RECENT REGULATION

SECURITIES REGULATION — DODD-FRANK WALL STREET REFORM AND CONSUMER PROTECTION ACT — SEC FINALIZES REGULATIONS REQUIRING COMPANIES TO DISCLOSE PAY RATIO BETWEEN THE CEO AND MEDIAN EMPLOYEE. — Pay Ratio Disclosure, 80 Fed. Reg. 50,104 (Aug. 18, 2015) (to be codified at 17 C.F.R. pts. 229, 240, 249).

The recent rise in executive compensation has been followed by regulations requiring disclosure of the compensation of high-ranking executives.[1] The Securities and Exchange Commission (SEC) recently added to these requirements by finalizing a pay ratio–disclosure rule that requires certain publicly traded companies to disclose the ratio of the compensation of the CEO to that of the median employee.[2] In promulgating this rule, the SEC did not investigate whether or how investors would use this information in practice.[3] As a result, the SEC may have left itself open to challenges that its cost-benefit analysis was arbitrary and capricious under the Administrative Procedure Act[4] (APA). In one possible line of attack, a party challenging the rule could argue that the SEC was both unable to assess the possible costs of its decision to allow each company to select the date on which to determine its employee base and unable to weigh these concerns against the purported benefits of this flexibility.

On July 21, 2010, President Obama signed the Dodd-Frank Wall Street Reform and Consumer Protection Act.[5] Among the Act's numerous provisions was section 953(b), which required the SEC to amend the Code of Federal Regulations to require issuers to disclose "(A) the median of the annual total compensation of all employees" (excluding the CEO), "(B) the annual total compensation of the chief executive officer," and (C) the ratio of these two numbers.[6]

On September 18, 2013, the SEC proposed an amendment to Item 402 of Regulation S-K[7] to implement its statutory mandate under sec-

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[1] *See* Executive Compensation, 17 C.F.R. § 229.402 (2015).

[2] Pay Ratio Disclosure, 80 Fed. Reg. 50,104 (Aug. 18, 2015) (to be codified at 17 C.F.R. pts. 229, 240, 249).

[3] *See* Michael S. Piwowar, *Dissenting Statement at Open Meeting on Pay Ratio Disclosure*, SEC (Aug. 5, 2015), http://www.sec.gov/news/statement/dissenting-statement-at-open-meeting-on-pay-ratio-disclosure.html [http://perma.cc/BY5E-HGWB].

[4] Pub. L. No. 79-404, 60 Stat. 237 (1946) (codified as amended in scattered sections of 5 U.S.C.).

[5] Pub. L. No. 111-203, 124 Stat. 1376 (2010) (codified as amended in scattered sections of the U.S. Code).

[6] *Id.* § 953(b), 124 Stat. at 1904 (codified as amended at 15 U.S.C. § 78*l* note (2012)).

[7] This provision requires disclosure of the compensation of high-ranking executives in publicly traded companies. *See* 17 C.F.R. § 229.402 (2015).

tion 953(b).[8] The Commission also requested public comment on "whether the proposed rule would address sufficiently the practical difficulties of data collection, whether other alternative approaches consistent with Section 953(b) could provide the potential benefits of pay ratio information at a lower cost, and whether the proposed flexible approach would appropriately implement Section 953(b)."[9]

The Commission received over 287,400 comment letters regarding the proposed rule.[10] Of these, over 285,900 were various form letters that either specifically supported the proposed rule or generally supported adopting a rule based on section 953(b).[11] In contrast, there was also significant opposition to the proposed rule from both industry groups and commentators.[12] Finally, the delay in finalizing the proposed rule frustrated some in Congress, notably Senator Elizabeth Warren.[13] On August 5, 2015, the Commission voted three to two to approve the final rule.[14] Commissioners Michael S. Piwowar and Daniel M. Gallagher, the two Republican members of the Commission, each issued dissents against the final rule.[15]

Companies must begin reporting the pay ratio for their first full fiscal year that begins on or after January 1, 2017.[16] As the statute requires particular figures to be disclosed, the rule focuses on the specif-

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[8] Pay Ratio Disclosure, 80 Fed. Reg. at 50,105 & n.8; *see also* Pay Ratio Disclosure, 78 Fed. Reg. 60,560 (proposed Oct. 1, 2013) (to be codified at 17 C.F.R. pts. 229, 249).

