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Can Executive Compensation Reform Cure Short-Termism?

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EXECUTIVE SUMMARY

There is an increasingly pervasive view among corporate governance observers that senior managers are too focused on short-term results at the expense of long-term interests. Concerns about "short-termism" have been expressed within the financial industry context and outside of it, but because of the recent financial crisis, much of the discussion has been directed at financial institutions. To combat short-termism, several commentators have advocated executive compensation reform to encourage senior managers to adopt a longer-term perspective. Yet these reforms will likely prove ineffective because of other significant pressures on managers to maintain current stock prices.

Short-Termism Generally

Short-termism is the tendency of public companies to overweight short-term results relative to long-term consequences when making decisions. Most critics of short-termism point to managers' intense focus on current share prices as clear evidence of the phenomenon. If capital markets were perfectly efficient, current share prices would incorporate predictions of long-term performance, which would mean that short-termist strategies would reduce, rather than increase, current stock prices. Nevertheless, a significant finance literature suggests that equity markets overweight short-term benefits and costs and underweight long-term ones, causing managers to prefer some suboptimal strategies.

Short-termism can impose significant social costs. It could lead to excessively risky behavior. In fact, some have attributed the recent financial crisis to short-termism. Under this view, financial institutions that originated, packaged, sold, and invested in mortgage-backed securities effectively received premiums to insure against a collapse of the housing market, which was viewed as an extremely unlikely event that would occur in the distant future, if ever. These premiums boosted current earnings, which in turn boosted current stock prices; meanwhile the risk that was taken on by the financial institutions was not fully reflected in these prices.[1] While short-termism can lead to this sort of reckless behavior, it can also result in much more mundane though still problematic practices. For example, a company could reduce research and development expenses to ensure that it satisfies current earnings expectations, even if that strategy would be unprofitable over the long term.

First, short-termism could be the result of myopic shareholder preferences for current results… Second, short-termism could be the result of poorly designed executive compensation arrangements.

Short-termism is generally attributed to two causes. First, short-termism could be the result of myopic shareholder preferences for current results, which leads to systemic over-discounting of long-term opportunities and costs. This would stem principally from information asymmetry between investors and management and the peculiar nature of modern shareholders. Because investors cannot easily assess the long-term consequences of decisions, they might tend to focus unduly on short-term consequences, which are far easier to assess.[2] Similarly, investors who are unable to gauge whether current earnings disappointments are the result of "investments in the future" or merely managerial incompetence may simply assume the latter.[3] On this view, these myopic shareholder preferences would manifest themselves in pressure placed on boards and managers to make decisions that increase current share prices.

Second, short-termism could be the result of poorly designed executive compensation arrangements. Under this view, stock options and restricted stock that can be liquidated in short order unduly focus managerial attention on near-term performance at the expense of long-term results. Short-termism would therefore be a peculiar species of the traditional agency costs stemming from the separation of ownership and control of public companies.[4]

[1] In addition to the excessive discounting of long-term consequences, this failure also may have reflected the sheer complexity of many of the financial products that effectively bet against a significant collapse of the housing market.

[2] *See* Judith F. Samuelson & Lynn A. Stout, Are Executives Paid Too Much?, Wall St. J., Feb. 26, 2009, at A13 ("It is extremely difficult for an outside investor to gauge whether a company is making sound, long-term investments by training employees, improving customer service, or developing promising new products. By comparison, it's easy to see whether the stock price went up today. As a result, institutional and individual investors alike became preoccupied with quarterly earnings forecasts and short-term share price changes, and were quick to challenge the management of any bank or corporation that failed to 'maximize shareholder value.'")

[3] Another factor might be the nature of modern shareholders. The vast majority of equity in public companies is now held by institutional shareholders, who are plagued by their own agency problems, see Ronald J. Gilson & Jeffrey N. Gordon, Capital Markets, Efficient Risk Bearing and Corporate Governance: The Agency Costs of Agency Capitalism (on file with authors), which may cause them to take a short-termist perspective.

[4] Some have suggested that short-termism might be attributed to a third cause: managerial myopia. See David I. Walker, The Challenge of Improving the Long-Term Focus of Executive Pay, 51 B.C. L. Rev. 435, 441-42 (2010). However, we are skeptical of this account. For short-termism to stem from managerial myopia, either managers would have to be pervasively misreading the market's preferences (i.e., by overestimating the extent or intensity of shareholder short-termism) or managers would have to have a shorter investment horizon than the average shareholder. As we discuss below, market mechanisms are, more than ever before, ruthlessly

