

CASEINPOINT

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May 2007

: Perspectives on Corporate Governance: Executive Compensation

More than a fourth of companies granting stock options manipulated the date of the option grant at some time or another¹. This behavior represents top managers surreptitiously paying themselves more at the expense of shareholders. This behavior is both illegal and apparently common. The pervasiveness of top executive law-breaking underscores the broader problem that boards of directors routinely provide incentives for top executives to destroy long-term shareholder value – although happily not all executives respond to these incentives.

These scandals raise a serious question for boards of directors: Why use a compensation scheme for top executives that provides incentives for perverse behavior, especially if you believe that your own executives will not indulge in these behaviors?

There are many ways in which poorly designed incentives schemes reward executives for destroying long-term shareholder value and (in many cases) breaking the law. For example, most top executives receive a bonus that depends on quarterly profits and stock price, providing executives with strong incentives to delay bad news and speed up good news.

Rewards based on short-term financial results provide executives incentive to cut investments in the intangible assets that make up much of the value of major corporations. That is, any top executive can increase this quarter's accounting profits by reducing product quality, breaking promises to suppliers, reducing investments in training and new product development, delaying preventive maintenance, and so forth. The stock market often has a hard time measuring these intangibles. Thus, cutting these hard-to-monitor investments can raise the next quarter's accounting profits which, in turn, raise the stock price that quarter. Unfortunately, that price increase is typically followed by a larger decline when shareholders see the consequences of cutting quality, training, maintenance and so forth.

Moreover, most executives are permitted to sell their stock and vested stock options at dates that they choose. That flexibility also provides incentives to executives to jack up the short-term stock price at the expense of long-term shareholder value. Conversely, most American companies who grant stock options base the strike price on the stock price on the day of the options grant. Thus, if an executive can speed up bad news or delay good news, the stock price will be lower on the date of the

¹ Randall Heron and Erik Lie "What fraction of stock option grants to top executives have been backdated or manipulated?" July 14, 2006, mimeo [<http://www.issproxy.com/pdf/OptionsBackdatingStudy071406.pdf>]

grant and the options will be more valuable if the stock price eventually rises. Many forms of this manipulation are legal, although they are akin to insider trading.

What is to be done?

Boards of directors can remove these perverse incentives which promote short-term gain at the expense of long-term performance in three ways:

- Defer more compensation;
- Measure and reward investments in intangibles; and
- Smooth stock-related compensation over an extended time period.

One part of the solution is to ensure that executives are rewarded for long-term performance as well as short-term financial results. For example, part of a bonus tied to current profits could be held in escrow until the profit increase is sustained. Similarly, when executives receive stock, they should not be able to sell it immediately. Most option grants involve such vesting over time; that principle should be extended to almost all bonuses and stock grants.

On his own initiative, Jeff Immelt, the CEO at GE, took this approach when he promised not to sell any shares until he retires. This commitment sends the comforting message to investors that he will not destroy shareholder value for short-term gains. This approach should not change, however, even after retirement. Executives also should be required to hold a substantial portion of their shares for several years after retirement to further guarantee a focus on long-term performance. Boards face a trade-off, as they do not want executives to bear too much risk for poor decisions made after their departure. At the same time, executives *should* bear some of the cost of bad decisions they made in their final years.

Boards also should monitor whether top executives are meeting short-term accounting goals by simply reducing valuable intangible assets. Boards must never reward executives for *reducing* profitable investments in intangible assets such as product quality, customer satisfaction, suppliers' capabilities, employees' skill, and organizational innovation. Investments in these intangible assets should provide leading indicators of future accounting profits. As such, the board should identify the key intangible assets that create value for their enterprise, track them carefully, and reward their accumulation.

Smoothing out stock-related transactions may be the easiest way to address the temptation of executives to time information and transaction dates. The general principle of "smoothness" is to spread transactions out over time.

Companies can start by requiring top executives to preannounce any stock sales by a few months and to spread the sale evenly over the following few months. The same principle of smoothness can help solve problems relating to stock option strike prices; lack of "smoothness" was the proximate cause of the backdating scandal. Instead of basing option strike prices on current stock prices, companies can price options on strike prices over a longer period of time. For example, the grant could be based on the average share price over the following year or quarter.

Each of these changes appears to limit the liquidity of executives' shares and, thus, reduce executives' well-being. In fact, the opposite is true. If top executives can convince their boards to make changes like these, they will face better incentives for long-term value creation – which should be the goal of every top executive. It is a rare top executive who prefers to meet quarterly targets by destroying shareholder value. Even if most executives resist this temptation most of the time, it is both unfair and inefficient for boards of directors to set up such perverse incentives. Thus, better aligning that goal with their compensation can only improve the lives and effectiveness of top executives. As important, executives will then know that observers recognize they are not being paid to destroy long-term shareholder value.

Thoughts, discussion questions, or comments for the author? We welcome them all! Please send all responses to Alex.Roberts@aspeninstitute.org, who will pass your praise, questions, or criticisms onto the author.

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