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EXECUTIVE PAY LESSONS FROM PRIVATE EQUITY

DAVID I. WALKER*

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INTRODUCTION

Questions about the pay of public company executives – and, specifically, the structure of that pay – continue to dominate discussions regarding U.S. corporate governance. These concerns have been amplified by the recent financial meltdown. Some commentators suggest that the aggressive structure of executive pay packages – the heavy reliance on stock options – may have led to excessive risk taking at financial institutions that contributed to the collapse.¹ Others have argued that incentive compensation has become a fetish in corporate America and that the heavy reliance on performance-based pay is

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¹ See Lucian A. Bebchuk & Holger Spamann, *Regulating Bankers' Pay*, 98 GEO. L.J. 247, 249 (2010); see also Sanjai Bhagat & Roberta Romano, *Reforming Executive Compensation: Focusing and Committing to the Long-Term*, 26 YALE J. ON REG. 359, 360-61 (2009) (arguing for more conservative pay structures that would reduce excess risk taking at financial institutions and non-financial public companies).

no longer justified.² More generally, Professor Frankel argues that public company executives are paid more like owners than fiduciaries, but unlike most owners, corporate executives enjoy too much upside reward for the downside risk that is imposed upon them.³

This Essay considers what pay practices at a certain class of private companies – portfolio companies held by private equity funds – can tell us about these questions and about the state of public company executive pay in general. Private equity portfolio companies (or simply “portfolio companies”) provide a useful benchmark for several reasons. First, portfolio companies generally are similar to large public companies in size and scope. In fact, many portfolio companies were public companies, or divisions of public companies, prior to their acquisition by a private equity fund, and portfolio companies often become public companies after several years of private ownership.⁴ Moreover, the roles and responsibilities of executives in the two contexts are quite similar.

Of course, there are important differences between the two spheres, but these differences make the comparison all the more interesting. Portfolio companies have a controlling shareholder or group of shareholders that provide a degree of monitoring that is generally lacking in U.S. public companies.⁵ The boards of portfolio companies look quite different than public company boards. The CEO of a portfolio company rarely serves as board chairman and sometimes is not on the board at all.⁶ The directors of these companies are the private equity investors and individuals picked by these investors who have expertise in the company’s business.⁷ For all of these reasons, portfolio companies are frequently held out as models of good corporate governance, and executive pay arrangements at these companies are thought to be the product of bargaining at arm’s length.⁸

² Gregg D. Polsky & Andrew C.W. Lund, *The Diminishing Returns of Incentive Pay in Executive Compensation Contracts* 52-53 (2010) (unpublished manuscript) (on file with author) (focusing exclusively on compensation for CEOs and the most senior executives).

³ See TAMAR FRANKEL, *FIDUCIARY LAW* 139-40 (2011).

⁴ See, e.g., Philip Leslie & Paul Oyer, *Managerial Incentives and Value Creation: Evidence from Private Equity* 8 (November 2009) (unpublished manuscript), available at <http://www.stanford.edu/~pleslie/private%20equity.pdf> (finding that of the 144 portfolio companies sampled, 62 had previously been a division of a larger company, 47 had been privately held companies not owned by private equity investors, 16 had been held by another private equity investor, and 19 had been stand-alone public companies). Of course, there may be systematic differences between the pool of public companies or divisions that tend to be taken private and the pool of public companies/divisions generally.

⁵ See Ronald W. Masulis & Randall S. Thomas, *Does Private Equity Create Wealth? The Effects of Private Equity and Derivatives on Corporate Governance*, 76 U. CHI. L. REV. 219, 228 (2009).

⁶ See *id.* at 223-24.

⁷ See *id.* at 253.

⁸ See *id.* at 251-52. There are other more prosaic, but potentially important, differences

This Essay is prompted by two recent studies that compared CEO pay arrangements at private equity portfolio companies and public companies.⁹ The findings of these studies are noteworthy in several respects.

First, the studies provide no evidence of a statistically significant difference in the amount of CEO pay in the two spheres once controls were introduced for firm size, pay risk, and other relevant factors.¹⁰ Since portfolio company pay arrangements seem to be the result of an arm's length bargain, this finding might suggest that worries regarding excessive public company CEO pay are overblown. However, this Essay suggests several reasons to refrain from jumping to that conclusion, including the possibility that competition for executives between these two markets dictates a rough equilibrium.

Second, although equity-based pay has come to dominate public company executive compensation over the last twenty years, these studies found that public company CEO equity incentives continue to lag those seen at comparable portfolio companies.¹¹ By private equity portfolio company standards, at least, recent public company executive compensation practices do not over-emphasize equity.

Third, data from these studies indicate that stock options contributed more greatly to CEO incentives at the public companies sampled than at the comparable groups of private equity portfolio companies.¹² This observation might be seen as confirming fears that public company executive pay structures encouraged excessive risk-taking, but this Essay argues that the difference in reliance on options also is consistent with differences in the capital structure of these two types of companies, and possibly with differences in executive risk preferences, monitoring, and company objectives.

These studies provide important insights into executive pay. Unfortunately, the similarities and differences highlighted by these studies are open to conflicting interpretations. Moreover, while these two studies represent the latest word on public and private executive pay, to some extent they are already out of date. The public company executive pay world has changed in the few years since the data for these studies were collected. Specifically, public company executive pay has shifted from a heavy emphasis on options in the 1990s and early 2000s to a greater emphasis on stock today.¹³ Thus, even

between portfolio companies and public companies that may affect managerial incentives and incentive compensation. Portfolio company executives are relieved of the burden of meeting analyst earning expectations, at least in the short term, and complying with public company regulatory requirements, such as those imposed by the Sarbanes-Oxley Act or the Dodd-Frank Act. *See id.* at 230-32.

⁹ *See* Robert J. Jackson, Jr., Private Equity and Executive Compensation (July 12, 2009) (unpublished manuscript) (on file with author); Leslie & Oyer, *supra* note 4.

¹⁰ *See infra* Part III.A.

¹¹ *See infra* text accompanying note 51.

¹² *See infra* Part III.C.

¹³ *See infra* text accompanying note 84.

if the data support the view that public company pay practices encouraged excessive risk taking, a snapshot taken today of the mix of stock and options held by CEOs of public companies would look quite different.

