COMMENTS

of

WASHINGTON LEGAL FOUNDATION

to the

U.S. SECURITIES AND EXCHANGE COMMISSION

Concerning

Reconsideration of Pay-Ratio Rule Implementation

IN RESPONSE TO ACTING CHAIRMAN MICHAEL S. PIWOWAR'S FEBRUARY 6, 2017 INVITATION FOR DETAILED COMMENTS

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Submitted Electronically (http://www.sec.gov)
Acting Chairman Michael S. Piwowar
U.S. Securities and Exchange Commission
100 F Street, NE
Washington, DC 20549

Re: Comments Concerning Acting Chairman Piwowar's February 6, 2017 Statement on Reconsideration of Pay-Ratio Rule Implementation

Dear Chairman Piwowar:

Washington Legal Foundation (WLF) submits the following comments in response to your February 6, 2017 Statement on Reconsideration of Pay-Ratio Rule Implementation, which invited additional detailed comments and instructed SEC staff "to reconsider the implementation of the rule based on any comment submitted."

WLF appreciates this opportunity to urge SEC to abandon the Pay-Ratio Disclosure Rule, which requires regulated companies to disclose the "ratio of the median of the annual total compensation of all employees to the annual total compensation of the chief executive officer." WLF believes that focusing on concerns over perceived "income inequality" is not the proper province of the securities law or SEC. Simply put, the Pay-Ratio Disclosure Rule provides no benefit or meaningful information to investors and lacks any investor-protection justification. Moreover, by compelling companies to speak publicly on a matter that they otherwise would prefer not to, the rule raises serious free speech concerns under the First Amendment. *See* Andrew J. Morris, *Could a First Amendment Challenge to SEC's "Pay-Ratio" Rule Rein in CSR Disclosure Mandates?*, WLF Legal Backgrounder (Oct. 23, 2015), at http://www.wlf.org/publishing/publication_detail.asp?id=2532. While we recognize that SEC is responding to a Congressional directive, WLF urges the Commission to evaluate more fully whether ***any*** benefit justifies implementing the rule and to consider withdrawing the rule in its entirety.

I. Interests of WLF

WLF is a nonprofit, public-interest law firm and policy center based in Washington, DC, with supporters nationwide. Founded nearly 40 years ago, WLF devotes a substantial portion of its resources to defending free enterprise, individual rights, a limited and accountable government, and the rule of law. WLF has a longstanding interest in the work of the Commission, especially as it relates to several of WLF's comprehensive goals. These include protecting the stock markets from improper manipulation; protecting investors, pensioners, employees, and consumers from stock losses caused by frivolous securities and class-action litigation; reining in abusive practices of the plaintiffs' bar with respect to the securities industry; and restoring investor confidence in the financial markets through regulatory and judicial reforms. We believe SEC is best able to achieve these goals when it eschews regulations—such as the Pay-Ratio Disclosure Rule—that have nothing to do with maintaining the integrity of financial markets.

To that end, WLF has filed a number of comments with the Commission on matters of significant public interest. For example, on January 10, 2014, WLF filed comments in File No. 4-670 on issues raised at the Proxy Advisory Services Roundtable. On May 27, 2011, WLF submitted comments in File No. S7-12-11 on proposed rules for implementing the Enhanced Compensation Structure reporting requirements of Section 956 of The Dodd-Frank Wall Street Reform and Consumer Protection Act. Most recently, on March 17, 2017, WLF filed comments urging SEC to drastically alter or abolish altogether its Conflict Minerals Rule enacted under Section 1502 of the Dodd-Frank Wall Street Reform and Consumer Protection Act.

WLF also frequently appears as *amicus curiae* before federal courts in cases involving securities litigation. *See, e.g.*, *Kokesh v. SEC*, No. 16-529 (U.S. Sup. Ct., dec. pending); *Timbervest LLC v. SEC*, No. 15-1416 (D.C. Cir., dec. pending); *Morrison v. Nat'l Australia Bank Ltd.*, 130 S. Ct. 2869 (2010).

Similarly, WLF's Legal Studies Division, the publishing arm of WLF, produces and distributes timely publications on securities regulations and the SEC. Some of WLF's most recently published works in this area include: Andrew J. Morris, *Is the Clock Running out on SEC's Unchecked Pursuit of Disgorgement Penalties?* (WLF Legal Backgrounder, March 10, 2017); Lawrence S. Ebner, *Unconstitutionally Appointed Administrative Law Judges Continue to Haunt SEC* (WLF Legal Backgrounder, February 24, 2017); and Daniel M. Gallagher, *Shareholder Proposals: An Exit Strategy for the SEC* (WLF Working Paper, September, 2015).