Proposals to Redesign Compensation Structures to Combat Short-Termism

In response to the recent financial crisis (which was attributed in part to short-termism as well as the unrelated moral hazard stemming from governmental guarantees of financial firms' debt), a variety of commentators have proposed executive compensation reforms. While they differ in their specific details, they all would delay the ability of senior management to liquidate equity positions for relatively long periods of time. This would lengthen a manager's investment horizon, which in turn would discourage the manager from making short-termist decisions. For example, Judge Richard Posner has suggested that public companies be required to pay their CEOs "a specified percentage of his compensation in the form of restricted stock in the corporation—stock that he could not sell for a specified number of years."[5] Likewise, Professors Lucian Bebchuk and Jesse Fried have suggested detailed principles for senior management compensation, all of which would substantially extend the investment horizon of managers by delaying their ability to cash out their equity holdings through sales or hedging transactions.[6] Judith Samuelson and Professor Lynn Stout similarly would require that top executives hold "a significant portion of their equity for a period beyond their tenure" and would prohibit hedging downside risk during that period.[7] Finally, Professors Sanjai Bhagat and Roberta Romano would generally prohibit the liquidation of options or restricted stock until at least two to four years after the executive's tenure.[8] While Bhagat's and Romano's proposal was targeted mainly at those financial firms who received government assistance following the financial crisis and would require that only these firms adopt it, they also recommend that all firms, financial or otherwise, consider voluntarily adopting it.

Some policymakers have also warmed to the general idea. In 2009, Andrew Cuomo, then New York State Attorney General (and now governor), and Congressman Barney Frank discussed compensation reforms to address short-termism. Cuomo was reportedly interested in "examining ways to further stagger both cash and stock compensation payments over several years[, so

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effective in focusing managerial attention on shareholder preferences. It therefore would be hard to believe that managers are so badly misreading these preferences when their jobs literally depend on them. And, because shareholders of public companies can easily and quickly exit their investments, it is difficult to conceive of many situations where a manager's investment horizon will be shorter than that of a shareholder. Regardless, proponents of compensation reform to cure short-termism do not appear to focus on managerial myopia as a principal cause of the problem.

[5] Richard A. Posner, Are American CEOs Overpaid, and, If So, What If Anything Should Be Done About It?, 58 Duke L.J. 1013 (2009).

[6] Lucian A. Bebchuk & Jesse M. Fried, Paying for Long-Term Performance, 158 U. Pa. L. Rev. 1915 (2010).

[7] See Samuelson & Stout, supra note 2.

[8] Sanjai Bhagat & Roberta Romano, Reforming Executive Compensation: Focusing and Committing to the Long-term, 26 Yale J. on Reg. 359 (2009).

that]… if a business built on short-term risk-taking blows up, firms will be able to claw back pay."[9]

Questioning the Effectiveness of the Compensation Proposals

Compensation reformers have neglected to fully appreciate the evolution of these mechanisms which have developed to the point where incentive pay may now be redundant.

While compensation reform to address short-termism is a fairly new idea, executive compensation reform more generally has been in vogue for the past thirty or so years. In the 1980s, compensation experts began to argue that, absent large amounts of incentive compensation, managers would systematically fail to maximize shareholder wealth. Without proper compensation incentives, managers were expected to shirk their responsibilities to shareholders by giving insufficient effort, making inefficient decisions, engaging in entrenchment strategies, or self-dealing. One particular concern was that managers would cause their firms to take *too little* risk relative to shareholder desires because managers were less diversified than shareholders. These concerns drove compensation reformers to argue that larger and larger amounts of incentive pay, such as stock options, restricted stock, and performance-based bonuses, were essential for maximizing shareholder wealth. The arguments for greater incentive pay have dominated the discussion of executive compensation up to today, with the mantra of "pay for performance" repeated over and over again in academic papers, the popular press, shareholder voting guidelines, and political discourse. And this emphasis has had tangible effects—compensation packages of top management have changed drastically in the past thirty years to include increasingly large amounts of incentive pay. In fact, it is almost universally recognized that the exponential increase in overall CEO pay over that period has been fueled by the emphasis on incentive pay.

However, over the same 30-year period, other corporate governance mechanisms have developed to do much the same work as these compensation reforms. We recently argued that compensation reformers have neglected to fully appreciate the evolution of these mechanisms, which we contend have developed to the point where incentive pay's agency-cost-reducing effects may now be largely redundant.[10] We believe that these same mechanisms will make compensation reforms designed to mitigate short-termism largely ineffective.

The New Corporate Governance World

Over the past 30 years, shareholders have grown far more powerful. Increasing proportions of shares have been held by institutional shareholders, and institutions that were historically reluctant to participate in shareholder

[9] Susanne Craig, *Cuomo, Frank Seek to Link Executive Pay, Performance*, WALL ST. J., Mar. 13, 2009, at C1.
[10] See generally Andrew Lund & Gregg D. Polsky, The Diminishing Returns of Incentive Pay in Executive Compensation Contracts, 87 Notre Dame L. Rev. 677 (2011).

activism have become much more comfortable doing so.[11] Likewise, modern shareholders make far greater use of proxy advisory firms, which allows for easier monitoring and coordination of shareholder pressure. Technological advances have also reduced the costs of shareholder activism. Majority voting and proxy access have become ascendant, and Say on Pay voting (though non-binding) is now required by law. Not surprisingly, the end result of these developments is that management has become significantly more attentive to shareholders' desires.

