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CEO Stock Ownership Policies: Rhetoric and Reality

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CEO Stock Ownership Policies—Rhetoric and Reality

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This Article is the first academic endeavor to analyze the efficacy and transparency of 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 recent 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 these policies generally function in a way that allows CEOs to immediately unload virtually all of 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.

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Introduction

Since the 2008–09 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

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. on Banking 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. Leaders' Statement at the Pittsburgh Summit 2 (Sept. 24–25, 2009), *available at* https://www.g20.org/official_resources/leaders%E2%80%99_statement_pittsburgh_summit.The United Kingdom has already implemented requirements to establish remuneration policies that promote effective risk management. *See* Fin. Servs. Auth., Reforming Remuneration Practices in Financial Services: Feedback on CP09/10 and Final Rules app. 1 at 3–13 (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., Remuneration Schemes: Minimum Standards for Remuneration Schemes 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 remuneration schemes;

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 to adopt SOPs, the federal government has prescribed strict SOPs for some firms,[2] prominent public officials have emphasized the importance of SOPs,[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]

Firms have adopted SOPs and held them to attain very important goals. One such 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, in a response to Facebook cofounder and CEO Mark Zuckerberg's announcement on September

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independent control over the implementation of those schemes; and the structuring of remuneration to enhance risk awareness).

2. Despite its general approach against regulating the substance of corporate governance provisions, the federal government has 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* Emergency Economic Stabilization Act of 2008, 12 U.S.C. § 5221(b)(3)(D) (2012).

3. *See, e.g.*, Press Release, U.S. Dep't 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 (declaring that "compensation should be structured to account for the time horizon of risks"); Ben S. Bernanke, Chairman, 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 (stating that "poorly designed compensation policies can create perverse incentives" and that "[m]anagement 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").

4. *See, e.g.*, Lloyd Blankfein, *Do Not Destroy the Essential Catalyst of Risk*, FIN. TIMES, Feb. 9, 2009, at 7 (declaring that "an individual's performance should be evaluated over time so as to avoid excessive risk-taking").

5. *See generally* GARY HEWITT, INSTITUTIONAL S'HOLDER SERVS. INC., GOVERNANCE RISK INDICATORS 2.0 (2012), *available at* http://www.issgovernance.com/file/files/GRId2.0_TechnicalDocument20120306.pdf.

6. *See* MERIDIAN COMP. PARTNERS, LLC, 2013 CORPORATE GOVERNANCE & INCENTIVE DESIGN SURVEY 11 (2013) (reporting that only 5% of the 250 largest publicly traded firms did not disclose stock ownership guidelines for their CEOs), *available at* http://www.meridiancp.com/images/uploads/Meridian_2013_Governance_and_Design_Survey.pdf.

7. *See, e.g.*, Randall Morck, Andrei Shleifer & Robert W. Vishny, *Management Ownership and Market Valuation*, 20 J. FIN. ECON. 293, 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"). Tobin's Q, named after Nobel Prize winner James Tobin, is a measure that reflects the effectiveness with which a company turns a given book value into market value. It specifically measures the ratio of the combined market value of equity and debt to their combined book value.

4, 2012, that he would keep his Facebook stock for at least until 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 might have incentives to elevate the firm's 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 to avoid losses by quickly selling their stock before the price plummets.[10]

Third, firms hold their SOPs to discourage managers from sacrificing the long term for the short term. Without SOPs, managers might be tempted 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 do so if they could unload their stock before such an implosion occurs. Even if they do not know if or when such an implosion will actually occur, they might still take such a strategy if they can gradually sell enough stock, thereby 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.[11] SOPs are expected to discourage managers from taking such actions by limiting managers' ability to sell their stock.

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 have performed poorly may nevertheless earn a salary that is not commensurate with their performance. They might even generate profits by taking excessive risks.[12]

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8. *See* Sam Gustin, *Facebook Blame-Game: Who's at Fault for IPO Debacle?*, 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, such price was still 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 (Apr. 21, 2010), *available at* http://www.prlog.org/10637727-long-term-performance-compensation-is-most-popular-risk-management-strategy.html.

10. *See generally* Tao Chen, Vidhi Chhaochharia & Rik Sen, Holding On for Good Times: The Information Content of CEOs' Voluntary Equity Exposure (Aug. 2012) (unpublished manuscript), *available at* http://moya.bus.miami.edu/~vchhaochharia/dokuwiki/lib/exe/fetch.php?media=ceo_equity_exposure_19aug2012.pdf (reporting that CEOs have private information about future stock price performance and that they generally use that information to choose their stock exposure levels to the firm).

11. *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, 260 (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 2000–08, the years that led to the credit crisis). However, commentators disagree on whether poor incentives contributed to the recent crisis. *See infra* note 63 and accompanying text.

12. A CEO without an effective SOP may generate personal profits by increasing his stock holdings before taking an excessively risky project and unloading such stock before the project fails. For example, General Motors' decision not to fix the faulty ignition switches in its Chevrolet Cobalts more than ten years ago was mentioned as a consequence

Finally, these policies are important because they set rules that apply widely 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 today the median compensation packages of CEOs of firms included in the S&P 500 Composite Stock Price Index (S&P 500)[13] includes 80% of stock.[14] Moreover, the explosion of stock-based compensation was not accompanied by a reduction in non-stock-based compensation. Therefore, the total compensation amounts of the top five executives in public firms trended up to some 10% of these firms' total earnings.[15]

However, while in theory SOPs are important, in practice they are paper tigers. Using statistical analyses of quantitative and qualitative data disclosed in proxy statements of firms included in the S&P 500,[16] 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 of their vested stock whenever they wish.[17] For example, the SOP of UPS would not prevent its CEO, Scott Davis,

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of GM executive compensation incentives. It apparently saved GM costs and increased its stock price in the short term, but came at the expense of a severe long-term problem after this decision was linked to thirteen deaths. Without an effective SOP, GM executives might have generated personal profits by selling their stock before the catastrophic results were uncovered. *See* Gretchen Morgenson, *The Wallet as Ethics Enforcer,* N.Y. TIMES*,* Apr. 6, 2014, at BU1.

13. The S&P 500 Composite Stock Price Index is a market value weighted index composed of 500 stocks of leading companies in leading industries within the U.S. economy. *See S&P 500 Composite Stock Price Index*, U.S. Securities and Exchange Commission, http://www.sec.gov/answers/indices.htm.

14. *See* EQUILAR, INC., 2014 CEO PAY STRATEGIES REPORT 6, 14 (2014), *available at* http://info.equilar.com/rs/equilar/images/equilar-2014-ceo-pay-strategies-report.pdf?mkt_tok=3RkMMJWWfF9wsRojuKTNZKXonjHpfsX67%2BgqXrHr08Yy0EZ5VunJEUWy3YoITtQ%2FcOedCQkZHblFnV0PSq28UaoNoqIK (reporting that in 2013 the median S&P 500 CEO was paid a total compensation of roughly $10.1 million, while his stock-based compensation amounted to about $8.1 million).

15. *See* Lucian Bebchuk & Yaniv Grinstein, *The Growth of Executive Pay*, 21 OXFORD REV. ECON. POL'Y 283, 297 (2005) (reporting that the ratio of the aggregate top five compensation to the aggregate earnings of public firms increased from 5% in 1993–95 to 9.8% in 2001–03).

16. The SEC requires that shareholders of a public company receive a proxy statement prior to any shareholder meeting. The proxy statement must include all important facts about the issues on which shareholders are asked to vote. Such information should include how management is paid and what potential conflict-of-interest issues may arise with auditors. *See Proxy Statement*, U.S. Securities and Exchange Commission, http://www.sec.gov/answers/proxy.htm.

17. Vesting periods define when ownership of stock options or restricted stock transfers to managers. *See* Brian D. Cadman, Tjomme O. Rusticus & Jayanthi Sunder, *Stock Option Grant Vesting Terms: Economic and Financial Reporting Determinants*, 18 REV. ACCT. STUD. 1159, 1159 (2013). Vesting periods in the United States are usually three to five years for executives but are shorter for board members. *See* Brian J. Hall & Jeffrey B. Liebman, *The Taxation of Executive Compensation*, 14 TAX POL'Y & ECON. 1, 7 (2000). Typically, the executive earns the prorated amount of his equity grant each year. *See Equity Vesting Schedules for S&P 1500 CEOs*, EQUILAR, INC. (Apr. 26, 2013), http://www.equilar.com/publications/articles/equity-vesting-schedules-for-s-p-1500-ceos. For example, when an executive is granted three hundred restricted stock units with a three-year vesting schedule,

from immediately selling all his vested UPS stock—worth over $30 million—should he choose to do so.[18] 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.[19]

This Article is the first academic endeavor to discuss both the ineffectiveness and lack of transparency of SOPs. My research indicates that the ineffectiveness of recent 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 ways by their own design.

First, common SOPs allow managers to count their unvested stock (stock that they do not own yet)[20] to satisfy their SOP requirements; 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.[21]

Second, the average SOP sets its target stock-holding threshold lower than 50% of a single year's total compensation.[22] SOPs are commonly framed to require CEOs to hold five times their base salary.[23] But as the average S&P 500 CEO earns a base salary of less than 10% of his annual total pay,[24] his SOP threshold amounts to less than 50% of such pay.

Third, these policies usually allow CEOs to take five years to attain the required stock thresholds.[25] This delay is significant for S&P 500 CEOs, whose average tenure has recently shrunk to eight years.[26] Such weakness is particularly important

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that CEO will typically own one hundred units after one year, another one hundred units after two years, and the remaining one hundred units after three years. SOPs define the post-vesting stock holding requirements.

18. As of February 1, 2013, Scott Davis beneficially owned 385,167 Class A UPS shares. Because the market price of each such share on the NYSE was then $79.97, the total value of Davis's vested UPS stock was more than $30.8 million. This estimate does not take into account the $460 million worth of vested UPS stock owned by the Annie E. Casey Foundation, Inc., of which Davis serves on the corporate Board of Trustees. *See* United Parcel Serv., Inc., Proxy Statement (Form DEF 14A), at 29 (Mar. 15, 2013).

19. *See* Tomislav Ladika, Do Firms Replenish Executives' Incentives After Equity Sales? 2 (Sept. 8, 2013) (unpublished manuscript), *available at* http://papers.ssrn.com/sol3/papers.cfm?abstract_id=2023858 (reporting that 61% 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).

20. *See infra* Part V.B.

21. *See infra* Part V.B.

22. *See infra* note 142 and accompanying text.

23. *See infra* Part V.B.

24. The average S&P 500 CEO earns a base salary of less than 10% of his annual total pay because his base salary is some $1 million while his total compensation is some $10.1 million. EQUILAR, INC., *supra* note 14.

25. *See infra* Part V.D.

26. 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 BD., THE 2011 CEO SUCCESSION REPORT 13 (2011).

because most policies do not require CEOs to hit any stock ownership milestone before their phase-in periods lapse.

Finally, 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 SOPs. Absent mandatory sanctions on executives who, for example, sell their stock in violation of their SOPs, the board of directors is left to exercise its own discretion on how to deal with such violations. For a variety of financial, social, and psychological reasons, executives have power and influence over directors that make it costly and difficult for directors to act in ways that are unfavorable for executives.[27] Therefore, directors in publicly traded companies cannot be relied on to impose sanctions on their executives after a violation occurs.