[9] Pay Ratio Disclosure, 80 Fed. Reg. at 50,108.

[10] *Id.*

[11] *Id.*

[12] *See, e.g.*, Ctr. for Capital Mkts. Competitiveness, Comment Letter on Pay Ratio Disclosure Rule (Dec. 2, 2013), http://www.sec.gov/comments/s7-07-13/s70713-567.pdf [http://perma.cc/TUL3-JWW8]; Nat'l Ass'n of Mfrs., Comment Letter on Pay Ratio Disclosure Rule (Dec. 2, 2013), http://www.sec.gov/comments/s7-07-13/s70713-509.pdf [http://perma.cc/Z4AW-4V3F]; Michael J. Segal, *SEC Adopts Pay Ratio Disclosure Rules*, HARV. L. SCH. F. ON CORP. GOVERNANCE & FIN. REG. (Aug. 6, 2015), http://corpgov.law.harvard.edu/2015/08/06/sec-adopts-pay-ratio-disclosure-rules [http://perma.cc/V75A-2ZKR]. Notably, some critics have argued that this disclosure requirement may violate the First Amendment. *See, e.g.*, Ctr. on Exec. Comp., Comment Letter on Pay Ratio Disclosure Rule 3 n.5 (Dec. 2, 2013), http://www.sec.gov/comments/s7-07-13/s70713-572.pdf [http://perma.cc/PH6K-ZZ7R].

[13] *See* Letter from Senator Elizabeth Warren to Mary Jo White, Chair, SEC 2–4 (June 2, 2015), http://www.warren.senate.gov/files/documents/2015-6-2_Warren_letter_to_SEC.pdf [http://perma.cc/A7V8-C87C] ("I cannot understand how and why this rule has been delayed for so long, and I am perplexed as to why you told me personally that the rule would be completed by the fall of 2015 when it appears that you were or should have been aware of additional delays." *Id.* at 3–4.).

[14] Peter Eavis, *S.E.C. Approves Rule on C.E.O. Pay Ratio*, N.Y. TIMES: DEALBOOK (Aug. 5, 2015), http://www.nytimes.com/2015/08/06/business/dealbook/sec-approves-rule-on-ceo-pay-ratio.html.

[15] *See* Daniel M. Gallagher, *Dissenting Statement at an Open Meeting to Adopt the "Pay Ratio" Rule*, U.S. SEC. & EXCHANGE COMMISSION (Aug. 5, 2015), http://www.sec.gov/news/statement/dissenting-statement-at-open-meeting-to-adopt-the-pay-ratio-rule.html [http://perma.cc/3R2A-9CVZ]; Piwowar, *supra* note 3.

[16] Pay Ratio Disclosure, 80 Fed. Reg. at 50,112.

ics of how these figures are to be calculated. This inquiry necessitated five primary determinations. First, the SEC determined who counted as an employee. Generally, all individuals employed by the registrant[17] (and its consolidated subsidiaries) count as employees, including full-time, part-time, seasonal, and temporary workers.[18] Employees in foreign jurisdictions are included unless one of two conditions applies. Companies may exempt a number of foreign employees equal to five percent of their total workforce, even if foreign employees comprise over five percent of their employee base.[19] However, companies may not cherry-pick these employees — once a company exempts some employees in one jurisdiction, it must exclude all employees in that jurisdiction (up to the five percent threshold).[20] Further, if data privacy laws in a given foreign jurisdiction would conflict with this disclosure, companies are not required to include those foreign employees in their employee base.[21] In order to claim the data privacy exemption, a company must, inter alia, obtain a legal opinion that addresses its inability to obtain the requisite information.[22]

Second, the SEC established how a company should determine its median employee. Companies may determine the median employee either from their entire pool of workers or from a statistical sample of workers.[23] Moreover, companies are not required to use "total compensation" as defined by Item 402 to rank their employees, but if they do not use this measure, they must disclose their methodology.[24] For example, they may use payroll or tax records.[25]

