

MANAGERS vs. REGULATORS: POST-ENRON REGULATION AND THE GREAT RECESSION

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ABSTRACT

Combating managerial opportunism is a difficult task. Managers do not tend to sit idle when facing a regulatory attempt to restrict their activities. They often seek ways to circumvent the regulation or new, alternative avenues for enriching themselves. This Article uncovers one recent and pervasive form of this phenomenon. Specifically, I show how managers tend to take excessive risks in response to regulation that hinders stock price manipulation, stock option backdating or repricing and a variety of additional ill-conceived schemes. This novel theoretical argument is particularly pertinent in the wake of the recent financial crisis in the American market. Indeed, the lesson for regulators should be that any reform that improves disclosure and prevents managerial rent-seeking must also curb risk-taking tendencies.

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INTRODUCTION

It is commonly asserted that the current financial crisis is linked to prevailing executive compensation practices.¹ Huge stock option packages and annual bonuses, the argument goes, led managers to concentrate on the short run and disregard the downside of risk taking.² But this is only a partial explanation given that incentive pay schemes are hardly a new phenomenon.³ To fully understand what happened, I show that from the beginning of the 1990s until the start of the twenty-first century, managers employed a variety of tactics, including misrepresentation, in response to option-based compensation and other risk-inducing pay schemes. These practices enabled executives to enrich themselves with option-based pay, while at the same time curbing their risk taking tendencies. One after the other, however, these practices were blocked by regulation, resulting in the eruption of risk taking in at least one important sector of the economy.

The tactics managers employed can be classified into two groups. The first group of practices and schemes was developed by managers to allow them to make easy profits from their incentive-based compensation. These included, first and foremost, manipulation of financial disclosures, but also option dating games and option repricing. While the literature explains how these schemes facilitated easy profits for managers, what has been overlooked is the fact that they weakened the risk-taking incentives that options would have otherwise produced. Put differently, these undesirable practices had the non-trivial effect of enabling managers to reap hefty gains from their stock options and annual bonuses without any accompanying need to take greater risks.

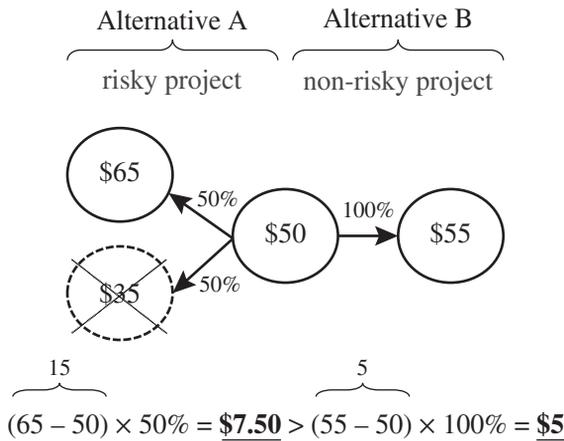
¹ 1 See, e.g., Press Release, Statement by Treasury Secretary Tim Geithner on Compensation (June 10, 2009), available at <http://www.treasury.gov/press-center/press-releases/Pages/tg163.aspx> ("This financial crisis had many significant causes, but executive compensation practices were a contributing factor. Incentives for short-term gains overwhelmed the checks and balances meant to mitigate against the risk of excess leverage.").

² See, e.g., Sanjai Bhagat & Roberta Romano, *Reforming Executive Compensation: Focusing and Committing to the Long-Term*, 26 YALE J. REG. 359 (2009) (discussing how the existing executive compensation system creates pervasive incentives to concentrate on the short-run and enhance risk and proposing reform); Lucian A. Bebchuk & Holger Spamann, *Regulating Bankers' Pay*, 98 GEO. L.J. 247, 255 (2010) (showing that the above phenomenon was especially pronounced in the financial industry where "the asymmetric payoffs that we analyze did not provide managers with incentives to take actions that would produce a loss with absolute certainty within the relevant period.").

³ While this article concentrates on executive stock options, the analysis also to a large extent applies to other types of performance pay, in particular annual bonuses, since all these mechanisms cause executive compensation to be convex in performance. Bonuses are usually granted yearly based on the achievements during the previous year. Since there are no "negative" bonuses in bad years, this type of compensation resembles options in that it mostly involves an upside. Hence, options and bonuses similarly add risk-taking incentives. See, e.g., Scott Patterson & Serena Ng, *Deutsche Bank Fallen Trader Left Behind \$1.8 Billion Hole*, WALL ST. J., Feb. 6, 2009, at A1 (describing how a Deutsche Bank trader who received tens of millions of dollars in bonuses per year during years of profitable trades in financial instruments "saddled the bank with \$1.8 billion in losses" when he left the bank during the 2008 crisis).

The following simple example illustrates how my argument about stock price manipulation plays out. Suppose that a manager of a firm must choose between two alternatives: a conservative project that would, with certainty, increase the firm’s share price by \$5, from \$50 to \$55 a share, and an excessively risky project that would have an equal chance of increasing share prices by \$15 to \$65 a share or decreasing them by \$15 to \$35 a share. In such a world, according to the existing literature, option-based compensation would push the manager towards the excessively risky profile, since options allow their holders to benefit from the upside of a risky decision without incurring the effects of its downside. In this example, the upside of the risky project is an average profit of \$7.50 per option for the manager (assuming she can exercise her options at the baseline price of \$50 per share),⁴ as compared with the certain outcome of the non-risky project, which would be a profit of only \$5 per option. This example of the risk-inducing feature of options is set up in Figure 1:

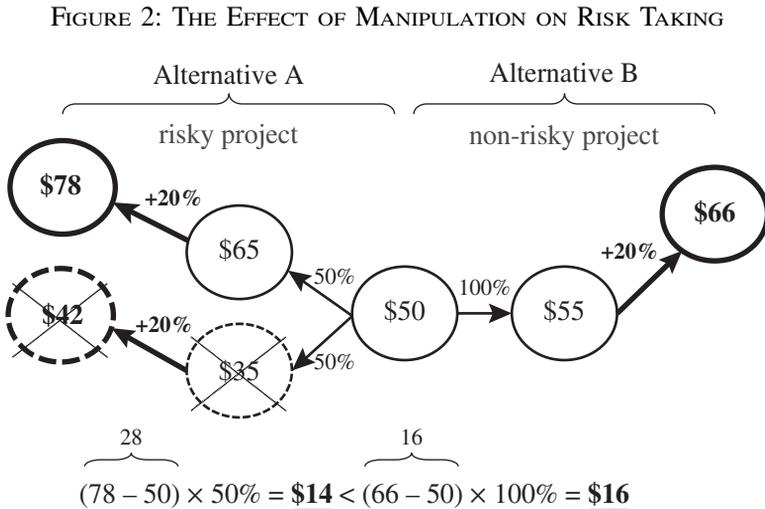
FIGURE 1: THE CLASSIC STORY—OPTIONS INDUCE RISKS



This often-heard explanation for the risk-inducing nature of options does not, however, account for the tradeoff between manipulation and risk taking. If managers have the power to manipulate share prices, they may counterintuitively forego their preference for excessive risk. To understand this novel argument, assume that our manager can misrepresent, to a certain extent, the results of the firm’s operations. This allows her to manipulate share prices at the point in time when she exercises her options. More specif-

⁴ In the good state of the world, share prices would reach \$65, which would lead to a \$15 gain per option after deducting the \$50 exercise price of the option. Since there is a 50% materialization rate in the good state of the world, the manager’s expected profits would be \$7.50 per option. Materialization in the bad state of the world would not impact the outcome, since the manager would not exercise her options if share prices were to drop to \$35.

ically, assume share prices can be inflated by 20% in comparison to their fair value. Interestingly, this would turn the outcome of our first example on its head, reversing the choice of the risky project. Here, under the non-risky alternative, the manager could exercise her options for a profit of \$16 per share—due to the \$66 share price after misrepresentation (120% of \$55, which is the certain outcome of the non-risky project without manipulation) minus the \$50 exercise price. The risky project, however, would now offer the manager an expected return of only \$14 per option. On the one hand, in the bad state of the world, the project still would generate zero returns for the manager even after misrepresentation.⁵ On the other hand, in 50% of the cases, the good state of the world would yield an inflated profit of \$28 (deriving from the \$78 share price that results from misrepresentation—120% of \$65—minus the \$50 exercise price). Since the average profit that could be derived from manipulation under the risky project is \$14 (50% of \$28), which is less than the profit that would obtain from the non-risky profile with manipulation (\$16), the manager’s preference for risk vanishes. More manipulation would only serve to boost this risk-reducing effect.⁶ Figure 2 presents this example:



⁵ In the bad state of the world of the risky profile, share prices would decline to \$45 (\$35 without misrepresentation), which would be less than the exercise price of \$50. However, and as I will demonstrate below, my argument does not rely at all on a requirement that the bad state of the world, given manipulation, does not yield a profit for the manager. I chose this example for the sake of simplicity.

⁶ These results are robust and general. See Sharon Hannes & Avraham Tabbach, More Manipulation, Less Risk Taking? (Jan. 2013) (unpublished manuscript), available at <http://www7.gsb.columbia.edu/richman/sites/default/files/files/Hannes%20S%20-%202010-5-11%20BS%20Preliminary.pdf> (presenting a formal model of the tradeoff).

The intuition behind this outcome is that a manipulative manager will not want to jeopardize the fruits of her wrongdoing by taking too much risk. There is a straightforward lesson to be learned from this argument: improved disclosure and anti-manipulation regulatory policies must be accompanied by a solid policy aimed at preventing excessive risk taking by managers.

The second group of adaptive tactics that managers employed was hidden compensation schemes that were kept from public scrutiny. These schemes included hefty pension arrangements and other types of stealth compensation, as well as IPO spinning, various self-dealing transactions, and additional covert benefits. Interestingly, most types of hidden pay tended not to be linked to firm performance. Hence, hiding this type of compensation lowered the actual proportion of incentive-based compensation relative to total pay. To appease market participants and institutional investors favoring incentive compensation, hidden pay practices allowed managers to report an artificially inflated percentage of pay-for-performance. These practices, however, also indirectly led managers to refrain from extreme risk-taking activities. Since hidden compensation is contingent on the manager's stint and does not fluctuate much with firm performance, managers did not want to rock the boat and endanger their positions.

With companies mounting options and annual bonuses at a steadily increasing rate, managers overwhelmingly resorted to these two types of tactics and for quite some time refrained from excessive risk taking. The huge potential for risk embedded in the compensation devices remained dormant, at least partially. A series of events at the outset of this century, however, particularly from 2002 onwards, exposed many of these ill-conceived practices, resulting in condemnation from both the market and regulators. Rapid regulatory reforms, the introduction of stock listing requirements, and the intensified market attention that followed the exposure of these practices inhibited most of the adaptive practices.⁷ An amendment to the securities regulations made option backdating almost impossible;⁸ the accounting profession underwent a major overhaul, leaving less leeway for management to manipulate favorable disclosures;⁹ and stock exchanges' listing requirements made option repricing unfeasible.¹⁰ This was also the fate of many other practices that allowed managers to conceal substantial portions of non-incentive-based compensation, such as stealth compensation and IPO spinning.¹¹

In response to this new reality, managers began to increase corporate risk levels, especially in the financial sector, where swift and partially covert action is possible. Preventing the usage of the distortive tactics almost im-

⁷ The fact that regulation often has unintended and undesirable effects is hardly surprising. See CASS R. SUNSTEIN, *FREE MARKETS AND SOCIAL JUSTICE* 223 (1997) ("It is a familiar point that government regulation that is aptly justified in principle may go very wrong in practice.").

⁸ See Part II.A.1, *infra*.

⁹ See Part II.A.2, *infra*.

¹⁰ See Part II.A.3, *infra*.

¹¹ See Part II.B, *infra*.

mediately let the genie of incentive compensation and the risk it fosters out of the bottle.¹² Indeed, the market reality that emerged laid the foundations for what became almost the only way that managers could make a lot of money through their compensation packages: by adding risk. The process by which option-based pay and annual bonuses were increased had been a gradual one, reaching a peak when the set of commonly used tactics became unavailable overnight. It was at that point that managers turned to the harmful alternative of excessive risk taking, and with such risk levels, systematic market crisis was only a matter of time. There is some indication that the market tried to adapt to the changing circumstances, and the use of stock option compensation has declined significantly since the beginning of this century.¹³ But certain industries, primarily the financial industry, are able to increase their risk profile rather rapidly.¹⁴ Thus, with the heightened incentive to add risk, it is little wonder that this sector brought the economy to near-meltdown.

¹² Many scholars have deemed the regulation that followed the Enron fraud crisis as inefficient and, therefore, hardly able to prevent any crisis. See, e.g., JONATHAN R. MACEY, *CORPORATE GOVERNANCE, PROMISES KEPT, PROMISES BROKEN* 45 (2008). My take on the post-Enron regulation is different in that I show that the regulation, which was somewhat beneficial in countering fraud, actually contributed to the new crisis that stemmed from excessive risk taking.

¹³ To be sure, I do not argue that the sole reason for the gradual drop in the use of stock options was the adaptation to the phenomenon exposed in this article. After all, the argument that market and regulatory changes intensified option compensation as a risk-inducing tool has never been discussed in the literature prior to this article. Other reasons for the decline may be the revelation that option compensation induces financial misrepresentation. See Sharon Hanes, *Compensating for Executive Compensation: The Case for Gatekeeper Incentive Pay*, 98 CAL. L. REV. 385 (2010) (discussing the relationship between option compensation and financial misrepresentation and the crash of the dot.com bubble). Another common explanation for the decline in the usage of executive stock options is the newly imposed requirement to write down the options value as an expense. See Yi Feng & Yisong S. Tian, *Option Expensing and Managerial Equity Incentives*, 18 FIN. MKTS., INST. & INSTRUMENTS 195, 195 (2009), (“[M]andatory option expensing removes the gap between the executives’ perceived cost and the ‘true’ economic cost of stock options, leading to a reduction in the use of option incentives. We find evidence consistent with this argument and that firms began to cut back their use of stock options as early as 2002.”). For the gradual decline in the usage of executive stock options, see David I. Walker, *Evolving Executive Equity Compensation and the Limits of Optimal Contracting*, 64 VAND. L. REV. 611, 633 fig.3 (2011).

¹⁴ And indeed, there is solid empirical evidence that incentive compensation rapidly induces risk taking in the financial industry. See, e.g., Ing-Haw Cheng, Harrison G. Hong & Jose A. Scheinkman, *Yesterday’s Heroes: Compensation and Creative Risk-Taking* (Nat’l Bureau of Econ. Research, Working Paper No. 16176, 2010), available at <http://ssrn.com/abstract=1636645> (“We investigate the link between compensation and risk taking among finance firms during the period of 1992-2008 . . . risk-taking measures are correlated with short-term pay such as bonuses and options even controlling for longer term incentives”); Haley Barton & Judith A. Laux, *Executive Pay Inefficiencies in the Financial Sector*, 26 J. APPLIED BUS. RES. 65, 65 (2010) (“The study examines data on 40 firms in the financial sector and 40 firms in the manufacturing sector to empirically test for a relationship between executive pay and leverage. . . . [C]ompensation is a significant determinant of a firm’s total debt-to-total assets ratio for the financial sector . . . while the manufacturing sector yielded no significant relationship.”).

