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The "Pay Ratio Provision" in the Dodd-Frank Act: Legislation to Repeal It in the 113th Congress

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Summary

Section 953(b) of the Dodd-Frank Consumer Protection and Wall Street Reform Act (Dodd-Frank Act; P.L. 111-203), known as the "pay ratio provision," requires the Securities and Exchange Commission (SEC) to write rules to implement a requirement that public companies disclose the ratio between the total compensation of a company's chief executive officer (CEO) and the median compensation of all other employees. On September 18, 2013, the agency released proposals to implement the pay ratio provision. A firm will be able to choose its own methodology to calculate worker median pay, including statistical sampling.

Supporters of the provision, including its sponsor Senator Robert Menendez, argue that the public company data on CEO-worker pay disparity that will result from the provision will pressure corporate boards to be more restrained in pay packages to CEOs. The strategy can be seen as a measure to address what some describe as a board/CEO dynamic that can result in perceived excessive compensation for CEOs: board members may feel beholden to the CEO, who may also serve as board chair. Research consistent with this notion of insufficiently independent boards exists. Other research, however, appears to be consistent with the view that public company CEOs operate in a generally competitive marketplace in which the value that they give to shareholders is fairly compensated.

Other supporters of the pay ratio provision, including consumer groups, labor groups, and pension funds, also claim that disclosures that will result from the provision will help to inform investor decision making, including on whether a CEO's compensation is reasonable given a firm's overall worker compensation picture. If a corporate disclosure adds value to the investing process, it is said to provide material information. Materiality is central to the SEC's adoption of disclosure regulations, including the compensation disclosure rules that it has issued over the years. The SEC has observed that the usefulness to investors of the company-specific pay ratio data in the pay ratio provision cannot be quantified.

Critics of the pay ratio provision, including the U.S. Chamber of Commerce, human resources groups, and other business-related groups, counter that the value of corporate disclosure data is linked to the ability of investors to use it to compare various firms. A principal concern is that this comparative value of the ratios will be undermined. An additional concern is that the provision will mislead investors who try to compare the CEO-worker pay ratios from domestic firms in industries with differing levels of worker pay and from domestic firms without a global workforce relative to domestic firms with global workers who are paid at varying wage levels in different currencies.

There is also some concern that the pay ratio provision is likely to result in substantial compliance challenges and costs, especially for large multinational or multi-segmented firms with decentralized payroll systems. Some estimates are that implementation costs for some companies could be in the millions of dollars. The SEC acknowledged that such firms would be likely to face greater compliance challenges and costs. In the aggregate, the proposal estimated that firms would spend about $72 million over a three-year period to comply with the pay ratio provision with large, multinational firms likely facing the greatest costs.

H.R. 1135 (Huizenga) would repeal the pay ratio provision, Section 953(b) of the Dodd-Frank Act. H.R. 1135 was ordered to be reported by the House Financial Services Committee on June 19, 2013. This report will be updated as events warrant.

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Introduction

The Dodd-Frank Wall Street Reform and Consumer Protection Act (Dodd-Frank Act; P.L. 111-203) was signed into law on July 21, 2010, as a response to the 2008-2009 financial crisis. The act mandated extensive financial regulatory reform.[1]

Section 953(b) of the act, the so-called pay ratio provision, requires the Securities and Exchange Commission (SEC) to craft rules necessary to implement a requirement that public company quarterly mandatory disclosures to the agency include the ratio between the total compensation of their chief executive officer (CEO) and all other employees. The pay ratio provision has been the subject of considerable interest and discussion in Congress and elsewhere. Driven by concerns that the corporate costs of arriving at the disclosures would exceed their benefits, legislation was introduced in the 113th Congress to repeal the provision. On September 18, 2013, the SEC proposed rules to implement the pay ratio provision. To address concerns over the challenges of calculating worker median pay, the SEC has proposed giving firms the flexibility to "select a [calculation] methodology," which could include the use of a statistical sample of the total worker population. After its release, the SEC proposal, which the public was invited to comment on for 60 days, became central to the public policy debate on the costs and benefits of implementing the pay ratio provision.

This report provides insight into the debate over the pay provision, the SEC proposal to implement the provision, and legislation to repeal the provision. It does so by (1) examining the debate over whether public company executives are overpaid; (2) describing the pay ratio provision and the SEC proposals to implement it; (3) examining various responses to the pay ratio provision and the proposal to implement them; (4) describing legislation to repeal the provision; and (5) examining the public policy debate over the potential costs and benefits of the pay ratio provision and the implementation proposal.

Background on Corporate Executive Pay

Public company corporate CEOs serve at the pleasure of a company's board of directors, whose members are supposed to represent the interests of—and are elected by—the shareholders. The CEO's pay is typically a combination of base pay, an annual bonus tied to performance, grants of stock, stock options, contributions to a retirement program, and various benefits such as the use of limousines and club memberships, and it is formally set by the company's board of directors. In principle, board members bargain for the CEO's services on behalf of company shareholders.

Moody's, a major credit rating agency, identified several reasons why the award of proper levels of compensation to corporate executives like the CEOs matters:

> [I]ncentives for the key leaders help to shape company policies and performance pressures. Managers of corporations have broad powers and a wide range of discretion. Boards typically offer managers substantial and elaborate financial incentives (particularly in the

[1] See CRS Report R41350, *The Dodd-Frank Wall Street Reform and Consumer Protection Act: Issues and Summary*, coordinated by Baird Webel.

> United States) in significant measure to encourage certain priorities and types of behavior. Second, effective compensation policies are important for executive recruitment and retention.... Excessive pay raises governance issues, but investor interests also can be harmed by executive remuneration policies that fail to attract and retain effective leadership. Third, where disclosure on executive compensation is reasonably good (as in the United States, Canada and certain other markets), pay practice can provide some visibility into the relationship between the board of directors and senior management, and on whether management is in fact accountable to the board. Unusually high pay can signal a weak board, particularly if pay levels have limited relationship to performance. A 2005 Moody's study … found an empirical relationship between (1) outliers that pay very high levels of bonus and stock option pay in comparison with peers and (2) subsequent realized credit risk. While the study did not demonstrate causation, we believe that a likely factor in this linkage is the degree to which unusually high executive pay can reflect weak board oversight.[2]

Debate on aligning executive pay with various metrics of corporate financial performance, called "pay for performance," became prominent in the 1980s. A feature of the pay for performance approach was the provision of stock options[3] as a major component of executive pay.[4]

Whether public company CEO compensation levels have become excessive, bearing little relationship to the goals of pay for performance, has regularly been a subject of public discourse. Describing this debate, one report observed,

[2] "U.S. Executive Pay Structure and Metrics," *Moody's*, June 2006, available at https://www.moodys.com/sites/products/AboutMoodysRatingsAttachments/2005700000426959.pdf.

[3] Stock options give employees the right to buy a company's stock at a specified "strike price" at a predetermined date in the future, but they are worthless if the stock does not reach that price. A major criticism of stock option grants is that they have largely been designed to reward absolute performance rather than relative performance: If a company's stock price rises by just as much as the overall market, then the executive's compensation will have risen because of trends largely beyond his control. Even if a company is outperformed by its competitors, the options could still have value in a bull market since "a rising tide lifts all ships." Moreover, stock options are usually granted "at the money" (they have a strike price equal to the market price at the time the option is granted). Because stocks usually rise over time, this will generally reward executives for doing nothing, a phenomenon that the prominent investor Warren Buffett once characterized as "a royalty for the passage of time." It has also been argued that once stock options are exercised (usually after a vesting period), they no longer provide executives with any incentives. Others, however, have argued that over time, the growing use of stock options has made total CEO pay progressively more sensitive to corporate performance, which they say helps validate the positive contributions stock options made in the realization of CEO pay for performance. See CRS Report RL33935, *The Economics of Corporate Executive Pay,* by Gary Shorter and Marc Labonte; and Michael Faulkender, Dalida Kadyrzhanova, N. Prabhala, and Lemma Senbet, "Executive Compensation: An Overview of Research on Corporate Practices and Proposed Reforms," *University of Maryland*, 2010, available at http://www.rhsmith.umd.edu/faculty/faulkender/ecomp_review.pdf. In contrast to stock options, restricted shares give an employee the full value of a company's stock, at a future date, or when a performance goal is reached. Reports indicate that due to a number of developments, including growing shareholder demands and the financial crisis, the number of stock option grants to senior executives has decreased, whereas the grant of restricted shares has been increasing. Emily Chasan, "Last Gasp for Stock Options?," *Wall Street Journal*, August 26, 2013, available at http://blogs.wsj.com/cfo/2013/08/26/last-gasp-for-stock-options/.

