PAY RATIO DISCLOSURE: ANOTHER FAILED ATTEMPT TO CURTAIL EXECUTIVE COMPENSATION

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INTRODUCTION

Executive compensation has been the cyclical target of intense

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criticism since the Great Depression, often attracting public ire and inducing Congressional action.[1] After the 2008 financial crisis, CEO compensation reemerged as a topic of fierce debate and substantial media attention.[2] The 2008 financial crisis proved to be the worst economic disaster since the Great Depression with the failure of some of the nation's largest financial institutions. In response, Congress passed the Dodd–Frank Wall Street Reform and Consumer Protection Act ("Dodd-Frank Act") in 2010 with sweeping reforms intended to reign in excessive corporate risk taking.[3] As part of the Dodd-Frank Act, Congress tasked the Securities and Exchange Commission (the "Commission" or "SEC") with amending Item 402 of Regulation S-K, which governs executive compensation.[4] The SEC must implement Section 953(b) of the Dodd-Frank Act, requiring publicly traded corporations (the "registrants" or "companies") to disclose: (1) the median annual compensation of all employees, except the CEO; (2) the annual compensation of the CEO; and (3) the ratio between these two compensation amounts.[5] The SEC's pay ratio disclosure rule (the "pay ratio rule" or "rule") requires corporations to disclose this compensation

1. *See* Joy Sabino Mullane, *Perfect Storms: Congressional Regulation of Executive Compensation*, 57 VILL. L. REV. 589, 591 (2012) [hereinafter Mullane] for a discussion of America's cyclical protests against corporate compensation since the 1930s.

2. The 2008 financial crisis saw its fair share of finger pointing. Some of the major culprits were deregulation, faulty corporate governance, and Wall Street greed. *See* Saule T. Omarova, *Wall Street As Community of Fate: Toward Financial Industry Self-Regulation*, 159 U. PA. L. REV. 411, 461-62 (2011) ("While it is widely accepted that Wall Street's greed and financial institutions' excessive risk-taking were the key ingredients of the fallout, many competing explanations are being offered," such as the central banks pursuit of crisis-inducing monetary policies, the negative effects of deregulatory legislation, and the "consumers of financial services, such as imprudent homeowners who borrowed beyond their ability to repay and then defaulted on their loans." (internal citations omitted)). *See also* Brooksley Born, *Forward: Deregulation: A Major Cause of the Financial Crisis*, 5 HARV. L. & POL'Y REV. 231, 231 (2011) ("The FCIC quite rightly concluded that failures in financial regulation and supervision along with failures of corporate governance and risk management at major financial firms were prime causes of the financial crisis engulfing this country in 2007 and 2008.").

3. Many politicians and academics blamed the excessive risk-taking of business executives, who paid their employees large bonuses which incentivized greater short-term profits, for precipitating the financial crisis. *See* Lucian A. Bebchuk & Holger Spamann, *Regulating Bankers' Pay*, 98 GEO. L.J. 247, 274 (2010) ("Some of the incentives for excessive risk-taking may be undesirable from the perspective of shareholders. For example, when pay arrangements reward executives for short-term gains, executives may have incentives to seek short-term gains even when doing so may adversely affect the expected long-term value of shareholder interests by creating an excessive risk of an implosion down the road.").

4. Pay Ratio Rule, 80 Fed. Reg. 50104, 50104 (Aug. 18, 2015) (to be codified at 17 C.F.R. pts. 229, 240, and 249) [hereinafter Pay Ratio Rule] ("Section 953(b) directs the Commission to amend Item 402 of Regulation S–K . . . .").

5. Pay Ratio Rule, *supra* note 4, at 50104.

data with annual reports, proxy solicitations,[6] and any other information or registration statements that Item 402 of Regulation S-K requires.[7] The SEC expects the rule to affect over 3,500 registrants in total.[8] After two years and over 300,000 comment letters,[9] the SEC adopted the final rule on August 5, 2015 by a 3-2 vote along party lines.[10]

The debate over excessive executive compensation is not novel. Congress and the public have castigated corporate executives in previous economic crashes, and the pay ratio rule has proven to be no less controversial. Historically, a high unemployment rate and economic recession are two of the main ingredients leading to legislative action against alleged excessive executive compensation.[11] Thus, it was no surprise public criticism crested in 2009 after American International Group (AIG), one of the major contributors to the crisis and the recipient of

6. Proxy solicitations are an important means for generating shareholder activism, such as altering corporate governance or replacing company directors. *See generally* Eric M. Fogel et al., *Public Company Shareholders Acting As Owners: Three Reforms-Introducing the "Oversight Shareholder"*, 29 DEL. J. CORP. L. 517, 527 (2004) (discussing the challenges shareholders face when using proxy solicitations to wage a proxy fight against corporate management to remove incumbent directors).

7. Regulation S-K increases publicly available information by requiring public companies to disclose important corporate information, including executive compensation data. Pay Ratio Rule, *supra* note 4, at 50104 ("The disclosure is required in any annual report, proxy or information statement, or registration statement that requires executive compensation disclosure pursuant to Item 402 of Regulation S–K.").

8. Pay Ratio Rule, *supra* note 4, at 50175 (discussing the number of registrants believed to be subject to the rule). *See also* Pay Ratio Rule, 78 Fed. Reg. 60560, 60594 (proposed Oct. 1, 2013) (to be codified at 17 C.F.R. pts. 229 and 249) [hereinafter Proposed Pay Ratio Rule] (same).

9. In order for executive or independent agencies to promulgate regulations a "[g]eneral notice of [the] proposed rule making shall be published in the Federal Register . . . [and] the agency shall give interested persons an opportunity to participate in the rule making through submission of written data, views, or arguments . . . ." 5 U.S.C. § 553 (2014). *See also* U.S. SEC. & EXCH. COMM'N, COMMENTS ON PAY RATIO DISCLOSURE, https://www.sec.gov/comments/s7-07-13/s70713.shtml (last updated Aug. 5, 2015), *archived at* https://perma.cc/4J72-7DPX (documenting the number of comments the Commission received in the rulemaking process).

10. Press Release, U.S. Sec. & Exch. Comm'n, SEC Adopts Rules for Pay Ratio Disclosure (August 5, 2015) http://www.sec.gov/news/pressrelease/2015-160.html, *archived at* http://perma.cc/VDZ4-TZ5J (announcing the adoption of the final Pay Ratio Disclosure Rule); Bill Chappell, *SEC Adopts CEO Pay Ratio Rule, Five Years After It Became Law*, NPR (Aug. 5, 2015), http://www.npr.org/sections/thetwo-way/2015/08/05/429628037/sec-to-vote-on-requiring-companies-to-disclose-ceo-pay-ratio, *archived at* http://perma.cc/Y4NK-W793 ("The SEC's five commissioners have voted 3-2 to adopt the CEO pay ratio rule. Both Republicans on the panel—Daniel Gallagher and Michael Piwowar cited the influence of big U.S. labor unions as they voted against the rule.").

11. Mullane, *supra* note 1, at 624 ("[For] points in time that Congress has chosen to act to regulate executive pay, three factors have been present: an economic recession, a rising unemployment rate, and an executive pay controversy. . . .").

more than $170 billion in taxpayer bailout money, revealed that it still expected to award over $165 million in bonuses at the same time many Americans faced unemployment.[12]

The SEC has a long history of attempting to curtail executive compensation to protect shareholders and the public. From a shareholder's perspective, excessive compensation is any payment exceeding what is required to reduce agency costs[13] and maximize executive performance. Attractive compensation packages can incentivize managers to exert more effort, guide the company in a particular path, and make business decisions that benefit the shareholders.[14] In theory, an effective compensation structure can provide an added level of protection to shareholders when directors are unable to consistently monitor their executives.[15] However, superfluous compensation is wasted capital that leads to less profitability, smaller dividends for shareholders, and lower productivity from workers.[16]

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12. Edmund L. Andrews & Peter Baker, *At A.I.G., Huge Bonuses After $170 Billion Bailout*, N.Y. TIMES, Mar. 15, 2009, at 1 ("The payment of so much money at a company at the heart of the financial collapse that sent the broader economy into a tailspin almost certainly will fuel a popular backlash against the government's efforts to prop up Wall Street.")

13. *See* LUCIAN BEBCHUK & JESSE FRIED, PAY WITHOUT PERFORMANCE: THE UNFULFILLED PROMISE OF EXECUTIVE COMPENSATION 17 (2004) [hereinafter Bebchuck & Fried] ("The official theory of executive compensation recognizes that there is an agency problem in publicly traded companies with separation of ownership and control. This agency problem is supposed to be addressed by the [board of directors'] supervision and monitoring of managers . . . . The threat of board intervention is expected to curb managers' tendency toward self-serving behavior, thereby reducing agency costs."); *see also* Richard A. Posner, *Are American CEOs Overpaid, and, If So, What If Anything Should Be Done About It?*, 58 DUKE L.J. 1013, 1015 (2009) [hereinafter Posner] (using economic terms to define "compensation [a]s excessive when it is greater than it would be if agency costs were zero").

14. For example, shareholders can attach compensation to certain desired benchmarks relating to stock price, revenue, market share, etc. Compensation can also incentivize certain corporate strategies, such as distributing profits back to shareholders rather than engaging in corporate empire building to increase the CEO's own prestige and reputation. *See* Bebchuk & Fried, *supra* note 13, at 18-20 (discussing the variety of ways shareholders and directors can use compensation to affect executive decision making).

15. *See* Bebchuk & Fried, *supra* note 13, at 19 ("[A] well designed compensation scheme can make up for the fact that directors cannot directly monitor or evaluate many of their top executives' decisions.").

16. *See* Omari Scott Simmons, *Taking the Blue Pill: The Imponderable Impact of Executive Compensation Reform*, 62 SMU L. REV. 299, 304-05 (2009) [hereinafter Simmons] (discussing examples of how excessive compensation can "coincide with poor corporate performance and unfavorable economic conditions"); Robert E. Wagner, *Mission Impossible: A Legislative Solution for Excessive Executive Compensation*, 45 CONN. L. REV. 549, 559 (2012) [hereinafter Wagner] ("[T]here are several deleterious effects that can arise from excessive salaries, including smaller dividends for shareholders, a reduction of earnings per share, inefficiencies within the workplace that result in a negative impact on worker morale, higher turnover, and increased competitiveness among workers."). *But see*

Instead, this capital should be invested in other areas of the firm or distributed to shareholders. From a societal perspective, systemic excessive compensation contributes to income inequality, which can contribute to several societal harms, from slowing economic growth to damaging public health.[17]

One of the SEC's chief methods for influencing executive pay has been through increased disclosure for shareholders. However, these previous attempts to restrain executive compensation have failed. CEO compensation has continued to rise with the average S&P 500 CEO pay in 2015 growing to 204[18] times the median American worker's.[19] For some companies, the CEO may earn over 400 times the average employee.[20] In

generally Christine Jolls, *Fairness, Minimum Wage Law, and Employee Benefits*, 77 N.Y.U. L. REV. 47, 55 (2002) ("Workers who receive wages above the low level predicted by the traditional analysis may offer high levels of effort in response based on their perceptions of the fairness of the employers' behavior, and employers, aware of this result, can maximize their profits by offering such generous wages.").

17. *See* Brett H. McDonnell, *Two Goals for Executive Compensation Reform*, 52 N.Y.L. SCH. L. REV. 585, 586 (2008) ("[T]here are at least two very different types of concerns that lead to two very dissimilar goals for proposals to reform executive compensation. One concern focuses on executive compensation as a problem that both reflects and exacerbates poor corporate governance. The other concern focuses on executive compensation as a source of increasing economic, political, and social inequality."); Richard Wilkinson, *How Economic Inequality Harms Societies*, TED (July 2011), https://www.ted.com/talks/richard_wilkinson/transcript?language=en, *archived at* https://perma.cc/F37L-7NHK (discussing how wealth inequality can lead to erosions in trust, excessive consumption, violence, physical and mental health problems, and increased obesity within a society). *See generally* RICHARD WILKINSON AND KATE PICKETT, THE SPIRIT LEVEL: WHY GREATER EQUALITY MAKES SOCIETIES STRONGER 49-87 (2010) (discussing the socially corrosive effects of extreme income inequality, such as undermining the trust, solidarity, and mutuality of the citizenry).

18. Before the recent dip in executive compensation, the pay gap between CEOs and average American workers grew from 195-to-1 in 1993 to 354-to-1 in 2012 and 774 times a minimum wage earner in 2013. *See* Sarah Anderson et al., *Bailed Out, Booted, Busted: A 20-Year Review of America's Top-Paid CEOs*, INST. FOR POLICY STUDIES 4 (2013), http://www.ips-dc.org/wp-content/uploads/2013/08/EE13-FINAL.pdf, *archived at* http://perma.cc/3VQ4-78T6 (documenting the growth of the pay gap between CEOs and average American workers); Kathryn Dill, *Report: CEOs Earn 331 Times As Much As Average Workers, 774 Times As Much As Minimum Wage Earners*, FORBES (Apr. 15, 2014), http://www.forbes.com/sites/kathryndill/2014/04/15/report-ceos-earn-331-times-as-much-as-average-workers-774-times-as-much-as-minimum-wage-earners/, *archived at* http://perma.cc/QJD3-JTZ3 [hereinafter Dill] (comparing the compensation of CEOs to that of minimum wage workers).

19. *See* Andrew Chamberlain, *CEO to Worker Pay Ratios: Average CEO Earns 204 Times Median Worker Pay*, GLASSDOOR (Aug. 28, 2015), https://www.glassdoor.com/research/ceo-pay-ratio//, *archived at* https://perma.cc/V3SS-9JQG (discussing executive to average worker pay ratios).

20. Claire Zillman, *This CEO has the highest pay compared to his workers*, FORTUNE (Aug. 6, 2015), http://fortune.com/2015/08/06/highest-ceo-worker-pay-ratio/, *archived at*

response to previous failures,[21] Congress and the SEC are attempting to influence executive pay once again. While the SEC's recent say-on-pay rule[22] gives shareholders the ability to demonstrate their disapproval of excessive compensation, pay ratio disclosures will allow shareholders to analyze executive compensation within a larger context that may help them determine whether the compensation is reasonable and fair.[23] Shareholders could compare their firm's ratio with that of other firms in the same industry or with ratios in the past to determine the optimal ratio, that is, the ratio that maximizes shareholder value.[24] Additionally, pay ratios may help

http://perma.cc/HLA9-KVEW ("According to a Payscale report, which calculated ratios based on the cash compensation of CEOs at the 100 highest-grossing public companies in the United States in 2013, CVS CEO Larry Merlo has the highest pay compared to his employees: $12,112,603—422 times as much as the average CVS employee, who earns $28,700 per year.").

21. Although attempts to reduce executive compensation are popular and optimistic, Congress' legislation never seems to successfully rein in the eye-catching compensation packages of America's top CEOs. Whether through increased tax rates or salary caps, the response of corporations has always been to pay more. *See* Mullane, *supra* note 1, at 613. (discussing how Congress' 1993 "tax penalty provision designed to encourage companies to limit executive pay unrelated to performance" spurred the pace of executive compensation to grow faster than any other period since the Great Depression). Congress has gone to great lengths to limit executive compensation in the past. *See generally* Mullane, *supra* note 1, at 602-03 ("Congress . . . enacted legislation mandating salary caps as a condition of doing business with the federal government. The Reconstruction Finance Corporation (RFC) [operated between 1932 and 1957] was authorized to deny federal financial assistance to companies providing executives with salaries the RFC deemed unreasonable . . . ." (internal citation omitted)).

22. The SEC say-on-pay rule requires companies to conduct a shareholder vote to approve the compensation of its executives. However, the shareholder vote is only advisory and not binding. *See* Shareholder Approval of Executive Compensation and Golden Parachute Compensation, 76 Fed. Reg. 6010, 6010 (Aug. 18, 2015) (to be codified at 17 C.F.R. pts. 229, 240, and 249) ("Section 951 of the Dodd-Frank Act . . . requires companies to conduct a separate shareholder *advisory* vote to approve the compensation of executives . . . ." (emphasis added)).

23. *See* U.S. Cong., Comment Letter on Pay Ratio Disclosure 1 (March 17, 2015), http://www.sec.gov/comments/s7-07-13/s70713-1550.pdf, *archived at* http://perma.cc/GCV8-N4W7 [hereinafter Congress of the United States] ("As the Wall Street Reform Act was enacted more than four years ago, we believe it's long past the time for the SEC to finalize this rule. . . . Disclosure of this information will help investors evaluate the reasonableness of CEO pay levels relative to other company employees when casting 'say-on-pay' advisory votes as is required by the Wall Street Reform Act."). *But see* Ctr. on Exec. Comp., Comment Letter on Pay Ratio Disclosure 4 (Dec. 2, 2013), http://www.sec.gov/comments/s7-07-13/s70713-572.pdf, *archived at* http://perma.cc/AW8Y-J8M3 [hereinafter Center on Executive Compensation] (discussing data collected by the Center on Executive Compensation, which found that from 2010 to 2013 "only 14 separate shareholder proposals request[ed] a pay ratio" disclosure from the corporation and those proposals received 93% opposition on average from shareholders).