The Article proceeds as follows. Part I discusses the advent of executive stock-option compensation and annual bonuses and how such compensation schemes can lead to excessive risk taking. Part II then describes managerial responses to the increased use of option-based compensation and other risk-inducing pay schemes. The discussion first presents adaptive tactics that tamper with the mechanisms and rationale of stock options (backdating, manipulation of financial disclosures, and option repricing), followed by an examination of how hidden pay practices operate. I show how each tactic influenced the incentive mechanism that options (and annual bonuses) yield, as well as the prevalent managerial reaction to the regulatory steps taken to ban these tactics. The Article then concludes and considers some of the lessons that can be drawn from the discussion.

I. THE PROMISE AND PERILS OF EXECUTIVE STOCK-OPTION COMPENSATION

Executive compensation is designed to align managers' incentives with those of the shareholders. In the particular case of stock options, this includes incentives to increase the corporation's risk profile. In the absence of such a pay arrangement, there is sound reason to believe that managers will be overly conservative.¹⁵ Since executives garner high salaries and other benefits from their stints, they may be reluctant to rock the boat and endanger their positions at the firm. Shareholders, especially diversified ones, might therefore wish to encourage managers to become more aggressive. This ideology came to dominate the American corporate scene more than twenty years ago and led to an explosion in the usage of stock options as a compensation tool.¹⁶ At its peak, stock-option compensation represented the lion's share of executive pay packages, comprising alone more than 60% of the value of all executive compensation at the turn of the twenty-first century.¹⁷ However, option compensation is a double-edged sword, for it can induce excessive risk taking levels. As shown in Figure 1 in the Introduction

¹⁵ See Michael C. Jensen & William H. Meckling, *Theory of the Firm: Managerial Behavior, Agency Costs and Ownership Structure*, 3 J. FIN. ECON. 305, 353 (1976) ("[T]his seems to capture some of the concern often expressed regarding the fact that managers of large publicly held corporations seem to behave in a risk averse way to the detriment of the equity holder. One solution to this would be to establish incentive compensation systems for the manager or to give him stock options which in effect give him a claim on the upper tail of the outcome distribution. This also seems to be a commonly observed phenomenon."); see also R.A. Haugen & L.W. Senbet, *Resolving the Agency Problems of External Capital through Options*, 36 J. FIN. 629 (1981) (an early formal model of the various roles that options can play in mitigating agency costs).

¹⁶ See Michael C. Jensen & Kevin J. Murphy, *CEO Incentives—It's Not How Much You Pay, But How*, 68 HARV. BUS. REV. 138 (1990) (advocating equity-based compensation before such a practice was widely employed in the economy); Brian J. Hall & Jeffrey B. Liebman, *Are CEOs Really Paid Like Bureaucrats?*, 113 Q. J. ECON. 653, 655 (1998) (reviewing compensation practices of the 400 largest public firms and concluding that executives are no longer paid like bureaucrats and that pay is linked to performance).

¹⁷ See Walker, *supra* note 13, at 633 fig.3.

and given the asymmetric nature of options as a compensation vehicle, managers might prefer a project with an inferior expected return. Similar consequences can ensue from a compensation method that includes short-term bonuses. Bonuses and options similarly create asymmetric payoffs between high profits in good scenarios and low penalties in bad scenarios.¹⁸ In other words, there can be too much of a good thing. A balanced pay package should calibrate the fraction of stock-option compensation out of the total pay to prevent too much risk taking.¹⁹ The problem is that no one really knows what the golden rule for such a compensation package should be.²⁰ Each corporation has its own different needs, and thus calculating the optimal compensation package in this respect involves many uncertainties. Most corporations try to overcome this challenge through the assistance of compensation consultants, whose work is characterized by much trial and error. In the twenty years leading up to the beginning of the twenty-first century, this process of calculating the appropriate fraction of options to grant executives seemed to lead in only one direction, with the proportion of options relative to total pay in the overall economy steadily increasing every year. Over the last decade, however, there was a gradual decline in option compensation, accompanied by an increase in restricted stock compensation, which induces less risk taking than options.²¹ Yet in many firms, even today, the most risk-inducing incentives, such as options and short-term performance bonuses, comprise the lion's share of the pay packages of the firm's top executives.

The changing figures of the total value of executive pay packages reveal a revolutionary shift in managers pay over the last three decades. Between the years 1980 and 1994, the average CEO compensation rose by

¹⁸ Some types of performance bonuses may exacerbate the above-mentioned risk-inducing nature. For instance, a guaranteed bonus raises the threshold of firm performance that the manager must meet in order to increase her pay without raising the penalties in the event of underperformance. See, e.g., Lucian Bebchuk, *Bonus Guarantees Can Fuel Risky Moves*, WALL ST. J. (Aug. 27, 2009), <http://online.wsj.com/article/SB125131480049161335.html> (discussing and illustrating the incentives generated by guaranteed bonuses).

¹⁹ See LUCIAN BEBCHUK & JESSE FRIED, *PAY WITHOUT PERFORMANCE: THE UNFULFILLED PROMISE OF EXECUTIVE COMPENSATION* 174–79 (2004) (explaining the common practices of executive stock-option grants, vesting, and exercise).

²⁰ See, e.g., MACEY, *supra* note 12, at 37 (“[I]nducing managers to engage in the appropriate levels of risk taking is one of the central challenges of corporate governance.”).

²¹ Restricted shares are shares that the executive must hold for a specified period. Shares provide a more symmetric link to performance than options do, since the executive benefits from increases in the share value as much as she suffers from drops. Another way to understand the less risk-inducing nature of restricted shares is to view them as options with an exercise price of zero (deep in-the-money options). Note, however, that when the corporation is highly leveraged, even restricted stock may induce overly excessive levels of risk from a social welfare point of view. Due to limited liability, share prices cannot become negative, and, hence, managers and shareholders alike may opt for excessive risk profiles at the expense of the firm's creditors. See generally Kevin J. Murphy, *Executive Compensation: Where We Are, and How We Got There*, in *HANDBOOK OF THE ECONOMICS OF FINANCE* (forthcoming 2013).

209%²² and, between the years 1992 and 2000, it almost tripled, with the median CEO compensation in the largest 500 U.S. companies climbing from \$2,335,000 to \$6,549,000.²³ The increase in average CEO total compensation was even more stunning in the period between 1993 and 2000, growing from \$3,700,000 to \$17,400,000.²⁴

This rise in executive pay should, to a large extent, be attributed to the increasing usage of stock-based compensation, especially stock options. In 1985, the value of options granted to executives comprised only 8% of the typical American CEO's salary;²⁵ however, this grew steadily, with the fraction of equity-based compensation peaking at 78% in 2000 and 76% in 2001.²⁶ Moreover, in the year 1999 alone, 94% of the largest companies granted options to their executives.²⁷

It was only at the beginning of the twenty-first century that the ratio of option compensation began to decline, leading also to a gradual reduction in the total value of executive pay. In one empirical dataset of the 350 of the largest U.S. corporations, the fraction of the value of options out of total compensation to the top five executives was 60% in 2000, 50% in 2001, 40% in 2002, 35% in 2003, and 25% from 2005 to 2007.²⁸ One of the major arguments made in this Article is that this gradual reduction was in part a market adaptation to phenomenon discussed here. As noted in Part II, when managerial adaptive tactics were exposed and subsequently impeded, the market had to deal with increased risk-taking incentives. A decline in the use of stock options would mitigate the problem.²⁹ However, at least for industries that can rapidly enhance their risk profile, particularly the finance industry, the gradual decline in options usage may not be a sufficient remedy.

²² Hall & Liebman, *supra* note 16, at 655 (reviewing the compensation practices of 400 of the largest publicly traded firms in the United States).

²³ Excludes financial firms and utilities. Kevin J. Murphy, *Explaining Executive Compensation: Managerial Power versus the Perceived Cost of Stock Options*, 69 U. CHI. L. REV. 847, 848 fig.1 (2002) (discussing growth in executive compensation).

²⁴ Lucian Bebchuk & Yaniv Grinstein, *The Growth of Executive Pay*, 21 OXFORD REV. ECON. POL'Y 283, 285 tbl.1 (2005) (reporting compensation figures for S&P 500 firms).

²⁵ Linda J. Barris, *The Overcompensation Problem: A Collective Approach to Controlling Executive Pay*, 68 IND. L.J. 59, 64 (1992) (studying overcompensation of CEOs).

²⁶ Bebchuk & Grinstein, *supra* note 24, at 290 tbl.4 (reporting compensation figures for S&P 500 firms); see also Murphy, *supra* note 23, at 848 fig.1 (discussing growth in executive compensation); Brian J. Hall, *Six Challenges in Designing Equity-Based Pay*, 15 J. APPLIED CORP. FIN., Spring 2003, at 21, 23.

²⁷ See Brian J. Hall & Kevin J. Murphy, *Stock Options for Undiversified Executives*, 33 J. ACCR. & ECON. 3, 4 (2002) (reviewing executive compensation in the largest 500 U.S. firms); see also Marcel Kahan, *The Limited Significance of Norms for Corporate Governance*, 149 U. PA. L. REV. 1869, 1888 (2001) (reporting that in 1996, in a sample of 250 large public firms, 94% used stock-option compensation).

²⁸ Walker, *supra* note 13, at 633 fig.3. However, there is considerable divergence among firms, with many still offering their top executives extremely generous option packages. Walker, *supra* note 13, at 645 fig.6.

²⁹ As a matter of timing, the decline followed the new regulation. Imen Fakhfakh, *Impact of Sox on CEO Compensation and Earnings Management* (May 7, 2009) (unpublished manuscript), available at <http://ssrn.com/abstract=1400683> ("We document that there was a significant decline in the ratio of incentive compensation to salary after the passage of SOX.").

Note, too, that a sharp reduction in option grants could actually enhance managerial incentive to add on risk since the discontinuation of option grants does not impact existing options. For as long as the executive anticipates future option grants, she might tend toward moderate risk levels, since extreme inferior outcomes may endanger her prospects of receiving such grants. But when expectations of future grants are suddenly reduced, the manager may take excessive risk in order to take full advantage of her last chance to earn large amounts from her existing options.³⁰

Moreover, concentrating on options alone underestimates the fraction of pay that induces extreme levels of risk taking. Performance bonuses, which have similar risk-incentivizing attributes, are also prominently used by firms, and the fraction of the value of options, combined with annual bonuses, still tops 50% even today. An exemplary case is that of Richard Fuld, the former CEO of Lehman Brothers, who was notorious for the risky activity that led the firm to collapse. Fuld, who was often ranked among the most highly paid executives in the U.S., received relatively modest option grants (\$900,000 in value per annum in 2004 and 2005), when compared to his base yearly salary of \$750,000.³¹ This, however, is misleading as to the real risk-inducing nature of his compensation. Indeed, his annual performance bonus of \$10,250,000 in 2004 and \$13,750,000 in 2005 could perhaps explain his managerial choices that led Lehman to such a seemingly good (but also extremely risky) performance shortly before its bankruptcy.³²

Today, many argue in retrospect that the described patterns of executive compensation led to the excessive risk levels that culminated in the current financial crisis.³³ Bear Stearns and Lehman Brothers, the two toppled financial giants, now infamously associated with adverse risk preferences, serve as good examples. The top five executives at Bear and Lehman earned, respectively, a total of \$1.4 billion and \$1 billion through short-term bonuses and sales of their equity compensation during the period of 2000 to 2008.³⁴

The questions that must be asked are how could the market disregard the enhanced risk potential and what delayed the emergence of crisis? The

³⁰ This prediction is in line with a somewhat analogous finding that links discontinuity in equity compensation and accounting irregularities. Qiang Cheng & Terry D. Warfield, *Equity Incentives and Earnings Management*, 80 ACCT. REV. 441, 467 (2005) ("Overall, these results suggest that CEOs with high equity incentives take more income-increasing abnormal accruals . . . [R]esults are largely driven by managers with less persistent equity incentives, who are less concerned with the accrual reversal and have fewer incentives to reserve for the future.").

³¹ Lehman Brothers Holdings Inc., Notice of 2007 Annual Meeting of Stockholders (Schedule 14A) (Feb. 26, 2007).

³² In 2007, the bonus dropped to \$4,250,000, and in 2008, he lost his seat when the company went bankrupt. In accordance with his compensation scheme, Fuld was never required to return the bonuses he had earned in the past. Fuld also received hefty grants of restricted stock (\$10,357,143 in 2004 and \$14,942,021 in 2005), meaning that the two components that spike risk levels (performance bonuses and options) amounted to about 50% of his compensation package. *Id.*

³³ See discussion and references *supra* notes 2–3.

³⁴ Lucian Bebchuk, Alma Cohen & Holger Spamann, *Bankers had Cashed in before the Music Stopped*, FIN. TIMES, Dec. 7, 2009, at 13.

crux of the answer that is offered in the next part of the Article is that managers used a variety of tactics to adapt to the risk-inducing pay schemes. These tactics enriched managers but also counterbalanced the effects of the risk-inducing incentives and allowed the market to intensify the usage of options and bonuses without causing any turmoil. At some point, due to regulatory changes and other market developments, many of the adaptive tactics became unavailable, rendering the incentive-pay structures far more potent as inducers of risk. Although a decline in the use of risk-inducing pay schemes did ensue under the new market conditions, this could not counterbalance the intensification of managers' proclivity for risk taking, especially in the financial industry, which has ample opportunities to rapidly enhance its risk profile. Understanding this series of events can therefore shed light on the delayed impact of the risk-inducing pay schemes. It can also explain how the market could overlook the possible ramifications of these pay schemes for such a prolonged period of time,³⁵ which, in 2008, became too drastic to ignore.

