PAYING FOR LONG-TERM PERFORMANCE

Lucian A. Bebchuk and Jesse Fried

Discussion Paper No. 658
12/2009

Harvard Law School
Cambridge, MA 02138

This paper can be downloaded without charge from:

The Harvard John M. Olin Discussion Paper Series:
http://www.law.harvard.edu/programs/olin_center/

The Social Science Research Network Electronic Paper Collection:
http://ssrn.com/abstract=1535355

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

Firms and regulators around the world are now seeking to ensure that the compensation of public company executives is tied to long-term results to avoid creating incentives for excessive risk-taking. This paper analyzes how this objective can be best achieved. Focusing on equity-based compensation, the primary component of executive pay packages, we identify how such compensation could be best structured to tie remuneration to long-term results rather than short-term gains that might turn out to be illusory. We also analyze how equity compensation could be best designed to prevent the gaming of equity grants at either the front-end or the back-end.

Key words: executive compensation, executive pay, equity-based compensation, restricted shares, options, risk-taking, long-term, retention, backdating, spring-loading, insider trading, hedging, derivatives.

JEL Classification: G28, K23
# Table of Contents

I. Toward a Redesign of Equity Compensation ................................................................. 1

II. Long-Term Retention of Equity Incentives ................................................................. 4

   A. Separating Vesting and Cash-out Dates ................................................................. 5

   B. When Should Executives Be Permitted to Cash Out Equity? ............................ 7

III. Preventing Gaming .................................................................................................... 11

   A. The Front End ........................................................................................................ 12

      1. The Timing of Equity Grants .............................................................................. 12

      2. Stock-Price Manipulation Around Equity Grants ............................................. 14

   B. The Back End ......................................................................................................... 16

      1. Using Inside Information to Time Equity Unwinding .................................... 16

      2. Stock-Price Manipulation Around Unwinding ................................................. 17

      3. Reducing Back-End Gaming ............................................................................. 19

         a. Average-Price Payoffs .................................................................................. 19

         b. Further Steps for Reducing Executives’ Insider Trading Profits .................. 21

            1. Pretrading Disclosure ............................................................................... 22

            2. “Hands-Off” Arrangements ..................................................................... 23

   C. Preserving the Principles of Good Equity Compensation .................................... 25

IV. Conclusion .................................................................................................................. 26
I. Toward a Redesign of Equity Compensation

In the aftermath of the financial crisis, legislators, regulators, and firms are seeking to put in place executive pay arrangements that avoid rewarding executives for short-term gains that do not reflect long-term performance. This essay seeks to contribute to these efforts by analyzing how pay arrangements can and should be tied to long-term performance. Our analysis focuses on equity-based compensation, the most important component of executive pay arrangements.

In our 2004 book, Pay without Performance: The Unfulfilled Promise of Executive Compensation, we warned that standard executive pay arrangements were leading executives to focus excessively on the short-term, motivating them to boost short-term results at the expense of long-term value. The crisis of 2008-2009 has led to a widespread recognition that pay arrangements that reward executives for short-term results can produce incentive to take excessive risks. The importance of avoiding such flawed structures has been emphasized not only by leading public officials, such as Fed Chairman Ben Bernanke and Treasury Secretary Timothy Geithner but also by top business leaders such as Goldman Sachs’ CEO Lloyd Blankfein.

The recognition of the significance of the problem has led to substantial interest in fixing it. Treasury Secretary Timothy Geithner has urged corporate boards to “pay top executives in...

---

1 Lucian Bebchuk and Jesse Fried, Pay Without Performance: The Unfulfilled Promise of Executive Compensation (Harvard University Press, 2004), chapter 14 (analyzing problems resulting from the broad freedom of executives to unload equity incentives). See also Richard Bernstein, Critic of High C.E.O. Pay Is Vindicated, New York Times, June 18, 2009 (New York Times article arguing that the analysis in our book was vindicated by the subsequent financial crisis).

2 See Ben S. Bernanke, The Financial Crisis and Community Banking, speech given at the Independent Community Bankers of America's National Convention and Techworld, Phoenix, Arizona (03/20/2009), available at http://www.federalreserve.gov/newsevents/speech/bernanke20090320a.htm#fin3 (declaring “poorly designed compensation policies can create perverse incentives … Management compensation policies should be aligned with the long-term prudential interests of the institution, be tied to the risks being borne by the organization … and avoid short-term payments for transactions with long-term horizons.”)

3 See statement by Treasury Secretary Tim Geithner on Compensation, June 10, 2009 (TG-163) (available at http://www.ustreas.gov/press/releases/tg163.htm) (stating that “compensation should be structured to account for the time horizon of risks”).

4 See Lloyd Blankfein, Do not destroy the essential catalyst of risk, Financial Times 02/09/2009, p. 7 (stating that “An individual's performance should be evaluated over time so as to avoid excessive risk-taking”).
ways that are tightly aligned with the long-term value and soundness of the firm.” The TARP bill, subsequence legislation amending TARP, and the Treasury regulations implementing TARP all require the elimination of incentives to take “unnecessary and excessive risks” in firms receiving TARP funds. The Treasury’s plan for financial regulatory reform calls on federal regulators to issue standards for all financial firms to avoid excessive risks, and a bill recently passed by the House requires regulators to adopt such standards.

At the international level, the Basel II framework has been recently amended to require banking regulators to monitor compensation structures with a view to aligning them with good risk management. And the Finance Ministers and central Bankers of the G-20 earlier this month called for global standards on pay structures “to ensure compensation practice are aligned with long-term value creation.”

While there is thus widespread recognition that improving executives’ long-term incentives is desirable, it is less clear how this should be accomplished. The devil here, not surprisingly, is in the details. In this paper, we seek to contribute to the reform of executive pay by providing a framework and a blueprint for tying executives’ equity-based compensation – the primary component of their pay packages – to long-term performance.

