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CEO STOCK OWNERSHIP POLICIES – RHETORIC AND REALITY

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Abstract

This paper is the first academic endeavor to analyze the efficacy and transparency of current stock ownership policies (SOPs) in U.S. public firms. SOPs generally require managers to hold some of their firms' stock for the long term. Following the 2008 financial crisis, firms universally adopted these policies and cited them more than any other policy as a key element in their mitigation of risk. However, my analysis of the current SOPs of S&P 500 CEOs disputes what firms claim about these policies. First, I find that SOPs are extremely ineffectual in making CEOs hold on to their firm's stock; this is because the way these policies function generally allows CEOs to immediately unload virtually all the stock they own. Second, I show that firms camouflage this weakness in their public filings. I explain why my findings are troubling, and I propose a regulatory reform to make SOPs transparent. Transparency can be expected to push boards and shareholders to improve the actual content of these policies.

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

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INTRODUCTION

Since 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 at the expense of long-term value.[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. In addition to shareholder pressure, prominent public officials have emphasized the importance of SOPs,[2] [3] business leaders have stressed the need for them,[4] and proxy-voting firms have rewarded firms for adopting them.[5] As a result, the prevalence of SOPs reached an all-time high of 95% among the top 250 U.S. public firms in 2013.[6]

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[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 MINISTERS AND CENT. BANK GOVERNORS, 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 that "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] Despite its general approach against regulating the substance of corporate governance provisions, the federal government prescribed strict SOPs for all Troubled Asset Relief Program (TARP) recipients. Specifically, 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).

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

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

[6] *See* Meridian Compensation Partners, LLC, *2013 Corporate Governance & Incentive Design Survey* (fall 2013), at 11.

Firms have adopted SOPs and have held them to attain very important goals. One goal is to align the interests of managers with those of their long-term shareholders. When SOPs tie managers' personal wealth to their firms' long-term value, managers have greater incentives to maximize such value. Empirical studies support this view and show that when management ownership rises, in widely held firms, firm value increases significantly.[7] Consistent with this theory, when Facebook cofounder and CEO Mark Zuckerberg announced on September 4, 2012, that he would keep his Facebook stock for at least the next year, Facebook's stock price rose by 5%.[8]

Second, because firms claim that their SOPs discourage excessive risk taking, they commonly cite those policies as a key element in their mitigation of risk.[9] The theory is that without SOPs, managers who have inside information and are allowed to sell a significant amount of stock quickly might have incentives to elevate the firm risk and increase stock price volatility. Such managers expect to profit from the higher volatility in stock price by pocketing greater amounts if they hold on to their stock while the price increases and avoiding greater losses if they sell their stock before the price plummets.

Third, firms hold their SOPs to discourage managers from sacrificing the long term for the short term. It should happen when these policies do not allow managers to take actions that would boost the stock price in the short term, even if those actions would pile up latent and excessive risk of an implosion later on. They might take these actions because their freedom to unload their stock allows them to keep their stock during the short-term stock price increase and sell their stock thereafter. Such managers do not necessarily expect to know if and when such implosion will actually materialize, so they might sell enough stock gradually, protecting themselves from a possible future collapse. A 2010 study suggests that such incentives played a role in the risk-taking decisions of the top five executives at Bear Stearns and Lehman Brothers during the years preceding their firms' meltdowns in 2008.[10]

In addition to what firms claim about their SOPs, these policies should fulfill an important function by tying pay to performance. Without effective SOPs, CEOs who

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[7] *See, e.g.,* Randall Morck, Andrei Shleifer, & Robert W. Vishny, *Management Ownership and Market Valuation*, 20 J. FIN. ECON. 293 (1988) (reporting that Tobin's Q first increases, then declines when ownership becomes concentrated, and finally rises slightly as ownership by the board of directors rises).

[8] *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/. While the company's stock price rose 5% on the day after Zuckerberg's announcement, it still remains at nearly 50% below the initial public offering (IPO) price).

[9] *See* Press Release, Equilar Inc., *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.

[10] *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 2000–2008, the years that led to the credit crisis). However, commentators disagree on whether poor incentives contributed to the recent crisis, as discussed in footnote [ ].

have performed poorly may nevertheless earn a salary that is not commensurate with their performance. They might even generate profits by taking excessive risks.

Finally, these policies are important because they 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 1990s pushed stock-based compensation so high that the average CEO of an S&P 500 firm today earns some two-thirds of his or her total pay in this form,[11] and the stock-based compensation of the top five executives in public firms amounts to some 7% of these firms' total earnings.[12]

However, while in theory SOPs are important, in practice they are paper tigers. Using statistical analyses of quantitative and qualitative data disclosed in S&P 500 firms' proxy statements,[13] I show that these policies are extremely ineffectual in making CEOs hold on to their firms' stock and, in fact, typically allow CEOs to unload virtually all their vested stock whenever they wish.[14] For example, the SOP of UPS would not prevent its CEO, Scott Davis, from immediately selling all his vested UPS stock—worth over $41 million—should he choose to do so. Moreover, a recent study shows that most top executives take full advantage of their freedom to unload their firms' stock and engage in massive stock selling.[15]

This article is the first academic endeavor to discuss both the ineffectiveness and the lack of transparency of SOPs. My research indicates that the ineffectiveness of current SOPs is driven by their design. In particular, firms generally fail to employ robust frameworks that require managers to always retain some of the stock they receive as compensation. Instead, the vast majority of SOPs require managers to hit a certain stock ownership threshold in the future but they are sabotaged in several different ways by their own design.

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[11] *See* Equilar Inc., *2013 CEO Pay Strategies: Compensation at S&P 500 Companies* (Feb. 2013), at 18 (reporting that in 2012 the median S&P 500 CEO was paid a total compensation of some $9.7 million, while her stock-based compensation amounted to some $6 million).

[12] *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).

[13] 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 for assessing how management is paid and what potential conflict-of-interest issues may arise with auditors.

[14] Vesting periods define when managers "earn" their stock options or restricted stock. Vesting periods in the United States are usually three to five years for executives but are shorter for board members. Typically, each year the executive earns the pro-rated amount of his or her equity grant. For example, when an executive is granted 300 restricted stock with a three-year vesting schedule, that CEO will typically own 100 stock after one year, another 100 stock after two years, and the remaining 100 stock after three years. SOPs define the post-vesting stock holding requirements.

[15] *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 60% of top executives in S&P 1500 firms sell firm equity at least once during their tenure, with the median sale equal to 15% of the executive's total holdings in the firm).

First, common SOPs allow managers to count their unvested stock—stock that they do not own yet[16]—to satisfy their SOP requirements, and for the CEOs who do this, it is usually their only effort at compliance with those policies. For example, Mr. Davis satisfies his $8.4 million UPS SOP requirement solely by counting $12.3 million worth of stock he does not own yet.

Second, the average SOP sets its target stock-holding threshold as low as 60% of a single year's total compensation. SOPs are commonly framed to require CEOs to hold five times their base salary. But as the average S&P 500 CEO earns a base salary of less than 12% of her annual total pay, her SOP threshold amounts to less than 60% of such pay.

Third, these policies usually allow CEOs to take five years to attain the required stock thresholds. This delay is significant for S&P 500 CEOs, whose average tenure has recently shrunk to eight years.[17] Such weakness is particularly important because most policies do not require CEOs to hit any stock ownership milestone before their phase-in periods lapse.

Finally, current SOPs commonly do not specify the sanctions for breaching them. This omission might suggest that these policies are merely advisory rather than mandatory, which further weakens them because directors cannot be relied on to impose sanctions on their executives. For a variety of financial, social, and psychological reasons, executives have power and influence over directors in publicly traded U.S. companies that make it personally costly and difficult for directors to act in ways that are unfavorable for executives.[18]

In addition to the extreme ineffectiveness of current SOPs—and certainly more troubling—is the lack of transparency as firms camouflage the weakness of their policies in their public filings. In particular, not a single firm discloses big-picture indicators of that weakness, such as the amount of stock that managers are allowed to unload immediately and the amount of stock recognized by their SOPs that they have already unloaded.

Firms also fail to disclose some critical terms of their SOPs, such as their counting policies, phase-in periods, or sanctions. Moreover, when such terms are

[16] *Id*.

[17] The average tenure of a departing S&P 500 CEO in the United States was eight years in 2010, down from ten years in 2000. See THE CONFERENCE BOARD, THE 2011 CEO SUCCESSION REPORT (July 2011).

[18] *See* Lucian Bebchuk & Jesse Fried, PAY WITHOUT PERFORMANCE: THE UNFULFILLED PROMISE OF EXECUTIVE COMPENSATION 124–25 (2004), at 23–27 (describing sources of executives' influence over directors in public companies).

disclosed, their implications are not made clear. For example, firms fail to indicate how their counting of unvested or hedged stock undermines their SOPs.[19]

My findings about current SOP ineffectiveness and lack of transparency are troubling. Because of their extreme ineffectiveness, these policies are unlikely to affect managers' incentives and behavior, and so they are incapable of achieving the important goals they were established to attain. Such ineffectiveness comes at shareholders' expense because their weakness makes them incapable of aligning managers' interests with those of their shareholders.

Also, because the ineffectiveness of these policies is camouflaged, investors are unable to know whether they are valuable and whether they fulfill their purpose. One needs credible and full information in order to exercise good judgment. Without such information about the functioning of current SOPs, boards and shareholders are unable to assess these policies accurately and make informed decisions as to whether and how they should be improved. The philosophy of U.S. securities regulations is to permit investors to make informed and intelligent choices,[20] but with current SOPs, investors simply cannot do that.

Shareholders believe that these policies are at least sometimes desirable, and so they push firms to adopt them; proxy-voting firms back shareholders up and reward firms for having SOPs; and firms adopt SOPs, declaring that their purpose is to attain important goals, such as acting as a curb on incentives for excessive managerial risk taking. However, declaring that SOPs are adopted to attain important goals and then camouflaging their inability to achieve those goals creates confusion and sends mixed messages.

Also, the fact that SOP ineffectiveness is camouflaged suggests that their weakness is undesirable. Otherwise, firms would not camouflage it because if the current weakness of SOPs is a selling point in markets, its disclosure would increase stock price and firm value. However, since firms are unable to justify the weakness of their policies, they hide it.

A possible explanation for why SOPs are both extremely ineffective and camouflaged is that managers have excessive power vis-à-vis shareholders. Such combination of limp and camouflaged policies allows managers to reap the reputational benefits of being subject to effective SOPs while avoiding the personal costs that are associated with having such policies. In particular, SOP camouflage misleads markets

[19] 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.

[20] *See* Ray Garrett Jr., Chairman, Securities and Exchange Commission, Speech at the Union League Club, Public Affairs Committee (Feb. 20, 1975), *available at* http://www.sec.gov/news/speech/1975/022075garrett.pdf, at p. 8 (declaring that, "notwithstanding some recent questioning of this philosophy, we are persuaded that the original assumptions—that full disclosure permits investors to make informed and intelligent choices…are as valid today as they were forty years ago").

into believing that managers' incentives are better aligned with those of long-term shareholders, that managers no longer have incentives to take excessive risks, and that boards are not feckless. At the same time, it allows managers to avoid incurring the personal diversification and liquidity costs associated with having effective SOPs. Finally, SOP camouflage serves managers by making it unlikely that outsiders will exert pressure on firms to make their SOPs more effective, which would, of course, force executives to incur the costs they seek to avoid.

To remedy these flaws, I propose a regulatory reform to make SOPs transparent. In particular, I propose reforming the rules that govern public firms' filings with the U.S. Securities and Exchange Commission (SEC) pursuant to Regulation S-K.[21] I offer specific quantitative measures to gauge SOP bottom-line efficacy, as well as certain qualitative measures that focus on the functioning of SOP design. With this information, I expect boards and shareholders, assisted by proxy advisors, executive compensation advisors, and practitioners, to identify and remedy the flaws inherent in current SOPs.

This article is developed in nine parts. First, I explain the importance of SOPs for managerial incentives to maximize long-term shareholder value and avoid excessive risk taking. Second, I describe the several waves of SOP adoptions and the widespread pressure that led to them. Third, I present my methodology for studying current SOPs in S&P 500 firms. Fourth, I describe the two major frameworks that firms use to design their SOPs. Fifth, I provide evidence for the extreme ineffectiveness of current SOPs, after which I analyze the camouflaging of such ineffectiveness. In the seventh section, I explain why SOP ineffectiveness and its camouflaging is troubling, and after that I propose reforms to make these policies transparent and explain how these reforms will improve current SOPs. The ninth part presents my conclusion.

I. THE IMPORTANCE OF STOCK OWNERSHIP POLICIES (SOPS)

Firms hold their SOPs to attain important goals.[22] Their three main goals in this regard are (i) to align managerial interests with those of their shareholders,[23] (ii) to discourage managers from pursuing short-term gains at the expense of long-term value creation,[24] and (iii) to discourage inappropriate risk taking related to the company's business.[25]

The proxy statement of Limited Brands, Inc., summarizes the commonly declared SOP objectives:

[21] 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.

[22] Firms declare these goals in their new mandatory reporting of risk management strategies and in the "Compensation Management Discussion and Analysis" chapter of their proxy statements.

[23] *See, e.g.,* (i) Marsh & McLennan Co., Proxy Statement (Schedule 14A) at 41 (Mar. 30, 2010); and (ii) First Horizon National Corp., Proxy Statement (Schedule 14A), at 53 (Mar. 16, 2010).