II. THE RISE AND FALL OF ADAPTIVE RESPONSES TO EQUITY-BASED COMPENSATION

For a good number of years, from the early 1990s to the beginning of the twenty-first century, managers reacted to the rising phenomenon of option compensation by employing a wide range of adaptive tactics, mostly hidden from the public eye. These tactics were aimed mainly at allowing managers to garner easy gains from their option compensation packages without any need for improved performance. But as we shall see below, these practices also diminished the risk-enhancing nature of option-based pay. Each year, compensation committees granted ever-increasing option packages, while managers resorted to more and more adaptive tactics. It was therefore small wonder that the risk-inducing nature of option compensation did not fully materialize for many years. Managers were abusing option compensation mainly through manipulation, and not by increasing risk. However, a series of events at the turn of the twenty-first century exposed and led to the condemnation of many of these tactics, which, as a consequence, almost completely vanished. At that point, the ramifications for risk taking were yet to be recognized. In the absence of adaptive tactics and with so many stock options already on board, enhanced risk and the ensuing financial crisis were only a matter of time. This Part will discuss the rise and

³⁵ Some critics recognized the inherent potential harm of the existing pay practices even before the current crisis. See, e.g., LAWRENCE E. MITCHELL, *THE SPECULATION ECONOMY: HOW FINANCE TRIUMPHED OVER INDUSTRY 1* (2007) ("The problem of business short-termism caused by the link between executive incentives and the stock market has become a popular subject of discussion in business, academic and policy circles. It was the central problem that I addressed in a book of my own in 2001."). This article differs in that it sheds light on the mechanisms that allowed the creation of the bubble of these pay practices.

fall of these various adaptive tactics. I begin with those tactics that directly circumvented the mechanism of option compensation (some of which are relevant to performance bonuses as well) and then proceed to the hidden pay practices that indirectly also countered the risk-inducing aspect of stock options and performance bonuses.

A. *Circumventing the Stock Option Mechanism:
Gains Without Performance*

There were at least three major adaptive tactics that managers used to reap easy profits from option compensation: backdating, financial misrepresentations, and option repricing.³⁶ I hold financial misrepresentation to be the major one of the three, but will begin my discussion with option backdating, since it has the most straightforward effect. As this Article explains, all these adverse practices had the side effect of averting much corporate risk taking. However, when new regulation, litigation, and market forces operated to thwart further usage of these tactics, it seems that no one fully grasped the inevitable consequence of enhanced incentive to add on risk. The necessary regulation for restraining risk taking was introduced only in 2010, following a major financial crisis in the United States.

1. *Backdating*

Of the three adaptive tactics mentioned above, option backdating has perhaps the most obvious impact on risk taking. Backdating is the illegal practice of issuing options with a misrepresentation of an earlier grant date when the company's share prices were especially low. In the U.S., options are almost always granted with an exercise price that is equal to the share market price on the date of grant, referred to as "at-the-money" grants.³⁷ With backdating, therefore, the options are in fact granted with an exercise price that is lower than the market price at the actual grant date, referred to as "in-the-money" grants. The public and regulatory outrage that ensued with the exposure of the pervasiveness of backdating revolved around the falsification that this practice involves and the profits that managers reap

³⁶ An obvious additional adaptive tactic that comes to mind is stock options hedging. In such a transaction, the manager would swap the income stream derived from her options with a steady stream of income. However, this type of hedging (unlike hedging of stock holdings) for top managers appears to be precluded by the regulation. See David M. Schizer, *Executives and Hedging: The Fragile Legal Foundation of Incentive Compatibility*, 100 COLUM. L. REV. 440, 445 (2000) ("[T]he bottom line is that, at least for now, executives are unable to hedge option grants [T]he securities law blocks some types of options hedging . . . and the tax law blocks the rest").

³⁷ See Brian J. Hall & Kevin J. Murphy, *Optimal Exercise Prices for Executive Stock Options*, 90 AM. ECON. REV. 209, 209 (2000) ("One of the most striking facts about executive stock options is that the exercise price is nearly always set equal to the current stock price at the grant date.").

from its usage.³⁸ In addition, however, backdating also lessens the risk-inducing nature of option grants. Simply put, a manager with at-the-money options has greater incentive to increase corporate risks than a manager with options that are in-the-money. A manager's payoff will be impacted only by the upside of a risky profile if she holds at-the-money options, whereas with in-the-money options, she will suffer loss from part of the downside too.

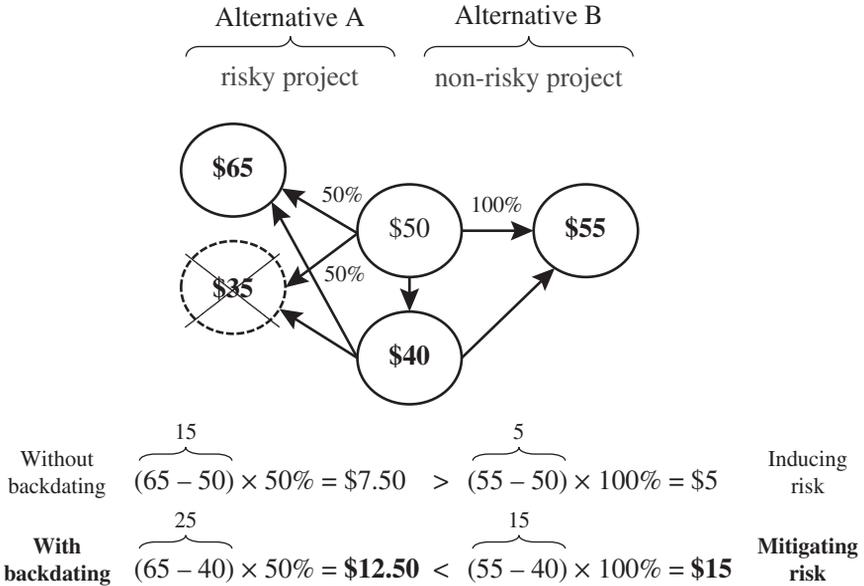
To illustrate, let us begin with our running example of an excessively risky project (figure 1 in the Introduction). Recall that our manager receives at-the-money options with a strike price of \$50 (the market value of the company's shares at the grant date). She must choose between two alternative projects: a conservative project that would, with certainty, increase share prices by \$5, to \$55 a share, and a risky project that would have equal odds of either increasing share prices by \$15, to \$65 a share, or decreasing prices by \$15, to \$35 a share. Recall, too, our conclusion that in this scenario option-based compensation would drive the manager to choose the risky project. The risky project offers the manager an expected profit of \$7.50 per option (since, as an option holder, she does not have to worry about the bad state of the world materializing),³⁹ whereas the non-risky alternative yields only a \$5 profit per option.

Now, let us add backdating to this example and examine its impact. Specifically, assume that through backdating, the manager receives her options with a strike price of \$40 instead of \$50 (she asserts falsely that the options were granted at an earlier date, when share prices were lower). Figure 3 depicts the impact of backdating.

³⁸ *But cf.* David I. Walker, *Unpacking Backdating: Economic Analysis and Observations on the Stock Option Scandal*, 87 B.U. L. REV. 561 (2007) (observing that since options cannot be exercised for several years, the difference between the market price and the exercise price at the date of the grant is an overestimation of the real gains that backdating brings about).

³⁹ In the good state of the world, share prices would reach \$65, and the manager would pocket \$15 per option after the \$50 exercise price is deducted. Since the good state of the world has a 50% materialization rate, the manager's expected profits are \$7.50 per option. The materialization of the bad state of the world would not influence the outcome, since the manager would not exercise her options if share prices were to decline to \$35.

FIGURE 3: THE EFFECT OF BACKDATING ON EXCESSIVE RISK-TAKING



If the manager opts for the non-risky project, she will now be able to exercise her options for a profit of \$15 each (a \$55 share price, minus the \$40 exercise price after backdating). The risky project, in contrast, would now offer the manager an expected return of only \$12.50 per option: the bad state of the world would still offer her no returns, even after misrepresentation,⁴⁰ whereas in the good state of the world (which has a 50% chance of materializing), she stands to make a \$25 profit (a \$65 share price, minus the \$40 exercise price after backdating). Since the average profit offered by the risky project (\$12.50) is smaller than that offered by the non-risky project (\$15), the manager’s affinity for risk would vanish.

The effect of backdating is thus similar to that of stock price inflation. This similarity is hardly surprising, because backdating and stock price manipulation are two sides of the same coin: stock price manipulation pushes up share prices at the options’ respective exercise dates, whereas backdating pulls down the options’ exercise price. These practices have similar results, including a similar mitigating impact on risk taking incentives. In fact, even putting aside the rational explanation illustrated by this example for this risk-aversion effect, it is fairly possible that backdating had an even greater impact on the reduction of risk taking: for managers, the very idea, at the out-

⁴⁰ In the risky project’s bad state of the world, share prices would drop to \$35—less than the exercise price of \$40.

set, of having to lose something could create a mindset that would cause them to be particularly careful when setting the corporate risk level.⁴¹

The exposure of the backdating practice, its unbelievable magnitude as a phenomenon, and the fact that managers were able to conceal it for so long came as a shock to the public.⁴² The SEC subsequently launched investigations into more than one hundred companies with respect to the timing and pricing of stock options they granted during the boom years of the late 1990s and early 2000s.⁴³ Apparently, however, this figure is merely the tip of the iceberg, with certain studies estimating that as much as 20% of the option grants to top executives in that period tainted by backdating.⁴⁴ Interestingly, unlike other adaptive tactics, it was not the revelation of backdating that triggered the enactment of the regulation (in this case the 2002 Sarbanes-Oxley Act) prohibiting the practice. Indeed, quite the opposite was the case: the preclusion of backdating was in fact an indirect outcome of the Sarbanes-Oxley legislation, which had never been intended to combat the still-unexposed practice.

A seminal empirical article by David Yermack with data from the 1990s showed that during this period, executives enjoyed better returns from their equity-based compensation than did other ordinary investors.⁴⁵ Specifi-

⁴¹ The tendency to avoid a sense of loss is described in the behavioral literature as loss aversion. See, e.g., Daniel Kahnman & Amos Tversky, *Loss Aversion and Riskless Choice: A Reference-Dependent Model*, 106 Q.J. ECON. 1039 (1991) (observing the loss-aversion phenomenon). The mindset described in the text is also linked to another behavioral bias known as the endowment effect. See, e.g., Daniel Kahnman et al., *Experimental Tests of the Endowment Effect and the Coase Theorem*, 98 J. POL. ECON. 1325 (1990) (describing the famous coffee mugs experiment, in which participants valued objects more after obtaining them).

⁴² This phenomenon has been discussed in numerous articles. See, e.g., Lucian A. Bebchuk, Yaniv Grinstein & Urs Peyer, *Lucky CEOs and Lucky Directors*, 65 J. FIN. 2363 (2010); Walker, *supra* note 13; Randall A. Heron, Eric Lie & Todd Perry, *On the Use (and Abuse) of Stock Option Grants*, 63 FIN. ANALYSTS J. 17 (2007). As expected, there is evidence that executive equity compensation significantly spurred the practice of backdating. See Daniel W. Collins, Guojin Gong & Haidan Li, *Corporate Governance and Backdating of Executive Stock Options*, 26 CONTEMPORARY ACCT. RES. 403 (2009) (showing that the tendency to backdate is stronger when stock options comprise the greater share (“the bulk”) of CEO compensation and that firms with weaker governance structures that allow CEOs to exercise greater power over the board and its committees are more likely to engage in executive-option backdating).

⁴³ See Walker, *supra* note 13, at 563 (“In the years since the scandal was uncovered, the SEC has launched investigations into suspicious timing and pricing of stock options granted during the go-go years of the late 1990s and early 2000s at more than one hundred companies”).

⁴⁴ *Id.* at 563 (“[R]ecent articles suggest that this figure represents only the tip of the iceberg—that perhaps 10% to 20% of options issued to senior executives during this period may have been backdated in order to reduce option exercise prices.”); see also John M. Bizjak, Michael L. Lemmon & Ryan J. Whitby, *Option Backdating and Board Interlocks*, 22 REV. FIN. STUD. 4821 (2009) (estimating that during most of their sample period, between 7% and 20% of the firms backdated).

⁴⁵ David Yermack, *Good Timing: CEO Stock Option Awards and Company News Announcements*, 52 J. FIN. 449 (1997) (finding that in a sample of 620 stock option awards to CEOs of Fortune 500 companies between 1992 and 1994, the timing of the awards coincided with favorable movements in company stock prices).

cally, Yermack uncovered a pattern in which options to executives were often granted just prior to a rise in share prices. The common interpretation for this finding was that managers were able to time the grant date of their option award before the company showed improved results, a practice known as spring loading.⁴⁶ In 2002, as part of a general initiative to improve transparency and rapid disclosure, the Sarbanes-Oxley legislation drastically shortened the timeframe for disclosure of executives' equity grants. Thereafter, managers had only two business days to report any option grant.⁴⁷ A few years down the road, Eric Lie inquired into the impact of this change on managers' returns from their options.⁴⁸ It emerged from the study that Sarbanes-Oxley had dramatically reduced these returns, a finding that led to the revelation of the scandalous practice of backdating. Since managers could no longer report option grants more than two days after the grant, they had to forsake falsely reporting older grant dates with artificially low strike prices. Inadvertently then, the Sarbanes-Oxley Act eradicated, almost entirely, the practice of backdating.

The almost immediate disappearance of backdating following the enactment of Sarbanes-Oxley in 2002 dealt a major blow to managerial adaptive responses to option compensation. For many years, and certainly from the mid-1990s until 2002, many managers had exploited a loophole in the then-existing regulation to receive in-the-money options disguised as at-the-money options.⁴⁹ This possibility was no longer available. As demonstrated and discussed above, backdating softens the risk-inducing incentives that options generate; when backdating departed the scene, it took that offsetting effect with it. Unfortunately, since it took quite a few years to uncover the scandal even after backdating became infeasible, no outsider could begin to imagine the elevated appetite for risk that this change would create. In fact, even after the exposure of backdating, attention was directed only at manag-

⁴⁶ See *Desimone v. Barrows*, 924 A.2d 908, 918 (Del. Ch. 2007) ("The practice of 'spring loading' stock options involves making market-value options grants at a time when the company possesses, but has not yet released, favorable, material non-public information that will likely increase the stock price when disclosed."). Another related practice, known as "bullet-dodging" that leads to superior returns for managers, is delaying the grant date until after the disclosure of negative information about the company, which, in turn, reduces the options strike price. *Id.* ("'[B]ullet-dodging' options are granted just after the company releases negative information to the market thereby allowing the recipient the benefit of a lower exercise price that reflects the price decline caused by the negative information."). See also *In re Tyson Foods, Inc.*, 919 A.2d 563, 593 (Del. Ch. 2007) (discussing spring loading and bullet-dodging).

⁴⁷ See Sarbanes-Oxley Act, Pub. L. No. 107-204, § 403, 116 Stat. 745 (2002) (codified at 15 U.S.C. § 78p) (amending Securities Exchange Act of 1934, § 16).

⁴⁸ See, e.g., Eric Lie, *On the Timing of CEO Stock Option Awards*, 51 *MGMT. SCI.* 802, 805 n.3 (2005) ("[E]ffective August 29, 2002, the SEC changed the reporting regulations with respect to stock option grants. Specifically, firms must now report executive stock option grants within two business days. This is likely to affect the timing of stock option grants documented herein.").

