How Much Does the Boss Make?

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By Lucian Bebchuk

Investors should applaud the SEC's vote yesterday to propose an expansion in disclosure requirements for executive pay. While there is room for reasonable disagreement on the merits of prevailing pay arrangements, there can be little disagreement on the quality of disclosure practices. These are highly inadequate.

Companies have commonly taken a "lawyerly" approach, not disclosing to investors much more than SEC regulations explicitly require. As a result, some information necessary to form a good picture of pay packages isn't disclosed. Other information is disclosed in ways that obfuscate, not inform. Investors shouldn't have to devote significant time and effort to put together a company jigsaw puzzle.

A recent study by Robert Jackson and myself highlights the problem with inadequate disclosures. Because firms generally don't report a dollar value for executives' pension plans, their value is omitted from pay figures relied on by investors, the media and compensation researchers. Companies do, however, disclose information that enables researchers willing to do some work to estimate the plans' value. After deriving estimates for CEOs of S&P 500 companies, our study found that their pension plans had a median value of $15 million; that the ratio of a CEO's pension value to the total compensation during service (including equity and non-equity pay) had a median value of 34%; and that including pension values would have increased from 15% to 39% the median percentage that salary-like annual payments comprise of a CEO's total compensation over time.

Investors have been even more in the dark about the benefits executives derive from deferred compensation plans. These enable executives to enjoy tax-free accumulation of investment gains by shifting tax liability to the company. With firms not reporting the amounts their executives have deferred -- as current disclosure requirements permit them to do -- it is difficult for outsiders to obtain even a rough estimate of executives' gains from such plans.

The good news is that firms could, at a small cost, provide investors with a much-improved picture by making certain additional disclosures that Jesse Fried and I put forward in our book on executive pay. Some of those improvements are in the proposals put forward by the SEC yesterday, and I hope that others will be included as the SEC proceeds with disclosure reform.

Companies should disclose each year, as the SEC would like them to do, the dollar value of every material benefit that executives derive from their employment, including the annual increase in the value of pension plans as well as annual gains from a deferred benefit plan. Such disclosures would eliminate distortions caused when pay-designers use some forms of compensation for camouflage value rather than economic efficiency. The massive use of defined benefit plans has been partly motivated by a desire to provide chunks of performance-insensitive pay under the radar screen.

Investors care not only about total pay but also the relationship between pay and performance. They should get information that enables them to assess the incentive effects of pay packages. When executives unload options, companies should report not only the resulting gains but also the amount by which these exceed, or fall short of, the gains the executive would have made had the company's stock return equaled the industry's return. Such disclosure will tell investors how much of an executive's equity-based compensation is due to market movements rather than firm-specific performance.

Investors should also be told the extent to which executives unload shares given to them as incentive compensation. Such unloading can dilute incentives or create perverse incentives to manipulate short-term stock prices. Companies should report what fraction of equity-based instruments awarded to each executive as compensation is still retained by the executive.

As to bonuses, companies should disclose not just the amounts paid but also the metrics that produced them. Investors should be able to judge whether generous bonuses result from good performance or from poor setting of targets. Empirical evidence suggests that bonus compensation has been relatively little correlated with performance -- a major concern.

Finally, because executives' incentives are influenced by their departure packages, companies should annually disclose, as the SEC is now considering, the dollar value of the package that each executive will receive upon departure in the scenarios of a takeover, termination and retirement. Investors should not learn the dollar value of departure packages only when an executive is out of the door, or on the way out.

Warren Buffet observed last year that "executive compensation is the acid test of corporate governance." Expanded disclosures will enable investors to better evaluate how companies score on this critical test. These disclosures, I expect, will highlight that much work remains to be done to fix our executive compensation system.

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