COMPENSATION COMMITTEE LEADERSHIP NETWORK
ViewPoints

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Pay ratios

Compensation Committee Leadership Network (CCLN) members did not mince words in their reactions to the proposed rule put forward by the Securities and Exchange Commission (SEC) requiring disclosure of the ratio of CEO-to-worker pay. *"On all my boards, we think the pay ratio rule is ridiculous. It will create a tremendous amount of work without a single positive outcome,"* one member said.

Although most members see the rule as a *"distraction"* and *"useless,"* many CCLN members noted that the rule reflects a real and important level of popular concern about pay equity. Members discussed the pay ratio rule and some of the broader themes it raises during a meeting on November 12 and 13. This *ViewPoints* briefly highlights member perspectives on these issues.[1]

Dodd-Frank's pay ratio requirement

On September 18, the SEC proposed a new rule for the disclosure of pay ratios, a requirement mandated by the 2010 Dodd-Frank Wall Street Reform and Consumer Protection Act.[2] Passed by a three-to-two vote, the proposal defines covered employers and employees broadly and provides some flexibility in determining the "median employee."[3] Disclosure will not be required for most companies before the 2016 proxy season.[4]

The SEC's proposal was the latest step on a circuitous journey toward mandatory pay ratio disclosure. Many suggest that the idea originated in 1997, when law professor James Cotton published an article calling for disclosure of CEO-to-worker pay ratios, in order to bring "fairness" to executive pay packages.[5] Others claim that no less a capitalist than J. P. Morgan refused to invest in any company where the CEO was paid more than 50% above the next level of executives[6] or more than 20 times the average worker's pay.[7]

Pay ratio disclosure was a point of considerable debate in the development of Dodd-Frank. Three years of intense lobbying, legislative challenges, and advance comment letters to the SEC following the act's passage identified extensive difficulties and costs associated with disclosing CEO-to-worker pay ratios.

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[1] *ViewPoints* reflects the network's use of a modified version of the Chatham House Rule whereby names of members and their company affiliations are a matter of public record, but comments are not attributed to individuals or corporations. Italicized quotations reflect comments made in connection with the meeting by network members and other meeting participants.

[2] Section 953(b) of Dodd-Frank requires disclosure of "(A) the median of the annual total compensation of all employees of the issuer, except the chief executive officer (or any equivalent position) of the issuer; (B) the annual total compensation of the chief executive officer (or any equivalent position) of the issuer; and (C) the ratio of the amount described in subparagraph (A) to the amount described in subparagraph (B)."

[3] There are numerous summaries and analyses of the SEC's pay ratio proposal. In particular, we recommend two: Meridian Compensation Partners, "SEC Posts Proposed Rule on CEO Pay Ratio," *Meridian Client Update* 4, no. 11 (September 25, 2013), 1; and Pearl Meyer & Partners, *Long-Awaited Pay Ratio Details Are Proposed: SEC Seeks to Balance Compliance with Flexibility* (New York: Pearl Meyer & Partners, 2013), 6.

[4] Pearl Meyer & Partners, *Long-Awaited Pay Ratio Details Are Proposed: SEC Seeks to Balance Compliance with Flexibility*, 6.

[5] James A. Cotton, "Toward Fairness in Compensation of Management and Labor: Compensation Ratios, a Proposal for Disclosure," *Northern Illinois University Law Review* 18 (Fall 1997).

[6] This is a frequently made but poorly sourced assertion. See, for example, Broc Romanek, "The Furor over Income Inequality: Directors Need to Look in the Mirror," *TheCorporateCounsel.net* (blog), January 27, 2012; Shiva Rajgopal and Suraj Srinivasan, "Pay Dispersion in the Executive Suite" (preliminary draft, University of Washington Business School and GSB, University of Chicago, April 20, 2006), 1; "Pay Disparity/Internal Pay Equity," *CompensationStandards.com*, accessed October 22, 2013.

[7] This is a less frequently made, equally poorly sourced assertion. See AFL-CIO, *Dodd-Frank Section 953(b): Why CEO-to-Worker Pay Ratios Matter for Investors* (New York, AFL-CIO Office of Investment, 2011), 3.

Determining a "good" ratio

Supporters of pay ratio disclosure do not agree on what constitutes a "good" ratio. The late Peter Drucker agreed with Morgan's putative assessment, saying, "I have often advised managers that a 20-to-1 salary ratio [CEO to average worker] is the limit beyond which they cannot go if they don't want resentment and falling morale to hit their companies."[8] Beyond this rule of thumb, one could reasonably compare a company's ratio with a number of other benchmarks:

- **Historical US ratios.** The ratio grew from 20.1 in 1965 to 273 in 2012, according to the Economic Policy Institute (see Figure 1).[9]
- **Contemporary foreign ratios.** A company's ratio could be compared with the average ratios of other countries, such as Australia (93), Germany (147), Japan (67), Switzerland (148), or the United Kingdom (84).[10]
- **Peer ratios.** Members expect that outsiders will evaluate a company's ratio in relation to its peers. One recent analysis of pay ratios at Fortune 100 companies reported that the 10 biggest disparities ranged from 355:1, at JPMorgan Chase, to 1,034:1, at Wal-Mart.[11] That analysis found only six Fortune 100 company ratios at or below 20:1.[12]