Third, the SEC determined how to calculate the compensation of the median employee. This figure is calculated in the same way as if the employee were a named executive officer whose compensation is already subject to disclosure.[26]

Fourth, the SEC determined which publicly traded companies were subject to this rule. As required by section 102(a)(3) of the Jumpstart Our Business Startups (JOBS) Act,[27] the rule finalized by the SEC excludes "emerging growth compan[ies]," which are defined "in the Securities Act and the Exchange Act as . . . issuer[s] with 'total annual

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[17] Used here, "registrant" refers to any company that is required to disclose its executive compensation. *Id.* at 50,105 n.6.

[18] *Id.* at 50,108.

[19] *Id.* at 50,124–25.

[20] *Id.* at 50,124.

[21] *Id.* at 50,123–24.

[22] *Id.*

[23] *Id.* at 50,135.

[24] *Id.*

[25] *Id.*

[26] *Id.* at 50,105.

[27] Pub. L. No. 112-106, 126 Stat. 306 (2012) (codified in scattered sections of 15 U.S.C.).

gross revenues' of less than $1 billion during [their] most recently completed fiscal year."[28] Additionally, the rule does not apply to foreign private issuers.[29]

Finally, the SEC determined the period for which an employer would calculate the number of employees it has (the "calculation date"). In its proposed rule, the Commission stated that an employer's workforce for this purpose consists of those it employed on the last date of its fiscal year.[30] The Commission believed that "a bright line calculation date for determining who is an employee would ease compliance for registrants by eliminating the need to monitor changes in workforce composition during the year."[31] The proposal would also have been consistent with the calculation for determining named executive officers under Item 402.[32] However, the Commission recognized the possibility that this requirement could be costlier for registrants whose temporary or seasonal workers are employed at the end of the year and might even cause some companies to restructure their employment arrangements to reduce the number of workers employed on this date.[33] To that effect, the Commission requested comment on this aspect of the rule, including whether the proposed specified-date provision was workable or whether registrants should have flexibility to pick a date.[34] Comments revealed numerous concerns with the proposal, including that some companies would not have enough time to collect and analyze the necessary information.[35] Responding to these concerns, the final rule defines an "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."[36] The registrant is required to disclose this date, and if it changes the date, it must disclose the reason it is making the change.[37]

The SEC's rulemaking obligations stem from two sources — the APA and the federal securities laws. Under the APA, a reviewing court shall "hold unlawful and set aside agency action, findings, and conclusions found to be . . . arbitrary, capricious, an abuse of discre-

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[28] *Jumpstart Our Business Startups Act Frequently Asked Questions: Generally Applicable Questions on Title I of the JOBS Act*, U.S. SEC. & EXCHANGE COMMISSION, http://www.sec.gov/divisions/corpfin/guidance/cfjjobsactfaq-title-i-general.htm (last updated Sept. 28, 2012) [http://perma.cc/7Y67-JLGQ] (quoting 15 U.S.C. § 78c(a)(80) (2012)).

[29] Pay Ratio Disclosure, 80 Fed. Reg. at 50,115.

[30] Pay Ratio Disclosure, 78 Fed. Reg. 60,560, 60,567 (proposed Oct. 1, 2013) (to be codified at 17 C.F.R. pts. 229, 249).

[31] Pay Ratio Disclosure, 80 Fed. Reg. at 50,112.

[32] *Id.* at 50,118.

[33] Pay Ratio Disclosure, 78 Fed. Reg. at 60,568.

[34] *See id.*

[35] Pay Ratio Disclosure, 80 Fed. Reg. at 50,119.