This Essay is organized as follows. Part I very briefly outlines concerns with the structure of public company executive pay that have been brought to the fore by the recent financial crisis. Part II provides an equally abbreviated introduction to the world of private equity. Part III is the heart of the Essay; it presents and analyzes the relevant data from the two recent studies on public and private CEO pay. Part IV considers the on-going evolution in public company executive pay practices and how those changes should impact our assessment.

I. WHAT'S WRONG WITH THE STRUCTURE OF PUBLIC COMPANY EXECUTIVE PAY?

There is a vast literature analyzing and critiquing executive compensation from a theoretical and an empirical perspective.¹⁴ This Essay will not engage that literature in any comprehensive fashion. Instead, it will simply touch on recent work raising concerns regarding the structure or composition of executive pay. The emphasis here, in other words, is not on whether executives are paid too much, but whether they are paid in ways that are inefficient or counterproductive. This approach is consistent with this Symposium's underlying focus on fiduciary relationships. The question of whether executives are paid like fiduciaries ultimately is not a question of how much executives are paid, but of how they are paid.

As is well known, over the last quarter century there has been a fundamental change in how public company executives are paid. In the early to mid-1980s, cash salary and bonuses dominated executive pay. Analyzing data from the mid-1970s to the mid-1980s, Professors Michael Jensen and Kevin Murphy famously calculated that the average CEO experienced a change in wealth of only \$3.25 for every \$1000 change in shareholder value, and they forcefully argued that the link between pay and performance was inadequate.¹⁵ The charge was that CEOs were being paid like bureaucrats.

No one would argue that today's public company executives are paid like bureaucrats. Even in the midst of a continuing financial and stock market malaise, well over half of the value of executive compensation received by senior executives of S&P 500 companies consists of equity.¹⁶ In fact, recent

¹⁴ See, e.g., Lucian Arye Bebchuk et al., *Managerial Power and Rent Extraction in the Design of Executive Compensation*, 69 U. CHI. L. REV. 751 (2002); Kevin J. Murphy, *Executive Compensation*, in 3 HANDBOOK OF LABOR ECONOMICS 2485 (Orley C. Ashenfelter & David Card eds., 1999).

¹⁵ See Michael C. Jensen & Kevin J. Murphy, *Performance Pay and Top-Management Incentives*, 98 J. POL. ECON. 225 (1990).

¹⁶ See David I. Walker, *Evolving Executive Equity Compensation and the Limits of Optimal Contracting*, 64 VAND. L. REV. 611, 633 fig. 3 (2011). The data focuses on a panel

empirical and theoretical work suggests that the emphasis on pay for performance at some public companies may have reached the point of being counter-productive. In a study of executive pay at a sample of large public companies between 1992 and 2004, Professors Ivan Brick, Oded Palmon, and John Wald show that higher “pay-performance sensitivity,” i.e., more stock and option pay, is associated with poorer stock price performance.¹⁷ The authors attribute some of this effect to executive risk aversion induced by their large holdings of equity.¹⁸

In a related vein, Professors Gregg Polsky and Andrew Lund have recently argued that performance-based pay has outlived its usefulness.¹⁹ They argue that performance-based pay is largely redundant given a more robust executive labor market and thus may no longer be worth the cost.²⁰

The recent financial crisis has highlighted a different set of concerns related to the structure of executive pay. While Brick, Palmon, and Wald conjecture that large equity stakes have led executives to shun risky projects, thus depressing returns, others have argued that at financial institutions option-heavy pay arrangements led executives to take on too much risk, which may have precipitated or contributed to the crisis.²¹ Some argue that these hyper-aggressive pay structures may have resulted, in part, from an excessive focus on aligning executive interests with those of shareholders to the detriment of creditors, including in this case U.S. taxpayers.²² Accordingly, some have called for revising pay packages at financial institutions to align executive incentives with creditors as well as shareholders.²³

Of course, financial institutions are different than other firms. As a result of the unique capital structure of these institutions and the explicit and implicit government guarantees of deposits and other obligations, bad outcomes from risk taking are externalized to a significant degree. But concerns regarding excessive risk taking by executives are not limited to financial institutions.

of executives drawn from 350 companies in the S&P 500 to avoid variability in S&P 500 membership and reflects the expected value of all compensation elements as of the date on which the compensation is granted. *Id.* at text accompanying note 64.

¹⁷ See Ivan E. Brick et al., Too Much Pay-Performance Sensitivity? 28 (May 21, 2010) (unpublished manuscript), available at <http://ssrn.com/abstract=1108522>.

¹⁸ See *id.*

¹⁹ See Polsky & Lund, *supra* note 2, at 52-53.

²⁰ *Id.* at 4. Equity compensation is costly because undiversified executives must be compensated for taking on the risk associated with stock and option pay. See *id.* at 35-36.

²¹ See Bebchuk & Spamann, *supra* note 1, at 249.

²² See *id.* at 251, 273-74.

²³ See *id.* at 283-85; Frederick Tung & Xue Wang, *Bank CEOs, Inside Debt Compensation, and the Global Financial Crisis* 11, 31 (Emory Pub. Law Research Paper No. 10-98; 5th Annual Conference on Empirical Legal Studies Paper, Emory Law and Econ. Research Paper No. 10-63, June 2010), available at <http://ssrn.com/abstract=1570161> (providing a preliminary examination of the effect of bank CEOs' inside debt holdings on bank performance).

Some have argued that heavy use of stock options may have led to excessively risky short term behavior by non-financial executives seeking to maximize stock price volatility and option payoffs.²⁴ Nonetheless, concerns with compensation design leading to excessive risk taking are most pressing in the financial sector.

In sum, the recent financial crisis has heightened the focus on how public company executives are paid. It is not clear whether pay packages induce too much or too little risk taking, and the answer to that question may vary based on industry (e.g., financial versus non-financial firms) and other factors, but most observers seem to have been persuaded that it matters how executives are paid. If the structure of executive pay matters, examining how private equity portfolio company executives are paid may prove instructive.

II. PRIVATE EQUITY FUND PRACTICE

Private equity funds and their portfolio companies may be less familiar to readers than their public company counterparts. This Part provides a brief overview.