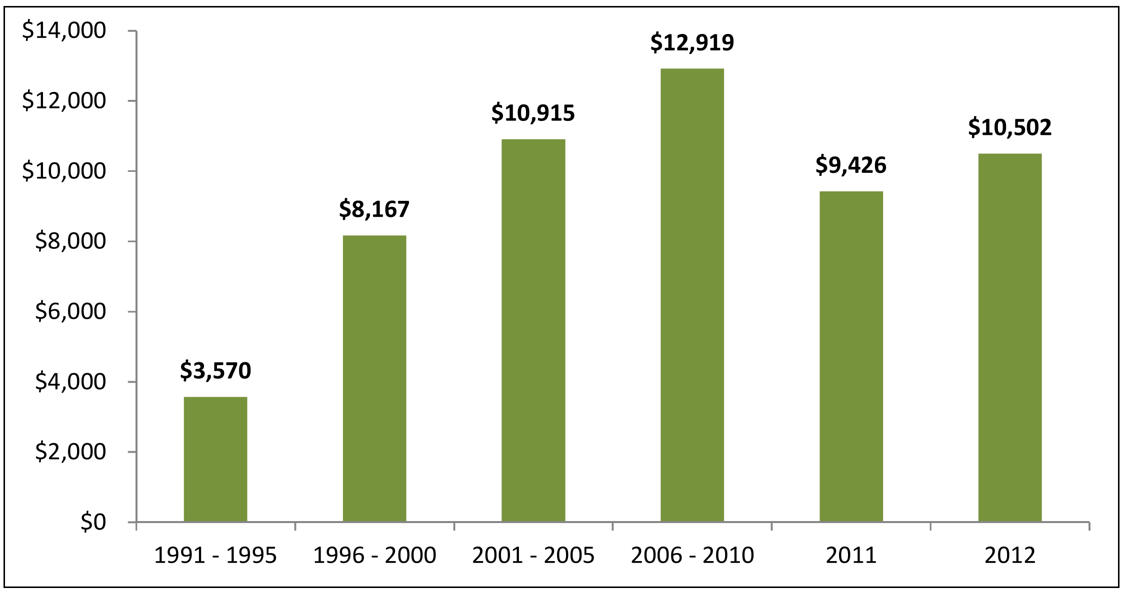
[4] For example, see Michael Faulkender, Dalida Kadyrzhanova, N. Prabhala, and Lemma Senbet, "Executive Compensation: An Overview of Research on Corporate Practices and Proposed Reforms." In addition, the rise in the use of executive stock options has reportedly been attributed to the advocacy of corporate boards and management, compensation consultants, and academics in response to developments that included (1) corporate raiders threatening to take over and dismantle public companies whose stock prices were perceived not to reflect the companies' inherent values; (2) leveraged buyout firms (firms that buy other companies through the use of a significant amount of borrowed money and often using target companies' assets as collateral for the loans) entering "sweetheart" deals with managements of companies to buy the firms and take them private; and (3) institutional investors and other shareholder advocates challenging corporate boards and managements to focus on the creation of shareholder value. See "Fred Cook Speaks to Directors about Executive Compensation at the Stanford Directors' College," June 20, 2005, available at http://www.fwcook.com/alert_letters/FredCookStanford%20speech%206-20-05.pdf.

> The question of whether CEOs of America's major companies are overpaid has been a perennial subject of interest for many years. Are the compensation practices for these elite men and women fair and appropriate? Do these compensation practices provide proper incentives? Or do they reward excessive caution or risk taking?[5]

Forbes calculated the average value of total CEO compensation for the largest public companies (the 800 largest domestic companies up to 1999 and the 500 largest domestic companies since then) in 2012 dollars for the past two decades. The data include average annual CEO total pay in five-year increments between 1991 and 2010 and then single-year annual pay data for 2011 and 2012 based on *Forbes*' calculations. As shown in **Figure 1**, *Forbes* finds that the average CEO compensation of $3.57 million during 1991-1995 grew by more than threefold to $12.9 million by 2006-2010, the peak pay period. The average pay then fell by about $3.5 million dollars to $9.4 million in 2011, then rose by about one-tenth to $10.5 million in 2012.

Figure 1. Average Value of CEO Total Compensation for Large Public Companies

(in thousands of 2012 dollars)



Source: *Forbes*.

Notes: *Forbes* calculated average value of total CEO compensation for the largest public companies (800 of the largest domestic companies up to 1999 and 500 of the largest domestic companies since then) in 2012 dollars.

A widely embraced view on corporate board and CEO dynamics is that several factors distort the market for public company CEOs. Some have observed that board directors are formally elected by shareholders, but are often nominated by top management. Under these circumstances, it is rare for management's slate of directors to be voted down. Once a director becomes a member of a board, he or she may be reluctant to bargain hard with top executives over the executive's pay because cordial relationships between the executives and board members are generally believed to be important for fostering functional boards.[6] In this narrative, rather than haggle over top

[5] "Executive Compensation: More Regulation, or Just More Transparency?," *Knowledge@Wharton*, February 17, 2010, available at http://knowledge.wharton.upenn.edu/article.cfm?articleid=2431.

[6] CRS Report RS22604, *Excessive CEO Pay: Background and Policy Approaches*, by Gary Shorter, Mark Jickling, and Alison Raab.

management pay, boards hire compensation consultants, who recommend a "best practices" approach, which generally involves matching what the most successful companies in the industry pay their (the peer group) heads. Other factors that may help to reinforce a "cozy" CEO/board dynamic are when CEOs also serve as the board chair and when many directors are themselves active or retired CEOs. Adherents of this view, often called the *managerial power thesis*, describe an inefficient market for public company CEOs.[7]

Evidence consistent with a CEO market in which there is some board "capture" by top management comes from research by Larcker, Richardson, Tuna, and Seary. The research examined possible connections between CEO pay and a CEO's "back door" links with members of the company's board, defined as shared board memberships in other companies. Among other things, the research found that CEOs with any back door link to someone on the company's board compensation committee (which oversees compensation issues) received $453,688 on average more than CEOs without such links.[8]

Another observation that appears to be consistent with the notion of a market for CEOs that does not conform with pay for performance comes from the Economic Policy Institute, a think tank: "[f]rom 1978 to 2012, CEO compensation measured with [stock] options realized increased about 875%, a rise more than double stock market growth."[9]

An opposing view is held by the so-called neoclassical school. Proponents say that various metrics indicate that the market for CEOs is generally competitive and efficient and has resulted in levels of executive pay that tend to reflect performance.

Research by Stephen Kaplan, an academic from the University of Chicago, concluded that for the CEOs of companies in the S&P 500 Index, average and median inflation-adjusted CEO pay has not risen continuously. After examining annual pay data through 2011, he found that the CEOs' average and median inflation-adjusted pay peaked in 2000 and 2001, respectively. Mr. Kaplan also noted that

> CEO pay levels relative to other highly paid groups today are comparable to their average levels in the early 1990s. In fact, the relative pay of large company CEOs is similar to its average level since the 1930s. The ratio of large company CEO pay to firm market value also has remained roughly constant since 1960.[10]

These findings complement observations that the tenure of public company CEOs has become less secure than was historically the case. It is a development that has in part been traced to growing demands by shareholders for CEO pay to better reflect CEO performance:

[7] Ibid.

[8] David F. Larcker, Scott A. Richardson and Irem Tuna, and Andrew J. Seary, "Back Door Links between Directors and Executive Compensation," 2005, available at http://knowledge.wharton.upenn.edu/papers/1291.pdf.

[9] Lawrence Mishel and Natalie Sabadish, "CEO Pay in 2012 Was Extraordinarily High Relative to Typical Workers and Other High Earners," *Economic Policy Institute*, June 26, 2013, available at http://www.epi.org/publication/ceo-pay-2012-extraordinarily-high/.