II. Overview of the Pay-Ratio Disclosure Rule

The Commission adopted its Pay-Ratio Disclosure Rule in August 2015, implementing § 953(b) of the Dodd-Frank Wall Street Reform and Consumer Protection Act. As finalized on August 5, 2015, the rule requires a public company to disclose the "ratio of the median of the annual total compensation of all employees to the annual total compensation of the chief executive officer." Although Congress did not articulate any specific objective or intended benefit of such a rule, the Commission has expressed its view that the purpose of the rule is to provide shareholders and investors with evaluative information about "executive compensation practices" and overall company efficiencies. *See* Pay Ratio Disclosure, 80 Fed. Reg. at 50107. The Commission delayed rule compliance for regulated companies until their first fiscal year beginning on or after January 1, 2017.

III. The Pay-Ratio Disclosure Rule Provides No Material Information or Benefit to Investors

The SEC's stated mission is "to protect investors, maintain fair, orderly, and efficient markets, and facilitate capital formation."[1] Because the Pay-Ratio Disclosure Rule has no connection to SEC's mission of ensuring the integrity of the financial markets, the rule provides no material benefit to shareholders or potential investors. Indeed, *no* substantive body of literature links the financial risks assumed by a publicly traded company with the ratio of the median of the annual total compensation of all employees to the annual total compensation of the company's CEO. After all, if no proper incentive for financial risk-taking exists, the risk-index of a company is unlikely to differ regardless whether the CEO makes 10, 100, or 1,000 times more than the median annual salary of all employees.

CEO pay is not the primary driver of income inequality. Studies have consistently concluded that CEO pay is, unsurprisingly, strongly correlated with the company's size and complexity (in terms of revenues and numbers of employees) as well as its performance (revenue growth and profitability). *See, e.g.,* Steven N. Kaplan, "CEO Pay and Corporate Governance in the US: Perceptions, Facts, and Challenges," 25 J. OF APPLIED CORP. FIN. 2, 8-24 (2013). The larger and more profitable a company is, the more its CEO is paid. *Ibid.* A recent study by Ike Brannon of Capital Policy Analytics shows that "earnings growth (whether earnings per share, net income, or operating income) has the highest correlation to shareholder value across industries." Ike Brannon,

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[1] *See* https://www.sec.gov/Article/whatwedo.html

Capital Policy Analytics, "The Egregious Costs of the SEC's Pay-Ratio Disclosure Regulation," Center for Capital Markets Competitiveness (May 2014). Of course, that is precisely what one would expect in a free-market economy where executive pay is determined by the demand for and supply of highly sought-after managerial talent.

Nor are executive compensation packages significant when compared to other more relevant indicators of a company's overall financial health. Even the largest compensation packages represent only a small fraction of a company's total revenue. As researchers Ira T. Kay and Steven Van Putten found in their sample study of 1,398 American corporations, total CEO pay "was just 0.09 percent of sales, 0.06 percent of market capitalization, and 1.3 percent of net income for the companies." Ira T. Kay and Steven Van Putten, "Executive Pay: Regulation vs. Market Competition," Cato Institute, Policy Analysis No. 619 (Sep. 10, 2008). Kay and Van Putten's study went on to conclude that corporate compensation committees endeavor to "continuously balance two goals: retaining and motivating their executive team and minimizing company costs." *Id.* at 10.

At bottom, the Pay-Ratio Disclosure Rule lacks any investor-protection justification and is nothing more than a thinly veiled attempt to "name and shame" public companies for their CEO's pay. Such a highly controversial and politicized rule strays far outside SEC's core mission of providing investors with useful information for making important investment decisions. Because the Pay-Ratio Disclosure Rule seeks to advance a naked political agenda rather than provide meaningful disclosures to investors, it should be withdrawn entirely.

IV. The Pay-Ratio Disclosure Rule Raises Significant First Amendment Concerns

WLF has consistently opposed regulatory efforts to compel commercial speakers to convey controversial messages with which they disagree. WLF believes that, in crafting both its proposed and final rulemakings for the Pay-Ratio Disclosure Rule, SEC failed even to consider relevant First Amendment standards. Indeed, notwithstanding that the rule fundamentally impacts free-speech rights under the Constitution—by compelling speech against the speaker's will—SEC has not taken the First Amendment into account in justifying its new regulation.

