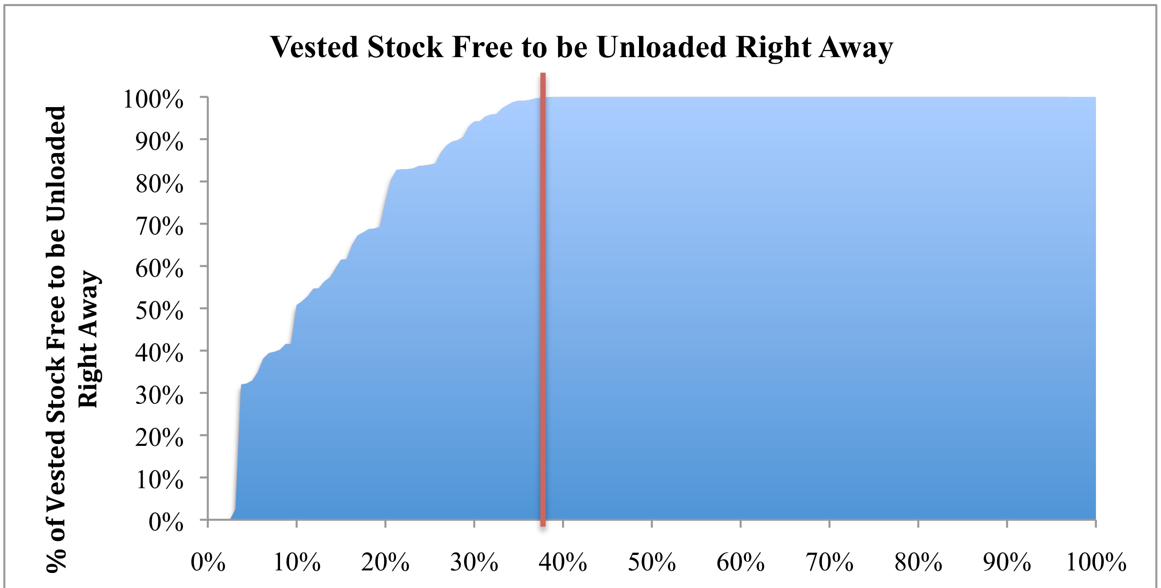
extreme ineffectiveness of current SOPs makes these polices unable to fulfill the important goals they are advertised to attain.[101] Moreover, the camouflaging of SOP ineffectiveness prevents investors from evaluating the strength of these policies.

Brian Dunn and John Donahoe demonstrate the extreme ineffectiveness of current SOPs. Brian Dunn, who was the CEO of Best Buy from April 2009 to April 2012, was allowed to unload all of his vested Best Buy stock and still comply with its SOP. The reason is that his unvested shares under the company's long-term incentive program satisfied his SOP requirements. Similarly, John J. Donahoe, eBay CEO since March 2008, may sell all of his over $16million worth of eBay vested stock, pursuant to eBay's ineffective SOP.

A. Current SOPs are designed to be extremely ineffective

Generally, SOPs allow CEOs to immediately sell virtually all of their vested stock. Allowing massive stock selling by CEOs frustrates the most fundamental expectation from SOPs – that they require their CEOs to hold a significant value of their firms' stock for the long-term. Figure V illustrates this bottom-line result:

Figure 5: Vested Stock Free to be Unloaded Right Away



Sample: 155 SOPs with clear counting policies of CEOs who phased-in

[101] In this article I do not aim to discuss the optimal level of SOP effectiveness. In general, such optimal level should be determined on a case-by-case basis in accordance with each firm's CEO wealth, CEO degree of risk aversion, CEO scope of unscrutinized action, CEO current holdings, strength of firm specific corporate governance arrangements, firm risk and industry risk. My claims about the implications of current SOP ineffectiveness are independent from the issue of the optimal level of SOP effectiveness.

Almost two thirds, or 62%, of CEOs are allowed to unload all of their vested stock immediately,[102] and the dollar amount of CEO ability to sell vested stock is significant. In particular, the median CEO is allowed to sell some $14 million worth of vested stock, or 2.75 times her SOP target threshold, and some 35% of CEOs are allowed to sell more than $30 million worth of their vested stock.

To be sure, there is significant variation in the effectiveness of SOPs. While the vast majority of policies are extremely ineffective, some policies do not allow CEOs to sell significant amounts of their vested stock. These relatively potent policies are, first, driven by atypical SOPs frameworks; namely, by retention policies and holding period policies. Second, effective SOPs are driven by strict counting policies; namely, policies that do not recognize unvested stock. Third, and to a lesser extent, some potent SOPs do not have strict counting policies or retention framework, but rather use high base salary multiples. Lastly, some SOPs appear effective because of circumstantial factors that are unrelated to their design. Such circumstantial factors include short CEO tenure, as well as the private preference of some CEOs to keep small amounts of vested stock.

Some SOPs can seem ineffective when CEOs choose to hold significant amounts of their vested stock voluntarily. When CEOs choose to hold on to their vested stock, the percentage of vested stock that is free to be unloaded increases. Then, the weakness of an SOP is not necessarily indicative of suboptimal target stock thresholds. However, if CEOs choose to hold significant amounts of stock on their own, then it is hard to think of a compelling explanation for why these SOPs are necessary. Even more puzzling, it is hard to explain why these unnecessary policies are advertised so aggressively.

Now, I turn to provide empirical data that breaks down the reasons why SOPs typically allow CEOs to unload the vast majority of their vested stock.

1. Failure to adopt retention and holding period approaches

Only some 4% of SOPs utilize holding period requirements and less than 2% of SOPs employ a stock retention approach for their SOPs. SOPs that use retention and holding period frameworks are significantly more effective than common SOPs and allow CEOs to sell a dramatically lower percentage of their vested stock.

Consider the rare retention SOP adopted by Goldman Sachs (Citigroup, JP Morgan and Morgan Stanley adopted similar policies):

> Each of our CEO, CFO, COO and Vice Chairmen… is required… for so long as he holds such position, to retain sole beneficial ownership of a number of shares of Common Stock equal to at least 75% of the shares he has received under our Stock Incentive Plan since becoming a Senior

[102] This result is based on a sample of 155 SOPs with clear counting policies, whose CEOs have phased-in. Of the 500 firms included in the S&P 500 index, only 283 firms disclose counting policies and therefore can be evaluated. Of these firms, only 155 CEOs have phased-in. only these 155 CEOs should and therefore already have to comply with their SOPs.

Executive.[103]

As opposed to the common SOP, which uses a 5 times base salary multiple, the target threshold of Goldman's SOP is equivalent to more than 95 times the $600,000 base salary of its Chairman and CEO, Lloyd Blankfein. This multiple will increase over time, as soon as Blankfein, who started serving as Goldman's senior manager in April 2002, is awarded more stock-based incentives.

Consider the rare holding period approach endorsed by ExxonMobil's SOP:

> Fifty percent of each grant is restricted for five years; and the balance is restricted for 10 years or until retirement, whichever is later.[104]

The current base salary multiple of Rex Tillerson, who was elected Chairman and Chief Executive Officer of ExxonMobil in 2006, is as high as 39 times his base salary, 6 times higher than the base salary multiple of the median CEO. Moreover, Mr. Tillerson's percentage of vested stock free to unwind is as low as 12%, dramatically lower than the 95.6% of the median CEO.

However, almost 95% of current SOPs do not endorse the retention approach or the holding period framework. Rather than requiring an ongoing retention of incentive pay they merely invoke ineffective conventional SOP frameworks that include target thresholds, counting policies and phase-in periods.

2. Lax target thresholds

For the vast majority of CEOs, SOP target threshold is lower than 60% of their annual total pay and even lower than their single year stock-based compensation.[105] At the same time, as few as 3% of current SOPs use a base salary multiple that requires CEOs to hold more than their single year total pay.

