ILLUSORY CEO STOCK OWNERSHIP POLICIES

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Abstract

In the aftermath of the 2007-2008 financial crisis, a widespread pressure has been placed on firms to curb excessive risk taking and to reform executive pay. Many firms responded to this pressure by adopting Stock Ownership Policies ("SOPs") that require their managers to hold a minimum value of firm stock. Firms allege that these policies, by tying managerial wealth to long term shareholders wealth, mitigate risk and encourage long-term value creation. However, by analyzing the 2010 SOPs of S&P 500 CEOs, I suggest that these policies do not live up to their expectations. They are extremely weak, as CEOs are allowed to unload virtually all of their vested equity. Moreover, this weakness is camouflaged in firms' public filings. Therefore, I put forward a regulatory reform proposal to make SOPs transparent.

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

INTRODUCTION

In the aftermath of the 2007-2008 financial crisis, many American firms responded to a widespread pressure to curb excessive risk taking by adopting Stock Ownership Policies (“SOPs”) that require top executives and directors to hold a certain value of their companies’ shares. Those policies, that became virtually universal, are disclosed in firms’ public filings. Most firms voluntarily declare their SOPs a key element in their mitigation of risk, a tool to incentivize managers for long-term focus and to align managerial interests with shareholders.

However, post-crisis SOPs do not live up to the expectations created by their declared objectives. Those policies, that are structurally designed to be ineffective, allow managers to engage in massive equity unloading. Moreover, such ineffectiveness is camouflaged in current firms public filings. Those reports do not disclose the amount of vested equity readily available to be unloaded, and do not indicate the significance of any structural flaw. They are also framed in a way that might mislead investors. Therefore, current SOPs are illusory.

Empirical evidence that I present in this Article suggests that current SOPs are consistent with self-serving managerial power. Therefore, I put forward a regulatory reform proposal to make SOPs transparent.

The remainder of this Article continues as follows. I start with a discussion of current SOPs and their theoretical foundations. Part II explain the relation of this Article to prior literature. Part III turns to analyze the widespread pressure to adopt SOPs, and Part IV reports the dramatic rise in SOPs prevalence. Part V describes the methodology used to collect the empirical evidence emphasizes SOP weakness reported in Part VI. Part VII discusses the camouflage of SOP ineffectiveness in firms public filings, and Part VIII responds to claims that I could not detect camouflage. The camouflaged ineffective SOPs gives rise to the proposal I put forward in Part IX to make SOPs transparent. Part X concludes.

I. SOPs AND THEIR THEORETICAL FOUNDATIONS

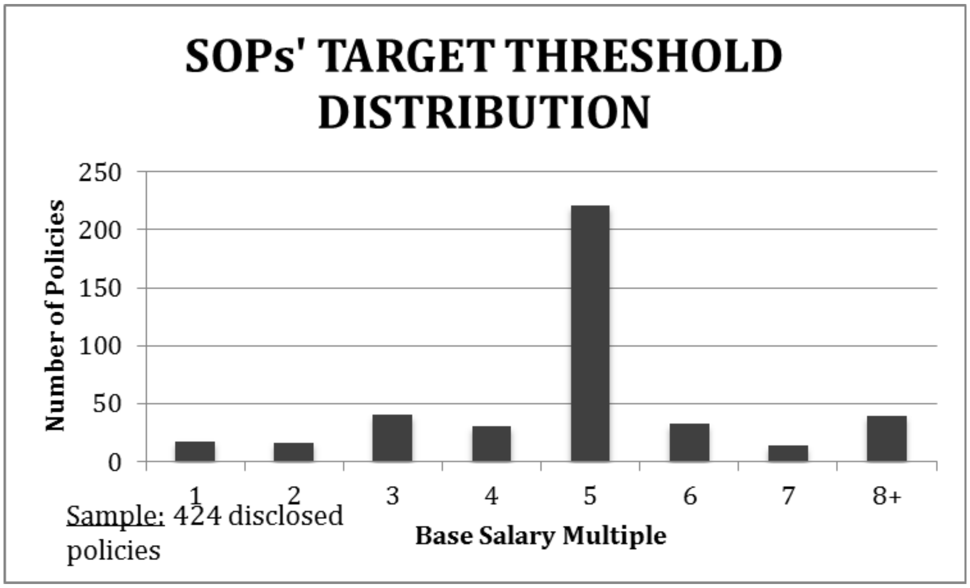
A. What are SOPs?

An SOP requires executive officers and directors to maintain a minimum ownership of shares of their company as long as they serve in their current positions. A typical SOP structure has three elements. First, it specifies the executive's target ownership threshold. This threshold is commonly defined as a multiple of the executive's base salary[1,2]. As indicated by Figure I below, 5x base salary is clearly the most common target threshold multiple. Some 52% of current SOPs use this multiple.

FIGURE I. TARGET THRESHOLD DISTRIBUTION OF SOPs

[1] I find that the prevalence rate of specifying a target threshold as a multiple of base salary is slightly more than 80%. Much less commonly, in some 13% of the policies, the target ownership is specified as a fixed number of shares, and 4% of the policies are framed as a combination of the two.

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



While most firms use a straight base salary multiple for defining their target threshold, some firms use other methods: (i) most financial firms, including Goldman Sacks and JP Morgan, employ stock retention policies, in addition or instead of the traditional stock ownership requirement[3]. Stock retention policies typically expect an executive to retain a certain percentage of all shares acquired through the exercise or vesting of stock options, restricted stock, and other equity awards[4]; (ii) some policies set the target threshold as a fixed number of shares, or as a combination of base salary multiple and a number of shares; and (iii) relatively few policies employ a holding period approach, according to which their CEO must hold her vested stock options or vested restricted stock for an

[3] I find that the other three firms that employ a full retention policy are: The Clorox Company, E*TRADE Financial Corporation, and United States Steel Corporation. Another 8 firms employ a partial retention policy, according to which, once the stock ownership requirement is met, executives are further expected, for an additional one year, to retain a certain percentage of all additional shares realized through the exercise of stock options and the vesting of restricted stock units and performance awards.

[4] Those policies typically provide allowances for the payment of any option exercise price and taxes

additional period of time.

The second element of a typical SOP is a counting policy, which specifies what type of equity can be counted to satisfy the ownership threshold. Such equity can be common stock (vested or unvested/restricted), 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, or other less common types of equity holdings. Over a quarter of current SOPs have opaque counting policies, such that are silent, ambiguous or too vague to determine what they allow to count.

Thirdly, a typical SOP specifies a phase-in period provision, which determines the number of years an executive/non-employee director has to attain the required ownership level. Typically, such period is five years, but shorter periods are commonly required for executives that get promoted to a position that requires them to have a higher target threshold.

A relatively detailed CEO 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 [target ownership threshold]... Stock ownership for the purpose of these guidelines does not include shares underlying stock options [counting policy]. Individuals subject to these guidelines are required to achieve the relevant ownership threshold

within five years after first becoming subject to the guidelines. If an individual becomes subject to a higher ownership threshold due to promotion or increase in base salary, that individual will be expected to meet the higher ownership threshold within three years [phase-in period]"[5].