[24] *See, e.g.,* (i) CA Inc., Proxy Statement (Schedule 14A) at 39 (June 8, 2010); and (ii) Family Dollar Stores, Inc., Proxy Statement (Schedule 14A) at 25 (Dec. 11, 2009).

[25] *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).

> 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.[26]

A. SOPs Help to Align Managers' Interests with Those of Shareholders

In most large American corporations, ownership is separate from control.[27] This happens when managers do not own most of the shares of the corporations they run. When managers-agents own little stock in a 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.[28] Such agency costs may be triggered by managers diverting corporate resources to themselves, taking perquisites, and exerting too little effort ("shirking"). The costs may also be triggered by managerial pursuit of non-value-maximizing objectives, such as making excessive acquisitions ("empire building"), encouraging excessive sales growth, and putting employee interests ahead of those of shareholders. When managers' time horizons differ from those of long-term shareholders,[29] they may take excessive risks and pursue short-term gains.

Managerial agency costs can be significantly reduced if divergences from shareholder interests are limited by establishing appropriate incentives for managers. In particular, SOPs align managers' interests with those of shareholders by requiring managers to hold a certain amount of their firms' stock.[30] The theory is that as their stakes rise, managers pay a larger share of the costs associated with their non-value-maximizing acts. Thus, they are less likely to squander corporate wealth and more likely to work harder to increase firm value. In support of this theory, a series of empirical studies shows that executives who hold more stock are significantly better stewards for shareholders, both in maximizing their value and in generating higher operating income.[31]

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

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

[28] *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).

[29] This may happen because of managers' career concerns or their ability to trade on inside information.

[30] *Id.*

[31] *See, e.g.,* Morck, Shleifer & Vishny, *supra* note 7. Also, *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 reported by Bhagat and Tookes with regard 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).

The desire to align managerial interests with shareholder interests by increasing managerial stock holdings resulted in a dramatic change in executive compensation in the 1990s. During that decade, stock-based compensation spread at explosive rates in the United States, and compensation committees routinely justified this surge as having the effect 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 fueled primarily by an increase in the use of stock options.[32] 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.[33] 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 also increased during the 2000s and has since become the biggest component of executive compensation at large, publicly traded U.S. firms. For the average S&P 500 CEO in 2012, stock-based compensation—namely, stock options and restricted stock—was worth over $6 million, almost two-thirds of the CEO's $9.7 million total compensation.[34]

By requiring managers to keep some of their stock-based compensation, SOPs aim to maintain the manager–shareholder alignment incentives that equity pay provides. Warren Buffett showed by self-example that he supports this view. In 2008, Buffett conditioned his sizable Goldman Sachs and GE investments by making those companies' executives commit to not selling more than 10% of their stock until the earlier of three years or the termination of Buffett's investment.[35] Many people believe that the importance that Buffett places on SOPs should serve as a wake-up call to both firms and investors in the aftermath of the recent financial crisis.[36]

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.[37]

B. SOPs Discourage Managers from Pursuing Short-Term Gains

Federal Reserve Chair Ben Bernanke stressed the importance of discouraging

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

[33] *See* Bebchuk & Grinstein, *supra* note [ ].

[34] *See* Equilar Inc., *supra* note [ ], at 18.

[35] *See* The Goldman Sachs Group, Inc., Proxy Statement (Schedule 14A) at 16 (Apr. 6, 2009).

[36] *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.

[37] *Supra note* 13.

managers from seeking short-term gains,[38] a goal that SOPs should fulfill by requiring managers to hold their firms' stock for the long term. Managers who are allowed to sell enough stock quickly might take actions that would boost the stock price in the short term even if they would certainly destroy value in the long term. Such actions include making distorted investment decisions,[39] engaging in real earning management[40] or earning manipulation,[41] and making certain public statements or performing other acts of "window dressing."[42]

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

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[38] *See* Ben S. Bernanke, *supra* note [ ] (stressing the need to avoid paying managers by using short-term metrics for transactions with long-term horizons).

[39] *See* Simia Kedia & Thomas Philippon, *The Economics of fraudulent Accounting*, 22 REV. FIN. STUD. 2169, 2195 (2009) (reporting evidence that firms that are 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 research and development intensity or share turnover).

[40] *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). To manage reported earnings, 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. *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 firms to pay extra taxes so that the firms can 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).

[41] *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 that it does not violate GAAP (generally accepted accounting principles), or illegal. From 1998 to 2004, for example, Fannie Mae illegally manipulated its quarterly earnings so that its executives could pocket higher bonuses. 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.

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

C. SOPs Help to Curb Managers' Incentives to Take Excessive Risks

SOPs should address two types of managerial incentives to take excessive risks. The first type involves opportunities to profit from stock price volatility.[43] Managers who are looking to capitalize on their inside information will pursue actions that may increase the riskiness of the firm's operations and thereby increase stock volatility; this is because greater stock volatility makes it more profitable for them to unload their stock before its value tanks or keep it if the price stands to increase.[44]

For example, consider a transaction that will boost a firm's stock price in the future from $40 to $60 if succeeds, but would tank the price from $40 to $20 if it fails. There is a 50% probability of either a success or a failure. Such a transaction significantly elevates the firm's risk but does not create any value for shareholders. Thus, managers who are unhampered by effective SOPs might be interested to pursue this project and take advantage of their inside information to sell their stock quickly if the project appears likely to fail (or buy new stock if it appears likely to succeed) before market price changes.[45] In support of this view, Peter Tufano's empirical study shows that firms whose managers hold more stock have better corporate risk management policies.[46]

The second type of incentive to take excessive risks involves short-termism. It happens when managers are able to realize a short-term increase in profits at the expense of latent and excessive risks of an implosion later on.[47] In this case, managers do not need inside information about if and when the excessive risk will translate into an actual implosion. Instead, if the short-term stock price increase is significant enough, the subsequent and consistent unloading of a significant amount of stock might suffice to render such a strategy profitable for managers. 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 in the risk-taking decisions of the top five executives at Bear Stearns and Lehman Brothers during the years preceding the firms' meltdown.[48]

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[43] For managers to have superior information, such risk should be latent, or that the timing in which it materializes should be known only to them.

[44] Such protection from stock depreciation renders managers' stock akin to stock options. This is because stock option holders may fully gain from stock price appreciation but are entirely protected against any decrease in stock price. Stock option value increases with volatility of stock for this reason: greater volatility offers its holder more potential for an upside without risking losses from greater potential for downside movements. Managers who may unload their stock freely enjoy similar incentives.

[45] *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 information to choose their stock exposure levels to the firm).

[46] See Peter Tufano, *Who Manages Risk? An Empirical Examination of Risk Management Practices in the Gold Mining Industry,* 51(4) J. FIN. 1097 (1996).

[47] *See* LUCIAN BEBCHUK & JESSE FRIED, PAY WITHOUT PERFORMANCE: THE UNFULFILLED PROMISE OF EXECUTIVE COMPENSATION, ch. 14 (Harvard University Press, 2004).

[48] *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 and cash

Effective SOPs would require managers to hold their firm stock for the long term rather than selling the stock quickly before the latent risk materializes and the value plummets. This would prevent managers from avoiding the potential future decline in stock price.

Because of their potential importance in risk mitigation, SOPs have become the most popular strategy that firms pursue to accomplish this goal. In 2010 the SEC required companies for the first time to discuss the level of risk inherent in their compensation programs within their proxy statements. Having SOPs was the most commonly cited policy (almost 60% in proxy filings of 100 companies with yearly revenues of $12.5 billion or greater),[49] ahead of 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[50] and hedging prohibition.[51]

In addition to the goals that firms declare for their SOPs, these policies are worth examining for three more reasons. First, they should help to tie pay to performance. Second, other rules, policies, norms, incentives, or mechanisms that could prevent managers from prematurely unloading stock are insufficient. Third, SOPs cost less than other policies that constrain managerial stock unloading

D. SOPs Help to Tie Pay to Performance

Because they can prevent managers from personally avoiding the negative consequences of their firms' stock implosion, SOPs create an important link between pay and performance. When managers are allowed to freely unload their stock, they may avoid decline of their stock value when their performance is poor if they sell their personal stock before stock price declines.

Absent SOPs, managers who perform poorly may not only avoid losses but also generate personal profits. First, as I explain in the previous section, excessively risky strategies can generate profits for managers who may sell their stock quickly. Second, the ability to sell stock freely, when combined with an ability to enter into hedging

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bonuses during 2000–2008, the years that led to the credit crisis). However, commentators disagree on whether poor incentives contributed to the crisis, as discussed in footnote 46.

[49] *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 is the most commonly cited strategy (72% in proxy filings of 100 companies with yearly revenues of $12.5 billion or greater).

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

[51] *Supra* note 19.

transactions, may create even more opportunities for these managers to generate profits. For example, managers who increase short-term profits and instill latent risks may not only sell their stock but also hedge their risk using a future contract, stipulating that they will sell some or all of their stock in the future for a predetermined price. Because only they know about the latent risk of implosion down the road, the future contract would not reflect this risk. Therefore, these managers are able to lock up their personal short-term stock profits at the expense of their counterparties.

Finally, SOPs tie pay to risk management, which is an important aspect of performance. This link is created because SOPs, by limiting stock unloading, expose managers' stock holdings to the long-term risk associated with the stock price. Without SOPs, managers can take advantage of their superior information by unloading their stock as a precaution against stock price volatility. Conversely, with SOPs, and because of their risk aversion, managers are encouraged to increase the stock price risk only if it creates an additional return that justifies it.

E. The Insufficiency of Other Tools That Could Prevent Managers from a Quick Stock Unwinding

Adopting SOPs and incurring their costs would be unnecessary if there were other rules, policies, norms, incentives, or mechanisms that could effectively prevent managers from quickly unloading their shares. The most important of such alternatives would be the ability of institutional shareholders and directors to exert informal pressure to hinder executives' stock unwinding.[52] There is evidence that institutional shareholders convey their views on executive compensation to selected boards of directors privately.[53] Institutions also use informal negotiations, backed by the threat of forcing a shareholder vote, filing shareholder proposals, launching "Just Vote No" campaigns, and using other activist efforts, as a way to pry concessions out of companies.[54]

Other mechanisms could incentivize or require managers to hold their firms' stock for the long-term as well. First, insider trading rules practically limit managerial unwinding of their firms' stock to predetermined short "trading windows" following the release of quarterly earnings or, alternatively, to plans created before the executive was in possession of material nonpublic information.[55] On top of these restrictions, Section

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

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

[54] *See* 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 nonbinding "Say on Pay" vote on executive compensation, they have more leverage to informally negotiate with management. Also, *see* Randall Thomas & Kenneth Martin, *The Effect of Shareholder Proposals on Executive Compensation,* 67(4) U. CIN. L. REV. 1021 (1999) (noting that since the 1990s stratospheric increases in CEO pay, outraged investors have made their views known to corporate boards of directors using shareholder proposals, binding bylaw amendments, "Just Vote No" campaigns, and other activist efforts).

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

16(b) of the Securities and Exchange Act aims to prohibit fraud by requiring an insider to disgorge any "short swing" profits realized from any purchase or sale of her firm's securities within six months.[56] Second, federal tax rules encourage executives to defer the receipt of their restricted stock or to exercise their stock options.[57]

We would also think that managers would not sell much of their stock because of their tendency to be over confident[58] as well as their cognitive dissonance.[59] Due to these psychological characteristics CEOs can be expected to hold more company stock than is desirable for them from a portfolio diversification viewpoint.

However, evidence shows that existing mechanisms are not enough to prevent executives from quick stock unloading. A recent study suggests that most top executives at S&P 1500 firms sell equity at least once during their tenure, with the median sale equal to 15% of the executive's total holdings of his firm's stock.[60] Also, executives typically exercise their stock options years before those options expire, and almost all of the shares acquired through option exercises are immediately sold.[61]

Currently, managers not only engage in massive stock sales but also time their sales often to beat the markets. 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.[62] Unfortunately Zucker is not the only executive to unload a massive amount of stock strategically. The top five executives of Bear Stearns and Lehman Brothers derived cash flows of about $1.1 billion and $850

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[56] *See* 15 U.S.C. § 78p(b) (1970).

[57] For restricted stock, tax payments are deferred to the date that the stock is sold, provided that the executive files a Section 83(b) election with the IRS within thirty days of the grant date. For incentive stock options, taxes are deferred until the stock is ultimately sold, and 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, the tax rate is reduced from a short-term capital gains rate of 28%–39.6% to a long-term capital gains rate of 20%.

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

[59] The theory of cognitive dissonance holds that contradictory beliefs compel the mind to acquire or invent new thoughts or beliefs, or to modify existing beliefs, so as to minimize the amount of dissonance between cognitions. *See* LEON FESTINGER, A THEORY OF COGNITIVE DISSONANCE (Stanford University Press, 1957). Therefore, cognitive dissonance might cause managers to reconcile their idea of them being successful managers with their fear from possible challenges along the way by holding a significant amount of their firms' stock for the long-term. Holding such stock aims to create a new cognition that creates a consistent belief system, according to which, despite the challenges that they might face along the way, their good abilities as managers will create value in the long-term. A large body of evidence from applied psychology shows that corporate executives routinely overestimate their ability. *See, e.g.,* Ulrike Malmendier & Geoffrey Tate, *CEO Overconfidence and Corporate Investment*, 60(6) J. FIN. 2661 (2005).

[60] *See* Ladika, *supra* note [ ].

[61] *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).