The remainder of the paper is organized as follows. Part II explains how executives should be incentivized to focus on the long term rather than the short run. Currently, managers

---

6 Section 7001 of the American Recovery and Reinvestment Act of 2009, 111 H.R. 1, amending Section 111(b) of the EESA (previous note).
9 Section 4(b) of the Corporate and Financial Institution Compensation Fairness Act of 2009, 111 H.R. 3269 (approved by the House on July 31, 2009).
10 See BASEL COMMITTEE ON BANKING SUPERVISION, ENHANCEMENTS TO THE BASEL II FRAMEWORK para. 84-94 (July 2009).
are generally free to cash out their equity once it vests. We explain that managers should not be able to freely unwind their equity once it vests. Rather, they should be “blocked” from cashing out the equity for a specified period of time after vesting. Importantly, the cashing out should not be tied – as some have proposed -- to an executive’s retirement date. Coupling large cash payouts to retirement, we show, can distort their decision to retire as well as undermine executives’ incentive to focus on long-term value as they approach retirement.

Part III describes how executive compensation arrangements should be structured to prevent various types of “gaming” that secretly increase executive pay at public shareholders’ expense and, in some cases, worsen executives’ incentives: so-called “spring-loading” (using inside information to time equity grants), selling on inside information, and the manipulation of the stock price around equity grants and dispositions. We discuss how to control both gaming at the “front-end” – when equity is granted – and gaming at the “back end” – when equity is cashed out.

At the front end, we suggest that the timing of equity grants should not be discretionary. Rather, equity should be awarded only on certain pre-specified dates. In addition, the terms and value of equity grants should not be linked to the grant-date stock price, which can easily be manipulated. The combination of these two steps at the front end – fixing equity grant dates and not tying equity grants to the grant-date stock price – would substantially reduce both springloading and stock price manipulation around equity grants.

At the back-end, we suggest that the payoffs to unwinding equity should be based on the average price over a sufficiently long-period rather than the price on a particular date. Such an approach, we show, would reduce executives’ ability to inflate their stock-sale profits by using inside information to time their sales. It would also reduce executives’ ability to manipulate the stock price around dispositions.

Two additional steps can be taken to further reduce executives’ ability to use inside information to increase their sale profits. First, executives could be required to announce their intentions to unwind equity in advance. Second, firms could use “hands-off” arrangements under which an executive’s vested equity is automatically sold according to a schedule that is specified when the equity is granted. The second proposal, we explain, would do more than just reduce executives’ insider selling profits: it would eliminate them altogether.
We end Part II by recommending that firms take steps to ensure that executives cannot easily evade the proposed arrangements – both those that require executives to hold equity for the long-term and those that prevent gaming. Deploying arrangements that are desirable in theory will have little effect if they can easily be circumvented in practice. A conclusion follows.

II. LONG-TERM RETENTION OF EQUITY INCENTIVES

The problem we identified in *Pay without Performance* is that many standard features of pay arrangements fail to provide managers with desirable incentives to generate value. Indeed, perversely, they often motivate executives to destroy value. This is the case with respect to pay arrangements that reward executives for short-term results that do not necessarily reflect long-term performance and may in fact come at the expense of long-term value.

Consider an executive who expects to be rewarded at the end of a given year based on performance measures tied to the stock price at the end of this year. This compensation structure may lead to two types of undesirable behavior. First, managers may take actions that boost the stock price in the short-run even if they would destroy value in the long run. For example, executives may enter into transactions that improve the current bottom line but create large latent risks that could cripple the firm in the future. Second, managers may engage in financial manipulation or other forms of “window dressing” that do not build firm value, merely to pump up short-term prices. In both cases, executives receive higher pay even though they fail to build firm value. And in the first scenario, executives receive more pay even though they destroy firm value. Thus, rewarding executives for short-term results not only fails to serve the goal of incentivizing executives to improve firm performance – it can actually work in the opposite direction.

Equity compensation arrangements should therefore incentivize executives to maximize long-term value, not the short-term stock price. But how should this be achieved? Below we explain that requiring executives to hold their equity until retirement, as some have proposed, would create undesirable incentives. A better approach, we show, would be to require executives to hold a large fraction of their equity for a fixed period after vesting.
A. Separating vesting and cash-out dates

Executive compensation arrangements usually include stock options, restricted stock, or a combination of both types of equity compensation. Under a typical stock option plan, a specified number of options vest each year as compensation for that year’s work. Such a vesting schedule encourages an executive to remain with the firm. Once options vest -- i.e., once they are “earned” -- executives are generally free to exercise the options, and sell the underlying shares. The options typically remain exercisable for 10 years from the grant date.

Restricted stock grants operate in much the same manner as stock option plans. The stock is called “restricted” because executives do not own the stock outright when it is granted. Rather, ownership of the stock vests over time, in part to give the executive an incentive to stay on the job. When the vesting period ends, the restricted shares “belong” to the executive and, as with options, she is generally free to cash them out.

Not surprisingly, executives take full advantage of their freedom to unload equity incentives after vesting. For example, stock options are exercised years before they expire, and almost all of the shares acquired through option exercises are immediately sold. As a result, executives are frequent sellers of their firms’ stock.

To be sure, a number of firms have created target stock ownership plans -- plans that either encourage or require executives to hold a certain amount of vested shares. The target amount is often expressed as a multiple of the executive’s salary. But because salary is typically only a small fraction of the executive’s total compensation, the targets tend to be low. Thus neither option plans nor restricted stock arrangements usually prevent executives from unloading a substantial amount of equity once it vests.

As we explained in our book, such early unwinding imposes two types of costs on shareholders. First, the corporation must now give the unwinding executive fresh equity grants to replenish her holdings; otherwise, the executive’s incentive to generate shareholder value will be diminished. These replenishment grants economically dilute current public shareholders by

---

14 See Bebchuk and Fried, supra note 12, at 177-178.
reducing their fractional ownership of the corporate pie. If executives were unable to unwind their stock and options so quickly after vesting, the cost of replenishing executives’ equity positions would be lower.

Second, and more importantly for our focus in this paper, the ability to sell equity shortly after vesting leads executives to focus excessively on short-term prices – the prices at which they can unload their shares and options. At any given point in time, executives may have accumulated – and wish to unload -- a large number of vested shares or options. Once executives have decided to sell large amounts of stock, they are motivated to maximize the short-run stock price, even if these steps reduce the corporation’s long-term value.