24. For example, "[t]he CEO-to-worker compensation ratio was 20-to-1 in 1965 and 29.9-to-1 in 1978, grew to 122.6-to-1 in 1995, peaked at 383.4-to-1 in 2000, and was 295.9-

more socially conscious shareholders determine if an executive's compensation package is excessive with reference to an ethical concept of fairness. Though say-on-pay alone has failed to lower executive compensation, pay ratios will prompt compensation comparisons with executives' employees rather than just their peers. This could give shareholders valuable information in a more understandable and eye-catching format, thereby increasing the likelihood of shareholder activism.[25] Disclosing inequitable compensation levels to the market may provoke investors to alter their investments to ensure their wealth is not misused for wasteful compensation programs and force executives to defend their compensation levels when compared to their peers, foreign counterparts, and predecessors.[26]

Beyond this, however, the pay ratio's desired benefits are not entirely clear. The SEC does not provide a benchmark ratio or optimal employment strategy for companies to achieve.[27] As the SEC noted, there was limited legislative history to inform the Commission's understanding of the legislative intent behind Section 953(b) of the Dodd-Frank Act.[28] Filling the void left by Congress, public commenters have highlighted many of the

to-1 in 2013" according to the Economic Policy Institute. Alyssa Davis & Lawrence Mishel, *CEO Pay Continues to Rise as Typical Workers are Paid Less*, ECON. POLICY INST.(June 12, 2014), http://www.epi.org/publication/ceo-pay-continues-to-rise/, *archived at* http://perma.cc/B67U-DE5P. A growing trend in executive compensation may have led shareholders to question the efficiency of these pay structures and learn that, right after the peak in 2000, top executive pay constituted almost 10% of corporate earnings. *See* David I. Walker, *Who Bears the Cost of Excessive Executive Compensation (and Other Corporate Agency Costs)?*, 57 VILL. L. REV. 653, 659 (2012) (asserting that the fraction of corporate earnings devoted to executive compensation had grown from 5.5% between 1993 and 1995 to almost 10% between 2001 and 2003). It is these type of inefficiencies that reduce shareholder value.

25. Congress of the United States, *supra* note 23, at 1 ("Congress enacted the CEO-to-worker pay ratio disclosure rule in response to public concern over high executive compensation and the need to have this information available in an understandable format.").

26. *See* Simmons, *supra* note 16 at 304-05 ("[H]efty levels of executive compensation, even in the absence of fraud or accounting irregularities, are either (i) criticized for their tenuous link to performance or (ii) become a rallying cry of populist concern, especially when they coincide with poor corporate performance and unfavorable economic conditions.").

27. *See* Pay Ratio Rule, *supra* note 4, at 50173 ("[W]e believe that the intended purpose of the pay ratio disclosure is to provide shareholders with a company-specific metric to evaluate the [CEO]'s compensation, rather than a benchmark for compensation arrangements across registrants.").

28. Pay Ratio Rule, *supra* note 4, at 50150. ("[W]hile neither the statute nor the related legislative history directly states the objectives or intended benefits of the provision, we believe, based on our analysis of the statute and comments received, that Section 953(b) was intended to provide shareholders with a company-specific metric that can assist in their evaluation of a registrant's executive compensation practices.").

potential and desired benefits of a pay ratio rule. But the wide-ranging responses from commenters have failed to specify the ratio's intended objective. Although the Great Recession spurred this legislation, there was no one actor or behavior that could be blamed. Instead, it was a perfect storm of widespread reckless behavior, only part of which included the information asymmetry of corporate pay structures. Therefore, commenters advocate for the inclusion of different data and, thereby, propose rules that address a variety of different issues. Many commenters, for example, argue the pay ratios' assistance in illuminating a CEO's current compensation and the board of director's ability to limit corporate excess[29] would improve shareholder oversight, mitigate reckless risk-taking, increase firm value, and create more long-term stability within the overall market.[30] Some proponents argue that using pay ratios as another metric to evaluate companies helps short-term investors. The data could serve as a proxy for a companies' investment in developing their human capital, which can reveal information on employee morale and productivity.[31] However, if these are the goals, the rule's effectiveness depends on the SEC's ability to tailor a rule that focuses on excessive executive compensation by requiring the right data from companies and producing accurate and reliable ratios.

Despite these goals, the SEC's pay ratio rule will likely result in another failed attempt to curtail executive compensation. Because Congress, through Section 953(b) of the Dodd-Frank Act, mandated that the SEC release a pay ratio rule, an argument as to whether the rule should exist is futile. Instead, this Comment focuses on the rule's likely results by highlighting approaches the SEC took to mitigate some of its harmful effects and where the SEC failed. In Part I, this Comment details how executive compensation has grown to its current levels and shows that

29. *See, e.g.*, Meredith Miller, Chief Corporate Governance Officer of UAW Retiree Medical Benefits Trust, Comment on Pay Ratio Disclosure 2 (Nov. 21, 2013), http://www.sec.gov/comments/s7-07-13/s70713-377.pdf, *archived at* http://perma.cc/3X3B-MW9N [hereinafter Miller] ("The Trust would use the CEO pay ratio, together with other compensation disclosures in the proxy statement, to evaluate companies' compensation policies and practices for purposes of proxy voting—including the management advisory vote on executive compensation or say on pay proposal—and identifying companies for engagement.").

30. For example, many institutional investors, such as pension funds, insurance companies, or mutual funds are especially concerned with the long-term sustainability of their investments and any means of improving that sustainability is generally welcomed. *See* Miller, *supra* note 29, at 1 ("The $58.8 billion UAW Retiree Medical Benefits Trust . . . [t]he largest non-governmental purchaser of retiree health care in the United States . . . depends on the creation of long-term sustainable value by the companies in which [it] invest[s].").

31. Pay Ratio Rule, *supra* note 4, at 60585.

previous disclosure requirements have not alleviated this growth. Part II investigates the expected costs for corporations that the pay ratio rule affects to better understand whether the benefits justify these costs. Part III investigates whether the SEC's pay ratio rule is likely to help investors gauge the fairness and appropriateness of corporations' compensation models, whether the pay ratio rule will contribute to corporations curtailing CEO compensation, and the utility of pay ratio information for shareholder say-on-pay votes. Part IV discusses the greatest failures of the rule, why it is unlikely to achieve its desired effects, and how these failures may mislead shareholders and arbitrarily harm some industries more than others. In its conclusion, this Comment suggests avoiding environment- and industry-specific factors that will significantly distort the pay ratios, making them less informative for the market and for those concerned with pay equity.

A. *The Current Rise in Executive Compensation*

Before examining the effectiveness of the pay ratio rule, it is important to have an understanding of how executive compensation in the US has risen to its current levels. The modern corporate form protects investors through limited liability. Investors can potentially increase their wealth without fear of losing more than what they invested. This, in turn, reduces the cost of capital for the corporation.[32] However, in exchange for this opportunity to profit from the corporation, shareholders must entrust corporate managers with control of their investment.[33] This relationship creates an agency cost—an inherent risk that executives can deviate from

32. *See* Chancellor William T. Allen, *Ambiguity in Corporation Law*, 22 DEL. J. CORP. L. 893, 896 (1997) ("Corporation law facilitates wealth creation principally by creating a legal structure that makes it substantially cheaper for investors to commit their capital to risky ventures. It does this through the innovation of tradable share interests, centralized management, limited liability, and the entity concept itself. The interaction of these legal characteristics facilitates diversification of investments and centralization of management. This allows capital to subject itself to greater risk. It is the ability to increase the degree of risk that can be rationally accepted that provides the greatest source of the efficiency of the corporate form."). For rare exceptions to shareholder limited liability, see Robert B. Thompson, *Piercing the Corporate Veil: An Empirical Study*, 76 CORNELL L. REV. 1036, 1036 (1991) ("'Piercing the corporate veil' refers to the judicially imposed exception to [the limited liability] principle by which courts disregard the separateness of the corporation and hold a shareholder responsible for the corporation's action as if it were the shareholder's own.").

33. The exception to this exchange is closely-held corporations controlled by owner-managers. For more information on the differences between closely-held corporations and publicly-held corporations, particularly in relation to agency costs, see generally Frank H. Easterbrook & Daniel R. Fischel, *Close Corporations and Agency Costs*, 38 STAN. L. REV. 271, 274 (1986).

the goals of investors. Thus, there is a constant tension between those that own the company and those that control it.[34]

One popular solution for alleviating this tension and correcting CEO incentives was implementing and increasing performance-based (or incentive-based) pay.[35] Investors hoped including incentive-based pay in executive compensation packages would reduce corruption and prevent CEOs from personally benefitting unless the entire corporation and its shareholders benefitted as well. Congress responded by implementing Section 162(m) of the Internal Revenue Code to spur corporations into using performance-based pay. Under the updated tax law, any compensation over $1 million had to be based on the company's performance in order to be tax deductible.[36] The tax incentive succeeded in driving the use of performance-based pay.[37] In the last decade, performance-based pay through stock options became ubiquitous in public companies' executive compensation packages.

Although incentive-based compensation mitigated agency problems between shareholders and executives, it simultaneously induced excessive

34. While the board of directors is expected to alleviate agency costs by preventing corporate corruption or mismanagement, their efforts are not always successful and their motivations are not always ethical. *See* Reed Abelson, *One Enron Inquiry Suggests Board Played Important Role*, N.Y. TIMES, Jan. 19, 2002, at C1 ("The board . . . went so far as to suspend Enron's code of ethics to approve the creation of the partnerships between Enron and its chief financial officer . . . . The partnerships kept significant debt off Enron's books and masked much of what was really going on at the company.").

35. For a discussion on common incentive-based compensation structures and how they can lead to unintended consequences, see Andrew C.W. Lund & Gregg D. Polsky, *The Diminishing Returns of Incentive Pay in Executive Compensation Contracts*, 87 NOTRE DAME L. REV. 677, 680-81 (2011) ("Traditionally, the goal of pay reformers was to more closely link executive compensation with firm performance in order to reduce agency costs . . . . [T]he benefits of incentive pay are lower than conventionally understood because its effects are largely redundant of incentive effects stemming from newly robust corporate governance mechanisms that discipline executives for poor stock performance . . . . [These mechanisms include] the activism of institutional investors, the oversight by more demanding boards, and, most significantly, the related reduction in CEO job security . . . ."). *See also* Bebchuk & Fried, *supra* note 13, at 137 ("Institutional investors and federal regulators, with the support of financial economists, began encouraging the use of such [performance-based] compensation in the early 1990s.").

36. *See* 26 U.S.C. § 162(m)(1), (4)(C) ("In the case of any publicly held corporation, no deduction shall be allowed under this chapter for applicable employee remuneration with respect to any covered employee to the extent that the amount of such remuneration for the taxable year with respect to such employee exceeds $1,000,000. . . . The term 'applicable employee remuneration' shall not include any remuneration payable solely on account of the attainment of one or more performance goals . . . .").

37. *See* Bebchuk & Fried, *supra* note 13, at 72 ("The enactment in the 1992 of Section 162(m) of the Internal Revenue Code . . . was intended to encourage the use of [performance-based] compensation.").

short-term risks through its asymmetrical rewards.[38] Because companies used certain metrics, like stock price, to determine the CEO's performance, they greatly incentivized CEOs to expand those metrics to increase their own compensation.[39] Furthermore, executive compensation that is dependent on future factors creates inherent uncertainty and limitless potential in how much compensation the executive can earn.[40] Tying pay to performance was Congress' solution to corporate corruption. Instead it was blamed as one of the chief contributors to the financial crisis because many of the stock options tied to CEO pay only correlated with short-term performance goals.[41] Worse, the Great Recession highlighted how employees and other stakeholders[42] can bear the costs of a CEO's excessive

38. *See* Bebchuk & Fried, *supra* note 13, at 135 (discussing how many performance-based payment structures received tax benefits but were only weakly tied to performance).

39. *See* Susan J. Stabile, *Motivating Executives: Does Performance-Based Compensation Positively Affect Managerial Performance?*, 2 U. PA. J. LAB. & EMP. L. 227, 234 (1999) ("A typical executive compensation package includes several types of contingent compensation, most typically short-term bonus plan payments, and one or more forms of long-term compensation, such as stock options and/or stock bonuses."). *See also* Robert J. Jackson, Jr. & Curtis J. Milhaupt, *Corporate Governance and Executive Compensation: Evidence from Japan*, 2014 COLUM. BUS. L. REV. 111, 120 (2014) ("CEO compensation is higher when the CEO is also the board chair, the board is larger, there is a greater percentage of the board composed of outside directors, and the outside directors are appointed by the CEO." (quoting John Core et al., *Corporate Governance, Chief Executive Officer Compensation, and Firm Performance*, 51 J. FIN. ECON. 371, 372 (1999))); Charles M. Yablon & Jennifer Hill, *Timing Corporate Disclosures to Maximize Performance-Based Remuneration: A Case of Misaligned Incentives?*, 35 WAKE FOREST L. REV. 83, 86 (2000) ("As a result of management's powers and discretion over financial reporting and disclosure, even the most carefully structured pay packages frequently provide CEOs with incentives other than a desire to maximize shareholder value.").

40. *See* Bebchuk & Fried, *supra* note 13, at 19 (discussing the uncertain results that will come from tying an executive's compensation to performance).

41. *See* Frederick Tung, *Pay for Banker Performance: Structuring Executive Compensation for Risk Regulation*, 105 NW. U. L. REV. 1205, 1216 (2011) ("Two parallel decades-long trends—the steady march of banking deregulation and the rise of equity-based performance pay generally-help to explain the evolution toward the high-powered equity incentives for bankers that we observe pre-crisis."). *But see, e.g.*, Patrick Bolton et al., *Pay for Short-Term Performance: Executive Compensation in Speculative Markets*, 30 J. CORP. L. 721, 724-25 (2005) ("[I]t is optimal for shareholders to offer compensation contracts that allow CEOs to profit early from a speculative stock price surge even if at a later date share prices collapse . . . . The CEO has a duty of loyalty towards current shareholders and not future shareholders. Thus, if he artificially drives up the stock price in the short run at the expense of long-run value he may be acting in the interests of his current principals. Current shareholders may well choose to incentivize the CEO for short-term stock performance, even if they understand that this also creates incentives for the CEO to manipulate earnings. The reason is simply that current shareholders want the CEO to pursue their interests even if this comes at the expense of future shareholders.").

42. For a discussion on the relationship between shareholders, stakeholders, and companies, see Lance Moir et al., *Measuring the Business Case: Linking Stakeholder and*

risk-taking. These realizations then galvanized support for increased regulation—such as the pay ratio rule—to mitigate overly risky corporate practices.[43]

Because the effectiveness of incentive-based compensation has diminishing returns where, at a certain point, the increase in performance-based compensation is not worth the reduction in agency costs—and may even counter shareholder interests by inducing reckless risk taking—shareholders and directors must calibrate the metrics in order to produce the most desirable and efficient incentives. Thus, the system relies on effective oversight by shareholders and directors to determine when increased compensation is no longer worth the additional costs and that the compensation continues to incentivize the desired results.[44] But

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Shareholder Value, 7 CORP. GOVERNANCE: THE INT'L J. OF BUS. IN SOC'Y 388, 388 (2007) ("The traditional neo-classical economic view suggests that the objective of the firm is to maximize shareholder value and that this should be its objective function. An opposing view . . . is that we need to rethink the purpose of the firm as being a social institution that needs to create value for stakeholders. . . . [I]f a firm does not pay attention and satisfy its multiple stakeholders, whether those be the dominant ones in the short-term of customers and employees or, in the longer run, wider society as evidenced by global communities and governments, it will cease to be legitimate.").

43. Letter from Sue Ravenscroft, Professor of Accounting, Iowa State Univ., to Kevin O'Neill & Lynn Powalski, Deputy Sec'y, Sec. & Exch. Comm'n (June 18, 2014), http://www.sec.gov/comments/s7-07-13/s70713-973.pdf, at 1, *archived at* http://perma.cc/9REZ-JTYY [hereinafter Ravenscroft] ("Section 953(b) of Dodd-Frank reflects legitimate concerns arising since the latest financial crisis about risk-sharing and about whether what Adam Smith called the 'grand bargain' is still being honored. That is, do all employees who contribute to the success of a company enjoy the perquisites of success? . . . On the down side, when firms make risky decisions, are CEOs or workers (and-in the recent crisis–displaced and under-water homeowners) the ones who bear the costs?"). *See also* William W. Bratton & Michael L. Wachter, *The Case Against Shareholder Empowerment*, 158 U. PA. L. REV. 653, 659 (2010) (discussing the excessive risk taking "at the heart of the capitalist system" that failed to internalize systematic risks that led to the 2007-'08 economic recession).

44. CEOs in particular are more difficult to manage through incentive-based compensation structures than other workers. It is difficult to grade a CEO's performance based on the performance of the entire firm because, in many instances, the CEO cannot realistically oversee every facet of the company's operations. As the number of operations and projects underneath a manager increases, more external factors and unpredictable variables influence the firm's success. Therefore, compensation based on the company stock price encapsulates much more than the CEO's performance, such as the general market performance. To illuminate the problem with an example, it would be akin to evaluating the President's performance based off the country's gross national product (GNP). While there may be correlations, it is not always so simple. Conversely, a low-level manager may only oversee a small team and rely on a handful of individuals to complete any task. With a reduction in external factors and unpredictable variables between a low-level manager and his subordinates, a performance-based system is more effective. *See* Posner, *supra* note 13, at 1026 ("The [President-GDP] analogy is particularly close in an industry like oil, in which the profits of an oil company are largely a function of the price of

determining which metrics and levels of compensation are most efficient in mitigating agency costs is very difficult.[45]

A company's board of directors—tasked with overseeing the effective use of performance-based compensation—is an unreliable supervisor. First, it is common for the board of directors to include the corporate executives of other corporations with their own financial stake in maintaining healthy corporate salaries.[46] CEOs also often serve on their own board, creating a clear conflict of interest.[47] Second, many CEOs influence the director nomination slate.[48] This influence fails to insulate directors from a potential quid pro quo relationship with the executives they are supposed to supervise.[49] Even after directors are elected, CEOs can influence director compensation through the position of board member or board chair.[50] While director compensation is usually determined by a

oil, over which the companies have little control.").

