JONES DAY

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GOVERNANCE PERSPECTIVES

THE SEC'S PROPOSED PAY RATIO RULES: REQUIRING DISCLOSURES WITH REAL COSTS AND ILLUSORY BENEFITS

- The proposed rules would require companies to disclose the "pay ratio" of the total annual compensation of their median employee to that of their CEO.
- The proposed rules permit flexibility in complying with the requirements in order to lower the costs of compliance, but they provide no apparent benefits to investors.
- Indeed, the SEC's acknowledgement that there are significant challenges in quantifying the potential economic benefits, if any, from the proposed pay ratio disclosures may signal an expectation of—or possibly even an invitation for—litigation challenging the rules.
- We encourage companies to submit substantive, "data-heavy" comment letters to the SEC to demonstrate that the perceived benefits of the rules—if any can be identified—cannot possibly outweigh the costs of compliance.

The SEC has proposed the pay ratio disclosure rules required by Dodd-Frank, more than three years after the statute's enactment and after its receipt of hundreds of substantive comment letters from trade groups, companies, unions, and investors. The proposal was accompanied by strongly worded dissenting statements from two objecting Commissioners.

We agree with the dissenters. In our view, the pay ratio disclosure rulemaking, like the provision of Dodd-Frank that mandated it, merely panders to special interests without any discernible investor benefits. Instead, the rules will only provide unions, pundits, and other members of the chattering classes a "shame card" to use to inflame employees and embarrass corporate America. This is not an appropriate goal for federal legislation, nor for the SEC's rulemaking efforts. At risk in particular will be large, global companies whose worldwide operations and sizeable workforces will drive ratios that may be perceived as excessive and will have substantial compliance costs notwithstanding the flexibility the SEC has proposed.

Some may argue that the pay ratios alter the total mix of information available to investors, because they will be able to analyze the ratios of comparable companies when making investment decisions and considering compensation-related proposals. However, the flexibility that the SEC has provided, and really had to provide, to companies in producing their ratios will by its nature make ratios impossible to compare across companies or industries. The SEC acknowledged this in its proposing release: “Although the proposed flexible approach could reduce the comparability of disclosure across registrants, we do not believe that precise conformity or comparability of the ratio across companies is necessary.” In essence, these ratios will be stand-alone numbers that will be driven largely by the nature, size, and location of a company’s workforces, and will be essentially meaningless to investors.

The SEC itself acknowledged, as it had to, that investor benefits of the proposed disclosures are not possible to identify:

> [T]here is limited legislative history to inform our understanding of the legislative intent behind [Dodd-Frank’s mandate] or the specific benefits the provision is intended to secure. In particular, the lack of a specific market failure identified as motivating the enactment of this provision poses significant challenges in quantifying potential economic benefits, if any, from the pay ratio disclosure.

While we commend the SEC for striving to mitigate the effects of a misguided Congressional directive, it is nonetheless troubling that the SEC would undertake this rulemaking—legislative mandate or not—without a clear idea of the benefits that it would provide to investors.

If the rules are in fact adopted, there will certainly be litigation challenging the SEC’s underlying cost-benefit analysis. In fact, perhaps the SEC’s admission that neither the objectives nor the intended benefits of pay ratio disclosures are evident in Dodd-Frank’s mandate or its legislative history signals that the SEC is inviting—or, at the very least, expecting—a challenge to the rules, if adopted, under the Administrative Procedure Act. (Recall that the Commission’s universal proxy access rules were ultimately invalidated through a successful challenge to its cost-benefit analysis in litigation filed under the APA by The Business Roundtable and the U.S. Chamber of Commerce.) While it is true that the flexibility afforded by the SEC to companies in determining their ratios eliminates many possible costs that *could* have been imposed by the rule, it remains impossible to justify adopting rules that have no discernible benefits. In the words of Commissioner Gallagher, who voted against the proposal: “Putting the most positive face possible on [the] proposal, then, its benefits are not so much elusive as *illusory*.... It amounts to this: Congress told us to do it, and since we could have done it in a more costly way than we did, the result is an implicit net benefit.”

Executive compensation has, of course, been a hot point for the chattering classes—not really for investors—for many years, and proxy statement disclosure requirements relating to compensation matters have grown exponentially in response. The proposed pay ratio disclosure rules, however, are a sizable departure from past rulemaking efforts not only in their scope, but also in their intent. Of course, partisan politicking often results in legislation that serves neither its stated purposes nor investors’ interests. Further, it is not surprising that this legislation—which was primarily designed to placate unions and promote their interests—penalizes the interests of corporate America and, consequently, investors. It is unfortunate that the SEC has, to paraphrase dissenting Commissioner Piwowar, surrendered its rulemaking agenda to special interests. Now that the rules have been proposed, however, it is time to rally against their adoption.

We plan to submit a comment letter to the SEC challenging the proposed rules. We encourage our clients and friends to do the same, and to include in their correspondence specific and realistic analyses of the anticipated costs of complying with the rules as proposed.

FURTHER INFORMATION

For further information, please contact your principal Firm representative or one of the lawyers listed below. General email messages may be sent using our "Contact Us" form, which can be found at www.jonesday.com.

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