In addition to the extreme ineffectiveness of 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 policy weakness, such as the amount of stock managers are allowed to immediately unload and the amount of stock they have already unloaded.[28]

Firms also fail to disclose some critical terms of their SOPs, such as counting policies,[29] phase-in periods,[30] or sanctions. Moreover, when such terms are disclosed, their implications are not made clear. For example, firms fail to indicate how their counting of unvested or hedged stock undermines their SOPs.[31]

My findings about 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 the shareholders' expense because the policies' weakness makes it impossible to align managers' interests with those of their shareholders.

Also, because the ineffectiveness of these policies is camouflaged, investors are unable to know whether the SOPs are valuable and whether they fulfill their purpose. One needs credible and detailed information in order to exercise good judgment. Without such information about the functionality of 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 facilitate informed and intelligent decision making by

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27. *See* LUCIAN BEBCHUK & JESSE FRIED, PAY WITHOUT PERFORMANCE: THE UNFULFILLED PROMISE OF EXECUTIVE COMPENSATION 23–27 (2004) (describing sources of executives' influence over directors in public companies).

28. *See infra* Part VI.A.

29. I call a "counting policy" the SOP terms that define the type of equity securities that may be counted toward meeting the policies' target ownership threshold.

30. I call a "phase-in period" the length of time allowed to the executive or director to attain his target stock threshold.

31. A "hedge" is buying one security and selling another to reduce risk. *See* RICHARD BREALY, STEWART MYERS & FRANKLIN ALLEN, PRINCIPLES OF CORPORATE FINANCE, G-8 (11th ed. 2013). When, for example, CEOs short sell their company stock against their SOP stock, they nullify their SOPs.

investors,[32] but with SOPs, investors simply do not have the information to make such decisions.

Shareholders believe that these policies are at least sometimes desirable, and so they push firms to adopt them; proxy-voting firms back up shareholders and reward firms for having SOPs;[33] 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.[34] 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. If the weakness of SOPs were 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. This combination of limp and camouflaged policies allows managers to reap the reputational benefits of being subject to effective SOPs, meanwhile avoiding the personal costs that are associated with having such policies. In particular, SOP camouflage misleads markets 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.[35] 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 their SOPs.

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32. *See* Ray Garrett Jr., Chairman, Sec. and Exch. Comm'n, Address at the Union League Club, Public Affairs Committee 8 (Feb. 20, 1975), *available at* http://www.sec.gov/news/speech/1975/022075garrett.pdf (declaring that "[n]otwithstanding 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").

33. *See infra* Part II.

34. *See* Equilar, Inc., *supra* note 9 (reporting that tying compensation to long-term performance is the most commonly cited risk-management strategy (72% in proxy filings of one hundred companies with yearly revenues of $12.5 billion or greater)).

35. 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. 17 C.F.R. § 229 (2013).

This Article is developed in nine Parts. First, I explain the importance of SOPs as 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 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 recent SOPs, after which I analyze the camouflaging of such ineffectiveness. In the seventh Part, I explain why SOP ineffectiveness and its camouflaging are troubling, and after that I propose reforms to make these policies transparent and therefore improve SOPs. The ninth Part presents my conclusion.

I. THE IMPORTANCE OF STOCK OWNERSHIP POLICIES (SOPS)

Firms hold their SOPs to attain important goals.[36] The three main goals in this regard are (1) to align managerial interests with those of their shareholders,[37] (2) to discourage managers from pursuing short-term gains at the expense of long-term value creation,[38] and (3) to discourage inappropriate risk taking related to the company's business.[39]

The proxy statement of Limited Brands, Inc. summarizes the commonly declared SOP objectives: "In addition to aligning the interests of our executive officers with those of our stockholders, the share ownership guidelines promote a long-term focus and discourage inappropriate risk-taking."[40]

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

In most large American corporations, ownership is separate from control.[41] This separation happens when managers do not own most of the shares of the corporations they run. When manager-agents own little stock in a firm and shareholder-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 the expense of shareholders.[42] Such agency costs may be triggered by managers

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36. 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.

37. *See, e.g.*, First Horizon Nat'l Corp., Proxy Statement (Form DEF 14A) 53 (Mar. 16, 2010); Marsh & McLennan Cos., Proxy Statement (Form DEF 14A) 41 (Mar. 30, 2010).

38. *See, e.g.*, CA, Inc., Proxy Statement (Form DEF 14A) 39 (June 8, 2010); Family Dollar Stores, Inc., Proxy Statement (Form DEF 14A) 25 (Dec. 11, 2009).

39. *See, e.g.*, Cabot Oil & Gas Corp., Proxy Statement (Form DEF 14A) 23 (Mar. 23, 2010); Family Dollar Stores, Inc., Proxy Statement (Form DEF 14A) 25 (Dec. 11, 2009).

40. Ltd. Brands, Inc., Proxy Statement (Form DEF 14A) 21 (Apr. 7, 2010).

41. *See* ADOLF A. BERLE, JR. & GARDINER C. MEANS, THE MODERN CORPORATION AND PRIVATE PROPERTY 119–25 (1932).

42. "Agency relationship" is a contract under which the principal(s) engage another person(s) (the agent(s)) to perform a service on behalf of the principal(s), which involves the delegation of a 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, 308 (1976).

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 shareholders' interests. When managers' time horizons differ from those of long-term shareholders,[43] 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. 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.[44] 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.[45]

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.[46] The ratio of the top five executives' aggregate pay to public firms' aggregate earnings increased from 5% in 1993–95 to some 10% in 2001–03.[47] Institutional investors and shareholder activists have tolerated and even encouraged the surge in executive pay, believing that managerial ownership may reduce agency problems.[48]

Stock-based compensation also increased during the 2000s and has since become the biggest component of executive compensation at large, publicly traded

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

44. *See* Jensen & Meckling, *supra* note 42, at 308 (explaining that "[t]he principal can limit divergences from his interest by establishing appropriate incentives for the agent . . . to limit the aberrant activities of the agent" (emphasis omitted)).

45. *See, e.g.*, Morck et al., *supra* note 7; Robert Tumarkin, How Much Do CEO Incentives Matter? (July 11, 2010) (unpublished manuscript), *available at* http://people.stern.nyu.edu /rtumarki/research/HMDCIM.pdf (reporting that "[f]or 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*, 18 EUR. J. FIN. 191 (2011).

46. *See* Brian J. Hall & Kevin J. Murphy, *The Trouble with Stock Options*, 17 J. ECON. PERSPS. 49, 51 (2003).

47. *See* Bebchuk & Grinstein, *supra* note 15.

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

U.S. firms. For the average S&P 500 CEO in 2013, stock-based compensation—namely stock options and restricted stock—was worth some $8.1 million, which amounted to more than 80% of the CEO's $10.1 million total compensation.[49]

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.[50] 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.[51]

Similarly, Facebook shareholders have made it clear that they value managerial ownership and see it as a sign of commitment to their company. Despite their growing concern 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, cofounder and CEO, that he would keep his Facebook stock for at least the next year.[52]

B. SOPs Discourage Managers from Pursuing Short-Term Gains

Federal Reserve Chair Ben Bernanke stressed the importance of discouraging managers from seeking short-term gains,[53] 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,[54] engaging in direct earnings management[55] or

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49. *See* EQUILAR, INC., *supra* note 14.

50. *See* The Goldman Sachs Grp., Inc., Proxy Statement (Form DEF 14A) 16 (Apr. 6, 2009).

51. *See* "*Hold Through Retirement": Maximizing the Benefits of Equity Awards While Minimizing Inappropriate Risk Taking*, CORP. EXEC. (Exec. Press, Inc., Concord, CA), Nov.–Dec. 2008, at 1.

52. *See* Gustin, *supra* note 8.

53. *See* Bernanke, *supra* note 3 (stressing the need to avoid using short-term metrics for transactions with long-term horizons when paying managers).

54. *See* Simi Kedia & Thomas Philippon, *The Economics of Fraudulent Accounting*, 22 REV. FIN. STUD. 2169, 2195 (2009) (reporting evidence that firms engaged in fraudulent accounting to boost short-term price also hire and invest too much, distorting the allocation of real sources); Christopher Polk & Paola Sapienza, *The Stock Market and Corporate Investment: A Test of Catering Theory*, 22 REV. FIN. STUD. 187, 212 (2009) (finding that managers with short-term horizons 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).

55. "Direct earnings 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 economic value. *See* François Degeorge, Jayendu Patel & Richard Zeckhauser, *Earnings Management To Exceed Thresholds,* 72 J. BUS., 1, 2–3 (1999). To manage reported earnings, for example, short-term managers

misreporting,[56] and making certain public statements or performing other acts of "window dressing."[57]

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 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.

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.[58] 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 managers to unload their stock before its value tanks or keep it if the price stands to increase.[59]

For example, consider a transaction that will boost a firm's stock price from $40 to $60 if it succeeds but would tank the price from $40 to $20 if it fails. There is a 50% probability of either success or failure. Such a transaction significantly

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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* (Harvard Bus. Sch., Working Paper No. 08-073, 2010), *available at* http://papers.ssrn.com/sol3/papers.cfm?abstract_id=930738. Real earning management neither violates securities law nor is prohibited by corporate law. *See, e.g.*, *Kamin v. Am. Express Co.*, 383 N.Y.S.2d 807, 811 (Sup. Ct. 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), *aff'd*, 387 N.Y.S.2d 993 (App. Div. 1976).

56. "Misreporting" is the practice of "earnings manipulation involving merely the discretionary accounting of decisions and outcomes already realized." *See* Degeorge et al., *supra* note 55, at 3. Earnings manipulation can either be legal, so that it does not violate the U.S. 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*, FOX NEWS (Dec. 7, 2006), http://www.foxnews.com/printer_friendly_wires/2006Dec07/0,4675,FannieMae,00.html.

57. 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).

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

59. 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 movement. Managers who may unload their stock freely enjoy similar incentives.

elevates the firm's risk but does not create any value for shareholders. Thus, managers who are unhampered by effective SOPs might be motivated to pursue this project and take advantage of their inside information to sell their stock before market price changes if the project appears likely to fail (or buy new stock if it appears likely to succeed).[60] In support of this view, Peter Tufano's empirical study shows that firms whose managers hold more stock have better corporate risk management policies.[61]

The second type of incentive to take excessive risks involves short-termism, which 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.[62] 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.[63]

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 regard to risk mitigation, SOPs have become the most popular single policy that firms cite to show that they 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 one hundred companies with yearly revenues of $12.5 billion or greater),[64] ahead of strategies that are directly designed to discourage undue risk, such as the balance of

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60. *See* Chen et al., *supra* note 10.

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

62. *See* Bebchuk et al., *supra* note 11, at 274 (explaining that the ability of executives at Bear Stearns and Lehman Brothers to unload their stock in the years leading to the financial crisis provided them with incentives to seek improvements in short-term results even at the cost of an elevated risk of an implosion in the future).