45. *See* Jill E. Fisch, *Leave It to Delaware: Why Congress Should Stay Out of Corporate Governance*, 37 DEL. J. CORP. L. 731, 749 (2013) ("Directors recognize the need for performance-based pay, but struggle with the selection of appropriate performance metrics and the identification of suitable time frames.").

46. *See* Posner, *supra* note 13, at 1023 ("The problem [of effective oversight] is exacerbated by the fact that a board of directors is likely to be dominated by highly paid business executives, including CEOs of other companies. They have a conflict of interest, since they have a financial stake in high corporate salaries, their own salaries being determined in part by the salaries paid to persons in comparable positions in other companies.").

47. For a discussion of whether director independence improves firm performance or prevents excessive CEO compensation, *see, e.g.*, Usha Rodrigues, *The Fetishization of Independence*, 33 J. CORP. L. 447, 461 (2008) ("The data indicate that independence does not lead to improved firm performance and may even be associated with sub-optimal performance." (citing Roberta Romano, *The Sarbanes Oxley Act and the Making of Quack Corporate Governance*, 114 YALE L.J. 1521, 1530 (2005))). *See also* Jeffrey N. Gordon, *The Rise of Independent Directors in the United States, 1950-2005: Of Shareholder Value and Stock Market Prices*, 59 STAN. L. REV. 1465, 1503-04 (2007) ("The empirical evidence on the compensation effects of independent directors is equivocal, with 'little evidence that independent directors do a better job than inside directors in establishing CEO pay.'" (quoting Sanjai Bhagat & Bernard Black, *The Uncertain Relationship Between Board Compensation and Firm Performance*, 54 BUS. LAW 921, 931 (1999))).

48. For examples of management and directors using nomination requirements to limit shareholders' ability to vote, see generally Lawrence A. Hamermesh, *Director Nominations*, 39 DEL. J. CORP. L. 117 (2014) (discussing shareholders' right to nominate candidates).

49. Wagner, *supra* note 16, at 559.

50. Wagner, *supra* note 16, at 559-560. Wagner also notes that outside and "independent" third parties are not necessarily any better at providing objective recommendations for executive compensation. Firms specializing in compensation consultation often provide other services for the firm, which are hired and compensated by the very same corporate executives whose salaries they are supposed to objectively evaluate. In one example, a consulting firm, which was hired to assist a compensation committee, recommended a 48% compensation increase for the CEO. However, significant conflict of interest concerns arose when the same consulting firm was receiving hundreds of millions of

compensation committee made up of independent directors, the CEO's significant power over firm resources can still influence independent directors in several ways, such as through donating firm assets to the alma matter or charities of directors, granting compensation on top of director fees, or doing business with the firms of directors.[51] Thus, it is no surprise that these quid pro quo relationships have led to a correlation between higher CEO compensation and higher director compensation, regardless of firm performance.[52] Another potential limitation is that directors may not objectively negotiate with managers over their pay because of personal relationships, a fear of awkwardness, or a subjective view that their managers are better than most—after all, they did hire their managers.[53]

Unfortunately, shareholders do not fare much better when it comes to oversight. Shareholders face a collective action problem.[54] Though they

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dollars in other services for the CEO. For information on how CEOs can influence the compensation of directors, see Bebchuk & Fried, *supra* note 13, at 30 ("As the company leader, usually as a board member, and often as board chair, the CEO has some say over director compensation."). *See also* Arthur Levitt, Jr., *Corporate Culture and the Problem of Executive Compensation*, 30 J. CORP. L. 749, 750 (2005) (discussing how this close relationship between executives and their directors could lead to a larger cultural problem). Directors often serve on multiple boards that can become fraternal in nature, giving each member an elite badge of prestige. Because individuals like being invited to join this small club and want to be re-invited, they may fear upsetting executives, *id*.

51. *See* Bebchuk & Fried, *supra* note 13, at 28-29 (discussing the actual independence of independent directors).

52. *See* Ivan E. Brick et al., *CEO Compensation, Director Compensation, and Firm Performance: Evidence of Cronyism?*, 12 J. OF CORP. FIN. 403, 417 (2006) ("CEO and director compensations are positively correlated even after correcting for many other factors. The question then is why? One possible reason . . . is that CEO and director compensation levels are positively related to firm complexity [and the needed managerial effort] . . . . An alternative explanation is that the positive relation between these variables reflects cronyism, whereby the board and CEO are more concerned with selfish objectives than with protecting shareholder interests.").

53. *See* Bebchuk & Fried, *supra* note 13, at 31-32 (discussing the social and psychological factors, such as friendship, loyalty, and collegiality, that can affect the objectivity of directors when setting executive compensation levels).

54. Collective action is the idea that, to further the interests of a group, individuals must sometimes act collectively. Yet, collective action can be difficult to achieve:

> Free riding is one particular problem that can stymie collective action. In situations where the benefits of collective action accrue to all the members of the group regardless of who contributed to its provision, individuals may reason that they are better off not contributing to the collective cause and instead free rid[e] on the efforts of others. The problem is that if everyone in a group reasons in this way, then no collective action will occur . . . .

KEITH DOWDING, ENCYCLOPEDIA OF POWER 119 (2011). Collective action problems extend as far back as the days of Aristotle. *See* ARISTOTLE, POLITICS 57 (Benjamin Jowett trans., Dover Publications 2000) ("That all persons call the same thing mine . . . is impracticable . . . . For that which is common to the greatest number has the least care bestowed upon it. . . . [E]verybody is more inclined to neglect the duty which he expects another to fulfill . . . .").

maintain the power to elect directors, they are often too dispersed to effectively monitor directors on routine business activities, such as setting CEO compensation. Inadequate supervision over directors exacerbates directors' role in holding executives accountable. In other words, "[m]onitors who are not monitored are imperfect agents of their principal, and so in the absence of effective monitoring of directors by the shareholders, boards have weak incentives to limit CEO compensation."[55]

Despite Congress' efforts to reduce agency costs, Section 162(m) incentivized reckless behavior and soaring compensation levels.[56] One view is that incentive-based pay failed because there has not been sufficient disclosure to shareholders. Without such disclosure, shareholders are unable to pressure directors to alter compensation structures. Therefore, proponents of the pay ratio rule argue that increasing shareholders' access to compensation data will curtail wasteful compensation packages by making shareholders more knowledgeable and active in the debate over executive compensation.

B. *Role of Public Disclosure*

Transparency is a vital component in maintaining market discipline and preventing the fraud and speculation that leads to market crashes.[57] Mandatory disclosure facilitates much of that transparency.[58] Because

55. Posner, *supra* note 13, at 1023.

56. *See* Lisa M. Fairfax, *Sue on Pay: Say on Pay's Impact on Directors' Fiduciary Duties*, 55 ARIZ. L. REV. 1, 8 (2013) [hereinafter Fairfax] ("[T]he average annual CEO pay at S&P 500 companies increased from $850,000 in 1970 to more than $14 million in 2000-an increase driven largely by the practice of awarding stock options and restricted stock.").

57. The SEC enacted the first executive compensation disclosure requirements in the Securities Act of 1933. Leigh Johnson et al., *Preparing Proxy Statements Under the SEC's New Rules Regarding Executive and Director Compensation Disclosures*, 7 U.C. DAVIS BUS. L.J. 373, 376 (2007) [hereinafter Johnson] (reviewing the history of executive compensation and related disclosure before 1992). The Act required companies to disclose the compensation of directors and officers, along with the identity of officers earning more than $25,000 in compensation. Johnson at 378.

58. Troy A. Paredes, Comm'r, Sec. & Exch. Comm'n, Statement at Open Meeting to Propose Amendments Regarding Facilitating Shareholder Director Nominations (May 20, 2009), https://www.sec.gov/news/speech/2009/spch052009tap.htm, *archived at* https://perma.cc/5PZT-GLFE ("Mandatory disclosure is at the core of the federal securities laws. Through mandatory disclosure, for example, the federal securities laws facilitate market discipline as a means of holding boards and management accountable."). Though disclosure is a fairly popular and, therefore, convenient remedy for Congress, it has been unsuccessful in curtailing executive compensation. *See* Wagner, *supra* note 16, at 555 ("Unfortunately, lawmakers have a tendency to go into 'crisis-mode' and have 'knee-jerk' regulatory reform responses in times of economic turmoil. As a result, many of the previous remedies to executive compensation, such as increased disclosure, which seemed to be 'uncontroversial,' not only failed to reduce compensation but arguably increased it.").

firms can develop new methods of circumventing regulatory attempts to limit executive compensation, solutions to overcompensation must be equally innovative. Thus, empowering shareholders to see and readily react as the corporate environment changes may be the best solution to tackling excessive compensation. If shareholders believe a company is engaged in wasteful or risky spending, they can elect new directors or sell their stock.[59] However, in order for shareholders to play this role effectively, they must be informed.[60] Through periodic reports and public offering documents, the SEC has greatly alleviated the information asymmetry between corporate insiders and more vulnerable, passive investors.[61] The hope is, as more information is unveiled, shareholders can use that information to make smarter investments and induce changes in corporate governance.[62] Included in these disclosures are the compensation packages of corporate executives. In theory, the more information shareholders receive on executive compensation, the better they will be at identifying inefficient compensation levels—or, in other words, compensation above what is required to eliminate agency costs.[63]

In an honest effort to help shareholders through increased disclosure, Congress has instead exacerbated the problem. Disclosing compensation data may actually be escalating the problem of excessive executive

59. Protesters can also shame and protest overly paid executives to try and induce change.

60. Arthur Levitt, Jr., *Corporate Culture and the Problem of Executive Compensation*, 30 J. CORP. L. 749, 750-51 (2005) ("[W]e need better disclosure of executive compensation. There are far too many ways for boards to . . . 'camouflage' executive compensation from the eyes of shareholders.").

61. Since the 1933 Act, the SEC has sought to create "greater transparency in the compensation decision making process by providing shareholders and boards of directors with clear and comparable information about compensation with which they could make more informed decisions." Kathryn J. Kennedy, *Excessive Executive Compensation: Prior Federal Attempts to Curb Perceived Abuses*, 10 HOUS. BUS. & TAX L.J. 196, 236 (2010) [hereinafter Kennedy]. *See* Louis Lowenstein, *Financial Transparency and Corporate Governance: You Manage What You Measure*, 96 COLUM. L. REV. 1335, 1335-36 (1996) [hereinafter Lowenstein] (discussing how increased transparency helps to inform investors in making investment decisions).

62. *See* Lowenstein, *supra* note 61, at 1335-36 ("Our disclosure policies were adopted in order to make Wall Street fair and efficient. They also give substance to shareholder rights by providing the information essential to their exercise. But quite apart from these intended benefits, good disclosure has been a most efficient and effective mechanism for inducing managers to manage better.").

63. *See* Kennedy, *supra* note 61, at 236 ("In 2006, the SEC revised disclosure rules in order to shed light on how compensation decisions were made and the particulars of executive compensation packages. The intent of the new rules was to require greater transparency in the compensation decision making process by providing shareholders and boards of directors with clear and comparable information about compensation with which they could make more informed decisions.").

compensation by informing CEOs if they are paid less than their peers. They can then leverage this information in negotiating their own pay. CEOs often argue that they are worth the expense because of their unique ability to create jobs and improve shareholder value and, therefore, should not have their compensation judged against other, lower paying industries or occupations.[64] Following this line of reasoning, CEO compensation is not problematic—for either the CEO or the shareholders—unless it significantly deviates from other, similarly situated CEOs.[65] But once a CEO's compensation is compared to other CEOs within their market, even their relative wage may carry great personal significance—when "the Wall Street Journal published a list of the world's wealthiest people [for example], only one person on that list was happy . . . ."[66] Therefore, a CEO's high absolute wage may not diminish the desire to out earn peers and may instead fuel a wasteful cycle of competitiveness.

On the other hand, decreasing disclosure is counterintuitive and may go against modern capitalist thinking. Though this Comment does not advocate for decreasing current federally-imposed disclosure requirements, the ineffectiveness of emphasizing disclosure as a panacea seems to be clear: the SEC's perpetual revisions and increased disclosure requirements reveal the limited and futile role executive compensation disclosures have in reducing CEO pay.[67] Therefore, it is important to weigh the costs and potential results of more disclosure, rather than simply assuming that more is always better.[68] The SEC's attempt to improve shareholder knowledge

64. *Compare Myths and Realities of Executive Pay: Hearing Before the S. Comm. on Fin.*, 107th Cong. 28 (2002) (statement of Ira Kay, Vice President & U.S. Practice Dir. For Exec. Comp., Watson Wyatt Worldwide, N.Y.C., NY) (discussing the level of CEO pay in the context of their contribution and in relation to other high paying markets, such as sports and entertainment), *with* Bebchuk & Fried, *supra* note 13, at 21 ("[C]lubs . . . generally do not provide athletes with complex deferred-compensation arrangements [or] . . . gratuitous payments in addition to the player's contractually entitled payouts" when they are released.).

65. *But see* Bebchuk & Fried, *supra* note 13, at 22 ("[While some argue that] compensation arrangements should not be seen as problematic as long as boards use market surveys . . . . the validity of [these] arguments for deference to market outcomes depends on whether those outcomes are largely generated by arm's-length negotiations . . . .").

66. Posner, *supra* note 13, at 1035.

67. *See* Bebchuk & Fried, *supra* note 13, at 68 (analyzing how previous "disclosure requirements have hardly brought an end to firms' ability to camouflage the amount and form of executive pay.").

68. *See* Geoffrey A. Manne, *The Hydraulic Theory of Disclosure Regulation and Other Costs of Disclosure*, 58 ALA. L. REV. 473, 480-81 (2007) [hereinafter Manne] ("[T]here must be a limit to the extent and scope of required disclosure. From the point of view of information recipients, the additional disclosures provide diminishing returns and increasing costs, some of which may be born directly by the recipient, most notably when the recipient is a stockholder in a company subject to the disclosure regulation. At the same time, additional disclosure also imposes increasing costs on firms, and even if we accept the

and power through required disclosure of corporate compensation demonstrates how disclosure can fail and may even inadvertently aggravate the problem. Will disclosing pay ratios be any different?

I. COSTS OF THE PAY RATIO RULE

Even if the pay ratio is effective in achieving its desired goals, its added value must be worth the added costs of producing it. Increased disclosure inherently means increased costs for corporations. The two largest costs for registrants with complex corporate or employment structures will be calculating the necessary information for the pay ratio disclosure and the potential liability exposure for releasing inaccurate ratios.

Along with determining which employees are used to calculate the median worker's compensation,[69] a company must determine their wages. For some registrants, obtaining this data will be a major difficulty. While disclosing the compensation of high-level executives is not difficult, many public companies lack a centralized database of all employee wages, making disclosure of the median wage much more problematic.[70] However, the final rule includes several alterations from the SEC's initial proposal that help to reduce these regulatory burdens, such as allowing registrants to exclude unconsolidated subsidiaries and allowing them to identify the median employee once every three years.

Although costs of implementing the new pay ratio rule will vary among individual companies, the SEC anticipates the rule to cost $1,314,694,544 in total and $368,159 for the average registrant.[71] The

argument that firms voluntarily *under*-produce information, an optimal information disclosure regime would surely not require disclosure of *all* private information. Optimal disclosure is not maximal disclosure."). Furthermore, increased disclosure is only helpful if that information is read and disseminated into the marketplace. *See* Manne, at 503-04 ("Although the SEC focuses on the importance of information for ordinary investment decisions, ordinary investors are rationally uninterested in such information. It is well-known that stockholders are relatively uninformed and apathetic in their roles as 'owners' of public companies: Small stakes, diversification, and attenuated influence render the acquisition and use of most firm-specific information far more costly than they would be worth." (internal citation omitted)).

69. *See* Sections IV-A and IV-C for a discussion on which employees are included in the pay ratio calculation.

70. Ctr. on Exec. Comp., Comment Letter on Pay Ratio Disclosure 4 (Sept. 26, 2014), http://www.sec.gov/comments/s7-07-13/s70713-1043.pdf, *archived at* http://perma.cc/3N6J-LL9X ("Because most companies do not have centralized pay or employee information, the pay ratio calculation will require a large manual data collection effort with companies having to evaluate their entire workforce . . . .").