⁴⁹ See *id.*; see also Bebcuk, Grinstein & Peyer, *supra* note 42, at 7–8, 38 ("About 12% of the CEO grant events were reported to be given at the lowest price of the month, whereas only 4% of the grant events were reported to be given at the highest price of the month.").

ers' misrepresentations and the gains they were able to reap through this adverse practice. The important impact on risk taking tendencies went by unnoticed. As explained in this Article, however, this was only one step of many towards changing the landscape of executive incentive compensation.⁵⁰ Another adaptive tactic, financial misrepresentation in firm disclosures, to which I turn to below, was perhaps the most significant one, impacting option compensation and performance bonuses alike.

2. *Financial Misrepresentation*

Perhaps the most pervasive and widely used adaptive tactic that offset managerial risk taking was the manipulation of financial disclosures. Part of the phenomenon is outright illegal, taking the form of securities fraud or "cooking the books"; the other part, however, lies somewhere in the legal grey area of abuse of managers' discretion in financial and accounting disclosures. Apparently, until the passage of the Sarbanes-Oxley Act in 2002, and the enactment of its accompanying regulation, the legal environment in the U.S. had been fairly lax, allowing managers considerable freedom to whitewash and sugarcoat disclosures.⁵¹ The empirical literature is quite unequivocal regarding the link between equity-based compensation and financial misrepresentation in all forms. Once managers receive equity-based compensation, they have incentives to not only improve firm performance but also to misrepresent it. What is less obvious, however, and has gone unnoticed in the literature thus far is the connection between financial misrepresentation and the incentive to reduce risk taking.

Generally speaking, the ability of managers to manipulate financial disclosures offsets, at least in part, the risk-inducing feature of option compensation (and performance bonuses). To illustrate this novel mitigating effect, I presented in the Introduction a numerical example of a manipulation scheme that allows managers to inflate share prices at the time of option exercise. In that example, the incentives for excessive risks disappear when manipulation is possible. This impact on risk taking, however, is not limited to the specific conditions depicted in the example. In fact, any manipulation that brings about a linear transformation in share prices has the effect of curbing excessive risk taking.⁵² Beyond some minimal level of manipulation, managers'

⁵⁰ Even in the absence of backdating, managers could still time the grant date (or time the release of news) to enrich themselves. These timing games may also soften the risk-inducing effect of options, but as evidenced by Lie's work, after the Sarbanes-Oxley legislation, the leeway became substantially narrower. See Lie, *supra* note 48, at 806. Moreover, in contrast to backdating, these other practices do not offer the same certainty that the options granted are in fact in-the-money.

⁵¹ John C. Coffee, Jr., *What Caused Enron? A Capsule Social and Economic History of the 1990s*, 89 CORNELL L. REV. 269, 282 (2004).

⁵² By linear transformation (more accurately defined as an affine transformation), I am referring to the following: if share prices without manipulation are X , then manipulation will inflate share prices to $A*X+B$, with $A>1$, and $B>0$.

proclivity for excessively risky projects will diminish and they will tend toward safer projects. I have developed the mathematical proof for this argument elsewhere.⁵³ Here, however, I offer an example to complement the example from the Introduction and further clarify my argument. Whereas the first example involved a proportional manipulation scheme (increasing share prices in all states of the world by a certain percentage), here I assume constant manipulation, with share prices increased by a fixed amount. Taken together, the two examples simulate an instance of so-called linear transformation.⁵⁴

Let us recall our running example, then, which starts out with an assumption of accurate disclosure, where a manager receives at-the-money options with a strike price of \$50 (the market value of the company's shares at the grant date). The manager must choose between one of two alternative projects: a conservative project that would yield with certainty a profit that would increase share prices by \$5 to \$55 a share and a risky project that would have an equal chance of either increasing share prices by \$15 to \$65 a share or decreasing prices by \$15 to \$35 a share. In such a world (depicted in Figure 1 in the Introduction), option compensation would drive the manager towards the risky project. The upside of the risky project is an expected profit of \$7.50 for the manager (as an option holder, she does not have to worry about the downside),⁵⁵ as compared to the non-risky alternative, which would yield only a \$5 profit per option.

Consider now that the manager can misrepresent the results of the firm's operations to a certain extent and manipulate share prices at the time that she can exercise her options. Assume that with any given risk profile and in any state of the world, share prices can be inflated in such a manner so as to add a value of \$10 to share prices at the point in time when the manager can exercise her options. Interestingly, and as depicted in Figure 4 below, this would turn the previous outcome on its head. With the non-risky project, the manager could now exercise her options for a profit of \$15 each (\$65 share price after misrepresentation minus \$50 exercise price). The risky project, however, would now offer the manager an expected return of only \$12.50 per option. The reason for this is that the bad state of the world still would generate no returns for the manager even after misrepresentation,⁵⁶

⁵³ See Hannes & Tabbach, *supra* note 5.

⁵⁴ As noted above, the full proof for this general and robust effect is developed in Hannes & Tabbach, *supra* note 5.

⁵⁵ In the good state of the world, share prices would reach \$65, which would lead to a \$15 gain per option after deducting the options' \$50 exercise price. Since the good state of the world has a 50% materialization rate, the manager's expected profits would be \$7.50 per option. The materialization of the bad state of the world would not influence the outcome, since the manager would not exercise her options when share prices decline to \$35.

⁵⁶ In the bad state of the world of the risky profile, share prices would drop to \$45 (\$35 without misrepresentation), which would be less than the exercise price of \$50. However, this effect is not contingent on the manager's lack of profit from her options in the bad state of the world following the manipulation. To illustrate, consider a manipulation that inflates share prices by \$40. The non-risky project now offers a profit of \$45 per option, whereas the risky

link between equity-based compensation and financial misrepresentation. The overlooked side effect of this link is that option compensation must have triggered less risk than it would otherwise have induced. It should come as no surprise that once misrepresentation became much less feasible for managers, risk levels rose rather rapidly. Indeed, the period during which there was a vast increase in option compensation arrangements witnessed also unprecedented securities fraud and earnings management. It seems that managers concentrated on manipulation instead of taking excessive risk. From an average of about 50 public company restatements per year in the period of 1990 to 1997,⁵⁷ the frequency rose to 201 in 2000 and 225 in 2001,⁵⁸ one year before the passage of the Sarbanes-Oxley legislation. Put differently, virtually one in ten U.S. public firms announced at least one restatement between 1997 and 2002,⁵⁹ with the incidence of restatements growing ten-fold from 1990 to 2002.⁶⁰ Moreover, since restatements are only required in the most extreme cases of accounting failure, these figures represent perhaps only the tip of the iceberg as to the actual financial misrepresentation that was going on during this period.⁶¹ Indeed, we should assume that much of the accounting manipulation and whitewashing simply went unnoticed or failed to reach the extreme of requiring a restatement.

Inaccurate accounting and earnings management came at a huge cost to the specific firms involved and the American market as a whole. The federal government's General Accountability Office estimated at least \$100 billion in market losses for restating corporations;⁶² one academic study showed that restating firms had lost, on average, no less than 25% of their market value.⁶³ Yet these numbers, too, are an underestimation of the actual loss, since not

⁵⁷ George B. Moriarty & Philip B. Livingston, *Quantitative Measures of the Quality of Financial Reporting*, 17 FIN. EXECUTIVE 53, 53–54 (2001).

⁵⁸ U.S. GEN. ACCT. OFFICE, REP. NO. GAO-03-138, FINANCIAL STATEMENT RESTATEMENTS: TRENDS, MARKET IMPACTS, REGULATORY RESPONSES, AND REMAINING CHALLENGES 12 (2002), available at <http://www.gao.gov/new.items/d03138.pdf> (a major survey of restatement events in the US just prior to the Sarbanes-Oxley legislation) [hereinafter GAO REPORT]; but cf. KAREN M. HENNES, ANDREW J. LEONE & BRIAN P. MILLER, *The Importance of Distinguishing Errors from Irregularities in Restatement Research: The Case of Restatements and CEO/CFO Turnover*, 83 ACCT. REV. 1487 (2008) (a cautionary note on the importance of distinguishing bona fide errors from irregularities in the GAO database on restatements).

⁵⁹ GAO REPORT, *supra* note 58, at 16.

⁶⁰ The evidence is summarized in John C. Coffee, Jr., *A Theory of Corporate Scandals: Why the USA and Europe Differ*, 21 OXFORD REV. ECON. POL'Y 198, 200–201 (2005).

⁶¹ See *id.* at 199 (“one suspects that these announced restatements were but the tip of the proverbial iceberg, with many more companies negotiating changes in their accounting practices with their outside auditors that averted a formal restatement”).

⁶² GAO REPORT, *supra* note 58, at 24.

⁶³ Scott A. Richardson, A. Irem Tuna & Min Wu, *Predicting Earnings Management: The Case of Earnings Restatements* (2002) (unpublished manuscript), available at <http://ssrn.com/abstract=338681>. For a comprehensive discussion of financial misrepresentation cases that were exposed and subject to enforcement action, see Jonathan M. Karpoff, D. Scott Lee & Gerald S. Martin, *The Legal Penalties for Financial Misrepresentation* (2007) (unpublished manuscript), available at <http://ssrn.com/abstract=933333> (providing an integrated analysis of private and regulatory penalties for financial misrepresentation).

all cases of fraud and financial irregularities were detected. Tellingly, it emerged from the findings in one study that an accounting restatement by one firm induced share price declines also among non-restating firms in the same industry.⁶⁴ All together, the direct and indirect consequences of financial fraud and misreporting contributed to the downturn of U.S. capital markets, which, from 2001 to 2002, plummeted by 32%.⁶⁵

As noted above, the theoretical and empirical literatures both reveal a link between equity-based compensation (especially options) and financial manipulation.⁶⁶ Michael Jensen has noted that the practice of paying managers with shares and stock options is like “throwing gasoline” onto the inflated stock prices’ “fire.”⁶⁷ Thus, even though the connection between financial misrepresentation and risk-taking incentives has not been discussed in the literature, the former has been identified as a managerial reaction to incentive pay.⁶⁸ Rather than trying to summarize the entire body of recent and steadily growing empirical literature on the subject, we shall concentrate on two pivotal and representative articles.⁶⁹ The first is a study that discusses detected cases of misrepresentation, and the second a study that addresses covert and implied cases.

The first study focused on accounting restatements and their relation to the structure of executive pay in a given firm.⁷⁰ An accounting restatement is a remake of previous financial reports that occurs upon discovery of a significant accounting error that resulted in a substantial misrepresentation of the earlier financial reports. Restatements are always related to misrepresentation and are often an indicator of pure fraud. This particular study found that

⁶⁴ Cristi A. Gleason, Nicole Thorne Jenkins & W. Bruce Johnson, *The Contagion Effects of Accounting Restatements*, 83 ACCT. REV. 83 (2008) (finding that accounting restatements that adversely affect shareholder wealth at restating firms also induce a parallel share price decline among non-restating firms in the same industry, especially if the other firms had the same external auditors or indications of low-quality accounting).

⁶⁵ Bengt Holmstrom & Steven N. Kaplan, *The State of US Corporate Governance: What's Right and What's Wrong*, 15 J. APPLIED CORP. FIN. 8, 30 (2003).

⁶⁶ See, e.g., Oren Bar-Gill & Lucian Bebchuk, *Misreporting Corporate Performance* (Harvard L. & Econ. Discussion Paper No. 400, 2003), available at http://papers.ssrn.com/sol3/papers.cfm?abstract_id=354141 (developing a model of the causes and consequences of misreporting corporate performance); Oren Bar-Gill & Lucian A. Bebchuk, *The Costs of Permitting Managers to Sell Shares* (2003) (unpublished manuscript), available at http://www.law.harvard.edu/programs/corp_gov/papers/03.Bar-Gill.Bebchuk.cost-permitting.pdf (analyzing the costs of permitting corporate managers to sell shares they held prior to the end of their service at the company); Coffee, *supra* note 60, at 202 (analyzing the pivotal role of executive compensation in securities fraud); Coffee, *supra* note 51 (discussing the pivotal role of executive compensation in Enron-era securities fraud cases).

⁶⁷ Michael C. Jensen, *Agency Cost of Overvalued Equity*, 34 FIN. MGMT. 5, 14 (2005).

⁶⁸ The view that equity-based compensation encourages financial misreporting is widespread as well, both amongst the public and within financial circles. See, for example, the statement made by Senator William Gramm linking the accounting misconduct of Enron's managers to their compensation scheme, at 148 CONG. REC. S6628 (daily ed. July 11, 2002).

⁶⁹ For a broader description of the relevant empirical literature, see Hannes, *supra* note 13.

⁷⁰ Jap Efendi, Anup Srivastava & Edward P. Swanson, *Why Do Corporate Managers Misstate Financial Statements? The Role of Option Compensation and Other Factors*, 85 J. FIN. ECON. 667 (2007).

the likelihood of misstated financial statements increases dramatically when the CEO has sizable holdings of in-the-money options.⁷¹ Examining restatements announced during 2001 and 2002, the study compared a sample of ninety-five restating firms with a control sample matched in size and industry.⁷² The authors measured many factors that could potentially differentiate between the restating firms and their control sample, with the most influential factor found to be the CEO's compensation structure and, specifically, the value of her in-the-money stock options.⁷³ The staggering findings gained even greater force in the specific context of restatements involving major accounting irregularities and malfeasance.

The magnitude of the differences between the restating firms and their non-restating peers was dramatic. The average value of CEO option holdings at restating firms was \$50,106,370, whereas at the matched firms, it stood at only \$8,881,680.⁷⁴ Moreover, the average value of CEO holdings at restating firms where there was evidence of accounting malfeasance was strikingly higher, at \$130,160,680, than the average of \$14,930,990 at the matched firms.⁷⁵ The study also exposed the immediate benefits that CEOs derived from misreporting. CEOs of companies that later announced accounting restatements exercised options worth an annual average of \$4,181,600 (and \$7,744,240 in cases of accounting malfeasance); this exceeded by far the average of \$436,930 (\$2,616,210 where there was accounting malfeasance) at the matched firms.⁷⁶ Finally, the study showed that misrepresentation actually inflated the value of the restating companies' stock (or at least backed up an already inflated value). Thus, the study revealed "that restating firms' returns exceeded the market by about 20% (27% for firms with accounting malfeasance); in comparison, control firms, matched on industry and size, earned approximately the market return."⁷⁷ These findings led the researchers to conclude that managers with option compensation take action to support the inflated stock price through accounting manipulation.⁷⁸

The second groundbreaking study analyzed firms that meet or just beat analysts' forecasts, without any explicit evidence of misrepresentation.⁷⁹ The authors found a significantly higher incidence of meeting or just beating forecasts amongst firms with higher managerial equity incentives.⁸⁰ "[A]

⁷¹ In-the-money options are options that have a strike price that is lower than the market value of the company's shares at the actual grant date. Thus, hypothetically, if exercised at such point, they reap an immediate profit. *See id.*

⁷² *Id.*

⁷³ *Id.*

⁷⁴ Efendi, Srivastava & Swanson, *supra* note 70, at 669.