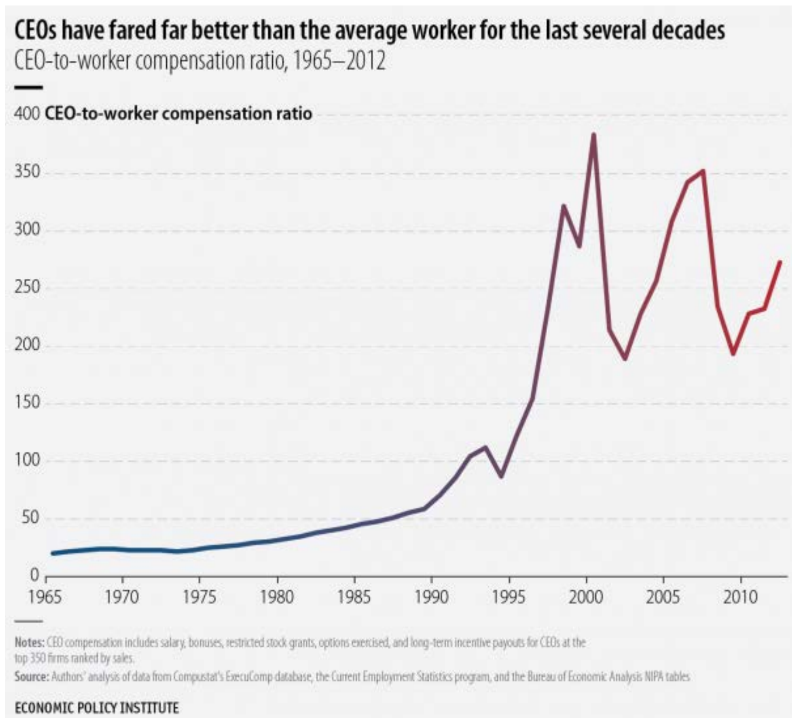

Figure 1 – Economic Policy Institute 2013

- **At the company.** Some members suggested that the flexibility built into the pay ratio calculation makes the resulting ratios incomparable. *"The ratio is applicable only for monitoring a given company year to year,"* one member said.

[8] Rick Wartzman, executive director of the Drucker Institute, to the Honorable Mary L. Schapiro, SEC, letter, February 17, 2011.

[9] Lawrence Mishel, "The CEO-to-Worker Compensation Ratio in 2012 of 273 Was Far Above That of the Late 1990s and 14 Times the Ratio of 20.1 in 1965," *Economic Snapshot*, September 24, 2013.

[10] AFL-CIO, "CEO-to-Worker Pay Ratios Around the World," *Executive Paywatch*, accessed October 22, 2013.

[11] Aubrey Bach, "PayScale Presents CEO Pay in Perspective," *PayScale*, April 1, 2013.

[12] Ibid.

Communicating the ratio

Members are currently working with their management teams and advisers to make their first pay ratio calculations. In addition to determining the most efficient way to gather the information, members are interested in determining what, exactly, to say about their company's CEO-to-worker pay ratio.

"With new regulatory requirements, we often start out legalistically – what's the minimum amount of information we can share in the fewest words? – as opposed to being more forthcoming and descriptive," one member said. *"I'd be surprised if we didn't take a very legalistic approach at the beginning."*

Others suggested addressing societal disapproval of current executive compensation levels more directly. A 2012 Rasmussen survey found that 69% of Americans believe that the level of pay and bonuses for executives at major US companies was too high.[13] "Committees are more deeply involved in all aspects of pay for performance because the public thinks that we are paying outrageous salaries," one member said at a prior meeting. *"We should not be so defensive,"* one member said. *"Let's explain the thinking behind our pay plans and behind our companies' overall pay philosophies."* Members thought that companies would benefit from more broadly publicizing how their companies provide employees with opportunities, citing Walmart's recent "The Real Walmart" campaign as an example.[14]

Consequences

Members observed that *"we can't know yet"* how the SEC's rule will unfold or how it will have broader impact. Some believe that it will lead to nothing more than headlines. Others suggested the most likely effects will be unintended: *"[The rule is] more likely going to cause a company to outsource the lowest-paid employees than to dock the CEO's pay."*

This, of course, assumes that the rule is implemented. Some have speculated that legal challenges will further delay or scuttle the implementation of the SEC's proposal, expecting that some may challenge the pay ratio rules based on a 2011 decision that struck down the SEC's proxy access rules for failure to adequately balance benefits and costs.

"Congress told us to do it"

Some critics have discussed the costs and benefits of the SEC's proposed implementation of Dodd-Frank – e.g., the definition of "issuer" and the requirement that ratios be filed, not furnished. But most criticism has focused on the pay ratio provision in Dodd-Frank itself. Dodd-Frank's mandate for pay ratios was clearer than its authorization to issue proxy access rules. The greater clarity of statutory provision for pay ratio disclosure rules may make it more difficult to challenge these rules on the same rationale as the Business Roundtable and Chamber of Commerce's successful challenge to proxy access rules in 2011.