[62] 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.

million, respectively, from stock sales during the eight years preceding their firms' colossal crash in 2008.[63] Also, in a study of executive trading in over 1,200 firms during a five-year period ending in January 2006, Alan Jagolinzer found that insiders regularly sell on inside information and generate above-market returns of 6%, on average.[64]

F. The Low Costs of SOPs

Theoretically, SOPs could be quite costly for shareholders. First, they could inflict liquidity costs on managers who need more cash in hand. Second, they could force managers to hold undiversified personal securities portfolios and hence be exposed to unnecessary idiosyncratic risk.[65] In both those cases these costs would be rolled over to the shareholders. Finally, SOPs will inflict direct costs on shareholders by discouraging managers from taking necessary and appropriate risks.[66]

However, in reality, SOPs impose low costs. There are practical and theoretical reasons for that. As a practical matter, my data from this study reveal that the average S&P 500 CEO voluntarily holds almost three times his SOP threshold, or some $14 million of his firm's stock. This indicates that CEOs typically choose to hold significant amounts of their firms' stock despite the costs associated with such activity. Theoretically, the high personal wealth of S&P 500 CEOs, resulting in part from their high compensation levels, can explain why their voluntary choice to hold a significant amount of their firms' stock costs them little in the way of diversification and liquidity. Wealthy people tolerate risk significantly better than others because a marginal loss of wealth reduces their utility less than it does for less affluent people. In addition, their need for liquidity is relatively low because their marginal propensity to consume is low and more of their basic human needs have already been met. Also, CEOs' tendency to be overconfident and their cognitive dissonance can exacerbate their tendency to hold stock even more than their low risk aversion and low liquidity needs can support.

SOPs are cheap in comparison to vesting schedules.[67] Longer vesting schedules

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[63] *See* Bebchuk et al., *supra* note [ ], 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).

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

[65] 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 firms' stock. See William F. Sharpe, *Capital Asset Prices: A Theory of Market Equilibrium under Conditions of Risk*, 19(3) J. FIN. 425 (1964).

[66] 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 that their incentives will be better aligned with those of their typically risk-neutral shareholders.

[67] Stock vesting policies limit managers' ability to unload their stock-based incentives by defining when managers "earn" their stock options or restricted stock. *Supra* note 14.

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 limit managers' ability to sell stock they already own. Imposing longer vesting periods is more costly than adopting SOPs because of the extra risk associated with delaying receipt of stock ownership rights that longer vesting periods impose.[68] These extra costs may be rolled over to shareholders.[69]

II. THE WAVES OF SOP ADOPTIONS

The importance of SOPs was not widely recognized in the 1990s, so their adoptions lagged behind the tectonic surge in stock-based compensation. Specifically, only 35% among top 250 companies disclosed SOPs in 2001.[70] Managers took advantage of their freedom to unload their incentive compensation. For example, when they exercised options to acquire stock, they sold nearly all of it. Consequently, the dramatic boom in stock-based pay did not translate into a significant increase in managerial ownership.[71]

The corporate scandals of 2001 and 2002 emphasized the importance of SOPs. This recognition was triggered by the massive stock sale of former Enron president Jeffery Skilling. Mr. Skilling unexpectedly resigned on August 14, 2001, and shortly thereafter sold large blocks of his Enron stock; four months later, Enron declared bankruptcy.[72] Mr. Skilling was later convicted of multiple federal felony charges relating to Enron's financial collapse and is now serving a twenty-four-year, four-month prison sentence. The corporate scandals and increased investor attention that followed, coupled with SEC requirements to increase transparency of compensation disclosure, led to a surge in the number of formal SOPs in 2002.[73] Specifically, 49% of Fortune 250 companies disclosed formal SOPs for their executives in 2002, representing a 40% increase from 2001.[74]

As recognition of the need for SOPs gained traction, pro-business organizations, such as the Business Roundtable and the Chamber of Commerce, declared SOPs to be a "best practice."[75] In addition, a 2003 report by The Conference Board, the leading

[68] 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.

[69] This notion follows Michael C. Jensen & William H. Meckling, supra note [ ].

[70] *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).

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

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

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

[74] *Id*.

[75] *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 executives and directors to hold meaningful amounts of stock so

independent business research organization in the United States, endorsed SOPs, stating that the long-term focus they promote "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."[76] This increased recognition in SOP importance resulted in their prevalence among Fortune 250 firms reached 70% in 2005[77] and 81% in 2008.[78]

The 2008–2009 financial crisis made the need to adopt SOPs unavoidable.[79] Prominent government officials made public statements urging firms to adopt such policies,[80] and the federal government prescribed strict SOPs for all Troubled Asset Relief Program (TARP) recipients.[81] Since then, institutional shareholders have used the momentum to exert unprecedented pressure on firms, urging them to adopt SOPs and submitting numerous stockholder proposals;[82] and the California Public Employees'

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that it is "economically material to the individual that a company succeed in the long-term"). *See* THE BUS. ROUNDTABLE, EXECUTIVE COMPENSATION: PRINCIPLES AND COMMENTARY (NOV. 2003).

The Chamber of Commerce endorsed the hold-past-retirement Aspen Principles, which state that "senior executives [should] hold a significant portion of their equity-based compensation for a period beyond their tenure." *See* THE ASPEN INST., LONG-TERM VALUE CREATION: GUIDING PRINCIPLES FOR CORPORATIONS AND INVESTORS (JUN. 2007).

[76] *See* THE CONFERENCE BOARD, COMMISSION ON PUBLIC TRUST AND PRIVATE ENTERPRISE: FINDINGS AND RECOMMENDATIONS 7 (2003).

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

[78] *See* CSuite Insight, *Ownership Guidelines: Executives,* (January 1, 2010), http://www.c-suiteinsight.com/index.php/2010/01/ownership-guidelines-executives/ (on file with the author).

[79] This consensus was formed despite disagreements about the causes of crisis. *See* discussion *supra* note [ ].

[80] See statements made by Treasury Secretary Tim Geithner and Federal Reserve Chairman Ben S. Bernanke *supra* note [ ].

[81] Specifically, 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).

[82] For example, shareholder proposals to adopt strict SOP (stock retention policies) were the most prevalent compensation-related proposals in the 2012 proxy season, amounting to over 30% of compensations proposals and twice as much as the second most prevalent proposal. In 2013 the number of SOP proposals was even greater. See Shirley Westcott, *The Advisor: Key Issues from the 2013 Proxy Season,* Alliance Advisors (Aug. 2013), at 13.

The American Federation of Labor and Congress of Industrial Organizations (AFL-CIO) has been particularly active in filing stockholder proposals, pursuant to Section 14a-8 of the Securities and Exchange Act of 1934, encouraging companies to adopt SOPs. It has filed such proposals in a handful of TARP companies, including Citigroup, JPMorgan Chase, and Bank of New York Mellon. *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), and Bank of New York Mellon Corp., Proxy Statement (Schedule 14A) at 79 (Mar. 15, 2010). For stockholder proposals in non-TARP firms, *see, e.g.,* Dow Chemical Co., Proxy Statement (Schedule 14A) at 42 (Mar. 31, 2010) (a stockholders proposal pushing Dow Chemical to adopt a policy requiring that senior executives retain at least 75% of net after-tax shares acquired through equity compensation programs until two years following the termination of their employment).

Retirement System (CalPERS), the largest public pension fund in the United States, has declared that SOPs should be adopted universally.[83]

The world's leading provider of proxy voting and corporate governance services, Institutional Shareholder Services (ISS),[84] has supported shareholder pressure. It has done so by (i) advising shareholders to vote for stockholder proposals that push companies to adopt SOPs;[85] (ii) rewarding firms that have SOPs on its newly debuted risk assessment system;[86] and (iii) recommending that shareholders vote on "Say on Pay" for firms with SOPs.[87] Because ISS has a tremendous influence on firms, its support in shareholder pressure is expected to play a decisive role in pushing firms to adopt SOPs.[88]

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

[84] For 25 years, ISS has been the leading provider of proxy research to institutional investors. It provides objective voting recommendations for more than 40,000 companies–every holding within its clients' portfolios–in over 100 markets worldwide. See INSTITUTIONAL SHAREHOLDER SERVICES INC., http://www.issgovernance.com/proxy/advisory (last visited December 10, 2013).

[85] *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.

[86] Such a risk assessment system is called Governance Risk Indicators (GRId). GRId, which was debuted on March 10, 2010, allows investors to assess their firms' level of corporate governance risk. Scores are based on each company's policy relative to what ISS views as "best practice" in the relevant global market. Answers are converted into numerical values using a grading system determined by ISS, and the results are 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" being a neutral score. Scores are then normalized on a 100-point scale (e.g., 0 to 100). *See* Institutional Shareholder Services Inc., *Governance Risk Indicators 2.0 Technical Document* (Mar. 6, 2012), *available at* http://www.issgovernance.com/grid/technical_document.

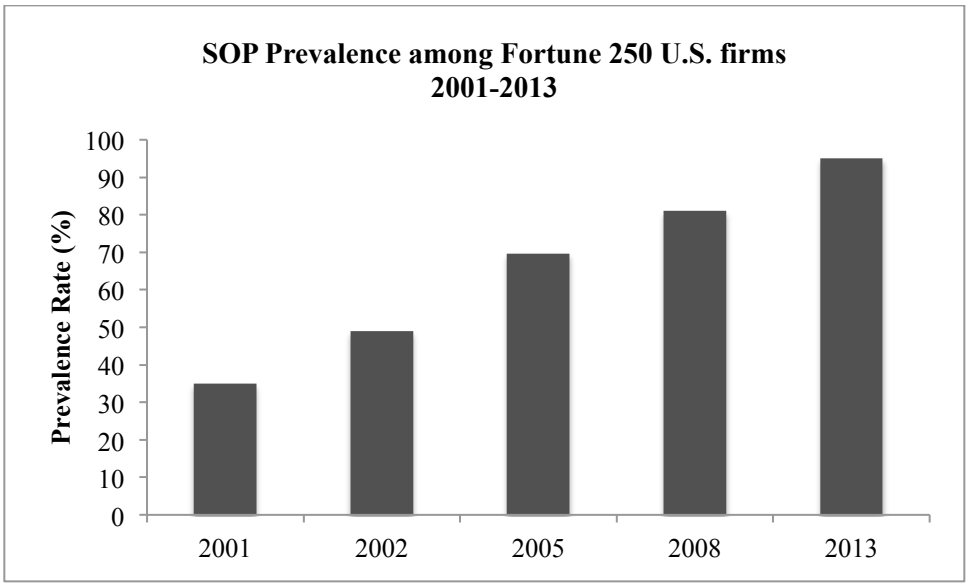
GRId includes twenty-eight compensation indicators, four of which exclusively discuss SOPs. Companies failing to disclose, or explicitly saying that they will not disclose, their SOPs score lowest on GRId, thereby receiving higher corporate governance risk assessment.

[87] As of 2011, ISS proxy voting summary guidelines urge shareholders to favor firms with robust SOPs when they cast their votes on "Say on Pay." The guidelines state that shareholders should consider robust SOPs as an important factor that mitigates the impact of risky pay incentives. *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.

[88] For example, in 2012 firms fortunate enough to receive an ISS "For" recommendation on "Say on Pay" received 95% shareholder support whereas firms that received an "Against" recommendation received only 65% support. *See* John D. England, *Say on Pay Soul Searching Required at Proxy Advisory Firms*, Pay Governance (June 2012), at 1–2. Therefore, companies often tailor their policies to meet ISS guidelines, and firms lobby for ISS support to fend off shareholder proposals. The relentless efforts that HP's former CEO, Carli Fiorina, has made to gain ISS support in the HP Compaq merger demonstrates the decisive importance of 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").

Leading business executives, such as Goldman Sachs's CEO, Lloyd Blankfein, have come up with their own proposals to adopt strong SOPs,[89] and leading investment banks have adopted considerably stringent policies.[90] As of 2013, SOPs have become virtually universal with 95% prevalence among top 250 U.S. public firms.[91] The rise of SOP prevalence is summarized in Figure 1 below.

Figure 1: SOP Prevalence among Fortune 250 U.S. Firms, 2001–2013



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 by surveying all disclosed SOPs of firms included in the S&P 500 index and analyzing these policies as they apply to the leader of the executive team, the CEO. I focus on the CEO because he is typically the most powerful figure within the top executive team, capturing

[89] In his 2010 hearing before the House Committee on Financial Services, Blankfein 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. *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 Sachs Group, Inc.).

[90] Goldman Sachs' 2013 SOP requires that "in addition to imposing transfer restrictions, we also require each of our Senior Executives, for so long as he holds such a position, to retain sole beneficial ownership (including, in certain cases, ownership through his spouse or estate planning entities established by him) of a number of shares of our Common Stock equal to at least 75% of the shares received (net of payment of any option exercise price and taxes) as compensation since becoming a Senior Executive." This policy is separate from and in addition to Warren Buffett's requirements in this regard discussed above. *See* The Goldman Sachs Group, Inc., Proxy Statement (Schedule 14A) at 34 (Apr. 12, 2013). Other banks have followed: JP Morgan, Citigroup, and Morgan Stanley all use a stringent requirement of a 75% stock retention rate.

[91] *See* Meridian Compensation Partners, LLC, *supra* note [ ], at 11.

the highest pay slice and having the strongest impact on the value, performance, and behavior of the public firm.[92] Naturally, current SOPs apply the most stringent requirements on CEOs compared to the other members of the executive team or the non-employee directors.