As shareholders have gained power, boards have naturally responded. Boards have become much more independent, and corporate governance committees are now nearly universal, while succession committees are much more common. Board committees meet more often, and boards are more likely to have formalized the CEO evaluation process and separated the CEO and Chairman positions. As a result of these developments, Professors Marcel Kahan and Edward Rock recently concluded that "[r]ather than help[ing] the corporate insider with managing the business of the corporation, boards are now increasingly engaged in monitoring management and planning for management changes." [12]

Changes to Senior Management Job Security

These developments have affected senior managers' level of job security. In fact, executives of public firms are now more likely than ever to get fired for perceived poor performance. This newfound risk of termination has focused managerial attention on shareholder preferences, namely the maintenance of current share prices by meeting earnings expectations, regardless of long-term consequences.

Recent empirical studies suggest that for current CEOs the risk of termination is both significant and increasing over time. Professors Steven Kaplan and Bernadette Minton found that, from 1998 through 2005, CEOs from a sample of large companies experienced a 17.4% annual turnover rate, which translates into an average CEO tenure of less than six years.[13] This is consistent with a 2010 Wall Street Journal study, which found that the typical CEO of an S&P 500 firm had served in that capacity for only 6.6 years.[14] This turnover rate is much higher than the rate that had been observed in earlier periods.

Furthermore, as one might expect, CEO turnover is significantly related to share price performance. This is true whether you adjust the company's share prices for industry performance or overall market performance. Based on this

[11] See Gilson & Gordon, supra note 3.

[12] Marcel Kahan & Edward Rock, Embattled CEOs, 88 Tex. L. Rev. 987, 1027 (2010).

[13] Steven N. Kaplan & Bernadette A. Minton, How Has CEO Turnover Changed? (Aug. 2008) (unpublished article), available at http://faculty.chicagobooth.edu/steven.kaplan/research/km.pdf.

[14] Joann S. Lublin, CEO Tenure, Stock Gains Often Go Hand-in-Hand, WALL ST. J., July 6, 2010, at B5.

evidence, it appears that the only way for CEOs to have a high degree of job security is to maintain their company's short-term share prices. In fact, the 2010 Wall Street Journal study found that there were only 28 long-serving (15 years or longer) CEOs in place; of those 28, only three had led firms whose stock price had not beaten the overall S&P index over the term of their tenure.[15]

For most senior managers, this enhanced risk of termination will be very disconcerting. Senior managers make large, undiversified investments of human, financial, and reputational capital in their firms. While termination could trigger a large severance package that might offset the financial loss resulting from termination, severance payments would not typically offset the effects on human and reputational capital. Severance package or not, one would expect senior managers to do everything in their power to avoid being terminated. The available evidence suggests that these managers will direct all of their efforts towards satisfying shareholder expectations, which generally means maintaining their company's short-term share prices.

One must search long and hard to find a CEO who does not care deeply about current share prices.

Importantly for present purposes, this is true whether a manager's compensation package pushes in that same direction by linking pay to current share prices or in the opposite direction by de-linking pay from those share prices. To satisfy the newly empowered short-termist shareholder base, senior managers will typically be compelled by career concerns to engage in strategies that prop up current share prices. If they do not, they risk lagging behind their competitors, thereby increasing their risk of termination. Once one firm sacrifices the future to boost current earnings, executives at other firms will be compelled to follow suit lest their share price and, correspondingly, their career prospects suffer. This, we think, is the best explanation for Chuck Prince's infamous explanation of big banks' behavior in the run-up to the recent crisis: "as long as the music is playing, you've got to get up and dance."

Whether the disciplinary action is quick and intense as in a termination or more gradual through an increase in intrusive monitoring by board members, shareholders, or the business press, shareholder expectations clearly are important in executive suites. One must search long and hard to find a CEO who does not care deeply about current share prices. It therefore seems naive to believe that managerial obsession with short-term share prices will be mitigated simply by restructuring compensation arrangements. For better or for worse, current share price is the metric by which CEOs are judged by shareholders and the public, just as NFL coaches are evaluated based on current wins and losses. Longtime Wall Street Journal journalist Holman Jenkins has made the same observation. In discussing the phenomenon of too-big-to-fail financial institutions that took on too much risk, Jenkins astutely predicted that commentators would propose compensation reform but was highly skeptical of this solution: "[L]et's not doubt that somebody somewhere is already polishing

[15] Id.

up a proposal to solve the problem by regulating CEO pay. Such faith is touching, though it overlooks a hard reality: The stock market would continue to assert its influence over managements."[16]

Better Options to Mitigate Short-Termism?