⁷⁵ *Id.*

⁷⁶ *Id.* at 670.

⁷⁷ *Id.* at 694.

⁷⁸ *Id.*

⁷⁹ Cheng & Warfield, *supra* note 30. The study used stock-based compensation and ownership data from the period of 1993–2000.

⁸⁰ *Id.* at 470. *See also* Mary Lea McAnally, Anup Srivastava & Connie D. Weaver, *Executive Stock Options, Missed Earnings and Earnings Management*, 83 ACCT. REV. 185 (2008)

one standard deviation increase in unexercisable options increases by 16.3 percent the odds of meeting or just beating analysts' forecasts, while a one standard deviation increase in ownership increases by 30.5 percent the odds of meeting or just beating analysts' forecasts."⁸¹ Moreover, "[o]f 4,301 firm-years with equity incentives and earnings surprises in the period 1993-2000, 25 percent have zero earnings surprises, i.e., meeting analysts' forecasts, 17 percent beat analysts' forecasts by one cent, but less than nine percent miss analysts' forecasts by one cent."⁸² Based on their analysis, which controlled for firm performance and other potential confounds, the authors concluded that their findings are more consistent with earnings management induced by equity incentives than improved firm performance.⁸³ It further emerged from the study that managers with high equity incentives sell more shares after meeting or beating analysts' forecasts than after missing forecasts. In contrast, the authors did not find evidence of similar behavior for managers with low equity incentives.⁸⁴ These outcomes are consistent with the notion that there is an increase in stock selling by managers with high equity incentives following earnings management. Lastly, the study found that managers with high equity incentives use, on average, more income-increasing accounting techniques (usage of abnormal accruals),⁸⁵ and that managers sell more shares after taking such measures.⁸⁶

The legal reaction to the accounting scandals at the beginning of the twenty-first century was swift, spearheaded by the Sarbanes-Oxley Act and the ensuing regulation.⁸⁷ The new measures instituted under the Act included: more stringent disclosure rules,⁸⁸ mandatory managerial certification of periodic reports,⁸⁹ incentive compensation claw-back provisions,⁹⁰ greater board independence with enhanced financial understanding,⁹¹ and improved

(showing that option grants sometimes encourage managers to miss a quarterly earning target intentionally and that, evidently, firms that miss earning targets have larger and more valuable subsequent grants); David Aboody & Ron Kasznik, *CEO Stock Option Awards and the Timing of Corporate Voluntary Disclosures*, 29 J. ACCT. & ECON. 73 (2000) (empirically showing that managers time stock grants and disclosures to earn rents).

⁸¹ Cheng & Warfield, *supra* note 30, at 455.

⁸² *Id.* at 452.

⁸³ *Id.* at 443.

⁸⁴ *Id.* at 443.

⁸⁵ This is especially true regarding managers with less persistent equity incentives—those who are less concerned with the reversal of accruals. *Id.* at 467.

⁸⁶ *Id.*

⁸⁷ Sarbanes-Oxley Act of 2002, Pub. L. No. 107-204, § 1, 116 Stat. 745 (codified at 15 U.S.C. § 78p); STEPHEN M. BAINBRIDGE, *THE COMPLETE GUIDE TO SARBANES-OXLEY: UNDERSTANDING HOW SARBANES-OXLEY AFFECTS YOUR BUSINESS* 66 (1st ed., 2007) (explaining that the Sarbanes-Oxley Act has had the biggest impact on American business of any federal securities legislation since the New Deal).

⁸⁸ For instance, increased disclosure of off-balance sheet transactions. Sarbanes-Oxley Act § 401(j).

⁸⁹ Sarbanes-Oxley Act § 906(a).

⁹⁰ Sarbanes-Oxley Act § 304(a).

⁹¹ Perhaps the most salient requirement in this area is that all listed companies create audit committees comprised solely of independent directors. Sarbanes-Oxley Act §§ 201, 301.

auditor oversight and independence requirements.⁹² The Act has both its proponents⁹³ and vocal opponents.⁹⁴ While it is hard to draw broad conclusions as to the Act's implications, the bottom line does seem to be an improved disclosure environment,⁹⁵ albeit at a perhaps high cost.⁹⁶ However, the new regulation neglected to include measures that would prevent excessive risk taking. The latter were introduced only much later, in the Dodd-Frank Act of 2010.⁹⁷ In the meantime, and assuming the claim made here that inaccurate disclosure restrained corporate risk taking, managers reacted to the improved disclosure environment with excessive risk taking. From the perspective of this Article, then, the important lesson to be learned is that Sarbanes-Oxley

⁹² Included amongst the steps taken is the creation of a public board to oversee auditors. Sarbanes-Oxley Act § 101.

⁹³ Proponents argue that the Act improved transparency and accuracy of financial reporting. See, e.g., Lawrence A. Cunningham, *The Sarbanes-Oxley Yawn: Heavy Rhetoric, Light Reform (and It Just Might Work)*, 35 CONN. L. REV. 915, 917 (2003); John C. Coates, IV, *The Goals and Promise of the Sarbanes-Oxley Act*, 21 J. ECON. PERSP. 91 (2007); Stephen Wagner & Lee Dittmar, *The Unexpected Benefits of Sarbanes-Oxley*, 84 HARV. BUS. REV. 133, 133 (2006).

⁹⁴ Opponents claim that the Act unjustifiably increased the regulatory burden on public firms. See, e.g., Harvey Coustan, Linda M. Leinicke, W. Max Rexford & Joyce A. Ostrosky, *Sarbanes-Oxley: What It Means to the Marketplace*, 197 J. ACCT. 43, 44 (2004); Jeffrey N. Gordon, *Governance Failures of the Enron Board and the New Information Order of Sarbanes-Oxley*, 35 CONN. L. REV. 1125, 1128 (2003) (“[T]he Act also seems to contemplate ‘real time’ disclosure of material business developments even in circumstances where premature disclosure may well sacrifice shareholder value for very little gain in capital market efficiency. This I call ‘price-perfecting disclosure’ and believe that eliminating the board’s discretion to this extent may be unwise”); Larry E. Ribstein, *Market vs. Regulatory Responses to Corporate Fraud: A Critique of the Sarbanes-Oxley Act of 2002*, 28 J. CORP. L. 1, 3 (2002); Roberta Romano, *The Sarbanes-Oxley Act and the Making of Quack Corporate Governance*, 114 YALE L.J. 1521, 1528 (2005) (“SOX was emergency legislation, enacted under conditions of limited legislative debate, during a media frenzy involving several high-profile corporate fraud and insolvency cases.”); Oliver Hart, *Regulation and Sarbanes-Oxley*, 47 J. ACC. RES. 437, 437 (2009) (suggesting that rather than being based on sound principles, the regulation was the consequence of the public outcry for action).

⁹⁵ For instance, one recent study showed that the proportion of securities fraud uncovered by auditors has risen substantially in the post Sarbanes-Oxley era. I.J. Alexander Dyck et al., *Who Blows the Whistle on Corporate Fraud?*, 65 J. FIN. 2213, 2218 (2010) (reviewing a sample of 230 cases of corporate fraud between 1996–2004). For the marketplace views on the Act, see, for example, Joann S. Lublin & Kara Scannell, *Critics See Some Good From Sarbanes-Oxley*, WALL ST. J., July 30, 2007, at B1 (citing market participants on the fifth anniversary of the Act and recognizing some of its benefits, albeit viewing it largely as excessively costly).

⁹⁶ See, e.g., Peter Iliev, *The Effect of the SOX Section 404: Cost, Earnings Quality, and Stock Prices* 65 J. FIN. 1163, 1164-6 (2010) (showing that firms with a public float of about \$75 million incurred double the amount of their previous annual audit fees due to the certification requirement, with audit fees rising on average from \$370,700 to \$882,300, but also showing that the requirement for a certification report induced managers to cut back on discretionary accruals). One should also keep in mind the indirect costs of the legislation. See Ehud Kamar et al., *Going Private Decisions and the Sarbanes-Oxley Act of 2002: A Cross-Country Analysis*, 25 J. L. ECON. & ORGANIZATION 107 (2009). (finding that the Sarbanes-Oxley Act caused small-sized firms to go private).

⁹⁷ Dodd-Frank Wall Street Reform and Consumer Protection Act, Pub. L. No. 111-203, 124 Stat. 1376 (2010).

should have been accompanied by risk-restraining measures, for their absence produced yet another type of cost: enhanced risk taking incentives.⁹⁸

3. Option Repricing

A third adaptive tactic that was widely used until it was regulated by the major stock exchanges is option repricing. Repricing is the practice of resetting the exercise price of options once share prices have declined and the options become deeply out-of-the-money.⁹⁹ This tactic was never illegal, nor was it a covert mechanism (unlike backdating and financial misrepresentation, corporations made public announcements about repricing). Nevertheless, since it was developed by executives, it was a practice that shareholders could do little to oppose. Managers therefore took advantage of this mechanism in order to reap gains from options that would have otherwise been all but obsolete.¹⁰⁰

Repricing has complex risk taking implications that have never been fully discussed in the literature. Ex ante, when options are granted, the possibility of repricing can actually boost managers' risk taking tendencies,¹⁰¹ for managers know that even if they lead the firm to a severe loss, they will still have a second opportunity to generate a profit from their otherwise worthless options. However, ex post, when options are already out of the money (often for reasons completely unrelated to the managers' performance), the possibility of repricing diminishes risk taking.¹⁰² In the absence of the repricing

⁹⁸ Interestingly, one important empirical study came to the opposite conclusion with regard to a sample of foreign firms that cross list on the U.S. stock markets. Kate Litvak, *Defensive Management: Does the Sarbanes-Oxley Act Discourage Corporate Risk-Taking?* (U. of Texas Sch. of Law, Law and Econ. Research Paper No. 108, 2008), available at http://papers.ssrn.com/sol3/papers.cfm?abstract_id=1120971 (finding that the risk levels of Sarbanes-Oxley-exposed foreign firms declined after the legislation). However, since foreign firms do not tend to have the typical U.S. executive-compensation arrangements, the Litvak article may not have captured the effect discussed in the text, which is based on the interaction between the legislation and certain types of incentive-based compensation.

⁹⁹ See, e.g., M. Brenner et al., *Altering the Terms of Executive Stock Options*, 57 J. FIN. ECON. 103 (2000) (analyzing option repricing); M.E. Carter & L.J. Lynch, *An Examination of Executive Stock Option Repricing*, 61 J. FIN. ECON. 207, 207 (2001) (discussing the reasons for repricing); N.K. Chidambaran & N.R. Prabhala, *Executive Stock Option Repricing, Internal Governance Mechanisms, and Management Turnover*, 69 J. FIN. ECON. 153, 155 (2003) (discussing the reasons for repricing).

¹⁰⁰ There is also evidence that managers abused the timing of the repricing events. See S.R. Callaghan et al., *The Timing of Option Repricing*, 59 J. FIN. 1651 (2004) (finding that the repricing date often precedes good news or follows bad news); D.M. Chance et al., *The "Repricing" of Executive Stock Options*, 57 J. FIN. ECON. 129, 131 (2000) (finding that repricing follows poor firm-specific performance and is more likely to occur in firms with greater agency problems).

¹⁰¹ See S.A. Johnson & Y.S. Tian, *The Value and Incentive Effects of Nontraditional Executive Stock Options Plans*, 57 J. FIN. ECON. 3, 26 (2000) (illustrating that the initial incentive effects of repricable options relative to non-repricable ones are lower incentives to enhance stock prices and enhanced incentives for volatility).

¹⁰² Several researchers have explored this effect. See, e.g., Daniel A. Rogers, *Managerial Risk-Taking Incentives and Executive Stock Option Repricing: A Study of US Casino Executives*, 34 FIN. MGMT. 95 (2005) (showing that in the U.S., casino industry repricing often

mechanism, out-of-the-money options may increase the tendency to add risk to an extreme point. To illustrate, options with an exercise price of \$50 when the share price is \$25 require that the manager yield a return of 100% for the shareholders before she can earn a dime from her options. Such returns are highly unlikely without significantly intensifying risk levels. However, resetting the exercise price down to the market price of \$25 reinstates the original incentive scheme, which induces less risk. Therefore, if there is a strong fear of excessive risk taking when share prices decline drastically, then the ability to reprice options is an important mechanism for averting such risk taking.

Despite this impact on risk taking, however, repricing drew strong fire from both the press and market participants.¹⁰³ The bursting of the dot com bubble and the 2001 market crash were followed by many repricing events and, subsequently, the public outrage that eventually led to the passage of new regulation.¹⁰⁴ In 2003, the New York Stock Exchange and NASDAQ changed their corporate governance listing requirements in an effort to contend with option repricing, making repricing of employee stock options contingent on a shareholder vote of approval, with limited exceptions.¹⁰⁵ The combination of this new requirement and the general animosity of institutional investors towards repricing¹⁰⁶ led to a sharp decline in its use.¹⁰⁷

targeted managers with excessive risk-taking incentives); Stuart C. Gilson & Michael R. Vet-sypens, *Creditor Control in Financially Distressed Firms: The Empirical Evidence*, 72 WASH. U. L. Q. 1005 (1994) (arguing that creditors encourage repricing to discourage managers from risk-shifting behavior).

¹⁰³ See James L. Hauser, *The Stock Option Repricing Dilemma*, 17 J. COMPENSATION & BENEFITS 17 (2001) (discussing the prevalence of stock-option repricing and the market reaction to such events prior to the current regulation that requires a shareholders vote for their approval).

¹⁰⁴ See, e.g., *Re-examining Stock Options as a Way to Compensate Executives*, KNOWLEDGE @ WHARTON (Mar. 12, 2002), <http://knowledge.wharton.upenn.edu/article.cfm?articleid=526> (last visited Apr. 6, 2013) (citing Warren Buffett, Berkshire Hathaway's legendary chairman, who has publicly blasted the stock repricings that were prevalent at the time); Interview by Paul Solman with Peter G. Peterson, Chairman, Blackstone Group (July 12, 2002), *available at* http://www.pbs.org/newshour/bb/business/july-dec02/ceos_7-12.html (criticizing repricing).

