The Dodd-Frank Pay Ratio Is Unjustifiably Burdensome and Contrary to Sound Disclosure Policy

Hearing on Legislative Proposals to Relieve the
Red Tape Burden on Investors and Job Creators

Subcommittee on Capital Markets and
Government Sponsored Enterprises

House Committee on Financial Services

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Written Testimony of
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Chairman Garrett, Vice Chairman Hurt, Ranking Member Maloney and Members of the House Financial Services Committee:

My name is Charlie Tharp, and on behalf of the Center On Executive Compensation, I am pleased to provide our views on section 953(b) of the Dodd-Frank Wall Street Reform and Consumer Protection Act, known as the pay ratio mandate, and our strong support for Congressman Huizenga's bill, H.R. 1135, the Burdensome Data Collection Relief Act, which would repeal the pay ratio provision. The Center believes that this mandate would impose significant costs on public companies, especially large global public companies, causing them to redirect resources from more productive uses, such as job creation or investment, without providing meaningful or material information to investors. For this reason, the Center urges that Subcommittee repeal the pay ratio provision and thereby free up SEC resources to ensure that existing disclosures provide a clear explanation of the link between executive compensation and performance.

The Center On Executive Compensation is a research and advocacy organization that seeks to provide a principles-based approach to executive compensation policy. The Center is a division of HR Policy Association, which represents the chief human resource officers of over 340 large companies, and the Center's more than 100 subscribing companies are HR Policy members that represent a broad cross-section of industries. Because chief human resource officers oversee human resource policies globally, including compensation, payroll, and benefits, and also support the compensation committee chair with respect to executive compensation matters, we believe that our Subscribers' views can be particularly helpful in understanding the complexities that would be required to implement the pay ratio requirement and why repeal of this provision is the best solution.

I. Overview of the Pay Ratio Disclosure Requirement

The pay ratio provision in Section 953(b) of the Dodd-Frank Act directs the SEC to draft rules requiring all public companies to disclose in their proxy statements the ratio of the median pay of all employees (except for the chief executive officer ("CEO")) to the total pay of the CEO. Unlike many other provisions in Title IX of the Dodd-Frank Act, which give the SEC a fair amount of discretion in implementation, the statutory language of the pay ratio is overly prescriptive, and requires the following:

- <u>Unduly Complex Calculation of the Median</u>. The Dodd-Frank pay ratio requires companies to find the median—not the average—compensation for all employees other than the CEO. The median is the number that is exactly in the middle of a group of numbers. Under the pay ratio requirement, companies will likely be required to calculate compensation for all employees the same way that companies calculate pay for their named executive officers, which includes:
    - Cash compensation;
    - Equity compensation;
    - Benefits that are not received by the general employee population; and
    - Other compensation.

- All Employees. The statute refers to the pay of "all employees" and it is likely that companies would be required to calculate the pay of every employee globally, including part-time employees, in the same manner as compensation is calculated for the named executive officers. As discussed below, large employers do not keep pay data centrally housed in a format that would facilitate calculation of the required ratio.

- Compensation Calculated Under SEC Rules That Apply to Proxy Officers as of July 9, 2010. As if to add a further burden to companies, the statute requires companies to calculate the pay ratio based on the SEC's disclosure rules as they existed prior to the enactment of the Dodd-Frank Act. Thus, as the SEC's rules change, the pay ratio will need to be calculated based on the rules in effect in 2010.

Former SEC officials from Chair Mary Schapiro to the Director of the Division of Corporation Finance Meredith Cross indicated in their previous appearances before Congressional committees that due to the prescriptive nature of the provision, the SEC has very little interpretive authority and thus would interpret it narrowly. Last week, SEC Chair Mary Jo White reiterated that the pay ratio provision was proving difficult for the staff to implement.

Costs of the Pay Ratio Requirement Far Outweigh Its Benefit

The burden of calculating this median pay ratio requirement is significant and will typically be more costly for companies with broad global workforces, as is the case for most large corporations. It would require a company to gather and calculate compensation information for each employee as required for senior executives under the SEC disclosure rules, determine the pay of each employee from highest to lowest, and then identify the employee whose pay is at the midpoint between the highest- and lowest-paid employee. However, no public company currently calculates each employee's total compensation as it calculates total pay for CEOs on the proxy statement.

The Center engaged its Subscribers to gain a better understanding of the burden and difficulty in gathering and calculating this information through qualitative discussions and a 2011 survey of Subscribers and HR Policy Association members. We summarized these findings in comments submitted to the SEC, and attached the detailed survey results. Our findings reinforce the fact that the costs of implementing the ratio will outweigh any potential benefits of doing so.