The common practice of lax target thresholds renders many SOPs futile as soon as they are adopted. Accordingly, a recent study reports that: "71% of the CEOs already have a multiple larger than the target by the time the guidelines are initiated."[106]

3. *Counting Policies render most SOPs completely ineffective*

---

[103] *Supra* note 71, at 23.

[104] *See* ExxonMobil Corp., Proxy Statement (Schedule 14A) at 30 (Apr. 13, 2010).

[105] This outcome results from the fact that some 80% of SOPs require CEOs to hold 5 times their base salary or less, while the median S&P 500 CEO is paid a $1 million base salary, her total compensation is some $8.7million, $5.5million thereof in the form of stock-based compensation. *See* Equilar, *supra* note 7.

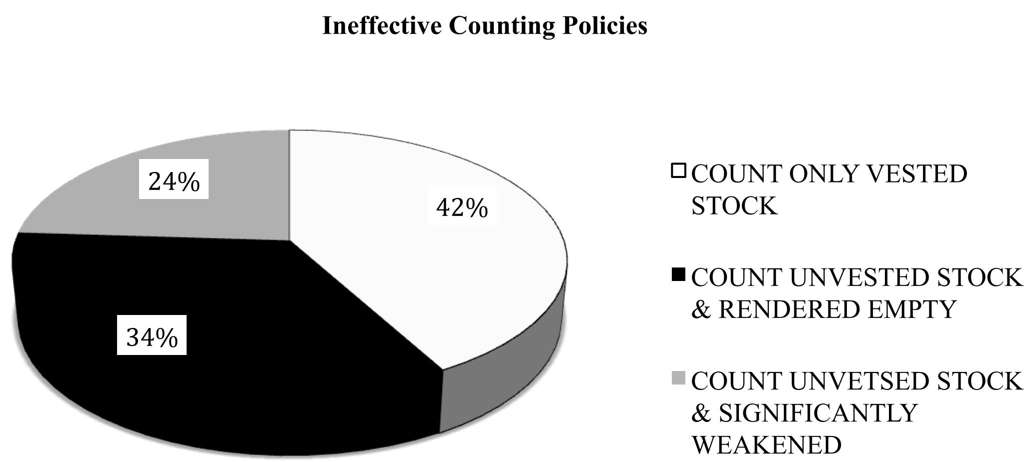
[106] *See* Ying Cao, Zhaoyang Gu, & George Y. Yang, *Adoption of Executive Ownership Guidelines: A New Look* (September 2, 2010) (unpublished manuscript), http://ssrn.com/abstract=1596503 (last visited September 27, 2012).

Most counting policies recognize unvested stock and hence obviate SOPs. A policy similar to the median SOP demonstrates this problem. Consider firm A, which requires its CEO to hold 5 times her base salary and counts both unvested and vested stock. Firm A CEO's base salary is $1 million and she receives each year a $6 million grant of stock that vests gradually over 3 years. Thus, after two years of stock grants the CEO will be granted $12 million worth of stock, $6 million of which will already be vested. This CEO's vesting schedule prohibits her to sell her $6 million worth of unvested stock and thus fulfills and obviates the requirement of her SOP to hold at least $5 million worth of stock, whether vested or unvested.

In my sample, the median SOPs' target threshold is $5 million. The median S&P 500 CEOs' annual grant of unvested stock is almost $6 million and her stock grant's vesting periods are typically 3-5 years. Therefore, recognizing unvested stock for satisfying SOP requirements obviates many SOPs in a way similar to the abovementioned example.

Figure VI below summarizes my findings regarding the effect of disclosed counting policies on SOP effectiveness for S&P 500 CEOs:

Figure 6: Ineffective Counting Policies of Disclosed SOPs



Sample: 283 SOPs with disclosed counting policies

Some 58% of disclosed counting policies allow the counting of unvested stock. Most SOPs that count unvested stock are rendered completely ineffective in the sense that their CEOs are free to immediately unload 100% of their vested stock.[107] The remainder of SOPs with disclosed counting policies are significantly weakened as a result

[107] Even those SOPs that are not rendered completely empty by counting unvested stock might not require CEOs to hold on to some of their vested stock. The reason is that these policies might count forms of vested stock that CEOs cannot practically sell, such as stock in 401(k) accounts, deferred compensation, stock in trust accounts, etc.

of their counting of unvested stock.

Most SOPs that recognize unvested stock are rendered completely ineffective, across all levels of CEO tenure and even for CEOs that have not phased-in yet.[108] Moreover, the median amount of each CEO's unvested stock exceeds her SOPs' target threshold, across all levels of CEO tenure. Table I focuses on SOPs that count unvested stock and summarizes their pervasive power to render SOPs ineffective:

Table 1: The Effect of Counting Unvested Stock on SOP Effectiveness

Number of Policies	*Years before (after) Phase-in*[109]	*Unvested Stock/Target Threshold (Median)*	*Likelihood of Counting Policy to render SOP Completely Ineffective*
26	**2 to 0**	**1.49**	**62%**
30	**(-2) to 0**	**1.01**	**50%**
39	**(-3) or less**	**1.26**	**62%**
95	**All**	**1.16**	**58%**

Sample: 95 SOPs that count unvested stock, disclose their phase-in policies, and their CEOs have 2 years or less to phase-in.

Dell is one of 164 firms that allow the counting of unvested stock for their SOPs. The pervasiveness of this practice that obviates SOPs is fully acknowledged by Dell - Dell not only allows the counting of unvested stock, but it also declares that it merely follows the market:[110]

> Unvested restricted stock, RSUs [Restricted Stock Units] and PBUs [Performance Based Units] (earned) may be used to satisfy these minimum ownership requirements, but unexercised stock options and awards subject to a performance requirement may not. Dell believes these ownership guidelines to be in line with the prevalent ownership guidelines among peer companies.[111]

4. *Ineffective Phase-in Policies*

Some 85% of policies specify a fixed number of years by which their CEOs have

[108] I define these CEOs to include those who have more than 2 years to phase-in. The reason for my decision is that in those cases CEOs may plan to satisfy their SOPs with their future unvested stock grants, and thus, they may sell their vested stock even if they have not met their SOP thresholds yet.

[109] Calculated as CEO tenure minus phase-in period (Years). This column is a proxy for tenure, as more tenured CEOs are more likely to have lower number of years to phase-in.

[110] Michael Dell, Dell's founder, Chairman and CEO holds significant amount of Dell's stock. He already owns more than 11% of the company's stock, more than the amount that any reasonable SOP would have required him to hold. However, Dell's SOP applies to all other Dell's senior executives as well.

[111] *See* Dell Inc., Proxy Statement (Schedule 14A) at 38 (May 27, 2010).

to comply with their SOPs, starting from the day they were named CEOs (the "fixed-number-of-years phase-in method"). Only 15% of SOPs require their CEOs to retain a certain ratio of their stock upon vesting until they satisfy their target ownership thresholds (the "gradual phase-in method"). The gradual phase-in method may either stand-alone or, alternatively, add on to the fixed-number-of-years phase-in method.

Current phase-in policies render 40% of SOPs inapplicable. The reason for this result is that the vast majority of policies use the fixed-number-of-years phase-in method alone and the median CEO's tenure under these policies is only 5.01 years.[112] The inapplicability of these policies persists even if their counting policies and other elements are effective.

5. *Hedging can nullify SOPs*

A perfect hedge nullifies the incentives provided by holding stock pursuant to an SOP. It does so by stripping the upside and downside risks associated with stock price change for the person who purchased the hedge. According to SEC filings, the most common hedging instruments used by executives are: pre-paid variable forwards (forwards), zero-cost collars (collars), and equity swaps.[113] Each of these strategies allows executives to exchange their future returns on their firm's stock for a predetermined cash flow that is not affected by their firm's future stock price or performance.