71. Pay Ratio Rule, *supra* note 4, at 50161 (estimating the initial cost of compliance for all 3,571 registrants and the average registrant affected by the Section 953(b)

Commission also estimates "that the total incremental cost of [utilizing] outside professionals for annual reports will be approximately $315,389,390 per year and the total incremental internal burden will be approximately 2,367,563 hours per year."[72] However, opponents like the U.S. Chamber of Commerce challenge these numbers and argue that the SEC's analysis has underestimated some of these costs by as much as nearly 200%.[73] Some of the major factors influencing costs differences are:

> [The] size and nature of the workforce, complexity of the organization, the stratification of pay levels across the workforce, the types of compensation the employees receive, the extent that different currencies are involved, the number of tax and accounting regimes involved, the number of payroll systems the registrant has, and the degree of difficulty involved in integrating payroll systems to readily compile total compensation information for all employees.[74]

For example, a medium-sized company with a primarily American workforce may face fewer hurdles and costs than a large multinational company with thousands of employees across the globe.[75] Because of these costs, opponents of the rule argue that the rule's burdens and inefficiencies overshadow any potential benefits, especially when the information likely misleads shareholders.[76] Furthermore, the rule risks putting US companies at a competitive disadvantage against foreign corporations that do not have

requirements). *See* Table 1 in Appendix for further cost details.

72. *See* Pay Ratio Rule, *supra* note 4, at 50182.

73. *See* Tom Quaadman, Vice President of the U.S. Chamber of Commerce, Comment Letter on Pay Ratio Disclosure (May 22, 2014), http://www.sec.gov/comments/s7-07-13/s70713-969.pdf at 2, *archived at* http://perma.cc/7UXP-83FJ (discussing how the SEC likely underestimated the cost of utilizing outside professionals, with annual costs to the private sector of over $700 million versus the $315.4 million estimated by the SEC in its final rule and the $72.7 million estimated in its proposed rule).

74. Pay Ratio Rule, *supra* note 4, at 50173.

75. *See* Proposed Pay Ratio Rule, *supra* note 8, at 60601 ("[T]he actual burden will vary depending on factors including the size of the company, the number of employees and how many are located outside of the United States.").

76. Kevin Douglas & Andrea Orr, *SEC's CEO pay-Ratio Proposal Gives Companies Flexibility to Satisfy Dodd-Frank*, BLOOMBERG BNA (Oct. 11, 2013), http://www.bna.com/secs-ceo-pay-ratio-proposal-gives-companies-flexibility-to-satisfy-dodd-frank/, *archived at* http://perma.cc/BN9P-9HA9 [hereinafter Douglas] ("[O]pponents note that, even within a single industry, median employee pay can vary based on numerous factors, including differences in organizational structures, geographical distribution of employees and degree of reliance on seasonal and outsourced workers. Opponents also argue that any benefit to investors from the pay ratio disclosure is far outweighed by the difficulties and time-consuming exercise of calculating median employee pay, especially for companies with large diverse workforces, multiple payroll and other compensation systems and global operations.").

to expend the extra resources in compiling compensation data.

A. *Gathering Employee Wage Information for Complex Corporate Structures*

The rule endeavors to eliminate advantages of unique corporate structures by including employees of subsidiaries. Otherwise, companies could utilize their subsidiaries to hide employee data and alter pay ratios. The SEC did, however, heed commenters' warnings and define "'employee' to include only the employees of the registrant's *consolidated subsidiaries*."[77] Otherwise, many corporations with several unconsolidated subsidiaries, or subsidiaries with separate financial information, would face increased costs in retrieving the necessary data from each separate subsidiary. Even holding companies with more than 50% ownership over a subsidiary are not necessarily actively controlling it. Both management and the employees of the parent company and unconsolidated subsidiary may view themselves as belonging to discrete corporate entities. For these reasons, parent companies would have a much more difficult time retrieving and converting the data for unconsolidated companies because they often lack convenient access to the relevant financial information.

Still, large, international holding companies may face significant regulatory burdens in retrieving the requisite employee data. The SEC relied on the compliance costs of previous executive disclosure rules to estimate the costs for disclosing median workers' compensation.[78] However, estimating the cost of executive pay for the 2006 disclosure regulation, for instance, is much less burdensome than determining the average pay of median employees. Some large, complex corporations have multiple HR departments, each with their own payroll information.[79] These

77. Pay Ratio Rule, *supra* note 4, at 50112 (emphasis added). Unconsolidated subsidiaries are companies owned, at least in part, by a holding company. However, unlike consolidated subsidiaries, unconsolidated subsidiaries' financial statements are not included with those of the holding company. Instead, the unconsolidated subsidiary is treated as an investment of the parent company, rather than an appendage of its greater operations. *See* JONATHAN LAW, OXFORD DICTIONARY OF ACCOUNTING 423 (4th ed. Oxford University Press 2010) (defining unconsolidated subsidiary as "[a]n undertaking that, although it is a subsidiary undertaking of a group, is not included in the consolidated financial statement of the group").

78. Center on Executive Compensation, *supra* note 23, at 11 ("The SEC's cost estimates for calculating the pay ratio are erroneously based on the Commission's unsubstantiated speculation that the compliance time for the proposed pay ratio rule will be two times the compliance hours estimate it estimated for the 2006 compensation disclosure changes.").

79. *Id*. at 10 (discussing one proposed method of using multiple HR teams in various countries and regions to complete the requisite data collection).

companies will have to manually collect data from each separate database.[80] Although the SEC predicted it would take twice as long to determine the pay of median employees as opposed to executives, some corporations fear a much higher multiple is more accurate.[81] Furthermore, multinational companies will now have to implement teams in each country rather than just their headquarters in order to collect the necessary data.[82]

Some corporations do, however, have access to this information already. In a comment to the SEC, Intel's VP of Legal and Corporate Affairs reduced her original cost estimate for complying with the rule from $250,000-$500,000 to $15,000 annually.[83] What led to such an extreme

80. The final rule did, however, address concerns over international privacy laws. Many commenters warned that "data privacy restrictions in certain countries will add to the time and expense required to identify the median employee. . . . [C]ompliance with the data protection laws of each European Union member country will be a significant obstacle to the collection of necessary information." Center on Executive Compensation, *supra* note 23, at 10. The final rule "provides an exemption for circumstances in which foreign data privacy laws or regulations make registrants unable to comply with the final rule." Pay Ratio Rule, *supra* note 4, at 50111. Nevertheless, registrants must still pay the cost of:

> seeking an exemption or other relief under any governing data privacy laws or regulations . . . . [and] obtain a legal opinion from counsel that opines on the inability of the registrant to obtain or process the information necessary for compliance with the final rule without violating that jurisdiction's data privacy laws or regulations . . . .

Pay Ratio Rule, *supra* note 4, at 50111.

81. Center on Executive Compensation, *supra* note 23, at 11 ("The SEC's cost estimates for calculating the pay ratio are erroneously based on the Commission's unsubstantiated speculation that the compliance time for the proposed pay ratio rule will be two times the compliance hours estimate it estimated for the 2006 compensation disclosure changes [requiring disclosure of executive and director compensation]. . . . The development of the named executive officer disclosure is largely manual, involving a relatively small team, typically at company headquarters as opposed to locations in countries across the globe. . . . '[I]dentifying the median employee and calculating total compensation will require education of team members in these countries, developing a process for collection of the information, ensuring that the information is reliable, and identifying the median employee among all employees.'").

82. Center on Executive Compensation, *supra* note 23, at 11 (comparing the named executive officer disclosure to the disclosure requirement involving employees located across the globe). It is worth noting that numerous large, multinational corporations sent a combined comment seeking several changes to the proposed rule but did not seek to exclude foreign employees. Some of the companies in the combined comment include Microsoft, Pfizer, Verizon, Johnson & Johnson, and Morgan Stanley. They did, however, recommend excluding unconsolidated subsidiaries, which may accomplish the same objective if those subsidiaries hire a large number of foreign employees. For a full list of commenters and their proposed amendments, *see generally* Keith Nelsen, General Counsel of Best Buy Co., et al., Comment Letter on Pay Ratio Disclosure (Dec. 17, 2013), http://www.sec.gov/comments/s7-07-13/s70713-660.pdf, *archived at* http://perma.cc/2GYY-JEJC (Discussing the commenters proposed amendments).

83. Cary Klafter, VP Legal and Corporate Affairs for Intel, Comment Letter on Pay Ratio Disclosure 1 (Nov. 27, 2013) http://www.sec.gov/comments/s7-07-13/s70713-

decrease? Intel already recorded the W-2 forms (and their foreign equivalents) for its 105,000 employees.[84] This was possible because the SEC allows companies to implement a methodology that works best for each individualized company's situation, such as utilizing data gathering systems that are already in place or taking a statistical sample of workers. The Intel example highlights how even large, multinational corporations with tens of thousands of employees worldwide can efficiently comply with the disclosure rule.[85] However, many other companies do not have the same luxury.

B. *Use of Reasonable Estimates and Assumptions*

It is difficult for some companies to calculate the median wage, even if they do have access to the necessary data. To lessen this financial burden of calculating the pay ratio, the SEC's pay ratio rule allows for registrants to use reasonable estimates and assumptions in their calculations.[86] The SEC hopes to limit costs by allowing corporations to implement customized methodologies, like statistical sampling, that best fit an individual company's needs, so long as the methodology is reasonable and consistent.[87] Just how much freedom companies have, however, is the source of much concern. Certain adjustments and assumptions, such as full-time equivalent adjustments for part-time workers[88] and annualizing adjustments for temporary or seasonal employees[89], are not permitted. In

658.pdf, *archived at* http://perma.cc/8BBM-JB78.

84. *Id.* ("This reduction is primarily due to the ability afforded by the proposed rule for registrants to use a consistently applied compensation measure, such as payroll records or W-2 reportable wages and the equivalents for non-U.S. employees, to identify the median employee.").

85. *Id.* ("Accordingly, [Intel] would be spared from the burdensome and costly task of calculating the compensation of each of [its] employees (approximately 105,000 persons worldwide) pursuant to Item 402 of Regulation S-K in order to identify [its] median employee for the purpose of determining the pay ratio. The cost of computing the change in the present value of pension benefits for all of [Intel's] employees would have been particularly costly and time consuming.").

86. *See* Pay Ratio Rule, *supra* note 4, at 50141 (discussing registrants' ability to use estimates and assumptions as long as they "briefly describe and consistently apply any methodology . . . .")

87. *See* Pay Ratio Rule, *supra* note 4, at 50135 (discussing the final rule's flexibility in determining the median employee).

88. "A full-time equivalent adjustment involves taking the compensation of a part-time employee and projecting what the employee would have made if the employee were employed on a full-time basis. Full-time equivalent adjustments are prohibited under the final rule under all circumstances." Pay Ratio Rule, *supra* note 4, at 50129.

89. Temporary workers are excluded because:

Annualization involves taking the compensation of an employee who worked for only part its final rule, the SEC attempts to strike a balance between implementing methods that reduce costs while still presenting useful and accurate information to shareholders.

One example is the use of random sampling to determine the median employee's compensation. Rather than finding the compensation and in kind compensation of every employee, the company would only calculate the information for randomly selected employees. In the SEC's initial proposal, the Commission believed simple random sampling would suffice for about half of the registrants subject to the pay ratio rule because their compensation structure naturally had a tractable statistical distribution.[90] However, sampling may be more difficult for the other half of registrants with multiple business or geographical segments.[91] In the Center on Executive Compensation's survey[92] of 128 public companies, only 16.8% believed they would use statistical sampling.[93] Many voiced concerns over not having enough information within their systems to conduct an effective statistical sample.[94] The survey suggests sampling will not be as convenient for some companies as the SEC submits.

But beyond the example of random sampling, the rule gives little guidance in calculating the compensation of employees.[95] The SEC does "not prescribe specific estimation techniques or confidence levels for an estimated median because [according to the SEC] . . . companies would be

of the registrant's fiscal year and projecting that compensation as if the employee worked the full fiscal year at the schedule that the employee worked for the portion of the year the employee worked. Annualization is allowed under the rule for full-time and part-time employees who did not work for the registrant's full fiscal year for some reason . . . . Annualization is only allowed for permanent employees . . . .
Id.

90. Proposed Pay Ratio Rule, *supra* note 8, at 60594 (estimating that about 50% of the nearly 4,000 registrants have an organizational structure with a tractable statistical compensation distribution).

91. *See id*. ("[G]enerating reasonable estimates through statistical sampling could result in a disproportionally higher cost to registrants with more complicated payroll systems or organization structures.").

92. In the survey, 5% of companies had revenues greater than $100 billion, 54% had revenues between $10 and $100 billion, 30% had revenues between $2 and $10 billion, and 11% had revenues less than $2 billion. Center on Executive Compensation, *supra* note 23, at Appendix 1, ii.

93. *Id*. at 10.

94. *See id*. at 10-11 ("Several [potential registrants] noted that they do not currently track pay information at the level of detail required by the rule. . . . Others noted that the scope of their businesses made developing a sample challenging. . . . 'A statistically valid random sample of the workforce would need to consider various factors, including the distribution of compensation data across the organization, employees (full-time, part-time, seasonal and temporary), geographies, lines of business, etc.'").

95. For example, "[t]he final rule does not provide specific parameters for statistical sampling, including the appropriate sample size." Pay Ratio Rule, *supra* note 4, at 50136.

in the best position to determine what is *reasonable* in light of their own employee population and access to compensation data (emphasis added)."[96] And the Commission does not define "reasonable" techniques because it believes companies should "make their own determinations on what is appropriate based on their own facts and circumstances."[97] Furthermore, in terms of valuing unique pay structures or in kind compensation, the Commission does "not believe it would be practicable . . . to provide detailed, prescriptive rules on valuing particular types of employee compensation."[98] Instead, the Commission provides companies with latitude to utilize estimates and assumptions to create their own methodologies for determining the median employee's pay. The SEC believes that "mandating a particular methodology would [not] 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."[99] In other words, the SEC understands that the plethora of variables affecting these ratios already makes comparability so difficult, that allowing any methodology (within reason) could not make the ratios much more inaccurate than they already are.

Despite its failure to provide detailed and efficient methodologies, the final rule greatly improves upon the SEC's initial proposal by allowing companies to identify their median employee once every three years, instead of every year.[100] If the SEC is incapable of reducing the burdens of determining the median employee, it can at least decrease the frequency. Furthermore, if the median employee leaves the company, the registrant can simply use another employee who has substantially similar compensation until the three year mark is met.[101] While it is a simple nuance to the proposed rule, it will greatly reduce costs for large companies.

The SEC's acceptance of estimates, sampling, and reasonable assumptions in calculating the ratio is crucial. First, the rule's requirement that registrants gather the pay of their CEO and median employee so that a ratio of the two can be disclosed will be a difficult and expensive enterprise for many companies.[102] There has already been a noticeable shift in

96. Proposed Pay Ratio Rule, *supra* note 8, at 60570.
97. Pay Ratio Rule, *supra* note 4, at 50136.
98. Proposed Pay Ratio Rule, *supra* note 8, at 60574.
99. Proposed Pay Ratio Rule, *supra* note 8, at 60594.
100. *See* Pay Ratio Rule, *supra* note 4, at 50172 ("[T]he final rule allows registrants to identify the median employee once every three years unless there has been a change in the registrant's employee population or employee compensation arrangements that it reasonably believes would result in a significant change in the pay ratio disclosure.").
101. *Id.*
102. The cost of determining the median compensation can vary widely depending on

companies seeking to stay private longer due to the increasing burdens and liabilities of going public.[103] If the rule does not sufficiently allow for companies to minimize costs, it will further discourage companies from going public, reducing their access to capital and reducing the number of lucrative investment opportunities for investors.[104] Second, by allowing different industries and corporations to implement the calculation practices that work best for their circumstances, the SEC would encourage a "natural laboratory from which best practices can emerge from experience, peer benchmarking, and investor and stakeholder dialog[ue]."[105] Therefore, the SEC's flexibility through assumptions and estimates will prove essential for both managers and shareholders. However, flexibility lacking guidance, coupled with registrant's fear of liability, will nullify much of the flexibility the SEC's hopes to create.

C. *Liability Risks*

The SEC, along with some large public corporations, argue that the rule gives registrants enough flexibility to reduce costs by implementing customized and efficient methods for calculating the information. Nevertheless, the requirement that companies "file" rather than "furnish" their pay ratios, which imposes greater liability for inaccuracies,

the size and complexity of the workforce and the type of compensation received. *See generally* Pay Ratio Rule, *supra* note 4, at 50161 (noting a varying degree of indirect costs especially on public companies with overseas employees, subsidiaries, or low-wage workers). *See also* Proposed Pay Ratio Rule, *supra* note 8, at 60570 (listing the particular facts and circumstances that affect the appropriate and most cost effective methodology for identifying the median compensation); Ctr. on Exec. Comp., Comment Letter on Pay Ratio Disclosure 5 (Sept. 26, 2014) ("[U]nlike officer pay programs, when calculating the pay ratio, shifts in calculation methodologies and employee populations will ensure high continued compliance costs.").

103. *See* James Angel, Associate Professor of Finance at Georgetown University, Comment Letter on Pay Ratio Disclosure (Nov. 22, 2013), http://www.sec.gov/comments/s7-07-13/s70713-347.pdf, *archived at* http://perma.cc/A6M8-K6V6 [hereinafter Angel] at 6-7 ("As this rule imposes costs on public companies but not private ones, it is likely to tip the balance further away from the public markets. The alarming decrease in the number of public US companies is a sign that our markets have not been receptive to smaller public companies. Adding more burdens to public companies but not private ones adds yet another reason for the companies to remain or go private. . . . This crisis in capital formation is one of the things that led Congress to pass the JOBS Act subsequent to Dodd-Frank.").

104. *Id*. ("This withering of the public markets creates fewer choices for growing companies to access needed capital, and fewer exit opportunities for venture capital investors.").