63. *Id.* However, commentators disagree on whether poor incentives contributed to the crisis. *See, e.g.*, Rüdiger Fahlenbrach & René M. Stulz, *Bank CEO Incentives and the Credit Crisis*, 99 J. FIN. ECON. 11, 22–23 (2011) (stating that bank performance during the recent credit crisis is not related to CEO incentives before the crisis).

64. *See* Equilar, Inc., *supra* note 9 (reporting that, among proxy filings of one hundred companies with yearly revenues of $12.5 billion or greater, tying long-term performance was the most cited general strategy for mitigation of risk. Under this broad category, many of such companies cited SOPs as a key element in reducing their risk. The second-greatest percentage, 59% of companies, specifically disclosed that their SOPs contributed to their mitigation of risk.).

short-term and long-term incentives compensation, or policies like excess-pay clawbacks[65] and hedging prohibition.[66]

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 poor-performing managers are allowed to freely unload their stock, they may avoid taking a loss if they sell their stock before its price declines.

Absent SOPs, managers who perform poorly may not only avoid losses but also generate personal profits. First, as I explained in the previous subpart, excessively risky strategies can generate profits for managers who may sell their stock quickly.[67] Second, the ability to enter into hedging transactions may create even more opportunities for these managers to separate their pay from their performance. For example, managers who increase short-term profits and instill latent risks may not only sell their stock later but also hedge their risk ex ante by using a future contract, which stipulates that they will sell some or all of their stock in the future for a predetermined price.[68] Because only the managers 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 and hedge against a potential stock plummet.

Finally, SOPs tie pay to risk management, which is an important aspect of performance. This link is created because SOPs, by limiting managers' ability to unload stock, expose managers' 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.

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65. 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-management strategy. *See id.*

66. *See supra* note 31.

67. *See*, *e.g.*, *supra* note 12 (discussing the perverse incentives that GM executive compensation incentives created not to fix the faulty ignition switches in its Chevrolet Cobalts).

68. *See generally* David Schizer, *Executives and Hedging: The Fragile Legal Foundation of Incentive Compatibility*, 100 COLUM. L. REV. 440 (2000) (noting that combining executive stock options together with derivatives raises a serious concern. Options are supposed to motivate better performance by tying pay to the stock price, but using derivatives for hedging can simulate a sale of such options without violating the executive contract with the firm. Then the incentive justification for option grants would no longer hold.).

E. The Need for SOPs Despite the Existence of Vesting Schedules

Firms have universally adopted vesting schedules for their equity grants.[69] Such schedules stipulate that managers may "earn" their stock options or restricted stock only in the future and only after certain conditions are met.[70] Unless stock is earned, it is nontransferable and certainly cannot be sold by the manager.

Nevertheless, well-construed SOPs are still important. Whereas both SOPs and vesting schedules impose unloading restrictions on stock that has not yet been earned by the manager, only SOPs define unloading restrictions for managerial stock that has already been vested. Restricting managerial freedom to unload vested stock is important both when managers sell their shares upon vesting and when they hold their shares to sell at a later date.

First, if an executive sells all of his shares upon the vesting of his awards, his tangible alignment with shareholder interests will significantly decrease. For example, consider a newly appointed manager who is granted a fixed amount of stock every year, which vests in three equal annual installments.[71] This manager, who sells all of his stock incentives upon their vesting, is expected to sell two-thirds of his total stock awards by his fifth anniversary. Going forward, the ratio of stock incentives that he unloads will increase even further.[72]

Without SOPs, replenishing such stock incentives is very expensive. This is because, on average, stock-based compensation has reached an all-time high of roughly 80% of total pay for executives, and such stock vests over a period of only three to four years.[73] Consequently, in order to replenish its CEO's stock incentives, the average S&P 500 firm will have to grant its executive new stock worth almost $7 million per year.

If the firm wants to avoid incurring such a significant cost, it would be better off imposing an SOP rather than extending its stock vesting schedules. Stretching vesting schedules increases the period in which options or restricted stock do not belong to the manager, thus making it costly for the manager who incurs the costs

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69. *See* EQUILAR, INC., 2014 EQUITY TRENDS REPORT 15–17 (2014), *available at* http://info.equilar.com/rs/equilar/images/equilar-2014-equity-trends-report.pdf.

70. For time-based vesting, all vesting periods are at least one year in length and a three-year vesting period is the most common. For performance equity, long-term performance metrics are the most common condition for vesting, with a growing popularity of time-based vesting restrictions following such performance periods. *See id.* at 14–16.

71. Such a vesting schedule is in line with the common practice for vesting schedules. For example, graded stock and option awards in S&P 1500 firms both had average vesting periods of 3.6 years. *See id.* at 4.

72. If, for example, his annual stock grant is 100 shares, he will hold 200 unvested shares at his fifth-year anniversary and will sell 400 shares by then. Going forward, every following year he will sell another 100 shares and be granted the same amount of unvested stock. Therefore, the amount of unvested stock he holds will remain 200 but the amount of stock sales will increase by 100 shares every year.

73. *See* EQUILAR, INC., *supra* note 14; EQUILAR, INC., *supra* note 69, at 16 (reporting that a three-year cliff and three- and four-year graded vesting schedules are the most popular vesting periods).

associated with the extended risk of never earning his unvested stock.[74] Additionally, the manager will lose the time value of money resulting from pushing his vesting date forward. Conversely, by requiring the manager to hold his already-vested stock for the long term, an SOP merely limits the manager's ability to sell stock he already owns. Thus, imposing SOPs is cheaper than extending vesting periods because it does not impose the extra risk associated with the possibility that a future receipt of stock ownership rights will not occur. These extra costs may be rolled over to shareholders.[75]

Second, when the manager does not routinely unload his stock incentives upon vesting, well-construed SOPs become even more important because their effectiveness in attaining the goals discussed earlier in this Part increases. For example, unlike a manager who sells his stock upon vesting, a manager who consistently avoids selling his vested stock[76] may be more tempted to push his firm to take excessive risks. If the gamble pans out and he keeps all of his vested stock, its value will appreciate more than if he had sold some of it. But if the unnecessary corporate adventure does not succeed, the manager will be able to avoid taking part in his shareholders' loss by quickly unloading the considerable amount of vested stock that he still holds.

Consider David Zucker, Midway Games CEO. Between December 19, 2006, and January 6, 2007, Zucker sold a total of 650,000 Midway Games shares for $12.9 million. Between mid-December 2006 and late February 2007, Midway Games stock lost almost 60% of its value.[77] Unfortunately, Zucker is not the only executive to unload a massive amount of stock when gambles do not seem to pan out. The top five executives of Bear Stearns and Lehman Brothers derived cash flows of about $1.1 billion and $850 million, respectively, from stock sales during

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74. A manager incurs a significant risk that his unvested stock will never vest for several reasons. For time-vested stock, the manager is not certain that he will remain with the firm until such time lapses. This is a significant risk because the average CEO tenure today is only eight years. *See* THE CONFERENCE BD., *supra* note 26. For performance-based unvested stock, the manager is not certain that he will meet the performance criteria, which are often largely dependent on factors beyond the manager's control, such as stock market performance, competitors' performance, and pure luck.

75. A similar idea is that a shift of risk from the shareholders to a risk-averse CEO will result in more compensation being paid by the shareholders to the CEO. *See generally, e.g.*, Michael C. Jensen & Kevin J. Murphy, *CEO Incentives—It's Not How Much You Pay, but How*, HARV. BUS. REV., May 1990, at 138 (indicating that a shift of such risk, by tying more pay to performance, may be desirable despite the increase in CEO pay).

76. My study shows that many CEOs keep significant amounts of their vested stock and, more specifically, that the median S&P 500 CEO holds roughly $14 million worth of his vested stock incentives.

77. 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 (describing how Zucker and other executives took advantage of the SEC rule known as a 10b5-1 plan to sell shares without facing insider-trading charges). Despite several conditions that such plans should meet, the article cites evidence that executives who set up such plans appear to be earning outsize gains.

the eight years preceding their firms' colossal crashes in 2008.[78] Also, in a study of executive trading in over 1200 firms during a five-year period ending in January 2006, Alan Jagolinzer found that insiders regularly sell on inside information and thereby consistently generate above-market returns.[79]

Finally, regardless of whether the manager sells some of his vested stock, restricting the sale of vested stock is more effective in changing managerial incentives than restricting the unloading of unvested stock. Vested stock is worth more for the manager than unvested stock because, as discussed before, stock vesting is uncertain. Therefore, the manager's inability to sell his vested stock when its value decreases is more costly for him than refraining from selling an identical amount of his unvested stock. In turn, a manager who is subject to effective SOPs will have a greater incentive to avoid a long-term depreciation of his stock price compared to a manager who is merely restricted by his vesting schedules.

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

In addition to SOPs and vesting schedules, there are other rules, policies, norms, and incentives that could theoretically prevent managers from quickly unloading their shares. However, such tools are insufficient to restrict the unloading of managerial stock.

The most important of these alternatives is the ability of institutional shareholders and directors to exert informal pressure to hinder executives' stock unwinding.[80] There is evidence that institutional shareholders convey their views on executive compensation to selected boards of directors privately.[81] 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.[82]

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78. Bebchuk et al., *supra* note 11, at 260. 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's equity. *See* Fahlenbrach & Stulz, *supra* note 63.

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

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

81. *See* James E. Heard, *Executive Compensation: Perspective of the Institutional Investor*, 63 U. CIN. L. REV. 749, 758 (1995).

82. *See* Joshua A. Kreinberg, *Reaching Beyond Performance Compensation in Attempts to Own the Corporate Executive*, 45 DUKE L.J. 138, 167 (1995) (noting that "[l]arge 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. *See* Randall S. Thomas & Kenneth J. Martin, *The Effect of Shareholder Proposals on Executive Compensation*, 67 U. CIN. L. REV. 1021, 1021 (1999) (noting that since the stratospheric increases in CEO pay of the 1990s, "[o]utraged investors have made their

Among other mechanisms that could incentivize or require managers to hold their firms' stock for the long term are insider-trading rules. Practically, such rules limit managerial unwinding of 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.[83] On top of these restrictions, Section 16(b) of the Securities and Exchange Act aims to prohibit fraud by requiring insiders to disgorge any "short swing" profits realized from any purchase or sale of their firms' securities within six months.[84] In addition, federal tax rules encourage executives to defer the sale of their restricted stock and to defer the sale of their stock options.[85]

We would also think that managers would not sell much of their stock because of their tendencies to be overconfident[86] as well as their cognitive dissonance.[87] Because of their cognitive dissonance and overconfident tendencies, CEOs can be expected to hold more company stock than is desired from a portfolio diversification viewpoint.

However, evidence shows that these existing mechanisms are not sufficient to prevent executives from quick stock unloading. A 2012 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.[88] Also, executives typically exercise their stock options years before those options

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views known to corporate boards of directors using shareholder proposals, binding bylaw amendments, 'Just Vote No' campaigns, and other activist efforts").

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

84. *See* 15 U.S.C. § 78p(b) (2012).