For example, when an SOP requires an executive to hold 50,000 shares of her firm's stock for the long-term, and the firm stock is currently traded at $100, then the executive is exposed to future losses in her firm's stock price of up to $5 million and to an unlimited potential profit if her firm's stock price increases. This should incentivize her to avoid taking excessive risks and to work hard in order to maximize the long-term stock price. However, if such an executive fully fs her SOP stock by purchasing a collar, she will buy 50,000 put options and sell 50,000 call options, both with a strike price of $100 for each option. This hedge fully protects the executive from any increase or decrease in her firm's stock price because the exercise of the call (put) options will nullify any positive (negative) cash flow associated with any future increase (decrease) in

---

[112] The average tenure of a departing S&P 500 CEO in the U.S. was 8 years in 2010, down from 10 years in 2000. See THE CONFERENCE BOARD, THE 2011 CEO SUCCESSION REPORT (July 2011).

[113] *See* Carr Bettis, John Bizjak & Swaminathan Kalpathy, *Why Do Insiders Hedge Their Ownership? An Empirical Examination,* (Feb. 2012) (unpublished manuscript) http://papers.ssrn.com/sol3/papers.cfm?abstract_id=1364810 (last visited November 10, 2012).
A forward transaction consists of an agreement between buyer and seller to exchange allowances for money at a future date as specified**.** When an executive agrees to sell his stock to a buyer at a future date in return for a predetermined allowance she will no longer benefit from stock price increase or loose out of stock price decrease. Zero cost collars strategies involve the simultaneous purchase of a put option and sale of a call option covering the firm's shares such as that both costs cancel each other out. An equity swap is a financial derivative contract (a swap) where a set of future cash flows are agreed to be exchanged between two counterparties at set dates in the future. Equity swaps allow investors to exchange the future returns on their stock for the cash flows of another financial instrument such as a debt instrument (e.g., the cash flows associated with the return of the LIBOR), or any other financial instrument such as the S&P 500. For example, an executive can swap the future return of her firm's stock for the return of the LIBOR.

stock price. The economic incentives provided by this hedge are equivalent to the sale of her 50,000 SOP stock. Her SOP holdings therefore no longer provide her with any economic incentives.

I find that only 2 out of all 424 disclosed SOPs of S&P 500 firms do not count shares subject to hedging.[114] Although more disclosure of derivative transactions by executives is now required,[115] hedging is not prohibited. Therefore, executives may freely alter or undo their SOPs by entering into hedging transactions.

My results potentially underestimate the ineffectiveness of current SOPs because I do not account for hedging activity that CEOs might have entered into. A future work should analyze the impact of actual hedging transactions on the ineffectiveness of current SOPs.

6. *Ineffective sanctions*

Only rarely do SOPs disclose sanctions that may be imposed for breaching these policies. In particular, more than 90% of policies, or 379, have not disclosed sanctions policies. The board of directors does not need a special authorization to penalize SOP violators, as it has an inherent prerogative to manage the business and affairs of every corporation.[116] However, the lack of regard to sanctions may deliver an implicit message according to which boards of directors do not take SOP violations seriously.

Moreover, the few disclosed sanctions generally do not impose meaningful penalties. Most of these so-called sanctions merely impose a partial prohibition on future equity award sales rather than a penalty,[117] and many of them are framed in ways that leave discretion to the board of directors. Only in a very few cases, like with Merck's SOP, firms penalize SOP violators by reducing their future equity grants.[118]

7. Suggestive language

Many firms frame their SOPs in a suggestive form. In particular, their policies are not phrased to require their top executive and directors to follow their SOPs. Instead, their policies merely "call" their leadership team members to hold certain stock in their firms. For example, Archer Daniels Midland's SOP uses the following language: "The policy calls for members of senior management to own shares of common stock…"[119]

---

[114] These two firms are Public Service Enterprise Group and SunTrust Banks.

[115] See discussion in Chapter VI.

[116] *See* DEL. CODE ANN. tit. 8, § 141(a).

[117] Twenty-eight out of 45. Such an ineffective sanction is mentioned in Qualcomm's SOP: "If a NEO [Named Executive Officer – N.S.] has not met the guidelines by the deadline, we will require that the NEO, upon a stock option exercise, hold at least 50% of the net shares remaining after required tax withholdings until they meet the minimum guideline." See Qualcomm Inc., Proxy Statement (Schedule 14A) at 23 (Jan. 13, 2009).

[118] *See* Merck & Co., Proxy Statement (Schedule 14A) at 31 (Apr. 27, 2009).

[119] *See* Archer Daniels Midland Co., Proxy Statement (Schedule 14A) at 5 (Sep. 25, 2009).

This language, along with the scarcity of sanctions I have just discussed, may indicate that many SOPs are not designed to be mandatory. Rather, they set general expectations from managers to hold a certain amount of their firms' stock, but this expectation is only declarative and does not involve concrete implications if it is not met.

B. The discrepancy between the functioning of current SOPs and the goals they are held to fulfill

SOPs are extremely ineffective and, therefore, they are unable to fulfill the important goals they are advertised to attain. The ineffectiveness of current SOPs is commonly extreme, as most CEOs are allowed to sell virtually all of their vested stock immediately. Therefore, current SOPs cannot potentially change the behavior or incentives of CEOs. In particular, CEOs' incentives to take excessive risks or to seek short-term gains cannot be affected by current SOPs.

VI. SOP INEFFECTIVENESS IS CAMOUFLAGED

Firms camouflage the extreme ineffectiveness of their SOPs and sometimes use obscure phrases to describe major SOP terms in their proxy statements. The combination of limp policies with the ability of firms to conceal their ineffectiveness is troubling. The camouflaging of the ineffectiveness of current SOPs disguise incentives which managers might have to take excessive risks and to seek short-term gains. It is also suggestive of excessive managerial power and prevents an informed dialogue among firms, investors and governance reformers to ensure that SOPs serve the important goals they are held to attain.

Camouflaging of the extreme ineffectiveness of current SOPs takes place in two ways: first, many SOPs do not disclose critical information to investors; and second, when critical terms are disclosed, their functioning is not salient.

A. Many SOPs do not disclose critical information to investors

Firms do not disclose critical SOP information to their investors both by not indicating the overall effectiveness of their SOPs and by not providing specific information about some critical terms of their policies. Therefore, investors are not only directly deprived from bottom-line information about their SOP effectiveness, but they are also deprived from critical information that would allow them to evaluate SOP effectiveness on their own.

1. Firms do not indicate the overall effectiveness of their SOPs

Firms directly disguise the overall ineffectiveness of their SOPs by not providing their investors with quantitative indices regarding the bottom-line ineffectiveness of their SOPs. Specifically, they do not report the amount of vested stock that CEOs are allowed to unload going forward or the scope of backward-looking SOP-stock unwinding activity. Therefore, investors are unable to directly evaluate the ineffectiveness of these policies.

a. *Current SOPs fail to indicate the amount of vested stock readily available to be unloaded*

Current disclosures in firms' proxy statements fail to indicate the amount and percentage of vested stock that CEOs may unwind according to their SOPs. An investor who is interested in estimating this figure will have to make multiple calculations and assumptions but many times she will not be able to estimate this number at all. She will presumably start her search by gathering information from the "information on stock ownership of directors and executive officers" table in her firm's proxy statement. However, this table is governed by Section 16 to the Securities and Exchange Act, and does not follow the SOP framework. In particular, it does not follow SOPs counting policies and generally does not disclose unvested stock or unvested options.

Moreover, the vested stock number disclosed in the "Information on Stock Ownership of Directors and Executive Officers" table does not follow the SOP framework either. For example, shares in trusts, in deferred compensation accounts or in 401(k) plans should be disclosed in the said table but may not count to satisfy SOP requirements. In addition, disclosed counting policies are typically not as detailed as Section 16 requirements. Therefore, investors have to make multiple assumptions on whether certain types of stock specified in this table are counted to satisfy their SOPs requirements.