B. Theoretical Foundations

SOPs ought to represent the principle that one should be rewarded for taking risks with other people's money only if she puts her own money at risk as well. Classical agency theory predicts that in some situations it will pay the manager-agent to expend bonding costs to guarantee to maximize the welfare of her shareholder-principal and minimize divergence between the manager-agent's decisions and those decisions which would maximize the welfare of the shareholder-principal [6]. The core intuition behind this model is that maximizing the welfare of the shareholder-principal maximizes the pie. When markets function well, maximizing the pie will maximize managers-agent slice as well. SOPs, according to this view, represent bonding costs incurred by the agent-manager. SOPs are costly for managers, as they loose liquidity and diversification of their portfolio, but guarantee shareholders that managers will not take actions that will reduce long-term shareholder value, as SOPs mandates managers to hold firm stock for the long run. This view is consistent with what

[5] See Johnson and Johnson's March 17, 2010 proxy statement, page 42; available at: http://www.sec.gov/Archives/edgar/data/200406/000095012310025426/y81646def14a.htm

[6] See Jensen, Michael C. and William H. Meckling (1976), "Theory of the Firm: Managerial Behavior, Agency Costs and Ownership Structure," Journal of Financial Economics 3: 305-360. Jensen and Meckling argue that: "..in some situations it will pay the *agent* to expend resources (bonding costs) to guarantee that he will not take certain actions which would harm the principal or to ensure that the principal will be compensated if he does take such actions" at p. 5.

firms say about the objectives of their SOPs[7].

The managerial power theory opposes the classical agency theory. It describes the mechanism whereby management can assume effective control of the firm through the appointment of the proxy committee, which they dub management control[8]. Therefore, managers have the incentives and power to devise self-serving contracts. Instead of mitigating the agency conflicts between management and shareholders, compensation contracts became the product of the same agency problem[9].

Moreover, according to the managerial power approach, outrage is important social pressure, which constraints managers[10]. Therefore, when a board approves a policy favorable to managers, the extent to which managers bear economic or social costs will depend on how important outsiders perceive the arrangement. The more outrage a compensation arrangement is expected to generate, the larger will be the potential economic and social costs, and thus the more reluctant the directors will be to approve it and the more hesitant managers will be to propose it in the first place.

I suggest that a similar mechanism applies when a board approves a policy that is aimed to reduce the ability to favor managers at the expense of shareholders. The extent to which managers reduce their economic and social

[7] See part V Section B.
[8] Berle, Adolph A. and Gardiner C. Means, 1932. The Modern Corporation and Private Property. Paperback edition published in 1991 by Transaction Publishers, at p. 30-32.

[9] See Bebchuk, Lucian A., and Jesse M. Fried. 2004. Pay without Performance: The Unfulfilled Promise of Executive Compensation. Cambridge and London: Harvard University Press, at 176-77.

[10] See Bebchuk and Fried, *supra* note 2, at p. 82.

costs will depend on how the policy is perceived by outsiders whose views are important to directors and executives. The more persuasive in reducing managerial conflicts with shareholders the policy will look, the larger will be the potential economic and social benefits for managers, and thus the more enthusiastic the directors will be to approve it and the more inclined managers will be to propose it in the first place.

Therefore, the primary benefit to directors and managers from adopting an SOP does not depend on how effective this policy is in preventing managers from short-term behavior or in aligning their interests with shareholders. Rather, it will depend on how SOPs are perceived by outsiders whose views matter to the directors and executives.

This article aims to test whether current SOPs are more consistent with classical agency theory or with managerial power theory.

II. RELATION TO PRIOR RESEARCH

Despite the importance of this matter, academic research on SOPs is fairly scarce. One line of SOPs literature investigates whether SOPs increase firm value. A 2010 study by Cao, Gu and Yang suggests that while pre-2002 SOP adoptions appear to be driven primarily by efficient contracting between managers and shareholders, post-2002 adoptions appear to be driven mainly by public pressure and firms' herding tendency[11]. As a result, significant post-

[11] 2002 was selected as in that year a wave of corporate scandals swept many American companies. Such wave was followed by widespread outrage.

adoption improvements in stock performance and increases in long-term investment are observed among early adopters but not among recent adopters[12].

Cao, Gu and Yang complete the older study of Core and Guay, that provides evidence from the 1990's to suggest that firms set optimal equity incentive levels and grant new equity incentives in a manner that is consistent with efficient contracting[13].

A related problem is the free unwinding of equity by executives. When SOPs are not binding, CEOs are free to sell significant amounts of their stock. One recent paper provides evidence for massive stock selling by top executives[14]. A recent working paper suggests that CEOs have information about future stock price performance and they use that to choose their equity exposure levels to the firm. This explains the puzzling observation that many CEOs seem to voluntarily hold large amounts of their own company stock[15]. On the other hand, Fahlenbrach and Stulz suggest that such theory is not consistent with unloading activity in the recent financial crisis. Specifically, they indicate that

[12] See Cao, Ying , Gu, Zhaoyang and Yang, Yong George, Adoption of Executive Ownership Guidelines: A New Look (September 2, 2010). Available at SSRN: http://ssrn.com/abstract=1596503 or http://dx.doi.org/10.2139/ssrn.1596503

[13] Core, J. & Guay, W. (1999), `The use of equity grants to manage optimal equity incentive levels', Journal of Accounting and Economics 28, 151-184.

[14] See Ladika, Tomislav, Do Firms Replenish Executives' Incentives after Equity Sales? (March 15, 2012). Available at SSRN: http://ssrn.com/abstract=2023858.

[15] See Vidhi Chhaochharia, Tao Chen and Rik Sen, "Stocking up for good times: The information content of CEO's voluntary holdings", working paper, July 2011.

Bank CEOs did not reduce their holdings of shares in anticipation of the crisis or during the crisis[16].

Surprisingly, no academic article so far has tested SOPs transparency. This article aims to fill this gap. In order to test SOPs transparency, I will, first, describe the SOPs story. Namely, I will describe the pressure to adopt those policies, the rise of SOPs prevalence and the weakness of adopted SOPs. Then, I will discuss SOPs transparency, and will suggest a regulatory reform to make those policies transparent.

III. WIDESPREAD PRESSURE TO ADOPT SOPs

Despite disagreements on whether poor incentives led to the recent crisis, the aftermath of the crisis recruited a widespread support for pay arrangements that will discourage managerial excessive risk taking and short-term focus. Classical agency theory supporters believe that free markets would induce firms to adopt such policies on their own. When agency costs are too high, the argument goes, market forces would bolster bonding (and monitoring) measures, so overall agency costs will be pushed back to their optimal level. However, managerial power theory suggests that self-serving managers will not adopt such policies on their own. Therefore, the argument goes, there is a reason to test whether regulatory measures will reduce agency costs better.

SOPs are a natural candidate for such a test-case. Their declared

[16] Fahlenbrach and Stultz, *supra* note 4.

objectives directly address agency costs in the aftermath of the crisis: improving long-term incentives and curbing excessive risk taking. Now, I will show how, consistent with classical agency theory, markets placed a significant pressure on firms to adopt SOPs. Such large coalition pushing for SOPs adoption includes the government, the ISS and institutional shareholders. Moreover, SOPs importance has also been accepted by business leaders and pro-business organizations, and backed by the general public sentiment.

A. __Government Regulation__

The government had to react fast to the sudden and rapid collapse in the financial markets. "Executive compensation reforms must align compensation practices with sound risk management and long-term growth", urged U.S. Treasury Secretary Tim Geithner, when announcing a set of principles developed from discussions with Security and Exchange Commission Chairwoman Mary Schapiro, Federal Reserve Governor Dan Tarullo, and top experts[17].

Indeed, treasury regulations from February 2009 mandate SOPs for all Troubled Asset Relief Program (TARP) recipients. Specifically, those regulations preclude executives from cashing out any vested equity before TARP funds are repaid[18]. Furthermore, Kenneth Feinberg, the Special Master for TARP Executive

[17] See Press Release, U.S. Dep't of the Treasury, Statement by Treasury Secretary Tim Geithner on Compensation (June 10, 2009), available at http://www.ustreas.gov/press/releases/tg163.htm ("[C]ompensation should be structured to account for the time horizon of risks.").
[18] See the American Recovery and Reinvestment Act of 2009 (ARRA) interim final regulations, at http://www.treas.gov/press/releases/tg165.htm.