[10] Steven N. Kaplan, "Executive Compensation and Corporate Governance in the U.S.: Perceptions, Facts and Challenges," University of Chicago Booth School Research Paper No. 12-42, August 22, 2012, available at http://ssrn.com/abstract=2134208 or http://dx.doi.org/10.2139/ssrn.2134208.

> [2012] CEO turnover report parallels what has been going on in the economy over the past several years, says Challenger Gray [an executive placement firm] CEO John Challenger, relatively flat but with continuing risks. "It's not a job for someone who thinks they're going to stay in one spot for a long career right now," he says. "Tenures are short," particularly in big public companies. According to Challenger Gray the average tenure of CEOs who left all companies over the last 18 months was 8.1 years… To Challenger, most CEO changes over the past few years reflect the fact that stakeholders "are much more vigilant than they ever were before." Not only shareholders, but employees and even the public "have their sights trained on the performance of companies," Challenger says, and the CEO is the public face of that performance. "When things go wrong, [those] constituencies demand action, which often starts at the top," he adds.[11]

The CEO-Worker Pay Ratio

Related to the subject of CEO pay is the concept of a ratio between a company CEO's compensation and the average or median worker compensation of other employees at the same firm. An early advocate of evaluating and monitoring the ratio of corporate CEO pay to that earned by the average or median worker was the late Peter Drucker, a globally respected management consultant. In the 1980s, Mr. Drucker argued that companies should try to adhere to a CEO-to-average worker pay ratio of 25:1, which he later changed to 20:1.[12] He stressed that corporate pay disparities that exceeded those ratios could impede the ability of companies to foster the teamwork and trust that he deemed critical for corporate success.[13]

Bloomberg estimated that the CEO pay-to-average-worker pay ratio for the average firm in the Standard & Poor's 500 Stock Index (S&P 500) was 204:1 in 2012, a 20% increase over their 2009 estimate of 170:1 when the financial crisis reportedly caused many of the firms to reduce CEO pay.[14]

Bloomberg also observed that historical estimates by various academics and trade unions have tended to place the average ratio for S&P 500 firms at around 20:1 during the 1950s, 42:1 in 1980, and 120:1 by 2000.[15] Alternatively, examining average worker and CEO pay, which included stock options granted at the nation's largest 350 corporations, the Economic Policy Institute (EPI) reported that the CEO-to-worker pay ratio was 18:1 in 1965, 27:1 in 1978, 137:1 in 1995, and peaked at 411:1 in 2000. In 2012, the ratio was 202.3:1, which EPI indicated was significantly higher than it had been for comparable firms in the 1960s, 1970s, 1980s, and 1990s.[16]

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[11] Steve Schaefer, "Watch Your Backs, CEOs: The Margin For Error Is Shrinking," *Forbes*, July 19, 2012, available at http://www.forbes.com/sites/steveschaefer/2012/07/19/watch-your-backs-ceos-the-margin-for-error-is-shrinking/.

[12] "Letter from the Drucker Insitute of the Clarement Graduate University to SEC Chair Mary Schapiro," February 17, 2011, available at http://thedx.dreamhosters.com/wp-content/uploads/2011/02/SECcomment.pdf.

[13] Ibid.

[14] Elliot Blair Smith and Phil Kuntz, "CEO Pay 1,795-to-1 Multiple of Wages Skirts U.S. Law," *Bloomberg*, April 30, 2012, available at http://www.bloomberg.com/news/2013-04-30/ceo-pay-1-795-to-1-multiple-of-workers-skirts-law-as-sec-delays.html. Although the index has always represented the larger domestic public firms, the composition of specific firms has frequently changed through the years.

[15] Ibid.

[16] Lawrence Mishel and Natalie Sabadish, "CEO Pay in 2012 Was Extraordinarily High Relative to Typical Workers and Other High Earners," *Economic Policy Institute*, June 26, 2013, available at http://www.epi.org/publication/ceo-
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Given these ratios, is there a sense of how ratios of varying sizes may have affected various aspects of worker and corporate performance? Research in this area is limited. One of the few such efforts in this area was conducted by Faleye, Reis, and Venkateswaran. The authors used data on CEO and employee compensation on about 450 firms of varying sizes to examine the relationships between CEO-employee pay ratios, employee productivity, and corporate performance between 1993 and 2006.[17]

Among their findings were as follows:

- Generally for larger firms with 3,250 employees or more, the authors could not discern a statistically significant inverse relationship between the CEO-employee pay ratio and firm productivity, which was said to suggest that the size of the ratio had no bearing on employee productivity.
- Generally for smaller firms with less than 3,250 employees who are well informed about worker CEO pay differentials and work in an environment in which promotion is largely merit-based, the CEO-employee pay ratio was found to be significantly and positively related to gains in firm productivity.
- Generally, firm stock valuation and firm operating performance increased as CEO-employee pay ratios increased.
- The CEO-employee pay ratio was strongly associated with variables that affect a CEO's bargaining power such as firm size, firm performance, and the level of firm risk.
- Variables associated with greater employee bargaining power such as unionization were generally associated with lower CEO-employee pay ratios.[18]

The CEO-Worker Pay Ratio Inequality Nexus

As noted earlier, *Bloomberg* reported that the pay ratio between public company CEOs and other company employees has generally been growing over time.[19]

Meanwhile, various researchers have found that the United States has generally experienced growing income inequality over the past few decades.[20] Some studies have spoken of economic costs of this growing income inequality, such as an amplification of the risks of a financial crisis, and heightening the challenges for poorer citizens to invest in education.[21] There is also research

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pay-2012-extraordinarily-high/.

[17] Olubunmi Faeye, Ebru Reis, and Anand Venkateswaran, "The Determinants and Effects of CEO–Employee Relative Pay," April 2012, available at http://dx.doi.org/10.2139/ssrn.2079369.

[18] Ibid.

[19] For example, see, Elliot Blair Smith and Phil Kuntz, "CEO Pay 1,795-to-1 Multiple of Wages Skirts U.S. Law," *Bloomberg*, April 30, 2012.

[20] CRS Report RS20811, "The Distribution of Household Income and the Middle Class," by Craig K. Elwell; CRS Report R42348, *The Trend in Family Income from 1979 to 2010*, by Gerald Mayer.

[21] For example, see, Andrew G. Berg and Jonathan D. Ostry, "Inequality and Unsustainable Growth: Two Sides of the Same Coin?" *International Monetary Fund Staff Discussion Notes*, April 8, 2011, available at http://www.imf.org/ (continued...)

that posits that income inequality can confer economic benefits, including a more effective market economy and the provision of economic incentives deemed necessary for entrepreneurial risk taking.[22]

The subject of income inequality is, however, outside of the scope of this report. The reader can find a number of CRS reports that examine this and related areas.[23]

The perceived widening income inequality has also been featured in discussions over the potential ramifications of CEO-worker pay ratios. For example, one academic examination of the link between executive pay and income inequality argued that higher CEO pay levels amidst stagnant levels of worker pay have helped to drive growing income inequality:

> Executive compensation has reached scandalous levels at many public companies, making it the number one problem in corporate law. And as a major factor in the growing income inequality in America, it is even more significantly a threat to the economic well-being of our nation. Things were not that way during the wide spread prosperity that followed the Second World War. During the last several decades, however, as the living standards of most Americans have remained stagnant or gone backwards, top corporate pay has grown to outrageous proportions.[24]

Questions have been raised over the notion that the growth in CEO pay packages has played a role in the widening national income inequality. It has been argued that there are simply not enough highly compensated large company CEOs to have a meaningful impact on national income statistics. The idea is that one could hypothesize an extreme scenario in which a large portion of CEOs' pay is redistributed to the other corporate employees. Even under this implausible scenario, it is argued that because CEO pay tends to be a small fraction of the total corporate payroll, such redistribution would have very little impact on the size of the other workers' pay.[25]

The SEC's Mandatory Disclosure and Executive Pay

A key goal of the SEC is to ensure that market participants have access to enough information to make informed decisions, rather than to limit the riskiness of the business models of publicly traded firms.[26] As part of this, since 1933, public companies have had to publicly disclose certain

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external/pubs/ft/sdn/2011/sdn1108.pdf.