105. John Seethoff, VP and Deputy General Counsel for Microsoft, Comment Letter on Pay Ratio Disclosure (Dec. 4 2013) http://www.sec.gov/comments/s7-07-13/s70713-604.pdf at 3, *archived at* http://perma.cc/WP7M-53ZS [hereinafter Seethoff].

undermines much of this flexibility.[106]

The difference between "filing" and "furnishing" is substantial. By filing information to the SEC, rather than furnishing it, the information is subject to liability for any false or misleading statements. While there may still be penalties for furnishing unreliable information, the bar for liability is higher. Though "registrants will have to review a large amount of data and make a significant number of estimates, assumptions, and judgment calls,"[107] they still face the possibility of litigation arising from inaccurate filings of the pay ratio.[108] And without the existence of a safe harbor from the SEC, the filing requirement greatly concerns those registrants that believe some level of imprecision is inevitable.[109] While an overwhelming number of companies would rather furnish the disclosure rather than file it, the SEC stands by the filing requirement.

In response to the numerous objections, the SEC maintains that the companies concerned with limiting liability can warn shareholders of possible imprecisions in their disclosures[110] and are free to choose methodologies less likely to produce misleading information.[111] For companies with centralized systems of employee information already in

106. *See* Pay Ratio Rule, *supra* note 4, at 50143 ("Although we recognize that identifying the median employee and calculating total compensation may require registrants to review a large amount of data and make a significant number of estimates, assumptions, and judgment calls, we do not believe this fact alone justifies exempting this information from being 'filed.'"). *See generally* EDWARD M. WELSH, MORRISON & FOERSTER, FREQUENTLY ASKED QUESTIONS ABOUT FORM 8-K 6 (2015), http://media.mofo.com/files/Uploads/Images/FAQ-Form-8-K.pdf, *archived at* http://perma.cc/WN4P-6XMV ("Section 18 of the Exchange Act imposes liability for material misstatements or omissions contained in reports and other information filed with SEC. By contrast, reports and other information that are 'furnished' to SEC (to the extent expressly permitted under applicable SEC rules) do not attract liability under Section 18.").

107. Pay Ratio Rule, *supra* note 4, at 50143.

108. *See* Proposed Pay Ratio Rule, *supra* note 8, at 60580 ("We note that one of the reasons that commenters recommended treating the information as furnished and not filed is because of the difficulty that some companies may have in determining and verifying the information, which must be covered by the certifications required for Exchange Act filings under the Sarbanes-Oxley Act of 2002.").

109. *See* Pay Ratio Rule, *supra* note 4, at 50143 ("Some noted that this imprecision will subject a registrant to potential liability and litigation, make it difficult to validate the information sufficiently for Sarbanes-Oxley Act certification purposes, and/or not permit the information to be audited . . . .").

110. *See* Pay Ratio Rule, *supra* note 4, at 50143 ("[T]he required disclosure about the assumptions and methodologies underlying the calculations, will permit registrants to clearly explain to shareholders where potential imprecisions may be introduced into the reported statistic.").

111. *See* Proposed Pay Ratio Rule, *supra* note 8, at 60597 (highlighting how companies can use reasonable estimates and develop individualized compliance procedures when gathering and verifying information for a filing).

place, disclosing accurate information may not present a major hurdle. But for companies lacking that luxury, they may be forced to use methods ill-suited and inefficient for their business. Large, decentralized companies relying on too many assumptions and estimations—even if they are educated deductions—could expose themselves to undeserved liability.[112] Therefore, the filing requirement undermines much of the flexibility the SEC claims to offer. Corporations that do not already have systems in place to calculate median employee compensation will have to develop new methods of obtaining that information in order to avoid potential litigation.[113]

In addition, a furnishing requirement may also allow companies freedom to discover which methods produce the most accurate and efficient results. They could "leverage the efficiency of existing systems and processes" or experiment with different techniques without the constant fear of litigation.[114] Furthermore, reducing the risk of liability may reduce the amount of boilerplate clauses full of redundant legalese that makes finding material information more time consuming for stakeholders.[115] The SEC should encourage more concise disclosures to better inform the market.[116] A "filing" requirement creates the opposite incentive.

II. POTENTIAL BENEFITS OF THE PAY RATIO RULE

The pay ratio rule strives to inform stakeholders on the issues of pay

112. *See* Center on Executive Compensation, *supra* note 23, at 27 ("[H]aving to obtain Sarbanes-Oxley certification for the pay ratio is likely to undermine the flexibility on which the Commission relies in its attempt to lessen the burdens of being a filed document and result in significant additional administrative burdens and compliance costs.").

113. *See* Center on Executive Compensation, *supra* note 23, at 27-28 (discussing how a filing requirement is not compelled by the statutory construction of the Dodd–Frank Wall Street Reform and Consumer Protection Act).

114. Seethoff, *supra* note 100, at 3.

115. *See* Angel, *supra* note 103, at 7 ("Often, the material [in corporate disclosures] is so repetitive that it is easy to overlook the important points. This drives up costs for investors and results in poorer understanding in the marketplace.").

116. The amount of information corporations disclose continues to increase every decade. *See* Steven M. Davidoff & Claire A. Hill, *Limits of Disclosure*, 36 SEATTLE U. L. REV. 599, 607 (2013) [hereinafter Davidoff] ("The federal securities laws have also continued to emphasize disclosure. Professor Jeffrey Gordon documented the increase in length of disclosure documents from 1950 to 2004. During that time period, the average number of pages from a sample of Fortune 500 company 10-Ks went from almost sixteen pages to a little over 166 pages with the average number of financial pages increasing from 4.41 to 38.15 pages. From 1974 to 2004, the number of MD&A pages went from 1.88 to 24.05. The increasing length of disclosure documents reflects the increasing emphasis on disclosure in federal regulations.").

equity and investor value.[117] Supporters of the pay ratio rule—including unions, labor advocates, and institutional investors—believe the growing disparity in wages may lead to lower company morale, productivity, and profitability, all of which harm firm value.[118] The rule may also alleviate a broader societal problem concerning growing income inequality. With the recent recession, Americans feel they are earning less and less while "CEO pay balloons and corporate profits soar."[119] Lastly, pay ratio information could serve as a useful tool for shareholder say-on-pay voting. If disclosing the pay ratio increases firm value through greater shareholder activism and increased competition for more efficient payment structures, firms will become stronger, creating a healthier and more stable market.

A. *Pay Ratio Information May Help Shareholders Evaluate Firm Value*

Proponents of the rule assert that releasing pay ratio information to shareholders may contribute to better evaluations of CEO's performance and whether it merits current compensation levels.[120] Currently, shareholders are able to compare the compensation packages of CEOs across companies and relay their dissatisfaction through proxy solicitations and yearly say-on-pay votes.[121] Information on the earnings of employees

117. *See, e.g.*, Pay Ratio Disclosure Comment Letter Type B, U.S. Sec. & Exch. Comm'n (last updated Oct. 12, 2013), https://www.sec.gov/comments/s7-07-13/s70713-190.htm, *archived at* https://perma.cc/8AZ9-3KT4 [hereinafter Comment Letter Type B] ("Disclosing corporate pay ratios between CEOs and average employees will finally show which corporations are driving this [pay inequity] trend, which siphons money away from investors, and into the pockets of CEOs.").

118. *See* Douglas, *supra* note 76 ("Supporters of the mandated disclosure, including unions and labor advocates, claim the CEO pay ratio constitutes material information for investors, particularly in light of the widely reported increase in income disparity in the U.S. between CEO pay and that of rank-and-file workers and the corresponding impact such disparity may have on employee morale and productivity."). *See also* Alex Edmans, *Does The Stock Market Fully Value Intangibles? Employee Satisfaction and Equity Prices*, 101 J. OF FIN. ECON. 621, 621 (2011), http://faculty.london.edu/aedmans/Rowe.pdf, *archived at* http://perma.cc/EVK7-69QH [hereinafter Edmans] (suggesting that employee satisfaction is positively correlated with shareholder returns).

119. Comment Letter Type B, *supra* note 117.

120. *See supra* quote accompanying note 118.

121. *See* Randall S. Thomas et. al., *Dodd-Frank's Say on Pay: Will It Lead to A Greater Role for Shareholders in Corporate Governance?*, 97 CORNELL L. REV. 1213, 1215 (2012) ("The Act mandates that public shareholders have an advisory vote on the prior year's compensation of the corporation's top five executives—a 'say on pay.'"). The goal of say-on-pay is to allow shareholders to fire a warning shot to directors if they are dissatisfied with inefficient pay structures. However, a "warning shot is effective only if it can be followed by more serious firepower." Jeremy Ryan Delman, *Structuring Say-on-Pay: A Comparative Look at Global Variations in Shareholder Voting on Executive Compensation*,

within different industries is also available to investors, though accessibility may vary widely depending on the industry and the specificity desired.[122] Nevertheless, without the rule, shareholders are not entitled access to data comparing the pay between a specific company's CEO and its employees.[123] Arguably, this information helps investors compare companies' human capital investment, which can help shareholders determine firm value.[124]

The professed importance of increasing shareholder value by investing in the company's human capital has developed significantly in the last several decades.[125] Some common examples include improving employee morale and satisfaction. Under the traditional model, managers relied only on labor efficiency and daily output as the indicators of successful employee management.[126] Managers often viewed corporate profits and employee wages as having a zero-sum relationship.[127] Today, there is a much greater interest in corporate responsibility, whether that involves a

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2010 COLUM. BUS. L. REV. 583, 624 (2010). Unfortunately, even if shareholders believe compensation is excessive, removing directors can be very difficult due to dispersed shareholders, staggered boards, and costly proxy solicitations. Therefore, some critics argue that say-on-pay is just another failed attempt to curtail executive compensation.

122. *See* Angel, *supra* note 103, at 2 (citing the Bureau of Labor Statistics, which gives the average compensation in various industries based on the type of employment). *But see* Proposed Pay Ratio Rule, *supra* note 8, at 60585 ("Company-specific information about median employee pay would be new information generated pursuant to the Section 953(b) requirements, and thus the potential incremental benefits identified by commenters primarily derive from this company-specific information.").

123. Proposed Pay Ratio Rule, *supra* note 8, at 60584.

124. *See* Pay Ratio Rule, *supra* note 4, at 50153 ("[C]ommenters suggested that a comparison of [CEO] compensation to employee compensation could be used by shareholders to approximate employee morale and/or productivity or analyzed as a measure of a particular registrant's approach to managing human capital.").

125. See generally JACK J. PHILLIPS, INVESTING IN YOUR COMPANY'S HUMAN CAPITAL: STRATEGIES TO AVOID SPENDING TOO LITTLE—OR TOO MUCH (American Management Association, 2005) for typical examples of management techniques focusing on human capital investments.

126. FREDERICK WINSLOW TAYLOR, THE PRINCIPLES OF SCIENTIFIC MANAGEMENT 1 (Harper & Brothers Publishers 1911), http://www.eldritchpress.org/fwt/t1.html, *archived at* http://perma.cc/CR24-L9MH [hereinafter Taylor] ("[M]aximum prosperity for each employé means not only higher wages than are usually received by men of his class, but, of more importance still, it also means the development of each man to his state of maximum efficiency. . . .").

127. *See* Edmans, *supra* note 118, at 622 ("Traditional theories . . . are based on the capital-intensive firm of the early 20th century, which focused on cost efficiency. . . . [J]ust like other inputs such as raw materials, management's goal is to extract maximum output while minimizing their cost. [Employee s]atisfaction arises if employees are overpaid or underworked, both of which reduce firm value."). *See also* Taylor, *supra* note 126, at 1 ("The majority of [employers] believe that the fundamental interests of employés and employers are necessarily antagonistic.").

greater concern over social issues, public policy, or stakeholders.[128] Recent studies have found "a strong, robust, positive correlation between [employee] satisfaction and shareholder returns."[129] For example, since 1998, Fortune magazine has released a list of the "100 Best Companies to Work For in America."[130] These companies "exhibit significantly more positive earnings surprises and stock price reactions to earnings announcements . . . . [E]ach year, they earn 1.2-1.7% more than peer firms."[131] There are numerous theories on how increased employee satisfaction improves shareholder value. It can lower turnover, increase recruitment, engender employees to internalize corporate goals, and serve as a motivating force pushing employees to increase outputs.[132] Corporations can also receive indirect value from increasing employee benefits. While many industries do not face significant consumer pressure to improve employee benefits, there are instances of consumers demanding that companies improve their labor practices.[133] Just as some shareholders prefer to invest in socially responsible companies, some customers prefer to patronize companies that treat their employees well.[134]

128. *See generally* Janet E. Kerr, *The Creative Capitalism Spectrum: Evaluating Corporate Social Responsibility Through A Legal Lens*, 81 TEMP. L. REV. 831, 832 (2008) ("Welcome to the age of corporate conscience. . . . The pursuit of this 'double bottom line' is supported by existing corporate laws that allow boards to consider stakeholders other than shareholders; the growing body of knowledge on measuring social impacts qualitatively and quantitatively; and the increasing demand by consumers, investors, and governments for sustainable and responsible business practices.").

129. Edmans, *supra* note 118, at 622.

130. *See 100 Best Companies to Work For*, FORTUNE (2015), http://fortune.com/best-companies/, *archived at* http://perma.cc/3Y9T-7ZGB.

131. Edmans, *supra* note 118, at 622.

132. Edmans, *supra* note 118, at 624.

133. *See* DAVID VOGEL, THE MARKET FOR VIRTUE: THE POTENTIAL AND LIMITS OF CORPORATE SOCIAL RESPONSIBILITY 78-79 (The Brookings Institution 2005) [hereinafter Vogel] ("In July 1996, Life magazine published a story about child labor in Pakistan, which featured a photo of a 12-year-old boy stitching a Nike soccer ball. . . . A subsequent report by students at Dartmouth's Tuck School of Business, commissioned by Nike. . . . found that factory workers [in Vietnam] had significant discretionary income—enough to purchase items such as bicycles and wedding gifts for family members—[but] it was the contrast between the daily wages of $1.67 paid to factory workers in Vietnam and the retail price of $150 for a pair of Nike's basketball sneakers that caught the public's attention.").

134. For example, Starbucks brands their coffee with a Fair Trade label, guaranteeing an above-world-market price for their producers; Ikea prohibits its suppliers from employing children; and Timberland grants employees one week of paid leave every year to work with charities. *See* Vogel, *supra* note 133, at 1, 16-17 (discussing how companies focusing on corporate social responsibility to improve employee morale or company reputation will be in a better position to attract and retain loyal customers). For an example of how investing in stakeholders can improve a company's reputation, see *World's Most Ethical Companies - Honorees*, ETHISPHERE (2015), http://ethisphere.com/worlds-most-ethical/wme-honorees/, *archived at* http://perma.cc/K9QX-575U (honoring companies that conduct business

Proponents of the pay ratio rule assume investors will utilize the new pay ratio information and invest accordingly.[135] This theory that increased disclosure will help investors evaluate firms inherently relies on a semi-strong form efficient market that instantaneously impounds and reflects all information in its stock prices.[136] Yet, empirical studies show that a company's investment in human capital usually does not affect stock price until it translates into tangible profits.[137] Although improving employee satisfaction can increase output and long-term firm value, most investors fail to fully appreciate the financial benefits of these initiatives.[138] For example, the earnings surprises of the 100 companies on Fortune's list are significantly better than their peers.[139] Yet, firms that stay on the list slowly experience a mispricing correction over the next several years after investing in employee satisfaction, meaning that these firms are undervalued for several years.[140] So why are shareholders not investing in these companies when evidence shows investing in human capital can lead to increased firm value? There are two potential explanations. Either (1) the market understands the value of human capital investments but is unaware of particular firms' investment in employee satisfaction or (2) the market is unconvinced that investing in human capital will increase returns.

Strong correlations between high employee satisfaction and greater long-term value make it unlikely that shareholders are simply unaware that investments in human capital *can* improve firm value. However, one study suggests that shareholders are unconvinced and that they commonly view increases in union benefits solely as a cost to the company with no net

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ethically beyond what is expected).

135. *See* Pay Ratio Disclosure Comment Letter Type G, U.S. Sec. & Exch. Comm'n (last updated Nov. 13, 2014), https://www.sec.gov/comments/s7-07-13/s70713-311.htm, *archived at* https://perma.cc/R7ND-PJUZ ("[I]nvestors have a strong need for such information . . . in order to evaluate a company's long-term soundness. It is widely acknowledged that runaway pay practices, linked to short-term corporate gains, encourage recklessness, excessive short- termism [sic] and unethical acts.").

136. *See* Eugene Fama, *Efficient Capital Markets: A Review of Theory and Empirical Work*, 25 J. FIN. 383, 383 (1970) ("[T]he ideal is a market in which. . . . investors can choose among the securities that represent ownership of firms' activities under the assumption that security prices at any time 'fully reflect' all available information. . . . [In semi-strong form markets] prices efficiently adjust to other information that is. . . . publicly available (e.g., announcements of annual earnings, stock splits, etc.). . . .").

137. Edmans, *supra* note 118, at 629.

138. *See* Edmans, *supra* note 118, at 629-30 (hypothesizing that employee satisfaction is not immediately capitalized because of the intangibility of such a factor's effect on firm value).

139. Edmans, *supra* note 118, at 630.

140. Edmans, *supra* note 118, at 631-32 ("[T]he drift dies out in the fifth year. . . . because the market has learned of their valuable intangibles.").

returns.[141] For market valuations "changes in union wealth are offset by opposite changes in shareholder wealth of the same magnitude, on average."[142] Therefore, at least some employee benefits are not valued by shareholders, and the market may view some types of investments in human capital as more valuable than others. While shareholders expect union benefits to harm firm value, other benefits, like tuition reimbursement, may increase firm value.