Compensation, was instructed to focus on tying pay to long-term performance[19].

Interestingly, the UK mandates SOPs – the UK Remuneration Code of 2009 mandates top banking executives and earners to defer 60% of their total compensation for a three-year period, with further restrictions limiting when and how much bankers can cash in[20].

However, the U.S. government did not promulgate specific regulations that will mandate SOPs for non-TARP companies. Instead, more general rules to deal with long-term performance and risk management were adopted: (i) the Dodd-Frank Wall Street Reform and Consumer Protection Act created new federally mandated risk management procedures principally for financial institutions[21]; (ii) in 2010, the SEC added requirements for proxy statement discussion of a company's board leadership structure and role in risk oversight[22]; and (iii) on June 21, 2010, the federal banking regulators – the Federal Reserve Board of

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[19] *See* TARP Standards for Compensation and Corporate Governance, 74 Fed. Reg. 28,394 (June 15, 2009) (to be codified at 31 C.F.R. pt. 30) (establishing guidelines for executive compensation at firms receiving TARP assistance).

[20] See a speech by Thomas F. Huertas Director, Banking Sector, FSA and Vice Chairman, Merton College, Oxford, "A Cure for Crises: Work in Progress", dated 14 September 2010; available at: http://www.fsa.gov.uk/pages/Library/Communication/Speeches/2010/0914_th.shtml.

[21] The Dodd-Frank requires bank holding companies with total assets of $10 billion or more, and certain other non-bank financial companies as well, to have a separate risk committee which includes at least one risk management expert with experience managing risk of large companies.

[22] Companies are required to disclose in their annual reports the extent of the board's role in risk oversight, such as how the board administers its oversight function, the effect that risk oversight has on the board's process (e.g., whether the persons who oversee risk management report directly to the board as whole, to a committee, such as the audit committee, or to one of the other standing committees of the board) and whether and how the board, or board committee, monitors risk. The SEC proxy rules also require a company to discuss the extent that risks arising from a company's compensation policies are reasonably likely to have a "material adverse effect" on the company. A company must further discuss how its compensation policies and practices, including that of its non-executive officers, relate to risk management and risk-taking incentives.

Governors, the Office of the Comptroller of the Currency (OCC), the Office of Thrift Supervision (OTS), and the Federal Deposit Insurance Corporation (FDIC) - issued Final Guidance on Sound Incentive Compensation Practices, pursuant to section 956 of the Dodd-Frank Wall Street Reform and Consumer Protection Act, prohibiting incentive compensation arrangements that encourage bank employees to expose their organizations to imprudent risk[23].

This philosophy, of encouraging the broadening of executives share ownership, has also been endorsed by the New York Stock Exchange listing standards[24].

B. The ISS Pressure

RiskMetrics Group, formerly known as Institutional Shareholder Services (the "ISS") is the world's leading provider of proxy voting and corporate governance services[25]. Between the shares that the ISS votes on behalf of clients and the shares held by institutions that follow ISS recommendations, an ISS recommendation can make a 15-20% difference in shareholder vote[26]. Consequently, companies often tailor their policies to meet ISS guidelines.

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[23] *Federal Reserve, OCC, OTS, FDIC Issue Final Guidance on Incentive Compensation*, joint press release, June 21, 2010, is available at http://www.federalreserve.gov/newsevents/press/bcreg/20100621a.htm.

[24] *See* Section 309.00 of the NYSE Listed Company Manual, available at http://nysemanual.nyse.com/LCMTools/PlatformViewer.asp?selectednode=chp_1_4_7&manual=%2Flcm%2Fsections%2Flcm-sections%2F.

[25] ISS serves more than 1,500 institutional and corporate clients and provides objective voting recommendations for more than 33,000 companies across 115 markets worldwide. See at http://www.issproxy.com/about/index.jsp.

[26] See Bernard Black, Shareholder Activism and Corporate Governance in the United States, in 3 The New Palgrave Dictionary of Economics and the Law 459 (Peter Newman ed., 1998), at 466.

Moreover, company managers lobby for ISS support to oppose shareholder proposals they oppose[27].

The ISS followed the encouragement that the U.S. government explicitly put forward. On March 10, 2010, the ISS published its new scoring system to measure corporate governance practices, which it has named "Governance Risk Indicators" ("GRId"). Risk Metrics introduced GRId as a new tool intended to allow investors to assess the level of corporate governance risk of companies[28] [29].

Four of the 28 remuneration GRId questions that apply to U.S. firms evaluate CEO SOPs. Companies get the highest score if their SOPs require at least six times base salary. Companies failing to disclose, or explicitly saying they will not disclose their CEO SOPs, get the lowest score[30]. GRId also has a

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

[28] See Institutional Shareholder Services Governance Risk Indicators 2.0 technical document, March 6, 2012, available at http://www.issgovernance.com/grid-info

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

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

policy on a related issue – post-vesting holding periods for executives stock options and restricted shares. According to this policy, a two-year post-vesting requirement or more scores the highest[31].

To be sure, RiskMetrics indicates that the GRId ratings will not serve as the basis for RiskMetrics proxy voting recommendations. However, the ISS, in its 2012 and 2011 proxy voting summary guidelines, urged shareholders to weight robust SOPs as an important factor that mitigates the impact of risky pay incentives when voting on "say on pay"[32].

C. *Shareholder Pressure*

Institutional shareholders echoed the ISS approach. The California Public Employees' Retirement System ("CalPERS"), the largest public pension fund in the United States, states that it "believes equity ownership guidelines and holding requirements should be an integral component of company's equity plan and overall compensation philosophy". Consequently, shareholders took a proactive approach, and submitted numerous 14a-8 shareholder proposals, urging their

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remuneration category score. Question 143 evaluates directors SOPs in a similar way, using lower base salary multiples.

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

[32] See ISS 2012 U.S. Policy Summary Guidelines, available at: http://www.issgovernance.com/policy/2012/policy_information and ISS 2011 U.S. Policy Summary Guidelines, available at: http://www.issgovernance.com/policy/2011/policy_information

companies to adopt stringent SOPs[33]. For example, the American Federation of Labor and Congress of Industrial Organizations, called the AFL-CIO, filed shareholder proposals encouraging companies to adopt SOPs. Those policies commit executives in a handful of TARP companies, to hold significant equity stakes past their retirement. These companies include Citigroup, JPMorgan Chase, and Bank of New York Mellon[34]. ISS recommended in 2010 and 2011 to vote for shareholder proposals pushing companies to adopt SOPs[35].

IV. <u>THE RISE OF SOPs</u>

In response to the widespread pressure, prominent business people and pro-business organizations have reacted to the widespread call for SOPs adoption, reflected in the government regulation, in ISS and institutional shareholder pressure, and echoed in the general post-crisis popular sentiment.

Business people "voted with their feet" in support of SOPs. The "Oracle from Omaha", Warren Buffet, showed by self-example what he thinks about the need for effective SOPs. In his 2008 sizable Goldman Sachs and GE investments, Buffet required that those companies' executives must not sell more

[33] See, for example, Stockholders Proposal on Executive Stock Retention on Dow Chemical Company's proxy statement dated March 31, 2009, available at: http://www.sec.gov/Archives/edgar/data/29915/000104746909003530/a2191412zdef14a.htm, on page 42.