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[13] Rasmussen Reports, "17% Favor Government Regulation of All Executive Pay," April 23, 2012. But Steven Kaplan, a professor at the University of Chicago's Booth School of Business, notes that since 2000, average pay for Standard & Poor's (S&P) 500 CEOs has declined by 46%. Relative pay equity has also improved: in 2000, CEOs made 350 times median household income; now, a CEO only makes 200 times as much. CEOs also make relatively less than hedge fund and private equity leaders; the ratio of average CEO pay to the average pay of the ".1 percenters" is comparable to or lower than the ratio in the early 1990s. See "Bargain Bosses," *Schumpeter* (blog), *Economist,* September 8, 2012.

[14] Wal-Mart Stores, "The Real Walmart," 2013.

The SEC pointed to Congressional constraint when the pay ratio rule was proposed. Voting against the proposal, Commissioner Gallagher noted: "It could have been worse, and I commend, as always, our expert staff in the Division of Corporation Finance, under the Chair's direction, for taking a somewhat more flexible approach to the proposal than many which have been considered. But the fact that the Commission could have imposed even greater costs does not create some otherwise absent benefit to mitigate the wasteful costs of the proposal. It merely confirms that there are even more costly ways to accomplish nothing. So why do this at all? Simple. Dodd-Frank says we must … 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. I believe this is the best that DERA could do with such a rotten mandate, but none of us should be happy about it."

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Society is unrelenting in its demand for more transparency about executive pay. Compensation committees face a dilemma in fostering transparency: measures such as pay ratios seem simple but, as members observed, they are often misleading. The data in a CD&A provide a more complete view, but can be so complex that they don't get read; and even when read, present the risk of "losing the forest for the trees." If boards fail to evolve disclosures that are both comprehensive and understandable, we can expect government and regulators to make further attempts at partial solutions, such as the proposed pay ratio rule. As with the proposed rule, most boards are likely to find these partial solutions expensive to implement and limited in the value they create.

About this document

Appendix 1: Examples of current pay ratio disclosures

- **DuPont.** According to the company's 2013 proxy statement, "The Committee has a long-standing practice of comparing CEO pay to that of other executives. To ensure that [named executive officers (NEOs)] are paid appropriately relative to each other and that we manage the pay differential between the CEO and the other NEOs, we apply a pay equity multiple to average target total cash compensation ('TCC' equals base salary plus [short-term incentive program] awards) and average target total direct compensation ('TDC' equals TCC plus [long-term incentives])." In 2012, the TCC multiple was 2.7, and the TDC multiple was 3.2.[15]

- **Whole Foods.** According to the company's 2013 proxy statement, "We review the compensation practices of other companies generally to better understand the market and the spectrum of compensation philosophies and options across the United States. To some extent, our compensation plan is based on the market and companies against which we compete for team members, including executives, and we must remain competitive; however, our compensation philosophy emphasizes internal pay equity and fair treatment of all stakeholders.

  "The salary cap relates to the Company's commitment to stakeholder equity as a principle. This principle has led us to generally limit the maximum cash compensation we pay team members in relation to any fiscal year (the 'salary cap'). Cash payments, including base salary and amounts paid under our incentive compensation plan, fall within the scope of the Company's salary cap.

  "The salary cap is set each fiscal year by our Compensation Committee through use of a multiple of the Company's average annual wage. In reviewing the multiple for a fiscal year, the Compensation Committee looks to general marketplace conditions and the compensation levels it believes to be required to attract and retain outstanding team members." From 2008 to 2012, the company capped salary at 19 times the average annual wage.[16]

[15] DuPont, *Proxy Statement* (Wilmington, DE: E.I. du Pont de Nemours and Company, 2013), 29.
[16] Whole Foods, *Proxy Statement* (La Jolla, CA: Whole Foods Market, 2013), 17–18.

Appendix 2: Contributing members[17]

The following members participated in the discussion:

- Thomas A. Dattilo, Harris Corporation
- Errol Davis, Union Pacific Railroad
- Thomas J. Donohue, Union Pacific Railroad
- David R. Goode, Caterpillar and Delta Air Lines
- Karen N. Horn, Eli Lilly and Company
- Annette Leckie, Meridian Compensation Partners
- Mel Lagomasino, Avon Products and The Coca-Cola Company
- Marjorie M. Magner, Accenture
- Mary McDowell, AutoDesk
- Steven S. Reinemund, Marriott International
- Marc Ullman, Meridian Compensation Partners

The following members took part in pre-meeting or post-meeting discussions:

- Lloyd H. Dean, Wells Fargo
- Marshall O. Larsen, Lowe's Companies
- Samuel C. Scott, III, Bank of New York Mellon Corporation
- Laurie Siegel, CenturyLink
- Anne Stevens, Lockheed Martin Corporation
- Kelvin R. Westbrook, Archer Daniels Midland Company

[17] The compensation committee leaders are identified by their compensation committee membership. Annette Leckie and Marc Ullman participated in their capacity as compensation experts.