Regardless of how their compensation is structured, senior managers will continue to take actions to satisfy shareholder demands, for better or for worse, because their jobs depend on it. Therefore, we believe that compensation reform to mitigate short-termism is destined to fail. That much is easy for us to conclude. The much more difficult question is: what would work to combat short-termism? The question has bedeviled others for a long time now. Because our principal endeavor in this paper is to rebut the claim that executive compensation reform can cure short-termism, we only briefly and tentatively discuss some potentially better solutions.

Responses to short-termism must focus on the enormous pressure brought to bear on boards and executives by capital markets. Reformers can try to change either market preferences or firms' sensitivities to the pressures created by those preferences. Executive compensation reform is an ineffective version of the latter, as it seeks to change the sensitivities of executives within the firm to short-term share prices. In an earlier paper for this series, Professor Larry Mitchell took a stab at changing market preferences, proposing a sliding scale capital gains tax rate structure, which would tax shorter-term gains at a higher rate than longer-term gains.[17] While this proposal is intriguing because it is targeted at the empowered shareholder group, we worry about its effectiveness in practice. U.S. tax law has long struggled with tax-deferral strategies that allow taxpayers to hold on to appreciated securities while hedging out future risk and reward. Section 1259 of the Internal Revenue Code was enacted to treat perfect or near-perfect hedges as constructive sales, which trigger the capital gains tax. But this provision still leaves room for taxpayers to avoid the capital gains tax by engaging in hedging strategies that are not quite perfect enough to trigger a constructive sale. Mitchell's proposal would create even greater incentives to navigate around the constructive sale rules. It is not clear to us whether a tax on shorter-term gains could be both high enough to alter short-termist preferences and low enough to discourage end-runs around the tax.[18]

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[16] Holman Jenkins, Bank CEOs and the Bewitching Carrot, WALL ST. J., July 14, 2010, at A17.

[17] Lawrence E. Mitchell, Whose Capital; What Gains?: Why the U.S. Economy Needs to Change Incentives, available at http://www.brookings.edu/research/papers/2012/07/10-corporate-purpose-mitchell.

[18] If the tax was low enough, the transaction costs in implementing a hedging strategy that successfully navigated the constructive sales rules could exceed the tax, in which case the taxpayer would not hedge. But if the tax was that low, it likely would not deter short-termist behavior in the first place. Another concern relates to the fact that many of the shares of public companies are held (directly or indirectly) by tax-exempt investors, such as public pension funds, who because of their own agency problems, tend to have a very short-term perspective. A sliding capital gains rate would have no effect on these investors' preferences; therefore, in light

Reforming disclosure rules may be a better option in combating short-termism. Disclosure reform is interesting because arguments can be made in favor of both increased and decreased disclosure. If the gap between current share prices and long-term prospects is the result of information asymmetry, perhaps the gap might be reduced through greater disclosure, especially about the expected long-term consequences of current decisions. However, it is somewhat difficult to see how managers can credibly indicate long-term projections to the market when anti-fraud enforcement will have a necessarily weaker bite in policing soft, forward-looking information.

Counter-intuitively, reduced disclosure might actually be worth considering. Private firms are more insulated from the short-term pressures imposed by the capital markets. This, for instance, was a popular explanation for Mark Zuckerberg's ultimately unsuccessful attempt to keep Facebook from becoming a public company. Allowing more firms to remain private, while still providing them with reasonable access to capital, might permit these firms to focus on the long term without interference by short-termist public shareholders. The recent JOBS Act nodded in this direction by increasing the limit on the number of shareholders firms could have without becoming public. Allowing more firms to remain private would present significant capital allocation and investor protection issues, so obviously there is more to think about in deciding where to draw the line between public and private firms. But greater freedom for managers to take the long-term view by insulating them from stock market pressure may be a worthy consideration.

The quandary between more versus less disclosure is a microcosm of the problems facing reformers and speaks to a broader point. Short-termist behavior by public firms is a predictable downside of the general move toward increased accountability for boards and executives to public shareholders. The corporate governance regime in the U.S. has generally opted for a low-friction system that deals with the principal-agent problem by emphasizing responsiveness to short-term equity prices. It stands to reason that, if we are interested in reducing the resulting short-termism, we might have to accept an increase in agency costs occasioned by throwing sand in the gears. It is one thing to abhor short-termism. It is another to prefer the alternative, and advocates need to be clear about the trade-offs before setting out on the path towards reform.

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of their substantial shareholdings, the Mitchell proposal might not be effective, even leaving aside the circumvention problem.

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