[34] See Citi's March 12, 2010 proxy statement, page 130; available at: http://www.sec.gov/Archives/edgar/data/831001/000119312510055351/ddef14a.htm, see JPM's March 31, 2010 proxy statement, page 40; available at: http://www.sec.gov/Archives/edgar/data/19617/000119312510073533/ddef14a.htm, and see BNY's March 15, 2010 proxy statement, page 79; available at: http://www.sec.gov/Archives/edgar/data/1390777/000119312510057058/ddef14a.htm.

[35] See 2010 RiskMetrics Group U.S. Proxy Voting Guidelines Summary, available at: http://www.issgovernance.com/files/RMG_2010_US_SummaryGuidelines20100225.pdf, at page 51-52.

than 10% of their stock until the earlier of three years or the termination of Buffett's investment. Many people believe that Buffett's focus on aligning the interests of Goldman's senior executives with his own through an SOP should serve as a wake up call to both companies and investors that such requirements are emerging as an important part of the post-crisis world[36].

Indeed, Goldman Sach's CEO, Lloyd Blankfein, responded to this wake up call by coming up with his own proposal in 2010, according to which, senior executive officers should be required to retain the bulk of the equity they receive until they retire, and equity delivery schedules should continue to apply after the individual has left the firm[37]. This proposal was implemented by Goldman Sachs and by other leading investment banks.

Moreover, policy guidelines that clearly support SOPs were announced by pro-business organizations. Such guidelines were announced by the Business-Roundtable, a politically conservative group of Major U.S. CEOs, formed to promote pro-business public policy[38]. SOPs were identified as a "best practice" for executive compensation programs by other influential pro-business organizations as well, such as the Conference Board's Commission on Public

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[36] See "Hold Through Retirement": Maximizing the Benefits of Equity Awards While Minimizing Inappropriate Risk Taking", The Corporate Executive, Vol. XXII, No. 5, November-December 2008, on page 1.

[37] See United States House of Representatives, Committee on Financial Services Hearing, Testimony of Lloyd C. Blankfein, January 13, 2010.

[38] See CFA Centre for Financial Market integrity/ Business Roundtable Institute for Corporate Ethics, "Breaking the Short Term Cycle", Discussion and Recommendations on How Corporate Leaders, Asset Managers, Investors and Analysts Can Refocus on Long-Term Value, 2006. According to their policy guidelines, "Stock ownership guidelines should require all executives and directors to hold a meaningful amount of equity in the company at which they serve. "Meaningful" in this context can be defined as an amount that makes it economically material to the individual that a company succeed in the long-term".

Trust and Private Enterprise[39] and the Business Roundtable's Executive Compensation: Principles and Commentary[40].

Now I will show how the widespread pressure to adopt SOPs led to virtually universal adoption of those policies.

A. SOPs Became Universal

SOPs were initially introduced in the early 1990's. Such adoption occurred on the background of concerns that increasing equity awards did not result in increased levels of stock ownership by executives[41]. The importance of these policies was then highlighted by the corporate scandals in 2002. These scandals, and the increased attention from investors that followed, served as a catalyst for additional companies to adopt SOPs. This impetus, coupled with the requirement to disclose existing stock ownership programs in proxy statements and other SEC requirements increasing transparency of compensation disclosure, has led to a surge in the number of formal SOPs in 2002. Forty nine percent of the top 250 companies disclosed formal SOPs for their executives in 2002, representing a 37% increase from 2001[42]. Whereas only 2.8% of top 250 companies who

[39] The Conference Board's Commission on Public Trust and Private Enterprise stated that, "compensation policies should encourage a meaningful financial stake in the corporate through long-term 'acquire and hold' practices by key executives and directors." See The Conference Board Commission on Public Trust and Private Enterprise, Findings and Recommendations 2003, on p. 11.

[40] See Executive Compensation: Principles and Commentary, the Business Roundtable (November 2003).

[41] See Frederic W. Cook & Co., Inc., Stock Ownership Guidelines Prevalence and Design of Executive and Director Ownership Guidelines Among the Top 250 Companies, October 23, 2009.

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

disclosed SOPs in 2001 reported that their SOPs were new or amended in 2001, in 2004 things were dramatically different: 25.5% of companies who disclosed SOPs in that year reported that their policies were new or amended in 2004[43].

The 2007-2008 financial crisis has brought an unprecedented popular outrage directed at executive compensation, as described above. Consequently, in 2010 SOPs have become virtually universal among large companies, reaching ninety-six percent prevalence among Mega Cap S&P 500 companies[44] [45].

B. What firms currently say about their SOPs?

In the aftermath of the 2007-2008 financial crisis, many firms have voluntarily communicated the objectives of their SOPs to their shareholders. They primarily state three highly important goals of SOPs, that addresses the concerns reflected in the universal post-crisis pressure to adopt SOPs: (i) to align the financial interests of executive officers with those of shareholders; (ii) to promote a long-term focus; and (iii) to discourage management from taking unreasonable risky business activities.

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[43] See Research Newsletter, Executive Compensation Trends, October 2005, Equilar Inc., on p. 3.

[44] This figure in my data is consistent with the ninety-five percent SOP prevalence of Fortune 100 companies in 2010. See Frederic W. Cook & Co., Inc., Executive Stock Ownership Policies – Trends and Developments, September 13, 2010, on p. 1.

[45] SOP prevalence rate surged from 69.7 percent in 2005 to a record adoption level of 84.4 percent among Fortune 250 companies in 2010. See Equilar 2007 Executive Stock Ownership Guidelines Report, page 9, and Equilar press release "Over 80 Percent of Fortune 250 Companies Use Executive Stock Ownership Guidelines" dated July 28, 2010; also available at http://www.equilar.com/company/press-release/index.php.

The 2010 proxy statement of Limited Brands, Inc. summarizes nicely the common declared SOPs objectives:

> *"In addition to aligning the interests of our executive officers with those of our stockholders, the share ownership guidelines promote a long-term focus and discourage inappropriate risk-taking."*[46]

Moreover, the 2010 proxy season was the first one that the SEC required listed companies to discuss the level of risk inherent to their compensation programs within their proxy statements. Slightly more than 70 percent of companies cited the tying of long-term performance to compensation as a risk-management policy, with almost 60 percent citing their SOPs as a key element in their mitigation of risk[47].

C. What Theory is More Consistent with SOPs Rise?

Does the widespread adoption of SOPs in the aftermath of the 2007-2008 financial crisis reflect an efficient managerial reaction to a healthy market pressure, consistent with classical agency theory? A conclusive answer to this question is unlikely to be provided. Such an answer will have to test whether adopted policies have managed to result in optimal agency costs.

This article does not aim to evaluate the efficiency of current SOPs.

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[46] See Limited Brands' proxy statement, dated April 7, 2010, page 29; available at: http://www.sec.gov/Archives/edgar/data/701985/000119312510078464/ddef14a.htm.

[47] See Equilar press release "Long-Term Performance Compensation Is Most Popular Risk-Management Strategy " dated April 21, 2010; also available at http://www.equilar.com/company/press-release/index.php

Instead, this article focuses on a preliminary condition for SOPs to be consistent with classical agency theory. Namely, that SOPs are transparent to outsiders.

If SOPs are transparent to outsiders, they can evaluate the policies, and make informed decisions that will fuel market forces. Such decisions will include the decision to buy or sell stock of certain firms that adopted SOPs, whether to exert pressure to improve SOPs, and generally to provide market feedback on SOPs.

However, when SOPs are not transparent, market forces are futile, and no effective market check on SOPs is feasible. In turn, managers might take advantage of such vagueness to mislead the markets and to perpetuate their self-serving pay arrangements, consistent with managerial power theory. Now I will describe my methodology to test SOPs transparency.