Diverse Operations. The survey showed that most respondents are global and have a large number of employees all over the world. More specifically:

- Number of Employees. Over three-quarters of the respondents (78.7%) have over 10,000 employees globally and over a third (37.2%) has over 50,000 employees globally.

- Number of Countries. Three-quarters of respondents (74.5%) have employees in more than 10 countries. Based on the qualitative responses, it appears that many large companies have employees in at least 30 countries.

- Global Locations. Over 70% of respondents have at least hundreds of locations and nearly 30% have thousands of locations.

Dispersed Information Requires Manual Calculations. Even though most of our Subscribers are large, sophisticated global companies, their HR, payroll and benefits systems are not often centralized and the calculation of the pay ratio is not available at the touch of a button. This holds true even if it was assumed that the ratio would be based on cash compensation alone (in reality it is more broadly defined). Among our survey respondents, 84% indicated that just obtaining annual cash compensation globally on an individualized basis was not easily accomplished, and 70% of those indicated that gathering the information would be very difficult. An illustration of some of the comments issuers made in explaining why the determination would be difficult include:

- "Cash comp[ensation] in the US and Canada can come from our [human resources information system]. For the other 30 countries, we would have to go to each local payroll and define the types of pay we would need for each employee (which I'm sure are all coded differently in each different payroll system). And that would only give us base & incentives and some other special payments."

- We "currently have approximately 3 dozen payroll systems/vendors globally. Not all locations have a centralized HR shop either, so we would have to devote a lot of people/time."

- "90 different payrolls . . . in different systems or statutory [requirements]; currency conversions difficult. Very difficult as cash compensation has different components in different markets."

- "Cash compensation is handled by each country individually with little oversight in terms of delivery between the local HR staff and the country-specific payroll system. To get accurate data, we would likely have to work with every payroll vendor globally to request records for the prior year from which we can generate the total cash compensation figures for employees. Since payroll systems are outsourced outside of North America, this would likely be both time consuming and costly to complete. Depending on the definition of cash compensation, it may be next to impossible to certify that the information is accurate across all the countries in which we pay employees."

- "Small populations spread across the world with varying international pay plans."

- "The level of economic development varies significantly amongst our sites (developing to modern), with significant differences in amounts and forms of compensation, as well as currency values, economic/tax/social structures."

- "First, we have no existing way of calculating the annual total compensation of every employee around the world. … We have 101 payroll systems worldwide. We have approximately 3,600 international assignees, and these assignees get paid in two places (home and host country). … We have six countries that use non-calendar tax years. Not only do we have numerous part-time employees, but we have many different employee types; e.g., multiple types of supplemental employees, different types of inactive employees, and employees who work for wholly owned and less than wholly owned subsidiaries. In addition to the challenge of making an accurate calculation, privacy regulations in certain areas around the world make the data difficult to even obtain. Also, it would be impossible to anonymize data for international assignees because they end up with an identification number for both their home and host country, so there isn't a way to tie the employee to both payments."

Under the pay ratio provision, the scope of the information-gathering requirement presents significant hurdles for companies. Accuracy is a significant concern, since compensation data is housed in dozens of computer systems and subject to the compensation and benefits rules of different countries worldwide. Furthermore, these illustrations say nothing with respect to the impact that exchange rate fluctuations will have on the calculations. Companies would be required to develop and coordinate a consistent calculation across all countries and then ensure that the results were accurate since Section 302 of Sarbanes-Oxley requires the CEO and the CFO to sign the proxy statement certifying its accuracy.

Half of Respondents Would Need at Least Three Months to Calculate the Ratio. In our survey, nearly half of all respondents (49.5%) stated that it would take their companies at least three months to calculate median employee compensation. Nearly another 20% (18.7%) indicated that it would take their companies five months or more to do the calculation.

The cost of implementing the requirement for many companies is likely to be in the millions of dollars. One company estimated that the total cost of calculating the pay ratio, including systems changes, would be at least $7.6 million. Another estimated that the cost of calculating just the pension component of total compensation across all payroll systems would be $2 million. Clearly, given that few shareholders are interested in the information, the cost of generating the pay ratio does not generate sufficient benefit to justify the mandate.

Based on the information above, most employers would have to calculate the median employee pay for the preceding fiscal year, because they would not have the raw compensation data in a timely manner to include the ratio in their annual proxy statement. As discussed below, this reinforces the argument that the information produced will not be useful for investors, since the ratio would be one year behind the rest of the proxy statement data.