I obtained most of my data from the most recent information posted on the SEC website by all S&P 500 firms as of August 4, 2010. The SOP terms I collected from firms' "Compensation Discussion and Analysis" chapter of their proxy statements are the following: *declared goals, target thresholds, counting policies, phase-in periods,* and *sanctions*. In order to analyze firms' counting policies, I coded each policy according to its counting of the following parameters: vested stock, vested options, deferred compensation, unvested stock, and unvested options. I further used each firm's proxy statement to record CEO actual holdings, which I obtained from the "Common Stock and Total Stock-Based Holdings" tables, counting only such stock-based holdings recognized by the counting policy that applies to the CEO.

I also relied on some data outside the information disclosed in firms' proxy statements, such as data available on the firms' websites. In addition, I recorded share prices from Google Finance and determined CEO tenure for each firm using data I obtained on Compustat Execucomp also as of August 4, 2010.

Finally, I calculated the percentage of vested equity that each SOP allows its CEO to unwind. I did so by applying the following formula:

> (vested equity – target threshold + min (target threshold, unvested equity that can be counted for satisfying the SOP))/vested equity.

IV. THE CURRENT DESIGN OF SOPS

Before analyzing the ineffectiveness and lack of transparency of current SOPs, it is important to explain the way these policies are designed. I find that 94% of current SOPs disclose a target ownership framework while only 6% invoke a framework that requires ongoing stock retention.

A. The Target Ownership Framework

This common SOP framework calls CEOs[93] to maintain minimum ownership of their firm's stock, typically valued at a certain multiple of their base salary, as long as they serve in their current positions. The target threshold framework also includes a counting policy, which describes the type of stock that may be counted to satisfy its specified ownership threshold. Finally, it contains a phase-in period term, which specifies

[92] *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).

[93] SOPs and their target thresholds generally apply to senior executive officers and all non-employee directors. Because my analysis focuses on CEOs, I ignore all other SOP objects, such as that target ownership thresholds for non-employee directors are specified as a multiple of their regular annual cash retainer.

the number of years the executive has to attain his or her required stock threshold.[94]

1. A Required Stock Ownership Level

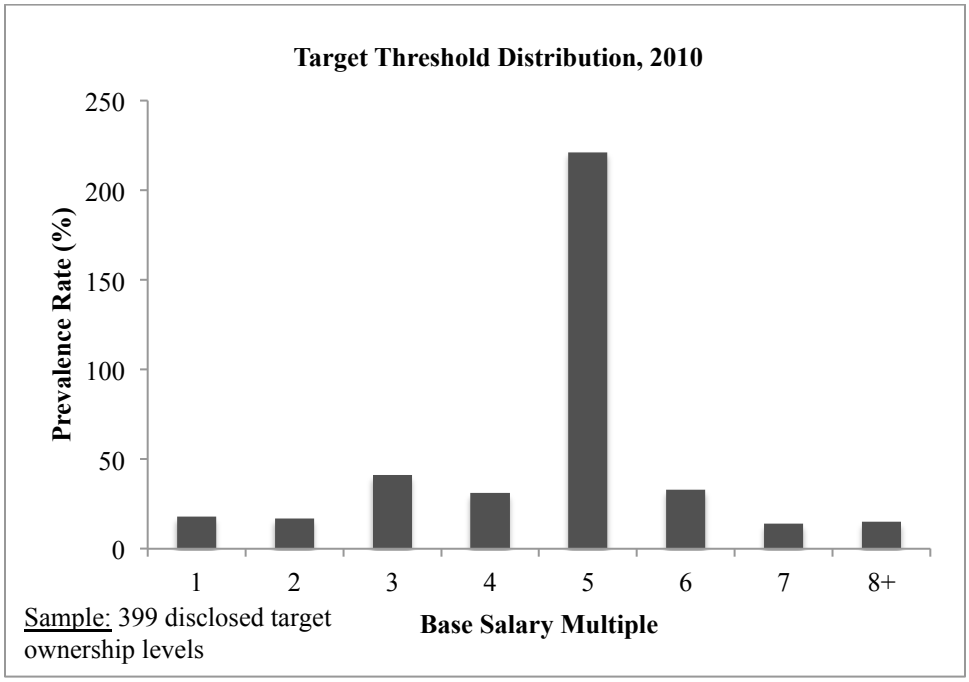
All firms that employ the target ownership framework disclose a minimum amount or value of company stock that their executives or directors should own. For more than 80% of SOPs, this threshold is set at a value equal to at least a certain multiple of the CEO's base annual salary. Much less commonly, in some 15% of such policies, the target ownership is specified as a fixed number of shares, while only 5% of the policies are framed as a combination of the two.

To describe the target ownership levels of SOPs that use a base-salary-multiple method alongside those that use a fixed-number-of-shares method, I converted the fixed-number-of-shares policies into a base-salary-multiple equivalent. I did so by multiplying the fixed number of stock requirement by the company's stock price and dividing the result by the CEO's most recent base salary. When necessary, I rounded the multiples to their closets integers. The resulting distribution is summarized in Figure 2 below.[95]

[94] 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).

[95] Relatively few firms reduce their base salary multiple or totally waive their SOPs for executives who 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.

Figure 2: Target Ownership Distribution for S&P 500 CEOs

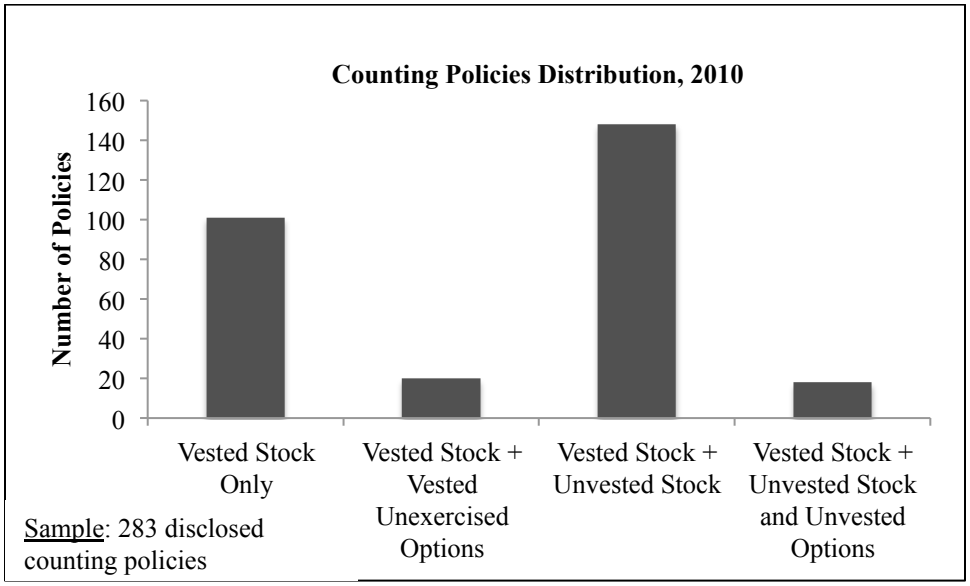


In Figure 2, the distribution of target ownership levels of SOPs that employ such a framework is centrally condensed at the five-times-base-salary multiple. More than half of such policies use this multiple, while the second most common multiple is roughly shared by the three-, four-, and six-time multiples, each of which shares slightly less than 10% of the distribution. Overall, the distribution on both sides of the five-times multiple is uneven, with over 70% more density in the lower tail.

2. Counting Policy

The second element of a target ownership framework defines the type of equity securities that may be counted toward meeting the policies' target ownership threshold. Types of equity securities are abundant, so 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. Figure 3 shows the distribution of SOPs that disclose their counting policies.

Figure 3: Counting Policies Distribution for S&P 500 CEOs

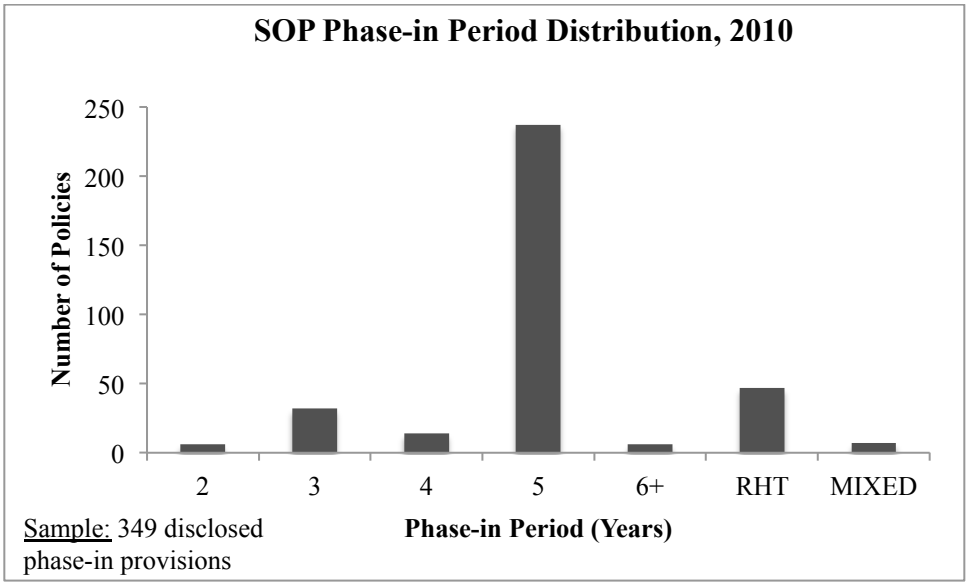


3. Phase-In Period

Finally, SOPs that invoke the target ownership framework typically provide a phase-in period, which is 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 required stock ownership levels. Firms that fail to disclose their phase-in policies include Google, Chevron, Chesapeake Energy, Comcast, and Expedia.

Phase-in policies generally use one of two methods. The first method utilizes the "fixed number of years" approach, or "FNY", which specifies the number of years in which the executive or director must attain his 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 later policies "retain until you hit your target threshold," or "RHT." I aggregated data from all disclosed phase-in policies and summarize their distribution in Figure 4.

Figure 4: SOP Phase-in Period Distribution for S&P 500 CEOs



Some 85% of phase-in policies utilize the FNY approach, whereas only 13% 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 FNY approach.

Among the common FNY policies, slightly more than 80% allow their executives to wait five years before they have to attain their SOPs' target ownership thresholds. Another 10% of policies allow only three years for this purpose, 5% allow four years, and the remaining 5% are equally distributed between a two-year and more than a six-year period.

B. The Ongoing Stock Retention Framework

A small minority of SOPs—namely, those regarding stock retention and holding periods—require executives to always hold new shares. Instead of specifying target ownership levels, these policies invoke ongoing requirements for managers to retain new stock that they are granted as compensation. Such guidelines apply to all stock-based compensation granted, regardless of the executive's or director's stock holdings at that time.

In particular, only about 4% of policies disclose a holding period requirement. Such a requirement stipulates that, in addition to meeting a certain stock target threshold, the executive officer or director is further expected to retain a portion of stock for an additional period ranging from six months to ten years. Such stock is calculated as a certain percentage of all stock realized through the exercise of stock options and the vesting of restricted stock, restricted stock units, performance stock, and performance stock units awards.

Notably, less than 2% of SOPs (eight policies), mostly of financial firms, including

Goldman Sacks and JP Morgan, employ a stock retention approach for their SOPs.[96] Stock retention policies do not use ownership thresholds or limited holding periods. Rather, they require executives 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 high ratio of 75% retention rate.[97]

V. SOP INEFFECTIVENESS

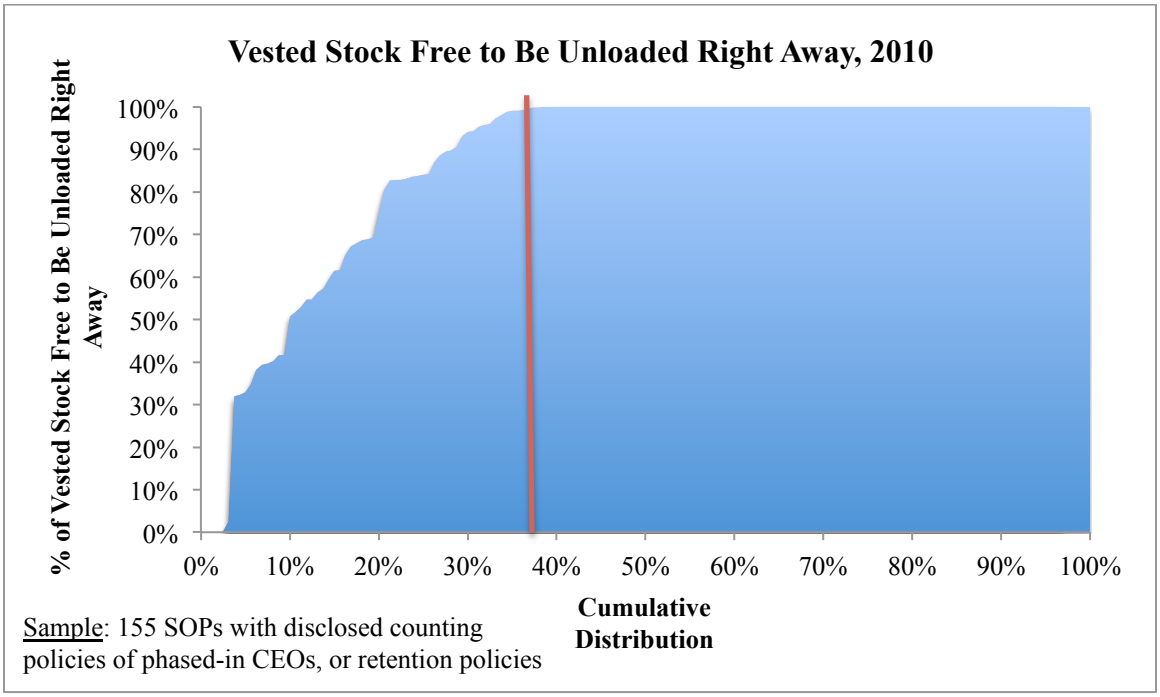
In this part, I draw on the structural analysis of Part IV to show that current SOPs are highly ineffective in making CEOs hold on to their vested stock.[98] As noted earlier, Scott Davis, the CEO of UPS since January 2008, may sell *all* of his over $41 million worth of vested UPS stock and still comply with his SOP. Unfortunately, Mr. Davis is not alone. Generally, SOPs allow CEOs to sell virtually all of their vested stock immediately. Allowing massive stock selling by CEOs frustrates the most fundamental expectation from SOPs: that they require CEOs to hold a significant value of their firms' stock for the long term. Figure 5 illustrates this bottom-line result.