Both of the costs associated with early unwinding can be mitigated with a simple step: separating the time that restricted stock or options can be cashed out from the time that the equity vests. By requiring an executive to hold the equity for a longer period of time, the board will not need to replenish that executive’s holdings as frequently. This, in turn, will reduce the cost to shareholders of maintaining the executive’s equity ownership at an adequate level. Such a holding requirement will also reduce the executive’s incentive to focus on the short-term, since the payoff from her equity will depend on stock prices in the long run.

Although the end of the vesting period and earliest cash-out date are almost always the same under current option and restricted stock plans, there is no reason for the two dates to be identical. As soon as an executive has completed an additional year at the firm, the restricted stock or options that were promised as compensation for that year’s work should vest: they should belong to the executive even if the executive immediately leaves the firm. But the fact that the equity is now the executive’s to keep does not mean that the executive should be able to immediately cash out the equity.

This leads us to:

**Principle 1: Executives should not be free to unload restricted stock and options as soon as they vest. Rather, executives should be “blocked” from cashing out the equity for a specified period of time after vesting.**

---

15 See Bebchuk and Fried, supra note 12, at 175-176.
B. When should executives be permitted to cash out equity?

If, as we suggest, cash-out dates are separated from vesting dates, the length of the “blocking” period between vesting and cash-out must be determined. A number of commentators and shareholder activists have proposed that the cash-out date be linked to retirement. 16 Under such an approach, executives would be blocked from unwinding their equity positions until after they had retired from their firms.

Several dozen firms, including Deere, Boeing, Exxon Mobil, and Citigroup have already adopted variants of retirement-based plans. Most of these plans require executives to hold a certain amount of stock until retirement – at which point they are free to unload the stock. For example, Citigroup requires that directors and the Executive Committee of its senior management must hold 75% of the net shares granted to them under the firm’s equity programs until they leave those positions, with a reset of the holding requirement at age 65 if the covered person has not yet retired.

The appeal of retirement-based cash-out dates is understandable. Such an approach would reduce the costs of replenishing executives’ equity holdings. It would also cause executives to focus more on the long term and less on the short term. The potential benefits to shareholders could be substantial.

Unfortunately, however, permitting executives to sell their shares upon retirement may create undesirable incentives. To begin with, it may cause an executive to resign even though the firm could still benefit from his services. Suppose, for example, that an executive with large amounts of unliquidated equity has information suggesting that the firm’s stock is overvalued and its price is likely to decline over the next several years. Resigning at once would enable the executive to unload his accumulated equity earlier, and the prospect of large profits from such an unwinding may induce the executive to leave. If the executive is the best person to run the firm,

his departure could impose a substantial cost on the corporation and its shareholders. Retirement-based cash-out dates may thus undermine the important retention purpose of equity arrangements.

Indeed, retirement-based blocking provisions could, perversely, lead the most successful executives to retire. The executives with the strongest temptation to quit will be those with the largest amounts of unliquidated equity. The value of such equity will generally be higher when the executive has generated considerable returns for shareholders over a long period of time, so tying equity unwinding to retirement may provide an especially strong incentive for long-serving and successful executives to leave their firms.\(^\text{17}\)

In addition, if the executive is permitted to cash out all of his blocked equity immediately upon retirement, the arrangement will not give him an incentive to think long-term in his last year or two of tenure. Consider an executive who plans to leave in a year or two, either because of the retirement-based cash-out provision or for some other reason. Knowing that he will be able to cash out all of his equity in one or two years, the executive will have much less incentive to focus on the long run.\(^\text{18}\)

Given the potential costs associated with tying the unwinding of equity incentives to retirement, there is a better approach to designing long-term holding requirements. This approach – which we put forward in our book and continue to find appealing -- allows the unloading of

\(^{17}\) More generally, one must be careful of arrangements that enable an executive to cash out his equity on the occurrence of some event X, where X is at least partly under the control of the executive and may not always be desirable. For example, the federal government prohibits executives of TARP firms from cashing out their restricted stock until the government is repaid in full. Although this restriction is understandable – it prevents executives from reaping large stock profits before taxpayers recover their investment – it may give the executives a strong personal incentive to repay the government even if this would leave their firms with insufficient capital.

\(^{18}\) The proposals by Brill, Bhagat and Romano, and AFSCME, see supra note 5, all would require executives to hold their equity for at least two years after the retirement date. Such an arrangement should adequately address the problem of short-termism in the period leading up to retirement. Interestingly, when Warren Buffett invested in Goldman Sachs, he imposed sale restrictions on high-ranking executives that extended for three years beyond termination or retirement. See “Hold Through Retirement: Maximizing the Benefits of Equity Awards While Minimizing Inappropriate Risk Taking,” XXII The Corporate Executive No.5 (November-December 2008), p.1. However, the relatively few other firms that have adopted post-retirement holding periods tend to use periods shorter than 2 years. For example, ConAgra Foods prohibits executives from selling certain shares until 6 months have passed after termination, and Becton Dickinson uses a 1-year post-retirement holding period. We believe these holding periods are too short to prevent short-term bias in the CEO’s decision-making as she approaches retirement.
equity after a specified period of time (say, 10 years) has elapsed from the vesting date of that equity grant. 19

This fixed-date approach would avoid both costs associated with using a retirement-based approach. Because an executive’s ability to cash out a particular equity grant would be a fixed date on the calendar, her decision whether to remain at the firm or retire would not be affected by the prospect of being able to unwind large amounts of equity. Whether she remains at the firm or retires, the executive can cash out that particular grant of equity when – and only when – she reaches that fixed date.

In addition, under the fixed-date approach, executives would not have an incentive to focus on the short term as retirement approached. Each equity grant is made at a distinct point in time. Each equity grant thus vests, and later becomes unloadable, on a different date than other equity grants. As a result, the executive does not face a situation where almost all of her unliquidated equity can be cashed out at once. Thus, even when the executive is in her last year or two in office, she will still have an incentive to consider the effect of her decisions on long-term share value.

Though few if any firms have yet adopted the fixed-date approach to cashing out vested equity, Exxon Mobil uses a hybrid plan featuring both fixed dates and retirement. Under Exxon Mobil’s plan, 50% of an executive’s stock grant must be held until the later of 10 years from grant or retirement. Thus, if retirement occurs early, the stock can be cashed out only after 10 years have passed since the grant date. However, if retirement occurs more than 10 years from the grant date, the departing executive is permitted to cash out his equity.