¹⁰⁵ See Section 303A.08: *Shareholder Approval of Equity Compensation Plans*, NYSE LISTED COMPANY MANUAL, <http://nysemanual.nyse.com/LCMTTools/PlatformViewer.asp?selectednode=chp%5F1%5F4%5F3%5F10&manual=%2F1cm%2Fsections%2F1cm%2Dsections%2F> (last amended Nov. 25, 2009). ("Shareholders must be given the opportunity to vote on all equity-compensation plans and material revisions thereto, with limited exemptions explained below."). See also Rule 5635(c): *Shareholder Approval*, NASDAQ STOCK MARKET RULES, <http://nasdaq.cchwallstreet.com/NASDAQTools/PlatformViewer.asp?selectednode=chp%5F1%5F1%54%5F2&manual=%2Fnasdaq%2Fmain%2Fnasdaq%2Dequityrules%2F> ("Shareholder approval is required prior to the issuance of securities when a stock option or purchase plan is to be established or materially amended or other equity compensation arrangement made or materially amended . . .").

¹⁰⁶ See ISS PROXY VOTING GUIDELINES SUMMARY 42 (Jan. 27, 2011), *available at* <http://www.issgovernance.com/files/ISS2011USPolicySummaryGuidelines20101216.pdf>.

¹⁰⁷ See David. A. Westenberg et al., *Option Repricing, Version 2009* (Mar. 24, 2009), <http://www.wilmerhale.com/publications/whPubsDetail.aspx?publication=8851> (noting that the shareholders approval requirement, coupled with institutional shareholders' opposition to repricing, has made implementing option repricing more difficult).

Shareholder resentment towards repricing is understandable. After all, shareholders and non-employee option holders do not have the option to “reprice” and regain their losses from declines in share prices.¹⁰⁸ However, one side effect of the regulation impeding repricing is enhanced risk-inducement. In the absence of a significant likelihood of repricing, managers with out-of-the-money options must increase risk, sometimes dramatically, in order to make money from their options. Similar to the regulation preventing backdating and the regulation improving financial disclosure, here, too, an important risk-mitigating response to executive compensation disappeared. Yet again, the new regulation heightened the risk-inducing nature of stock-option compensation.

B. Hidden Pay Practices

Another category of prevalent managerial adaptive tactics that indirectly offset risk-taking incentives is hidden pay practices. As we shall see, hidden pay and benefits flow from the manager’s tenure at the company and are not particularly sensitive to performance. Therefore, in order to secure this type of pay and benefits, managers will tend to reduce the risk that option compensation and performance bonuses would otherwise yield. The larger the fraction of compensation that is untied to performance, the lesser the risk we should expect. At the outset of the twenty-first century, it became clear that U.S. managers reap hefty benefits from hidden pay practices, including pension rewards, executive loans, IPO-spinning, and certain types of self-dealing transactions. Market developments, media coverage, exposure in academic studies, and new regulation (beginning with the Sarbanes-Oxley legislation and ending with the 2006 SEC-enhanced disclosure requirements) all hampered the availability of many of these practices. Indirectly, these constraints on hidden pay practices meant that the proportion of compensation unrelated to performance declined and, hence, risk-taking incentives rose.

Managers have always had an incentive to obscure as much of their compensation as possible; public and investor outrage are good enough reasons for avoiding exposure.¹⁰⁹ However, hidden pay should also be understood as an adaptive response to incentive compensation, and it therefore flourished alongside the ascent of incentive pay. Since institutional share-

¹⁰⁸ Note, however, that at least some of the literature views option repricing favorably. See, e.g., Viral V. Acharya, Kose John & Rangarajan K. Sundaram, *On the Optimality of Resetting Executive Stock Options*, 57 J. FIN. ECON. 65 (2000) (noting that some degree of resetting will always lead to a positive outcome, even when managers have influence over the process).

¹⁰⁹ Bebchuk & Fried, *supra* note 19, at 61 (“Because managers and directors might have to bear market penalties and social costs if they adopt pay arrangements that are perceived as egregious, ‘outrage’ costs and constraints place some limits on deviations from arm’s-length contracting. To avoid outrage, compensation designers attempt to hide, obscure, and justify—in other words to ‘camouflage’—the amount and form of executive pay.”).

holders and other market participants became keen on option compensation, it was important for managers to report a high fraction of incentive pay out of their total compensation.¹¹⁰ With hidden pay that is unrelated to firm performance, managers can report an artificially inflated percentage of option and stock-based compensation. Thus, while simultaneously reporting a high sensitivity of pay-for-performance, executives could reap significant earnings without the burden of improved performance (and, more pertinent to our current discussion, without increasing risk). As will be shown below, following their exposure, many of the hidden pay practices became much less useful to managers, for reported sensitivity of pay-for-performance became more accurate and, ultimately, also incentivized managers to add on risk. As noted earlier, perhaps partially in response to this phenomenon, the fraction of option compensation out of total pay began to decline.¹¹¹ However, this decline may have been either too slow or too late to overcome the increased tendency towards risk, at least for some firms.

The following four subsections highlight certain practices of hidden or obscure pay and benefits to corporate executives. These practices were prevalent for a long period of time but were ultimately constrained at the beginning of the twenty-first century. The rise and fall of these practices, which used to mitigate risk taking, shed light on the distorted incentives that contributed to the 2008–2009 financial crisis.

1. Executive Pensions

Executive pensions are a prominent instance of obscure pay that indirectly mitigates risk taking as well. The benefits ingrained in executive pensions were concealed from the public eye until they attracted considerable attention at the beginning of this century.¹¹² For many years, it had been difficult to discern the huge amounts of executive wealth hidden or “camouflaged” in this type of pay.¹¹³ The annual disclosure of summary compensation tables that included the dollar value of different forms of top executive

¹¹⁰ See, e.g., *id.* at 111 (“Because of the camouflaging . . . not only manager’s total compensation is higher than it appears from the compensation tables but also the fraction of total compensation that is decoupled from performance is larger than an examination of these tables would suggest.”).

¹¹¹ See Part I, *supra*.

¹¹² See, e.g., Bebhuk & Fried, *supra* note 19, at 95–111; Lucian A. Bebchuk & Robert J. Jackson Jr., *Executive Pensions*, 30 J. CORP. L. 823 (2005); Ellen E. Schultz & Theo Francis, *Executives Get Pension Security While Plans for Workers Falter*, WALL ST. J., Apr. 24, 2003, at A1; David Cay Johnston, *Executive Pensions Eclipse Years on the Job*, N.Y. TIMES, Dec. 17, 2002, at C2.

¹¹³ Bebhuk & Fried, *supra* note 19, at 96 (“[F]irms do not have to disclose the value transferred to executives through these channels in the same way that other forms of compensation—such as salary, bonus, and stock options—must be disclosed. Retirement benefits hence offer what might be called ‘stealth compensation.’”). As we shall see immediately below in the text, the current regulation of post-retirement benefits is far tighter and more transparent than it was at that time.

compensation simply did not detail most pension benefits.¹¹⁴ As explained below, executive pensions operated as an extremely potent device for offsetting risk-taking incentives. But with the uncovering and subsequent criticism of the wealth channeled to these pension arrangements, this practice ceased to serve this purpose for managers to the same extent. Once their usage was in decline or was at least expected to decline, pensions could no longer effectively mitigate risk taking. Therefore, an important managerial adaptive response to incentive compensation became partially unavailable, which was then followed by the predictable result of enhanced risk profiles. I begin below with an explanation of the virtues of executive pensions in offsetting risk and show that empirically they do, indeed, function as such. I then explain how managers were able to conceal these benefits for such a long time and reveal the large scope of benefits that remained hidden due to this practice. Finally, I describe how these benefits were exposed in the previous decade, leading ultimately, in 2006, to the SEC's improvement of its disclosure requirements for post-retirement benefits. Placing them in the spotlight meant that pensions could no longer operate as a hidden pay tactic. Given this exposure, the anticipated drop in the funneling of executive pay to pensions in the future reduced the risk-offsetting advantage of this mechanism.

The reason that executive pensions can serve to offset risk-taking incentives is twofold. First, executive pensions are typically pension plans with defined benefits but without defined contributions, unlike what is customary with the pensions of other employees.¹¹⁵ This means that the firm commits to some level of pension benefits for executives regardless of whether the assets it invests for that purpose actually yield the necessary returns.¹¹⁶ Executives thereby effectively become unsecured debt holders of the company for a huge fraction of their personal wealth, which makes them especially vulnerable to corporate insolvency. Thus, managers have a compelling incentive to avoid extreme risk, which—at least in part—offsets the risk-inducing nature of option-based compensation and annual performance bonuses. Second, and perhaps more importantly, irrespective of the vulnerability to corporate insolvency of the amounts accrued to executive pensions,¹¹⁷ pensions still act as a risk-offsetting device. So long as the manager maintains her position at the firm, she can expect future accumulation of pension benefits. These accrued pension benefits are typically keyed to the manager's

¹¹⁴ Bebchuk & Fried, *supra* note 19, at 99–100 (“An important camouflage benefit of SERPs [Supplemental Executive Retirement Plans] is that the annual increase in the present value of an executive’s defined benefit plan—due to pay raises and the addition of another year of service—is largely hidden from view: firms are not required to include this increase in value in the compensation tables . . .”).

¹¹⁵ *Id.* at 98.

¹¹⁶ In practice, many firms do not bother to commit any funds to executive post-retirement plans. *Id.* at 101 (“[F]irms do not bother funding SERP. Executives’ retirement benefits are thus at greater risk of nonpayment than the benefits of ordinary workers . . .”).

¹¹⁷ Some firms shield their executives from insolvency by using one of several techniques, such as outside insurance. *See id.* at 101.

tenure and annual salary, which do not fluctuate significantly with performance.¹¹⁸ The necessity to preserve this future flow of benefits curbs the manager's appetite for risk, since financial difficulties (even without actual insolvency) could result in the manager losing her position at the firm and, therefore, its accompanying future pension benefits. Put differently, the perception of accumulation of future pension benefits prevents managers from rocking the boat.

From an empirical standpoint, studies show that, in practice, lucrative retirement benefits make executives more conservative and risk-averse. For example, one study showed that the disclosure of sizeable retirement benefits leads to an immediate rise in the firm's bond prices, a decline in its share prices, and a decreased volatility in its securities prices.¹¹⁹ These findings reflect the market's appreciation that larger pension benefits act as a constraint on a manager's appetite for risk.

Regardless, a loophole in the SEC executive compensation disclosure requirements allowed managers to obscure the lion's share of their pension benefits. Since 1992, the SEC has required companies to summarize and quantify executive compensation in easy-to-understand summary compensation tables.¹²⁰ Anything falling outside the scope of these tables is rarely exposed to public scrutiny and is unlikely to be covered by the media or included in executive compensation databases and academic research. Executive pension benefits are one such example. Before the SEC set new guidelines a few years ago, most pension benefits were not required to appear in the summary tables.¹²¹ Indeed, most firms did not even quantify these benefits, leaving readers of the annual reports with a formula that was hard to comprehend.¹²² It is therefore little wonder that only at the turn of the twenty-first century did research increasingly delve into executive pensions, particularly their scope.¹²³ In their analyses, researchers criticized the prevalent usage of pensions as a method of compensation. Two prominent authors noted "compensating executives with debt of the firm could neutralize some of the beneficial effects of option grants and lead executives to be too conservative."¹²⁴ Ironically, however, this argument also works in the opposite direction: if managers are overly risk-preferring due to their incentive pay,

¹¹⁸ *Id.* at 99 ("SERP payments—like salary—are therefore largely decoupled from the executive's own performance.").

¹¹⁹ Chenyang (Jason) Wei & David Yermack, *Deferred Compensation, Risk, and Company Value: Investor Reactions to CEO Incentives* (FRBNY Staff Rep., 2011), available at http://papers.ssrn.com/sol3/papers.cfm?abstract_id=1604046. See also Rangarajan K. Sundaram, *Pay Me Later: Inside Debt and Its Role in Managerial Compensation*, 62 J. FIN. 1551 (2007) (showing that CEOs with large retirement benefits manage their firms conservatively).

¹²⁰ Executive Compensation Disclosure, 57 Fed. Reg. 48,126 (Oct. 21, 1992).

¹²¹ Bebchuk & Fried, *supra* note 19, at 100.

¹²² *Id.*

¹²³ See, e.g., Bebchuk & Jackson, *supra* note 112; Schultz & Francis, *supra* note 112; Johnston, *supra* note 112.

¹²⁴ Bebchuk & Jackson, *supra* note 112, at 830.

then large pensions could beneficially restrain them, and any step that curtails the use of pensions as compensation could open up a Pandora's box of risk taking.

The pressure from both academic circles and the media led to the SEC ultimately closing the loophole.¹²⁵ Until that point, managers were able to accumulate pension benefits of an absolutely enormous magnitude without fair disclosure. Among the many well-known examples was the pension of IBM CEO Louis Gerstner, who retired in 2001 after nine years with the guarantee of an annual pension of \$1.14 million.¹²⁶ The fair actuary value of this annuity was approximated at \$18 million, which was more or less equal to the total in salary that he earned during his entire tenure at the firm.¹²⁷ At the time, IBM was not required to include this huge benefit in its compensation tables, nor was it required to quantify it. One can only imagine the influence of this enormous portion of obscure inside debt on the CEO's behavior, particularly its impact on his (lack of) appetite for risk. Another striking example is the 2001 retirement pension of Jack Welch, legendary CEO of General Electric, which amounted to approximately \$10 million annually.¹²⁸ Again, the amassing of this enormous fortune throughout his years of service was never included in the compensation tables, nor did GE ever place a dollar value on it.¹²⁹

One study, which, due to the opacity of executive retirement benefits, had to rely on certain assumptions and estimates, revealed an amazing picture of hidden benefits.¹³⁰ From a sample of CEOs of S&P 500 firms who retired during 2003–2004, the study estimated that the average present value of the pensions granted was no less than \$15 million,¹³¹ almost three times the CEOs' total earnings in salary during their time as CEOs.¹³² As noted, there was absolutely no mention of these pension benefits in the annual summary disclosures of executive compensation, leading to a complete distortion in what was reported as the fraction of incentive-based compensation. For the sample in this particular study, including pension benefits as part of

¹²⁵ For a partial summary of media criticism of executive pensions at the beginning of the twenty-first century, see Bebchuk & Jackson, *supra* note 112, at 825 nn.4–5.

¹²⁶ See Int'l Bus. Machs. Corp., Notice of 2001 Annual Meeting and Proxy Statement (Schedule 14-A) (Mar. 12, 2001).

¹²⁷ Bebchuk & Fried, *supra* note 19, at 100.

¹²⁸ See PAUL HODGSON, GOLDEN PARACHUTES AND CUSHIONED LANDINGS—TERMINATION PAYMENTS & POLICY IN THE S&P 500 13 (2003); see also MACEY, *supra* note 12, at 9 (discussing the post-retirement benefits that were disclosed during Welch's divorce trial).

¹²⁹ Yet another illustrative example is the 2004 retirement package of Franklin Raines, Fannie Mae CEO, which included pension benefits estimated at \$24,000,000. See Lucian A. Bebchuk & Jesse M. Fried, *Executive Compensation at Fannie Mae: A Case Study of Perverse Incentives, Nonperformance Pay, and Camouflage*, 30 J. CORP. L. 807 (2005) (a detailed analysis of Raines' pension and post-retirement benefits).