V. METHODOLOGY

I will use two-step analysis to test SOPs transparency. The first step will test to what extent SOPs make a difference in reality. Namely (i) whether those policies impose a binding constraint on managerial stock unloading; and (ii) how SOPs structure affects their effectiveness. The second step will test whether the results of the first step are transparent in current firms public filings.

While SOPs commonly apply to executives and directors in general, this article's focus is on SOPs as applied to CEOs. I choose to focus on the CEO because she is the leader of the executive team, capturing the highest pay slice and having the strongest impact over the value, performance and behavior of the public firm[48]. Naturally, current SOPs impose on CEOs the highest target ownership thresholds in comparison to the other members of the executive team or the non-employee directors.

My sample contains all 500 firms included in the Standard and Poor 500 stock-market index ("S&P 500") as of August 4, 2010. I obtain most of my data by hand-collecting information from the S&P 500 companies' proxy statements for the 2010 proxy season, as posted on the SEC website. I also checked firms' own websites whenever those firms' proxy statements missed relevant information. The elements I collected using this method, for each CEO SOP, are: target threshold, counting policy, phase-in period, actual holdings, and sanctions for violating the policy. I also obtain data on actual CEO holdings from each firm's 2010 proxy statement, counting only those elements permitted by each firm's SOP counting policy.

I also obtain some data outside of the S&P 500 firms proxy statements: I recorded share prices from Google Finance, as of August 4, 2010, and determined CEO tenure for each firm using data I obtain on Compustat Execucomp.

VI. <u>FINDINGS: SOPs DO NOT WORK</u>

Classical agency theory predicts that managers will self-impose costly

[48] See Cremers, Martijn, Bebchuk, Lucian A. and Peyer, Urs C., CEO Centrality. Harvard Law and Economics Discussion Paper No. 601, 2007. Available at SSRN: http://ssrn.com/abstract=1030107

SOPs on themselves to maximize shareholder value, while managerial power theory predicts that managers will devise self-serving contracts and might abuse empty SOPs, that look good to outsiders, to fend off outrage.

Therefore, there are two predictions that differentiate between the two competing theories as they apply to SOPs. First, the classical agency theory predicts that SOPs will be costly to managers, while managerial power theory predicts that those policies will be self-serving, and thus ineffective or empty. Second, classical agency theory suggests that SOPs will be transparent to shareholders while managerial power supporters will emphasize the outside appearance of SOPs that does not match the actual content of these policies.

To begin with, I report my findings regarding the first difference in predictions between the two theories. Importantly, I do not claim that effectiveness is equivalent to efficiency. I merely ask whether current SOPs work.

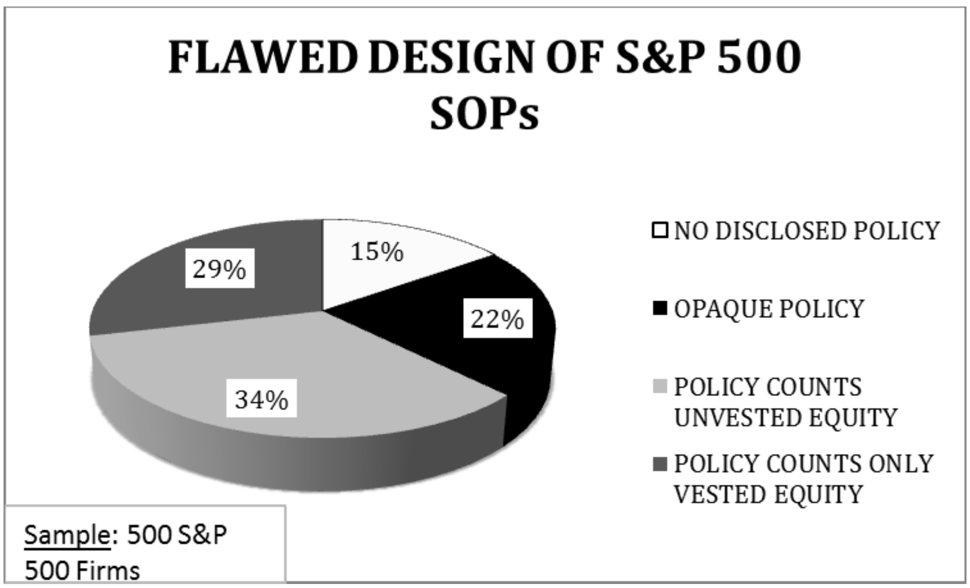
A. ***<u>SOPs are designed to be ineffective</u>***

By definition, SOPs should aim to separate vesting from freedom to unwind, and to prohibit unwinding of equity incentives for a specified period of time *after* vesting[49]. However, Fifty five percent of non-opaque policies allow the

[49] There are various reasons to justify the existence of SOPs separately from vesting requirements. While vesting is designed to encourage retention and is a costly and restrictive means, SOPs are designed to align interests between manager and shareholders, and are more flexible and cheaper than vesting. SOPs are cheaper than vesting as the departing executive will own her shares that are subject to SOP, but not her unvested shares. Therefore, in efficient markets we will expect to observe both SOPs and vesting policies, as the combination of the two will be tailored to minimize overall agency costs.

counting of unvested equity toward satisfying their target ownership threshold[50]. On average, some 47% of S&P 500 CEOs' equity is unvested[51]. Therefore, counting unvested equity renders SOP completely empty for the average CEO. Moreover, more than a quarter[52] of current SOPs do not disclose clear counting policies. Rather, their counting policies are silent, ambiguous or vague.

FIGURE II. Flawed Design of S&P 500 SOPs



Second, the median SOP requires a phase-in period of 5 years[53]. The average tenure of a departing S&P 500 CEO in the U.S. is 8 years as of 2010,

[50] The exact number is 54.3%, which are 170 companies out of 306 companies who disclosed clear policies. Of the 170 companies that allow for unvested equity, all of those companies count unvested restricted stock and 4 companies also count unvested options (Southwestern Energy Company, The Travelers Companies , Staples , and El Paso).

[51] I calculated this ratio for the 306 S&P 500 companies with clear policies only. I excluded 6 outliers with an extremely high ratio of unvested to vested equity.

[52] 26.2%, or 111 out of 424 companies who adopted SOPs in their 2010 proxy statements. Those 111 polices amount to some 22% of the overall S&P 500 firms.

down from 10 years in 2000[54]. Therefore, for the median S&P 500 CEO, her SOP would not apply to her for most of her tenure.

Third, even if SOPs were substantively and structurally meaningful, they would have failed to have a meaningful bite, as the sanctions they impose on violators are extremely weak. Only 45 companies who adopted SOPs, or approximately 10 percent, have disclosed sanctions that might be imposed in the event that their CEOs do not meet their minimum guidelines. Many of those sanctions are framed in a way that leaves discretion to the board. Moreover, most of those so-called sanctions[55] merely impose a partial prohibition on future equity awards sales rather than a penalty[56]. Only in a very few cases, like Merck's SOP, firms penalize SOP violators by reducing their future equity grants[57].

B. <u>SOPs allow massive equity unloading</u>

Figure III below suggests that the median CEO is allowed to immediately unload 95.6% of her vested equity. This result is consistent with some other indicators I collected: (i) 74% of phased-in CEOs are allowed to dump 100% of their vested equity; (ii) the median CEO voluntarily holds 3 times her SOP

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[54] See The Conference Board report.