[36] *Id.*

[37] *Id.*

tion, or otherwise not in accordance with law."[38] The Supreme Court has interpreted this provision to demand that an agency "examine the relevant data and articulate a satisfactory explanation for its action including a 'rational connection between the facts found and the choice made.'"[39] Under amendments to the 1933 Securities Act and 1934 Exchange Act, when the SEC engages in "rulemaking that requires [it] to consider or determine whether an action is necessary or appropriate in the public interest,"[40] as is the case here,[41] it must also "consider whether the action will promote efficiency, competition, and capital formation."[42] Although one could interpret the APA to require cost-benefit analysis, the Supreme Court has never done so.[43] Alternatively, one could argue that it would be arbitrary and capricious under the APA not to analyze costs and benefits when considering "efficiency, competition, and capital formation."[44] However, this reading is not self-evident.[45] Regardless of the merits of any of these positions, in practice the D.C. Circuit — most notably in *Business Roundtable v. SEC*[46] — has seemingly extended these mandates to require cost-benefit analysis by stating that the SEC is required to "apprise itself — and hence the public and the Congress — of the economic consequences of a proposed regulation."[47]

In justifying its choices with respect to the pay ratio–disclosure rule, the SEC could have done more to bolster its defense against this

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[38] 5 U.S.C. § 706(2)(A) (2012).

[39] Motor Vehicle Mfrs. Ass'n of the U.S. v. State Farm Mut. Auto. Ins. Co., 463 U.S. 29, 43 (1983) (quoting Burlington Truck Lines v. United States, 371 U.S. 156, 168 (1962)).

[40] Pay Ratio Disclosure, 80 Fed. Reg. at 50,149; *see also* 15 U.S.C. §§ 77b(b), 78c(f) (2012).

[41] The SEC construed section 953(b) as a "Congressional directive to . . . rely on our Exchange Act and Securities Act rulemaking authorities to amend [17 C.F.R.] § 229.402 . . . to require the pay ratio disclosure. The pay ratio amendments that we are adopting, therefore, are rules or regulations under the Exchange Act and the Securities Act." Pay Ratio Disclosure, 80 Fed. Reg. at 50,122 n.181.

[42] *Id.* at 50,149 (citing 15 U.S.C. §§ 77b(b), 78c(f)).

[43] *See* Michigan v. EPA, 135 S. Ct. 2699 (2015) (holding that the EPA impermissibly interpreted the Clear Air Act "to mean that it could ignore cost when deciding whether to regulate power plants," *id.* at 2707); *cf.* Am. Textile Mfrs. Inst., Inc. v. Donovan, 452 U.S. 490, 510 (1981) ("When Congress has intended that an agency engage in cost-benefit analysis, it has clearly indicated such intent on the face of the statute.").

[44] *See, e.g.*, Jerry Ellig & Hester Peirce, *SEC Regulatory Analysis: "A Long Way to Go and a Short Time to Get There*," 8 BROOK. J. CORP. FIN. & COM. L. 361, 364–66 (2014).

[45] *See* Jill E. Fisch, *The Long Road Back:* Business Roundtable *and the Future of SEC Rulemaking*, 36 SEATTLE U. L. REV. 695, 713–16 (2013) (describing the nature of court oversight).

[46] 647 F.3d 1144 (D.C. Cir. 2011).

[47] *Id.* at 1148 (quoting Chamber of Commerce v. SEC, 412 F.3d 133, 144 (D.C. Cir. 2005)). *See generally* John C. Coates IV, *Cost-Benefit Analysis of Financial Regulation: Case Studies and Implications*, 124 YALE L.J. 882 (2015) ("[T]he D.C. Circuit's new interpretations of the APA and statutes authorizing financial regulation have permitted panels to overturn regulatory changes on the ground that a court would conduct its guesstimated [cost-benefit analysis] differently than an agency would." *Id.* at 920.).

type of stringent review.[48] Specifically, the SEC could have conducted investor testing to try to determine how investors would use pay ratio information.[49] This could have included surveying investors to see how they planned to use the information or conducting more formal experiments in which investors responded to such a disclosure in a "laboratory" setting.[50] Investor testing would have helped the SEC defend one of its decisions in particular: the decision to allow employers to select their calculation date. Because the SEC did not know how investors would use the pay ratio, it was unable to calculate the potential harm a company would face if it did not pick a date that reduced its pay ratio and further unable to compare this harm to the purported cost savings.