Because Exxon Mobil’s arrangement sometimes functions like a fixed-date plan, in certain cases it will create better incentives than a pure retirement-based plan. Consider the situation where executive A chooses to retire well before 10 years have elapsed since the grant date (say, 5 years). In the period leading up to retirement, executive A will remain focused on the long term.

But to the extent that Exxon Mobil’s plan functions like a retirement-based plan, it will create undesirable incentives. Consider the situation where 10 years have passed since the equity grant to executive B. Executive B is considering whether to retire. Exxon Mobil’s plan, which

19 See Bebchuk and Fried, supra note 12, at 175.
will allow executive B to cash out the entire equity grant upon retirement, may induce executive B to retire too quickly. In addition, whenever executive B decides to retire, the cashing-out restriction on this equity grant will not give Executive B an incentive to maximize long-term value in the period leading to retirement. Both of these problems could be solved if, as we have urged, Exxon Mobil used a pure fixed-date approach to cashing out equity.

What of the concern that any approach requiring an executive to hold stock after retirement subjects that executive to undue risk? For example, consider a CEO receiving equity with a cash-out date in 10 years who will retire in 5 years. Her final payoff will in part be a function of her successor’s decisions in years 6 through 10. If the next CEO performs poorly during those years, the current CEO’s payoff could be substantially diminished.

However, this concern would have little merit. The risk created by delaying the cash-out date is no different from the risk borne by the CEO under any equity-based pay arrangement. As we explained in Pay without Performance, only 30% of a firm’s stock-price movement is driven by firm-specific factors; industry and market factors explain the remaining 70%. And only a part of the 30% firm-specific component is associated with the current CEO’s contribution to firm value; some of this 30% is due to the contributions of other current employees, as well as the contributions of former employees, including the former CEO. Thus, any equity-based pay arrangement subjects the CEO’s payoff to a considerable amount of risk, and in some companies, the CEO is subject to much more than the average amount of risk.

The key question is whether a CEO’s incentives are improved by requiring her to hold an equity grant for a fixed period of time, even if that fixed period may extend into her retirement. If the CEO’s wealth does not depend in any way on the value of the firm in X years, she will not have adequate incentive to make decisions that are expected to lead to a higher stock price in X years. If, on the other hand, a CEO’s wealth is in part tied to the value of the firm in X years, her incentives to create that value will be greater. Accordingly, the CEO will be less likely to attempt to maximize the short-term stock price at the expense of long-term value.

Finally, it is worth noting that the fixed-date cashing-out approach we recommend will fail to create desirable incentives if executives can hedge their equity positions after they step down. To the extent an executive can hedge her unliquidated stock as soon as she retires, she is no different than an executive who expects to sells his stock upon retirement. In both cases, the

---

20 See Bebchuk and Fried, supra note 12, at 179.
executive’s wealth will not depend on how the stock performs during the period between retirement and the cash-out date, but rather only on the retirement-date price. Thus, when an executive can hedge her position after retiring, she will have an incentive to focus only on how the stock performs in the period leading up to retirement, and may retire too early. It follows that, for the fixed-date approach to work, firms must contractually prohibit executives from hedging their stock positions after they retire. We suggest that firms hold the blocked stock of a retired executive in an escrow account and, before releasing the stock on the cash-out date, require the executive to sign an affidavit indicating that he did not engage in any hedging transactions during or before retirement.

This brings us to the following principle:

**Principle 2: After a particular grant of restricted shares or options vests, executives should not be allowed to cash out or hedge that equity until a specified period elapses from the time of vesting.**

As we will see in the next Part, there are potential costs associated with allowing a non-retired executive to unload large amounts of stock on a single date or over a short period of time, costs that can be reduced by restricting how such executives sell their shares once the blocking period has passed. Thus, we are not suggesting that executives be permitted to freely cash out an entire grant of stock as long as a certain period has passed since vesting. Rather, our recommendation is simply that the unwinding process – however it is handled— should not commence until that specified date.

### III. Preventing Gaming

Executive compensation arrangements should be structured to minimize the likelihood of executives engaging in various types of “gaming” – such as springloading, insider trading, and manipulating the stock price both prior to receiving equity grants and before unwinding that equity. We explain below what steps should be taken to reduce such gaming at both the “front

---

21 The vesting of restricted stock may trigger an immediate tax on the executive (whether or not the stock is cashed out). Thus executives receiving restricted stock should be permitted to immediately unload, upon the vesting of the restricted stock, enough stock to pay the taxes triggered by the vesting.
end” – when equity is granted – and the “back end” – when it is cashed out. More generally, firms should ensure that executives do not evade or water down the various restrictions we propose to tie pay more closely to performance.

A. The Front End

Firms must ensure that executives do not manipulate either the timing or the pricing of equity grants to shift value from public shareholders to themselves.

1. The Timing of Equity Grants

Executives can secretly enrich themselves by using inside information to time their option and restricted stock grants. In particular, equity grants can be accelerated when the executive knows that good news will emerge in the near future. This practice of informed grant-timing is called “springloading.”

Executives have the greatest incentive to springload option grants. Public-company executives frequently receive large, multiyear option grants – sometimes totaling tens or hundreds of millions of dollars -- on a specific grant date. Most of these option grants are issued at-the-money: the strike price is set to the market price on the grant date. The value of the option grant depends critically on the strike price; a lower strike price increases the value of the option. An executive who knows that good news will emerge shortly, boosting the stock price, can thus benefit by accelerating an option grant so that the strike price is set to the (low) current price.

To illustrate how springloading benefits executives, suppose ABC stock is trading at $90 on Monday. The board is planning to issue at-the-money options on Friday. However, it knows that good news will emerge by Friday, boosting the stock price to $100 on that date. Instead of waiting until Friday to issue an at-the-money option with a strike price of $100, the board issues an at-the-money option on Monday with a strike price of $90. By Friday, when the board was originally planning to issue the option, the stock price is $100 and the Monday-issued option is

22 For example, in 2001 Apple gave Steve Jobs a single option grant with a Black-Scholes value of around $500 million. See Bebchuk & Fried, supra note 12, at 161.
already $10 in-the-money. Essentially, springloading is economically equivalent to giving an executive an in-the-money option disguised as an at-the-money option.  