22 Ibid.

23 For example, see, CRS Report R42348, *The Trend in Family Income from 1979 to 2010*, by Gerald Mayer; CRS Report RS20811, *The Distribution of Household Income and the Middle Class*, by Craig K. Elwell; CRS Report RL33433, *An Analysis of the Distribution of Wealth Across Households*, 1989-2010, by Craig K. Elwell; and CRS Report RL33069, *Poverty in the United States: 2012*," by Thomas Gabe.

24 Daniel Morrissey, "Executive Compensation and Income Equality," Gonzaga University School of Law Legal Studies Research Paper No. 2012-2, 2012, available at http://ssrn.com/abstract=2048698.

25 For example, see, "Executive Pay Matters, What Its Proponents Get Wrong About the CEO Pay Ratio," *Towers Watson*, August 7, 2013, available at http://www.towerswatson.com/en/Insights/Newsletters/Global/executive-pay-matters/2013/What-Its-Proponents-Get-Wrong-About-the-CEO-Pay-Ratio; and Megan McArdle, "The Logic of Life: CEO Pay," *The Atlantic*, February 7, 2008, available at http://www.theatlantic.com/business/archive/2008/02/the-logic-of-life-ceo-pay/2694/.

26 See CRS Report R43087, *Who Regulates Whom and How? An Overview of U.S. Financial Regulatory Policy for*
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information on CEO pay. Since 1938, as part of its mission to ensure that public companies provide investors with material information to make informed investment and corporate governance voting decisions,[27] the SEC has adopted an array of additional executive pay-related mandatory corporate disclosure regulations, including

- disclosure of information concerning the amount and the kinds of compensation paid to its chief executive officer, chief financial officer, and the three other most highly compensated executive officers;
- disclosure of the criteria used in reaching executive compensation decisions and the degree of the relationship between the company's executive compensation practices and corporate performance;[28]
- disclosure on how a company's executive pay policies might encourage excessive risk-taking;
- the objectives of the company's compensation program;
- what kinds of performance the compensation program is designed to reward;
- the elements of the compensation program;
- why the company has selected each element in the compensation program;
- how the amount of each compensation element is determined; and
- how each compensation element fits into the issuer's overall compensation objectives.

In 2010, through the Dodd-Frank Act, Congress expanded the SEC's executive pay-related mandatory corporate disclosures and related corporate governance requirements, including the following:

- Corporate board compensation committees were required to be composed exclusively of independent directors.
- Corporate board compensation committees were empowered to retain or obtain the advice of a compensation consultant, legal counsel, or other advisor. The act also provides that the compensation committee is directly responsible for the compensation and oversight of those advisors.

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Banking and Securities Markets, by Edward V. Murphy.

[27] For example, see the comments of Shelley Parratt, SEC Deputy Director, Division of Corporation Finance, in which she said that "the SEC's role in this area [compensation disclosure] is … to see that investors have the critical disclosure they need to make informed investment and voting decisions." "Executive Compensation Disclosure: Observations on the 2009 Proxy Season and Expectations for 2010," November 9, 2009, available at http://www.sec.gov/news/speech/2009/spch110909sp.htm. Explaining the notion of materiality, an SEC commissioner observed: "Issuers, investors, and regulators have struggled with applying the materiality test since the enactment of the securities laws. Materiality is an objective test: the Supreme Court has said that something is material if "there is a substantial likelihood that a reasonable shareholder would consider it … as having significantly altered the 'total mix' of information made available." Speech by SEC Commissioner Paul Atkins, "Remarks to the 'SEC Speaks in 2008 Program of the Practicing Law Institute," February 8, 2008, available at http://www.sec.gov/news/speech/2008/spch020808psa.htm.

[28] "Executive Compensation," Securities and Exchange Commission, available at http://www.sec.gov/answers/execomp.htm.

- Companies must disclose the relationship between executive compensation actually paid and the financial performance of the company.
- Companies must allow their shareholders to have an advisory vote on executive compensation, known as "say-on-pay."
- Companies must disclose "golden parachute" compensation arrangements with certain executive officers in connection with merger transactions.
- The SEC was required to direct national securities exchanges to require companies to develop and implement policies providing for the clawback of incentive-based compensation (including stock options) paid to current or former executive officers in the event of an accounting restatement due to the company's material noncompliance with any financial reporting.
- Federal financial regulators, including the Federal Reserve System and the Office of the Comptroller of the Currency, were to jointly adopt guidance requiring applicable financial institutions (including depository institutions, broker-dealers, credit unions, investment advisers, Fannie Mae, and Freddie Mac) with more than $1 billion in assets to prohibit incentive-based pay arrangements for executives, employees, directors, or principal shareholders deemed to be excessive, or that could lead to material financial loss at the financial institution.

The Dodd-Frank Act's Pay Ratio Provision

In addition to the aforementioned executive pay-related and corporate governance-related disclosure and requirements mandated in the Dodd-Frank Act, Section 953(b) of the act requires the SEC to issue regulations amending the rules under Item 402 of Regulation S-K for filings under the Securities Act of 1933 and the Securities Exchange Act of 1934.[29] After the rulemaking, for which there is no deadline, public companies will be required to disclose the following information in the various mandatory financial disclosure SEC filings, including quarterly financial reports known as 10-Qs: (1) the median of the annual total compensation of all company employees (excluding the CEO); (2) the annual total compensation of the company CEO, a long-standing required disclosure; and (3) the ratio of the median employee annual total compensation to the CEO's annual total compensation, the pay ratio. "Total compensation" is required to be calculated in accordance with the current rules for determining a named executive officer's total compensation under prevailing SEC disclosure protocol.

[29] These delineate reporting requirements for various SEC filings used by public companies with respect to executive compensation disclosures.

The SEC's Proposal to Implement the Pay Ratio Provision

On September 18, 2013, the SEC voted 3-2 to propose a new rule that would require public companies to disclose the ratio of the total compensation of its CEO to the median total compensation of the rest of its employees as required by Section 953(b) of the Dodd-Frank Act.

The proposal does not prescribe a specific methodology for companies to use in calculating a pay ratio. A company would have the flexibility to determine the median annual total compensation of its employees in a manner that "best suits its particular circumstances." As an example, a company would be allowed to calculate the median employee's total compensation either through the use of its total workforce or through the use of a statistical sample of that population.[30]

Companies would have to briefly explain any methodology used to identify the median along with any material assumptions, adjustments, or estimates that are employed to calculate the median or to determine total compensation or any components of the total compensation.[31]

In the vote for the proposal, one of the two dissenting commissioners, Michael Piwowar, observed,

> I am not only unable to support the pay ratio disclosure proposal, I object to the Commission even considering it. The Commission should not be spending any of its limited resources on any rulemaking that unambiguously harms investors, negatively affects competition, promotes inefficiencies, and restricts capital formation.… Proponents of the pay ratio disclosure rule, to their credit, have been transparent about the fact that the objective of the rule has nothing to do with any part of the Commission's core mission of protecting investors, maintaining fair, orderly, and efficient markets, and promoting capital formation. In fact, proponents have acknowledged that the sole objective of the pay ratio disclosure rule is to shame CEOs.[32]

Pending his review of the SEC proposal, Senator Robert Menendez, the pay provision's sponsor, expressed cautious optimism about the proposal in a press release:

> I welcome the SEC's step today towards implementing this important rule and I look forward to reviewing their proposal…. I'm encouraged by the initial information out of the SEC today, but want to review the proposal to ensure that it strikes the right balance between flexibility and accountability…. We have middle class Americans who have gone years without seeing a pay raise, while CEO pay is soaring. This simple benchmark will help investors monitor both how a company treats its average workers and whether its executive pay is reasonable.[33]

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[30] "SEC Proposes Rules for Pay Ratio Disclosure," Securities and Exchange Commission, September 18, 2013, available at http://www.sec.gov/News/PressRelease/Detail/PressRelease/1370539817895#.UjsqGoa8jJY.

[31] "Pay Ratio Disclosure," Securities and Exchange Commission, p. 59.