The SEC believed that "the primary benefit that Congress intended with pay ratio disclosure is to provide shareholders with a company-specific metric that they can use to inform their voting decisions regarding executive compensation."[51] However, the SEC was "unable to quantify this benefit."[52] Although the SEC recognized that comment

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[48] There is a fundamental question as to whether this type of stringent arbitrary and capricious analysis would even apply to the determinations the SEC made in the pay ratio–disclosure rule, or whether the Commission would receive deference under *Chevron U.S.A. Inc. v. Natural Resources Defense Council, Inc.*, 467 U.S. 837 (1984). A related question concerns whether there are any substantive differences between these two frameworks for review. Recently, the Supreme Court suggested arbitrary and capricious review and *Chevron* step two are the same inquiry. *See* Judulang v. Holder, 132 S. Ct. 476, 483 n.7 (2011) ("[U]nder *Chevron* step two, we ask whether an agency interpretation is 'arbitrary or capricious in substance.'" (quoting Mayo Found. for Med. Educ. & Research v. United States, 131 S. Ct. 704, 711 (2011))). The D.C. Circuit has had difficulties delineating the exact boundaries and respective scope of each form of inquiry. *Compare* Arent v. Shalala, 70 F.3d 610, 614–15 (D.C. Cir. 1995) (holding that arbitrary and capricious review, and not *Chevron* deference, applied), *with id.* at 619 (Wald, J., concurring in the judgment) (arguing that *Chevron* deference should apply). This problem is not confined to the D.C. Circuit. *See, e.g.*, Citizens Coal Council v. EPA, 447 F.3d 879, 889–90 n.10 (6th Cir. 2006) (en banc) ("We recognize that there is support for the proposition that in review of rulemaking the second step of *Chevron* indeed amounts to the same inquiry as arbitrary or capricious review under the APA."). For an argument that arbitrary and capricious review normatively should be not just similar, but identical, to *Chevron* step two, see Ronald M. Levin, *The Anatomy of* Chevron*: Step Two Reconsidered*, 72 CHI.-KENT L. REV. 1253 (1997).

[49] Section 912 of the Dodd-Frank Act clarifies that the SEC is allowed to (1) "gather information from and communicate with investors," (2) "engage in such temporary investor testing programs as the [SEC] determines are in the public interest or would protect investors," and (3) "consult with academics and consultants." Dodd-Frank Wall Street Reform and Consumer Protection Act § 912, 15 U.S.C. § 77s(e) (2012).

[50] For example, the Consumer Financial Protection Bureau studied the impact of proposed mortgage disclosure changes both by using focus groups and by testing people's ability to answer questions about a hypothetical mortgage. *See* KLEIMANN COMMC'N GRP., INC., KNOW BEFORE YOU OWE: QUANTITATIVE STUDY OF THE CURRENT AND INTEGRATED TILA-RESPA DISCLOSURES, at vii–x (2013), http://files.consumerfinance.gov/f/201311_cfpb_study_tila-respa_disclosure-comparison.pdf [http://perma.cc/7ES8-LPKP].

[51] Pay Ratio Disclosure, 80 Fed. Reg. at 50,149.

[52] *Id.* at 50,153.

letters suggested that investors might use the ratio for a variety of different purposes,[53] it made no independent effort to quantify how investors would use this information in practice.[54] How investors would use this ratio is intrinsically related to the benefits (and costs) the rule would provide, as both dissenting Commissioners noted.[55] Without having any indication of how investors would use the ratio, the SEC was unable to analyze completely the costs and benefits of the rule.

The SEC's insufficient reliance on empirical data on how investors would use the pay ratio could provide grounds for setting aside the rule. The D.C. Circuit invalidated a rule on similar grounds in *Business Roudtable*. In that case, Judge Ginsburg faulted the SEC for "ducking serious evaluation of the costs that could be imposed upon companies from use of [a proxy access rule] by shareholders representing special interests, particularly union and government pension funds,"[56] as well as doing "nothing to estimate and quantify the costs it expected companies to incur."[57] Most importantly, he faulted the Commission for not addressing "whether and to what extent [the rule at issue] will take the place of traditional proxy contests. Without this crucial datum, the Commission has no way of knowing whether the rule will facilitate enough elections contests to be of net benefit."[58] Analogizing to the pay ratio rule, a court could find that without knowledge of whether investors would use the ratio to compare companies, the SEC had no way of knowing the extent to which companies would undertake costly steps to reduce their ratio.[59]

One specific cost the SEC was unable to analyze was the potential effects of allowing companies flexibility in selecting their calculation date. As some commenters noted, having a fixed date could have an adverse impact on industries that employ a large number of temporary

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[53] *See id.* at 50,153–54.