A widely reported instance of springloading occurred at Cyberonics in 2004. The board approved stock option grants for top executives one evening, after the company had received positive news several hours earlier about the regulatory prospects for one of its products. The next day, Cyberonics’ stock price took off. So did the value of the options. The company’s chair and CEO “earned” instant paper profits of $2.3 million. Cyberonics was not an isolated incident, but rather is part of a widespread pattern that has continued even after passage of the Sarbanes Oxley Act.

Boards seeking to favor executives may also have an incentive to “springload” restricted stock grants. For example, if the value of the grant is fixed, springloading will allow the firm to give the executive more shares, boosting the executive’s overall compensation. Suppose again that ABC stock is trading at $90 per share on Monday but the board knows that good news will emerge on Friday, boosting the stock price to $100 per share. And suppose ABC’s CEO is entitled to receive $9 million worth of stock this year, valued at the current trading price. If the board grants the CEO the stock on Friday, the CEO will receive 90,000 shares ($9 million/$100). If the board grants the CEO the stock on Monday, the CEO receives 100,000 shares ($9 million/$90). Springloading the restricted stock grant in this example thus gives the CEO an extra 10,000 shares worth $100 a piece, or an extra $1 million.

In that respect, springloading is similar to grant backdating, which also disguises in-the-money options as at-the-money options. See Lucian Bebchuk et. al. Lucky CEOs and Lucky Directors (forthcoming, J. Fin.) ; Jesse Fried, Option Backdating and Its Implications, 65 Washington & Lee L. Rev. 853 (2008).

Barnaby J. Feder, “Question Raised on Another Chief’s Stock Options,” N.Y. Times, June 9, 2006, at ___. Following the publication of the story, the federal government began an investigation into the firm’s stock-option practices, and the CEO and other directors resigned. See “Cyberonics CEO Resigns Amid Options Probe,” The Wall Street Journal, November 21, 2006.

See Daniel W. Collins, Guojin Gong, and Haidan Li, The Effect of the Sarbanes Oxley Act on the Timing and Manipulation of CEO Stock Option Awards (working paper, 2005) (reporting that there are positive abnormal returns in the 40-day period following unscheduled option grants after SOX and concluding that this must reflect the award of options before good news). While such returns are also consistent with backdating, these returns continued after the adoption of Sarbanes Oxley’s new reporting requirements, which substantially reduced the amount of backdating; see Jesse Fried, Option Backdating and Its Implications, 65 Washington & Lee L. Rev. 853 (2008), suggesting that the observed pattern represented springloading.

If the number of shares granted is fixed, springloading (accelerating) the stock grant may still benefit the executive by enabling the firm to report less compensation for the executive and lower compensation
Executives’ ability to benefit from the springloading of options and restricted stock can be substantially reduced by granting both types of equity on fixed dates throughout the firm’s calendar. Such dates might include (i) the first regularly scheduled compensation committee meeting following the executive’s initial hire; (ii) the meeting of the compensation committee accompanying the company’s annual meeting of shareholders, or (iii) the regularly scheduled meeting of the compensation committee for the first quarter. A number of companies have already adopted this approach. For example, United Healthcare, Juniper, and certain other companies accused of backdating stock options have, as part of their settlements of backdating-related claims, agreed to restrict substantially the dates on which options and restricted stock can be granted to executives. Other companies could benefit from following their example.

This brings us to the following principle:

**Principle 3:** The timing of equity awards to executives (option grants, restricted stock awards, etc.) should not be discretionary. Rather, such grants should be made only on pre-specified dates.

2. *Stock-Price Manipulation Around Equity Grants*

Even if equity grant dates are fixed in advance, executives may be able to manipulate stock prices around these grants to secretly increase (or hide the full extent of) their pay. For example, executives may prematurely release bad news – or withhold good news -- to lower the stock price on the grant date. Artificially lowering the stock price in this manner can benefit executives whether the grant consists of options or restricted stock.

Executives have the strongest incentive to manipulate the stock price around option grants. A lower grant-date price reduces the exercise price of at-the-money options, boosting managers’ profits when the options are later exercised. Thus, even if managers cannot control the timing of option grants, they can profit by depressing the grant-date price, thereby getting options with exercise prices that are, on average, below the “true” value of the stock at the grant expense, boosting reported earnings. In this scenario, springloading is likely to reduce shareholder outrage over the amount of the executive’s pay (by making it seem lower), as well as to increase any earnings-based bonuses.
date. Like the “springloading” described above, such manipulation disguises in-the-money options as at-the-money options.

A number of studies find a systematic connection between option grants and corporate disclosures. Specifically, companies are more likely to release bad news and less likely to release good news just before options are granted. 27 One study examines companies that have scheduled option grant dates – that is, companies where managers do not appear to have control over the timing of their option grants. It finds that managers time voluntary disclosures both to reduce the stock price before getting their at-the-money options and to boost the stock price afterwards. Another study finds that executives manage earnings around the grant date.28 In particular, managers boost income-decreasing accruals prior to stock option grants.

An executive about to receive a restricted stock grant may also have an incentive to lower the stock price on the grant-date. For example, if the value of the grant is fixed, and the number of shares is variable, depressing the grant-date stock price gets the executive more shares, boosting her compensation directly. If the executive can reduce the stock price by (say) 10%, she will get approximately 10% more shares in the option grant.

The incentive to manipulate the grant-date stock price around the grant of stock options or restricted stock could be eliminated by not setting the exercise price to the grant-date stock price. For example, consider an executive who is promised that, over each of X years, Y options will be granted each year. Instead of setting the exercise price to the stock price on the grant date each year – a price that could be manipulated – the exercise price could be set to the stock price at the time of hiring.

Similarly, the incentive to manipulate the stock price around the grant date of restricted stock would be reduced if the promised grants of restricted stock each year are specified in terms of the number of shares rather than their value at the time of grant. Otherwise, the executive may have an incentive to depress the stock price around the grant date to boost the number of shares.29 This brings us to yet another principle:

27 David Aboody and Ron Kasznik, CEO Stock Option Awards and the Timing of Corporate Voluntary Disclosures, 29 J. Account. & Econ. (2000).
29 The executive may still have an incentive to manipulate the grant-date stock price around fixed-number restricted stock grants. Depressing the stock price could provide two benefits to the executive. It
Principle 4: The terms and amount of post-hiring equity awards should not be based on the grant-date stock price (which can be manipulated).