85. 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. *See* Treas. Reg. § 1.83-2 (2014). The grant of stock options is not a taxable event. If the options are "qualified" (if the executive holds the shares for at least one year after the exercise date and two years after the grant date of the stock) the employee pays nothing upon exercise and pays capital gains only when eventually selling the stock option. *See* Brian J. Hall & Kevin J. Murphy, *The Trouble with Stock Options*, 17 J. ECON. PERSP. 49, 53 (2003).

86. *See* Ulrike Malmendier & Geoffrey Tate, *CEO Overconfidence and Corporate Investment*, 60 J. FIN. 2661, 2662 (2005) (reporting that CEOs are overconfident in the sense that they systematically overestimate the return to their investment projects, and hence they account for corporate investment distortions).

87. 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 generally* LEON FESTINGER, A THEORY OF COGNITIVE DISSONANCE (1957). Therefore, cognitive dissonance might cause managers to reconcile their visions of themselves as successful managers with their fears of possible challenges along the way by holding a significant amount of their firms' stock for the long term. Doing so would create new cognitions within consistent belief systems, according to which (despite the challenges that they might face along the way) managers could believe that their good abilities as managers would create value in the long term. A large body of evidence from applied psychology shows that corporate executives routinely overestimate their abilities. *See generally, e.g.*, Malmendier & Tate, *supra* note 86.

88. *See* Ladika, *supra* note 19.

expire, and almost all of the shares acquired through option exercises are immediately sold.[89]

G. The Low Costs of SOPs

Theoretically, SOPs could be quite costly for shareholders. First, SOPs 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 expose managers to unnecessary idiosyncratic risk.[90] In both cases, the costs would be rolled over to the shareholders. Finally, SOPs could inflict direct costs on shareholders by discouraging managers from taking necessary and appropriate risks.[91]

However, in reality, SOPs impose low costs. There are practical and theoretical reasons for this conclusion. 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.[92] 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.[93] In addition, their need for liquidity is relatively low because their marginal propensity to consume is low and more of

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89. *See* BEBCHUK & FRIED, *supra* note 27, at 176–77 (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).

90. 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 the firms' stock. *See generally* William F. Sharpe, *Capital Asset Prices: A Theory of Market Equilibrium Under Conditions of Risk*, 19 J. FIN. 425 (1964).

91. One of the rationales for stock-based compensation (and especially option compensation) is to make risk-averse managers more likely to take risks so that their incentives will be better aligned with those of their typically risk-neutral shareholders. Because options value increases with firm volatility, they are purported to give executives incentives to increased risk-taking. *See generally* Randolph B. Cohen, Brian J. Hall & Luis M. Viceira, Do Executive Stock Options Encourage Risk-Taking? (Mar. 2000) (unpublished manuscript), *available at* http://www.people.hbs.edu/lviceira/cohallvic3.pdf.

92. I obtained such data from the most recent information posted on the SEC website by all S&P 500 firms as of August 4, 2010. I specifically recorded each CEO's actual holdings from his firm's "Common Stock and Total Stock-Based Holdings" table in its proxy statement, counting only such holdings recognized by the counting policy that applies to the CEO.

93. Almost three hundred years ago, Nicholas Bernoulli argued that the marginal utility of wealth decreases as wealth increases, a view that is at the core of most conventional economic theory today. This view holds that the disutility from losing an additional dollar would decrease with wealth. ASWATH DAMODARAN, STRATEGIC RISK TAKING: A FRAMEWORK FOR RISK MANAGEMENT 12–13 (2008).

their basic human needs have already been met. Also, CEOs' cognitive dissonance and overconfident tendencies can exacerbate their propensity to hold stock even more than their low risk aversion and low liquidity needs can support.[94]

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 about 35% among the top 250 companies disclosed SOPs in 2001.[95] Managers took advantage of their freedom to unload their incentive compensation. For example, when managers 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.[96]

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. Skilling unexpectedly resigned in August 2001, and shortly thereafter sold large blocks of his Enron stock before Enron declared bankruptcy.[97] 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.[98] 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.[99] Specifically, 49% of Fortune 250 companies disclosed formal SOPs for their executives in 2002, representing a 37% increase from 2001.[100]

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."[101] In addition, a 2003 report by The Conference Board (the

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94. *See supra* notes 86–87.

95. *See* FREDERIC W. COOK & CO., STOCK OWNERSHIP POLICIES: PREVALENCE AND DESIGN OF EXECUTIVE AND DIRECTOR OWNERSHIP POLICIES AMONG THE TOP 250 COMPANIES 5 (2003), *available at* http://www.fwcook.com/alert_letters/FWC_Stock_Ownership_09.03.pdf.

96. *See* Ofek & Yermack, *supra* note 48, at 1383.

97. *See* Richard A. Oppel, Jr., *Former Head of Enron Denies Wrongdoing*, N.Y. TIMES, Dec. 22, 2001, at C1; *Enron CEO Skilling Quits*, CNN MONEY (Aug. 14, 2001, 5:16 PM), http://money.cnn.com/2001/08/14/companies/enron/; *Enron Files for Bankruptcy*, BBC NEWS (Dec. 3, 2001, 5:08 AM), http://news.bbc.co.uk/2/hi/business/1688550.stm.

98. Carrie Johnson, *Skilling Gets 24 Years for Fraud at Enron; Former Workers Tell of Hard Times Over Lost Jobs, Retirement Savings*, WASH. POST, Oct. 24, 2006, at A1.

99. *See* FREDERIC W. COOK & CO., *supra* note 95, at 5.

100. *Id.*

101. *See* THE ASPEN INST., LONG-TERM VALUE CREATION: GUIDING PRINCIPLES FOR CORPORATIONS AND INVESTORS (2007) (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."); BUS. ROUNDTABLE, EXECUTIVE COMPENSATION: PRINCIPLES AND COMMENTARY 1 (2003); 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 9

leading 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."[102] This increased recognition of SOPs' importance resulted in their prevalence among Fortune 250 firms reaching 69.7% in 2005[103] and 82.1% in 2008.[104]

The 2008–09 financial crisis made the need to adopt SOPs unavoidable.[105] Prominent government officials made public statements urging firms to adopt such policies,[106] and the federal government prescribed strict SOPs for all Troubled Asset Relief Program (TARP) recipients.[107] Since then, institutional shareholders have used this momentum to exert unprecedented pressure on firms, urging them to adopt SOPs and submitting numerous stockholder proposals.[108] Even the California Public Employees' Retirement System, the largest public pension fund in the United States, has declared that SOPs should be adopted universally.[109]

The world's leading provider of proxy voting and corporate governance services, Institutional Shareholder Services (ISS),[110] has supported shareholder

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(2006) (recommending that companies require executives and directors to hold meaningful amounts of stock so that it is "economically material to the individual that a company succeed in the long-term").

102. THE CONFERENCE BD. COMM'N ON PUB. TRUST AND PRIVATE ENTER., FINDINGS AND RECOMMENDATIONS 7 (2003).

103. EQUILAR, INC., 2007 EXECUTIVE STOCK OWNERSHIP GUIDELINES REPORT 3 (2008).

104. EQUILAR, INC., 2009 EXECUTIVE STOCK OWNERSHIP GUIDELINES REPORT 5 (2010).

105. This consensus was formed despite disagreements about the causes of crisis. *See supra* note 63.

106. *See supra* note 3.

107. Specifically, the Treasury regulations preclude TARP recipient executives from cashing out any of the stock they receive before their TARP funds are repaid. *See* Emergency Economic Stabilization Act of 2008, 12 U.S.C. § 5221(b)(3)(D) (2012).

108. For example, shareholder proposals seeking to require executives to adopt strict SOPs were the second most frequent compensation-related topic in 2013. "Thirty-four such proposals have been voted on . . . , receiving average support of 24.4%." Memorandum from Gibson Dunn, Shareholder Proposal Developments During the 2013 Proxy Season 8 (July 9, 2013). The American Federation of Labor and Congress of Industrial Organizations 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* Bank of N.Y. Mellon Corp., Proxy Statement (Form DEF 14A) 79 (Mar. 15, 2010); Citigroup Inc., Proxy Statement (Form DEF 14A) 130 (Mar. 12, 2010); JPMorgan Chase & Co., Proxy Statement (Form DEF 14A) 40 (Mar. 31, 2010). For stockholder proposals in non-TARP firms, *see, e.g.*, Dow Chem. Co., Proxy Statement (Form DEF 14A) 48 (Mar. 31, 2010) (discussing 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).

109. THE CAL. PUB. EMPS.' RET. SYS., GLOBAL PRINCIPLES OF ACCOUNTABLE CORPORATE GOVERNANCE 68 (2010) (stating that "equity ownership guidelines and holding requirements should be an integral component of company's equity plan and overall compensation philosophy").

110. "For nearly 30 years, ISS has been the leading provider of governance research to

pressure. It has done so by (1) advising shareholders to vote for stockholder proposals that push companies to adopt SOPs,[111] (2) rewarding firms that have SOPs on its newly debuted risk assessment system,[112] and (3) recommending that shareholders vote on "Say-on-Pay" for firms with SOPs.[113] 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.[114]

Leading business executives, such as Goldman Sachs's CEO Lloyd Blankfein, have come up with their own proposals to adopt strong SOPs,[115] and leading

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institutional investors . . . [serving] approximately 39,000 companies across 115 countries." *Governance Advisory Services*, ISS GOVERNANCE, http://www.issgovernance.com /governance-solutions/governance-advisory-services/.

111. *See* RISKMETRICS GRP., 2010 U.S. PROXY VOTING GUIDELINES SUMMARY 51–52 (2010), *available at* http://www.issgovernance.com/file/files/RMG_2010_US_Summary Guidelines20100225.pdf.

112. Such a risk assessment system is called Governance Risk Indicators (GRId). GRId, which 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). GRId includes twenty-eight compensation indicators, four of which exclusively discuss SOPs. Companies failing to disclose, or explicitly saying that they will not disclose, receive the lowest score on GRId, thereby receiving higher corporate governance risk assessment. *See* Hewitt, *supra* note 5.

113. Current 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 SERVS. INC., 2014 U.S. PROXY VOTING SUMMARY GUIDELINES 40 (Jan. 13, 2014), *available at* http://www.issgovernance.com/file /files/ISS2014USSummaryGuidelines.pdf.

114. 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. John D. England, *Say on Pay Soul-Searching Required at Proxy Advisory Firms*, *in* PAY GOVERNANCE LLC, EXECUTIVE PAY AT A TURNING POINT: DEMONSTRATING PAY FOR PERFORMANCE & OTHER BEST PRACTICES IN CORPORATE GOVERNANCE 65, 65–66 (Ira T. Kay ed., 2nd ed. 2012). 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 former Hewlett-Packard CEO Carli Fiorina has made to gain ISS support in the Hewlett-Packard-Compaq merger demonstrates the decisive importance of ISS. *See* Pui-Wing Tam & Gary McWilliams, *H-P Garners Major Endorsement of Deal: ISS Advisory Firm Backs Acquisition of Compaq; Vote Seen as Still Close*, 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").