Shareholders may also view the importance of human capital differently with different industries. For some sectors, where innovation, creativity, and independent thinking play an important role, investment in human capital is essential to running a successful business.[143] For other industries, the optimal employment strategy may rely on maintaining low labor costs.[144] In addition, while increased satisfaction through a reward

141. *See* John M. Abowd, *Collective Bargaining and the Division of the Value of the Enterprise* 41 (Nat'l Bur. of Econ. Res., Working Paper No. 2137, 1987) [hereinafter Abowd], http://www.nber.org/papers/w2137.pdf, *archived at* http://perma.cc/2JMN-N36Q ("Shareholders do not expect to recoup additional union wage cost in the form of extra productivity since they expect to bear the full financial burden of any unexpected increases.").

142. Abowd, *supra* note 141, at 42.

143. *See, e.g.*, Ken Silverstein, *Energy Companies Now Investing in Human Capital and Generating Jobs*, FORBES (Mar. 1, 2013), http://www.forbes.com/sites/kensilverstein/2013/03/01/energy-companies-now-investing-in-human-capital-and-generating-jobs/, *archived at* https://perma.cc/3VBS-KR34 ("The economy is bouncing up and enabling energy companies to prepare for the next round of prosperity. As such, they are investing not just in their businesses but also in their local school systems to build human capital."); *Human Capital for Agriculture in Africa* THE WORLD BANK (Mar. 2014), http://www-wds.worldbank.org/external/default/WDSContentServer/WDSP/IB/2014/03/05/000442464_20140305150314/Rendered/PDF/857130BRI0WB0H00Box382147B00PUBLIC0.pdf, *archived at* http://perma.cc/3CTK-DDD7 ("The low level of human capital in Africa's agricultural sector remains a significant constraint to growth, poverty reduction, and food security on the continent."). *But see* Stuart C. Carr & David McLoughlin, *Effects of Unreasonable Pay Discrepancies for Under- and Overpayment on Double Demotivation*, 122 GENETIC, SOC., & GEN. PSYCHOLOGY MONOGRAPHS 477, 477 ("Compared with equitably paid workers, employees who felt they were being under- or overpaid reported lower job satisfaction and greater readiness to change jobs. The results provide experimental support for double demotivation, which is relevant not only to international development cooperation but also to Western enterprise bargaining [and] merit pay. . . .").

144. For some successful industries, investment in human capital is extremely low. *See* SYLVIA A. ALLEGRETTO, ET AL., FAST FOOD, POVERTY WAGES: THE PUBLIC COST OF LOW-WAGE JOBS IN THE FAST FOOD INDUSTRY 1 (2013), http://laborcenter.berkeley.edu/pdf/2013/fast_food_poverty_wages.pdf, *archived at* http://perma.cc/RRW8-H7PX ("More than half (52 percent) of the families of front-line fast-food workers are enrolled in one or more public programs, compared to 25 percent of the workforce as a whole. . . . People working in fast-food jobs are more likely to live in or near poverty. One in five families with a member holding a fast-food job has an income below the poverty line, and 43 percent have an income two times the federal poverty level

system, like bonus pay, could motivate employees to work harder, rewards have diminishing returns.[145] Workers can only increase output by so much. Once this point is reached, further employee benefits will only increase corporate costs. Therefore, shareholders may only invest in companies that effectively invest in human capital until it no longer improves outputs.

If different benefits garner differing views from shareholders, a broad pay ratio that includes salary and all forms of in kind benefits may not be very helpful in evaluating companies. While one firm may invest heavily in human capital to increase its pay ratio, it may not be in an industry where human capital is essential to increasing performance or the expenditures may not be the form of investment in human capital that shareholders value. Alternatively, if investors continue to value human capital investments under a traditional, zero-sum model, a lack of information is not the problem. Shareholders will continue to use other metrics to evaluate firm value instead. There is some evidence that shareholders do not greatly value human capital investments, generally. For example, despite having access to the list of companies with the greatest human capital investments through Fortune Magazine's "widely respected and highly publicized" "100 Best Companies to Work For in America" employee survey, investors still undervalued these firms.[146]

On the other hand, if shareholders do not invest in companies with high employee satisfaction because they are simply unaware that these companies value their human capital more than others do, disclosing the pay ratio can improve company valuations and make a more information-efficient market. Pay ratio information could add data to the total mix of material information shareholders rely upon in making their investment decisions. Proponents of the rule sent thousands of letters to the SEC during the notice-and-comment period, hoping the rule would reveal which corporations wastefully spend corporate dollars on executive compensation at the shareholders' expense instead of reinvesting it back into the corporation and its workforce.[147] But even if pay ratios can highlight

or less.").

145. *See* Taylor, *supra* note 120, at 27 (discussing how rewards can "be effective in stimulating men to do their best work"). But once they have reached their best, why give employees more rewards?

146. *See* Edmans, *supra* note 118, at 638 (discussing the market's failure "to incorporate intangible assets fully into stock valuations" and the possibility that these long-run investments in human capital are not valued by shareholders).

147. *See, e.g.*, Pay Ratio Disclosure Comment Letter Type A, U.S. Sec. & Exch. Comm'n (last updated Sept. 25, 2013), https://www.sec.gov/comments/s7-07-13/s70713-30.htm, *archived at* https://perma.cc/SSR7-YS79 ("Knowing which corporations heap riches upon their executives while squeezing struggling employees also will be a useful factor . . . ."); Pay Ratio Disclosure Comment Letter Type B, U.S. Sec. & Exch. Comm'n

material information to the market, the ratios must be meaningful and quantifiable to succeed. Increasing information on employee satisfaction alone may not improve the company if there is an inability of traditional valuation models to incorporate these kinds of intangibles.[148] Moreover, if the pay ratios are flawed and detached from any corporate governance strategies because of other external variables, the rule may actually impair firm valuations.

B. *Pay Ratio Information May Curtail Executive Compensation*

Proponents of the rule assert that limiting excessive compensation may not just increase value for investors, but may also improve a broader public policy concern over income inequality. Public opinion polls reveal that most Americans and institutional investors believe that current executive compensation levels are too high.[149] For many investors, social concerns over company practices can play a role in their investment decisions.[150] For these socially conscious investors, information on pay

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(last updated Dec. 2, 2013), https://www.sec.gov/comments/s7-07-13/s70713-850.htm, *archived at* https://perma.cc/RY7M-57RS ("American workers are more productive than ever, but, year after year, studies show working Americans earning less and less . . . ."); Pay Ratio Disclosure Comment Letter Type C, U.S. Sec. & Exch. Comm'n (last updated Oct. 16, 2013), https://www.sec.gov/comments/s7-07-13/s70713-231.pdf, *archived at* https://perma.cc/S3B8-ZHMB ("High pay disparities inside a company can impair employee morale and productivity . . . ."); Pay Ratio Disclosure Comment Letter Type D, U.S. Sec. & Exch. Comm'n (last updated Oct. 22, 2013), http://www.sec.gov/comments/s7-07-13/s70713-241.htm, *archived at* http://perma.cc/EP7Q-UKAN ("Disclosure of the pay ratios will help the capital markets better allocate capital to those companies that invest in their workforces."); Pay Ratio Disclosure Comment Letter Type E, U.S. Sec. & Exch. Comm'n (last updated Oct. 25, 2013), http://www.sec.gov/comments/s7-07-13/s70713-247.htm, *archived at* http://perma.cc/8WN4-B49C ("I believe CEO pay must be put into perspective with pay levels throughout a company's employees.").

148. *See* Ruth Sullivan, *Will the SEC Pay-Ratio Rules Help Shareholders?*, BLOOMBERG, Aug. 25, 2015, http://www.bloomberg.com/news/articles/2015-08-25/will-the-sec-pay-ratio-rules-help-shareholders-, *archived at* http://perma.cc/6GPQ-P26J ("'Given the large number of moving parts in each company's calculations, true comparability across industry sector peer groups will be difficult to achieve. The resulting inability to perform portfolio-wide analyses may hinder widespread usage of the new data . . . .'").

149. "At least one survey reveals that about 90% of institutional investors view executives' pay as excessive." Fairfax, *supra* note 56, at 10.

150. *See* Michael Chamberlain, *Socially Responsible Investing: What You Need to Know*, FORBES, Apr. 24, 2013, http://www.forbes.com/sites/feeonlyplanner/2013/04/24/socially-responsible-investing-what-you-need-to-know/, *archived at* http://perma.cc/89XW-G5M6 ("Socially Responsible Investing (SRI) is sometimes referred to as 'sustainable', 'socially conscious', 'mission', 'green' or 'ethical' investing. In general, socially responsible investors are looking to promote concepts and ideals that they feel strongly about."). Some states have even given socially conscious companies a distinct status. *See, e.g.*, H.B. 2239, 64th Leg., Reg. Sess.

equity could be pivotal, especially now when the gap between the upper and middle class is larger than ever.[151] Some economists argue the U.S. is facing a "record level of inequality of income from labor [] probably higher than in any other society at any time in the past, anywhere in the world . . . [due to] extremely high remunerations at the summit of the wage hierarchy, particularly among top managers of large firms . . . ."[152] The U.S. has witnessed a particularly high increase in wealth disparity compared to its European counterparts.[153] Thus, it is no surprise that American CEOs are commonly paid twice as much as foreign CEOs in similar industries,[154] "even though companies in other nations are as productive, as profitable, and face similar challenges."[155]

Stakeholders living in the same community as these companies may be concerned with pay ratios as well. With localities giving ever-increasing tax incentives to attract large corporations, "citizens who do not invest but simply live in an area where a company operates tax-free have

(Wash. 2015), http://lawfilesext.leg.wa.gov/biennium/2011-12/Pdf/Bills/House%20Passed%20Legislature/2239-S.PL.pdf, *archived at* http://perma.cc/3GE6-5JUZ ("In addition to the general social purpose set forth in . . . this act, every corporation governed by this chapter may have one or more specific social purposes for which the corporation is organized.").

151. *See* Richard Fry & Rakesh Kochhar, *America's Wealth Gap Between Middle-Income and Upper-Income Families is Widest on Record*, PEW RESEARCH CENTER (Dec. 17, 2014), http://www.pewresearch.org/fact-tank/2014/12/17/wealth-gap-upper-middle-income/, *archived at* http://perma.cc/4XWC-3URW ("In 2013, the median wealth of the nation's upper-income families ($639,400) was nearly seven times the median wealth of middle-income families ($96,500), the widest wealth gap seen in 30 years when the Federal Reserve began collecting these data . . . ."). *See also* Zanny Minton Beddoes, *For Richer, For Poorer*, THE ECONOMIST, Oct. 13, 2012, at 3 ("Disparities in wealth are less visible in Americans' everyday lives today than they were a century ago. Even poor people have televisions, air conditioners and cars. But appearances deceive. The democratisation of living standards has masked a dramatic concentration of incomes over the past 30 years, on a scale that matches, or even exceeds, the first Gilded Age.").

152. THOMAS PIKETTY, CAPITAL IN THE 21ST CENTURY 265, 298 (2013).

153. *See* Max Fisher, *Map: How the world's countries compare on income inequality (the U.S. ranks below Nigeria)*, THE WASHINGTON POST (Sept. 27, 2013), https://www.washingtonpost.com/news/worldviews/wp/2013/09/27/map-how-the-worlds-countries-compare-on-income-inequality-the-u-s-ranks-below-nigeria/, *archived at* https://perma.cc/2W4D-YMW4 ("The data offer a reminder that the United States might enjoy greater economic equality than much of the world, but it is at the bottom end of the developed world.")

154. "This is not because Americans at all levels earn more than their foreign counterparts; the margin is much smaller below the CEO level, and sometimes is negative. The proximate cause of American CEOs' higher incomes is that . . . salaries are a much smaller fraction of their compensation than of foreign CEOs' incomes—less than half—with the rest consisting partly of bonuses but mainly of stock options." Posner, *supra note* 13, at 1020-21.

155. Ravenscroft, *supra* note 43, at 2.

interests in how firms pay their workers."[156] Because corporations often promise localities new jobs in return for tax deductions, stakeholders should know just how beneficial those jobs would be in their community. The implications are even political. As money continues to play a larger role in the political arena, "[t]o the extent money carries political weight, we weaken the ability of a broad range of people to speak and be heard . . . ."[157]

In light of these socioeconomic concerns, the rule could help shareholders and the public determine if an executive's compensation package is excessive "with reference to an ethical concept of a 'just' reward . . . ."[158] This concept would be based on notions of an acceptable ratio between the compensation of the executive and a median worker in the firm. If a CEO earned, for example, 331 times the average American worker's salary—what the average American CEO earned in 2013—the public may evaluate if the CEO's contribution merits that compensation relative to the average worker's.[159] Many commenters hope the glaring discrepancies can, at the very least, spark a conversation in the boardroom.[160] The public might also evaluate if said CEO can really contribute the equivalent of 331 average workers to shareholders. Many proponents of the rule argue that "often CEOs are paid 'for luck'" and others argue that CEO pay is more attributable to market trends rather than individual efforts.[161]

Still, in order for stakeholders to make judgments based on some ethical concept of fair compensation, the pay ratio information must be meaningful. One opponent of the rule highlighted how indiscriminate inputs can nullify the value of pay ratio information:

> [S]uppose there are two otherwise identical companies selling identical widgets and making the same amount of money and whose CEOs each earn $1 million. The only difference is that

156. Ravenscroft, *supra* note 43, at 3.
157. Ravenscroft, *supra* note 43, at 2.
158. Posner, *supra* note 13, at 1015.
159. Dill, *supra* note 18.
160. Greater public awareness may pressure directors to act. *See* Pay Ratio Rule, *supra* note 4, at 50153 ("[S]ome commenters suggested that comparing the total compensation of the median employee and [CEO] . . . could provide insight into the effectiveness of board oversight and sound board governance."); Victoria McGrane & Joann S. Lublin, *SEC Approval of Pay-Gap Rule Sparks Concerns*, THE WALL STREET JOURNAL, Aug. 5, 2015, at B3 ("Activist hedge funds have also been making an issue out of CEO pay, though from a different vantage point. These investors, who take stakes in companies and push for financial or strategic changes, don't have a populist take on compensation and generally are happy to compensate executives for market-beating results. Rather, what concerns them is when CEOs are paid if they don't, in the activist's view, deliver for shareholders.").
161. Ravenscroft, *supra* note 43, at 2.

> one company outsources its lower-wage manufacturing to a forced labor camp in North Korea, leaving only the most highly compensated technical and administrative employees in the company, who have a median compensation of $100,000. The CEO to median pay ratio would be 10.0. The other company did not outsource and has a median worker compensation of $50,000. This company has a CEO-to-median pay ratio of 20.0. Does this mean that the compensation of the CEO that did not outsource is twice as "excessive" as the compensation of the CEO that outsourced?[162]

The example sheds light on the potential flaws in the pay ratio calculations and the undue burdens it could create for companies if stakeholders over rely on a simplistic measure in determining whether compensation levels are just.

On the other hand, if the purpose of executive compensation is not about creating a just reward, but producing high-performing executives and reducing agency costs by aligning the goals of the executive with the goals of the shareholders, then a different analysis is required. Under this view, it is less important for shareholders to measure the pay ratio between executives and their employees. Instead, shareholders should compare the performance and pay of their CEO with that of other CEOs in the same market. So long as the market dictates the value of high-quality CEOs, the compensation is acceptable.[163] And if the board of directors believes increasing performance-based compensation is requisite to aligning executive interests with shareholders, shareholders should only concern themselves with the effectiveness of said incentives and not whether the compensation is just or deserved.[164]

In predicting whether a pay ratio rule will curtail executive compensation, the best evidence lies with shareholders' previous preferences, particularly with the SEC's recent say-on-pay rule. Although the rule is non-binding, it allows shareholders to voice their disapproval of

162. Angel, *supra* note 103, at 3.

163. *See* Corporate Governance and Executive Compensation: Hearing before the S. Committee on Finance, 107th Cong. 29 (2002) (statement of Ira T. Kay, Vice President and U.S. Practice Director for Executive Compensation, Watson, Wyatt Worldwide) ("The CEO labor market meets all of the criteria of any market, including independent supply and demand, transparency and liquidity.").

164. Fairfax, *supra* note 56, at 10-11 ("Whatever the causes, the pay-for-performance disconnect appears to be the primary driver of discontent over executive compensation. . . . [T]he primary reason shareholders give for rejecting a company's pay package relates to pay-for-performance issues. For example, shareholders rejected the pay arrangements at a company in which the CEO received a $6.7 million increase in pay while the company's one-year shareholder return was negative 10.3% and its three-year return was negative 30.6%.").

a CEO's compensation. Surprisingly, only 2% of corporations putting forth a say-on-pay proposal have received less than 50% approval.[165] Though the increased disclosure and say-on-pay regulations were criticized for not having enough teeth, this would only explain the continued increase in executive compensation since its enactment. A say-on-pay vote's lack of force would not, however, explain the overwhelming acceptance by shareholders of current compensation levels. The SEC's recent implementation of Section 951's say-on-pay rule seems to further endorse the current trend in executive compensation. While many public comments advocated for greater say in executive compensation, shareholders may not be as willing to force these compensation changes.[166] Even if increasing executive pay might seem unwarranted from a public policy perspective, shareholders could still approve increased compensation levels if they believe it helps to lower agency costs or retain effective leadership.