Private equity funds are pooled investment vehicles that combine the business selection and management expertise of fund managers such as Blackstone, Carlyle, and KKR with passive investments by pension funds, universities, and a few very high wealth individuals.²⁵ The funds have a well defined life cycle. Over the course of ten to fifteen years, a fund manager secures equity commitments, combines this equity with large amounts of secured and unsecured debt to acquire portfolio companies, enhances the values of the portfolio companies by improving operations or redirecting the business, and realizes gains through sale. The fund managers, who generally invest little initial capital, typically receive twenty percent of fund profits plus a management fee equal to two percent of amounts invested.²⁶

To be clear, this Essay does not seek to compare public company executive pay arrangements with this now (in)famous “two and twenty” fund manager compensation.²⁷ It is the compensation of the executives of the portfolio

²⁴ See Bhagat & Romano, *supra* note 1, at 362-63.

²⁵ For a concise background, see Steven N. Kaplan & Per Strömberg, *Leveraged Buyouts and Private Equity*, 23 J. ECON. PERS. 121, 123-24 (2009); Masulis & Thomas, *supra* note 5, at 222.

²⁶ The economic significance of the private equity form of ownership has varied over time. In 1989, Professor Michael Jensen argued that private equity would eclipse public shareholder ownership as the dominant business model for large corporate enterprises in the United States. See Michael C. Jensen, *Eclipse of the Public Corporation*, HARV. BUS. REV., Sept.-Oct. 1989, at 61. That has not occurred. Instead, we have seen several private equity waves in which the significance of private equity ownership has peaked and ebbed. See Kaplan & Strömberg, *supra* note 25, at 122, 124.

²⁷ See, e.g., Victor Fleischer, *Two and Twenty: Taxing Partnership Profits in Private Equity Funds*, 83 N.Y.U. L. REV. 1, 1 (2008) (defining “two and twenty” as a “two percent

companies held by the private equity funds that is analogous to public company executive pay.

Private equity funds acquire these portfolio companies in two principal ways. They acquire portfolio companies from other private equity funds,²⁸ and they engineer leveraged buyouts of existing public companies or divisions of public companies. In the leveraged buyout model, debt financing typically accounts for between sixty and ninety percent of the total acquisition cost, with the debt divided between senior secured debt held by investment banks or institutional investors, such as hedge funds, and junior unsecured debt comprised of high yield bonds.²⁹ The remaining ten to forty percent of the investment consists of equity investments made by the private equity fund or a group of funds and equity contributions made by the portfolio company's executives.³⁰ Although executive equity investments tend to represent a small fraction of the total capital invested, they are generally very significant from the point of view of the executives. Portfolio company executives are properly thought of as owners in the private equity model.

Given the limited duration of private equity funds, successful exit from portfolio company investments is critical to fund success. Steven Kaplan and Per Strömberg found that exit was most commonly achieved through sale to a strategic buyer, sale to another private equity fund, or sale of stock to the public in an initial public offering.³¹ The relative popularity of these exit options varies with the strength of the public equity markets and other factors.³²

During their period of ownership, private equity funds seek to increase portfolio company value through enhancing management incentives, cutting costs and improving productivity, and strategic repositioning.³³ Private equity funds and the boards they create are active monitors and managers of the portfolio companies.³⁴ As we will see in the next Part, by requiring portfolio company executives to make sizable investments in their companies and by compensating them chiefly with equity, private equity funds create managerial

management fee and twenty percent profits interest" generally taken by private equity fund managers).

²⁸ See Kaplan & Strömberg, *supra* note 25, at 130 (observing a "high fraction of secondary buyouts in recent years").

²⁹ *Id.* at 124-25.

³⁰ *Id.*

³¹ *Id.* at 129.

³² See *id.* (further observing that while sales to other private equity funds have increased over time, IPOs have decreased in relative importance).

³³ *Id.* at 132; see also Masulis & Thomas, *supra* note 5, at 253-54.

³⁴ Kaplan & Strömberg, *supra* note 25, at 131-32; Masulis & Thomas, *supra* note 5, at 253-54.

incentives that are stronger than those observed at comparable public companies.³⁵

III. EXECUTIVE COMPENSATION AT PORTFOLIO COMPANIES AND PUBLIC COMPANIES

Two recent studies have examined executive pay at private equity portfolio companies, relying on the same strategy to collect data. Although private companies are not required to disclose pay data generally, companies that go public are required to disclose executive pay data for a period prior to going public.³⁶ These studies examined executive pay at a subset of portfolio companies, those that successfully undertook a public stock offering.³⁷

Professors Leslie and Oyer analyzed CEO pay data at 144 portfolio companies that went public between 1996 and 2005.³⁸ They compared pay before and after the public offering and also compared executive pay at a sample of public companies.³⁹ Professor Jackson compared CEO pay at 108 portfolio companies that went public between 2000 and 2004 to CEO pay at a group of comparable companies that had recently gone public and that had not been previously owned by private equity investors.⁴⁰

A. Amount of CEO Pay

After controlling for firm size, Jackson found no statistically significant difference between the salary and bonus or the total annual compensation received by portfolio company and public company CEOs.⁴¹ As discussed in

³⁵ In addition to the quantitative differences in equity incentives in the two spheres that are discussed in the next Part, management incentives at private equity portfolio companies differ qualitatively from public company executive incentives in two ways. First, because these companies are private, equity incentives are illiquid. Typically, management's opportunity to cash in is tied to the private equity fund's exit. Second, the highly leveraged nature of these portfolio companies places added pressure on management to cut costs and operate efficiently.

³⁶ 17 C.F.R. § 229.401 (2010); *see also* Masulis & Thomas, *supra* note 5, at 235-36 (discussing potential effects of selective reporting).

³⁷ This analytical strategy raises an obvious concern regarding selection bias. Jackson notes that the subset of portfolio companies that go public are among the most successful, and one might think that compensation patterns at these firms might differ from portfolio company compensation generally or that portfolio companies might modify compensation arrangements in anticipation of an IPO. *See* Jackson, *supra* note 9, at 17 n.35. Jackson cites interviews with private equity executives suggesting that differences in pay practices within this subset are not significant. *Id.*

³⁸ *See* Leslie & Oyer, *supra* note 4, at 7.

³⁹ Leslie's and Oyer's public company sample initially includes all firms included in the ExecuComp database. In some analyses, they limit the public company sample to a subset that more closely matches the size of the portfolio companies. *See id.* at 9.