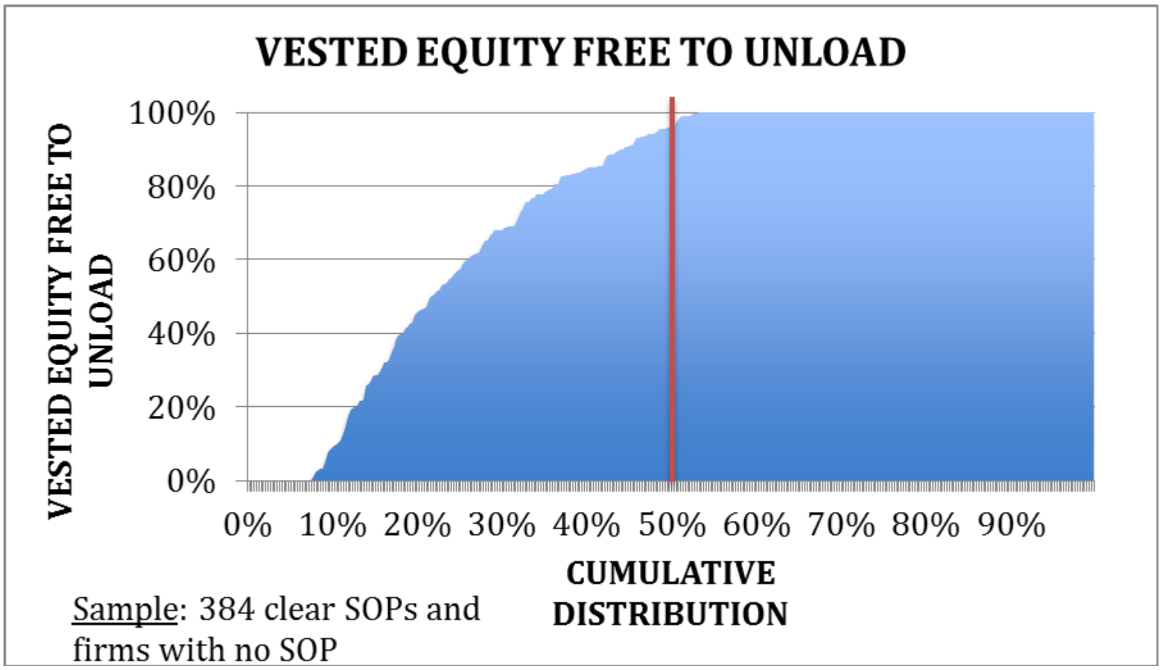
[55] Twenty eight out of 45.

[56] Such a weak sanction is mentioned in Qualcomm's SOP: "*If a NEO [Named Executive Officer – N.S.] has not met the guidelines by the deadline, we will require that the NEO, upon a stock option exercise, hold at least 50% of the net shares remaining after required tax withholdings until they meet the minimum guideline.*" See Qualcomm's proxy statement, dated January 13, 2009, on p. 23, available at http://www.sec.gov/Archives/edgar/data/804328/000093639209000011/a50913dedef14a.htm.

[57] See Merck's proxy statement, dated April 27, 2009, available at http://www.sec.gov/Archives/edgar/data/310158/000095012309007279/y74527def14a.htm, on p. 31.

threshold[58]; and (iii) for the median CEO, SOP threshold is slightly lower than a single annual total compensation. Moreover, my results are consistent with the recent study of Cao, Gu and Yang, that report: “71% of the CEOs already have a multiple larger than the target by the time of the guidelines are initiated”[59].

FIGURE III. VESTED EQUITY FREE TO UNLOAD



The ability of CEOs to immediately unload the vast majority of their vested equity encourages short-term focus and excessive risk taking. Treasury Secretary Geithner has pointed this out in July 2009:

"[s]ome of the decisions that contributed to this crisis occurred when people were able to earn immediate gains without their compensation reflecting

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[58] Applying her SOP counting policy to her voluntary holdings.

[59] See Cao, Ying , Gu, Zhaoyang and Yang, Yong George, Adoption of Executive Ownership Guidelines: A New Look (September 2, 2010). Available at SSRN: http://ssrn.com/abstract=1596503 or http://dx.doi.org/10.2139/ssrn.1596503

the long-term risks they were taking for their companies and their shareholders."[60]

C. ***Managers engage in frequent equity unloading***

Unsurprisingly, CEOs take full advantage of the said flaws and ineffectiveness of current SOPs to unload big portions of their equity incentives. For example, executives commonly exercise stock options years before they expire, and they immediately sell almost all of the shares they acquire through option exercises[61]. There is also widespread evidence on executives frequent selling based on inside information[62]. Moreover, a recent study indicates that 45 percent of top executives at S&P 1500 firms sell equity at least as often as every other year. The median sale is equal to 15 percent of an executive's total holdings of firm equity, with a median dollar value of $560,000[63]. Therefore, among top executives, stock "sales outweigh purchases by a substantial margin"[64].

Such a massive sale was made on September 22, 2011 by Richard B.

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[60] See a press release, Statement by Treasury Secretary Tim Geithner on Compensation, dated June 10, 2009; also available at http://www.financialstability.gov/latest/tg-163.html.

[61] See Bebchuk, Lucian A., and Jesse M. Fried. 2004. Pay without Performance: The Unfulfilled Promise of Executive Compensation. Cambridge and London: Harvard University Press, 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).

[62] Jesse M. Fried, Reducing the Profitability of Corporate Insider Trading Through Pre-trading Disclosure, 71 S. CAL. L. REV. 303, 317-27 (1998) (surveying evidence of insider trading by corporate executives).

[63] See Ladika, Tomislav, Do Firms Replenish Executives' Incentives after Equity Sales? (March 15, 2012). Available at SSRN: http://ssrn.com/abstract=2023858, on p. 2.

[64] The Dumbest Investment Move: Why Owning Your Company's Stock In Your 401(K) Can Be a Big Mistake, SmartMoney, February 22, 2012, quoting Professor Bebchuk.

Handler, the head of the Wall Street investment bank Jefferies Group — and the highest-paid chief executive of a major Wall Street bank last year[65]. Mr. Handler sold $25.2 million worth of stock, to the bank's largest shareholder. The sale was a surprise for the staff at Jefferies, which, like many Wall Street banks, is known for a staunch stock-ownership culture. Goldman, in a research report, said it saw "continued downside" in Jefferies stock. The news sent shares of Jefferies tumbling more than 11 percent, before they recovered.

As executives unwind significant amount of their incentive compensation, one might hope, that boards would try to restore incentives and at least change the composition of executive pay following sales. However, the evidence does not support this hope either, contrary to the classical agency theory perspective[66].

D. SOPs ineffectiveness might raise serious concerns

Indeed, it is not argued that SOPs ineffectiveness is equivalent to inefficiency. Showing that SOPs are inefficiently weak takes an analysis that is not the focus of this Article. However, I would like to highlight some reasons for why the actual content of current SOPs might raise serious concerns.

First, as Bebchuk and Fried suggest in their book, executive

[65] See Chief Sells $25 Million in Shares of Jefferies, By Peter Lattman and Susanne Craig, Deal Break, September 22, 2011.

[66] See *supra* note 55.

compensation practices in the U.S. are generally not optimal[67]. Those arrangements benefit corporate executives at the expense of shareholders through flaws in the pay-setting process. The core reason is that under current legal arrangements, boards cannot be expected to contract at arm's length with the executives whose pay they set, largely due to management's control over the director nomination process. SOPs are being discussed and adopted in the same manner that other compensation arrangements are being set. Therefore, they generally suffer from the same flawed processes that make those arrangements benefit corporate executives at the expense of shareholders.

Second, effective SOPs might impose significant costs on CEOs – costs that are saved by keeping SOPs sterilized. These costs are: (i) costs of diversification. CEOs have a lot of their personal wealth and human capital invested in their firms, which creates a significant specific risk to volatility in their firm's performance. Therefore, the most foolish investment of all might be an investment in their own firms stock[68]; (ii) liquidity costs. Equity is the largest component of pay for most top executives. Since 2000, executives at large publicly traded U.S. firms have received on average 42% of their annual pay in stock or stock options (28% in salary and 24% in cash-based incentive pay)[69]. Therefore, lack of freedom to unload stock might impose on CEOs significant

[67] See *supra* note 59.