B. The Back End

Our analysis in Part I emphasized the importance of requiring executives to hold stock for the long term. We explained why it was desirable to hold their equity for a fixed period after the vesting date rather than until a retirement-linked date. Otherwise, executives may have an incentive to retire prematurely, and to focus excessively on the short term as they approach retirement.

We now focus more closely on the exact manner by which executives should be permitted to unwind their unblocked equity. Currently, executives have considerable discretion over when they sell their shares, including stock received via the exercise of options. As we explain below, giving executives such freedom over the precise timing of unwinding after unblocking could give rise to two types of problems whenever the unblocking occurs while the executive is still in office. First, executives could use inside information to determine when to sell their stock. Second, whatever an executive’s motive for selling, the anticipated sale of a large block of stock gives the executive an incentive to inflate the short-term stock price to boost his trading profits. Below, we explain in more detail each of these problems associated with giving executives control over the precise timing for selling their stock.

1. Using Inside Information to Time Equity Unwinding

Executives who are free to determine when to sell their shares may use inside information to time their sales, selling before bad news emerges and the stock price declines.\(^\text{30}\) For example, executives tend to exercise their options and sell the underlying stock before earnings deteriorate

---

\(^{30}\) See Fried, supra note 13, at 317-20 (surveying the literature through 1998).
and the price of the stock underperforms the market. These studies help explain the body of evidence indicating that managers make considerable “abnormal” profits—that is, above-market returns—when trading in their own firms’ stock.

The previous decade has provided many dramatic examples of insiders unloading shares before their firms’ stock prices plunged. A study published by Fortune in September 2002 examined executive trading in the shares of publicly held firms that had reached a market capitalization of at least $400 million and whose shares subsequently had fallen at least 75%. The firms were ranked by the amount of executive sales. At the top twenty-five firms, 466 executives collectively sold $23 billion before their stocks plummeted.

2. Stock-Price Manipulation Around Unwinding

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

---

31 See Jennifer N. Carpenter & Barbara Remmers, Executive Stock Option Exercises and Inside Information, 74 J. BUS. 513, 531-32 (2001) (finding that top managers at small firms time the exercise of their options based on inside information); Bin Ke, Steven Huddart & Kathy Petroni, What Insiders Know About Future Earnings and How They Use It: Evidence from Insider Trades, 35 J. ACCT. & ECON. 315, 342-43 (2003) (finding that insiders time their trades well in advance of negative news in order to avoid the appearance of trading on inside information).
33 Mark Gimein, You Bought, They Sold, FORTUNE, Sept. 2, 2002, at 64.
35 Scott L. Summers & John T. Sweeney, Fraudulently Misstated Financial Statements and Insider Trading: An Empirical Analysis, 73 ACCT. REV. 131, 144 (1998). See also Messod D. Beneish, Incentives and Penalties Related to Earnings Overstatements That Violate GAAP, 74 ACCT. REV. 425, 454 (1999) (finding that managers of firms whose earnings were overstated tended to sell at a high rate before the overstatements were corrected); Natasha Burns & Simi Kedia, The Impact of Performance-Based
The passage of the Sarbanes Oxley Act of 2002 (SOX), which was motivated in part by the evidence of widespread earnings manipulation in the 1990s, has reduced – but not eliminated – executives’ ability to misreport earnings. For example, in 2006, four years into the post-SOX era, the number of earnings restatements filed by public companies reached an all-time record: 1,876. Thus, SOX does not appear to have prevented managers from misreporting.

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

Because real earnings management does not violate the accounting rules as long as all transactions are reflected properly in a firm’s financial statements, SOX cannot prevent or deter it. Indeed, such manipulation appears to have increased after SOX. Thus, we can expect executives who sell large blocks of stock to continue manipulating the stock price around these

Compensation on Misreporting, 79 J. Fin. Econ. 35, 63 (2006) (finding that top managers of firms that experienced accounting irregularities and were subsequently subject to SEC enforcement actions had exercised their options in the preceding period at a higher rate than top managers of other firms); Shane A. Johnson, Harley E. Ryan & Yisong S. Tian, Managerial Incentives and Corporate Fraud: The Sources of the Incentives Matter 25 (Nov. 8, 2007), available at http://papers.ssrn.com/sol3/papers.cfm?abstract_id=395960 (finding that executives at firms that commit fraud exercise significantly larger fractions of their vested options than other executives).

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

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

sales—through both misreporting and real earnings management—to increase their trading profits.

3. Reducing Back-End Gaming

Both forms of back-end gaming -- executives’ use of inside information to time their sales and price manipulation to boost their trading profits -- hurt public investors. Each extra dollar pocketed by managers comes at the expense of public shareholders. More importantly, executives’ ability to sell on inside information and inflate the short-term stock price before unwinding can reduce the size of the total corporate pie by distorting managers’ operational decisions ex ante. The indirect costs to public investors of such distortions could be far larger than the value directly captured by executives.

Fortunately, firms can easily reduce both forms of back-end gaming. In particular, firms should limit the extent to which the payoff from stock sales depends on a single stock price. Rather, as we explain below, the payoff should be based on the average stock price over a significant period of time. Moreover, executives should be required to either (a) disclose several months in advance before they begin their sales or (b) unload their stock under an automatic schedule created when the equity is granted.

a. Average-Price Payoffs

Currently, executives can choose the precise date and price at which they will sell a large amount of stock. This allows the executives to use inside information to make the sale when the stock price is high and about to decline. Moreover, whatever the motive for the sale, executives about to unload a large amount of stock have an incentive to manipulate the stock price to increase their profits from the sale. We present two approaches to tying payoffs to the average stock price: “immediate cash-out” and “gradual cash-out,” and show that either approach would reduce both types of back-end gaming.