⁴⁰ Jackson, *supra* note 9, at 18.

⁴¹ *See id.* at 22-23.

the next subsection, the average portfolio company CEO received a riskier pay package than the average public company executive, but Jackson continued to find no statistically significant difference in pay even after adjusting his analysis for the compensation risk.⁴² Leslie and Oyer did not perform the same exact calculations, but their data do not appear to be inconsistent with Jackson's findings on total pay.⁴³

At first blush, this data might seem to rebut the popular view that public company executive pay is excessive.⁴⁴ Private equity managers negotiate portfolio company CEO pay contracts at arm's length. The fund managers should not be disabled by the agency problems that supposedly plague public company executive pay arrangements.⁴⁵ If these private equity investors voluntarily pay their executives amounts similar to those received by executives of comparable public companies, doesn't that indicate that public company pay approximates the arm's length ideal?

Not necessarily. First, although the private equity pay negotiations should have been at arm's length, interpreting the results can be tricky. Almost forty percent of the portfolio company CEOs in Jackson's sample were incumbents at the time the company had been taken private or had otherwise been acquired by the private equity investor.⁴⁶ Jackson showed that the CEOs in this subsample were paid forty percent more, on average, than were CEOs that had been newly hired by the private equity investors.⁴⁷ Jackson suggests that the difference represents "deal bounties," payments made to incumbent CEOs to facilitate the acquisition of their companies by private equity investors.⁴⁸ If so, comparing raw compensation between portfolio company and public company CEOs is an apples to oranges comparison, and figures that seem comparable at first blush may indeed suggest that public company executives receive more total pay than their portfolio company peers, once "deal bounties" are subtracted out.

Second, even ignoring the deal bounty problem, the fact that arm's length pay negotiations in the private equity setting result in overall levels of executive pay comparable to those found in public companies doesn't

⁴² See *id.* at 23 n.45.

⁴³ Controlling for firm size, Leslie and Oyer found that portfolio company CEO salaries were about ten percent lower than public company salaries, but they found that CEO bonuses at portfolio companies accounted for about thirteen percent more of total cash (salary plus bonus) compensation. These differences roughly offset one another. See Leslie & Oyer, *supra* note 4, at 2, 17.

⁴⁴ See, e.g., GRAEF S. CRYSTAL, *IN SEARCH OF EXCESS* (1991).

⁴⁵ See generally Michael C. Jensen & William H. Meckling, *Theory of the Firm: Managerial Behavior, Agency Costs and Ownership Structure*, 3 J. FIN. ECON. 305, 357 (1976).

⁴⁶ See Jackson, *supra* note 9, at 31 n.59.

⁴⁷ See *id.* at 32.

⁴⁸ See *id.* at 4.

necessarily tell us anything about the adequacy of the public company pay bargain. Perhaps private equity funds compete with public companies for executive talent and find themselves forced to pay at similar levels.⁴⁹ Although some studies have found segmentation in executive labor markets between private and public companies,⁵⁰ it seems likely that this particular subset of private companies – private equity portfolio companies – do compete with public companies for executive talent. As noted, in many cases the portfolio companies were formerly public companies or divisions of public companies. The managers that make the transition are former public company executives with ongoing relationships in that sphere. This is a very different private company market than that comprised of companies that have never made the leap to public ownership. Naturally, if the relevant executive labor market is comprised of both public companies and portfolio companies, neither private equity investors nor public company compensation committee members can ignore compensation being offered by the other.

As we will see momentarily, there are significant differences in the form of compensation paid to the CEOs of the two types of firms, so this is not to suggest that the market somehow forces equivalent terms on private equity investors and public companies. But total compensation figures are quite salient, so it may not be surprising that the market homogenization is greater with regard to this metric.

B. *CEO Ownership and Equity Incentives*

Both the Leslie and Oyer study and the Jackson study find that CEO equity incentives are much stronger at private equity portfolio companies than at comparable public companies. Reflecting the ownership mentality, portfolio company CEOs are required to contribute capital to the enterprise. In addition, like public company executives, portfolio company CEOs receive equity compensation. Moreover, given the private ownership, the equity held by portfolio company executives is illiquid. Executives are expected to hold the equity until a “liquidity event” – an IPO or sale of the portfolio company to another private equity investor – allows everyone to cash in.

Leslie and Oyer estimate that portfolio company CEOs hold 2.3 percentage points more equity than CEOs of comparable public companies – a 64% difference.⁵¹ Similarly, Jackson finds that controlling for firm size, portfolio

⁴⁹ See *id.* at 23 n.45 (suggesting that competition between the two types of firms for executive talent “may cause pay to rise in both groups,” but finding it more difficult to explain differences in how the two groups of CEOs are paid).

⁵⁰ See, e.g., Huasheng Gao et al., A Comparison of CEO Pay in Public and Private US Firms 28-29 (Nov. 2010) (unpublished manuscript), available at <http://ssrn.com/abstract=1572406>.

⁵¹ See Leslie & Oyer, *supra* note 4, at 14. In determining the fraction of the firm owned, Leslie and Oyer include shares owned outright, restricted stock, and shares underlying options. They recognize that option shares should not be included on a one-for-one basis

company executives effectively hold about 2.5% of firm equity, while public company CEOs hold only about 1%.⁵²

This data confirms the conventional wisdom that one way in which private equity investors squeeze value out of portfolio companies is by significantly ratcheting up managerial incentives.⁵³ On its face, the data suggests that while pay for performance incentives at public companies have increased in the last two decades,⁵⁴ they remain well below those viewed as optimal by private equity investors. Although portfolio companies and public companies may not be perfectly comparable, this data may provide some comfort that public company pay is not excessively focused on performance.⁵⁵ Of course, the data is from several years ago, and the costs and benefits of performance-based pay may have shifted in the interim, but in the period studied, private equity investors clearly believed that the cost of forcing executives to take on risk was justified by the expected performance improvements.

C. *The Composition of Executive Incentives*

In addition to demonstrating that executive equity incentives are stronger at portfolio companies, these studies document that there is a significant difference in how CEOs of private and publicly held companies are exposed to share price. Compared to public company pay practices, portfolio company equity incentives were driven more by stock and less by options. This difference has important implications for thinking about the impact these pay packages have on executive appetites for risk.