[54] Of the comment letters the SEC received, 111,553 of them explicitly or implicitly made the claim that the commenter would use the ratio to compare companies against each other. *See Comments on Pay Ratio Disclosure*, U.S. SEC. & EXCHANGE COMMISSION, http://www.sec.gov/comments/s7-07-13/s70713.shtml [http://perma.cc/KK78-6K3R] (Letter Types A, B, C, D, E, F, and H).

[55] *See* Gallagher, *supra* note 15; Piwowar, *supra* note 3. Commissioner Piwowar in particular focused on the possibility of using investor testing. *See id.* ("If the Commission was serious about understanding how investors might react to the pay ratio disclosure, it would have engaged in investor testing.").

[56] Bus. Roundtable v. SEC, 647 F.3d 1144, 1152 (D.C. Cir. 2011).

[57] *Id.* at 1150.

[58] *Id.* at 1153 (citation omitted).

[59] Such an argument may gain traction, given that it was a focus of both dissenting Commissioners. *See generally* Luke N. Roniger, Note, *Regulatory Dissent and Judicial Review*, 2015 COLUM. BUS. L. REV. 390 (tracing the consideration and desirability of the D.C. Circuit's reliance on dissents by SEC Commissioners).

workers on that date by making the ratio "artificially" high.[60] Thus, a firm likely has two objectives in selecting a date: minimizing its compliance costs and minimizing its pay ratio. These factors may be optimized on different dates.[61] Stated differently, a company may be incentivized to pick a date that does not minimize compliance costs in order to pick a date that reduces its pay ratio. Consider a retailer that has a fiscal year ending December 31 and that hires many seasonal workers (who are paid a salary below that of the median worker) in order to meet increased holiday demand. Assume further that this employer has its tax and payroll systems based on the end of the fiscal year as well, such that compliance costs in fact would be minimized if they were calculated on the last day of the fiscal year. If this employer believes that its competitors will pick a calculation date that optimizes their ratios and that the harm from inaction is greater than the increase in compliance costs is, it will change its calculation date to one before its hiring of the seasonal workers. In this scenario, then, the employer's compliance costs are higher than they would have been in the original proposal. Perhaps this scenario is unlikely, or even nonexistent. Even so, without knowing how investors will actually use the pay ratio disclosure, a court could find that the SEC's claims about the potential costs of this rule (or comparisons between costs and benefits) "ha[ve] no basis beyond mere speculation."[62]

Whether or not a judicial mandate that the SEC perform cost-benefit analysis is normatively desirable, it is in fact what the SEC could face if the pay ratio–disclosure rule is challenged in court. An empirical study investigating how investors would use the ratio would have allowed the Commission to compare the potential costs and benefits of allowing companies flexibility in selecting a calculation date.[63] By neglecting to do so, the SEC may have left the pay ratio–disclosure rule open to attack.

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[60] *See, e.g.*, Pearl Meyer & Partners, Comment Letter on Pay Ratio Disclosure 3 (Dec. 2, 2013), http://www.sec.gov/comments/s7-07-13/s70713-493.pdf [http://perma.cc/9NNP-GKDG].

[61] Some companies noted that allowing more flexibility may let them select a date that "better utilizes [their] internal resources." Pay Ratio Disclosure, 80 Fed. Reg. at 50,170.

[62] *Bus. Roundtable*, 647 F.3d at 1150.

[63] The SEC may have not conducted such a study because of its interpretation of the benefit intended by Congress. *Cf.* Pay Ratio Disclosure, 80 Fed. Reg. at 50,149.