In order to gather information about CEOs' holdings of unvested stock, investors may research past and current information on the "Grant of Plan-based Awards Table" in multiple years' proxy statements. However, this table does not indicate whether CEOs sold their stock-based incentives and does not have vesting schedules. Therefore, more assumptions will be inevitable, and oftentimes investors' estimation of the vested stock that their CEOs may freely unwind will be materially wrong.

b. *Firms fail to disclose unwinding activity of stock counted for SOP purposes*

Despite related disclosure rules, investors do not have information on the unwinding activity of stock that counts towards satisfaction of SOPs. Section 16(a) of the Securities Exchange Act of 1934 requires CEOs, as well as other insiders, to report their individual stock purchases and sales on Form 4, within 48 hours of such activity.[120] Section 16(a) also requires these insiders to file an annual statement of beneficial ownership of securities on Form 5. However, the rules governing such reporting do not follow each individual firm's SOP counting policy, but rather are motivated by insider trading considerations and rules. Furthermore, Form 4 reporting is separate from the proxy statement, on which SOP is reported. Therefore, investors are not provided with relevant information as for their CEO's annual unwinding activity, per her SOP counting policy. Such information would have helped investors to evaluate the historical effectiveness of their SOPs and would help them to consider the need to strengthen these

[120] *See* 15 U.S.C. 78p(a).

policies.

2. Firms do not provide information regarding critical terms of their SOPs

I have just suggested that investors are not provided with any direct assessment of the effectiveness of their SOPs. Now I show that investors oftentimes are not provided with enough information that would allow them to form such an assessment on their own. In particular, investors are not provided with information about critical terms of their SOPs – terms that determine the effectiveness of these policies.

a. *Some 90% of SOPs do not disclose sanctions*

Only 45 out of 424 disclosed policies specify sanctions, which makes sanctions the least disclosed SOP term. This finding is troubling because the lack of a sanctions policy can render an SOP completely toothless and therefore ineffective. Although Boards posses inherent powers to impose sanctions on any violation of any corporate policy,[121] sanctions disclosure conveys a message of seriousness by the Board, under which the Board will not tolerate policy violations. Such a message should have a positive ex-ante deterrence effect. Unfortunately, firms have almost universally adopted a "lawyerly approach" and narrowly interpreted the general materiality test applicable under Regulation S-K[122] to avoid disclosure of their sanction policies.

b. *One third of SOPs do not disclose counting policies*

One third of existing policies are silent with regard to the type of stock that may be counted to satisfy their SOPs. Regulation S-K item 402(b)(2)(xiii) requires firms to disclose the "forms of ownership" recognized for their SOPs.[123] Many firms have interpreted this provision narrowly and merely stated that "stock" is the form of ownership required under their SOPs rather than describing their counting policies. As I report that many counting policies render their SOPs completely ineffective, especially by recognizing unvested stock, this common camouflage of counting policies precludes investors from evaluating the effectiveness of their SOPs.

Figure VII illustrates how the said opaqueness of counting policies adds on their ineffectiveness discussed in the previous Chapter and summarized in Figure VI:

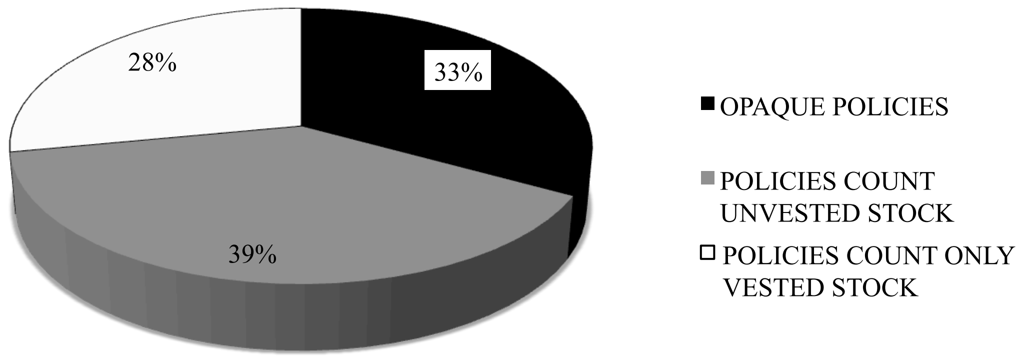
Figure 7: Ineffectiveness and Camouflage of Counting Policies

[121] *See* DEL. CODE ANN. tit. 8, § 141(a).

[122] Treas. Reg. § 229.402(b)(1)(2006) states that: "The discussion shall explain all material elements".

[123] *See* Treas. Reg. § 229.402(b)(2)(xiii)(2006).

Ineffectiveness and Camouflage of Counting Policies



Sample: Disclosed 424 SOPs

Among all disclosed SOPs one third do not disclose counting policies despite the crucial importance that counting policies have in evaluating SOPs. Most of the disclosed counting policies recognize unvested stock and are often rendered completely ineffective,[124] while merely 28% of policies disclose that they recognize only vested stock. Overall, I report a significant failure of firms to disclose counting policies as well as a significant failure of disclosed counting policies to be effective.

c. *Some 20% of SOPs do not disclose phase-in policies*

Almost one fifth of SOPs do not disclose their phase-in policies. Unlike with counting policies, Regulation S-K does not provide any specific guidance for counting policy disclosure and therefore the applicable legal standard for phase-in policies is a general materiality test.[125] Many firms chose to avoid disclosing their phase-in policies despite its clear importance for investors who are interested in evaluating the effectiveness of their SOPs. Such importance stems from the fact that as many as 40% of disclosed phase-in policies render SOPs inapplicable and thus ineffective.

Comparing the disclosure rates of sanctions, counting policies and phase-in policies reveals a selective disclosure pattern, according to which, firms tend to camouflage more aggressively critical provisions that may render their SOPs more ineffective or provide more valuable information to their investors. For starters, Lack of sanction policies can render SOPs completely toothless and hence ineffective, but sanction policies are the least disclosed policy. Second, counting policies render SOPs ineffective in only 58% of cases and vary quite significantly across firms, and they are the second least disclosed policy. Finally, phase-in policies are the most disclosed policies on this list despite their being the least valuable for investors. Phase-in policies posses the least valuable information for investors because only 40% of them render

---

124 59% of these 33% of policies are completely empty and the remainder is significantly weakened.

125 *Supra* note 121.

SOPs ineffective and the variation across disclosed phase-in policies is the most limited.

Moreover, because of the overall scarcity of disclosure regarding critical SOP terms, these policies have not been included in the standard databases that financial economists use for research on executive compensation. This, in turn, makes it harder for researchers and professional investors alike to make a fast, systemic and cheap assessment of the effectiveness of these policies.

B. *When SOPs disclose critical terms their functioning is not salient*

The discussion in section A highlights that firms deprive investors from information about their SOP effectiveness. In this section I turn to explain that, when firms *disclose* material terms of their SOPs, they do not indicate the impact of these terms on the effectiveness of their SOPs despite the fact that some of these terms render these policies highly ineffective. Similarly, some disclosed critical SOP terms are framed in an obscure way that might confuse investors to think that they do not render SOPs ineffective.

1. The impact of critical terms on SOP effectiveness is not salient

Firms fail to disclose that some critical terms of their SOPs render these policies ineffective or significantly crippling these policies. The most important examples are counting policies and hedging policies, both have the potential to render SOPs completely ineffective.

a. Current SOPs fail to disclose how counting unvested stock affects SOP potency

Despite its crucial effect on the effectiveness of current SOPs, current policies never indicate the effect of their counting policies on their SOP effectiveness. In particular, no policy indicates whether allowing the counting of unvested stock renders the policy ineffective. An example of such a policy is the 2012 SOP of KLA-Tencor Inc., which states:

> Unexercised options and unearned performance shares or units do not count for purposes of measuring compliance with the ownership guidelines. The value of unvested restricted stock or stock units is included in measuring compliance.[126]

KLA-Tencor discloses its detailed counting policy but it does not explain that this policy renders its SOP completely ineffective for its CEO. KLA-Tencor never mentions that the unvested stock held by its CEO, Richard Wallace, equals to more than four times his SOP threshold. The implication of this counting policy is that Mr. Wallace is in automatic compliance with his SOP without even holding a single stock that he owns. However, this material fact is not salient in KLA-Tencor proxy statement.

b. *Current SOPs fail to indicate the effect of hedging on their SOPs*

[126] *See* KLA-Tencor Inc., Proxy Statement (Schedule 14A) at 59 (September 27, 2012).