Under the immediate cash-out approach, executives would be permitted to liquidate large amounts of “unblocked” equity by selling the equity to the firm at the current market price; a certain number of months later (“X” months), the transaction price would be retroactively adjusted to reflect the average price of the stock over those X months. To illustrate, suppose an
executive of ABC Corporation decided to sell 100,000 shares of ABC stock, then trading at $10 per share. The executive would transfer the stock to ABC in exchange for an immediate payment of $1 million (100,000 x $10). The firm would track the average closing price over the next X months. To the extent that the average closing price of the stock exceeded $10, the executive would receive an additional payout at the end of X months. If the average monthly closing price fell short of $10, the executive would be required to return some of the $1 million to ABC at the end of X months.

Alternatively, an executive wishing to unload unblocked equity could be permitted to sell the shares in the market, but only gradually, according to a pre-specified, automatic plan. Consider again the executive of ABC Corporation. If she decided to sell 100,000 shares of company stock, she would be permitted to sell 100,000/X shares on (say) the first trading day of each of the following X months. Under this gradual cash-out approach, the executive would be required to execute all planned trades; she could not back out of them if she later obtained inside information suggesting that she would be better off not selling the stock.

This gradual cash-out approach is similar to widely used 10b5-1 trading plans, but with an important difference. An executive can terminate a 10b5-1 plan midstream if he later obtains inside information suggesting that he is better off keeping his stock—thereby enabling him to make higher trading profits at the expense of public shareholders. Under our proposed approach, sales—once announced—must be effected according to the terms of specified plans. They may not be terminated midstream.

By tying the executives’ equity payoff to the average price over a sufficiently long period of time, both the immediate cash-out approach and the gradual cash-out approach would make it more difficult for executives to use inside information to time their stock sales. An executive could, of course, initiate an unwinding based upon inside information indicating that the stock

![Image](https://example.com/image.png)

---

40 The gradual cash-out approach is different from the immediate cash-out approach in two respects. First, it is administratively simpler. The executive unloads his stock directly into the market on specified dates; the payoff is determined by the prices on those dates. Unlike the immediate cash-out approach, the firm need not intermediate the initial transaction and then, X months later, determine the amount to be transferred to or from the executive to ensure that his net payoff equals the average stock price over the X-month period. Second, unlike the immediate cash-out approach, the executive must wait X months to fully liquidate the equity being unwound. Administrative simplicity thus comes at the expense of higher liquidity costs for the executive.
price is likely to drop. But the payout from each unwinding would be a function of the average stock price over a period of X months. To the extent the inside information emerges and become incorporated into the stock price before the X-month period ends, the payoff from the unwinding would be lower than under current practice, where the executive can dump all his stock at a single price.

Similarly, both the immediate and gradual cash-out approaches would reduce executives’ incentives to manipulate the short-term stock price prior to unwinding. Such manipulation might affect the stock price at the beginning of the X-month period. But if the specified period is sufficiently long, any temporary boost in the price would be at least partially reversed (and perhaps followed by an offsetting dip) later in the X-month period, reducing the net payoff to the executive from manipulating the stock price (and perhaps eliminating it altogether).

b. Further Steps for Reducing Executives’ Insider Trading Profits

The immediate or gradual cash-out approaches described above would reduce executives’ ability to profit from inside information by tying payoffs to the average stock price over a specified period. However, neither would eliminate executives’ ability to use inside information to time their sales. The reason is that executives often have inside information bearing on the performance of the stock price many months in advance.41

Thus, tying executives’ payoffs to the average stock price over a certain period (X months) may not affect their ability to sell on inside information if this period is relatively short. Consider an executive of a firm using a 5-month cash-out period for determining payoffs who has inside information suggesting the stock price will fall in 6 months. If this executive unwinds his stock under either an immediate or gradual cash-out arrangement, he will receive more for the stock than it is actually worth.

And even if the cash-out period is relatively long, the use of average prices during this period would merely reduce — but not eliminate — executives’ ability to sell on inside information. Consider again the executive who has inside information suggesting that the stock

price will fall in 6 months. Suppose now that the cash-out period is a year. If the insider initiates an unwinding, the stock price during the first 6 months of the 12-month period will be higher than its true value; in the second 6 months, the stock price will (let us suppose) reflect its true value. The average stock price over the entire 12-month period will thus be higher than its true value, and the executive will be able to generate more proceeds from selling the stock if he begins unwinding now rather than later.

Indeed, the above analysis may help explain why 10b5-1 plans have not been that effective in reducing insider trading profits. One study of executive trading in more than 1,200 firms during the five-year period ending in January 2006 (which includes several years after Sarbanes-Oxley had been in effect) found that insiders regularly use 10b5-1 plans to sell on inside information.\(^42\) In fact, it found that executives using 10b5-1 plans were more likely to sell on valuable inside information than executives not using such plans.\(^43\)

To further reduce executives’ ability to sell on inside information, firms should take one of the additional steps we describe below: either (1) require executives to disclose their intended sales far in advance or (2) use a “hands-off” arrangement under which the cash-out dates are specified when the equity is granted, leaving executives with no discretion over when their stock is sold.

1. Pretrading Disclosure

To the extent that executives have any discretion over when they cash out their equity, they should be required to disclose their intended unwinding in advance, a proposal made by one of us more than 10 years ago.\(^44\) Such advance disclosure, coupled with average-price payoffs, would further reduce executives’ ability to profit from the back-end gaming of insider trading.


\(^{43}\) Id. at 13 and accompanying tables.

To begin with, advance disclosure would give any inside information on which the executive is trading more time to emerge and become incorporated into the stock price. The average stock price during the payoff period would thus more accurately reflect the actual value of the stock, improving the link between pay and performance. For example, suppose that the average price used to determine the payoff to the unwinding executive is based on a 5-month period. If the executive were required to disclose the intended unwinding Y months before the 5-month period began, any inside information that the executive is trading on will have Y more months to emerge and affect the stock price during this period, making it more likely that the stock price used to calculate the payoff to the executive is more accurate.