115. In a 2010 hearing of the Financial Crisis Inquiry Commission, Blankfein declared that senior executive officers should be required to retain the bulk of the stock they receive until they retire and that stock delivery schedules should continue to apply after the individual has left the firm. *See* FINANCIAL CRISIS INQUIRY COMMISSION, FIRST PUBLIC HEARING 6–11 (2010) (statement of Chairman and CEO Lloyd C. Blankfein of Goldman Sachs Group, Inc.).

investment banks have adopted considerably stringent policies.[116] As of 2013, SOPs have become virtually universal, with 95% prevalence among top 250 U.S. public firms.[117] The rise of SOP prevalence is summarized in Figure 1 below.

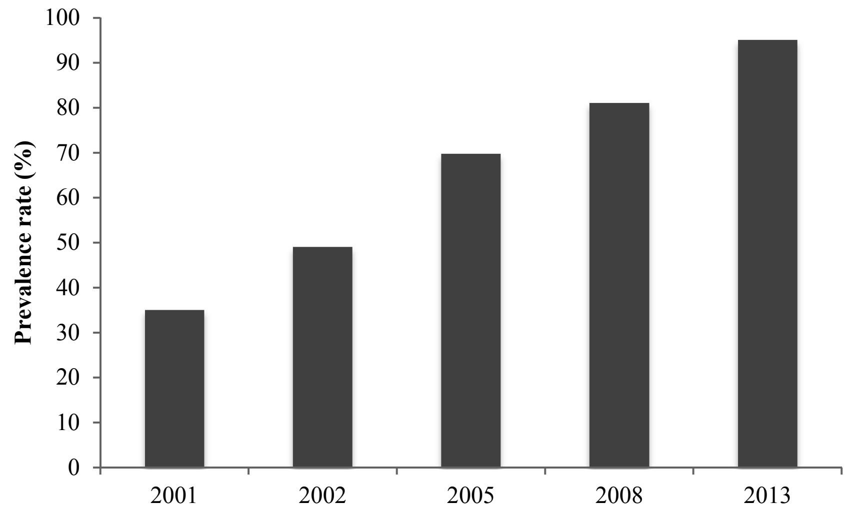

Figure 1. SOP prevalence among Fortune 250 U.S. firms, 2001–13

III. Methodology for Studying SOPs in S&P 500 Companies

I now turn to test the effectiveness and transparency of SOPs 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 the highest pay slice and having the strongest impact on the value, performance, and behavior of the public firm.[118] Naturally, SOPs apply the most

116. Goldman Sachs' 2013 SOP requires that "[i]n 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." The Goldman Sachs Grp., Inc., Proxy Statement (Form DEF 14A) 34 (Apr. 12, 2013). This policy is separate from and in addition to Warren Buffett's requirements in this regard discussed above. *See supra* text accompanying notes 50–51. Other banks have followed: Citigroup, JPMorgan, and Morgan Stanley all use a stringent requirement of a 75% stock retention rate. *See* Citigroup Inc., *supra* note 108, at 64; JPMorgan Chase & Co., *supra* note 108, at 26–27; Morgan Stanley, Proxy Statement (Form DEF 14A) 19 (Mar. 28, 2013).

117. *See* MERIDIAN COMP. PARTNERS, LLC, *supra* note 6.

118. *See generally* Lucian A. Bebchuk, Martijn Cremers & Urs Peyer, *CEO Centrality* (Nat'l Bureau of Econ. Research, Working Paper No. 13701, 2007), *available at* http://www.nber.org/papers/w13701.

stringent requirements on CEOs compared to the other members of the executive team or the nonemployee 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 the firms' "Compensation Discussion and Analysis" chapters of their proxy statements are the following: declared goals, target thresholds, counting policies, phase-in periods, and sanctions. In order to analyze the 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 the stock-based holdings that apply to the CEO.

I also relied on some data outside the information disclosed in the 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 from the Compustat ExecuComp database 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 may be counted for satisfying the SOP)) / vested equity

IV. THE DESIGN OF SOPS

Before analyzing the ineffectiveness and lack of transparency of SOPs, it is important to explain how these policies are designed. I find that 94% of recent 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 for CEOs[119] to maintain minimum ownership of their firms' 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, the framework contains a phase-in period term, which specifies the number of years the executive has to attain his or her required stock threshold.[120]

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119. SOPs and their target thresholds generally apply to senior executive officers and all nonemployee directors. Because my analysis focuses on CEOs, I ignore all other SOP objectives, such as target ownership thresholds for nonemployee directors that are specified as a multiple of their regular annual cash retainer.

120. 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

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.[121]

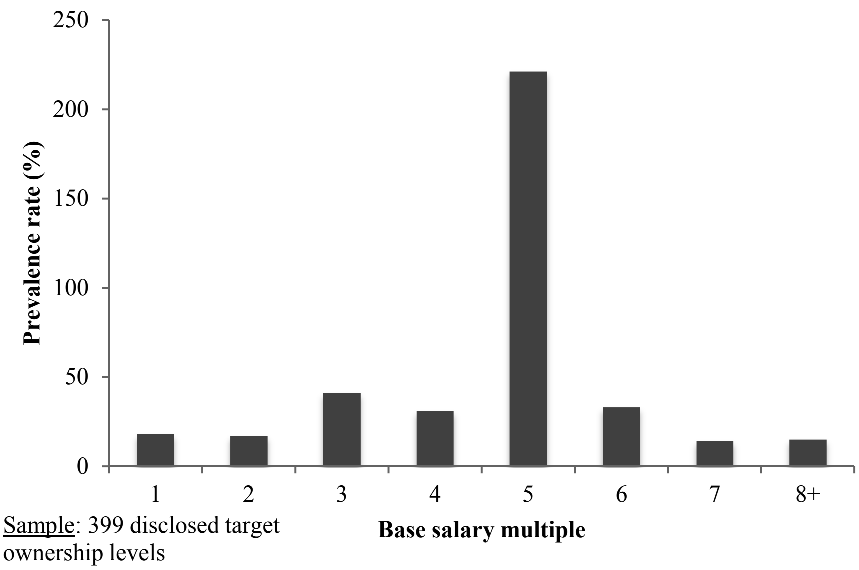

Figure 2. Target threshold distribution, 2010

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

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." Johnson & Johnson, Proxy Statement (Form DEF 14A) 42 (Mar. 17, 2010).

121. Relatively few firms reduce their base salary multiple or totally waive their SOPs for executives who reach the age of sixty or sixty-two. I did not adjust the multiples accordingly, as I did not want my analysis to depend on the identity of the CEO. Regardless, such adjustment would have been quite insignificant.

roughly shared by the three-, four-, and six-times 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), 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.

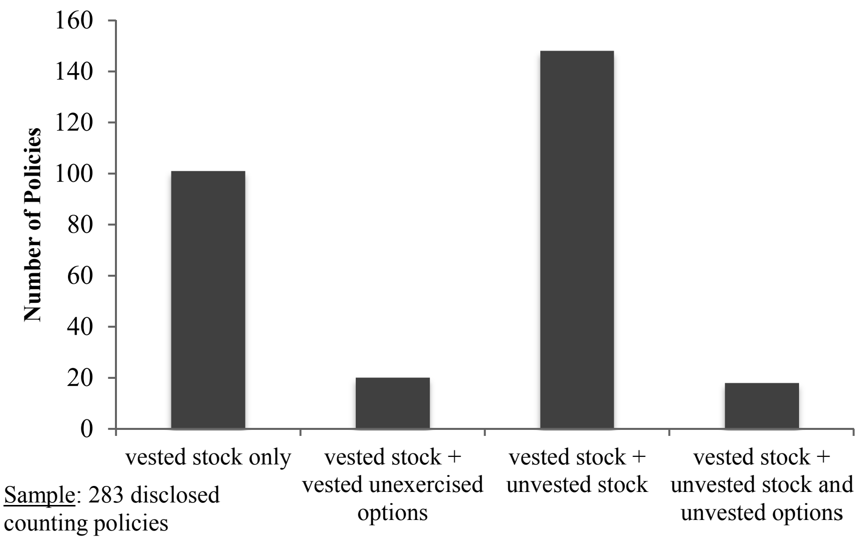

Figure 3. Counting policies distribution for S&P 500 CEOs

3. Phase-In Period

Finally, SOPs that invoke the target ownership framework typically stipulate the length of time allowed to the executive or director to attain her target stock threshold. Disclosure of such 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 an approach I call "fixed number of years," or "FNY," which specifies the number of years in which the executive or director must attain his policy's stock threshold. The other method utilizes an approach I call "retain until you hit your target threshold," or "RHT," which 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 aggregated data from all disclosed phase-in policies and summarized their distribution in Figure 4.

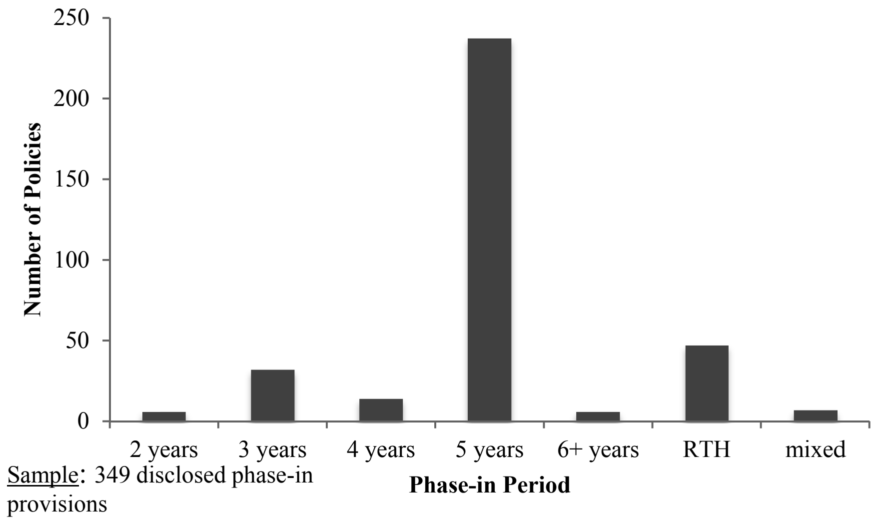

Figure 4. SOP phase-in period distribution for S&P 500 CEOs

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 a mixed approach, which includes both RHT and FNY methods.

Among the common FNY policies, more than 80% allow their executives to wait at least five years before they have to attain their SOPs' target ownership thresholds. Only slightly more than 10% of the FNY policies allow no more than three years for CEOs to attain their SOP stated stock threshold.

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 they are granted as compensation. Such guidelines apply to all stock-based compensation regardless of the executives' or directors' 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, executive officers or directors are 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), including mostly financial firms such as Goldman Sachs and JPMorgan, employ a stock retention approach for their SOPs.[122] Stock retention policies do not use ownership thresholds or limited holding periods; rather, they require executives and directors to retain a significant percentage of their after-tax shares they receive as compensation. Such percentages range from 50% to 75%. Goldman Sachs, JPMorgan, Citigroup, and Morgan Stanley all use a high ratio of 75% retention rate.[123]

V. SOP INEFFECTIVENESS

In this Part, I draw on the structural analysis of Part IV to show that SOPs are highly ineffective in making CEOs hold on to their vested stock.[124] As noted earlier, Scott Davis, the CEO of UPS since January 2008, may sell *all* of his over $30 million worth of vested UPS stock and still comply with his SOP. Unfortunately, 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 of 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.