[96] Another three nonfinancial firms employ a pure retention policy: The Clorox Company, E*TRADE Financial Corporation, and United States Steel Corporation.

[97] Goldman Sachs' SOP is in addition to Warren Buffett's requirement that Goldmans' senior executives' stock unloading be restricted to 10% for three years. *See* The Goldman Sachs Group, Inc., Proxy Statement (Schedule 14A), *supra* note 35.

[98] My claims about the implications of current SOP ineffectiveness are independent from the issue of the optimal level of SOP effectiveness. In general, such a level should be determined on a case-by-case basis in accordance with the wealth, degree of risk aversion, scope of unscrutinized action, and current holdings of each firm's CEO, as well as with the strength of firm-specific corporate governance arrangements, firm risk, and industry risk.

Figure 5: Vested Stock Free to Be Unloaded Right Away by S&P 500 CEOs



Almost two-thirds, or 62%, of CEOs are allowed to unload all their vested stock immediately,[99] and the dollar amount of this capability is significant. In particular, the median CEO is allowed to sell some $14 million worth of vested stock, or 2.75 times his or her SOP target threshold, and 35% of CEOs are allowed to sell more than $30 million worth of their vested stock.

Yet there is considerable variation in the effectiveness of SOPs. While the vast majority of policies are extremely ineffective, there are some that do not allow CEOs to sell significant amounts of their vested stock. A few points are worth noting here. First, these strong policies are driven by the use of the uncommon ongoing retention framework. Second, relatively effective SOPs tend to impose strict counting policies—namely, policies that do not recognize unvested stock. Third, and to a lesser extent, some stringent SOPs do not have strict counting policies or a 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 as CEOs who choose to keep small amounts of vested stock. Such relatively small stock holdings are strongly correlated with a short CEO tenure.

Some SOPs allow CEOs to unload a significant percentage of their vested stock not because those policies are weak but because those CEOs hold significant amounts of

[99] This result is based on a sample of 155 CEOs who already have to comply with their SOPs and whose policies can be evaluated. Of all the firms included in the S&P 500 index, only 283 firms disclose counting policies and therefore can be evaluated. Of the CEOs of these firms, only 147 CEOs have phased-in policies; another eight firms disclose retention policies that do not require a phase-in term.

vested stock voluntarily, significantly above what their SOPs require them to hold. In such cases, however, it is hard to think of a compelling explanation for why these SOPs are necessary. Even more puzzling, it is hard to explain why firms advertise these unnecessary policies so aggressively.

Now, I analyze how SOP failure to require CEOs to hold on to their firms' stock is a function of policy design.

A. Failure to Adopt the Ongoing Retention Framework

Despite the significantly enhanced effectiveness that the ongoing retention framework provides, only about 4% of SOPs use holding period requirements and less than 2% employ a stock retention approach. These SOPs are significantly more effective than common SOPs as they 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 Executive.[100]

As opposed to the common target ownership framework SOP, which uses a five-time-base-salary multiple, the target threshold of Goldman's SOP is equivalent to more than ninety-five 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.[101]

The current base salary multiple of Rex Tillerson, who was elected chairman and CEO of ExxonMobil in 2006, is as high as thirty-nine times his base salary, six 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 100% of the median CEO.

The vast majority of SOPs that employ a target ownership framework not only fail to require ongoing retention of stock after their ownership levels are met, but also fail

[100] *Supra* note 92, at 23.
[101] *See* ExxonMobil Corp., Proxy Statement (Schedule 14A) at 30 (Apr. 13, 2010).

to invoke an RHT approach, which guides CEOs to retain stock before such levels are attained. RHT policies use retention rates ranging from 25% to a 100%, with almost half of them (twenty-one policies) requiring a 100% retention rate.[102] Dun & Bradstreet Corp discloses such exceptional policy:

> 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.[103]

Now I analyze how the design of SOPs that use a target ownership framework significantly weakens these policies and often renders them entirely ineffective.

B. Counting Policies Render Most SOPs Entirely Ineffective

Policies that allow the counting of unvested stock obviate themselves. Vesting schedules define when managers "earn" their stock options or restricted stock.[104] Unless shares are earned, they are nontransferable and certainly cannot be sold. SOPs define the amount of stock that cannot be unloaded. This is why Mr. Davis, UPS CEO, may sell all of the stock he owns; because his SOP allows him to count his $12.3 million worth of UPS unvested shares to satisfy his $8.4 million target ownership requirement.

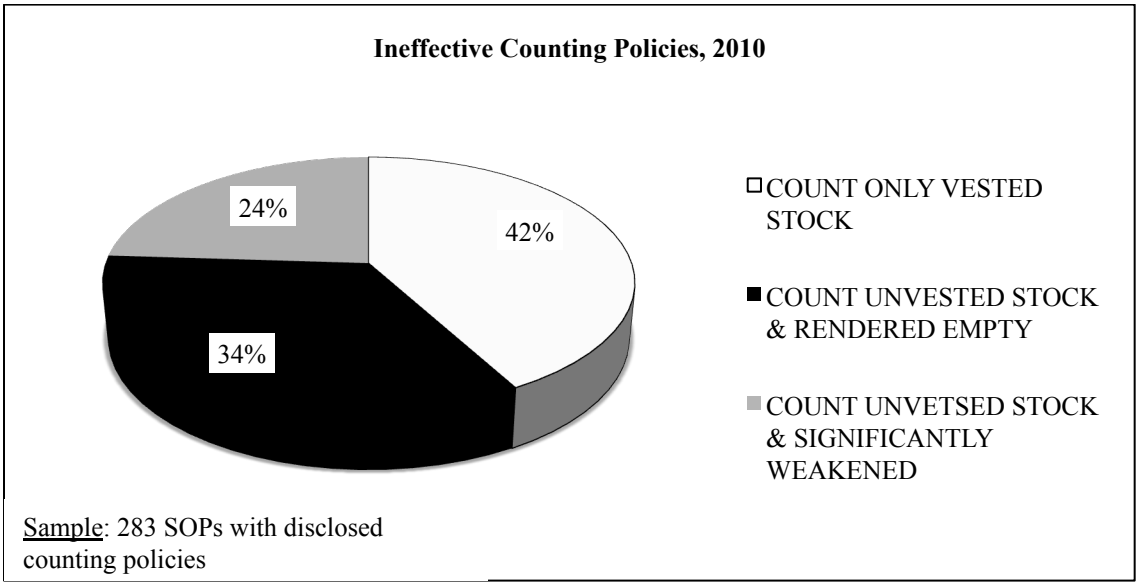
Figure 6 summarizes my findings regarding the effect of disclosed counting policies on SOP effectiveness for S&P 500 CEOs.

[102] The retention rates of the remaining twenty-six RHT policies are distributed as follows: seven policies require a 75% rate, nine require a 50% rate, two require a 30% rate, and eight require a 25% rate.

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

[104] *Supra* note 14.

Figure 6: Ineffective Counting Policies of Disclosed SOPs for S&P 500 CEOs



Some 58% of disclosed counting policies allow the counting of unvested stock. Most of those policies (the black sector of in the pie chart) are rendered entirely ineffective in that their CEOs are free to unload 100% of their vested stock immediately.[105] The remaining SOPs that count unvested stock (the grey sector of in the pie chart) are significantly weakened by this laxity.

The impact of counting unvested stock on SOP effectiveness should not be surprising. The average SOP requires the CEO to hold, in five years, five times his base salary, and it counts both unvested and vested stock to satisfy this threshold. The average CEO roughly earns a $1 million annual base salary and each year he receives some $6 million grant of stock that vests gradually over three years. Thus, starting in the beginning of his third year of stock grants, he will hold $12 million worth of unvested stock, which he does not own yet but can nevertheless apply toward his $5 million SOP requirement. Hence, the counting policy that recognizes unvested stock may easily render an SOP entirely ineffective.

This focus on policies that allow the counting of unvested stock shows that such policies render most SOPs entirely ineffective for all levels of CEO tenure, even for CEOs who have not phased in yet. Also, the median amount of unvested stock exceeds SOPs' target threshold for all levels of CEO tenure. Table 1 summarizes the pervasive power of counting unvested stock in rendering SOPs ineffective.

[105] Even when counting unvested stock does not render SOPs completely ineffective, counting certain types of vested stock may still thoroughly undercut them—as, for example, when they allow the counting of vested stock that CEOs cannot practically sell, such as stock in 401(k) accounts, deferred compensation, and stock in trust accounts.

Table 1: The Effect of Counting Unvested Stock on SOP Effectiveness for S&P 500 CEOs, 2010

Number of Policies	*Years after CEO Phased In*[106]	*Unvested Stock/Target Threshold (Median)*	*Likelihood of Counting Policy to Render SOP Completely Ineffective*
26	**(–2) to 0**	**1.49**	**62%**
30	**0 to 2**	**1.01**	**50%**
39	**3 or more**	**1.26**	**62%**
95	**All**	**1.16**	**58%**

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

Dell, one of 164 firms that allow the counting of unvested stock, acknowledges that the pervasive market norm of counting unvested stock has influenced its decision to do the same.[107] Dell explicitly indicates that its lax counting policy follows the market:

> 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.[108]

C. Lax Target Ownership Levels

For most CEOs, SOP target ownership levels are lower than 60% of their annual total pay and even lower than their single-year stock-based compensation.[109] Only 3% of current SOPs use a base salary multiple that requires CEOs to hold more than their single-year total pay.

[106] Calculated as CEO tenure minus phase-in period (years). This column is a proxy for tenure, as more tenured CEOs are more likely to require fewer years to phase in.

[107] Despite the fact that Michael Dell, Dell's founder, chairman, and CEO, holds more than 11% of the company's stock, Dell's other top executives and non-employee directors can take advantage of the company's ineffective SOP.

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

[109] This outcome results from the fact that some 80% of SOPs require CEOs to hold five times their base salary or less, while the average S&P 500 CEO is paid a $1 million base salary and her total compensation is some $9.7 million, $6 million of which is in the form of stock-based compensation. *See* Equilar Inc., *supra* note [ ].

The common practice of lax target thresholds renders many SOPs futile as soon as they are adopted. According to a 2010 study, "71% of the CEOs already have a multiple larger than the target by the time the guidelines are initiated."[110]

D. Phase-In Policies Suspend Many SOPs

Current phase-in policies render 43% of SOPs inapplicable. The reason for this is that CEOs are expected to attain their target ownership levels only after serving five years in their positions. Because the median CEO tenure of S&P 500 CEOs in my survey is just 5.01 years,[111] almost half of CEOs are not required to hold any stock yet, solely because of their firms' feckless phase-in policies. In addition, virtually all phase-in policies do not invoke an RHT approach, which requires an ongoing accumulation of stock before CEOs hit their target ownership thresholds.

The bottom line result I reported earlier, according to which almost two-thirds of CEOs are allowed to unload their stock immediately, is underestimated as it does not take into account the 128 CEOs who have not phased in yet. When those CEOs are included, the percentage of CEOs who are allowed to unload all their vested stock immediately and still comply with their SOPs jumps to almost 80%.[112]

E. CEOs Are Allowed to Nullify Their SOPs through Hedging

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 movements in exchange for a predetermined cash flow that is not affected by the firm's future stock price or performance. Bettis, Bizjak, and Lemmon document that many managers use zero-cost collars and equity swaps[113] to hedge the risk associated with their equity holdings.[114] Managers even possess some timing abilities; that is, they can initiate hedging transactions immediately following large price run-ups and prior to poor

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[110] *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).

[111] This finding is in line with the fact that the average tenure of a departing S&P 500 CEO in the United States was only eight years in 2010. *See* THE CONFERENCE BOARD, *supra* note [ ].

[112] The calculation goes as follows: the population of all SOPs that can be evaluated (those with clear counting policies) is 283, compared with only 155 policies of CEOs who have phased in. Ninety-six out of the 155 phased-in CEOs, as well as the 128 non-phased-in CEOs, are allowed to sell all their stock immediately. The total of 128 + 96 out of 283, or 79.2%, is the sum of the CEOs who are allowed to sell 100% of their vested stock and still be in compliance with their SOPs.