¹³⁰ Bebchuk & Jackson, *supra* note 112.

¹³¹ *Id.* at 843 tbl.5.

¹³² *Id.* at 845 tbl.6. Moreover, the combined value of these pensions amounted to 44% of the average total compensation reported for them over the course of their entire careers as CEOs. *Id.* at 847 tbl.7.

the reported salary would have increased the reported fraction of salary-type pay out of total compensation from 16.2% to 38.9%.¹³³ Evidently, managers covertly built a huge apparatus that reduced their incentive to add on risk. The reported fraction of incentive pay (including option-based compensation) out of total pay was highly exaggerated.

This risk-disincentive mechanism, however, is no longer available to the same extent. Today, most, if not all, pension benefits are fully quantified and reflected in the summary compensation tables. An amendment to the securities regulations, drafted in 2005 and implemented in 2006, put an end to the possibility of easily camouflaging executive pensions and post-retirement benefits.¹³⁴ Although the new regulation applies only to disclosures from the end of 2006, managers could feel the tension building up around this matter long before, when the academia and press picked up on the subject.¹³⁵ Since the perception of future accumulation of pension is an important risk-offsetting device, the anticipated exposure and, in turn, anticipated decline in the usage of this device impaired its risk-mitigating function. When hidden pay practices are expected to be exposed, they can no longer be trusted by managers and therefore also cease to guide their behavior. Thus, the uncovering of executive pensions combined with the other factors discussed in this Article augment the inherent risk factor of incentive pay.¹³⁶

¹³³ *Id.* at 850 tbl.8.

¹³⁴ The amendment to the regulation came close on the heels of an earlier recommendation made by Jeffery Gordon, which was first articulated in 2004. Jeffrey N. Gordon, *Executive Compensation: If There's A Problem, What's the Remedy? The Case for Compensation Discussion and Analysis*, 30 J. CORP. L. 675, 689 (2005) ("Disclosure should be buttressed by amendment to current SEC rules to better report the 'bottom line' amounts of various sources of compensation, particularly retirement benefits and deferred compensation."). For the amendment itself, see Executive Compensation Disclosure, 71 Fed. Reg. 78,338 (Dec. 29, 2006); Executive Compensation and Related Party Disclosure, 71 Fed. Reg. 6542 (Feb. 8, 2006). For the amendment itself, see Executive Compensation Disclosure, 71 Fed. Reg. 78,338 (Dec. 22, 2006); SEC Release No. 33-8732a, Executive Compensation and Related Person Disclosure (Sept. 8, 2006). See also Executive Compensation Disclosure, 71 Fed. Reg. 53,267 (Sept. 8, 2006); Executive Compensation and Related Party Disclosure, 71 Fed. Reg. 65,421 (proposed Jan. 27, 2006) (to be codified at 17 C.F.R. pt. 228).

¹³⁵ A turning point in the outing of executive pensions in the press was the story of Richard Grasso, Chairman of the NYSE. Although not an executive at a public corporation, Grasso's case brought executive pensions into the limelight, when, on August 27, 2003, it was revealed that he had received a deferred compensation pay package worth almost \$140 million. Ben White, *NYSE Ousts Grasso as Chairman*, WASH. POST, Sept. 18, 2003, at A01. For academic work highlighting executive pensions and the related disclosure failure, see Bebchuk & Fried, *supra* note 19; Bebchuk & Jackson, *supra* note 112.

¹³⁶ Somewhat ironically, we are witnessing today a proliferation of proposals in the academic literature to compensate executives with debt instruments in order to restrain risk taking. See Jeffrey N. Gordon, *Executive Compensation and Corporate Governance in Financial Firms: The Case for Convertible Equity-Based Pay* (Columbia Law & Econ. Working Paper No. 373, 2010), available at <http://ssrn.com/abstract=1633906>; Bebchuk & Spamann, *supra* note 2; Frederick Tung, *Pay for Banker Performance: Structuring Executive Compensation for Risk Regulation*, 105 Nw. U. L. REV. 10 (2010).

2. Executive Loans

The benefits stemming from executive loans are another prominent example of an adaptive device that offsets the forces of incentive pay. Executive loans flourished alongside the rise in incentive pay and then disappeared almost instantaneously when the Sarbanes-Oxley legislation broadly prohibited them in 2002. Accordingly, when executive loans and their attached benefits became unavailable, their ability to repress risk-taking incentives disappeared as well.

Not too long before the passage of the prohibition on executive loans, a substantial fraction of Corporate America had granted hefty loans to top executives. It emerged from one study that at the end of the twentieth century, no less than 30% of the 1500 largest corporations had given loans to their executives.¹³⁷ The average corporation's insider indebtedness stood at \$11 million, with the size of some loans quite astounding.¹³⁸ One good example is the \$62 million loan given to Dennis Kozlowski, the now notorious CEO of Tyco, to cover "relocation costs."¹³⁹

The full extent of the benefits built into these loans is often partially hidden from the public eye. Corporations must publicly disclose such loans and their terms but, as discussed earlier,¹⁴⁰ a benefit is far less salient if it is not quantified and recorded in the summary compensation tables. Aside from their actual dollar value, a significant benefit stemming from executive loans is their lenient terms. In one study, almost all the executive loans examined were either unsecured or partially secured,¹⁴¹ with about 50% interest-free and the rest bearing below-market interest.¹⁴² Disclosure of the benefit in the compensation tables was required only when the interest rate was below "market rate,"¹⁴³ a term vague enough to allow firms to hide much of the benefit.¹⁴⁴ In one infamous example, WorldCom, just prior to its collapse in 2002, did not record any of the interest benefits granted to its CEO, Bernard Ebbers, on the \$165 million he received in cheap loans from the company.¹⁴⁵

¹³⁷ PAUL HODGSON, MY BIG FAT CORPORATE LOAN 1 (2002).

¹³⁸ *Id.*

¹³⁹ L. Dennis Kozlowski, Litigation Release No. 21129, 96 SEC Docket 1082 (July 14, 2009).

¹⁴⁰ See 57 Fed. Reg. 48,126 (Oct. 21, 1992). See text accompanying note 120, *supra*.

¹⁴¹ Bebchuk & Fried, *supra* note 19, at 112.

¹⁴² *Id.* at 115.

¹⁴³ See Executive Compensation Disclosure, Securities Act Release No. 33-6962, 57 Fed. Reg. 48,126 (Oct. 21, 1992); See generally David Leonhardt, *It's Called a "Loan" But It's Far Sweeter*, N.Y. TIMES, Feb. 3, 2002, at C1.

¹⁴⁴ This is in stark contrast to the IRS policy that defines market rates quite clearly for the purpose of quantifying the taxable benefits accruing to employees who receive loans from the firm. See Bebchuk & Fried, *supra* note 19, at 115.

¹⁴⁵ See WorldCom, Proxy Statement (Form DEF 14A) 14 (Apr. 22, 2002) ("[I]n addition to the guaranty arrangements, during 2000 we agreed to loan up to \$100 million to Mr. Ebbers. Since January 1, 2001, we have agreed to loan him up to an additional \$65 million, for a total maximum principal amount of \$165 million. These loans bear interest at floating rates equal to that under certain of our credit facilities . . .").

The fact that their benefits were partially obscured made executive loans a lucrative compensation vehicle for many managers. At the same time, in being detached from firm performance, the prospects of these benefits also served to counterbalance risk-taking incentives, for so long as the manager held her position, she could secure these future benefits. If taking more risk could cause the manager to lose her position or perhaps even lead the firm into bankruptcy, it would also result in her loss of these lucrative benefits. It could be argued, however, that not all executive loans were actually untied to firm performance. In theory, many loans were granted to fund the purchase of firm shares, which, in turn, should have presumably provided incentive to improve firm performance. However, research shows that, in practice, managers overcame these additional incentives by simultaneously selling previously held shares. It was found that, on average, loans granted to purchase shares had actually increased managers' net holdings in their firm by only 8% of the total amount of shares that could have been purchased with the loan.¹⁴⁶ Moreover, executive loans were often forgiven by companies, pointing to yet another huge benefit managers reaped from this arrangement. As one study showed, during the period of 1996 to 2000, 12.6% of executive loans were forgiven and, in an additional 10.2% of the cases, the accrued interest was forgiven.¹⁴⁷

But in 2002 the party ended almost instantly and with almost no prior warning, when a straightforward prohibition on executive loans was included as part of the Sarbanes-Oxley legislation. Thus, a major source of profit that was only partially disclosed to the public and mostly decoupled from performance simply disappeared.¹⁴⁸ Similar to the other developments discussed in this Article, the elimination of this adaptive device invigorated the force of options and other types of incentive pay in fostering risk taking on the part of managers.¹⁴⁹ Moreover, the risk-incentives for managers were further bolstered by the structure of the new regulation. Section 402 of the Sarbanes-Oxley Act included a grandfather clause that exempted existing loans from the prohibition.¹⁵⁰ In a sense, this arrangement only intensified

¹⁴⁶ Kathleen M. Kahle & Kuldeep Shastri, *Executive Loans*, 39 J. FIN. & QUANTITATIVE ANALYSIS 791, 810 (2004) ("A loan that enables a manager to buy 100 shares of stock results in only an eight-share increase in ownership.").

¹⁴⁷ *Id.* at 798.

¹⁴⁸ This was the outcome of section 402 of the Sarbanes-Oxley legislation, which added section 13(k) to the Exchange Act of 1934. Sarbanes-Oxley Act of 2002, Pub. L. No. 107-204, § 402(a), 116 Stat. 745, 787 (codified at 15 U.S.C. § 78m(k) (2006)) (prohibiting personal loans to executives).

¹⁴⁹ The new prohibition on executive loans also brought to an end the practice of granting managers so-called "split-dollar" life insurance policies. This was a practice that, similar to other types of executive loans, had a mitigating effect on risk taking. Under a split-dollar life insurance arrangement, the firm paid the premium on the manager's life insurance policy. These premium payments were considered a loan to the manager, to be repaid only when she collected her insurance payout. See Bebchuk & Fried, *supra* note 19, at 131-32.

¹⁵⁰ Sarbanes-Oxley Act of 2002, Pub. L. No. 107-204, § 402(a), 116 Stat. 787 (codified at 15 U.S.C. § 78m(k)) ("An extension of credit maintained by the issuer on the date of enactment of this subsection shall not be subject to the provisions of this subsection, provided that

the tendency of managers to add on risk, for they could no longer hope for new loans with benefits stemming from their stint and unlinked to firm performance. However, there were huge loans to be repaid, and since executive incentive compensation usually includes equity, managers were driven to increase their company's risk profile to obtain large gains on their equity holdings. Just as with any other type of leverage, the creditor—in this case, the company—bore much of the cost of this additional risk, whereas the gains accrued mostly to the managers.

3. *IPO Spinning and Benefits Derived from Third Parties*

Up to this point, our discussion has concentrated on the benefits managers derive from their own firms. When such benefits are insensitive to firm performance, they reduce managers' incentive to add on risk, since the materialization of the risk may interfere with the flow of their benefits. The firm, however, may not be the only source of benefits and payments to managers. Third parties can apparently also be a significant source of considerable wealth to managers by virtue of their positions as firm executives. Since these particular benefits are also generally unlinked to performance, managers are required only to hold on to their positions in order to guarantee the benefits from the third parties. Thus, these benefits perform the same familiar function of mitigating risk taking as do pensions and executive loans, negating the risk-inducing forces of incentive compensation since risk taking could impede the flow of the benefits.

Managers' benefits from third parties reached the public spotlight and were eventually denounced by the media with the revelation of the phenomenon dubbed "IPO spinning." Spinning is the derogatory term for firms' improper practice of allocating shares of "hot" initial public offerings to executives at other firms in order to draw the business of the latter's firm.¹⁵¹ The most prestigious investment banking firms and many high-profile corporations were at one time heavily engaged in this practice. And although this practice was arguably legal until 2003, the media presented it as nothing less than pure bribery.¹⁵² In perhaps the most famous instance of spinning, allegations were made that eBay executives had been offered by Goldman

there is no material modification to any term of any such extension of credit or any renewal of any such extension of credit on or after that date of enactment."); see also William Baue, *Sarbanes-Oxley Fails to Kill Corporate Insider Loans, Some of Which Pay Posthumously*, SOCIAL FUNDS (Jan. 21, 2004), <http://www.socialfunds.com/news/article.cgi/1319.html>.

¹⁵¹ See, e.g., Sean J. Griffith, *Spinning and Underpricing: A Legal and Economic Analysis of the Preferential Allocation of Shares in Initial Public Offerings*, 69 BROOK. L. REV. 583 (2004) (discussing spinning and the incentives of the different actors in the scheme); Therese H. Maynard, *Spinning in a Hot IPO: A Matter of Business Ethics* (2002) (Loyola-LA Public Law Research Paper No. 22, 2002), available at http://papers.ssrn.com/sol3/papers.cfm?abstract_id=337300 (exemplifying and analyzing the spinning phenomenon).

¹⁵² See, e.g., James Surowiecki, *The Bribe Effect*, NEW YORKER, Oct. 7, 2002 at 46 (citing Massachusetts Secretary of State William Galvin: "The problem with I.P.O. spinning is that it's bribery.") (quoting Massachusetts Secretary of State William Galvin).

Sachs shares in numerous promising startups represented by Goldman and then subsequently sold the shares—in some cases, within a matter of hours after the initial public offering—at substantial profit.¹⁵³ A critical point was that Goldman had served as lead underwriter for eBay in its 1998 IPO and 1999 secondary offering, as well as serving as eBay's financial advisor in its 2001 PayPal acquisition.¹⁵⁴ While no clear causal connection can be drawn between the events, an impression of harsh wrongdoing nevertheless emerged. Eventually, an eBay shareholders suit, alleging usurpation of a corporate opportunity, was settled, with eBay's three top executives compensating shareholders by paying more than \$3 million to the firm.¹⁵⁵ Another case that drew considerable public attention involved Salomon Smith Barney and Bernie Ebbers, then-CEO of WorldCom. In 1997, Salomon (then Salomon Brothers) offered Ebbers the opportunity to buy more than 200,000 shares in the IPO of Qwest, a sure bet at the time.¹⁵⁶ Ebbers bought the shares, which went up 27% on the first day of trading alone, and within three days, he started selling the shares, ultimately making a two-million-dollar profit. Concurrently, between 1996 and 2001, Salomon helped Ebbers make \$11 million in profits by flipping IPO shares.¹⁵⁷ Moreover and significantly, during the same period, WorldCom paid Salomon \$140 million in underwriting fees and an additional \$76 million in M&A consulting fees.¹⁵⁸

These instances of spinning, which were practically unknown to the market prior to 2003, were far from isolated occurrences.¹⁵⁹ The illicit practice of IPO spinning became a major thread in a much broader investigation directed against Wall Street investment bankers for their aggressive tactics. This high-profile investigation led to the famous 2003 “global settlement” that followed enforcement actions against ten of the nation's top investment banks.¹⁶⁰ The SEC, NYSE, NASD, and other regulators headed the investigation and settlement, with the outcome of an unprecedented payment of \$875

¹⁵³ See, e.g., Andrew McIntosh, *Whitman's IPO Stock Deals Have Critics Raising Ethics Issues*, SACRAMENTO BEE, May 24, 2009, at 23A, available at <http://www.sacbee.com/politics/story/1887681.html> (reporting on the eBay spinning event).