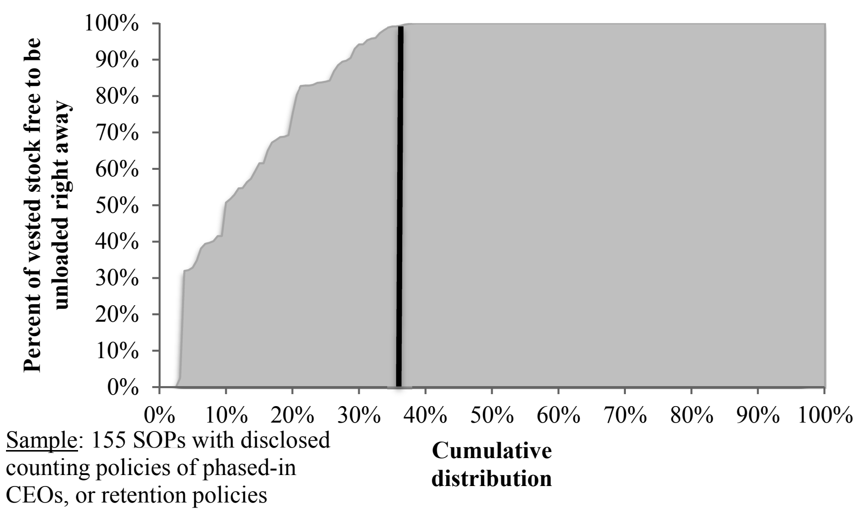

Figure 5. Vested stock free to be unloaded right away by S&P 500 CEOs

122. Three other nonfinancial firms employ a pure retention policy: The Clorox Company, E*TRADE Financial Corporation, and United States Steel Corporation.

123. Goldman Sachs's SOP supplements Warren Buffett's requirement that Goldman's senior executives be restricted to unloading a maximum of 10% of their stock for three years. *See* The Goldman Sachs Grp., Inc., *supra* note 50.

124. My claims about the implications of 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 the strength of firm-specific corporate governance arrangements, firm risk, and industry risk.

Almost two-thirds (62%) of CEOs are allowed to unload all of their vested stock immediately,[125] and the dollar amount of this capability is significant. In particular, half of CEOs are allowed to sell more than $14 million worth of their vested stock (which equals to more than 2.75 times their 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.[126] A few points are worth noting here. First, these strong policies are driven by the use of the uncommon, ongoing retention framework.[127] Second, among standard SOP frameworks, those that tend to be effective impose strict counting policies—namely, they do not recognize unvested stock.[128] 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.[129] 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.[130] Such relatively small stock holdings strongly correlate 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 vested stock voluntarily, significantly above what their SOPs require them to hold.[131] 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.

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125. 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. Therefore, only these firms' policies 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 phase-in terms.

126. Such effective SOPs are mostly those of financial firms, including Goldman Sachs and JPMorgan. *See supra* Part IV.B.

127. *See supra* Part IV.B.

128. Aetna, an American managed health care company, established a stringent counting policy. It strictly defines ownership as including "shares owned and vested stock units but not stock options or [Stock Appreciation Rights]." Aetna Inc., Proxy Statement (Form DEF 14A) 51 (Apr. 12, 2010).

129. General Dynamics, an American aerospace and defense company, established a stringent SOP requiring its officers to "retain Common Stock until they own outright shares with a market value ranging from eight to 15 times their base salary depending on the officer's position." Gen. Dynamics Corp., Proxy Statement (Form DEF 14A) 25 (Mar. 19, 2010). A fifteen-times-base-salary multiple for the CEO is extremely high considering the norm of five-times multiple for CEOs. *See supra* Figure 2.

130. For example, Hershey CEO David West holds, as of March 8, 2010, only 2.7 times his base salary and hence is required to accumulate shares equal to five times his base salary by October 2, 2012. The Hershey Co., Proxy Statement (Form DEF 14A) 61 (Mar. 22, 2010).

131. Michael Dell, Dell's founder, chairman, and CEO, holds more than 11% of the company's stock, which amounts to 461 times his holding requirement. Therefore, his SOP allows him to sell more than 99% of his stock. *See* Dell Inc., Proxy Statement (Form DEA 14A) 38, 48 (May 27, 2010).

Now, I analyze how SOPs fail to require CEOs to hold on to their firms' stock as a function of policy design.

A. Failure To Adopt the Ongoing Retention Framework

Despite the significantly enhanced effectiveness that the ongoing retention framework provides, my analysis shows that 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:

> [E]ach of our Senior Executives . . . 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.[132]

As opposed to the common target ownership framework SOP, which uses a five-times-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 Exxon Mobil's SOP: "50 percent of each grant is restricted for five years;" and "[t]he balance is restricted for 10 years or until retirement, <u>whichever is later</u>."[133]

For Rex Tillerson, who was elected chairman and CEO of Exxon Mobil in 2006, the stock subject to SOP is equal to thirty-nine times his base salary, compared to only five-times-base-salary multiple for the median CEO. Moreover, Tillerson's percentage of vested stock free to unwind is as low as 12%, dramatically lower than the 100% freedom to unwind for the median CEO.[134]

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 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 100%, with almost half of them (twenty-one policies) requiring a 100% retention rate.[135] Dun & Bradstreet discloses such an exceptional policy: "[A]ll executives

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132. The Goldman Sachs Grp., Inc., *supra* note 50, at 41. Citigroup, JPMorgan, and Morgan Stanley adopted similar policies. *See* Citigroup Inc., *supra* note 108, at 64; JPMorgan Chase & Co., *supra* note 108, at 26–27; Morgan Stanley, *supra* note 116, at 19.

133. Exxon Mobil Corp., Proxy Statement (Form DEA 14A) 30 (Apr. 13, 2010) (emphasis in original).

134. *Id.*

135. 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.

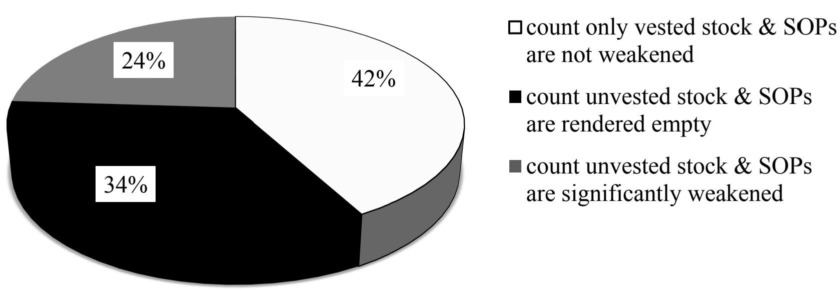
covered by our stock ownership guidelines are expected to retain 100% of net shares resulting from equity compensation awards and shares otherwise acquired by them outright until the stock ownership guideline is achieved."[136]

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.[137] 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 the CEO of UPS 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.



Sample: 283 SOPs with disclosed counting policies

Figure 6. Ineffective counting policies, 2010

Some 58% of disclosed counting policies allow the counting of unvested stock. Most of those policies (the black sector of the pie chart) are rendered entirely ineffective in that their CEOs are free to unload 100% of their vested stock immediately.[138] The remaining SOPs that count unvested stock (the grey sector of the pie chart) are significantly weakened by this laxity.

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136. The Dun & Bradstreet Corp., Proxy Statement (Form DEA 14A) 35 (Mar. 25, 2010).
137. *See supra* note 17.
138. 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

The impact of counting unvested stock on SOP effectiveness should not be surprising. The average SOP requires the CEO to hold five times his base salary in five years, counting both unvested and vested stock to satisfy this threshold. CEOs earn, on average, a $1 million annual base salary, and each year they receive some $6 million grant of stock that vests gradually over three years.[139] Thus, starting in the beginning of their third year of stock grants, CEOs will hold, on average, $12 million worth of unvested stock, which they do not own yet but can nevertheless apply toward their average $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.

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	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%

<u>Sample</u>: Ninety-five 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.[140] Dell explicitly indicates that its lax counting policy follows the market:

> Unvested restricted stock, [Restricted Stock Units] and [Performance-Based Restricted Stock 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.[141]

in 401(k) accounts, deferred compensation, and stock in trust accounts.

139. EQUILAR, INC., *supra* note 14.

140. Despite the fact that Michael Dell holds more than 11% of the company's stock, Dell's other top executives and nonemployee directors can take advantage of the company's ineffective SOP.

141. Dell Inc., *supra* note 131, at 38.

C. Lax Target Ownership Levels

For most CEOs, SOP target ownership levels are lower than 50% of their annual total pay and even lower than their single-year stock-based compensation.[142] Only 3% of SOPs use a base salary multiple that requires CEOs to hold more than their single-year total pay.

The common practice of lax target thresholds renders many SOPs futile as soon as they are adopted. According to a 2011 study, "71% of the CEOs already have a multiple larger than the target by the time the guidelines are initiated."[143]

D. Phase-In Policies Suspend Many SOPs

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,[144] 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 immediately unload all of their vested stock and still comply with their SOPs jumps to almost 80%.[145]

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

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142. 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 his total compensation is some $10.1 million, $8.1 million of which is in the form of stock-based compensation. EQUILAR, INC., *supra* note 14.

143. Ying Cao, Zhaoyang Gu & Yong George Yang, Adoption of Executive Ownership Guidelines: A New Look 13 (Feb. 2011) (unpublished manuscript), *available at* http://ssrn.com/abstract=1596503.

144. 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. THE CONFERENCE BD., *supra* note 26.

145. 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 plus 96 divided by 283 (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.

that many managers use zero-cost collars and equity swaps[146] to hedge the risk associated with their equity holdings.[147] Managers even possess some timing abilities; that is, they can initiate hedging transactions immediately following large price run-ups and prior to poor earnings announcements.[148]

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 his firm's stock for the long term; consider further that the stock currently trades at one hundred dollars. This leaves the executive exposed to future losses of up to $5 million if his firm's stock price drops and poised to earn an unlimited potential profit if that price increases. This balance between potential gains and losses should incentivize him to avoid taking excessive risks and to work hard to maximize the long-term stock price. However, if he wishes to fully hedge his SOP stock by purchasing a zero-cost collar, he can buy 50,000 put options and sell 50,000 call options with a strike price of one hundred dollars for each option. This hedge fully protects him from any increase or decrease in his 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 his 50,000 SOP stock. His SOP holdings therefore no longer provide him with any economic incentives.[149]

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.[150] Although firms are now required to disclose more of their executives' derivative transactions,[151] 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 SOPs.

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146. 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 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 London Interbank Offered Rate) or any other financial instrument, such as the S&P 500. *See* J. Carr Bettis, John M. Bizjak & Michael L. Lemmon, *Managerial Ownership, Incentive Contracting, and the Use of Zero-Cost Collars and Equity Swaps by Corporate Insiders*, 36 J. FIN. & QUANTITATIVE ANALYSIS 345, 345 (2001).

147. *Id.* at 359–71 (indicating that zero-cost collars and equity swaps involve high ranking insiders and cover over a third of their equity holdings).

148. *Id.* at 347.

149. *See* Schizer, *supra* note 68.

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

151. *See infra* Part VI.C.1.b.