It is important for investors to know how actual hedging activity conducted by their managers interferes with the economic incentives allegedly provided by their SOP stock. Firms argue that their SOPs tie managerial wealth to shareholder wealth over the long-term, and that this is the mechanism by which their SOPs mitigate risk and encourage long-term value creation. However, as explained in Chapter V, CEOs may hedge their SOP stock and thereby nullify the incentives provided by their SOPs.

The recent Dodd-Frank Act tightened the reporting obligations imposed on firms with regards to hedging transactions of their directors or employees. Before the Dodd-Frank firms were already required to report with the SEC derivative transactions made by their executives.[127] Section 955 of the Dodd-Frank Act extended the hedging reporting requirements by mandating firms to disclose whether their directors and employees are permitted to hedge any decrease in market value of the company's stock.[128]

However, firms are not required and never indicate the effect of stock hedging conducted by their managers on the economic incentives that their SOP stock is held to attain. This is particularly important because, as I report in Chapter V, only 2 firms in my sample do not count stock subject to hedging. Therefore, fully hedged stock held by an executive is almost always counted to satisfy her SOP but at the same time investors are kept in the dark as for how such hedging affects the effectiveness of their SOPs.

Investors are unable to reasonably infer the nullifying effect of hedging on the incentives provided by their SOPs. First, when counting policies are obscure, investors cannot infer whether hedging activity relates to stock held pursuant to an SOP or to stock held voluntarily by the executive. Second, current hedging disclosure rules do not cover all potential hedging activity. Section 955 of the Dodd-Frank only requires disclose of corporate permission to hedge rather than an actual hedging activity conducted by executives and directors. Reporting under Forms 3,4 and 5 only requires insiders to report acquisitions or dispositions of derivative securities. However, acquisition of stock of competitors or stock or indices of industries that have a negative correlation with the firms stock may have a similar hedging outcome but may not be reported.[129] Finally, even when the full hedging activity is disclosed, it may be hard for investors to infer the effect of the hedge on SOP incentives. For example, the strike price of the hedge, the expiration

---

[127] Forms 3, 4 and 5 require insiders to report acquisitions or dispositions of derivative securities "of any class of equity securities of the issuer and the beneficial ownership of that class of securities following the reported transaction(s)." Form 3 should be filed after a company IPO when insiders make their initial transactions. *See* 17 C.F.R. § 249.103 (2012), *available at* http:// www.sec.gov/about/forms/form3.pdf; Form 4 should be filed before the end of the second business day following the day on which the transaction has been executed. *See* 17 C.F.R. § 249.104 (2012), *available at* http://www.sec.gov/about/forms/form4.pdf. Form 5 should be filed annually. 17 C.F.R. § 249.104 (2012), *available at* http:// www.sec.gov/about/forms/form4.pdf; and 17 C.F.R. § 249.105 (2012), *available at* http:// www.sec.gov/about/forms/form5.pdf.

[128] *See* 15 U.S.C.A. SEC. § 78n(j).

[129] *Id.* Forms 3, 4 and 5 require insiders only to report acquisitions or dispositions of derivative securities "of any class of equity securities of the issuer and the beneficial ownership of that class of securities following the reported transaction(s)."

date, and the relation to other hedges may require an advanced sophistication. Therefore, in the current state of affairs, investors cannot reasonably gauge the effect of their CEOs' hedging on the incentives that their SOPs are held to attain.

2. Critical SOP terms are obscure

The second way in which SOP disclosure is not salient happens when critical terms of SOPs are obscure or confusing. It is not only important that investors are informed directly about the effectiveness of their SOPs and that they can confirm such assessment by themselves. It is also important that investors are unequivocally informed when critical terms that render SOPs ineffective are incorporated.

a. Target thresholds are typically obscure

The use of the term "salary" in describing the target thresholds of current SOPs is obscure. The median policy, as indicated above, requires CEOs to hold 5 times their "base salary", or "salary".[130] While for most employees, "salary" means total compensation, it means only less than 12% of total compensation for the median S&P 500 CEO.[131] Therefore, the median SOP threshold amounts to less than 60% of the median CEO's single annual total compensation.

The rational for having SOPs in the first place makes it harder to infer that the definition of "salary" does not include the stock portion of executive pay. SOPs aim to regulate only the stock portion of executive pay and to translate the dramatic increase in stock-based compensation into managerial ownership. Putting aside the doubtful wisdom behind linking SOPs merely to the non-stock portion of executive pay, it is counter-intuitive to infer that target thresholds of SOPs are only linked to the non-stock portion of executive compensation.

b. ***Counting policies are commonly obscure***

It is important for investors to unequivocally know when their SOPs allow the counting of unvested stock. The reason is that counting unvested stock renders SOPs completely ineffective in almost 60% of the cases and significantly weakens these policies in the remainder of policies.

Nonetheless, firms that count unvested stock commonly camouflage the fact that they count stock not owned by the executive. In particular, they frame the holding of unvested stock, stock not owned yet by the executive, as "ownership". The counting policy of AK Steel demonstrates this:

---

[130] I report only one firm, Chesapeake Energy Corp., that includes annual bonus as part of their SOP salary multiple. Such inclusion increases their SOP salary multiple from 5x to 15x of their CEO's base salary.

[131] In 2011, the median S&P 500 CEO was paid a total compensation of some $8.7m, while her base salary was $1m. Her equity compensation amounted to some $5.5m, her annual bonus was some $2.1m, and she earned other compensation of $0.1m. *See* Equilar, *supra* note 7, at 13.

> "Ownership" includes... shares of Company restricted stock held directly by an Executive Officer, whether or not yet vested.[132]

AK Steel uses the phrase "ownership" to describe stock not owned yet by the executive, hence unvested stock. Stating that "ownership" includes stock that is not owned yet by the executive might confuse investors and obstruct them from realizing that these provisions render their SOPs completely ineffective.

C. Reasons why the camouflaging of SOP ineffectiveness is Troubling

The discussion in this Chapter and in Chapters V highlights the ineffectiveness of current SOPs and the camouflaging of this ineffectiveness. Before turning to put forward a regulatory reform to make SOPs transparent, it is important to explain why the camouflaging of SOPs is troubling and why investors should be informed about the effectiveness of their SOPs.

1. Managers may have disguised incentives to take inappropriate risks and to run their firms for the short-term

Current SOPs may not provide managers with adequate incentives to maximize long-term value and to avoid excessive risk-taking. Firms advertise their SOPs as a key element in their risk mitigation and long-term value creation. They argue that SOPs attain this by tying managerial wealth to long-term shareholders wealth. Effective SOPs, like the current SOPs of Exxon Mobil and Goldman Sachs, are expected to provide significant incentives to managers to maximize long-term value. However, I show in Chapter V that SOPs are extremely ineffective. Consequently, I conclude that SOPs do not live up to the expectations firms have created.

Therefore, the camouflaging of limp SOPs may disguise managers' incentives to take inappropriate risks and to seek short-term gains. Had the ineffectiveness of current SOPs been transparent, outsiders would have known that SOPs do not live up to the expectations firms have created and that they do not tie managerial wealth to this of long-term shareholders. Outsiders might mistakenly believe that SOPs are effective enough to force managers to hold significant amount of their vested stock for the long term, and that their stock holdings encourage them to maximize long term firm value.

2. The lack of transparency is consistent with excessive managerial power

The second explanation for the camouflaging of SOP ineffectiveness is that executives will oppose making their ineffective SOPs transparent in order to reduce the likelihood that they will have to incur the costs associated with subjecting themselves to effective SOPs. The board of directors, in turn, will be reluctant to make SOPs transparent against executive's wishes.