[113] Zero-cost collar strategies involve the simultaneous purchase of a put option and sale of a call option covering the firm's shares so that both costs cancel each other out. An equity swap is a financial derivative contract (a swap) in which two parties agree to exchange a set of cash flows at set dates in the future. Equity swaps allow investors to exchange the future returns on their stock for the cash flow 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.

[114] Carr Bettis, John Bizjak, & Michael Lemmon, *Managerial Ownership, Incentive Contracting, and the Use of Zero-Cost Collars and Equity Swaps by Corporate Insiders,* 36 J. FIN. & QUANT. ANAL. 345 (2001).

earnings announcements.[115]

To demonstrate how a zero-cost collar transaction may nullify an SOP, consider an SOP that requires an executive to hold 50,000 shares of her firm's stock for the long term and that stock is currently being traded at $100. This leaves the executive exposed to future losses of up to $5 million if her firm's stock price drops, and poised to make an unlimited potential profit if that price increases. This should incentivize her to avoid taking excessive risks and to work hard to maximize the long-term stock price. However, if she wishes to fully hedge her SOP stock by purchasing a zero-cost collar, she can buy 50,000 put options and sell 50,000 call options, with a strike price of $100 for each option. This hedge fully protects her 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 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 the few SOPs that employ retention frameworks and another two SOPs that use the common target ownership framework do not count shares subject to hedging.[116] Although firms are now required to disclose more of their executives' derivative transactions,[117] the law does not prohibit executives from hedging their stock. Therefore, they may freely weaken or undo their SOPs by entering into hedging transactions.

My results for overall SOP ineffectiveness are probably again underestimated because I do not account for possible CEO hedging activity. A future work should analyze the impact of actual hedging transactions on the ineffectiveness of current SOPs.

F. Lack of Sanctions

Only rarely do SOPs disclose sanctions that may be imposed for breaching these policies. In particular, more than 90% of policies in my study, or 379, have not disclosed sanctions. A 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.[118] Still, having a binding sanction policy is important because, for a variety of financial, psychological, and social reasons, boards cannot be expected to initiate the penalizing of executives who breach the terms of their SOPs.[119] Therefore, the lack of sanctions delivers an implicit message to investors that boards are not expected to take

[115] *Id.*

[116] Firms that invoke retention policies also prohibit hedging by their executives. The two firms that employ the common target ownership framework and do not count hedged stock are Public Service Enterprise Group and SunTrust Banks.

[117] See discussion in Part VII.

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

[119] *See* Lucian Bebchuk & Jesse Fried, PAY WITHOUT PERFORMANCE: THE UNFULFILLED PROMISE OF EXECUTIVE COMPENSATION 124–25 (2004), at 23–27 (describing sources of executives' influence over directors in public companies).

SOP violations seriously.[120] In practical terms, it can mean that SOPs are rendered inspirational rather than binding.

Moreover, the few disclosed sanctions generally do not impose meaningful penalties; most (twenty-eight of forty-five) merely impose a partial prohibition on future equity award sales,[121] and many of them are framed in ways that leave such a penalty to the discretion of the board of directors. Only in a very few cases, as with Merck's SOP, do firms penalize SOP violators by reducing their future equity grants.[122]

G. Suggestive Language

Many firms frame their SOPs in advisory rather than mandatory terms. That is, their policies are not phrased to require their top executive and directors to follow their SOPs but instead merely "call" their leadership team members to hold certain stock in their firms. For example, Archer Daniels Midland's SOP states, "The policy calls for members of senior management to own shares of common stock…."[123] Such language, along with the scarcity of sanctions, indicates that many SOPs are not designed to be binding.

VI. SOP INEFFECTIVENESS IS CAMOUFLAGED

Firms camouflage the extreme ineffectiveness of their SOPs in three ways: first, they do not provide bottom-line information regarding the effectiveness of their policies; second, many do not disclose critical terms of their SOPs to their investors; and third, when they do disclose critical terms, the implications of those terms are not apparent.

Firms manage to camouflage the ineffectiveness of their SOPs in part because the current disclosure rules, mandated by Regulation S-K, item 402,[124] allow them to do so. Such rules merely require them to disclose in their proxy statements their SOP objectives,[125] as well as provide a general description of the policy, including applicable

[120] Jesse Fried and I report a similar pattern with voluntarily adopted clawback policies. *See* Jesse Fried & Nitzan Shilon, *Excess–Pay Clawbacks*, 36 J. CORP. L. 722, 737 (2011) (reporting that among 81% of S&P 500 firms with policies (182/225), boards have discretion to forgo recovering excess pay, even if they find that the executive receiving the excess pay has committed misconduct).

[121] 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).

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

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

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

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

amounts and forms of ownership.[126] Firms may also disclose information not required by current disclosure rules. With SOPs, however, they seem to adopt a "lawyerly approach" and reveal only the information they are required to disclose.

A. Firms Do Not Indicate the Overall Effectiveness of Their SOPs

Firms do not disclose bottom-line information regarding the effectiveness of their SOPs. Specifically, they fail to report both the amount of vested stock that their CEOs are allowed to unload going forward and the scope of historical unwinding activity of stock recognized by their SOPs.

1. *Current SOPs Fail to Indicate the Amount of Vested Stock CEOs May Immediately Unload*

Current disclosures in firms' proxy statements fail to indicate the amount or the percentage of vested stock that CEOs may unwind according to their SOPs. Because this amount of stock reflects the amount of incentive that the CEO might have to deviate from SOP objectives, such information is the single most important indicator that should be disclosed in order to facilitate informed investor choice. In particular, as CEOs are allowed to sell more stock, their SOPs are less effective in aligning their incentives with those of their shareholders, in curbing their tendency toward excessive risk taking, and in incentivizing them to focus on long-term value maximization.

The lack of such disclosure not only is theoretically disturbing but also has a clear, practical importance. Hiding the bottom-line ineffectiveness of current SOPs disguises the fact that most policies allow CEOs to sell all the stock they own. Moreover, this flaw cannot be rectified by having shareholders figure out these numbers on their own. As I explain in section B below, even diligent and dedicated outsiders are often unable to produce the bottom-line effectiveness numbers for SOPs on their own.

2. *Firms Fail to Disclose Unwinding Activity of Stock Counted for SOP Purposes*

Because SOP terms, such as counting policies, are commonly both vague and potentially destructive for the effectiveness of these policies, knowing the bottom line for actual unloading activity becomes very important. Unfortunately, investors are not provided with information regarding how much stock recognized for SOP purposes their CEOs unloaded in previous reporting periods.

Section 16(a) of the Securities Exchange Act of 1934, which governs disclosure of stock-unloading activity related to insider trading, cannot substitute for specific disclosures regarding such activity recognized by SOPs. Although Section 16(a) requires CEOs, as well as other insiders, to report their individual stock purchases and sales on

[126] Item 402(b)(2) states that "examples 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).

Form 4 within forty-eight hours of such activity[127] and to file an annual statement of beneficial ownership of securities on Form 5, these disclosures do not give a full picture of the stock-unloading activity that may be counted for SOP purposes. This is because SOP counting policies commonly differ from the counting of securities by Section 16(a).

Knowing the historical stock unloading activity of their CEOs, even if they do not know the absolute strength of the SOPs, would help investors evaluate their managers' behavior in the shadow of the constraints those SOPs provide. Hence, it would help them determine the need to modify the strength of such policies.

B. Firms Do Not Disclose Critical Terms of Their SOPs

Having shown that investors are not provided with an overall assessment of the effectiveness of their SOPs, I now show that they are also not often provided with enough information—specifically, about critical terms that determine the functioning and effectiveness of these policies—to be able to form such an assessment on their own.

1. *Some 90% of SOPs Do Not Disclose Sanctions*

Only 45 of the 424 firms in this study that disclose their SOPs specify sanctions, which makes sanctions the least disclosed SOP term. Because Regulation S-K does not require sanctions to be disclosed, investors do not know whether this nondisclosure is due to the lack of sanctions in their firms' SOPs or to their firms' choice not to disclose them.

Leaving investors in the dark as to the existence of sanctions is troubling. As explained in Part V, the lack of binding sanctions sends a message that SOPs are not to be taken seriously, and it may even render these policies advisory rather than binding. Not knowing whether SOPs are binding is a critical hindrance for investors in their assessment of SOPs, as well as for the SOPs themselves in the accomplishment of the important goals they are intended to attain.

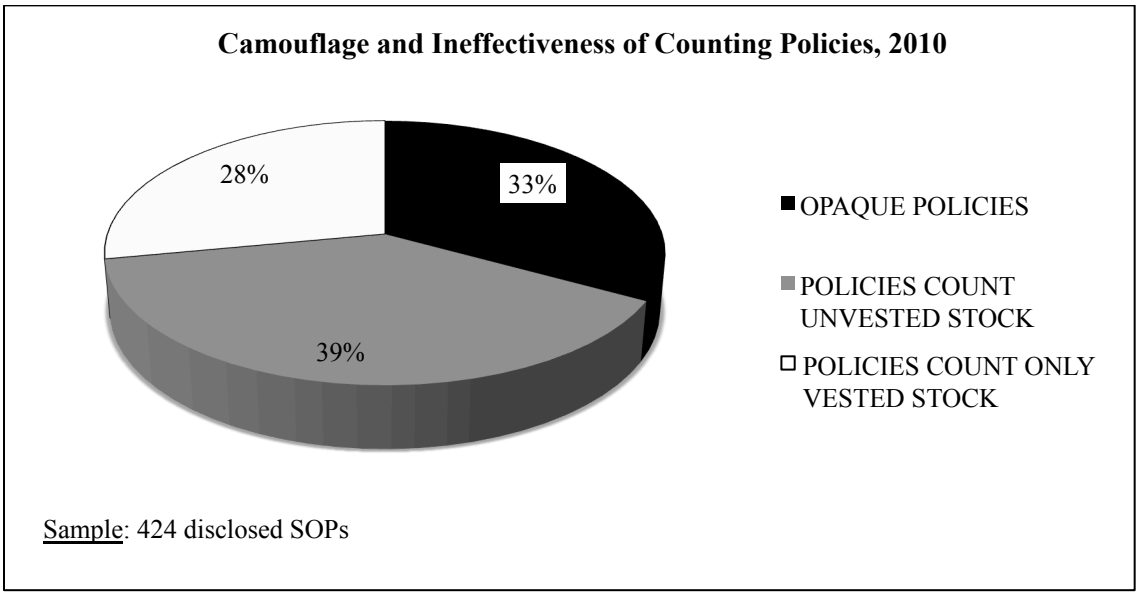
2. *One Third of SOPs Do Not Disclose Counting Policies*

Although counting policies are of crucial importance for SOP effectiveness, one third of policies do not disclose what type of stock may be recognized to satisfy them. Regulation S-K item 402(b)(2)(xiii) requires firms to disclose the "forms of ownership" recognized for their SOPs,[128] and many firms have interpreted this provision narrowly. For example, policies adopted by Cisco, Colgate-Palmolive, and Adobe merely identify *shares* or *common stock* for their counting policies without describing what type of shares or common stock may be counted to satisfy their requirements. Figure 7 illustrates how this opaqueness of counting policies adds to their ineffectiveness.

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

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

Figure 7: Camouflage and Ineffectiveness of Counting Policies as Applied to S&P 500 CEOs



Among all disclosed SOPs, one-third do not disclose counting policies despite the critical importance of such policies for evaluating SOPs. Most of the disclosed counting policies recognize unvested stock, thereby often rendering the SOPs completely ineffective,[129] while just 28% recognize only vested stock. Overall, my findings reveal not only a significant failure of firms to disclose counting policies but also a significant portion of SOPs being obviated when they do disclose counting policies.

Because counting policies are crucial in rendering SOPs ineffective, the nondisclosure of counting policies certainly precludes investors from evaluating their SOPs. Concern over this finding increases if one considers that such nondisclosure might present an adverse selection problem—namely, that firms that avoid revealing their counting policies do so because they have the least effective policies. Still, investors cannot simply assume that this is the case. Rather, they need clear information.

3. 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 phase-in policy disclosure, so the applicable legal standard for such policies is a general materiality test, according to which firms should consider whether their phase-in policies should be disclosed as part of their "general description of the policy."[130] Many firms choose to avoid disclosing their phase-in policies despite the great importance of such disclosure for investors who are interested in evaluating the effectiveness of their SOPs.

[129] Fifty-nine percent of these policies are completely empty, while the rest are significantly weakened.

[130] *Supra* note [124].

Such importance results from the fact that, as I reported in Part V, as many as 43% of disclosed phase-in policies render SOPs inapplicable.

Comparing the disclosure rates of various policies reveals a selective disclosure pattern, according to which firms tend to be more aggressive in camouflaging critical provisions that may render their SOPs more ineffective or may provide more valuable information to their investors. The most hidden SOP component is sanctions, despite the fact that the lack thereof can render SOPs entirely toothless. The second most hidden SOP component is counting policies, the nondisclosure of which renders SOPs ineffective in 58% of cases. Finally, the least hidden component is phase-in policies, which provide the least valuable information for investors; this is because only 43% of these policies render SOPs ineffective and the variation across disclosed phase-in policies is the least significant.

Because critical SOP terms tend to be camouflaged overall, SOPs have not been included in 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 these policies.

C. When Firms Disclose Critical SOP Terms, the Functioning of Those Terms Is Not Apparent

The discussion in section B highlights that firms frequently withhold information about critical SOP terms that could allow investors to assess SOPs on their own. In this section I explain that when firms *do* disclose critical terms of their SOPs, they do not indicate the impact of these terms on the effectiveness of their SOPs. In addition, some critical SOP terms are disclosed in an obscure way that might leave investors with the impression that they might not render these policies ineffective.