[32] "Statement at Open Meeting Regarding Municipal Advisors and Pay Ratio Disclosure Commissioner Michael S. Piwowar Open Meeting," September 18, 2013, available at http://www.sec.gov/News/Speech/Detail/Speech/1370539811778#.UjnNd4a8jJY. The other dissenting voter was Commissioner Daniel M. Gallagher.

[33] "Menendez Applauds SEC Movement on Disclosing CEO-to-Worker Pay Ratios," *Press Release from the Office of Senator Robert Menendez*, September 18, 2013, available at http://www.menendez.senate.gov/newsroom/press/ (continued...)

Legislation to Repeal the Pay Ratio Provision

Legislation in the 113th Congress would repeal Section 953(b) of the Dodd-Frank Act. H.R. 1135 (Huizenga) was ordered to be reported by the House Financial Services Committee on June 19, 2013, and is similar to legislation in the 112th Congress, H.R. 1062 (Hayworth), which also would have repealed the pay ratio provision. H.R. 1062 was reported by the House Financial Services Committee on July 12, 2011 (H.Rept. 112-142).

On introducing H.R. 1135, the bill's sponsor said that the pay ratio provision of the Dodd-Frank Act

> [C]reates an enormous burden for publicly traded companies while offering no corresponding benefit. By forcing publicly traded companies to report median total compensation, the federal government is requiring companies to provide data that is potentially misleading to investors due to the differing geographic locations of the business. A salary in Detroit is going to be different than a salary in San Francisco, which is going to be different than a salary in London.[34]

The chairman of the House Financial Services Committee, Jeb Hensarling, leveled similar criticism. Chairman Hensarling reportedly asserted that there were probably "an infinite number of ratios some investors would find helpful to their decisions" and companies might as well be required to formulate the ratio of workers with and without college degrees, the ratios of older relative to younger workers, or the ratio of office supplies purchased from big box retailers to those for locally based office suppliers.[35]

By contrast, Senator Robert Menendez, the original sponsor of the pay ratio provision, has defended the provision:

> It's evident that excessive compensation schemes provided part of the fuel for the financial crash. And by requiring companies to disclose just how much, and how skewed, CEO pay can be, there's a strong possibility they'll think more about their compensation structures…. ,A company's treatment of their average workers is not just a reflection of their corporate values, but is also material information for investors. So, it's time Wall Street shine a light on their CEO pay…. What's too costly here are the big paydays for CEOs. And the burden is falling on workers with stagnant wages.[36]

During the House Financial Services Committee's markup of H.R. 1062 (Hayworth) in the 112th Congress, then-Representative Barney Frank, at that time ranking committee Member and a

(...continued)

menendez-applauds-sec-movement-on-disclosing-ceo-to-worker-pay-ratios.

[34] "Huizenga: Dodd-Frank Pay Ratio Provision Not Worth the Cost, Needs To Be Repealed," *Press Release from the Office of Congressman Bill Huizenga*, March 21, 2013, available at http://huizenga.house.gov/news/documentsingle.aspx?DocumentID=325003.

[35] Emily Chasan, "Legislators Take Aim at Dodd-Frank Pay-Ratio Rule," *Wall Street Journal*, June 20, 2013, available at http://blogs.wsj.com/cfo/2013/06/20/legislators-take-aim-at-dodd-frank-pay-ratio-rule/.

[36] "Menendez Calls on SEC to Expedite Adoption of CEO-to-Median Pay Disclosure Rule Menendez's Compensation Reform was Included in Dodd-Frank, but Has Yet to be Implemented," *Press Release from the Office of Robert Menendez*, March 12, 2013, available at http://www.menendez.senate.gov/newsroom/press/menendez-calls-on-sec-to-expedite-adoption-of-ceo-to-median-pay-disclosure-rule.

sponsor of the Dodd-Frank Act, said that he viewed the issue of "excessive inequality" as a legitimate issue and that he did not support repeal of the pay provision. During the committee's markup of H.R. 1062, Representative Frank introduced unsuccessful amendments aimed at reducing some of the corporate costs of complying with the pay ratio provision, including a requirement that the pay ratio provision data be a part of annual instead of quarterly financial disclosures; the disclosed pay ratio information cover corporate domestic workers, not corporate workers located outside of the United States; and pay ratio data be based on cash compensation, not total compensation as currently required.[37]

During the House Financial Services Committee's markup of H.R. 1135 on June 19, 2013, Representative Maxine Waters, the ranking committee Member, spoke of her opposition to the repeal legislation. She argued that the pay ratio provision "has the potential to provide useful information to shareholders about the ratio of CEO pay to median worker pay."[38] Representative Waters also noted that the bill's supporters "like to say that their bill is … about [the pay ratio provision's] burdensome reporting," a fact that she said had some potential legitimacy. Representative Waters, however, said that the bill's supporters had no interest in making "it easier to implement,"[39] as she introduced an unsuccessful amendment that would have required annual instead of quarterly disclosure of the pay ratio data; the use of pay data from corporate domestic workers, not workers outside of the United States; and the provision's worker compensation calculations to be based on cash compensation, rather than total compensation.[40]

Support for and Opposition to Repealing the Pay Ratio Provision Outside of Congress

Outside of Congress, criticism of the pay ratio provision has come from business-related entities. Among them are reportedly the American Benefits Council, American Insurance Association, the Business Roundtable, the National Association of Manufacturers, the National Retail Federation, the Financial Services Roundtable, the Securities Industry and Financial Markets Association, IBM, McDonald's, AT&T, the New York Stock Exchange, the U.S. Chamber of Commerce, and the Center on Executive Compensation.[41]

[37] "House Financial Services Committee Holds Markup on Six Financial-Related Bills (H.R. 940, H.R. 2072, H.R. 1070, H.R. 1082, H.R. 33, H.R. 1062) as well as the Committee's Semiannual Committee Activity Report," *CQ Congressional Transcripts*, June 22, 2011, available at http://www.cq.com/doc/congressionaltranscripts-3894679?wr=RDlYTlRja3lSajczVXEzRmU5SUhFUQ.

[38] "Ranking Member Waters' Opening Statement at Full Committee Markup of Capital Markets Bills," *Press Release from the House Financial Service Committee's Democrats*, June 19, 2013, available at http://democrats.financialservices.house.gov/press/PRArticle.aspx?NewsID=1558.

[39] See the comments of Representative Maxine Waters in "House Financial Services Committee Holds Markup on H.R. 1135, 'Burdensome Data Collection Relief Act,' *CQ Congressional Transcripts*, June 19, 2013, available at http://www.cq.com/doc/congressionaltranscripts-4300706?wr=eFF6UlQqRXM3azEwYmRWbjlpaWNBZw.

[40] "Amendment to H.R. 1135 Offered by Ms. Waters, June 19, 2013, available at http://financialservices.house.gov/uploadedfiles/bills-113-hr1135-w000187-amdt-001.pdf.

[41] Jerry Markon and Dina ElBoghdady, "Dodd-Frank Executive Pay Rule Still in Limbo Amid Pushback from Corporate America," *Washington Post*, July 6, 2013, available at http://articles.washingtonpost.com/2013-07-06/politics/40404900_1_rule-financial-overhaul-legislation-agency. "Letter to SEC Chairman Mary Schapiro Regarding Section 953(b) of the Dodd-Frank Wall Street Reform and Consumer Protection Act," January 19, 2012, available at http://www.centerforcapitalmarkets.com/wp-content/uploads/2010/04/2012-1.18-Trades-Ltr-to-SEC-re-pay-ratio-rules1.pdf.

Outside of Congress, support for the pay ratio provision has come from unions, civil rights groups, consumer advocacy groups, social justice groups, liberal think tanks, and others. These reportedly include the AARP, the AFL-CIO, AFSCME, the Alliance for Justice, the Americans for Democratic Action, the Center for Economic and Policy Research, the Center for Economic Progress, Common Cause, the Communications Workers, the Consumer Federation of America, the Economic Policy Institute, the International Federation of Teamsters, the NAACP, and the United Food and Commercial Workers.[42]

By mid-August 2013, reports indicate that the SEC had received more than 20,000 letters from investors asking the agency to finalize the rules for the pay ratio provision.[43]

Key Arguments in the Debate on the Pay Ratio Provision

As discussed earlier, supporters of the pay ratio provision have spoken of the provision as a vehicle for newly disclosed data that could play a role in reducing income inequality. However, as also noted earlier, income inequality may have both economic costs and benefits. Moreover, some have argued that even if there were massive redistributions of CEO pay to other corporate employees, national income inequality would still not be significantly narrowed.