[68] See *supra* note 56.

[69] These statistics are for all executives listed in the Compustat Execucomp database at firms with market capitalization of at least $1 billion, from 2000 to 2007. Cash-based incentive pay is the sum of bonuses and long-term incentive payments. The other six percent of pay includes perks and pension payments.

liquidity constraints; and (iii) Despite recent reforms, public company executives can still use inside information to time their stock sales, secretly boosting their pay[70]. They can also still inflate the stock price before selling. This insider trading and price manipulation enriches CEOs and imposes large costs on shareholders. Lack of freedom to sell their stock would prevent CEOs from benefiting from this illegal, albeit significant, profits.

Third, CEOs can camouflage their SOPs and still get away with current arrangements. (i) Existing regulation of SOP disclosure are specified in Regulation S-K, item 402(b)(2)(xiii), which mandates disclosure under Compensation Discussion and Analysis, of: “The registrant's equity or other security ownership requirements or guidelines (specifying applicable amounts and forms of ownership)”. Yet, Regulation S-K does not mandate disclosure of any of the elements I specified above, that make SOPs camouflaged[71]; (ii) as I mention above, camouflaged empty SOPs can still get the maximum score under Risk Metric’s GRId[72].

Fourth, as indicated before, CEOs massively sell their stock, and their sales outweigh purchases by a substantial margin[73].

Finally, we should be alarmed by current camouflaged SOPs, as empirical

[70] See Fried, Jesse M., Hands-Off Options (June 24, 2011). Vanderbilt Law Review, Vol. 61, pp. 453-474, 2008; UC Berkeley Public Law Research Paper No. 1091068. Available at SSRN: http://ssrn.com/abstract=1091068.

[71] Please refer to my discussion on p. [20] of “SOPs camouflage”.

[72] Please refer to my discussion on p. [6-7] of “The ISS Governance Risk Indicators”.

[73] See my discussion on p. [19], under “In reality, CEOs unload significant amounts of their vested equity“.

studies suggest that current SOPs, unlike the early ones, destroy shareholder value. Cao, Gu and Young report that while early (pre-2002) SOPs appear to be driven primarily by efficient contracting between managers and shareholders, recent (post-2002) adoptions appear to be driven primarily by public pressure and firms' herding tendency. As a result, significant post-adoption improvements in stock performance and increases in long-term investment are observed among early adopters but not among recent adopters. In addition, some recent adopters exhibit abnormal increase in equity compensation that early adopters do not[74].

VII. __CAMOUFLAGE__

Now, after it has been established that current SOPs are ineffective, I report my findings in regards to the second difference in predictions between the classical agency theory and the managerial power theory. Classical agency theory suggests that SOPs will be transparent while managerial power supporters will predict that these policies will only look good on the outside. Transparency is crucial to understand whether SOPs are self-served or designed to maximize shareholder value. If SOPs are ineffective but transparent, one might suggest that SOPs weakness, although cheap for managers, might be efficient and desirable, and agent-managers communicate this message to their shareholders. However, camouflage clearly indicates that SOPs are self-serving. It suggests that managers adopted those policies to look good on the outside and minimize outrage, but their true self-serving nature is hidden from shareholders.

[74] See *supra* note 45, on p. 1.

I find that current SOPs are camouflaged. Firms fail to disclose the significant ineffectiveness of their policies. Moreover, such ineffectiveness comes as a surprise on background of the expectations created by what firms say about their SOPs. Firms cite their policies as an important means for risk monitoring and alignment of interests between managers and shareholders, but, at the same time, current SOPs do not work. SOPs are not the way they are advertised.

Below I discuss the specific disclosure failures associated with SOPs.

A. ***Current SOPs fail to indicate the amount of vested equity readily available to be unloaded***

The most emphasized objective that firms report about their SOPs is that those policies are designed to curb excessive risk taking. In order for this objective to be accomplished, executives should tie their own wealth to the firm's long-term shareholders. However, as indicated above, current SOPs do not prevent the median CEO from unloading virtually all of her vested equity. This can be translated into an excessively risky behavior in two ways. First, if the CEO believes that she has enough inside information about future decline in stock price, she might be motivated to take on overly risky business strategy, knowing that if the strategy does not pan out well, she will sell her stock before it declines. Second, even when the CEO does not have such inside information, she still can take large amounts of incentive compensation off the table based on short-term results. Therefore, she has incentives to seek improvements in short-term results even at the cost of an excessive elevation of the risk of large losses at some (uncertain) point in the future[75].

B. ***<u>Current SOPs fail to disclose the aggregate amount of unwinding activity</u>***.

CEOs, along with other insiders, should report their individual unloading activities on Form 4, within 48 hours of such activity. They should also report their aggregate stock sales. However, the rules govern such reporting does not follow each individual firm's SOP counting policy, but rather is motivated by insider trading considerations. Furthermore, From 4 reporting is separate from the proxy statement, on which SOP is reported. Therefore, investors are not provided with relevant information as for last year's unwinding activity of their CEO. Such information would have helped investors to evaluate the effectiveness and potential need to strengthen their firms' SOPs.

C. ***<u>Current SOPs fail to disclose how counting unvested equity affects SOP potency</u>***.

As indicated before, counting unvested equity renders SOP completely empty for the average CEO. Also, the effect of counting unvested equity differs a lot across firms. However, investors do not get a clear indication of how such counting policy affects the potency of their SOP. Therefore, investors do not know if their policy works.

D. ***<u>Over a quarter of SOPs do not disclose their counting policies</u>***.

[75] See Bebchuk, Cohen and Spamann, at *supra* note 2.

Sometimes, certain assumptions and calculations might help investors to get indication for the effect of their counting policies on SOP potency. However, over a quarter of the policies are silent on their counting policies. Current disclosure rules, governed by Regulation S-K item 402(b)(2)(xiii), require firms to specify their SOPs “forms of ownership”. However, some firms narrowly interpreted this provision, mentioning “stock” as the form of ownership under their SOPs, rather than describing their counting policies. Such disclosure completely precludes investors from evaluating the potency of their SOP.

E. ***Some 90% of current SOPs do not disclose the sanctions for policy violations***.

> Indeed, sanctions serve a declaratory function more than an operative one. Boards always have the power to impose severe sanctions on any corporate policy violators. This is an inherent power that boards posses as part of their monopoly over the business and affairs of every corporation[76]. Still, when boards incorporate unequivocal strict sanctions to their policies, they send an important message that they take those policies seriously. This should have a positive ex-ante deterrence effect. Unfortunately, the vast majority of S&P 500 boards chose not to do so with their SOPs.

F. ***Current SOPs frame their target threshold in a way that may not be transparent for many investors***.

The median policy, as indicated above, requires the CEO to hold 5 times her “base salary”, or “salary”. While “salary” for many investors means total

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

compensation, it means only less than 12% of total compensation for the median S&P 500 CEO[77]. Therefore, the median SOP threshold amounts to less than 60% of a single year CEO total compensation.

Interestingly, because of the limitations of existing disclosure, SOPs have not been included in the standard databases that financial economists use for research on executive compensation. This, in turn, makes it harder for researchers to empirically study SOPs at work.

VIII. CLAIMS THAT I COULD NOT DETECT CAMOUFLAGE AND THEIR RESPONSE

Logic might suggest that camouflage cannot be revealed by any outside observer. Therefore, the argument goes, my argument, that I detect camouflage by using public information only, defeats itself. Moreover, this Article surveyed 500 companies, and therefore it required a significant effort and extensive calculations. However, the common investor is not required to do such a thorough exercise in order to evaluate the effectiveness of her portfolio companies SOPs. I have two responses in this regard.