1. When Firms Disclose Critical SOP Terms, the Impact of Those Terms Is Not Apparent

Firms commonly fail to disclose that some critical terms of their SOPs render these policies entirely ineffective or significantly cripple them. The most important examples are counting policies and hedging policies.

a. Firms fail to disclose how counting unvested stock affects their SOPs

Despite the tremendous impact of counting policies on the effectiveness of current SOPs, firms never indicate *how* their counting policies affect the strength of their SOPs or whether allowing the counting of unvested stock renders a policy ineffective. For example, in describing its counting policy, UPS states that:

> Shares of class A common stock, deferred units and vested and unvested RSUs [restricted stock units] and RPUs [restricted performance units] are considered as

owned for purposes of calculating ownership."[131]

But UPS does not state that recognizing unvested RSUs and RPUs renders its SOP entirely ineffective for its CEO. It specifically does not disclose that its counting policy allows its CEO, Mr. Davis, to count his $12.3 million worth of his unvested RSUs and RPUs to satisfy his $8.4 million SOP commitment in full.

The detailed counting policy of KLA-Tencor Inc., suffers from a similar flaw:

> 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.[132]

KLA-Tencor does not explain that this policy renders its SOP entirely ineffective for its CEO, nor does it mention that the unvested stock, restricted stock, and stock units held by its CEO, Richard Wallace, equal more than four times Mr. Wallace's SOP threshold. The implication of this counting policy is that Mr. Wallace is in automatic compliance with his SOP without holding even a single stock that he owns. However, as with UPS, this material fact is not noted in the KLA-Tencor proxy statement.

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

It is important for investors to know how a CEO's actual hedging activity interferes with the economic incentives allegedly provided by the firm's 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 I explained in Part V, CEOs may hedge their SOP stock and thereby nullify the incentives provided by those policies.

Before the 2010 Dodd-Frank Act, which tightened the reporting obligations imposed on firms with regard to the hedging transactions of their directors or employees, firms were already required to report to the SEC derivative transactions made by their executives.[133] Section 955 of Dodd-Frank extended the hedging reporting requirements by requiring firms to disclose whether their directors and employees are permitted to hedge any decrease in market value of the company's stock.[134]

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[131] *See* United Parcel Services, Inc., Proxy Statement (Schedule 14A) at 45 (May 2, 2013).

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

[133] Forms 3, 4, and 5, pursuant to Sections 16(a) and 23(a) of the Securities Exchange Act of 1934, and Sections 30(h) and 38 of the Investment Company Act of 1940, 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's 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; *see* 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.

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

Still, firms are not required to—and never do—indicate how their managers' stock hedging affects their SOPs. This is particularly important because, as I reported in Part V, only two firms in my sample do not count stock subject to hedging. Therefore, fully hedged stock held by an executive is counted to satisfy his or her SOP, but investors are kept in the dark regarding the existence of such stock.

2. Critical SOP Terms Are Confusing

The second reason why the functioning of critical SOP terms is not apparent is that the framing of such terms is confusing, as can be seen primarily in the disclosures of target ownership levels and of counting policies.

a. Target ownership levels are typically obscure

The meaning of the term *salary* in describing the target ownership thresholds of current SOPs is confusing. The average policy, as I reported in Part IV, requires CEOs to hold five times their *base salary*.[135] However, some firms, such as UPS, use the term *salary* or *annual salary* to describe the *base salary* multiple of its CEO's target ownership level.[136] While for most employees, *salary* means total compensation, it means only less than 12% of total compensation for the average S&P 500 CEO.[137]

There is no a priori philological reason to assume that managers' salary is different from their total compensation. The exclusion of the stock-based portion of executive pay from the definition of *salary* becomes even less intuitive when one considers the SOP objective to translate the dramatic increase in stock-based compensation into managerial ownership. Therefore, using the term *salary* is not only confusing but also likely to give investors an impression that their SOPs function more effectively than they actually do.

b. Counting policies are commonly obscure

It is important for investors to know unequivocally when their SOPs allow the counting of unvested stock. This is because counting unvested stock renders SOPs completely ineffective in almost 60% of the cases and significantly weakens them in the remaining 40%.

Nonetheless, firms that count unvested stock commonly camouflage this fact. In

[135] I report only one firm, Chesapeake Energy Corp., that includes the annual bonus as part of its SOP salary multiple. This inclusion increases its SOP salary multiple from five to fifteen times its CEO's base salary.

[136] The SOP of UPS states that "target ownership for the Chief Executive Officer is eight times annual salary." *See* UPS Inc., Proxy Statement (Schedule 14A) at 45 (Mar. 18, 2013).

[137] In 2012, the average S&P 500 CEO was paid a total compensation of some $9.7 million, while her base salary was $1 million. Her equity compensation amounted to some $6 million, her annual bonus was some $2.3 million, and she earned other compensation of $0.4 million. *See* Equilar Inc., *supra* note [ ], at 18.

particular, they frame the holding of unvested stock—stock not owned yet by the executive—as *ownership,* as evidenced by the counting policy of AK Steel: "Ownership" includes...shares of Company restricted stock held directly by an Executive Officer, whether or not yet vested."[138] AK Steel uses the word *ownership* to describe unvested stock. Stating that *ownership* includes stock that is not yet owned by the executive might confuse investors and prevent them from realizing that such provisions significantly weaken SOPs and often render them entirely ineffective.

VII. THE TROUBLING IMPLICATIONS OF SOP INEFFECTIVENESS AND CAMOUFLAGE

Before proposing a regulatory reform to make SOPs transparent, it is important to explain why the ineffectiveness of current SOPs, and especially the camouflaging of such ineffectiveness, is troubling.

A. SOP Ineffectiveness Prevents These Policies from Achieving the Important Goals They Have Been Established to Attain

Because they are so ineffectual, current SOPs are not likely to affect managers' incentives and behavior. I reported in Part V that current SOPs allow two-thirds of CEOs to sell 100% of their vested stock immediately. Such CEOs are not likely to shy away from taking excessive risks any more than are managers who do not have SOPs. Similarly, current SOPs do not curtail managers' incentives to take other actions that those policies were designed to discourage.

Evidence from the years leading up to the 2008 financial crisis casts doubt upon the efficacy of SOPs in curtailing managers' incentives to take excessive risks, even in the face of SOPs that are significantly more effective than current ones. Specifically, at that time Lehman Brothers[139] had an SOP imposing a "liquidity limit," which prohibited its senior managers from unloading stock in any given year in excess of 20% of their total equity holdings in the company (including outstanding equity awards).[140] Compared to current SOPs, Lehman's SOP was relatively strict. Nevertheless, the company's top five executives sold Lehman stock worth $1.1 billion between 2000 and 2008.[141] This finding suggests that Lehman's SOP did not curtail its executives' incentives to take excessive risks.[142] If a 20% annual unloading cap did not curb Lehman's executives' incentives to take excessive risks, then the significantly weaker unloading limitations in current SOPs should fair much worse.

Similarly, because they are ineffectual in preventing managers from unloading their incentive compensation, current SOPs are not expected to help align managers' interests with those of shareholders. That managers are able to unload their stock poses

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

[139] Lehman Brothers bankruptcy filing in September 2008 triggered a widespread panic that prompted a global financial crisis.

[140] *See* Lehman Brothers Holdings, Inc., Proxy Statement (Schedule 14A) at 23 (Mar. 5, 2008).

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

[142] *Id.*

the risks not only that such stock will be sold and that managers will have less "skin in the game," but also that managers will have incentives to act against shareholder interests, as they do when they take excessive risks. Thus, ineffective SOPs do not discourage such actions and sometimes even encourages them.

Finally, the current ineffectiveness of SOPs precludes these policies from helping to tie pay to performance. In the first part of this article, I explained how SOPs could help in this regard by decreasing managers' ability to (i) avoid suffering personal losses resulting from their poor performance, (ii) generate personal profits despite their poor performance, and (iii) earn a salary that is not commensurate with their risk management abilities. Because camouflaging the ineffectiveness of such policies enables managers to engage with impunity in activities that SOPs were meant to prevent, I conclude that SOPs do not live up to the expectations firms have created.

B. The Camouflage of SOP Ineffectiveness Misleads Investors and Inhibits Attempts to Fix These Policies

While SOP ineffectiveness prevents current SOPs from attaining their goals, the camouflaging of such ineffectiveness misleads investors into believing that these policies actually achieve their goals. Specifically, when firms tout their SOPs as a key element in their mitigation of risk and then camouflage the inability of these policies to achieve that goal, they send mixed messages to the markets and create confusion.

If the ineffectiveness of current SOPs were transparent, outsiders would know that these policies do not live up to the expectations firms have created and do not tie managers' wealth to that of long-term shareholders. Outsiders might mistakenly believe that SOPs are effective enough to force managers to hold a significant amount of their vested stock for the long term, and that their stock holdings would encourage them to maximize their firms' long-term value.

However, because SOP ineffectiveness is camouflaged, investors tend not to realize that these policies do not attain their goals; accordingly, investors are not inclined to consider possible responses to remedy this failure. Such responses might include three courses of action. First, investors might conclude that SOP ineffectiveness is optimal, considering the liquidity and diversification costs associated with having effective SOPs, and in light of such costs, they might even decide that they prefer not to have SOPs. Second, they might decide, after weighting the costs and benefits, that SOPs should be more effective. Third, they might decide that it is more cost-effective to attain SOP goals by strengthening other policies. For example, to curb excessive risk taking, they might push for increasing the long-term portions of managerial incentive pay or for reducing the convexity of executive pay arrangements by moving from stock options to restricted stock pay.

The camouflage of SOP ineffectiveness and the illusion that these policies achieve their goals not only inhibits shareholder action but also makes board action unlikely. While the lack of transparency hampers investors' ability to make accurate

assessments of current SOPs and perhaps to pressure boards to change those policies, it distracts boards of directors from understanding how these policies function (or do not function). Without disclosure of credible and full information about the functioning of current SOPs, boards are unaware of the need to confer with their executives about how SOPs should be designed. Currently, boards are unaware of the need to improve their SOPs in order to fulfill the important goals they are held to attain.

C. The Camouflage of SOP Ineffectiveness Suggests That Their Weakness Is Undesirable

That the weakness of SOPs is camouflaged indicates that firms think that such weakness, if it becomes transparent, will come across as undesirable; otherwise, firms would disclose it. A decision to have ineffective SOP or to avoid adopting an SOP altogether, is desirable when the personal costs that managers stand to incur if an effective policy is adopted outweigh the potential benefits that shareholders stand to gain. Because such managerial costs are likely to be rolled over to shareholders[143]—for example, in the form of an increase in executive pay—a desirable decision to render an SOP ineffective protects shareholders from incurring such costs.

However, if the current weakness of SOPs were a selling point in markets, disclosure of their ineffectiveness would be expected to increase stock price and firm value. This is consistent with empirical studies that show that corporate governance terms that benefit shareholders are associated with higher stock price.[144] Similarly, corporate governance terms that do not benefit shareholders are associated with lower stock prices. Therefore, firms' choice to camouflage the ineffectiveness of current SOPs indicates that they think that these policies are value-decreasing and that their transparency would result in a stock price decline.

D. SOP Ineffectiveness and Camouflage Indicate Managers' Excessive Power vis-à-vis Shareholders

Adopting ineffective SOPs and camouflaging their ineffectiveness allows executives to have the best of both worlds. Namely, it allows them to reap the reputational gains associated with having effective SOPs without incurring the personal costs associated with stringent SOPs.[145] The camouflage of these policies allows this to happen because it hides from investors the fact that managers should not be rewarded with such reputational gains. Moreover, SOP camouflage makes it unlikely that outsiders will exert pressure on firms to make their SOPs more effective, which would, of course, force executives to incur the costs they seek to avoid.

Bebchuk and Fried explain that, for a variety of financial, social, and

[143] *See* Michael C. Jensen & William H. Meckling, *supra* note [ ].

[144] *See* Lucian Bebchuk, Alma Cohen, & Charles C.Y. Wang, *Learning and the Disappearing Association Between Governance and Returns*, 108 (2) J. FIN. ECON. 323 (2013) (reporting the disappearance of the governance-return correlation in 2000–2008).

[145] For a discussion of such liquidity and diversification costs, please see Part I.

psychological reasons, it is personally difficult for directors in public firms to support compensation decisions that are costly for executives.[146] This same reasoning should explain why it is hard for directors in public firms to support pay disclosures that stand to embarrass executives. For example, a director who was put on the board by the CEO might feel uncomfortable proposing that the ineffectiveness of the SOP, which is supposed to constrain the CEO, be made transparent. In this way, executives have considerable power vis-à-vis directors.

Compared to other corporate policies, SOPs put directors in a greater conflict of interest with shareholders. This is because directors are typically subject to SOPs similar to the ones that apply to executives. Therefore, the interests of the executives with regards to SOPs are aligned with those of their directors, which makes the directors' task to supervise and monitor the executive team in order to protect shareholders significantly harder. The weakness of directorial incentives to use SOPs as an effective monitoring tool results in sacrificing shareholder interests for the benefit of the executives and the directors themselves.