Thus, a discussion over the value of the pay ratio provision—and hence the value of legislation to repeal it—should arguably involve two basic public policy concerns: (1) Will the disclosures required by the provision provide material information to investors and valuable information to other corporate stakeholders? (2) What kinds of costs and challenges are likely to be associated with corporate compliance with the pay provision? These questions are examined in this section.

The Provision's Disclosures and the Provision of Material and Valuable Information to Investors

As explained by a former SEC commissioner, the concept of investor materiality is not a well-defined notion:

> Issuers, investors, and regulators have struggled with applying the materiality test since the enactment of the securities laws. Materiality is an objective test: the Supreme Court has said that something is material if "… there is a substantial likelihood that a reasonable shareholder would consider it … as having significantly altered the 'total mix' of information made available."[44]

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[42] "Letter from Americans for Financial Reform in Opposition to H.R. 1135," May 22, 2013, available at http://ourfinancialsecurity.org/blogs/wp-content/ourfinancialsecurity.org/uploads/2013/05/AFR-Oppose-HR-1135-5-22-13.pdf.

[43] "New Director Says SEC Corp Fin Wrestling with Calculation Methodology for Pay Ratios," *BNA's Securities Regulation & Law Report*, August 19, 2013.

[44] "Speech by SEC Commissioner Paul Atkins: Remarks to the 'SEC Speaks in 2008' Program of the Practicing Law Institute," February 8, 2008, available at http://www.sec.gov/news/speech/2008/spch020808psa.htm.

Some critics of the pay ratio provision have acknowledged public policy concern with respect to pay disparities.[45] Still, there appears to be a general consensus among critics that the provision is not likely to result in meaningful information to investors because the resulting data are not likely to pass the materiality test.[46]

Over the years, a presumption of investor materiality has been fundamental to mandatory corporate disclosures, including compensation-related regulations that have been proposed and then adopted by the SEC. An argument advanced by supporters of the pay ratio provision is that the data from the resulting disclosures will provide investors with critical information required to ascertain whether a company's executive compensation packages are acceptable in light of the overall compensation picture at the company. The provision's proponents also argue that data on the median employee compensation levels and wage disparities between workers and the CEO will give investors a better understanding of how specific firms compare to their industry peers and the compensation strategies of specific industries.[47]

Among other things, Section 951 of the Dodd-Frank Act requires public companies to provide their shareholders with an advisory vote on executive compensation, also called "say-on-pay" votes. Supporters of the pay ratio provision say that the say-on-pay votes give a company's shareholders an opportunity to express themselves on the "reasonableness" of executive compensation. They also argue that this notion of reasonableness requires a contextual framework and that the disclosures in the pay ratio provision should help provide this context by providing a mechanism for evaluating the reasonableness of the compensation within a given firm.[48]

In the SEC pay ratio proposal, the SEC staff summarized its view on the provision's usefulness to investors: "As mentioned above, currently it is not possible to quantify the usefulness to investors of company-specific pay ratio information as required by Section 953(b) as compared to the usefulness of publicly available statistics on average salaries, or the usefulness of any other company-specific metric of employee compensation or satisfaction."[49]

Relatedly, a *New York Times* editorial argued that the data to be provided through the pay ratio provision could assist investors in assessing a company's pay structure on productivity, efficiency,

[45] For example, see "Written Testimony of Robert Smith Corporate Secretary, Vice President & Deputy General Counsel NiSource, Incorporated and Chair, Policy Advisory Committee Society of Corporate Secretaries and Governance Professionals before the Subcommittee on Capital Markets and Government Sponsored Enterprises, House Committee on Financial Services," May 23, 2013, available at http://higherlogicdownload.s3.amazonaws.com/GOVERNANCEPROFESSIONALS/26582a95-d501-4284-afd8-8e18fa9426a2/UploadedImages/HomePageDocs/SmithHouseSubcommitteeTestimonyMay2013.pdf.

[46] In addition, there were minority Senator comments in the report that accompanied the Senate bill before the conference with the House bill, which produced the Dodd-Frank Act: "Although provisions like this appeal to popular notions that chief executive officer salaries are too high, they do not provide material information to investors who are trying to make a reasoned assessment of how executive compensation levels are set. Existing SEC disclosures already do this." Report of the Senate Committee on Banking, Housing and Urban Affairs to Accompany S. 3217, S.Rept. 111-176, April 30, 2010, p. 245.

[47] For example, see, "Statement of Damon A. Silvers, Policy Director and Special Counsel, American Federation of Labor and Congress of Industrial Organizations Committee on House Financial Services Subcommittee on Capital Markets and Government Sponsored Enterprises," *CQ Transcripts*, March 16, 2011, available at http://www.cq.com/doc/testimony-3832303/5?wr=bzR2QWhQbmtjMGtLTTk4WFlHMkFNdw.

[48] J. Robert Brown, Jr., "Dodd-Frank, Compensation Ratios, and the Expanding Role of Shareholders in the Governance Process," *Harvard Business Law Review*, October 2011.

[49] "Pay Ratio Disclosure," Securities and Exchange Commission, p. 97.

innovation, and other aspects of a company's work force performance. Outside of the realm of investor insight, the editorial also argued that the provision could help economists and policy makers better detect imminent asset bubbles and economic crashes, which it said tend to correlate with widening income gaps.[50] Regarding this assertion, as mentioned earlier, even major redistributions of CEO pay to their employees would be unlikely to make a meaningful dent in national income inequality.[51]

Some investor groups have lent conceptual support to the operational importance of firms paying attention to CEO-worker pay ratios. For example, the Council of Institutional Investors, a coalition of pension funds, has argued that board compensation committees should consider the "goals for distribution of awards throughout the company" and "the relationship of executive pay to the pay of other employees" as factors in developing their executive pay strategy.[52]

Similarly, others who argue for the importance of the pay ratio provision say that the resulting disclosures may improve the decision making of company boards when they craft executive pay packages. An example is a scenario in which a high CEO-worker pay ratio could publicly embarrass a corporate board. The argument is that a board might then have greater incentives to bargain for executive pay packages that will not appear to be excessive.[53] Though plausible, the scenario has potential shortcomings. For example, it appears to presume that public companies tend to overpay a CEO who is operating in a suboptimally efficient market for his or her services. Some researchers question this way of looking at the market for CEOs' services.

In addition, some might question whether concerns over an unpredictable and possibly emotionally driven public response to pay ratio disclosure should be a rational part of a board's CEO pay formulation calculus.[54]

Critics of the pay ratio provision predict that the mandated disclosure will not provide meaningful investor data because there will frequently be a lack of meaningful comparative context. For example, some have warned against comparing such disclosures across firms from different industries, which can have substantially different CEO-worker pay ratios because companies in different sectors may have different labor and management mixes and wage levels.

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[50] "Overpaid? Or Worth Every Penny?," *New York Times*, July 13, 2013, available at http://www.nytimes.com/2013/07/14/opinion/sunday/overpaid-or-worth-every-penny.html?_r=1&.

[51] On the notion that growing income inequality may contribute to asset bubbles, there appears to be no consensus among economists on this dynamic. After examining the discourse in this area, one economist observed that a number of dynamics are possible and no particular one has been definitively proven. Large asset bubbles may cause income to become more concentrated. More concentrated income may lead to asset bubbles. Growing income inequality and emerging asset bubbles could also occur simultaneously and run in both directions. Alternatively, neither may be a source of causation as the widening income gap and emerging asset bubbles may both be have been fueled by an unidentified third factor. However, at least one economist, Justin Fox, editor at the *Harvard Business Review*, has reportedly examined the question and found that asset bubbles appear to have been a contributing factor to income inequality. Mark Thomas, "The Asset Bubble Theory of Income Inequality," *Economist's View*, April 16, 2009, available at http://economistsview.typepad.com/economistsview/2009/04/the-asset-bubble-theory-of-income-inequality.html.