In the periods studied by Leslie and Oyer and by Jackson, public company CEO equity exposure would have resulted largely from vested and unvested options held by the executives plus any stock received as a result of exercising options that they continued to hold.⁵⁶ As noted above, private equity portfolio company CEOs are required to make a significant equity investment at the

given the possibility of expiration out of the money, but they lack the data to calculate option delta. *See id.* at 10.

⁵² *See* Jackson, *supra* note 9, at 26. Jackson calculates option delta and adjusts dollar on dollar incentives accordingly. Jackson does not characterize his data as CEO “ownership.” I am using this term to simplify the presentation.

⁵³ *See* Kaplan & Stromberg, *supra* note 25, at 130-31; Masulis & Thomas, *supra* note 5, 221.

⁵⁴ *See infra* text accompanying notes 91-93.

⁵⁵ It is difficult to draw any firmer conclusions from this data given differences in monitoring in public and private sectors and other differences between public companies and portfolio companies.

⁵⁶ Leslie & Oyer’s study focuses on firms going public between 1996 and 2005. Leslie & Oyer, *supra* note 4, at 26. Jackson collected data on firms going public between 2000 and 2004. Jackson, *supra* note 9, at 18. In aggregate prior to 2005, large public companies relied much more heavily on options than restricted stock in creating equity incentives for senior executives. *See* Walker, *supra* note 16, at 611 fig. 3.

outset.⁵⁷ In addition, portfolio company executives typically receive equity compensation in an amount equal to two to three times their investment.⁵⁸ Leslie and Oyer note that a CEO's equity investment in a portfolio company often is a rollover of equity previously held in the company.⁵⁹

In unreported data, Leslie and Oyer found that options represented a larger fraction of the "ownership" of public company CEOs than of private equity portfolio company CEOs, which means, of course, that portfolio company executives tended to own more stock outright or more restricted stock, relatively. In Leslie and Oyer's sample, shares underlying stock options accounted for twenty-two percent of CEO equity incentives at private equity portfolio companies, on average, compared to thirty-four percent at the average public company.⁶⁰ Jackson's unreported data is directionally consistent with this result.⁶¹

All else being equal, an executive holding a greater fraction of equity incentives in the form of stock would tend to have a lesser appetite for risk than an executive holding a greater share of options. Although executive stock ownership aligns managerial and shareholder outcomes, high levels of stock ownership by under-diversified, risk averse executives may lead them to take steps that inefficiently reduce firm risk or to forgo valuable, but risky, projects.⁶² The corporate finance rationale for adding stock options to executive portfolios is to help offset the risk aversion that arises from executives' lack of diversification and to better align risk-taking incentives with those of shareholders.⁶³ Diversified shareholders are presumed to favor all positive net present value projects. For these investors, downside risk and upside potential weigh equally. But for the undiversified executive holding only stock, the downside risk would loom larger. Stock options can provide executives with upside potential and little downside risk. The payoff on an at-the-money option is the same whether the stock price remains steady or falls fifty percent: zero. But the potential for gain if the share price rises is great. Thus, when prudently added to executive portfolios, stock options can help align risk-taking incentives which may contribute to overall maximization of

⁵⁷ See *supra* Part III.B.

⁵⁸ Leslie & Oyer, *supra* note 4, at 5.

⁵⁹ See *id.*

⁶⁰ See Email from Paul Oyer, Professor of Econ., Stanford Business School, to David I. Walker (Oct. 18, 2010, 4:13 AM) (on file with author).

⁶¹ See Email from Robert Jackson, Assoc. Professor of Law, Columbia Law School, to David I. Walker (Dec. 23, 2010, 1:27 PM) (on file with author).

⁶² See John E. Core et al., *Executive Equity Compensation and Incentives: A Survey*, FED. RESERVE BD. OF N.Y. ECON. POLICY REVIEW, Apr. 2003, at 27, 33, available at <http://www.ny.frb.org/research/epr/03v09n1/0304core.html>.

⁶³ See *id.* at 34.

shareholder value. Of course, overuse of options might result in executives having an excessive appetite for risk.⁶⁴

Admittedly, the foregoing is only a rough generalization,⁶⁵ but taken at face value the difference in the makeup of CEO equity incentives between public company and private equity portfolio company executives found by Leslie and Oyer and by Jackson would seem to suggest greater exposure to downside risk and a lesser appetite for taking on risky opportunities at portfolio companies. In fact, we have now seen three effects that point in this direction. First, portfolio company executive equity exposure is more heavily stock based. Second, total executive equity exposure is much greater at portfolio companies than at comparable public companies.⁶⁶ Third, the equity held by portfolio company executives is less liquid than that held by public company executives.⁶⁷

D. *Explaining Differences in Executive Risk Exposures and Incentives at Public Companies and Portfolio Companies*

At first blush, one might be inclined to conclude from the foregoing that portfolio company executives bear too much downside risk or that public company executives receive too much option compensation that could encourage excessively risky bets. Either could be true, but the differences observed above are, in fact, directionally consistent with differences in capital structure, monitoring, and other intrinsic differences in the two organizational forms.

The observed difference in equity portfolio composition is directionally consistent with the difference in ownership structure. Debt finance plays a

⁶⁴ Bebchuk & Spamann, *supra* note 1, at 262-64.

⁶⁵ The generalization is rough because the influence of holding an option on an executive's appetite for risk depends, among other things, on the relationship between the option exercise price and the company's current share price. An option that is far in the money, i.e., with an exercise price well below the current share price, has incentive properties that resemble those of stock. *See* Walker, *supra* note 16, at 7.

⁶⁶ Recall that Brick, Palmon, and Wald found in the public company setting that high levels of performance-based pay lead to lower stock returns at public companies, a finding that they attribute, in part, to a reduced appetite for risk. *See* Brick et al., *supra* note 17, at 28.

