The SEC's Test

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JOHN PIERPONT Morgan, who dominated Wall Street a hundred years ago, famously doubted the stability of companies that paid their top executive more than 20 times what the lowliest employee got. Business norms have since undergone a revolution, with the median chief executive in a survey of 2,000 large companies pocketing $2.5 million in 2004, up from $1 million five years earlier. Some of these packages may be justified as rewards for strong performance. But others amount to a cash-grab at the expense of shareholders, many of them unsuspecting owners of mutual fund shares and 401(k) retirement plans. One recent study identified 60 underwhelming companies that lost $769 billion in market value in the five years ending in 2004. Their top five executives pocketed more than $12 billion over this period, meaning that they averaged more than $8 million each per year.

The challenge of disciplining bosses' pay must fall to the bosses' bosses: company shareholders and the boards of directors that represent them. But this isn't going to happen unless, at a minimum, bosses' pay is disclosed accurately. Today the Securities and Exchange Commission will unveil a proposal to improve transparency. If the proposal survives the SEC's sometimes rancorous rulemaking process, companies will be required to report the total compensation for five top executives, including stock-option grants, perks and retirement promises.

The question is whether the SEC's proposal will go as far as it should, especially on retirement compensation. At present, firms are not required to disclose the value of defined-benefit pension promises to executives, so reports of bosses' pay generally leave these out. But the value of these promises can be enormous. When Franklin D. Raines was pushed out of the top job at Fannie Mae in 2004, he left with an annual pension of $1.4 million for as long as he or his wife lives. Pension promises generally account for almost a third of a chief executive's total career compensation, according to Harvard's Lucian A. Bebchuk.

The SEC's five commissioners have been debating the details of their proposal. They apparently want better pension disclosure, but not the sort that would count most. What shareholders need is an honest estimate of the cost of future pension payments, expressed in today's money: Thus a promise of a $1 million pension has to be multiplied by the number of years the executive can be expected to collect, then discounted to reflect the fact that the payments will be made in the future. According to an SEC spokesman, the commissioners may be content merely to require firms to disclose what the boss stands to collect after retirement. But that doesn't tell shareholders how much the boss is costing them today.

The SEC hasn't revamped rules on executive pay since the early 1990s, and its new

chairman, Christopher Cox, deserves credit for tackling the issue. But if he stops short on pensions, he will be missing one-third of executives' compensation. Moreover, that third is especially troubling, because it tends not to be linked to executive performance. And of course that third is bound to grow rapidly if it is allowed to remain murky while other forms of compensation are dragged into the light.