[52] For example, see "Corporate Governance Policies," *Council of Institutional Investors*, September 29, 2010, available at http://www.cii.org/CouncilCorporateGovernancePolicies/.

[53] J. Robert Brown, Jr, "Dodd-Frank, Compensation Ratios, and the Expanding Role of Shareholders in the Governance Process," *Harvard Business Law Review*, October 2011.

[54] For example, see Scott Thurm, "Pay for Performance No Longer a Punchline," *Wall Street Journal*, March 20, 2013, available at http://online.wsj.com/article/SB10001424127887324373204578372444079319544.html.

It has also been argued that comparing pay ratio data for firms across companies of different sizes is likely to have little value because companies with higher annual sales tend to pay their CEOs more. A related argument has been made that comparisons of pay ratios of domestic companies with no overseas workers with those with a global worker presence could also be problematic. This is because global firms could have overseas workers who reside in different countries with different average wage rates, different costs of living, different tax regimes, and different levels of government-provided benefits.[55]

For example, some claim that meaningless inconsistencies would follow from a comparison of the pay ratios of a company that has outsourced jobs (for example, call centers) to locales with lower worker pay levels to those of otherwise similar firms who have remained entirely stateside. Such inconsistencies, it is argued, could be further exacerbated by currency exchange rate fluctuations.[56]

Proponents of the pay ratio provision counter that such shortcomings can be reasonably addressed. To make the pay ratio disclosures more compatible, they suggest that pay ratio data based on a company's full-time domestic employees and its non-domestic workers could be disclosed separately. They also argue that pay ratio disclosure data could be made more meaningful if companies were encouraged to append a detailed narrative discussion on composition of the ratios to their disclosures.[57]

On the comparability problems posed by differences in compensation levels across various industries, supporters of the pay ratio provision also could arguably make the same "apples to oranges" criticisms against the various corporate financial ratios that are widely used by analysts and investors.[58] The SEC, however, does not require the disclosure of financial ratios. They are calculated by outsiders who use the data from the mandatory corporate financial disclosures that are required by the SEC.

Expressing doubts about the benefits some ascribe to the pay ratio provision, SEC staff commentary in the SEC's pay provision proposal noted that company-specific information about median employee pay would be new investor information that resulted from the pay ratio provision. However, the staff also observed that various pay ratio advocates

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[55] For example, see, W. Leigh Culpepper and Eric Hurst, "Reporting CEO-to-Employee Pay Ratios: Navigating the Minefield," *Society for Human Resource Management*, November 2010, available at http://www.shrm.org/hrdisciplines/compensation/articles/pages/payratios.aspx.

[56] For, example, see, "Written Testimony of Charles G. Tharp, Chief Executive Officer, Center On Executive Compensation at the Hearing on Legislative Proposals to Relieve the Red Tape Burden on Investors and Job Creators, Subcommittee on Capital Markets and Government Sponsored Enterprises, House Committee on Financial Services," May 23, 2013, available at http://search.proquest.com/docview/1355948772?accountid=12084; and John H. Lowell, "Dodd-Frank Section 953(b): Why It Is a Legislated Disaster," *Bloomberg Finance*, 2012, available at http://about.bloomberglaw.com/practitioner-contributions/dodd-frank-section/. In the September 2013 pay ratio proposal, the SEC observed that the agency did not agree that mandating a specific approach for calculating median worker pay "would necessarily improve the comparability across companies because of the numerous other factors that could also cause the ratios to be less meaningful for company-to-company comparison." "Pay Ratio Disclosure," *Securities and Exchange Commission*, p. 47.

[57] "Americans for Financial Reform Letter to the SEC Re: Dodd-Frank Section 953(b)," March 23, 2011, available at http://www.sec.gov/comments/df-title-ix/executive-compensation/executivecompensation-63.pdf.

[58] Ibid.

> have not specified whether this type of company-specific information would be equally useful in connection with all types of companies or whether the potential benefits are more relevant to certain types of businesses, industries, business structure or size of registrant [the company] and … have not specified what an optimal pay ratio is or what a proper benchmark should be. They also have not specified what effect a pay ratio has on employee morale and productivity relative to other environment-specific and company-specific factors. To the extent that factors exist that could cause the ratios to differ, precise comparability across companies may not be relevant and could generate potentially misleading interpretations or conclusions.[59]

Critics of the pay provision can also cite a body of work on how numerous and sometimes complex mandatory corporate disclosure requirements can potentially overwhelm some investors and erode the overall value of a firm's disclosures to investors.[60]

The provision's detractors have also argued that the number of annual public corporate shareholder proposals for disclosing CEO and worker pay ratios has been limited over the years. For example, in 2010, there were reportedly nine such shareholder proposals with an average level of support from all shareholders of 6.4%.[61] Others would, however, argue that shareholder proposals are merely precatory, meaning that they are just advisory and corporate boards are not required to comply with them. Thus, such figures may underrepresent the level of actual shareholder interest in CEO/worker pay ratio disclosure.

Critics of the pay ratio provision can also point to the fact that although the SEC has proposed and adopted several executive pay-related mandatory disclosures since 1938, the agency has done so under the rubric of its mission of ensuring that investors have access to material information. In this context, the Congressional Research Service (CRS) was not able to find any SEC proposed or adopted executive pay-related proposals in the area of mandatory disclosures of CEO and worker pay ratios. Various proponents of the pay provision, such as Senator Robert Menendez (its original sponsor), say that the provision was in part a response to perceived excessive CEO pay levels.[62] As such, they can cite research findings that similar congressional concerns were behind executive pay disclosure requirements in the first federal securities law, the Securities Act of 1933.[63] They can also cite other congressionally passed executive pay-related legislation, which appears to have also been motivated by perceptions of excessive executive pay.[64]

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[59] "Pay Ratio Disclosure," Securities and Exchange Commission, p. 93.

[60] For example, see "Disclosure Overload and Complexity: Hidden in Plain Sight," *KPMG*, 2011, available at http://www.kpmg.com/US/en/IssuesAndInsights/ArticlesPublications/Documents/disclosure-overload-complexity.pdf.

[61] David McCann, "Dodd-Frank Pay Provision Is a Net Zero," *CFO.com*, February 25, 2013, available at http://www3.cfo.com/article/2013/2/compensation_bartl-aguilar-executive-compensation-dodd-frank.

[62] See the comments of Senator Robert Menendez in: "Senator Tim Johnson Holds a Hearing on Consumer Financial Protection Bureau and Securities and Exchange Commission Nominations," *Washington Transcript Service*, March 12, 2013.

[63] For example, see Joy Sabino Mullane, "Perfect Storms: Congressional Regulation of Executive Compensation," *Villanova Law Review*, November 2012, available at http://www.law.villanova.edu/lawreview/wp-content/uploads/2012/12/VLR309.pdf.

[64] For example, the Omnibus Budget Reconciliation Act of 1993 (OBRA, P.L. 103-66) implemented section 162(m) of the Internal Revenue Code, which eliminated the business deductibility for executive compensation in excess of $1 million unless it qualified as "performance-based" pay. Stating the rationale behind the legislation, which originated with the Clinton Administration, the House Ways and Means Committee observed: "Recently, the amount of compensation received by corporate executives has been the subject of scrutiny and criticism. The committee believes that excessive compensation will be reduced if the deduction for compensation (other than performance-based (continued...)