---

[132] *See* AK Steel Corp., Proxy Statement (Schedule 14A) at 37 (Apr. 12, 2010).

Executives will support the camouflaging of their ineffective SOPs. As I discussed in Chapter I, effective SOPs are costly for executives, both in terms of liquidity and in terms of diversification. The camouflaging of SOPs makes it hard and costly for outsiders, such as shareholders, to detect their ineffectiveness. This, in turn, makes it less likely that these outsiders will exert pressure on firms to make their SOPs more effective and make executives incur the costs associated with such effective policies.

For a variety of reasons, directors will be reluctant to make SOPs transparent against executive's wishes. As Bebchuk and Fried argued, for financial, social, and psychological reasons, it is personally difficult for directors in public firms to support compensation decisions that are costly for executives.[133] Thus, a director who was put on the board by the CEO might feel uncomfortable to suggest making transparent the fact that the SOP applicable to the CEO is completely ineffective. With SOPs directors suffer from an inherent conflict of interests, because directors typically subject themselves to SOPs similar to the ones that apply to executives, but with lower thresholds. Therefore, it will be against the director's self interest, for example, to make it transparent that a counting policy of an SOP is ineffective if the same policy applies to her.

Managers' ability to camouflage the ineffectiveness of their SOPs also explains why firms adopted SOPs virtually universally. Having SOPs creates the impression that managerial interests are consistent with sound risk management and maximization of shareholder value. This, in turn, generates reputation gains for executives. The ability to adopt ineffective SOPs while camouflaging their ineffectiveness allows executives to have their cake and eat it too. Namely, executives can reap the reputation gains from having SOPs without incurring the personal costs associated with having effective SOPs.

Excessive managerial power can also explain why firms tend to disclose their SOP provisions selectively and camouflage more aggressively provisions that render their policies more ineffective. First, the transparency of provisions that render SOPs more ineffective is more damaging to executives' reputation, and therefore it is more important for executives to camouflage these provisions. Second, making these limp provisions transparent increases the most the likelihood that outsiders will pressure firms to change these provisions and impose direct diversification and liquidity costs on executives.

Excessive managerial power is also consistent with firms avoiding from disclosure of sanctions, which leaves significant room for board discretion. In another article, Jesse Fried and I argued that excessive managerial power might explain why directors are likely to leave discretion for themselves before penalizing executives.[134] Because executives have significant power and influence over directors, it is likely that boards will avoid from penalizing executives severely for violating their SOPs. Consistent with this view, I report earlier in this Chapter that the sanctions that firms

---

133 *See, e.g.,* BEBCHUK & FRIED, *supra* note 48, at 23–27 (describing sources of executives' influence over directors in public firms).

134 *See* Jesse Fried & Nitzan Shilon, *Excess–Pay Clawbacks*, 36 J. CORP. L. 722, 739 (2011) (explaining that requiring directors to recoup excess-pay, without leaving discretion to the board, is the only way to ensure that such recovery occurs).

disclose for SOP violations are ineffective and that most of these so-called sanctions do not involve any penalty.

3. The lack of transparency prevents an informed dialogue on how SOPs should be designed

The lack of transparency denies investors, firms, public officials and governance reformers access to accurate assessments of current SOPs. When managers keep the information on the effectiveness of their SOPs away from outsiders, outsiders do not have the tools to conduct an informed dialogue with managers on how SOPs should be designed. Therefore, making SOPs transparent is an essential step in facilitating a constructive process to improve current SOPs.

D. Potential objections to my ability to detect camouflage

One might argue that camouflage cannot be revealed by any outside observer. However, for camouflage to be successful in practice, it should not necessarily be impervious to detection. Even if a diligent and dedicated researcher can obtain information on SOP effectiveness by sifting through stacks of reports filed with the SEC, requiring firms to compile and report transparent and salient information regarding their SOPs would highlight for all investors the function of these policies.

The 1992 reform that set standards for how information about executive pay must be presented can demonstrate this matter. Before 1992, the SEC required firms to report executive compensation but allowed them to do it in a format that of their choosing. An SEC official describes the pre-1992 camouflage of the amount and form of executive pay:

> The information was wholly unintelligible… The typical compensation disclosure ran ten to fourteen pages… [Y]ou might get reference to a $3,500,081 pay package spelled out rather than in numbers. That gives you an idea of the nature of the disclosures: it was legalistic, turgid, and opaque; the numbers were buried somewhere in the fourteen pages. Someone once gave a series of institutional investor analysts a proxy statement and asked them to compute the compensation received by the executives covered in the proxy statement. No two analysts came up with the same number. The numbers varied widely.[135]

Therefore, the 1992 disclosure reform, that required standardized compensation tables that now firms must use, made camouflage more difficult. Similarly, a disclosure reform is needed in order to make SOP camouflage harder. Moreover, I report a significant proportion of firms that provide information of their SOPs that does not allow any effectiveness assessment, even for the diligent and dedicated researcher. Therefore, the case for SOP disclosure reform might even be more justifiable than the 1992 SEC

---

[135] *See* Linda C. Quinn, *Executive Compensation under the New SEC Disclosure Requirements*, 63 U. CIN. L. REV. 769, 770-71 (1995).

disclosure reform.

Finally, for camouflage to be successful in practice, it is enough that market leaders do not detect it. In the SOP context, the market leaders are the institutional investors, who typically follow the ISS guidelines. Unfortunately, firms can score the highest on GRId and still have completely ineffective SOPs. According to GRId, when a policy requires a six times base salary multiple and a two-year holding period, it gets the highest score. However, as my analysis suggests, limp counting policies, phase-in periods and sanctions, as well as hedging activity, render SOPs completely ineffective even when the policy scores high on GRId.

VI. MAKING SOPS TRANSPARENT

The camouflaging of the extreme ineffectiveness of current SOPs hinders an informed discussion on how SOPs should be designed. Therefore, I turn to discuss my proposal to make SOPs transparent.

A. Proposal to reform Regulation S-K

Regulatory intervention may take different courses of action. The most aggressive intervention would be implementation of mandatory rules for SOP design. This option is not desirable for SOPs, as there is no one SOP prescription that fits all firms.

A less intrusive policy might suggest default SOP rules. This will allow some market forces to tailor the desirable policy to the needs and circumstances of each firm, but the outcome will likely be affected by these default rules.[136] Thus, this course of action might be desirable for certain SOP elements, such as counting policy or sanctions, that happen to consistently be an Achilles' heel in many SOPs. However, as a first step I prefer to take the least intrusive measure that is expected to improve current SOPs.

Making the effectiveness of SOPs transparent and salient should allow shareholders, boards and policy makers to engage in a dialogue to improve current SOPs, according to each firm's individual characteristics. This course of action is the least intrusive, as it does not prescribe any substantive intervention. Transparency is particularly important in the case of SOPs, because SOPs are not one-size-fit-all, and hence, the healthy operation of market forces is necessary in order to provide checks on boards in tailoring the right policy for each firm. Therefore, I put forward a proposal to make SOPs transparent.

1. Disclosure of quantitative indices for SOP bottom-line effectiveness

I propose to revise Regulation S-K, Item 402, and to require disclosure of quantitative indices for SOP bottom-line effectiveness. In particular, firms should be

---

[136] *See* Russell B. Korobkin, *The Status Quo Bias and Contract Default Rules*, 83 CORNELL L. REV. 609 (1998) (explaining that default rules can change the outcome, because equilibrium can be path dependent).

required to add an SOP section to their "Common Stock and Total Stock-based Holdings" table in their proxy statements. The SOP section should include three columns, as follows: (1) the separate values of vested and unvested equity held by each of the top-five executives that is recognized by her SOP counting policy; (2) the percentage and value of vested and non-hedged equity that any top executive is allowed to immediately unload; and (3) the percentage and aggregate value of equity recognized by its SOP that each of its top-five executives sold during each of the previous three years. This information will provide investors some minimum information as for the effectiveness of their firm's SOP.