⁶⁷ Of course, unvested options also are illiquid, but public company executives frequently receive annual equity grants with the result that a tranche of options becomes exercisable each year. Differences in inside debt may be a countervailing factor. Professors Tung and Wang show that bank CEOs hold significant amounts of "inside debt" in the form of deferred compensation and pension benefits. *See* Tung & Wang, *supra* note 23, at 6. Inside debt holdings are not limited to bank CEOs and may be greater for public company executives than for executives of private equity portfolio companies. Opportunities to defer cash compensation may be similar, but given the focus on exit, portfolio companies seem less likely to provide defined benefit pension programs. In any event, inside debt positions would tend to dampen risk-taking incentives.

much larger role in the private equity setting. As noted above, the classic leveraged buy-out typically results in a capital structure consisting of sixty to ninety percent debt,⁶⁸ far exceeding the levels of debt carried by most public companies. Reduced risk-taking incentives associated with more stock-heavy equity holdings by portfolio company executives are consistent with the much larger role of debt finance in the private equity setting. Dampening risk-taking incentives would be consistent with protecting the interests of these important investors.⁶⁹ Greater risk-taking incentives generated by greater reliance on options would be consistent with the lesser role of debt in the capital structure of the typical public company.

A second explanation for the observed differences in risk exposure and risk-taking incentives may lie in the enhanced monitoring provided by private equity investors and knowledgeable board members. If one assumes that executive risk taking would manifest itself in project selection or other strategic decision-making,⁷⁰ direct monitoring may reduce the need to provide risk-inducing incentives for managers.

A third possibility is that private equity investors identify executives with a high appetite for risk or that risk-loving executives self select into leveraged buy-outs. In either case, these executives would not need the same level of risk-generating incentives as their more inherently risk averse public company counterparts.

A fourth possible explanation is that the need for strong risk-inducing incentives is obviated and, in fact, such incentives would be misplaced, at private equity portfolio companies, given their traditional focus on improving operations, generating steady cash flows that can service high levels of debt, and generally “cleaning up” the firms in hopes of near term public offerings, rather than on chasing highly speculative opportunities.⁷¹

⁶⁸ See *supra* text accompanying note 29.

⁶⁹ Moreover, the leverage provides a form of optionality that can act as a substitute for stock option grants.

⁷⁰ See Core et al., *supra* note 62, at 33 (discussing corporate finance concern that risk averse executives will reject valuable but risky projects or take other actions that reduce firm risk).

⁷¹ Some observers suggest that as obvious turnaround candidates become scarce, the focus of private equity investment will shift away from operational enhancement to strategic repositioning. See Kaplan & Strömberg, *supra* note 25, at 132. If so, one might expect to see a shift in portfolio company executive pay to encourage greater risk taking. *But see* Leslie & Oyer, *supra* note 4, at 2 (suggesting that private equity firms have become more operationally focused over time).

Moreover, the potential IPO “hurdle” faced by private equity portfolio companies creates its own set of incentives that may affect optimal compensation incentives. For example, risk aversion on the part of portfolio company executives may be mitigated by their realization that a certain level of performance would be needed to justify an IPO and provide an attractive liquidity event. I thank Chuck Whitehead for this observation.

It is possible that these factors explain the difference in the composition of executive equity portfolios at public companies and portfolio companies. Further research would be needed to explore this possibility. It would be interesting, for example, to determine whether cross-sectional differences in the degree of debt finance, board expertise, and private equity fund strategy are associated with differences in CEO equity incentive mix at portfolio companies.

Of course, a final possibility is that differences in the mix of stock and options are less important than financial economists predict. Perhaps the level of equity incentives is the most important factor and differences in the mix of stock and option-based incentives at public and private companies reflect how these incentives arose rather than a preconceived plan regarding mix. In the public company setting, it appears that tax and accounting rules have played a major role in the shape of equity pay. In cases in which public companies are taken private and incumbent CEOs are retained, the executives typically will hold equity that is available to be rolled over, which may have a significant influence on their overall mix of incentives.

E. *Does the Equity Mix Evidence Suggest that Public Company Pay Has Encouraged Excessive Risk Taking?*

Both the Leslie and Oyer study and the Jackson study demonstrate that differences in CEO risk-taking incentives between public companies and portfolio companies were directionally consistent with leverage, monitoring, and other differences in the private equity and public company environments. This does not mean, however, that the level of risk-taking incentives at public companies was optimal. It is conceivable that public company executives, particularly in the financial sector, had an incentive to take on excessive risk.

Professors Lucian Bebchuk and Holger Spamann argue that bank executives did have excessive risk-taking incentives going into the recent financial crisis.⁷² Although their paper is more theoretical than empirical, they show that option shares accounted for forty percent of total equity shares held by the CEOs of Citigroup and Bank of America at the end of 2006.⁷³ They argue that the highly leveraged nature of bank holding companies combined with the large fraction of options in their individual portfolios provided these CEOs with “strong incentives to take excessive risks.”⁷⁴ On the other hand, they also recognize that significant stock ownership may cause undiversified executives to act conservatively,⁷⁵ so it is not clear how they can conclude that the addition of options to these portfolios resulted in risk-taking incentives that were greater than those preferred by shareholders and/or society at large.⁷⁶

⁷² See Bebchuk & Spamann, *supra* note 1, at 249.

⁷³ *Id.* at 265.

⁷⁴ *Id.* at 266.

⁷⁵ See *id.* at 262.

⁷⁶ The analysis is further complicated by the fact that banks are subject to regulatory

Professors Rüdiger Fahlenbrach and René Stulz have provided evidence that they argue is inconsistent with the idea that bank executive portfolio incentives led to excessive risk-taking that triggered the crisis.⁷⁷ They show, for example, that banks whose CEOs held larger option portfolios did not perform more poorly than other banks during the crisis.⁷⁸

The jury is still out on the question of whether executive risk-taking incentives at public companies contributed to practices that led to the financial crisis. Leslie and Oyer's and Jackson's data demonstrating that public companies relied more heavily on options in creating executive equity incentives than did private equity funds are not inconsistent with that story, but that is all one can say on that front.⁷⁹

IV. DO THE PORTFOLIO COMPANY LESSONS FOR PUBLIC COMPANY EXECUTIVE PAY STILL HOLD?

Over the last twenty years, public company executive pay practices have moved in the direction of private equity portfolio company pay.⁸⁰ Nonetheless,

constraints on risk taking that would affect the optimal equity compensation mix and would make it difficult to assess whether such incentives were greater or less than optimal.