In addition, the disclosure of large or otherwise unusual sale orders would intensify scrutiny of the firm and its managers. An unusually large sale order, for example, would signal the possibility that the executive knows bad news. If further investigation suggests that the stock is overpriced, market participants will drive the price down even before the payoff period begins, reducing the prices used to calculate the total proceeds from the unwinding.\textsuperscript{45}

Currently, market professionals analyze insiders’ post-transaction trading reports to identify executives whose purchases and sales predict large price movements. These executives’ trades are used to figure out whether a particular stock is overpriced or underpriced. Managers with non-predictive trades attract far less attention. Under advance disclosure, we can expect executives who sell before large price declines to subsequently face larger adjustments than executives who do not. This should reduce managers’ incentive to trade on inside information in the first place.

2. “Hands-Off” Arrangements

While pretrading disclosure would further reduce executives’ ability to profit from their access to inside information, such profits could be eliminated entirely through a “hands-off”

\textsuperscript{45} To be sure, when an executive sells on inside information, the price adjustment is unlikely to completely eliminate her insider trading profit from that trade. Public investors cannot be certain that the trade is information-driven. The executive could be selling for liquidity or diversification reasons. So the price adjustment may be too small. However, when that same executive does in fact sell for liquidity or diversification reasons, public investors may suspect the trade is information-based, leading to a price adjustment that is too large. Over time, such “over-adjustments” will force the executive to give back to public investors more of her insider trading profits.
arrangement that leaves executives no discretion over when their equity is cashed out. Under this arrangement, restricted stock and stock options are cashed out according to a fixed, gradual, and pre-announced schedule set when the equity is granted. At least one firm has adopted the “hands-off” approach to its option compensation. In 2007, Level 3 Communications filed a compensation plan with the SEC under which executives’ options are cash-settled according to a pre-disclosed gradual schedule.

Because hands-off equity leaves executives no discretion as to when their equity is cashed out, executives compensated with such equity cannot use inside information to decide when to sell. Hands-off options thus would eliminate all the insider trading profits that executives make in connection with stock sales. No other arrangement would be more effective at reducing executives’ insider trading profits.

Some may be concerned that hands-off arrangements would undesirably reduce executive equity holdings. But if a corporate board identifies the desired level of executive equity ownership ex ante, it can design the hands-off plan to ensure that the executive always retains that amount of equity. And should changing circumstances make the optimal level of equity ownership higher than had been expected, the board can arrange for the executive to acquire additional equity (by, for example, reducing cash compensation and issuing more hands-off equity). Indeed, properly structured, hands-off arrangements could ensure that executives always have sufficient equity.

This brings us to our next principle:

**Principle 5: The payoffs from the unloading of executives’ restricted stock or options should be tied to the average price over a reasonably long period of time. If executives are permitted to choose the timing of unwinding, such decisions should be announced in**

---

48 In addition to ensuring that executives retain a desirable amount of equity, hands-off equity might yield several other collateral benefits. For example, the practice would encourage managers to focus on running the business, rather than timing their trades. It would also reduce arbitrary differences in executives’ payoffs due to transaction timing luck, increasing pay equity within the management team.
advance. Alternatively, the unloading of executives’ equity could be effected according to a pre-specified schedule put in place when the equity is originally granted.

C. Preserving the Principles of Good Equity Compensation

The recommendations we have advanced for improving executive compensation will do little good if, as has often been the case, executives remain free to circumvent these arrangements through hedging or other strategies designed to decouple their pay from long-term performance.

As we highlighted in our book, boards have often failed to restrict the use of financial instruments that can weaken or eliminate entirely the incentive effects of unvested options and restricted shares. Executives are generally allowed to hedge away their equity exposure before and after these instruments vest. Indeed, boards frequently do not even request restrictions on hedging.

The failure of boards to prevent executive hedging has led to a situation in which the use of hedging transactions among executives of American public companies has become quite common. Although the precise amount of hedging is difficult to gauge, in part because many hedging transactions may not be publicly reported, a recent study finds that hedging is widespread. Between 1996 and 2006, more than 1,000 insiders hedged their stock positions, and the average level of ownership hedged through the most common forms of hedging transactions was significant, around 30%. The study found that hedging transactions were preceded by large abnormal price returns, and often followed by large negative abnormal returns. This pattern is consistent with executives using either inside information or stock price manipulation to lock in large gains through hedging.

The problem of insider hedging is likely to become even more severe if restrictions on unloading become more expansive. Thus boards and outsiders monitoring public firms (both shareholders and regulators) must be extra vigilant in ensuring that executives do not take steps to undo the desirable effects of the arrangements we recommend. Among other things, it is simply insufficient for boards to come up with holding requirements. They must also specifically forbid any type of hedging arrangement that will undo the effect of the holding requirement. No

49 See Bebchuk & Fried, supra note 12, at 176-177.
matter how good the limitations are in theory, they will not do much if they can be circumvented in practice.

This leads us to our final principle.

**Principle 6: Executives should be contractually prohibited from engaging in any hedging, derivative, or other transactions with respect to equity-based awards granted as incentive compensation (such as buying puts, selling calls, or employing other risk-minimizing techniques) and be subject to penalties (including, but not limited to, forfeiture of any profits made from such transactions) if they engage in such prohibited transactions.**

IV. CONCLUSION

In the aftermath of the financial crisis of 2008-2009, legislators, regulators, and business have begun to recognize that equity based compensation that is not adequately tied to long-term results, and rewards executives for short-term gains that may prove illusory, can produce substantial distortions. In this paper, we have sought to contribute to the reform of executive pay by providing a framework of analysis for understanding these defects and putting forward principles for remedying them.

We explained how executives should be incentivized to focus on the long term rather than the short run. Managers should be “blocked” from cashing out the equity for a specified period of time after vesting. Importantly, the cashing out should not be tied – as some have proposed -- to an executive’s retirement date. Coupling large cash payouts to retirement, we show, can distort executives’ decision to retire, as well as undermine their incentive to focus on long-term value as they approach retirement.

We then described how executive compensation arrangements should be structured to prevent various types of “gaming” that secretly increase executive pay at public shareholders’ expense: so-called “springloading” (using inside information to time equity grants), selling on inside information, and the manipulation of the stock price around equity grants and dispositions. More generally, firms must take steps to ensure that executives cannot easily evade the limitations designed to improve their incentives to generate long-term shareholder value. We
hope that our analysis will be useful to policymakers, regulators, directors, and shareholders seeking to improve executive compensation arrangements at public firms.