This quantitative information is crucial to enable investors to evaluate the overall effectiveness of their firms' SOPs. Whereas the first indicator makes a clear assessment of managerial SOP holdings, the second indicator provides an important bottom-line effectiveness check, while the third indicator looks back to report investors the actual unloading of SOP security instruments. Such transparency would highlight for all investors the extent to which their managers have used and may use their freedom to unwind their equity grants.

2. Disclosure of qualitative indices for the functioning of SOPs

In addition to providing indices for SOPs' bottom-line quantitative effectiveness, firms should be required to provide qualitative data about the functioning of their SOPs. In particular, the following additional information should be disclosed in firms' SOP narrative section: (1) SOP counting policy, and specifically the type of stock-based holdings that are counted towards satisfying the firm's SOP, with a special emphasis on unvested stock and hedged stock. When an SOP recognizes unvested or hedged stock, the policy should disclose the percentage of its SOP threshold that is satisfied by counting that unvested or hedged stock; (2) the applicable SOP phase-in periods for each executive and whether such executive have phased-in yet; and (3) the sanctions, if any, that executives face if they violate their SOPs.

This qualitative information on SOP design proved to be important in this Article. Counting unvested stock render many SOPs empty, and counting hedged stock has the potential to have the same effect. Investors should take a particular notice on counting policies, together with the quantitative information suggested before. Sanctions are mostly declarative. However, they can improve the quality of discourse between managers and investors and indicate to the markets how seriously firms take their SOPs.

Improved disclosure of SOP design and effectiveness would, at a minimum, significantly improve the accuracy of investor information regarding their top executives risk-taking incentives and stock-based securities that they may sell and could also contribute to the improvement of SOP practices, all the while imposing minimal compliance costs upon firms. More rigorous SOP disclosure requirements will aid in the efforts to make sure that SOPs serve the important goals they propose to attain.

My proposal to reform Regulation S-K is cheap to implement because firms generally already have low-cost access to provide the information I propose.[137] Undoubtedly, firms can obtain this information at lower cost than can shareholders or researchers.[138] Executives are already required to report their trades with their company's stock within 48 hours,[139] and boards, in performing their general supervisory role, should already process this information and determine how these trades affect their top executives' compliance with their SOPs.

3. Example of how my proposal to reform Regulation S-K would change disclosure

Consider how my proposal to reform Regulation S-K would have changed the 2010 SOP disclosure of Coca Cola Enterprises, Inc. ("Coca Cola"). Coca Cola disclosed its SOP as follows:

> Our stock ownership policy requires that each senior officer acquire and maintain significant levels of company stock, generally within five years of becoming subject to the policy. The ownership levels are determined as a multiple of the senior officer's base salary: five times for the CEO… An officer's current ownership level, which is reviewed annually, is determined by including shares owned by the officer or an immediate family member, 60% of the value of shares underlying in-the money options, and all performance stock units or restricted stock units for which the performance conditions to vesting have been met.[140]

First, I propose to require firms to disclose the value of equity, vested and unvested, held by their top executives and recognized by the counting policies of their SOPs. As for its CEO, Coca Cola should disclose that John F. Brock holds some $135m worth of equity recognized by his SOP, and that over $71m of which is unvested equity. In the case of Coca Cola, over $54m worth of unvested stock (and another $17m worth of stock underlying unvested options) held by Mr. Brock is counted toward his SOP. Such stock is not vested yet despite its satisfaction of Coca Cola's SOP condition that performance conditions should be met. The reason is that the vesting of this performance stock is still conditioned on continued employment of Mr. Brock through a future date.

Second, I propose that firms should be required to disclose the percentage and value of vested and non-hedged equity that any top executive is allowed to unload at any time. Coca Cola should provide us with specific hedging information for Mr. Brock and all other top executives. If Mr. Brock did not hedge his vested stock of Coca Cola, Coca

[137] For a detailed analysis of the low costs generally associated with mandatory disclosure of the type I propose here, *see* Allen Ferrell, *The Case for Mandatory Disclosure in Securities Regulation Around the World,* 2 BROOK. J. BUS. L. 81 (2007).

[138] For an economic justification of mandatory disclosure grounded in the notion that firms are the lowest-cost obtainers of most information relevant to securities valuation, *see* Paul G. Mahoney, *Mandatory Disclosure as a Solution to Agency Problems*, 62 U. CHI. L. REV. 1047, 1048-49 (1995).

[139] *Supra note* 120.

[140] *See* Coca Cola Enterprises, Inc., Proxy Statement (Schedule 14A) at 36 (Mar. 5, 2012).

Cola should disclose that its SOP allows Mr. Brock to immediately sell all of the over $63m worth of vested stock of Coca Cola that he owns. A similar disclosure should be made for Coca Cola's other top executives.

Third, I suggest that firms will be required to disclose the aggregate figures of executive unloading activity of stock recognized by their SOPs during each of the previous three years. Coca Cola should be required to process the relevant information from its various Form 5's and incorporate it into its SOP section of its proxy statement. The top-five executives of Lehman Brothers and Bear Sterns sold stock worth $1.1 billion and $850 million respectively during 2000-2008, but disclosure of these aggregate numbers was never made.[141]

Finally, in terms of the qualitative indices, I suggest that companies fully disclose the counting policies of their SOPs, with a special emphasis on counting unvested stock. Coca Cola discloses a detailed counting policy. However, my proposal would require Coca Cola to make it salient that Mr. Brock satisfies his SOP requirements exclusively by counting stock that he does not own yet. It will also require Coca Cola to disclose its sanctions policy.

B. Greater transparency should improve current SOPs

I expect that better transparency will improve the actual content of SOPs because not only that investors and boards will know better what these policies do but they will act on this information. First, boards will be able to evaluate these policies better and be motivated to improve them. There is no direct evidence that indicates that currently boards process the information provided to them and therefore are aware of the information I propose to disclose. Also, when SOPs are transparent, outrage costs[142] may move boards to reform SOPs in order to avoid embarrassment and social costs associated with having extremely ineffective SOPs while declaring that these policies serve key element in mitigation of risk. Past experience indicates that social costs can significantly affect board behavior. For example, boards were more likely to remove the executives responsible for stock option backdating when there was greater media attention.[143]

Second, better disclosure will make shareholder action cheaper and alleviate their collective action problems.[144] Currently, if a shareholder wishes to push for a policy to be

---

[141] *See* Bebchuk et al., *supra* note 32, at 272.

[142] Outrage costs are the social and economic costs that managers suffer when outsiders perceive certain pay arrangements as unjustified or even abusive or "outrageous". *See* BEBCHUK & FRIED, supra note 48, at 65.

[143] *See* Margarethe F. Wiersema & Yan Zhang, *Executive Turnover in the Stock Option Backdating Wave: The Impact of Social Context* (Mar. 2011) (unpublished manuscript) (presented at the 2011 University of Missouri Corporate Governance Conference), http://muconf.missouri.edu/corporate_governance/abstracts/Session%205%20%20Zhang%20Conference%20Paper.pdf.

[144] The term "collective action problem" for investors describes the situation in which multiple shareholders would all benefit from a certain action (such as exerting pressure to improve their firms'

improved he or she would need to expand considerable resources to obtain a clear picture on how the policy functions. In some instances it is impossible to evaluate the effectiveness of the policy even when considerable resources are being expanded. With transparency a shareholder would not have to expand considerable resources in order to evaluate the effectiveness of the policy and he will always be able to get a clear picture of this effectiveness. Better disclosure will also assist institutional investors in identifying systemic problems regarding SOPs in their portfolio and in evaluating proposed SOP reforms.

Third, the current camouflage of SOP ineffectiveness indicates that managers are probably concerned that shareholders would have exerted pressure on boards to reform their policies had they known the current ineffectiveness of most SOPs. If managers believed that the ineffectiveness of their SOPs is perceived positively, they would have made it salient.