II. The Pay Ratio Requirement Would Not Provide Material Information and Is Inconsistent With Purposes of Proxy Statement Disclosure

The pay ratio mandate would not provide information useful to investors, and for this reason, is inconsistent with the purpose of the SEC disclosure rules. The SEC generally requires that companies disclose in the proxy statement all material information necessary to inform an investor of how and why a company compensates its named executive officers. Material information is that which would impact an investor's decision to invest in the company or its vote for directors. Therefore, the addition of nonmaterial information simply lengthens the disclosure and dilutes the impact of material information. Further, the inclusion of this ratio could mislead investors who seek to compare ratios between companies.

The ratio would not be comparable between companies as the pay of employees at all levels of an organization is based on the company's size and global reach, competitive and geographic labor market forces, the industry in which a company operates, the mix of jobs within a company, and other factors which reduce the comparability of such disclosures across companies. Companies employing more highly paid employees will likely have a smaller ratio due to the structure of their workforce as opposed to those employing a larger share of lower paid employees, such as retail clerks. However, the difference would not tell investors whether the company with the lower ratio is a better investment.

Moreover, the ratio does not account for a company's global operational structure or business strategy, which would certainly have an impact. One company may rely on third parties for certain services like manufacturing or information processing whereas another company may use their own employees to perform such work, thereby distorting the comparison between companies. Again, comparing the ratios between two such companies would provide little useful information. Contrary to the arguments of some activists, differences in pay ratios would not reflect differences in risk between companies. Instead, different ratios would merely reflect differences in market rates of pay for various positions across geographic areas and neither a higher nor lower ratio is indicative of a greater or lesser investment risk.

CFO Magazine recently ran a column on the pay ratio provision calling it a "net zero" and not worth the cost. Editor David McCann, who identified himself as a Democrat in the column, stated, "while shareholders are very hot on pay for performance, they don't give a whit about pay ratio" because the "so-called 'pay ratio' does not tell investors anything useful about a company."

Since 2006, the SEC has made significant changes to its executive compensation disclosure rules in an effort to expand the material information that is available to investors. Because of these rules and other changes since then, independent executive compensation information provider Equilar recently calculated that the median word count of an S&P 1500 company's explanation of its executive compensation programs has increased by 26% between 2008 and 2012, from 6,080 words to 7,665 words (or about four pages of typewritten text). The addition of nonmaterial information in the form of the ratio and any narrative disclosure to explain the ratio would only add to the length and make it more difficult for investors to digest the material information.

Moreover, shareholders have not supported disclosure of this information when given the opportunity to vote for it. In 2010, nine shareholder resolutions calling for disclosure of a pay ratio received an average support of 6.4%. To date, there have only been two resolutions dealing with the pay ratio voted on since 2010, with an activist investor submitting the same proposal to a single company in both 2012 and 2013. Neither fared well, with the 2013 proposal receiving 6.7% support, a drop from the 7.2% support the proposal received a year earlier. The message is clear: investors are not asking for this information, and its inclusion would only make unduly long disclosures even longer.

The Center continues to oppose the pay ratio requirement because the calculation of the median compensation of all employees globally using the statutorily mandated SEC definition of compensation is unjustifiably complex. Based on feedback from our Subscribers, we believe the costs and burdens of calculating the ratio would be excessive relative to the information it would provide. In addition, the pay ratio is the result of different market rates of pay for various positions in different locations, and therefore does not reflect differences in risk but rather differences in markets.

Conclusion

In sum, the pay ratio requirement would not provide material information, would be extremely costly to implement and is inconsistent with the reasons for disclosing compensation in the proxy statement.

The Center appreciates the opportunity to provide its views on this extremely important policy matter. We look forward to working with you and members of your staffs to ensure that the Dodd-Frank Act will lead to the positive reform that was intended when it was enacted.

United States House of Representatives
Committee on Financial Services

"Truth in Testimony" Disclosure Form

Clause 2(g) of rule XI of the Rules of the House of Representatives and the Rules of the Committee on Financial Services require the disclosure of the following information. A copy of this form should be attached to your written testimony.

1. Name: Charles G. Tharp	**2. Organization or organizations you are representing:** Center On Executive Compensation
3. Business Address and telephone number: 1100 13th St NW, Suite 850 Washington, DC, 2005 202-315-5577	
4. Have you received any Federal grants or contracts (including any subgrants and subcontracts) since October 1, 2010 related to the subject on which you have been invited to testify? ☐ **Yes** ☑ **No**	**5. Have any of the organizations you are representing received any Federal grants or contracts (including any subgrants and subcontracts) since October 1, 2010 related to the subject on which you have been invited to testify?** ☐ **Yes** ☑ **No**
6. If you answered "yes" to either item 4 or 5, please list the source and amount of each grant or contract, and indicate whether the recipient of such grant was you or the organization(s) you are representing. You may list additional grants or contracts on additional sheets.	
7. Signature:	

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