Executive Envy

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Here we go again, with one more round of financial journalism deploring the exorbitant, outrageous, immoral, offensive -- have we left out any adjectives? -- compensation of CEOs. The difference is that this time the government may not commit the kind of policy blunder that helps increase executive pay even more.

That's exactly what happened the last time Congress waded into this thicket of envy, capping the tax deductibility of salaries at $1 million in 1993. Corporate boards -- which hire and set the pay of CEOs -- naturally reacted by finding other ways to compensate their most important employees.

A favorite route was with stock options, which during the dot-com and stock-market bubble of the late 1990s rewarded even many lousy CEOs as if they were Jack Welch. But instead of giving Congress its share of the blame for this unintended consequence of populist opportunism, the financial press finds it easier to keep shouting "greed."

Who knows what is "exorbitant" pay anyway? The modern CEO position requires a variety of skills and experience that aren't easily found. Especially in a Sarbanes-Oxley world, CEOs face more scrutiny and have shorter tenures. It's also notable that many of today's most informed and sophisticated investors are only too happy to pay handsomely, perhaps even exorbitantly, for the right CEO candidate. Private-equity firms in particular have persisted in giving out large pay packages to the top managers they hire to turn companies around. And because they are paying with their own money, they have a big stake in getting it right.

No doubt some executives earn more than their performance deserves, but that ought to be an issue for shareholders. And the best way to give shareholders influence over managers and their pay is to restore the market for corporate control -- that is, remove the legal and other impediments to takeovers.

The CEOs and boards most likely to pad their own pay despite lousy performance are those who know their jobs aren't at risk. Yet the poison pills, staggered boards and other anti-takeover tools that have proliferated in recent decades don't receive the same political outrage. If certain media moralists want to oust bad CEOs, they should call for a repeal of the Williams Act, which requires that investors disclose any large share accumulation to the broader public. This has the effect of preventing quiet accumulations and making takeovers less profitable and more difficult.

Instead, we get lectures about a new study from Harvard's Lucian Bebchuk and Cornell's Yaniv Grinstein noting that, from 2001 to 2003, top executive compensation amounted to 9.8% of the net income of 1,500 publicly traded firms. This is thought to be . . . exorbitant.

The problem is that there is no way of knowing how much of that average was the result of a few windfall payouts to executives whose companies' stock performed particularly well. Figures like these say nothing about how shareholders benefited, or didn't, from management. Investors tend to measure performance based on stock price and dividends as much, if not more, than by earnings.

Which brings us to the latest proposals from the SEC calling for more, and clearer, disclosure on CEO pay. Our first reaction is that this is a case of admirable regulatory restraint. Instead of trying to reduce or set corporate pay, the new rules are designed to help shareholders better understand and judge it.

The most important proposal would require companies to collect pay and bonus figures and present a total compensation figure for their top executives -- as well as more details about perks and benefits. As occasional readers of proxy statements ourselves, we're all for greater clarity.

Some critics have worried about a Lake Wobegon effect from disclosure, meaning that more disclosure will raise pay levels because every board will want its CEO to be "above average." But pay levels are no secret among compensation professionals now, so we doubt that will be a problem.

The new rules would also require more information about payouts due executives upon a merger or corporate sale. These payouts can be an incentive to sell, and investors ought to be able to see what those incentives are. The SEC proposals will probably also spur a healthy discussion about deferred compensation, which has become increasingly common at the top echelons of companies.

The real danger comes when the government tries to play national paymaster and punish certain kinds of compensation. A good example is the "golden parachute tax," a 1984 law that imposed a tax on severance awards that were more than three times an executive's average historical compensation. The main effect was to drive parachute awards to the absolute maximum, as well as inspire a host of new compensation schemes to cover the cost of the tax.

We also hope the Commission stays away from any attempt to value stock options. The proposed rules require companies to place a value on stock options and include that number next to its other compensation figures. The problem is that any valuation is artificial, since the options may never be realized, and so very well might give an incorrectly inflated view of overall pay.

These quibbles aside, SEC Chairman Chris Cox and his fellow Commissioners are proving to be more intelligent, and less seduced by envy, than the financial press corps that denounces CEOs with such regularity. Now, about the Williams Act...