Keeping up with Mr. Jones, CEO

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A recently announced proposal by the SEC to curtail runaway CEO compensation by forcing increased corporate disclosure of total annual compensation is certainly well-intentioned. After all, the average large firm CEO now takes home $11.8 million in annual compensation -- a staggering 430 times what the average worker makes ($27,460). Instead of attempting to place direct limits on compensation, the SEC is hoping that greater transparency about CEO compensation practices will enable the market to punish and discipline companies, thereby giving corporate boards a greater incentive to prevent their CEOs from siphoning off shareholder value.

However, by attempting to quantify CEO compensation (including hard-to-value items like retirement benefits, severance packages, deferred compensation, perquisites and stock option grants) with a single number, the SEC may be unleashing the Law of Unintended Consequences. In other words, by focusing on a single number for annual executive compensation, the SEC may actually inflate future executive pay packages.

On the surface, the SEC appears to be taking the right step. After all, who could possibly be against any effort to curb outrageous executive compensation practices -- other than fat cat CEOs with their hands caught in the corporate cookie jar? According to the SEC's Christopher Cox, increased disclosure of total annual compensation for each of a company's five highest-paid executives will enable the market to punish and reward companies with out-of-whack compensation practices: "The market is capable of disciplining excessive compensation, provided the market has adequate information." Sunlight, as they say, is the best disinfectant. Once institutional investors and individual shareholders find out how much these CEOs make, well, that'll be the end of that noise for awhile.

Or will it? By attempting to reduce executive compensation to a single number, the SEC runs the risk of actually fanning the flames of compensation envy. It's a topic that has been broached more than a few times by academics, compensation experts and bloggers. Just last week, Peter Lattman of the Wall Street Journal's law blog and others -- such as law professors Larry Ribstein and Gordon Smith -- raised the prospect of a "ratcheting effect" if the SEC rule goes into effect. Ratcheting is not some arcane corporate governance term -- it's probably better known as "Keeping up with the Joneses." In this case, it's a matter of keeping up with the CEO next door.

Suppose Mr. Jones, CEO of Acme Corporation, has an annual salary of $11 million (we're being conservative here), retirement benefits worth an unknown amount, personal use of the corporate jet, stock option grants worth an unknown amount, and a golden parachute also worth an

unknown amount. Mrs. Smith, the CEO next door, also has an annual salary of $11 million, and a host of similar CEO goodies. In this case, it's difficult for Mrs. Smith to complain -- and even more difficult for her to compare apples with oranges (or in this case, Gulfstreams with LearJets), so the ratcheting effect is negated.

However, what if we know a single annual compensation number for Mr. Jones? Suppose the accountants and compensation experts come up with a number of $20 million for Mr. Jones? Now, it's a lot easier to play "Keeping up with the Joneses." There's no guesswork involved, and assuming that her company's overall economic performance is average-to-good, it's easy to see how Mrs. Smith could ratchet up her annual compensation package to keep pace with Mr. Jones. And so it goes. In the market for executive talent, this process of benchmarking CEO compensation is the norm rather than the exception.

While more disclosure is nice, and the goal of increasing market transparency is even nicer, the new SEC rule also places an enormous burden on shareholder activists. After all, if shareholders (the rightful owners of the company) realize that they are being ripped off, they must be prepared to discipline the CEO by applying pressure on the board of directors. However, even if shareholders receive comparable, side-by-side numbers on executive compensation, will they really be able to discipline any corporate board that approves an outrageous compensation scheme? Worse yet, if you buy into the "managerial power" model advanced by Bebchuk and Fried, which basically states that managers have stacked the compensation deck in their favor by de-coupling pay from performance and tainting the overall compensation process, board directors are powerless to stop CEOs from pushing through ever-higher compensation packages.

At the end of the day, what is the true market value of a CEO? Every MBA knows that the market value of anything (or anyone) is whatever the market is willing to bear. That's how Howard Stern walked away with a $600 million deal from Sirius before he had ever spoken a single word on satellite radio. Maybe he's worth it, maybe he's not. However, in the time period since he signed the mammoth contract with Sirius, the company's stock price has doubled, creating $5 billion in new shareholder value. All too appropriately, a recent Wall Street Journal article about Stern was titled "Shock-Jock Stern Has New Fan Base: Well-Paid Executives."

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