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 the corporation.[152] 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.[153] Therefore, the lack of sanctions delivers an implicit message to investors that boards are not expected to take SOP violations seriously.[154] In practical terms, it can mean that SOPs are rendered aspirational 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,[155] 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.[156]

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 executives 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 that "[t]he policy calls for members of senior management to own shares of common stock."[157] 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

152. *See, e.g.*, DEL. CODE ANN. tit. 8, § 141(a) (2011) (discussing the managing role of a board of directors).

153. *See* BEBCHUK & FRIED, *supra* note 27, at 23–44.

154. 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. 721, 737–38 (2011) (reporting that the vast majority of clawback policies adopted by S&P 500 firms leave discretion to boards to forgo recovering excess pay even when the executive receiving such pay committed misconduct).

155. Such an ineffective sanction is mentioned in Qualcomm's SOP: "If a [Named Executive Officer] 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." Qualcomm Inc., Proxy Statement (Form DEF 14A) 23 (Jan. 14, 2009).

156. Merck & Co., Proxy Statement (Form DEF 14A) 31 (Mar. 13, 2009).

157. Archer Daniels Midland Co., Proxy Statement (Form DEF 14A) 5 (Sept. 25, 2009).

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,[158] allow them to do so. Such rules merely require them to disclose their SOP objectives[159] in their proxy statements and to provide a general description of their policies, including applicable amounts and forms of ownership.[160] 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. SOPs Fail To Indicate the Amount of Vested Stock CEOs May Immediately Unload

I find that recent 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 CEOs 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 SOPs disguises the fact that most policies allow CEOs to sell all of the stock they own. Moreover, this flaw cannot be rectified by having shareholders calculate these numbers on their own. As I explain in subpart B below, even diligent and dedicated outsiders are often unable to produce the bottom-line effectiveness numbers for SOPs on their own.

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158. 17 C.F.R. § 229.402(b)(2)(xiii) (2013).

159. Item 402(b)(1) requires that "the discussion shall describe . . . (i) [t]he objectives of the registrant's compensation programs; [and] (ii) [w]hat the compensation program is designed to reward[.]" § 229.402(b)(1)(i)–(ii) (2011).

160. 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)." § 229.402(b)(2)(xiii) (2011).

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 Form 4 within forty-eight hours of such activity[161] and to file an annual statement of beneficial ownership of securities on Form 5,[162] these disclosures do not present 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 under Section 16(a).[163]

Knowing the historical unloading activity by CEOs of stock counted for their SOPs would help investors evaluate the effectiveness of SOPs. Such information does not only reflect the absolute strength of the policy but also the tendency of the CEO to take advantage of potential weaknesses of the policy in order to unload stock. Hence, it would help investors 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 be disclosed, investors do not know whether this nondisclosure is due to the lack of sanctions in the firms' SOPs or to the firms' choice not to disclose such sanctions.

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

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161. *See* 17 CFR § 249.104 (2012).

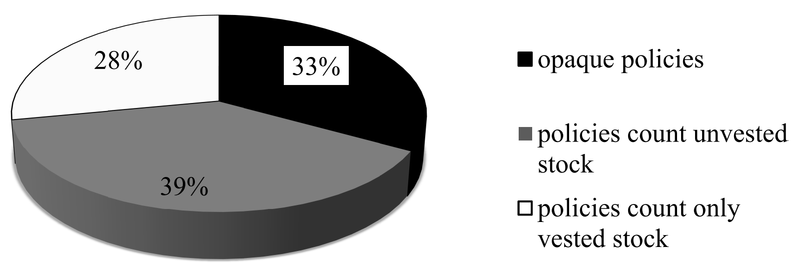
162. *See* 17 CFR § 249.105 (2012).

163. For example, I find that SOP counting policies differ greatly in the type of stock they count. In addition to stock owned outright, they might include vested options, unvested options, deferred stock, performance shares, stock units, stock in trusts, or stock owned by family members. Section 16, in contrast, applies equally to all firms and requires reporting of transactions in all equity securities of the firm, including derivatives, that the reporting person beneficially owns.

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 requires firms to disclose the "forms of ownership" recognized for their SOPs,[164] and many firms have interpreted this provision narrowly. For example, I find that 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.



Sample: 424 disclosed SOPs

Figure 7. Camouflage and ineffectiveness of counting policies as applied to S&P 500 CEOs, 2010

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,[165] 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.

164. § 229.402(b)(2)(xiii) (2011).

165. Of the policies that recognize unvested stock, 59% are rendered completely empty while the rest are significantly weakened.

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; instead, 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 policy description.[166] 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. Such importance results from the fact that, as I reported in Part V.D, as many as 43% of disclosed phase-in policies render SOPs inapplicable.

Comparing the disclosure rates of various policies reveals a selective disclosure pattern: firms tend to be more aggressive in camouflaging critical provisions that may render their SOPs more ineffective and may even provide more valuable information to their investors. Based on my research, the most frequently hidden SOP component is sanctions, despite the fact that the lack thereof can render SOPs entirely toothless. The second most frequently hidden SOP component is counting policies, the nondisclosure of which renders SOPs ineffective in 58% of cases. Finally, the least frequently 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, SOPs have not been included in standard databases that financial economists use for research on executive compensation.[167] 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 subpart B highlighted that firms frequently withhold information about critical SOP terms that could allow investors to assess SOPs on their own. In this subpart, I explain that when firms *do* disclose critical terms of their SOPs, they do not indicate the impact of such 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 these SOPs might not render policies ineffective.

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166. *See supra* text accompanying note 160.

167. For example, the popular S&P ExecuComp database does not include any of the SOP terms.

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 SOPs, my study shows that 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 "[s]hares of class A common stock, deferred units and vested and unvested [Restricted Stock Units] and [Restricted Performance Units] are considered as owned for purposes of calculating ownership."[168]

But UPS does not acknowledge that recognizing unvested Restricted Stock Units (RSUs) and Restricted Performance Units (RPUs) renders its SOP entirely ineffective for its CEO. It specifically does not disclose that its counting policy allows its CEO to count his $12.3 million worth of unvested RSUs and RPUs to satisfy his $8.4 million SOP commitment in full.

The detailed counting policy of KLA-Tencor 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."[169]

KLA-Tencor does not explain that this policy renders its SOP entirely ineffective for its CEO, nor does it mention that the unvested restricted stock units and the unvested performance share awards held by its CEO, Richard Wallace,[170] equal more than four times Wallace's SOP threshold. The implication of this counting policy is that 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. 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.[171] However, as I explained in Part V, CEOs may hedge their SOP stock and thereby nullify the incentives provided by those policies.

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168. *See* United Parcel Serv., Inc., *supra* note 18.
169. KLA-Tencor Corp., Proxy Statement (Form DEF 14A) 59 (Sept. 27, 2012).
170. For Wallace's unvested restricted stock units and unvested performance share awards, see *id.* at 41.
171. *See supra* notes 36–39.

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 any derivative transactions made by their executives.[172] 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.[173]

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 SOPs is confusing. The average policy, as I reported in Part IV, requires CEOs to hold five times their *base* salary.[174] However, some firms, such as UPS, use the term *salary* or *annual salary* to describe the *base* salary multiple of their CEOs' target ownership levels.[175] While for most employees salary means total compensation, it means only less than 10% of total compensation for the average S&P 500 CEO.[176]

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

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172. 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 holdings, acquisitions or dispositions of derivative securities. Specifically, Form 3 should be filed after a company's IPO, and report insiders' initial derivative securities holdings. *See* 17 C.F.R. § 249.103 (2013). Form 4 should be filed before the end of the second business day following the day on which an acquisition or a disposition of a derivative security has been executed. *See* 17 C.F.R. § 249.104 (2013). Form 5 should be filed annually, reporting insiders' derivative securities holdings. *See* 17 C.F.R. § 249.105 (2013). For copies of the forms themselves, see *Forms 3, 4, 5*, U.S. SECURITIES AND EXCHANGE COMMISSION, http://www.sec.gov/answers/form345.htm.

173. *See* 15 U.S.C.A. § 78n(j) (West 2012 & Supp. 2014).

174. I report only one firm, Chesapeake Energy, 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.

175. The SOP of UPS states that "[t]arget ownership for the Chief Executive Officer is eight times annual salary." United Parcel Serv., Inc., *supra* note 18.

176. In 2013, the average S&P 500 CEO was paid a total compensation of some $10.1 million, while his base salary was $1 million. *See* EQUILAR, INC., *supra* note 14.

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 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: "'[O]wnership' includes . . . shares of Company restricted stock held directly by an Executive Officer, whether or not yet vested."[177] 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 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, SOPs are not likely to affect managers' incentives and behavior. I reported in Part V that SOPs allow two-thirds of CEOs to sell 100% of their vested stock immediately. Such CEOs are not any more likely to shy away from taking excessive risks than are managers who do not have SOPs. Similarly, 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 recent ones. Specifically, at that time Lehman Brothers[178] 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).[179] Compared to recent SOPs, Lehman's SOP was

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177. *See* AK Steel Holding Corp., Proxy Statement (Form DEF 14A) 37 (Apr. 12, 2010).

178. Lehman Brothers' bankruptcy filing in September 2008 triggered a widespread panic that prompted a global financial crisis. *See* Carrick Mollenkamp, Susanne Craig, Jeffrey McCracken & Jon Hilsenrath, *The Two Faces of Lehman's Fall—Private Talks of Raising Capital Belied Firm's Public Optimism*, WALL ST. J., Oct. 6, 2008, at Al.

179. Lehman Bros. Holdings, Inc., Proxy Statement (Form DEA 14A) 23 (Mar. 5, 2008).

relatively strict. Nevertheless, the company's top five executives sold Lehman stock worth $1.1 billion between 2000 and 2008.[180] This finding suggests that Lehman's SOP did not curtail its executives' incentives to take excessive risks.[181] If a 20% annual unloading cap did not curb Lehman's executives' incentives to take excessive risks, then the significantly weaker unloading limitations in recent SOPs should fair much worse.[182]

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

Finally, the 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 (1) avoid suffering personal losses resulting from their poor performance, (2) generate personal profits despite their poor performance, and (3) 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 these policies from attaining their intended goals, the camouflaging of such ineffectiveness misleads investors to 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 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

180. Bebchuk et al., *supra* note 11, at 268.

181. *See id.*

182. Certainly, Lehman's aggressive culture contributed to its tendency to take excessive risks. However, well-constructed SOPs should be tailored to achieve their goals and to take into account the specific firm's corporate culture, industry, market conditions, managerial idiosyncratic situation, and so forth. Lehman's SOP failed to do so, and its relative strength compared with the strength of recent SOPs casts significant doubt on the efficacy of recent SOPs to achieve such goals as well.

inclined to consider possible responses to remedy this failure. Such responses might include three courses of action. First, investors might conclude, after weighing the potential costs and benefits of changing their SOPs, that these policies should be more effective and therefore might push their firms to make SOPs stronger. Second, 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. Third, investors might decide that it is more cost-effective to attain SOP goals by strengthening other policies. For example, to curb excessive risk taking, investors 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' abilities to make accurate assessments of 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 SOPs, boards are unaware of the need to confer with their executives about how SOPs should be designed. Currently, boards are unaware of the potential 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 an 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[183]—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 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 prices.[184] Similarly, corporate governance terms that do not benefit shareholders are associated with lower stock prices.[185] Therefore, firms' choices to camouflage the ineffectiveness of their SOPs

183. *See* Jensen & Meckling, *supra* note 42.