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

Excessive managerial power is also consistent with firms avoiding disclosure of sanctions, which leaves significant room for board discretion. Because executives possess significant power and influence over directors, it is likely that directors will avoid penalizing executives for SOP violations. The phenomenon of allowing board discretion in order to save executives from possible punishments is not exclusive to SOPs; it has also been shown that board discretion has been used to forego clawbacks of excess pay from executives.[147]

VIII. MAKING SOPS TRANSPARENT

Having shown that the camouflaging of SOP ineffectiveness is fundamentally troubling, I now explain why investors are not able to evaluate SOP effectiveness on their own. First, as I explained in Part VI, even diligent and dedicated investors are commonly unable to evaluate the bottom-line effectiveness of current SOPs on their own. This happens because firms do not disclose critical terms of their policies and because when they do disclose such terms, the functioning of those terms is not apparent.

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

[147] *See* Jesse Fried & Nitzan Shilon, *supra* note [ ], at 739 (2011) (reporting that boards can exercise discretion to avoid clawbacks even if they determine that an executive has committed misconduct, and explaining that requiring directors to recoup excess pay, without leaving it up to the board discretion, is the only way to ensure that such recovery occurs).

Second, even if critical terms are disclosed and their functioning is clear enough, investors would have to make multiple calculations and assumptions and would often end up with ambiguous estimations. For example, if they wanted information about current CEO holdings pursuant to the CEO's SOP, they would have to extract that information from the "information on stock ownership of directors and executive officers" table in firm's proxy statement. However, this table is governed by Section 16 of the Securities and Exchange Act and does not follow the SOP framework. In particular, it includes stock held in 401(k) plans, in trusts, and by family members, and many counting policies fail to address whether such stock should be counted. Similarly, in order to calculate the unvested stock that might be counted toward satisfying the SOP threshold, they would need to refer to the "outstanding equity awards at fiscal year-end table" in the firm's proxy statement. However, the distinctions that that table makes between various types of unvested stock often do not align with the distinctions made by counting policies.

The inability of investors to analyze SOP disclosures in order to reach unequivocal estimations of current SOP functioning is similar to their inability to analyze executive pay disclosures prior to the 1992 disclosure reform of executive compensation. An SEC official describes the pre-1992 camouflage of the amount and form of executive pay as follows:

> 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.[148]

The 1992 disclosure reform, which required the standardized compensation tables that firms must now use, made camouflage more difficult. Such a disclosure reform is similarly needed to make SOP camouflage harder.

Finally, because shareholders know ex-ante that even diligent and dedicated investors are unable to successfully evaluate SOPs and that such attempts will usually produce ambiguous results, they might choose to save the costs associated with evaluating SOPs and avoid engaging in this process. Because shareholders are typically dispersed and each individual investor will have to incur the full costs of evaluating an SOP but will benefit from only a fraction of its potential improvement, shareholder efforts to evaluate SOPs suffer from a collective action problem.[149] Such a problem will

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

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

discourage shareholders even more from attempting to evaluate SOPs.

It is not only investors who are unable to successfully evaluate current SOPs but also the influential ISS, whose guidelines are followed by institutional investors and firms alike. Unfortunately, firms can score high on ISS's GRId despite their grossly 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, my analysis shows that GRId ignores limp counting policies, phase-in periods, and sanctions, as well as hedging activity, and so does not evaluate the bottom-line effectiveness of SOPs.

Because SOP camouflage is troubling, because shareholders are unlikely to overcome it camouflage by evaluating SOP effectiveness on their own, and because ISS does not do a good job in pressing firms to improve their SOPs, there is no substitute for a regulatory intervention. Regulatory intervention may take different courses. The most aggressive intervention would be implementation of mandatory rules for SOP design. This option is not desirable, however, because there is no one SOP prescription that fits all firms. The benefits of having such SOPs vary greatly according to firms' propensity for risk and the magnitude of internal agency problems. Other parameters, such as firm size, industry, and shareholder composition and preferences, increase the variance in SOP benefits. The costs associated with having SOPs vary significantly as well, depending on such idiosyncratic managerial characteristics such as need for liquidity, voluntary stock holdings, portfolio composition and size, and risk aversion.

A less intrusive policy suggests default SOP rules. Such rules are designed, on the one hand, to allow market forces, to a certain extent, to tailor the desirable policy to meet the needs and circumstances of each firm. On the other hand, they are also designed to affect the outcome by setting up certain default rules.[150] This course of action might be desirable for certain SOP elements, such as counting policies or sanctions, that are consistent weaknesses. However, as a first step, it would be preferable to avoid dictating default rules and instead merely mandate that SOPs become transparent; this course of action would allow market forces to respond freely to such disclosures.

Making the ineffectiveness of SOPs transparent should allow shareholders, boards, and policy makers to engage in a dialogue to improve current SOPs according to each firm's individual characteristics and the needs of specific industries.[151] Protecting investors by providing them with critical information about their investments is the basic purpose behind securities regulation. Transparency is particularly important in the case of SOPs because knowing whether these policies accomplish what they were designed to accomplish constitutes critical information for investors. Therefore, I turn to discuss a

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firms' SOPs), but that action has an associated cost that makes it implausible that any one individual would find it cost-effective to undertake this action alone.

[150] *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).

[151] For example, bank regulators might be interested in imposing a special SOP regime on bank executives because of the prominence of risk-taking incentives in this sector.

proposal to make SOPs transparent and explain why such reform can be expected to start a process that will improve the content of these policies.

A. Proposal to Reform Regulation S-K

1. Disclosure of SOP Bottom-Line Effectiveness

I propose to revise Regulation S-K, Item 402, to require disclosure of quantitative indices for SOP bottom-line effectiveness. In particular, firms should be required to disclose for each of their top five executives (i) the percentage and value of vested and nonhedged equity that may be immediately unloaded; (ii) the separate values of vested and unvested equity held that are recognized by the firm's SOP counting policy; and (iii) the percentage and aggregate value of equity sold and accumulated during each of the previous three years. Whereas the first indicator highlights the extent to which executives may use their freedom to unwind their equity grants, the second indicator provides a clear picture of their current SOP holdings, and the third indicator provides information about the historical changes in their SOP holdings. This quantitative information is crucial to enable investors to evaluate the bottom-line effectiveness of their firms' SOPs.

Once such bottom-line effectiveness indicators are disclosed, reputation considerations are expected to push firms to improve their SOPs on their own; however, such improvements will not necessarily increase the effectiveness of current policies. Some firms might prefer to eliminate their SOPs altogether . This would be desirable as well, because it would put an end to all the feckless policies that are incapable of accomplishing what they were designed to do.

2. Disclosure of Critical SOP Terms

In addition to providing indices for SOPs' bottom-line effectiveness, firms should be required to provide qualitative data about the functioning of their SOPs. Here I focus on critical terms that have a major impact of current SOP effectiveness. In particular, the following additional information should be disclosed in firms' SOP narrative sections:

i. Counting policy, and specifically the type of stock-based holdings that are recognized for satisfying the policy requirements, with a special emphasis on unvested stock and hedged stock. When a policy allows the counting of unvested or hedged stock, it should specify the amount of such stock that it recognizes and the percentage of its target threshold that the stock satisfies.
ii. Applicable phase-in policy, whether its top five executives have already phased in, and whether the phase-in policy includes an RHT provision.
iii. Sanctions, if any, that executives face for violating their SOPs
iv. Any ongoing stock retention requirements.

Improved disclosure of SOP bottom-line effectiveness and critical qualitative terms will, at a minimum, significantly improve the accuracy of investor information and help to make sure that SOPs serve the important goals they were designed to attain. Also,

this reform will be inexpensive to implement because firms generally have access to this information already[152] and can undoubtedly obtain it at a lower cost than can shareholders or researchers.[153]

B. Greater Transparency Should Improve Current SOPs

I expect that better transparency will improve the actual content of SOPs because investors and boards not only will know better what these policies do but also will act on this information. Boards are expected to take actions to improve SOPs regardless of the pressure they might face from their shareholders. Currently, SOP camouflage keeps the problems associated with these policies hidden from their directors, who are part-time non-employees with limited time and abundant responsibilities in which to performing their monitoring duties. Because boards and compensation committees, even if loyal and dedicated, are unable to analyze the hidden aspects of all corporate policies, making SOPs transparent will provide them with the information they need to evaluate their SOPs and will alert them to problems that are currently hidden.

Better transparency is expected to improve board action even when boards are disloyal to investors. This is because when SOPs become transparent, outrage costs[154] will push boards for SOP reform in order to avoid embarrassment and the social costs associated with having SOPs that are incapable of achieving what they were designed to do. 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.[155]

In addition, better disclosure will encourage shareholder action as it will provide them with the processed information they need to successfully evaluate SOPs. Having such information will also alleviate shareholder collective action problems because shareholders will no longer need to expend considerable resources in order to collect and process such information. And better disclosure will help institutional investors identify systemic problems regarding SOPs in their portfolios and evaluate proposed SOP reforms. Transparency across the board will make systematic analysis available for institutions with a fairly modest investment of resources.

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[152] 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).

[153] 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).

[154] 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.

[155] *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.

Finally, the 2006 SEC reform of executive pensions disclosure serves as a precedent for the kind of reform I propose to improve the actual content of SOPs. In 2005, Bebchuk and Jackson revealed that the amounts of executive pensions were systematically camouflaged.[156] 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, thereby placing executive pension plans on investors' radar screens. Following this 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.[157]

The camouflaging of current SOP ineffectiveness is at least as severe as that of executive pensions before December 2006. It might even be more severe because, unlike pensions before December 2006, one-third of current SOPs cannot be evaluated at all, even if extensive assumptions are made.

C. Potential Objections to Making SOPs Transparent

Critics might argue that shareholders do not want their firms to adopt effective SOPs because most U.S. shareholders seek short-term gains and therefore want managers to have short-term incentives.[158] Based on the NYSE index data, the mean holding period of U.S. investors in 1940 was around seven years. This stayed the same for the next thirty-five years but has since fallen sharply to only around five months. 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 more than 100% per quarter in recent years.[159]

However, when it comes to corporate governance, institutional investors are more relevant than short-term traders. Between 1991 and 2009, as direct individual ownership in the United States fell from 60% of the market to 40%, institutional investors became the dominant investors, and their prominence is set to continue.[160] Institutional investors, and especially pension funds and life insurers, traditionally have investment horizons that are tied to the often long-term nature of their liabilities.[161]

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

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

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

[159] *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).

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

[161] Recently, institutional investors have been labeled as "short-termist." Signs of growing short-termism include the facts that investment holding periods are becoming shorter, and that allocations to less liquid, more long-term assets are generally very low and are being overtaken in importance by allocations

Critics might also be concerned that making SOPs transparent would not necessarily motivate firms to change the actual content and design of their SOPs. Rather, firms might prefer to leave their SOPs intact and explain why they choose to adopt ineffective policies, as Viacom Inc., has done.[162]

My response to this potential concern is that transparency will encourage checks on corporate decisions with regard to SOPs. It might be that some ineffective policies should remain weak, and I do not argue that all SOPs should necessarily be more stringent. The market checks on these policies will make sure that their design and effectiveness are in line with shareholder interests. My argument is consistent with the philosophy of U.S. securities laws, which require public companies to disclose meaningful financial and other information to the public. SOPs should make no exception to this basic principle.

Finally, some people might argue that the enhanced disclosure I propose might trigger unintended consequences, such as exerting populist pressure on firms to adopt overly restrictive SOPs. As I explained in Part VI, inefficiently stringent policies could end up inflating executive compensation as well as destroy more value by making managers too risk averse. Considering the history of congressional attempts to reform executive compensation, unintended consequences such as those that caused the surge in overall executive compensation as a result of stock options and bonuses following the attempt to cap executive salaries in 1993[163] should not come as a surprise.[164]

However, our experience with the market response to the 2006 SEC pensions enhanced disclosure reform should alleviate this concern. Disclosure of pension payments 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 improved efficiency in current SOPs when they become transparent.

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to hedge funds and other high-frequency traders. Other related concerns over the behavior of institutional investors are their herdlike mentality and their tendency to be "asleep at the wheel" and fail to exercise a voice in corporate governance. However, these concerns do not change institutional investors' basic long-term incentives, and now there is a trend for more "responsible" and longer-term investment among them—in particular, pension funds, life insurers, and mutual funds that operate in retirement savings arrangements. *See id,* at 4.

[162] *See* Viacom Inc., Proxy Statement (Schedule 14A) at 42 (Apr. 16, 2010) (stating: "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.")

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

[164] *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).

IX. CONCLUSION

This article has investigated current SOPs. These policies were universally adopted in response to the 2002 corporate scandals and especially to widespread pressure following the 2008–2009 financial crisis. I have shown that firms advertise SOPs as a key element in their mitigation of risk and their general alignment of managers' interests with the interests of shareholders. The current U.S. regulatory approach to SOPs leaves decisions on the adoption and design of these policies up to each firm's own determination, and disclosure requirements are severely flawed.

I contend that current SOPs are extremely ineffective in making CEOs hold on to their firm stock and that this ineffectiveness is camouflaged in firms' public filings. Taken together, these two circumstances are troubling. They raise concerns that SOPs are unable to fulfill the important objectives they were adopted to attain, that their content is undesirable, and that these weaknesses reflect excessive managerial power.

A regulatory reform that will focus on making SOPs transparent is expected to push both boards and shareholders to improve the actual content of SOPs in public firms. It would be a cheap and easy way to facilitate an informed assessment of SOPs, which would enable constructive discussion on how SOPs should be designed. I hope that my framework and analysis in this article will be useful for future research that will investigate how executive hedging affects SOP effectiveness. The case for making SOPs transparent is set.