First, for camouflage to be successful in practice, it should not necessarily be totally detective proof. It is enough that market leaders do not detect it. In the SOP context, the market leader is the ISS. The ISS policy, reflected in the GRId,

[77] In 2011, the median S&P 500 CEO was paid a total compensation of some $8.7m, while her base salary was $1m. Her equity compensation amounted to some $5.5m, her annual bonus was some $2.1m, and she earned other compensation of $0.1m. See Equilar 2012 Executive Compensation outlook Report Extended, at p. 13.

does not detect SOPs camouflage. According to GRId, when a policy contains a six times salary multiple, it gets the highest score. However, as my analysis suggests, SOPs are oftentimes completely empty, even when their salary multiple is high. Institutional investors generally follow the ISS approach in this regard.

Second, in 2005, Bebchuk and Jackson detected the problem of camouflage of executive pensions[78]. Their study offered evidence of the extent to which omitting the value of pension benefits has undermined the accuracy of existing estimates of executive pay, its variability, and its sensitivity to performance. The evidence the authors used was disclosed in the firms' SEC filings, but making their estimates was not accessible to outsiders without closely analyzing company disclosures and making a series of actuarial assumptions and calculations. Despite the fact that the authors based their analysis on public filings, the SEC was in the position that the value of pension benefits was nevertheless not salient enough for investors. Therefore, the SEC reformed its disclosure rules accordingly, made the value of pensions transparent, and placed executive pension plans on investors' radar screen.

I argue that SOPs' camouflage today is at least as severe as executive pensions in 2005. There are a number of reasons for my argument: (i) unlike with pensions in 2005, one quarter of current SOPs cannot be evaluated at all, no

[78] See Bebchuk, Lucian A. and Jackson, Robert J., Executive Pensions. Journal of Corporation Law, Vol. 30, No. 4, pp. 823-855, 2005; Harvard Law and Economics Discussion Paper No. 507. Available at SSRN: http://ssrn.com/abstract=694766 or http://dx.doi.org/10.2139/ssrn.694766.

matter what reasonable assumptions are made; (ii) while the information needed for Bebchuk and Jackson was limited to firms' public filings, testing SOP effectiveness invokes data from other external resources; (iii) SOPs, unlike pensions, have an important systemic goal – curbing excessive risk taking. Therefore, fixing SOP disclosure, unlike with pensions, aims to prevent negative externalities; and (iv) finally, the disclosure solutions that I propose below for SOP camouflage are similar to the solutions that have been successfully implemented for pensions. Unlike in 2005, we already have a successful targeted disclosure model, and thus the potential costs of regulation are diminished.

IX. MAKING SOPs TRANSPARENT

This Article's evidence suggests that SOPs camouflage is consistent with managerial power rather than with classical agency theory and efficient contracting. Managerial power theory further predicts that the board of directors fails to fully monitor managers. Therefore, one should not hope that the board of directors will fix the flaws of current SOPs. A call for regulator intervention is made.

Regulatory intervention may take different courses of action. The most aggressive intervention would be implementation of mandatory rules for SOPs design. This option fits the best a situation where there is a clear market failure, that cannot be cured by a less intrusive intervention.

A less intrusive regulation might suggest default SOP rules, to allow some market forces to tailor the desirable policy to the needs and circumstances of the company and its managers. Clearly, one SOP does not fit all. SOP optimal design will depend on many variables, like: risk profile of the company, its ownership structure, its industry, competition in the field, managerial clout and tenure, managerial wealth and current equity holdings. Still, default rules will affect the outcome, as some literature suggests that equilibrium will be path dependent.

Lastly, regulation may merely mandate disclosure rules, with the hope that market forces will be restored, and will drive an efficient and informed equilibrium. This course of action is particularly important in the case of SOPs. This Article indicates that SOPs weakness is not conclusively inefficient and SOPs should not necessarily be different than the way they are. However, this Article clearly suggests that SOPs are camouflaged and are not the way they are advertised. The combination of ineffectiveness and camouflage is particularly consistent with the managerial power theory. Such theory predicts that the board of directors will not fix SOPs flaws. Rather, a healthy dialogue between outside shareholders and the firm should be facilitated. Therefore, I propose a regulatory reform to make SOPs transparent.

I propose that firms should be required to disclose, in the summary compensation table of their proxy statements: (1) the percentage and value of vested equity that the top executive is allowed to immediately unwind; and (2) the percentage and aggregate value of equity that the top executive sold over the past year. This information will provide investors some minimum information as for the effectiveness of their firm's SOP.

This quantitative information is crucial for investors in evaluating the overall effectiveness of their firms SOPs. Whereas the first indicator looks to the future and indicates the potential for ineffectiveness, the second indicator provides investors a feedback as for how their managers responded historically to certain SOPs. Processing both forward looking and historical data will assist investors and other outsiders in their dialogue with management on SOP design, and will provide the market data to assess aggregate market risk.

Furthermore, in addition to disclosing the percentage and value of potential and past managerial equity unwinding, firms should be required to disclose annually, in their proxy statements, additional information about their SOPs design: (1) its counting policy, and specifically the type of equity holdings that are counted towards satisfying the firm's SOP, with a special emphasis on unvested equity; and (2) what are the sanctions that executives face if they violate their SOPs.

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

I do not expect that complying with these additional disclosure requirements will impose any meaningful costs on firms[79]. Firms generally already have low-cost access to all the information I propose to disclose. Moreover, I expect that if investors become aware of the value of the design and effectiveness of SOPs, outside scrutiny could put pressure on firms to make SOPs more potent in the appropriate circumstances.

Thus, improved disclosure of SOP design and effectiveness would, at a minimum, significantly improve the accuracy of investor information regarding their top executives risk taking incentives and equity that she must hold, and could also contribute to the improvement of SOP practices, all while imposing minimal compliance costs upon firms. More rigorous SOP disclosure requirements will aid in the efforts to improve corporate governance and risk monitoring in the aftermath of one of the most severe global financial crisis.

X. CONCLUSION

The widespread pressure to adopt SOPs in the aftermath of the 2007-2008 financial crisis has led firms to adopt largely ineffective SOPs. The combination of widespread adoption of ineffective policies together with the non-transparency of these policies is consistent with the managerial power theory. However, there are some limitations to my analysis. First, it is not clear that detecting camouflage by using public information alone is valid. Perhaps other

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[79] For a detailed analysis of the low costs generally associated with mandatory disclosure of the type we propose here, see Allen Ferrell, The Case for Mandatory Disclosure in Securities Regulation Around the World 8-10 (Harvard Law & Econ. Discussion Paper No. 492, 2005), available at http://www.law.harvard.edu/programs/olin_center/papers/pdf/Ferrell_492.pdf.

investors already do the same and get clear indications on SOP potency. Second, my analysis does not provide any direct efficiency evidence. I do not claim that current SOPs should be different than what they are. I merely argue that they are not the way they are advertised. However, one should be alarmed about SOPs if they destroy value, not when they secretly induce managers to do the right thing. Finally, my evidence is a snapshot of SOPs at one point in time. In order to make a comprehensive assessment of those policies, one should get more observations.

Nevertheless, the evidence provided in this Article suggests that SOPs are motivated by self-serving managers. Those polices hardly work, whereas firms cite them as a key element in their important tasks of mitigation of risk and long term value creation. A regulatory reform that will focus on making SOPs transparent should be a cheap and easy measure to make markets more informed. The case for making SOPs transparent is set.