The Costs of Complying with the Pay Provision

Complying with the pay ratio provision will impose some costs on public companies. A concern is that the cost of computing the ratio may impose what some describe as "immense" costs, especially for large multinational or multi-segment companies. Many of these reportedly have decentralized payrolls and no centralized compensation database for all their employees.[65] Related concerns are that the required formulation of total annual worker compensation data, which many think will be required in the pay ratio provision, will entail various components of employment income. Among these are salaries and bonuses, stock compensation, defined compensation arrangements, and pension and other post-retirement benefits. Various reports, however, say that many companies generally do not keep such information on those various compensation elements for all of their employees on an annual basis. As such, there are concerns that the complex demands of such disclosures are likely to mean that companies may have to build new and costly administrative systems to provide such data.[66]

It has also been reported that many large and sophisticated global companies have human resource, payroll, and benefits systems that are not centralized, which could mean that they would have to reconcile data calculations across all countries in which they have a presence and then ensure that the data are accurate to comply with the pay ratio provision. In addition, smaller firms are said to be more likely to lack the necessary personnel to perform the calculations needed for the pay ratio data and more apt to have high employee turnover, further complicating the calculations.[67]

The SEC pay ratio provision proposal acknowledged that calculating median worker compensation is more challenging when a company has "multiple business units, geographical operations, or subsidiaries [that] maintain payroll data at each business unit or subsidiary."[68] While the proposal agreed that the calculation of the average compensation for the consolidated corporate entity would only require each subsidiary or business unit to provide data on the total (or average) compensation and the number of its employees to the corporate parent, identification of the "median requires transferring the entire set of compensation data from each subsidiary to the parent entity."[69]

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compensation) paid to the top executives of publicly held corporations is limited to $1 million per year." "Reconciliation Recommendations of the House Committee on Ways and Means, *Committee Print 103-11*, May 18, 1993. Executives' cash compensation, the type of pay most directly affected by OBRA, increased slowly after OBRA took effect. But, starting in the 1990s, OBRA is widely thought to have contributed to the growing use of stock options in CEO compensation, which helped fuel an overall growth in the size of CEO pay packages. See CRS Report RL33935, *The Economics of Corporate Executive Pay*, by Gary Shorter and Marc Labonte.

[65] John S. Beasley, *Research Handbook on Executive Pay*, New York, Edward Elgar Publications, 2012, p. 17.

[66] "The Dodd-Frank Wall Street Reform and Consumer Protection Act: Impact on Executive Compensation," *Price Waterhouse and Coopers,* December 2010, available at http://www.pwc.com/us/en/financial-services/regulatory-services/publications/assets/closer-look-executive-compensation.pdf.

[67] Written Testimony of Charles G. Tharp, Chief Executive Officer Center On Executive Compensation, Legislative Proposals to Relieve the Red Tape Burden on Investors and Job Creators Subcommittee on Capital Markets and Government Sponsored Enterprises, House Committee on Financial Services, May 23, 2013, available at http://docs.house.gov/meetings/BA/BA16/20130523/100913/HHRG-113-BA16-Wstate-TharpC-20130523.pdf.

[68] "SEC Proposes Rules for Pay Ratio Disclosure," Securities and Exchange Commission, September 18, 2013.

[69] "Pay Ratio Disclosure," Securities and Exchange Commission, p. 147.

Similar observations on the challenges of calculating median worker pay were raised in 2011 when Meredith Cross, then-director of the SEC's Corporation Finance Division, testified that calculating the pay ratio could be "complex"—especially calculations involving a median as opposed to an average.[70]

The Center on Executive Compensation is a research and advocacy adjunct of the HR Policy Association, a public policy organization of chief human resource officers from some of the nation's largest corporations. The group has been active in lobbying for the repeal of the pay ratio provision and has surveyed member companies on the potential implications of implementing the provision.

About three-quarters of the survey's respondents had more than 10,000 employees worldwide and a little over one-third had more than 50,000 employees worldwide. In addition, three-quarters of the respondents reported having employees in more than 10 countries with many larger companies having employees in at least 30 countries.[71]

According to the survey's findings, almost half of the respondents reported that it would take their companies a minimum of three months to calculate median employee compensation. Nearly one-quarter reportedly indicated that the calculations were likely to take at least five months. Based on the survey, the center said that for many companies, implementation costs for the pay provisions are likely to be in the millions of dollars.[72]

Countering such views, pay ratio provision supporters cite the presence of a number of domestic companies without a global presence that disclose executive pay data along with average or median employee pay figures in their proxy filings to the SEC. Among them are the financial services firms MBIA and the Bank of South Carolina. In addition, Whole Foods, the retail grocer, maintains records of each employee's salary and bonus to ensure that no one earns more than 19 times the company's average pay. The pay cap at Whole Foods reportedly does not include stock options or pension benefits, the reporting of which is generally believed to be required under the pay ratio provision.[73]

SEC staff commentary in the agency's proposed rule for implementing the pay ratio provision noted that allowing firms to choose their own method for calculating median worker pay will enable them to conduct the required pay ratio disclosures in a "relatively cost-efficient" way.[74]

Overall, the SEC estimated that the aggregate corporate compliance costs associated with implementing the pay ratio provision over a three-year period would be about 545,792 hours of company personnel time and about $72,772,200 for the services of outside professionals. The estimates included both the time and the cost of "data gathering systems and disclosure controls

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[70] See the comments of Meredith Cross in: "House Committee on Financial Services, Subcommittee on Capital Markets and Government Sponsored Enterprises Holds a Hearing on Oversight of the Securities and Exchange Commission," *CQ Fair Disclosure Wire,* March 10, 2011.

[71] "Written Testimony of Charles G. Tharp, Chief Executive Officer, Center On Executive Compensation at the Hearing on Legislative Proposals to Relieve the Red Tape Burden on Investors and Job Creators, Subcommittee on Capital Markets and Government Sponsored Enterprises, House Committee on Financial Services," May 23, 2013.

[72] Ibid.

[73] Leslie Kwoh, "Firms Resist New Pay-Equity Rules," *Wall Street Journal*, June 26, 2012, available at http://online.wsj.com/article/SB10001424052702304458604577490842584787190.html.

[74] Pay Ratio Disclosure," Securities and Exchange Commission, p. 39.

and procedures, compiling necessary data, preparing and reviewing disclosure, filing documents and retaining records."[75]

The SEC proposal also noted that because it would provide for some flexibility in identifying the worker median pay, the corporate compliance burden could be lower if the methodology employed reduced the efforts required to collect the data. According to the SEC, the actual compliance burden would likely vary based on factors such as company size, the number of employees, and the number of workers located outside of the United States. For a company with a medium-sized workforce that is primarily domestically located, the proposal said that identifying a median employee from a sample of its employee population in which a consistently applied compensation measure was used would require a three-year average of 95 additional hours of work annually (based on 170 hours in year one, 80 hours in year two, and 35 hours in year three and thereafter). In contrast, it noted that for a large, multi-national firm employing hundreds of thousands of employees, the hours needed to comply with the pay ratio provision would probably be higher.[76]

After the proposal's release, some in the business community, such as the law firm Sidley Austin, said that the SEC proposal's flexibility could help produce some cost savings that would "be welcome to many U.S. public companies." But overall, the law firm echoed concerns expressed by other business-related entities, including the U.S. Chamber of Commerce, when it warned that "compliance with the new [proposed] rules still has the potential to be burdensome, particularly for large and/or multinational companies."[77]

Another potential consequence of having to comply with the pay ratio provision is that companies might be incentivized to present a more favorable CEO-to-worker pay ratio through workforce-based business restructuring. This could include substituting lower paid foreign-based corporate employees for domestic corporate employees, and shifting from company-employed workers to outsourced employees.

In its proposal, the SEC staff commented on such unintended business structural consequences: "[T]he potential value of this disclosure for assessing issues related to employee morale, productivity and investment in human capital may be diminished by the indirect costs of creating incentives for registrants to change their business structure."[78]

[75] Ibid, p. 143.

[76] Ibid, p. 146.

[77] "SEC Proposes CEO Pay Ratio Disclosure Rules Required by Dodd-Frank," Sidley Austin LLP, September 19, 2013, available at http://m.sidley.com/CorporateGovernanceUpdate_91913/. The U.S. Chamber of Commerce announced that it would be evaluating the SEC proposal, but noted said that the "proposal has the potential to drive up compliance burdens and costs for public companies with no benefit to investors, a formula that continues to make it less attractive to be a public company in the United States," U.S. Chamber Calls on SEC to Ensure Pay-Ratio Proposal Provides Investors with Useful Information," U.S. Chamber of Commerce, September 18, 2013, available at http://www.uschamber.com/press/releases/2013/september/us-chamber-calls-sec-ensure-pay-ratio-proposal-provides-investors-usef.

[78] "Pay Ratio Disclosure," Securities and Exchange Commission, p. 93.

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