There is a risk that disclosing pay ratio information could exacerbate the problem. Though counterintuitive, disclosures have had this effect in the past.[167] Industry-wide compensation figures shed light on the going rate of a qualified CEO for both shareholders and CEOs. If the data shows a mean or median compensation, most CEOs will use that as their baseline and aim higher. After all, CEOs are not going to admit that they are below

165. Even though:

Eighty-eight percent of companies received a >80% 'For' vote, 10% received a 50-80% 'For' vote, and 2% received a <50% 'For' vote. . . . Average CEO target pay has risen from $3.5 million in 2009 to $5 million in 2013 . . . . What is interesting is that the move toward performance-based [long-term incentive] compensation has been in addition to–not a replacement for–other types of pay, and it is primarily responsible for the increase in CEO target pay.

Robin Ferracone, *Proxy Season 2014: A Mid-Year Look at What's Hot and What's Not*, FORBES, July 8, 2014, http://www.forbes.com/sites/robinferracone/2014/07/08/proxy-season-2014-a-mid-year-look-at-whats-hot-and-whats-not/, *archived at* http://perma.cc/868K-9X7N.

166. Tens of thousands of commenters complained about recklessly excessive compensation packages for CEOs. U.S. SEC. & EXCH. COMM'N, COMMENTS ON PAY RATIO DISCLOSURE, https://www.sec.gov/comments/s7-07-13/s70713.shtml, *archived at* https://perma.cc/4WT7-D3SW (last updated Aug. 5, 2015). *See also* Pay Ratio Disclosure Comment Letter Type L, U.S. Sec. & Exch. Comm'n (last updated July 15, 2015), https://www.sec.gov/comments/s7-07-13/s70713-1571.htm, *archived at* https://perma.cc/MW6M-5NSJ ("Disclosing corporate pay disparities will discourage lavish CEO pay practices that reward recklessness and greed—and that fueled the 2008 economic crash. Rein in corporate recklessness: Tell the Securities and Exchange Commission you support disclosure of corporate pay disparities.").

167. *See* Davidoff, *supra* note 116, at 624 ("But its effect has, it seems, not been to rein in executive pay. Indeed, some evidence, and intuition, supports the possibility that disclosure may have had the opposite effect. Those who care about the disclosure the most may be CEOs and other executives. . . . Disclosure itself may have helped empower executives to demand higher pay packages, helping to push compensation up.").

average and, therefore, deserve below average compensation. With the mean or median compensation serving as the benchmark, one could see how compensation creeps higher, whether it is deserved or not. When shareholders and CEOs view the data stating that CEOs earn on average 331 times that of the median employee in their respective industry, they both are going to ask if the CEO really adds 331 times the value of a typical worker, but they may not necessarily come up with the same answer. With recent CEO compensation figures showing a pay ratio of 331-to-1,[168] a CEO seeking a pay raise can leverage that information.

C. *Pay Ratio Information May Assist Shareholder Say-on-Pay Votes*

In 2011, the SEC implemented the say-on-pay vote required by Dodd-Frank and started requiring publicly traded corporations to submit nonbinding shareholder votes on the firm's executive compensation packages, including incentive-based stock-option plans.[169] In addition, the SEC required companies to disclose the relationship between the compensation levels and the metrics used to determine the executives' performance.[170]

Many commenters assert that including pay ratio information in the proxy filings will help shareholders with say-on-pay voting.[171] As one Connecticut investor commented, he and other investors "will be more efficiently able to review CEOs" because the pay ratio data will allow them to be "more engaged and better informed."[172] There is no doubt a pay ratio

168. Dill, *supra* note 18.

169. *See* Press Release, U.S. Sec. & Exch. Comm'n, SEC Adopts Rules for Say-on-Pay and Golden Parachute Compensation as Required Under Dodd-Frank Act (January 25, 2011), https://www.sec.gov/news/press/2011/2011-25.htm, *archived at* https://perma.cc/835X-MYXD ("The SEC's new rules specify that say-on-pay votes required under the Dodd-Frank Act must occur at least once every three years beginning with the first annual shareholders' meeting taking place on or after Jan. 21, 2011. Companies also are required to hold a 'frequency' vote at least once every six years in order to allow shareholders to decide how often they would like to be presented with the say-on-pay vote.").

170. *See* James F. Cotter et. al., *The First Year of Say-on-Pay Under Dodd-Frank: An Empirical Analysis and Look Forward,* 81 GEO. WASH. L. REV. 967, 979 (2013) [hereinafter Cotter] ("In addition, the SEC required that companies disclose—in the next year's CD&A—whether the board had considered the results of the shareholder say-on-pay vote as part of making its decisions about future pay levels and, if so, how the board did so.").

171. *See* Pay Ratio Rule, *supra* note 4, at 50106 ("Some commenters in the pre-proposing period suggested specifically that shareholders of public companies could use the pay ratio information, together with pay-versus-performance disclosure, to help inform their say-on-pay votes, which could also be a tool for shareholders to hold companies accountable for their CEO compensation.")(footnote omitted).

172. Letter from Steven Towns, Investor from Hartford, Connecticut, Comment Letter

is a convenient tool for evaluating CEO compensation. Finding the same information through independent research may be impractical, particularly if one wants to find compensation data on smaller, lesser-known corporations. While industry averages can be found, they would only be estimates for the pay of any specific company. Even if a public corporation does release the necessary data, it could be time-consuming to find the information.

Others, however, believe an overly simple ratio may encourage uninformed voting.[173] Instead of educating the public, they argue it will create a "name-and-shame tactic" for special interest groups.[174] All the while, the average registrant is paying $368,159 to find, verify, and disclose the pay ratio information.[175] Ultimately, say-on-pay has brought little to no change to growing compensation for CEOs.[176] While the ratio will add new eye-catching statistics for dissatisfied stakeholders, it is not significantly worse than the salary and bonus amounts that shareholders already see. Furthermore, shareholders have already been able to use pay ratio estimates for say-on-pay votes in the past. Interested stakeholders calculate ratio estimates on their own for some of the worst pay ratio offenders and distribute that information to the public.[177]

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on Pay Ratio Disclosure (Nov. 19, 2013), https://www.sec.gov/comments/s7-07-13/s70713-317.pdf, *archived at* https://perma.cc/6934-7NU3.

173. *See* Letter from Tom Quaadman, V.P. of the Center for Capital Markets, Comment Letter on Pay Ratio Disclosure, at 6, (May 22, 2014), https://www.sec.gov/comments/s7-14-10/s71410-46.pdf, *archived at* https://perma.cc/5W8S-P5RM ("While objecting to merely asking firms for one more datum may seem petty to some, this piece of information will not help shed any further light on company performance, investor protection, or income inequality. Whether a CEO makes 20, 200, or 2,000 times as much as the median compensation of the firm's employees provides no particular insight whether a CEO or the median employee is fairly compensated. In fact, such a statistic could present a fundamentally misleading portrait of CEO pay, particularly compared across industries.").

174. *See id*. at 11 ("It seems that the point of forcing firms to calculate and publish the CEO - median worker compensation ratio is to generate outrage, hoping that it will provoke a lower ratio. This name-and-shame tactic will most likely not change the behavior of companies, while forcing them to expend effort and resources to calculate a statistic that will be of no use to them, their boards, their shareholders, or investors.").

175. *See supra* Part II.

176. *See* Cotter, *supra* note 170, at 970 ("In all, our findings suggest that the Dodd-Frank say-on-pay mandate has not broadly unleashed shareholder opposition to executive pay at U.S. companies, as some proponents had hoped for. Nonetheless, it has affected pay practices at outlier companies experiencing weak performance and high executive pay levels that are identified by proxy advisory firms like ISS.").

177. *See* Bonnie Kavoussi, *10 Companies where CEO Pay Is Seriously Out of Whack*, HUFFINGTON POST, (Dec. 11, 2012), http://www.huffingtonpost.com/2012/12/11/ceo-worker-pay-ratio_n_2259233.html, *archived at* http://perma.cc/4VAR-5WJ7 ("At some companies, CEO pay is especially out of whack, according to PayScale, which analyzed pay at the country's 50 biggest public companies last year. The compensation website compared

III. FAILURES OF THE PAY RATIO RULE

Because the SEC plays a pivotal role in informing investors, there is a natural tendency for the public to assume any required disclosure, "simply by its nature of being disclosed, is important, relevant, and helpful."[178] Therefore, it is imperative that the SEC's pay ratio rule conveys accurate and meaningful information. Otherwise, the information could arbitrarily harm corporations by misinforming shareholders.

The SEC believed a capacious definition of employee would create a more meaningful disclosure for shareholders.[179] Thus, "the final rule's definition of 'employee' [will] include the full-time, part-time, seasonal, and temporary employees employed by the registrant or any of its consolidated subsidiaries."[180] Only "workers who provide services to the registrant or its consolidated subsidiaries as independent contractors or 'leased' workers are excluded from the definition . . . ."[181]

By including seasonal, temporary, and foreign workers, the SEC's pay ratio creates a flawed picture of companies' pay practices. It makes the pay ratio data less useful for shareholders attempting to curtail excessive compensation levels and misleads public policy activists attempting to improve U.S. pay equity.[182] Even the SEC recognized how these arbitrary inputs could significantly alter a company's ratio and, therefore, perceived corporate excess. The initial, proposed rule explained:

> [O]ne company might outsource the labor-related (manufacturing) aspects of its business to a third-party to focus on product innovation, while another company competing in the

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CEO pay to the median pay of the typical full-time worker to compile the list. The entire methodology can be found at their website.").

178. Center on Executive Compensation, *supra* note 23, at 4.

179. *See* Pay Ratio Rule, *supra* note 4, at 50116 ("We believe that the 'all employees of the issuer' language in Section 953(b) is best implemented by including rather than excluding broad categories of employees. Further, even assuming there was any ambiguity in the statutory language, we believe that a more inclusive approach better serves Section 953(b)'s purpose of providing shareholders with additional information about a registrant's compensation practices that can be used in making voting decisions on executive compensation because it results in a pay ratio that is more reflective of the actual composition of the registrant's workforce.").

180. *Id.* at 50117.

181. *Id.*

182. *See* Center on Executive Compensation, *supra* note 23, at 15 (discussing arguments that the original statute is silent on the issue of whether foreign employees should be considered). *See also* Letter from Catherine Dixon, Chair of the Federal Regulation of Securities Committee of the American Bar Association, Comment Letter on Pay Ratio Disclosure, at 9, (Mar. 7, 2014), https://www.sec.gov/comments/s7-07-13/s70713-957.pdf, *archived at* https://perma.cc/PX9C-G5VC [hereinafter Dixon] (discussing the Congressional intent in writing "all employees" into the statute).

> same industry might choose to retain the labor aspect of its business. To the extent that product innovation requires higher pay than manufacturing, the outsourcing company will have a lower pay ratio for the same [CEO] pay.[183]

With companies utilizing different employment strategies, the ratios will differ and make precise comparability across companies less relevant. As the example above shows, it can even incentivize perverse employment structures, such as outsourcing low-cost labor jobs to third parties.

The final rule does include modifications to lessen the burden for registrants with large foreign or temporary labor forces: (1) an exclusion for 5% of a registrant's foreign workforce, (2) the ability to make cost-of-living adjustments for foreign employees, and (3) granting registrants a three-month window from the completed fiscal year to calculate the ratio.[184] However, for reasons discussed below, these modifications are insufficient in improving the pay ratio data. Furthermore, the SEC failed to address problems with nonpermanent employees[185] and the annualization of wages.[186]

183. Proposed Pay Ratio Rule, *supra* note 8, at 60585.

184. *See* Pay Ratio Rule, *supra* note 4, at 50111 ("[T]he final rule permits registrants to exempt non-U.S. employees where these employees account for 5% or less of the registrant's total U.S. and non-U.S. employees, with certain limitations."); *id.* ("In identifying the median employee, whether using annual total compensation or any other compensation measure that is consistently applied to all employees included in the calculation, the registrant may, but is not required to, make cost-of-living adjustments for the compensation of employees in jurisdictions other than the jurisdiction in which the PEO resides so that the compensation is adjusted to the cost of living in the jurisdiction in which the PEO resides . . . ."); *id.* at 50119 ("[T]he final rule defines 'employee' as an individual employed on any date of the registrant's choosing within the last three months of the registrant's last completed fiscal year.").

185. *See id.* at 50117 ("We believe this statutory language indicates that Congress intended the final rule to include all types of a registrant's employees, including part-time, seasonal, and temporary workers, and we do not think it is appropriate to provide a wholesale exemption for those broad categories of employees that are not employed full-time. Any such exemption would risk producing pay ratio disclosure that is significantly different than the pay ratio disclosure that Congress expressly directed us to require when it said 'all employees.'").

186. *See id.* at 50129 ("Annualization involves taking the compensation of an employee who worked for only part of the registrant's fiscal year and projecting that compensation as if the employee worked the full fiscal year at the schedule that the employee worked for the portion of the year the employee worked. Annualization is allowed under the rule for full-time and part-time employees who did not work for the registrant's full fiscal year for some reason . . . . Annualization is only allowed for permanent employees; it is not allowed under the final rule for seasonal or temporary employees.").

A. *Including Nonpermanent Employees*

The pay ratio rule creates significant problems for companies that are dependent on seasonal and temporary workers (collectively "nonpermanent workers" or "nonpermanent employees"). Including nonpermanent workers in the ratio could misrepresent compensation levels because nonpermanent workers are less likely to receive benefits, such as health insurance or company equity, than permanent workers.[187] The data is further skewed if companies are not able to annualize the pay of non-permanent workers as if they were employed on a year round basis.[188] Otherwise, temporary worker wage data will not be representative of the pay that workers actually earned from other employers during the year.[189]

There are entire industries that face seasonal changes in demand. These companies often rely on temporary workers to contribute during peak seasons.[190] The use of temporary workers allows these companies to expand their workforce for a short period of time and then contract it as demand subsides. Retailers, in particular, rely on this employment strategy for the winter holidays. However, because these temporary workers may only work for a few weeks or months, their compensation would inevitably be very low if it represented their only earnings for the entire year. In reality, these workers know the positions are temporary and would likely find a new job once their employment ended. Many of the temporary

187. *See* Dixon, *supra* note 182, at 11 ("[T]hese employees are unlikely to be eligible to receive most types of variable compensation, such as annual bonuses and long-term incentive compensation (including equity compensation). In addition, part-time employees often are ineligible to participate in a registrant's health and welfare benefit programs.").

188. *See* Dixon, *supra* note 182, at 23 ("For purposes of comparing the total compensation of the principal executive officer to that of the "typical" employee, it is only logical that such a comparison should be made over a comparable time period. Thus, the compensation of the comparators should be viewed on a full-time equivalency basis.").

189. Center on Executive Compensation, *supra* note 23, at 19-20 ("[T]he income that a part-time or seasonal employee receives from a single employer could give a significantly distorted picture of the employee's annual income, if the employee also works for other employers in the course of the year, as part-time and seasonal workers often do.").

190. *See* Jay Greene, *Amazon plans to hire*, THE SEATTLE TIMES, Oct. 16, 2014, at A10, http://www.seattletimes.com/business/amazon-plans-to-add-80000-temps-for-the-holiday-season/, *archived at* http://perma.cc/349L-8FAM ("To meet the demand for holiday orders, Amazon.com plans to hire 80,000 seasonal workers in the United States this holiday season, up 14 percent from a year ago."). *See also* Susan Adams, *Who's Hiring The Most, Holiday Season 2014*, FORBES, Nov. 5, 2014, http://www.forbes.com/sites/susanadams/2014/11/05/whos-hiring-the-most-holiday-season-2014/, *archived at* http://perma.cc/9TNS-8KP8 ("[UPS will] hire as many as 95,000 seasonal workers this year . . . . UPS, which only hired 50,000 seasonal workers last year and had trouble keeping up with the surging number of gifts that consumers ordered online, wound up repeatedly apologizing and issuing many refunds to customers.).

workers may also use the temporary position to supplement their permanent job. Nevertheless, the pay ratio rule treats these employees as if they were permanent, yearlong employees, which significantly skews the actual compensation of these employees.

One can look to Macy's, Inc. for an illustration of how this method misrepresents a company's compensation structure. According to Macy's CEO Terry Lundgren, Macy's department stores hired over 80,000 temporary employees for the 2013 holiday season, which is a nearly 50% increase in its total number of associates.[191] If one of these temporary employees works for one month, earning the same as the median Macy's employee, their salary would be $2,416.[192] Although this same employee may be earning much more than $2,900 a year through other part-time or full-time employment, Macy's must report the employee's annual salary as $2,900. Including these temporary employees would likely increase Macy's 345-to-1 pay ratio even further.