⁷⁷ See Rüdiger Fahlenbrach & René M. Stulz, *Bank CEO Incentives and the Credit Crisis*, 99 J. FIN. ECON. 11, 22-23 (2011).

⁷⁸ See *id.* at 19.

⁷⁹ Even if public company pay practices resulted in excessive risk-taking incentives, the creation of these incentives may or may not have been intentional. Much evidence suggests that the heavy use of options during the 1990s was driven by factors other than increasing the convexity of pay packages, notably by tax and accounting rules. See Walker, *supra* note 16, at 634-35. On the other hand, while option-based pay made sense in the 1990s for these reasons, firms did not need to switch from options to stock grants in order to dampen risk-taking incentives. Firms could have simply required executives to hold stock received on the exercise of options for some meaningful period. In this respect, public companies could have and still can take a lesson from private equity firms which place much greater liquidity constraints on executive equity holdings. Needless to say, executives would resist additional constraints being placed on their liquidity and would demand to be compensated. Moreover, the liquidity constraints in the two cases might not be viewed as being comparable. While it may seem reasonable to bind managers and private equity investors during the (hopefully) short life of the private equity turnaround project, there is no comparable horizon for binding public company executives to their equity holdings. Any holding period requirement placed on publicly traded stock received on the exercise of options will to some extent appear artificial.

⁸⁰ It is not clear that the relationship between public company and portfolio company pay practices is causal, but it would not be surprising. As noted above, the market for executive talent likely includes both public and private equity portfolio companies. See *supra* text accompanying notes 50-51. As loyal fiduciaries, public company directors cannot ignore the competition for their executives from private equity shops. But there is competition at another level as well. The public company and private equity models are competing forms of business organization. As Professors Ronald Gilson and Charles Whitehead have demonstrated, today public equity is essentially optional. See Ronald J. Gilson & Charles

at the firms studied by Leslie and Oyer and by Jackson, total public company equity incentives (i.e., the fraction of the company “owned” by the CEO) continued to lag those at portfolio companies.⁸¹ If one takes private equity as a model of good corporate governance and executive pay practices, this data undermines the view that public companies place too much emphasis on performance-based pay.⁸² Additionally, we have seen that the equity incentives of public company CEOs in these studies were more option-driven than are those of portfolio company executives, which may or may not be consistent with fundamental differences in the two capital models and could be the result of accident or design.⁸³

A further question is whether these differences in executive pay persist and will continue to persist. These two studies provide the latest available comparative data, but recent developments in public company pay practices may have rendered the comparison obsolete in one important respect. Although the fraction of public company executive pay represented by equity instruments has been reasonably stable over the last fifteen years, over the last decade many public companies have shifted their equity compensation emphasis from options to stock. Thus, the public company lag in total equity incentives seems likely to have continued to the present, but public company pay is less risk inducing on average today than it was during the periods studied by Leslie and Oyer and Jackson, and will likely become even more conservative in the future.⁸⁴

Leslie and Oyer’s data is from the period 1996 through 2005.⁸⁵ Jackson’s data covers the years 2000 through 2004.⁸⁶ In 1996, equity compensation accounted for between fifty and sixty percent of total ex ante compensation for senior executives of large public companies.⁸⁷ That fraction rose to seventy percent during the dot-com bubble, and it fell somewhat after that bubble burst.⁸⁸ But even in the wake of the recent financial and market crisis, equity has continued to account for more than fifty percent of the ex ante

K. Whitehead, *Deconstructing Equity: Public Ownership, Agency Costs, and Complete Capital Markets*, 108 COLUM. L. REV. 231, 251 (2008). Thus, it would not be surprising that public companies have learned and applied numerous lessons from private equity, and not just about executive pay.

⁸¹ See *supra* Part III.B.

⁸² See Polsky & Lund, *supra* note 2, at 52 (arguing that the marginal benefits of performance-based pay have fallen to such an extent that the overall effect on modern companies is negative).

⁸³ See *supra* Part III.C.

⁸⁴ There is, of course, a lag between the composition of annual equity grants and executive equity portfolios, but over time a shift from option-heavy to stock-heavy packages will be reflected in portfolios.

⁸⁵ *Supra* text accompanying note 38.

⁸⁶ *Supra* text accompanying note 40.

⁸⁷ See Walker, *supra* note 16, at 633 fig. 3.

⁸⁸ *Id.*

compensation of senior executives.⁸⁹ Moreover, there has been no significant change in equity compensation vesting practices over this period.⁹⁰ To be sure, total executive pay increased dramatically in the late 1990s, but total CEO pay was essentially flat across the most recent decade.⁹¹ In addition, executive equity holdings over the period will have varied based on market perception and other factors, but there has been little systematic change in total public company executive equity incentives over the last decade. Thus, it seems likely that total equity incentives, as measured by percent ownership, for example, continue to lag at public companies today relative to private equity portfolio companies.

By contrast, relative reliance on stock and options in public company executive pay packages has changed radically. During the periods studied by Leslie and Oyer and by Jackson, stock options dominated equity compensation programs at large public companies.⁹² In the year 2000, the value of stock options issued to large public company executives exceeded the value of stock by a ratio of six to one.⁹³ In the last decade the use of stock options has declined precipitously while stock grants have more than tripled in aggregate.⁹⁴ In 2005, roughly equal values of stock and options were granted.⁹⁵ In 2008, about fifty percent more stock was issued than options, by ex ante value.⁹⁶

However, those aggregated figures mask another change in compensation practices. Ten years ago, the great majority of large public companies relied exclusively on stock options when granting equity-based pay.⁹⁷ Today, there is much more diversity in equity pay practices. Some companies continue to rely exclusively on options; some rely exclusively on stock; and others utilize both stock and options.⁹⁸

⁸⁹ *See id.*

⁹⁰ Compare FREDERICK W. COOK & CO., INC., THE 2000 TOP 250: LONG-TERM AND STOCK-BASED GRANT PRACTICES FOR EXECUTIVES AND DIRECTORS 6, 8 (2000), available at <http://www.fwcook.com/top250-2000.pdf>, with FREDERICK W. COOK & CO., INC., THE 2010 TOP 250: LONG-TERM INCENTIVE GRANT PRACTICES FOR EXECUTIVES 9, 12-13 (2010), available at http://www.fwcook.com/alert_letters/The_2010_Top_250_Report.pdf (describing typical vesting terms in recent years).