184. *See generally* Lucian A. Bebchuk, Alma Cohen & Charles C.Y. Wang, *Learning and the Disappearing Association Between Governance and Returns*, 108 J. FIN. ECON. 323 (2013) (reporting that the disappearance of the correlation between corporate governance terms and stock returns in 2000–08 indicates that stock markets started in 2000 to accurately price corporate governance terms).

185. *Id.*

indicate that they think these policies decrease stock value 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.[186] 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 psychological reasons, it is personally difficult for directors in public firms to support compensation decisions that are costly for executives.[187] 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 regard to SOPs are aligned with those of their directors, which makes the directors' supervision of 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

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186. For a discussion of such liquidity and diversification costs, see *supra* Part I.

187. *See* BEBCHUK & FRIED, *supra* note 27 (describing sources of executives' influence over directors in public firms).

exclusive to SOPs; it has also been shown that board discretion has been used to forego clawbacks of excess pay from executives.[188]

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 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.

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 "Securities Ownership of Certain Beneficial Owners and Management" table in the firm's proxy statement.[189] 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, but 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.[190] 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 estimates of 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. . . . [T]he 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

188. *See* Fried & Shilon, *supra* note 154, at 739 (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's discretion, is the only way to ensure that such recovery occurs).

189. See, *e.g.,* United Parcel Serv., Inc., *supra* note 18.

190. *Id.* at 51.

> statement. No two analysts came up with the same number. The numbers varied widely.[191]

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.[192] Such a problem will discourage shareholders even more from attempting to evaluate SOPs.

It is not only investors who are unable to successfully evaluate SOPs but also the influential ISS, whose guidelines are followed by institutional investors and firms alike.[193] 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.[194] However, my analysis shows that GRId ignores limp counting policies, phase-in periods, and sanctions, as well as hedging activity, and therefore does not evaluate the bottom-line effectiveness of SOPs.

Because SOP camouflage is troubling, because shareholders are unlikely to overcome camouflage by evaluating SOP effectiveness on their own, and because the ISS does not do a good job at 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 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

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191. Symposium, *Executive Compensation Under the New SEC Disclosure Requirements*, 63 U. CIN. L. REV. 769, 770–71 (1995).

192. For investors, the term "collective action problem" describes the situation in which multiple shareholders would all benefit from taking a certain action (such as exerting pressure to improve their firms' SOPs), but such action has an associated cost that makes it implausible that any one individual would find it cost-effective to undertake this action alone. *See generally* MANCUR OLSON, THE LOGIC OF COLLECTIVE ACTION: PUBLIC GOODS AND THE THEORY OF GROUPS (2nd ed. 1971).

193. When evaluating SOPs, the ISS GRId does not allocate points according to the policies' bottom-line effectiveness. *See* HEWITT, *supra* note 5. For a discussion regarding the great influence that ISS has over institutional investors and firms, see *supra* note 114 and accompanying text.

194. *See id.* at 37.

idiosyncratic managerial characteristics such as the need for liquidity, voluntary stock holdings, risk aversion, and portfolio composition.

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 standards.[195] This course of action might be desirable for certain SOP elements that render these policies feckless, such as counting policies or sanctions. 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 policymakers to engage in a dialogue to improve SOPs according to each firm's individual characteristics and the needs of specific industries.[196] 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 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 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 (1) the percentage and value of vested and nonhedged equity that may be immediately unloaded, (2) the separate values of vested and unvested equity held that are recognized by the firm's SOP counting policy, and (3) 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 SOP holdings, and the third indicator provides information about the historical changes to 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 their policies. Some firms might prefer to eliminate their SOPs altogether. This would be

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195. *See generally* Russell Korobkin, *The Status Quo Bias and Contract Default Rules*, 83 CORNELL L. REV. 608 (1998) (explaining that default rules can change the outcome because equilibrium can be path-dependent).

196. 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.

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 on SOP effectiveness. In particular, the following additional information should be disclosed in firms' SOP narrative sections:

(1) Counting policy and, specifically, the types 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.
(2) Applicable phase-in policy, whether its top five executives have already phased in, and whether the phase-in policy includes an RHT provision.
(3) Sanctions, if any, that executives face for violating their SOPs.
(4) 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 ensure 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[197] and can undoubtedly obtain it at a lower cost than can shareholders or researchers.[198]

B. Greater Transparency Should Improve SOPs

I expect that better transparency will improve the actual content of SOPs because investors and boards not only will have a better understanding of what these policies do but will also act on this information. Boards are expected to take actions to improve SOPs regardless of the pressures they might face from their shareholders. Currently, SOP camouflage keeps the problems associated with these policies hidden from their directors, who are part-time nonemployees with limited time and abundant responsibilities in which to perform their monitoring duties.[199]

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

198. 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).

199. For example, Carter and Lorsch contend that since "the average director spends

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. When SOPs become transparent, "outrage costs"[200] will push boards for SOP reform in order to avoid embarrassment and to avoid the social costs associated with having SOPs that are incapable of achieving their declared goals. 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.[201]

In addition, better disclosure will encourage shareholder action because it will provide shareholders 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.

Finally, the 2006 SEC reform of executive pension disclosure serves as a precedent for the kind of reform I propose for SOPs. In 2005, Bebchuk and Jackson revealed that executive pension amounts were high and that they were being camouflaged.[202] Despite the fact that these findings were based on public filings, the SEC agreed that a disclosure reform is warranted. Accordingly, in December 2006 the agency added a new rule, requiring 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, investors expected a more conservative, lower-risk operating strategy for CEOs who are entitled to larger executive pension amounts. Therefore, bond prices increased, equity prices fell, firm risk decreased, and value shifted from equity toward debt holders.[203] Similarly, I expect that better disclosure of SOPs will improve the informational efficiency of securities markets and, hence, firms will be encouraged to improve the actual content of their policies.

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little more than two weeks a year" on the job, it is difficult to "develop much more than a rudimentary understanding of their companies' workings." COLIN B. CARTER & JAY W. LORSCH, BACK TO THE DRAWING BOARD: DESIGNING CORPORATE BOARDS FOR A COMPLEX WORLD 45 (2004).

200. "Outrage costs" are the social and economic costs that managers suffer when outsiders perceive certain pay arrangements as unjustified or even abusive. *See* BEBCHUK & FRIED, *supra* note 27, at 65.

201. *See* Margarethe F. Wiersema & Yan (Anthea) Zhang, *Executive Turnover in the Stock Option Backdating Wave: The Impact of Social Context*, 34 STRATEGIC MGMT. J. 590, 595–96 (2013), *available at* http://onlinelibrary.wiley.com/doi/10.1002/smj.2030/pdf, (reporting that, during the 2006 stock backdating scandal, an increase of media attention to a backdating scandal increases the likelihood that the firm experiences executive turnover).

202. *See generally* Lucian A. Bebchuk & Robert J. Jackson, Jr., *Executive Pensions*, 30 J. CORP. L. 823 (2005).

203. *See* Chenyang Wei & David Yermack, *Investor Reactions to CEOs' Inside Debt Incentives*, 24 REV. FIN. STUD. 3813, 3832–41 (2011).

The current camouflaging of SOP ineffectiveness is even more severe than that of executive pensions before its disclosure reform of December 2006. This is because, unlike the ability to use certain calculations and assumptions to estimate the magnitude of executive pensions before December 2006, one-third of recent SOPs cannot be evaluated at all, even if extensive assumptions are made.

C. Potential Objections to Making SOPs Transparent

Critics might argue that better disclosure will not be effective to improve the content of SOPs because shareholders do not want their firms to adopt effective policies. This is because most U.S. shareholders seek short-term gains and therefore want managers to have short-term incentives.[204] 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.[205] Moreover, "[s]hort-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."[206]

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.[207] 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.[208]

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 has done.[209]

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204. *See, e.g.*, Patrick Bolton, José Scheinkman & Wei Xiong, *Executive Compensation and Short-Termist Behavior in Speculative Markets*, 73 REV. ECON. STUD. 577 (2006).

205. *See* David, *Duration of Stock Holding Periods Continue To Fall Globally,* TOPFOREIGNSTOCKS.COM (Sep. 6, 2010), http://topforeignstocks.com/2010/09/06/duration-of-stock-holding-period-continues-to-fall-globally/.

206. *See* X. Frank Zhang, Investor Short-Termism and Asset Pricing 1 (November 2011) (unpublished manuscript), *available at* https://web.archive.org/web/20120412231625/http://mba.yale.edu/faculty/pdf/zhangxf_Investor_short_termism.pdf (accessed by searching "http://mba.yale.edu/faculty/pdf/zhangxf_Investor_short_termism.pdf" in the Browse History toolbar).

207. EUROFI, PROMOTING LONGER-TERM INVESTMENT BY INSTITUTIONAL INVESTORS: SELECTED ISSUES AND POLICIES 6 (2011), *available at* http://www.oecd.org/pensions/private-pensions/48281131.pdf.

208. Recently, institutional investors have been labeled as "short-termist." *Id.* at 1. 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 to hedge funds and other high-frequency traders. *Id.* However, these concerns do not change institutional investors' basic long-term incentives, and now there is a trend toward more "responsible" and longer-term investment among pension funds, life insurers and mutual funds. *Id.*

209. *See* Viacom Inc., Proxy Statement (Form DEF 14A) 42 (Apr. 16, 2010) ("Given the significant stock ownership of Messrs. Redstone, Dauman and Dooley ($1.3 billion, $9.5

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 ensure that their design and effectiveness are in line with shareholder interests. My argument is consistent with the philosophy of U.S. securities law, which requires public companies to disclose meaningful financial and other information to the public. SOPs should make no exception to this basic principle.

Finally, some critics 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 and destroying 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[210] should not come as a surprise.[211]

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 we should expect improved efficiency in SOPs when they become transparent.

CONCLUSION

This Article has investigated SOPs. These policies were universally adopted in response to the 2002 corporate scandals and especially to the widespread pressure to adopt these policies following the 2008–09 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.

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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.").

210. In 1993, provisions in the Omnibus Budget Reconciliation Act, implemented as section 162(m) of the Internal Revenue Code, eliminated deductibility for executive compensation in excess of $1 million unless it qualified as "performance-based" pay. *See* I.R.C. § 162(m) (1993). While proponents argued that this would constrain compensation packages by raising their cost to shareholders, corporate pay decisions have been relatively insulated from this policy intervention. *See* Nancy L. Rose & Catherine Wolfram, *Regulating Executive Pay: Using the Tax Code To Influence Chief Executive Officer Compensation*, 20 J. LAB. ECON. S138, S141 (2002).

211. *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).

I contend that SOPs are extremely ineffective in making CEOs retain 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. I leave for future research the empirical investigation of how executive stock hedging undermines SOP effectiveness and whether such effect is transparent to investors. Such future investigation might indicate that the concerns I highlight in this Article are even more severe.

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. The case for making SOPs transparent is set.