¹⁵⁴ *Id.*

¹⁵⁵ *In re eBay, Inc. S'holders Litig.*, 2004 WL 253521 (Del. Ch. 2004). In 2003, in a similar settlement, the former Qwest executives paid more than \$4.4 million following spinning allegations. Randall Smith & Dennis K. Berman, *Anschutz Settles IPO "Spinning" Case with Donation Pact*, WALL ST. J., May 14, 2003, at C1; *Qwest Executive Agrees to Pay Millions in Settlement*, ACCT. WEB (last visited Mar 30, 2013), <http://www.accountingweb.com/item/97566>.

¹⁵⁶ See Surowiecki, *supra* note 152.

¹⁵⁷ *Id.*

¹⁵⁸ *Id.*

¹⁵⁹ See, e.g., Xiaoding Liu & Jay R. Ritter, *The Economic Consequences of IPO Spinning*, 23 REV. FIN. STUD. 2024 (2010), available at <http://rfs.oxfordjournals.org/content/23/5/2024.abstract> (empirically assessing the consequences of fifty-six cases of spinning).

¹⁶⁰ See Joint Press Release, U.S. Sec. & Exch. Comm'n, N.Y. Att'y Gen., North Am. Sec. Admin. Ass'n, Nat'l Ass'n Sec. Dealers & N.Y. Stock Exch., For Immediate Release 2003-54, Ten of Nation's Top Investment Firms Settle Enforcement Actions Involving Conflicts of Interest Between Research and Investment Banking (Apr. 28, 2003), available at <http://www.sec.gov/news/press/2003-54.htm>.

million in fines and disgorgement of profits by these firms.¹⁶¹ Among other things, all ten firms committed to ending the spinning practice in order to “promote fairness in the allocation of IPO shares and prevent firms from using these shares to attract investment banking business.”¹⁶²

To be sure, these detrimental practices deserve condemnation, but their mitigating effect on risk taking must not be overlooked either. When managers derive benefits from their position at the firm, whether from an internal or external source, they must manage the firm conservatively to assure the flow of those benefits. The sweeping public revelation of third-party benefits garnered by managers along with the swift regulatory and shareholder action that was taken to restrict them changed the equation dramatically. Spinning aside, since 2003, managers need to be far more sensitive to public outrage over executive benefits deriving from a firm’s service-provider or supplier. They can expect much less tolerance of such practices. Out-and-out bribery has always been denounced, whereas the question of the legitimacy of benefits like spinning was somewhat cloudier. This was no longer the case following 2003, when they ceased to be regarded as acceptable. And as in the case of the other developments discussed in this Article, making these benefits unavailable to managers further bolstered the risk-taking incentives built into stock options and annual bonuses. Simply put, managers had less to lose by putting their firms in the danger zone.

4. *Improved Transparency*

Most types of non-transparent pay are decoupled from firm performance. This is no coincidence. These practices, as this Article suggests, are actually adaptive responses to incentive pay, designed to enrich managers without any need to enhance firm performance or risk levels. Improving transparency, however, discourages the use of hidden pay practices and thereby reignites the risk-promoting potential of incentive pay. The SEC’s disclosure regulation of executive pensions discussed earlier was but one example of the effect of improving transparency. However, in the twenty-first century, managers would have soon learnt that transparency of executive pay and benefits was about to increase far beyond the limited context of post-retirement benefits.

Our discussion in this Part of the Article thus far has presented a few types of executive benefits, which were by and large detached from firm performance. These benefits and their anticipated flow therefore served to restrain executive risk taking. A common feature of these benefits was the fact that they were, to a large extent, obscured from public scrutiny. The benefits built into pensions, executive loans, and spinning were all fairly

¹⁶¹ This includes \$487.5 million in penalties and \$387.5 million in disgorgement of profits for illicit practices that included spinning. *Id.*

¹⁶² *Id.*

illusive and covert. This was an important aspect of these benefits, since at the time, the market lauded pay-for-performance. Hidden benefits are not included in firms' summary compensation tables (and spinning, moreover, was never even noted in disclosure reports) and, thus, avoid any criticism for being salary-like benefits that are not tied to performance. Put differently, hiding the benefits we discussed above enabled managers to disclose an artificially elevated fraction of executive pay that was supposedly tied to firm performance. The implication is that a lax disclosure environment will promote the usage of pay types that are unrelated to performance without exposing them as such, which then offsets risk-taking incentives.

Each of the types of pay and benefits discussed above were ultimately addressed by a specific regulatory measure, but it is also important to note the general regulatory response to the phenomenon of hidden pay as a whole. The uncovering of the different practices eventually led regulators to impose requirements limiting the scope of any hidden or opaque pay mechanisms. This new regulation included measures aimed especially at exposing hidden spots in corporate pay practices. Moreover, it became far harder to give managers any type of compensation, other than salaries, that is decoupled from performance. Indirectly, this also meant that incentive pay became much more effective. And pushing managers harder ultimately leads to increased risk profiles.

The regulation broadening the disclosure requirements for executive pay and benefits came into effect only in 2006.¹⁶³ This was the first substantial revamp of managerial compensation disclosure since the SEC's major regulatory revision of pay disclosure in 1992. At the heart of the expanded regulation was the requirement for a "Compensation Discussion and Analysis" (CD&A) section in firms' proxy statements.¹⁶⁴ This section details extensively the material factors underlying the firm's compensation policies, including the objectives of the compensation program, why each element of pay was specifically opted for, and how each element is consistent with the overall objectives of the remuneration scheme. The CD&A must also address issues of timing and pricing of stock options,¹⁶⁵ which connects to our earlier discussion of managers' ability to time their grants.¹⁶⁶ The new regulation also instituted expanded disclosure of related party transactions,¹⁶⁷ improved the transparency of the compensation tables (including a requirement for an annual "all in" compensation number, which provides the current

¹⁶³ See Executive Compensation and Related Person Disclosure Exchange Act Release No. 34-54302A, 71 Fed. Reg. 53,158, 53,197-53,210 (Sept. 8, 2006).

¹⁶⁴ *Id.* at 53,164-69.

¹⁶⁵ *Id.* at 53,162-64.

¹⁶⁶ See the previous discussion of backdating, spring loading, and bullet-dodging at *supra* Part II.A.1.

¹⁶⁷ See Executive Compensation and Related Person Disclosure Exchange Act Release No. 34-54302A, 71 Fed. Reg. 53,158, 53,197-53,210 (Sept. 8, 2006).

value of all forms of compensation),¹⁶⁸ and closed such loopholes as the non-disclosure of pension benefits.¹⁶⁹

This tighter disclosure environment has made it much harder for managers to obtain hidden and obscure pay. And if, indeed, this type of pay functions as an offsetting response to incentive pay, then the outcome of the regulation must be enhanced risk taking by managers. Furthermore, although the regulation itself was passed only in 2006, managers could feel its heat a few years beforehand. The exposure in academic studies, followed by public outrage about hidden managerial benefits such as executive loans, pensions, spinning, spring loading, and backdating created an atmosphere that fostered the drafting of the tighter disclosure regulation.¹⁷⁰ In fact, the 2006 regulation and, particularly, the CD&A requirement came close on the heels of an academic proposal that was released in 2004.¹⁷¹

Managers, therefore, must have already sensed the tension mounting in the years leading up to the new regulation. The anticipation of enhanced disclosure requirements should have led them to foresee that they would face diminished availability of hidden and obscure pay in the future. Given this expectation of less hidden pay, managers had less reason to restrain the risk taking that incentive pay fosters. Simply put, they had less to lose. Thus, both the regulation and its very anticipation bolstered the forces of option compensation, annual bonuses, and the like. Given that the 2008–09 crisis was in some way related to unbalanced risk, the discussion above uncovers yet another reason for this unfortunate situation.

LESSONS FOR THE FUTURE AND CONCLUDING REMARKS

At the beginning of the twenty-first century, a major market failure led to the commonly-held belief that “[a]ll in all, the more logical inference to draw from the ‘accounting irregularity’ scandals of 2001 and 2002 is that erosion occurred during the 1990s in the quality of financial reporting.”¹⁷² Market deviations allowed managers to reap huge gains at great cost to society, until harsh regulation addressed what was regarded as an intolerable situation.

This Article explains that tax accounting and other irregularities such as backdating, spinning, and stealth compensation were all part of a complex reaction to the prevalent trends in executive compensation. It is clear how

¹⁶⁸ *Id.* at 53,170–71 (“Total Compensation Column”).

¹⁶⁹ *Id.* at 53,185–87.

¹⁷⁰ See the previous discussions of these mechanisms at *infra supra* Parts I.A.1, II.B.1–3.

¹⁷¹ Gordon, *supra* note 134, at 677 (“I argue that the SEC should require proxy disclosure of a ‘Compensation Discussion and Analysis’ statement (CD&A) signed by the members of the compensation committee This process of ‘ownership,’ reputation-staking, and publicity will strengthen the compensation committee . . . and will elicit both shareholder and public responses that become part of the social construction of value that is necessarily part of the compensation bargain.”).

¹⁷² Coffee, *supra* note 51, at 282.

these practices inflated managers' remuneration, but it is also important to grasp their impact on incentives to enhance risk. All things equal, managers prefer hefty guaranteed pay packages that do not require that they bear excessive risk. Annual performance bonuses and stock options, however, run counter to managers' natural tendencies and stoke their appetite for risk. The adaptive responses discussed in this Article allowed managers to enjoy the best of both worlds. Their pay packages were inflated, but at the same time, they did not have to take on much risk in order to reap considerable personal profit. And while the market was hailing the rising levels of incentive compensation, managers were working hard to diffuse its impact by devising further adaptive responses.

In the wake of the Enron crisis, many of these adaptive responses were harnessed or became completely unavailable due to the ensuing regulatory measures. The 2002 Sarbanes-Oxley Act concentrated on improved disclosure but failed to restrict risk taking. Consequently, the risk-inducing nature of the prevalent incentive pay schemes was unleashed as managers reacted accordingly. Evidently, the financial sector, in which there is significant leeway to quickly increase risk profiles, led the way with immense risks taken by managers. These risks were so extreme that they almost caused a full-blown meltdown of the entire U.S. economy. Before the crisis emerged, however, the gradual decline in the popularity of stock-option compensation could have been indication that the market had started to adapt to the new reality of intensified risk-inducement. Yet, at least in the financial sector, this change in pay practices came far too late.

Only after the 2008 crisis did the regulator directly tackle the problem of distorted risk-taking incentives.¹⁷³ This was quickly followed by federal legislation with the 2010 Dodd-Frank Act, the major financial legislation to be drafted in the wake of the crisis. The Act sets potent limitations on both the structure of incentive pay (which indirectly impact risk taking) as well as directly on the risk profile of systemically important financial firms. Prominent amongst these restrictive mechanisms is the "Say-on-Pay" procedure, which allows shareholders to voice their opinions on pay practices, and the "Volker Rule," which prevents banks from engaging in a large variety of risky activities.¹⁷⁴ From the perspective of this Article, these measures were

¹⁷³ The regulator understood and reacted to these unleashed powers only in the wake of the financial crisis. See SEC Proxy Disclosure Enhancement, Securities Act Release No. 33-9089, 74 Fed. Reg. 68,334 (Dec. 23, 2009) ("[T]o the extent that risks arising from a company's compensation policies and practices for employees are reasonably likely to have a material adverse effect on the company, discussion of the company's compensation policies or practices as they relate to risk management and risk-taking incentives that can affect the company's risk and management of that risk.").

¹⁷⁴ Dodd-Frank Wall Street Reform and Consumer Protection Act, Pub. L. No. 111-203, § 951, 124 Stat. 1376 (2010) ("shareholder vote on executive compensation disclosures") (adding new 14A to the Securities Exchange Act of 1934 (15 U.S.C. 78a et seq.); *Id.* § 619 ("Prohibitions on proprietary trading and certain relationships with hedge funds and private equity funds") (adding new §§ 13 and 13a to the Bank Holding Company Act of 1956 (12 U.S.C. § 1841 et seq.)).

belated complements to those implemented in 2002 to restrain manipulation, and it is no coincidence that they became so vital. The lesson to be learned, then, is that any steps taken to improve transparency and prevent manipulation must be accompanied by additional measures for averting immoderate risk taking.

Another, broader conclusion to be drawn from this discussion is that the regulator must acknowledge that plugging one hole in a complex system may cause another leak to spring elsewhere. Part of the problem can be solved if the market is prepared for the new regulatory environment in advance and allowed to adapt to the change. Emergency regulation that surprises the market in timing and scope is especially likely to cause unexpected harm by tilting the market. Gradual and suspended regulation may be a far better option. The drafters of the Dodd-Frank Act seem to have understood this.¹⁷⁵ As noted, a central part of the legislation was the Volcker Rule,¹⁷⁶ which generally bans U.S. banks from trading with their own capital and running hedge funds. This clearly represents a major transformation to U.S. financial regulation.¹⁷⁷ This legislation did not have immediate effect, however, providing for a gradual and suspended arrangement. The ban on new activities is to become effective only in 2012, two years after the passage of the legislation, and existing operations must cease in 2014, with a possible extension until 2017 and, in some cases, until 2022.¹⁷⁸ Thus, whatever the unexpected consequences of this regulation are to be, the market has at least been given plenty of time to adapt to the changes. That being said, these new layers of regulation could no doubt be setting the groundwork for a new, difficult-to-foresee challenge: Managers versus Regulators, Round III, perhaps?

¹⁷⁵ See generally *id.* (referring to entire act).

¹⁷⁶ *Id.* § 619 (“Prohibitions on proprietary trading and certain relationships with hedge funds and private equity funds”) (adding new §§ 13 and 13a to the Bank Holding Company Act of 1956 (12 U.S.C. 1841 et seq.)).

¹⁷⁷ For an explanation of the Volcker Rule, see John Cassidy, *The Volcker Rule—Obama’s Economic Adviser and His Battles over the Financial Reform Bill*, NEW YORKER, July 26, 2010, at 25.

¹⁷⁸ See Dodd-Frank Act § 619 (*amending* Bank Holding Company Act of 1956 § 13(c)).