⁹¹ The New York Times sponsors an annual survey of CEO compensation at 200 large public companies. For 2001, median total compensation for these executives was reported as \$9.1 million. *See Executive Pay: A Special Report*, N.Y. TIMES, Apr. 7, 2002 (Sunday Business), at 8-9. Their 2009 survey reported median total compensation as \$7.7 million. *See CEO Pay: The Tables*, N.Y. TIMES, Apr. 4, 2010 (Sunday Business), at 10-11.

⁹² *See supra* text accompanying note 56.

⁹³ *See Walker, supra* note 16, at 633 fig. 3.

⁹⁴ *See id.*

⁹⁵ *See id.*

⁹⁶ *See id.*

⁹⁷ *Id.* at 632-34.

⁹⁸ Walker, *supra* note 16, at 18.

Nonetheless, all else being equal, the shift by public companies from options to stock suggests that if a snapshot were taken today of public company executive equity holdings, the ratio of stock-based to option-based incentives would be greater than that exhibited in Leslie and Oyer's public company sample, and perhaps closer to the equity portfolio mix held by their sample of private equity portfolio executives.

Moreover, there are several reasons to think that public companies will continue to move in the direction of less risk-aggressive executive pay packages (i.e., fewer options and more stock) relative to private equity portfolio companies. First, there is likely to be continuing political pressure on "risky" pay practices at public companies, particularly at financial institutions. For example, the Dodd-Frank Act requires covered financial institutions to disclose incentive compensation arrangements that could lead to material losses and directs regulators to adopt rules prohibiting incentive compensation arrangements that "encourage[] inappropriate risks."⁹⁹ There is no political pressure being exerted on "risky" pay practices at private equity portfolio companies.¹⁰⁰

Second, although unintentional, it seems likely that two other Dodd-Frank provisions will further inhibit the use of option compensation at public companies. Dodd-Frank directs the SEC to require public companies to disclose the ratio between the total annual compensation of their CEOs and the total compensation of their median employees.¹⁰¹ For the purposes of Dodd-Frank, "total compensation" includes the grant date value of equity awards, which for awards of stock options is essentially their Black-Scholes value.¹⁰² Although CEOs want to be paid well, presumably, CEOs and other directors will want the disclosed ratio to be as low as possible.¹⁰³ Heavy reliance on options instead of stock would lead to a higher ratio for two reasons. First, although the disclosure rules allow for some adjustment to the Black-Scholes model to account for the peculiarities of compensatory options,¹⁰⁴ the adjusted

⁹⁹ Dodd-Frank Wall Street Reform and Consumer Protection Act, Pub. L. No. 111-203, § 956(b), 124 Stat. 1376, 1905 (2010) (to be codified at 12 U.S.C. § 5641).

¹⁰⁰ To be sure, the pressure on public company pay practices is not uniform either. While some have advocated in favor of more conservative pay practices generally, *see, e.g.*, Bhagat & Romano, *supra* note 1, at 361, most proposals directed at public company pay risk are focused on financial institutions.

¹⁰¹ Dodd-Frank Wall Street Reform and Consumer Protection Act, § 953(b), 124 Stat. at 1904; 17 C.F.R. § 229.402 (2010).

¹⁰² § 953(b)(2), 124 Stat. at 1904; 17 C.F.R. § 229.402(c)(2) (directing companies to include the aggregate grant date value of options in their summary executive compensation disclosure table).

¹⁰³ *See* Bebachuk et al., *supra* note 14, at 789 (proposing a rent extraction model of the executive compensation setting process and arguing that executives and directors would have an incentive to camouflage executive pay in order to reduce outrage among investors and in the financial press).

¹⁰⁴ The value of a traded call option is based, in part, on the time to expiration. The

model continues to overstate the value of options to under-diversified executives. Second, because options represent riskier pay for executives, executives demand to be paid more to take on this risk. In other words, even if the model accurately valued the options, the risk premium required by executives would result in option-heavy packages being of greater value. Taken together, the disclosed value of an option-heavy pay package may be significantly greater than the disclosed value of a stock-heavy package designed to be equivalent in value from a CEO's point of view.

Dodd-Frank also creates a mandatory shareholder "say on pay" system giving shareholders of public companies an advisory vote on executive pay.¹⁰⁵ "Say on pay" will be an up or down vote on the entirety of a company's executive pay practices, but because total bottom-line compensation is highly salient to shareholders, heavy use of options will be disadvantageous for the reasons just described.

Of course, companies may determine that the value of options in offsetting executive risk aversion outweighs the unattractive consequences for their Dodd-Frank disclosures. The points, however, are these. First, the additional disclosure requirements shift the balance away from options and towards stock to some extent. Second, there are no similar pressures on private equity portfolio company pay practices. As a result, one would expect that these pressures would tend to narrow the gap in the risk-aggressiveness of public company and private equity portfolio company executive pay packages.

CONCLUSION

Compared to their private equity portfolio company counterparts, public company CEOs had weaker total equity incentives, but a greater fraction of their incentives coming from stock options, during the periods examined by Leslie and Oyer and by Jackson. Although the observed differences might be viewed as providing evidence that portfolio company executives bear too much downside risk or that public company executives receive too much option compensation that could encourage excessively risky bets, this Essay has argued that the differences are, in fact, directionally consistent with differences in capital structure, monitoring, and other intrinsic differences in the two organizational forms. In addition, this Essay has suggested that the difference

longer the period to exercise, the greater the value. Because compensatory options cannot be transferred and because recipients are under-diversified, these options generally are not held until expiration. Recognizing this difference, current accounting rules allow companies to use an expected time to exercise for an option grant instead of the contractual duration in calculating Black-Scholes value. *See* FIN. ACCOUNTING STANDARDS BD., FIN. ACCOUNTING FOUND., TOPIC 718, PROPOSED ACCOUNTING STANDARDS UPDATE: STOCK COMPENSATION 5-6 (2009).

¹⁰⁵ Dodd-Frank Wall Street Reform and Consumer Protection Act, § 951, 124 Stat. at 1899-1900 (to be codified at 15 U.S.C. § 78n).

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found in the mix of equity incentives is likely to have shrunk over the intervening years and is likely to continue to shrink.