The U.S. Supreme Court has long recognized that the First Amendment, subject only to very narrow and well-understood exceptions, guarantees "both the right to speak freely and the right to refrain from speaking at all." *Wooley v.*

Maynard, 430 U.S. 705, 714 (1977). The right not to speak extends to statements of fact as well as statements of opinion, *see Riley v. Nat'l Fed. of the Blind*, 487 U.S. 781, 797-98 (1988), and to corporations as well as to individuals, *see Pacific Gas & Elec. Co. v. Public Utils. Comm'n of Cal.*, 475 U.S. 1, 12 (1986) ("For corporations as for individuals, the choice to speak includes the choice of what not to say."). These well-established restrictions on the government's ability to compel speech apply with equal force to SEC regulations.

Indeed, the U.S. Court of Appeals for the D.C. Circuit recently held that SEC violated the First Amendment by seeking, as here, to compel the speech of regulated entities. *See, e.g., Nat'l Ass'n of Manufacturers v. S.E.C.*, 800 F.3d 518, 524 (D.C. Cir. 2015) (*NAM*). In that case, the court held that the relaxed standard of First Amendment review the Supreme Court articulated in *Zauderer v. Office of Disciplinary Counsel of Supreme Court of Ohio*, 471 U.S. 626 (1985), applies only to regulations of voluntary advertising or point-of-purchase product labeling. Because SEC's Conflict Minerals Rule, which required companies to disclose the use of minerals originating in and around the Democratic Republic of the Congo, was not directed at advertising or product labeling, the court in *NAM* held that SEC must satisfy a more exacting standard of First Amendment review. So too here.

Accordingly, the burden rests on SEC at all times to demonstrate an interest sufficient to justify its regulation of speech. At a minimum, the Supreme Court requires that the regulation must "directly advance" a "substantial government interest" and be "narrowly tailored" to achieve a reasonable "fit" between SEC's stated goals and the agency's means of achieving them. *Cent. Hudson Gas & Elec. Corp. v. Pub. Serv. Comm'n*, 447 U.S. 557 (1980). Under the *Central Hudson* test, a challenged regulation violates the First Amendment unless government regulators can show that (1) they have identified a substantial government interest, (2) the regulation "directly advances" the asserted interest, and (3) the regulation "is no more extensive than is necessary to serve that interest." *Id.* at 566. SEC's Pay-Ratio Disclosure Rule cannot possibly satisfy this test.

What is SEC's interest in requiring companies to disclose the ratio between a CEO's compensation and the median salary of its employees? According to a House report submitted by the Committee on Financial Services, "[t]he legislative history and the Dodd-Frank Act itself are both silent with respect to the purported purpose of the pay ratio rule," H.R. Rep. No. 114-504, at 2 (2016), and Congress held no hearings to discuss the rule prior to its enactment. Without any guidance by the government, we are left only to guess at its purported interest. Proponents of the rule suggest that the "gap" between

the CEO's salaries and employees' median salary has increased significantly in the past fifty years. The implication is that forcing companies to disclose a pay ratio will somehow shame companies into adjusting their rates of compensation to narrow this gap.

Even accepting the premise that this was SEC's reason for enacting the Pay-Ratio Disclosure Rule, it is not a substantial government interest because the gap between compensation levels for a public company's CEO and its median employee has little to no impact on SEC's stated mission of protecting investors, maintaining fair, orderly, and efficient markets, or facilitating capital formation. Simply put, SEC's statutory role is not to address income inequality. Nor can SEC satisfy its burden to prove that the Pay-Ratio Disclosure Rule is directly advances its purported goal, because SEC has presented no evidence that forcing companies to disclose such information has any impact on closing the pay gap, much less on furthering investor protection.

Accordingly, the Pay-Ratio Disclosure Rule cannot survive even the intermediate scrutiny required by *Central Hudson*. Without any valid government interest, and absent any evidence that the pay-ratio rule furthered that interest, SEC cannot possibly satisfy its burden under the First Amendment.

V. Conclusion

For the foregoing reasons, WLF encourages SEC to abandon its failed experiment of regulating in areas that are wholly divorced from maintaining the integrity of financial markets. Because the Pay-Ratio Disclosure Rule provides no material information or benefit to investors, and because it runs afoul of basic First Amendment tenets, the Commission should strongly consider withdrawing the rule in its entirety.

Respectfully submitted,

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