The rule may force retail corporations, along with other industries with a high dependence on seasonal workers, to institute costlier, sub-optimal employment strategies.[193] Because pay ratio wage data is created from a snapshot of the company's workforce, the rule could arbitrarily harm some companies more than others if they employ a large number of low-salaried or seasonal employees during that time.[194] If a company's employee makeup changes throughout the year, snapshots taken on different dates may create completely different ratios for the same

191. Press Release, Macy's, Inc., Macy's, Inc. to Hire 86,000 Seasonal Associates in 2014 (Sept. 29, 2014), http://phx.corporate-ir.net/phoenix.zhtml?c=84477&p=irol-newsArticle&cat=news&ID=1971706, *archived at* http://perma.cc/D33D-WM3N [hereinafter Macy's]. "Seasonal associates at Macy's and Bloomingdale's serve customers on the selling floor, work in store operations positions, interact with customers via the telephone in call centers, and staff the distribution and fulfillment centers that coordinate shipments to stores and directly to customers who buy online or via mobile." *Id.*

192. Vivian Giang, *13 CEOs Who Get Paid Shockingly More than Their Employees*, BUSINESS INSIDER, (Mar. 29, 2013), http://www.businessinsider.com/ceos-who-get-paid-much-more-than-workers-2013-3#terry-j-lundgren-gets-paid-345-times-more-than-the-average-macys-employee-4, *archived at* http://perma.cc/4UL8-J34R.

193. Letter from Korok Ray, Assistant Professor of Accounting, The George Washington University Regulatory Studies Center, Public Interest Comment on The Securities and Exchange Commission's Proposed Rule: Pay Ratio Disclosure 17 (Dec. 2, 2013), http://www.sec.gov/comments/s7-07-13/s70713-524.pdf, *archived at* http://perma.cc/4DH2-A6DN ("The disclosure will hurt companies with large low-wage or seasonal work forces, for example food services and retail. . . . All of these will distort the firm's behavior and ultimately change the competitive landscape since it will move the firm away from its optimal choice.").

194. *See* Pay Ratio Rule, *supra* note 4, at 50119 ("A number of commenters contended that the final rule should allow registrants the flexibility to choose a calculation date within the registrant's last fiscal year.").

company. This could incentivize unwanted behavior, such as restructuring employment contracts to reduce the numbers of low-salaried employees when the pay ratio is calculated.

For example, companies like Macy's that experience a fluctuating need for employees, use nonpermanent positions as a useful tool to attract workers.[195] But, because independent contractors, leased workers, and temporary workers employed by third parties are not included in the ratio,[196] companies seeking to reduce their ratio could lease temporary workers from contractors. While this new incentive to reduce nonpermanent employees could translate into the creation of more full-time positions, it could also reduce the total number of positions available—positions that, according to Macy's CEO Terry Lundgren, "employ students working during break to help pay tuition, retirees seeking to remain active and individuals from many walks of life wanting to supplement their income."[197]

The final rule grants registrants greater flexibility than the SEC's initial proposal, however, by allowing registrants to select a date to calculate wages that is within three months of their completed fiscal year, rather than mandating that it be on the last day of the fiscal year.[198] For companies with short peak seasons, they can select a snapshot of employee data when their reliance on temporary workers is low. But for companies with peak seasons longer than three months, the SEC's solution offers little benefit. A better solution is to allow companies to annualize the earnings of temporary workers. Macy's could then report the salary of its temporary worker as $29,000 because that is the employee's salary if extended over an entire year. However, as discussed in the section below, the SEC disagreed.

195. *See* Letter from Michael Aitken, VP of Government Affairs, Society for Human Resource Management, Comment Letter on Pay Ratio Disclosure 3 (Dec. 30, 2013), http://www.sec.gov/comments/s7-07-13/s70713-720.pdf, *archived at* http://perma.cc/K5K5-RAJC [hereinafter Aitken] ("In many industries, a particular business strategy requires the use of non-full-time employees. In other cases, an employer may determine that, in order to attract and retain employees, it is beneficial to offer compensation structures that differ from a traditional full-time employment position.").

196. Pay Ratio Rule, *supra* note 4, at 50117. ("[W]orkers who provide services to the registrant or its consolidated subsidiaries as independent contractors or 'leased' workers are excluded from the definition as long as they are employed, and their compensation is determined, by an unaffiliated third party.").

197. Macy's, *supra* note 191.

198. *See* Pay Ratio Rule, *supra* note 4, at 50119 ("Only a few commenters . . . supported using the last day of the fiscal year calculation date.").

B. *Prohibition on the Annualization of Wages*

Permitting annualization for only full-time employees could disadvantage registrants that rely on a large part-time workforce. Some industries require part-time workers as part of their particular business strategy.[199] Registrants that require large numbers of temporary employees during certain parts of the year, such as holiday seasons, could also be unreasonably disadvantaged.[200]

The SEC wants to ensure that companies do not inflate the median workers' pay by annualizing the compensation data of seasonal and temporary employees.[201] The final rule only permits companies to annualize the compensation of employees where the employment relationship is permanent.[202] Instances where employees did not work for the full fiscal year because they were a new hire or because of a leave of absence, could be annualized, so long as companies use this method consistently.[203] Additionally, part-time employees can only have their

199. A Wal-Mart VP memo leaked in 2005 suggested the increase in part-time employees occurred in order to decrease healthcare costs. *See* Memorandum to Wal-Mart Board of Directors from Susan Chambers, Exec. VP of People, Wal-Mart Stores, Inc., Reviewing and Revising Wal-Mart's Benefits Strategy 10, http://www.nytimes.com/packages/pdf/business/26walmart.pdf, *archived at* http://perma.cc/6VQV-CEDX ("These initiatives include reducing the number of labor hours per store, increasing the percentage of part-time Associates in stores, and increasing the number of hours per Associate. These changes represent a major cost-savings opportunity with relatively little impact on existing Associates. The most significant challenge here is that the shift to more part-time Associates will lower Wal-Mart's healthcare enrollment (even with the more generous part-time offering outlined above), which could have an impact on public reputation.").

200. Aitken, *supra* note 195, at 3 ("If an accommodation for annualizing non-full-time employee compensation is not included in the final rule, the result will be skewed pay ratio data for employers who require an increased number of employees at certain points during the year, or those employers who have emphasized certain benefits through part-time employment positions.").

201. For example, "a retailer that hires a seasonal worker at minimum wage for three months during the holiday season would need to calculate annual total compensation for that employee as three months at $7.25/hour ($3,480) and could not "annualize" the wages as if the seasonal worker was paid for a full twelve months of work ($13,920)." Proposed Pay Ratio Rule, *supra* note 8, at 60569. However, if that same employee was terminated before the last day of the retailer's fiscal year, the retailer would exclude the employee's compensation from its calculation. *Id*.

202. Pay Ratio Rule, *supra* note 4, at 50108 ("[A] registrant would be permitted, but not required, to annualize the total compensation for a permanent employee who was employed at yearend but did not work for the entire year.").

203. *See* Pay Ratio Rule, *supra* note 4, at 50129 ("Annualization is allowed under the rule for full-time and part-time employees who did not work for the registrant's full fiscal year for some reason, such as they were employees who were newly hired, on leave under the Family and Medical Leave Act of 1993, called for active military duty, or took an

compensation annualized as part-time employees, and not to a full-time equivalent.[204]

If the purpose of the pay ratio rule is to provide accurate and comparable measures of a company's pay practices, the Commission must allow enough flexibility in the rule to incorporate alternative employment structures. Some industries face high employee turnover, either because the company purposefully creates temporary positions as part of a larger employment strategy or because employees in that industry tend to move between jobs frequently. Either way, entire industries should not be punished for exercising efficient employment practices that allow for much needed workforce flexibility.

C. *Requiring an Unadjusted Ratio for Foreign Employees*

The SEC originally banned cost-of-living adjustments to the pay ratio for non-U.S. workers, concerned that it would "diminish the potential usefulness of the disclosure."[205] But in the final rule, the Commission changed its stance, acknowledging:

> [T]hat differences in the underlying economic conditions of the countries in which registrants operate likely have an effect on the compensation paid to employees in those jurisdictions. As a result, requiring registrants to determine their median employee and calculate the pay ratio without permitting them to adjust for these different underlying economic conditions could result in what some would consider a statistic that does not appropriately reflect the value of the compensation paid to individuals in those countries.[206]

The final rule allows for registrants to make cost-of-living adjustments, so long as registrants "briefly describe any cost-of-living adjustments they used . . . disclose the country in which the median employee is located," and disclose an unadjusted ratio as well.[207] For example, registrants could adjust foreign compensation through purchasing power parity[208] statistics.[209] While this compromise improves the pay ratio

unpaid leave of absence during the period.").

204. Pay Ratio Rule, *supra* note 4, at 50129 (defining annualization for part time employees as "projecting that compensation as if the employee worked the full fiscal year at the schedule that the employee worked for the portion of the year the employee worked").

205. Proposed Pay Ratio Rule, *supra* note 8, at 60569.

206. Pay Ratio Rule, *supra* note 4, at 50125.

207. Pay Ratio Rule, *supra* note 4, at 50126.

208. *See* Rudiger Dornbusch, *Purchasing Power Parity*, (Nat'l Bureau of Econ. Research, Working Paper No. 1591, 1985), http://www.hks.harvard.edu/fs/jfrankel/ITF-220/readings/Dornbush-PPP-NBERWP1591.pdf, *archived at* http://perma.cc/7Z25-RY8N

accuracy of large, multinational corporations, it still creates regulatory burdens and attaches a skewed, unadjusted ratio to a registrant's disclosure.

Though some proponents of the rule hope including foreign worker information in the unadjusted ratio may incentivize firms to reduce outsourced employment, the unadjusted pay ratio will likely arbitrarily harm the reputations of companies or industries with a large multinational workforce in countries with lower costs of living. Because of the varying forms of in kind compensation and constant market fluctuations, any attempt to standardize compensation is unlikely to accurately convey its local value. These wide discrepancies, in turn, distort the comparability of ratios, making such information much less useful to shareholders.[210] The Bureau of Labor Statistics collected data on worldwide hourly direct pay in the manufacturing industry in 2010. Converted to U.S. dollars, it "showed an hourly wage of $1.13 in China (2009 data) and $.82 in India vs. $6.81 in Brazil and $16.03 in Israel . . . ."[211] In the US, the rate was $26.26.[212] Almost as enlightening as the Bureau's data on global pay discrepancies was the Bureau's concern with comparing international wages. The study noted there were several data gaps and methodological restraints that hindered their precision.[213] For example, many foreign workers receive

("Purchasing Power Parity (PPP) is a theory of exchange rate determination. It asserts (in the most common form) that the exchange rate change between two currencies over any period of time is determined by the change in the two countries' relative price levels.").

209. The SEC has made a complete 180 degree turn on this issue. *See* Proposed Pay Ratio Rule, *supra* note 8, at 60569 ("[A]djusting for these variables could distort an understanding of the registrant's compensation practices. For example, if a registrant with a workforce primarily located in jurisdictions with a lower cost of living than the United States adjusted the annual total compensation of those employees using purchasing power parity statistics, the median of the annual total compensation of all its employees would likely increase."). *But see* Pay Ratio Rule, *supra* note 4, at 50111, 50112 n.63 ("The registrant is also required to briefly describe the cost-of-living adjustments it used . . . . For example, registrants may use cost-of-living adjustments based on purchasing power parity ("PPP") conversion factors. A PPP conversion factor is the ratio of PPP exchange rate to the nominal exchange rate.").

210. Opponents believe the "statute is silent on whether 'all employees' refers to all employees in the U.S. or worldwide." Center on Executive Compensation, *supra* note 23, at 15. Furthermore, they point to the "well-established presumption against the extraterritoriality of U.S. laws . . . ," *id*.

211. Center on Executive Compensation, *supra* note 23, at 15.

212. Center on Executive Compensation, *supra* note 23, at 15-16.

213. Center on Executive Compensation, *supra* note 23, at 16 ("It is worth noting that the [Bureau of Labor Statistics] itself explicitly states that it is unable to directly compare wages in China and India to wages in other countries, due to 'various data gaps and methodological issues,' and goes so far as to present these wages completely separately from its other international data. While the issues inherent in the gathering of statistical data may not directly correlate to the gathering of corporate wage data, we highlight this discrepancy as an example of how significantly data can differ from country to country and

employment benefits as part of their compensation. These employers deduct salary in return for in kind compensation, such as healthcare, retirement, housing, or childcare assistance.[214] Similarly, some employees may augment their base salary by engaging in profit-sharing arrangements that account for much of the employee's compensation.[215] Another variable influencing wage ratios are currency exchange rates. Rates may change year to year because of global market conditions, altering a registrant's ratio without any change in corporate practices.[216] Therefore, retrieving data on just base salaries will not provide a full picture. Yet, trying to create a methodology that incorporates in kind compensation is costly and potentially inaccurate.

In its final rule, the SEC also included an exemption for up to 5% of foreign employees for the unadjusted ratio.[217] Though the SEC acknowledged "the inclusion of non-U.S. employees would raise compliance costs for multinational companies, would introduce cross-border compliance issues, could raise additional comparability concerns, and could have an adverse impact on competition," its meager 5% exclusion is not enough to mitigate these concerns.[218] The exemption only helps "address the payroll or other data challenges that may arise for registrants with a small percentage of non-U.S. employees."[219] Though registrants can still supply shareholders with multiple ratios to eliminate 100% of foreign employee data, providing multiple ratios discredits the

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how meaningless a statistic which simply combines them is." (internal citations omitted)).

214. Dixon, *supra* note 182, at 10 ("In our experience, compensation arrangements outside the United States vary widely based on such diverse factors as government-mandated benefits, foreign labor law requirements, prevailing wage standards and the difficulty in providing equity compensation because of the limitations contained in the applicable securities, tax, and other laws. For example, foreign employees may receive ancillary benefits of a significantly greater value than U.S.-based employees who perform equivalent functions, due to Works Council requirements and/or mandatory employer contributions to pay for employee benefits that, in the United States, are funded by the employees themselves.").

215. Aitken, *supra* note 195, at 2 ("[E]mployers might provide profit-sharing arrangements to employees that might not be comparable with traditional concepts of U.S. base compensation.").

216. Center on Executive Compensation, *supra* note 23, at 18 ("All data collected from foreign countries will need to be converted to U.S. dollars by the corporate HR team responsible for aggregating the data. This will require collecting an exchange rate based on the date of record for pay data provided by each country. Where different countries have chosen different dates of record, the exchange rates will not be consistent. Further, currency exchange may fluctuate significantly from year to year . . . .").

217. *See* Pay Ratio Rule, *supra* note 4, at 50111 (discussing Non-U.S. Employee Exemptions and Additional Permitted Disclosures).

218. Pay Ratio Rule, *supra* note 4, at 50110.

219. Pay Ratio Rule, *supra* note 4, at 50124.

value of the ratios and potentially confuses shareholders. If the goal of disclosure is to provide investors with material information, requiring an unadjusted ratio that includes foreign employees (even 95% of them) hampers that objective.

IV. CONCLUSION

Many opponents of the pay ratio rule argue that the potential gains of the rule, if any, do not justify its burdensome costs. They also believe different calculation methods would reduce costs while still remaining faithful to Section 953(b) of the Dodd-Frank Act.

Ultimately, the goal of the rule is to provide shareholders with more information to better evaluate firms and improve the pay of hardworking employees or, at the very least, curb the excess compensation of corporate management. While any rule may have failed to curtail the ever-increasing limits of executive compensation, the SEC squandered any chance it did have by including too many environment- and industry- specific factors that distort the pay ratio. Though "[f]inancial reports . . . are supposed to include the good, the bad, and the ugly," without such corrections, pay ratio comparability is ineffective and misleading.[220] Though firms should be forced to answer "for paying CEOs more in this country than they are paid in other countries [and] more in this era than they were paid relative to average workers forty years ago," the rule fails to expose the firms deserving of such pointed inquiries.[221] Worse, by creating a pay ratio rule, the "Commission creates a preconceived bias that the pay ratio provides useful information . . . ."[222] Although registrants can explain many of these flaws, a simple ratio is much more palatable for shareholders than lengthy clarifications. Thus, the rule destroys its own effectiveness by including overly expansive information, harms companies by misleading investors, and leads to negative corporate practices through misguided incentives.

220. Ravenscroft, *supra* note 43.
221. Ravenscroft, *supra* note 43.
222. Center on Executive Compensation, *supra* note 23, at 4.

V. APPENDIX

Table 1: Total Initial Compliance Cost Estimates for Affected Registrants[223]

Type of registrant	**Estimates**	**Calculation**
Registrants with foreign operations		
Registrants affected	1,470	
Total number of employees	27,595,305	
Cost / employee ratio	$38.04	
Total cost	$1,049,725,402	27,595,305*$38.04
Average cost per registrant	$714,099	$1,049,725,402 / 1,470
Registrants with U.S.-based operations only		
Registrants affected	793	
Total number of employees	6,522,626	
Cost / employee ratio	$19.02	$38.04*(1-0.5)
Total cost	$124,060,347	6,522,626*$19.02
Average cost per registrant	$156,444	$124,060,347 / 793

223. *See* Pay Ratio Rule, *supra* note 4, at 50160-61.

Median cost per registrant	$27,008.40	This number represents the median of (number of employees * $19.02) across the 793 U.S.-based registrants
Registrants with missing data, reclassified as registrants with U.S.-based operations only		
Registrants affected	1,308	
Registrants with available employee data	973	
Total number of employees for the 973 registrants	6,932,754	
Cost / employee ratio	$19.02	$38.04*(1-0.5)
Total cost for the 973 registrants	$131,860,981	6,932,754*$19.02
Registrants with no employee data	335	1,308 – 973
Total cost for the 335 registrants	$9,047,814	335 * $27,008.4
Total cost	$140,908,795	131,860,981+9,047,814
TOTAL	$1,314,694,544	$1,049,725,402 +$124,060,347 + $140,908,795