Viewpoint

A Plan for Dodd-Frank Incentive Pay Reform

By Sanjai Bhagat and Charles Elson

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Section 956 of the Dodd-Frank Wall Street Reform and Consumer Protection Act requires that the US Securities and Exchange Commission (SEC) and other bodies propose executive incentive compensation reform that discourages excessive risk-taking by large financial institutions. To date, these federal agencies have not adopted a formal rule on executive incentive compensation. The SEC is currently considering executive compensation reforms to address Section 956 of the Dodd-Frank Act as it impacts financial companies, and to enhance transparency of the relation between manager pay and company performance for all companies (both financial and nonfinancial). The SEC is planning to finalize these reforms by spring 2022.

Meanwhile, executive compensation continues to grow larger almost every year. Data from the Economic Policy Institute reveal that, on average, CEO compensation increased by 14 percent from 2018 to 2019 and by 16 percent from 2019 to 2020.

Here, we propose a simple and transparent executive compensation plan that would allow the required reform to achieve its intended purpose of ensuring the resiliency and stability of our financial system.

CEO Compensation Complexity

There has been a secular increase in the complexity of CEO compensation at US companies over the past decade, according to multiple sources. Complexity of pay is characterized both within a given company and across US organizations by the many forms of pay used (short-term cash bonus, long-term cash bonus, stock, restricted stock, stock options, etc.), the many forms of performance metrics employed (both absolute and relative), and the many different time periods over which performance is measured.

According to a 2018 academic paper written by authors from Boston University, Boston College, and the University of Virginia, and data released in an article that appeared in *The Accounting Review* in 2020, there are disconcerting regularities associated with increased CEO compensation complexity. Specifically, the complexity of CEO compensation packages is positively related to higher CEO compensation, as well as an increased number of compensation consultants hired by a given company. However, there is no evidence that this complexity leads to higher future financial or accounting performance.

The SEC, other federal agencies, and corporate boards should consider three criteria to evaluate executive compensation reform policies: simplicity, transparency, and a focus on creating and sustaining long-term shareholder value.

A simple and transparent incentive compensation structure is desirable, as today's economy is particularly fast-moving, making it difficult to predict what risks may emerge as markets develop. The more complicated and opaque the incentive package, the more difficult it will be to determine how managers will respond to changes in the markets and what risks will be incurred.

Second, as shareholders must vote on CEO compensation packages, a simple incentive structure is easier for them to understand and evaluate, reducing the need to rely on third-party vendors for proxy voting advice, the value of which has long been the subject of considerable controversy.

Finally, focusing reform on creating and sustaining long-term shareholder value would channel management's attention to the longer-term profitability of the company's strategy.

A Proposal for Executive Compensation

In light of the above, we propose that the incentive compensation of senior corporate executives should consist primarily of restricted stock and stock options. "Restricted" in this sense means that an individual cannot sell the shares or exercise the options for six to twelve months after their last day in office.

Under this restricted equity compensation plan, most incentive compensation would be driven by total shareholder return instead of short-term accounting-based measures of performance such as return on capital or earnings per share. The value of a restricted equity compensation plan is supported by the results of a recent survey conducted by the Rock Center for Corporate Governance at Stanford University. Fifty-one percent of Fortune 500 director respondents said that they consider total shareholder return to be the best measure of company performance compared to accounting-based measures.

The rationale behind restricting equity for six to twelve months after an executive's departure is to maintain incentives for the executive in an "end-game" situation—for example, as an individual makes decisions when they are reaching retirement. A further benefit of the proposal's vesting period is that because a CEO would be exposed to the impact of decisions made by their successor, the chief executive would focus more attentively on proactive succession planning.

Of course, this proposal imposes some costs. To begin with, if executives are required to hold restricted shares and options, their savings would most likely be under-diversified, with a resulting decrease in risk-adjusted expected return. In addition, if executives are required to hold restricted shares and options post-retirement, they may be concerned with lack of liquidity.

To address these concerns, we recommend the amounts of equity awarded under our proposal should be increased slightly from current levels in order to bring up the risk-adjusted expected return. Additionally, managers should be allowed to liquidate annually, with board approval, a minimal fraction of their incentive restricted equity.

One Size Does Not Fit All

Compensation committees should be the principal decision-makers regarding the following:

1. The mix of restricted stock and stock options a manager is awarded

2. The amount of restricted stock and stock options the manager is awarded

3. The maximum percentage of holdings the manager can liquidate annually

4. The number of years post-retirement or resignation for the restricted stock and options to vest

One size does not fit all. Corporate boards need to use their understanding of the unique circumstances of their companies' opportunities and challenges to amend the restricted equity plan to serve as their executive incentive compensation plan, ensuring that the resulting plan is focused on serving the interests of longterm shareholders.

Bank Capital

Our recommendation for executive compensation is based on our analysis of compensation structure in banks. We found in our research that unrestricted equity-based incentive programs lose their effectiveness in motivating managers to enhance shareholder value as a bank's equity value approaches zero (as they did for the too-big-to-fail banks in 2008). Additionally, evidence suggests that bank CEOs sell significantly greater amounts of their stock as the bank's equity capital (or tangible common-stock-to-total-assets ratio) decreases. Hence, for equity-based incentive structures to be effective, banks should be financed with considerably more equity than they currently are. Bank capital should be calibrated to the ratio of tangible common equity to total assets (i.e., to total assets independent of risk), and not the risk-weighted capital approach that is at the core of the Basel Accords. Bank capital should be at least 20 percent of total assets.

Nonfinancial Companies

The incentives generated by this compensation plan structure would be relevant for maximizing long-term shareholder value in nonfinancial companies as well. Consider the cases of Enron Corp., WorldCom, and Qwest Communications International, whose senior executives have been convicted of criminal violations of insider trading laws. Executives at these companies made misleading public statements regarding the earnings of their respective firms, which led to a temporary rise in the share prices of these companies. The executives then liquidated significant amounts of their equity positions during the period in which their companies' share prices were temporarily inflated. If these executives' incentive compensation plans had consisted of only restricted stock and restricted stock options that they could not liquidate for six to twelve months after their last day in office, they would not have had the financial incentives to make the mentioned misleading statements.

The aforementioned compensation structure for corporate executives, coupled with increased levels of bank equity capital, will drastically diminish the likelihood of a company falling into financial distress, or an executive taking extreme—and potentially illegal—measures for personal gain. This market-based reform will accomplish Dodd-Frank's worthy objectives—that is, to uphold the resilience and transparency of our financial system.