Fourth, revealing the ineffectiveness of current SOPs might urge public officials and governance reformers to regulate the content of current SOPs. In a similar context, the government responded to the 1992 disclosure reform of executive pay[145] by capping executive pay to $1,000,000 in 1993.

Finally, the December 2006 SEC reform of executive pensions disclosure suggests that the kind of disclosure I propose should improve the actual content of SOPs. In 2005, Bebchuk and Jackson revealed that the amounts of executive pensions were systematically camouflaged.[146] The authors based their analysis on public filings. The SEC agreed both that the pension amounts were high and that they were being camouflaged. Accordingly, in December 2006 the agency reformed its disclosure rules and required that the value of pensions be made transparent, and thereby placed executive pension plans on investors' radar screen. Following the pensions disclosure reform, market prices responded and better reflected the real value of executive pensions. In particular, bond prices increased, equity prices fell, firm risk decreased, and value shifted from equity toward debt holders.[147]

The camouflaging of current SOP ineffectiveness is at least as severe as executive pensions before the SEC reform of December 2006. One might even argue that SOP camouflage today is even more severe than pensions were in 2006, because unlike with pensions before December 2006, one quarter of current SOPs cannot be evaluated at all, even if extensive assumptions are made.

SOP), but has an associated cost making it implausible that any one individual will find it cost-effective to undertake this action alone.

[145] *See* 26 U.S.C. §162(m)(1) (2000) ("In the case of any publicly held corporation, no deduction shall be allowed under this chapter for applicable employee remuneration with respect to any covered employee to the extent that the amount of such remuneration…exceeds $1,000,000."). In 1992, the SEC tightened its disclosure rules by providing standards for how information about executive pay must be presented.

[146] *See* Lucian A. Bebchuk & Robert J. Jackson, *Executive Pensions*, 30 (4) J. CORP. L. 823 (2005).

[147] *See* Chenyang Wei & David Yermack, *Investor Reactions to CEOs' Inside Debt Incentives,* 24 (11) REV. FIN. STUD. 3813 (2011).

C. Potential objections to my proposal to reform Regulation S-K

Critics may argue that shareholders do not want their firms to adopt effective SOPs because most U.S. shareholders seek short-term gains, and therefore, they want managers to have short-term incentives.[148] Based on the NYSE index data, the mean duration of holding period by US investors was around 7 years in 1940. This stayed the same for the next 35 years, but has fallen sharply to around 5 months only. Moreover, short-term trading has become the dominant force in the U.S. capital market, accounting for about 78% of total dollar trading volume and bringing total share turnover to over a 100% per quarter in recent years.[149]

However, institutional investors rather than short-term traders are the most relevant investors when it comes to corporate governance. Direct individual ownership in the U.S. fell from 60% of the market to 40% between 1991-2009, institutional investors became the dominant investors in the U.S. markets, and the expansion of institutional investors is set to continue[150]. Institutional investors, and especially pension funds and life insurers, traditionally have investment horizon tied to the often long-term nature of their liabilities.[151]

Second, critiques may be concerned that making SOPs transparent might not bring a change to these policies because it may not encourage firms to change the actual content and design of their SOPs. Rather, firms may prefer to leave their SOPs intact and explain why they choose to adopt ineffective policies. Consistent with this view, some firms, like Viacom Inc., currently disclose that they choose not to adopt SOPs and provide explanation for that.[152]

---

[148] *See* Patrick Bolton, Jose Scheinkman & Wei Xiong, *Executive compensation and short-termist behavior in speculative markets*, 73 REV. ECON. STUD. 577 (2005).

[149] *See* X. Frank Zhang, *Investor short-termism and asset pricing* (November 2011) (unpublished manuscript), http://mba.yale.edu/faculty/pdf/zhangxf_Investor_short_termism.pdf (last visited November 19, 2012).

[150] EUROFI FIN. SER. IN EU., PROMOTING LONG-TERM INVESTMENT BY INSTITUTIONAL INVESTORS: SELECTED ISSUES AND POLICIES, OECD DISCUSSION NOTE, PARIS, 17-18 FEB. 2011.

[151] Recently, institutional investors are being labeled as “short-termist”. Sign of such growing short-termism include the fact that investment holding periods are declining, and that allocations to less liquid, long-term assets are generally very low and are being overtaken in importance by allocations to hedge funds and other high frequency traders. Other related concerns over the behavior of institutional investors are their herd-like mentality and their tendency to being “asleep at the wheel”, failing to exercise a voice in corporate governance. However, these concerns do not change the basic long-term incentives that institutional investors have and now there is trend for more “responsible” and longer-term investment among institutional investors, in particular pension funds, life insurers and mutual funds that operate in retirement savings arrangements. *See id*, at 4.

[152] *See* Viacom Inc., Proxy Statement (Schedule 14A) at 42 (Apr. 16, 2010) (stating that: “Given the significant stock ownership of Messrs. Redstone, Dauman and Dooley ($1.3 billion, $9.5 million and $7.9 million as of February 28, 2010), as well as the significant equity holdings (with multi-year vesting schedules) of our executive team, the Committee believes senior management is appropriately incented to manage the business in line with stockholders’ interests and has not established specified executive stock ownership requirements.”)

One cannot assure that my proposal will be enough to trigger a change to SOPs even if such a change is desirable. However, without information shareholders will not be able to do much in order to improve current SOPs. Also, I showed in section A.2. to this Chapter that the proposal advocated by this Article will not impose meaningful costs on firms. Therefore, even if some critics have doubts about the utility of making SOPs transparent, it is still worthwhile to do so.

Finally, some people may argue that the enhanced disclosure I propose might trigger unintended consequences such as pushing companies to adopt overly restrictive SOPs. Such policies could increase managers' liquidity and diversification costs and, hence, might push executive compensation up. In addition, overly restrictive SOPs could destroy more value by making managers too risk averse. Considering the history of congressional attempts to reform executive compensation, unintended consequences along the lines that caused the surge in overall executive compensation as a result of stock options and bonuses following the §162(m)[153] attempt to cap executive salaries in 1993 should not come as a surprise.[154]

However, our experience with the market response to the 2006 SEC pensions enhanced disclosure reform alleviates this concern. Making pension payment salient did not trigger an increase in the amount of pensions. Rather, the adjustment of market prices in connection with pension transparency suggests that we should expect an efficient improvement in current SOPs when they become transparent.

VIII. CONCLUSION

This article investigates current SOPs. These policies were universally adopted as a response to a widespread pressure in the aftermath of the 2008-2009 financial crisis and are advertised as a key element in mitigation of risk. The U.S. regulatory approach to SOPs left the decisions on adoption and design of these policies to firms' determination, while disclosure requirements were limited. Therefore, investigation of these policies is important for testing the current disclosure approach.

My results suggest that current SOPs are extremely ineffective and that their ineffectiveness is camouflaged. These policies are extremely ineffective, yet they are held to attain important goals. The combination of widespread adoption of ineffective policies together with the camouflaging of these policies is troubling and indicates that current SOPs disguise CEOs incentives to take excessive risks and to pursue short-term gains. It raises concerns that these policies are unable to fulfill the objectives they are held to attain and that they reflect excessive managerial power.

A regulatory reform that will focus on making SOPs transparent should improve the actual content of SOPs in public firms. It will be a cheap and easy way to facilitate an

---

[153] *See* 26 U.S.C. §162(m)(1) (2000).

[154] *See* Ryan Miske, Note, *Can't Cap Corporate Greed: Unintended Consequences of Trying to Control Executive Compensation Through the Tax Code*, 88 MINN. L. REV. 1673, 1687 (2004) (describing the eventual rise in overall executive compensation following the §162(m) attempt to cap executive pay).

informed assessment of SOPs, which will enable constructive discussion on how SOPs should be designed. Having both qualitative and quantitative indices of SOPs on the table is expected to help boards and investors in their efforts to improve SOPs. I also hope that my framework and analysis in this Article will be useful to firms, investors and policymakers in their endeavors to better SOP design. The case for making SOPs transparent is set.