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Full Disclosure: Moving Beyond Disclosure Regulations to Affirmative Regulation of Executive Compensation

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FULL DISCLOSURE: MOVING BEYOND DISCLOSURE REGULATIONS TO AFFIRMATIVE REGULATION OF EXECUTIVE COMPENSATION

ABSTRACT

In the period following the financial crisis of 2008, Congress passed the Dodd-Frank Wall Street Reform and Consumer Protection Act (Dodd-Frank), which compelled the Securities and Exchange Commission (SEC) to engage in substantial rulemaking. The Dodd-Frank mandate in Section 953(b) required the SEC to promulgate a rule, which it eventually finalized and is currently known as Pay Ratio Disclosure. Historically, SEC rulemaking has received great deference when rules are judicially challenged. However, following the passage of Dodd-Frank, the D.C. Circuit Court of Appeals has begun to grant less deference to SEC rulemaking where it has found that the SEC has not engaged in a proper cost-benefit analysis, and subsequently has invalidated a number of SEC rules. The Pay Ratio Disclosure requires publicly held companies to file: (1) the median of the annual total compensation of all the employees employed by the publicly held company, or registrant; (2) the annual total compensation of the registrant's Chief Executive Officer (CEO), or equivalent executive officer; and (3) in ratio form, the amount of the CEO compensation to the median employee pay. Since the Pay Ratio Disclosure's first proposal it has been met with criticism from both business organizations who have previously challenged other SEC rulemakings, as well as Republican members of Congress and Republican Commissioners of the SEC. This Note argues that Pay Ratio Disclosure, due to its burdensome compliance costs coupled with its lack of tangible benefits, should be invalidated. Further, this Note recommends that in place of Pay Ratio Disclosure, Congress should direct the SEC to promulgate a rule subjecting CEOs of publicly held companies to a soft pay cap.

INTRODUCTION

"*The nine most terrifying words in the English language are: I'm from the Government, and I'm here to help.*"[1]

Five years after President Obama signed the Dodd-Frank Wall Street Reform and Consumer Protection Act (Dodd-Frank) into law, the Securities and Exchange Commission (SEC) finalized and adopted,[2] pursuant to Section

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1. Ronald Reagan, President, *The President's News Conference*, THE AM. PRESIDENCY PROJECT (Aug. 12, 1986), http://www.presidency.ucsb.edu/ws/?pid=37733.

2. The SEC adopted the Pay Ratio Disclosure, by a three to two vote. SEC Chair, Mary Jo White and Commissioners, Luis A. Aguilar and Kara Stein, voted in favor of the Pay Ratio Disclosure, while Republican Commissioners, Michael Piwowar and Daniel Gallagher, dissented. *See* Brian J. Lane et. al., *SEC Adopts Final CEO Pay Ratio Disclosure Rules*, GIBSON DUNN (Aug.

953(b), what has become known as the Pay Ratio Disclosure (the Rule).[3] Section 953(b) of Dodd-Frank directed the SEC to adopt amendments to Item 402 of Regulation S-K to implement Section 953(b).[4] Pursuant to Section 953(b), the SEC was required to establish a rule that mandated publicly held companies to file: (1) the median of the annual total compensation of all the employees employed by the publicly held company, or registrant; (2) the annual total compensation of the registrant's Chief Executive Officer (CEO), or equivalent executive officer; and (3) in ratio form, the amount of the CEO compensation to the median employee pay.[5]

Following the Congressional mandate, the SEC developed the Pay Ratio Disclosure to implement Section 953(b).[6] The Pay Ratio Disclosure operates in two ways: (1) it implements Section 953(b) by requiring publicly held companies to file with the SEC the three components of Section 953(b);[7] and (2) it provides guidance to the registrant companies regarding compliance with the Rule.[8] The SEC, in its public release adopting the Pay Ratio Disclosure, stated that the Rule was "intended to provide shareholders with a company-specific metric that can assist in their evaluation of a registrant's executive compensation practice."[9] Thus, the intent of the Pay Ratio Disclosure was to provide "a complement to other executive compensation rules . . . that promote corporate accountability and enhance the information available to investors . . . in a manner that is reasonable and workable for issuers, while still providing for increased transparency and greater accountability in executive compensation matters."[10]

However, no matter how eloquently phrased and beneficial the Pay Ratio Disclosure was designed to be, there was at the time of proposal, and continues to be following its finalization, substantial pushback, particularly from Republicans in Congress, Republican SEC Commissioners, and business organizations, who have successfully challenged other SEC

6, 2015), http://www.gibsondunn.com/publications/Documents/SEC-Adopts-Final-CEO-Pay-Ratio-Disclosure-Rules.pdf; *see also* Kevin McCoy, *SEC Approves 'Pay Ratio' Disclosure for CEOs,* USA TODAY (Aug. 7, 2015, 3:58 PM), http://www.usatoday.com/story/money/2015/08/05/sec-pay-ratio-disclosure-vote/31112725/.

3. Dodd-Frank Wall Street Reform and Consumer Protection Act (Dodd-Frank), Pub L. No. 111-203, § 953(b), 124 Stat. 1376 (2010) (codified as amended at 15 U.S.C. § 78n (2012)); *see also* Pay Ratio Disclosure, Securities Act Release No. 9877, Exchange Act Release No. 75,610, 80 Fed. Reg. 50,104, 50,184–86 (Aug. 18, 2015) (codified at 17 C.F.R. pts. 229, 240, 249).

4. Dodd-Frank, § 953(b), 15 U.S.C. § 78n.

5. Pay Ratio Disclosure, 80 Fed Reg. at 50,184.

6. *Id.*

7. *Id.*

8. *Id.*

9. *Id.*

10. Luis A. Aguilar, Comm'r, Sec. & Exch. Comm'n, Public Statement, The CEO Pay Ratio Disclosure: A Workable Solution For Both Issuers and Investors (Aug. 5, 2015), http://www.sec.gov/news/statement/statement-on-open-meeting-on-pay-ratio-aguilar.html.

rulemakings in the past.[11] Indeed, "[no] corporate governance issue captures the imagination and frustration of the American public and politicians more than executive compensation."[12] The Pay Ratio Disclosure has proven to be no exception to this concept,[13] as former SEC Commissioner Luis A. Aguilar noted: "[t]he Congressional mandate under Section 953(b) has proven to be one of the most controversial rules that the Commission has been required to undertake under the Dodd-Frank Act."[14]

The Pay Ratio Disclosure is greatly controversial in the political arena.[15] More specifically, there is a partisan split between special interest groups,[16] that seek to use the federal government to regulate executive compensation, and those who feel that, for various reasons, corporate governance should be left to state law.[17] Both the Pay Ratio Disclosure and the SEC have come under intense criticism, as some have commented that the Rule purports to do nothing more than "name and shame"[18] the highest executives of publicly

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11. *See* Donald Kalfen, *SEC Issues Final Rule on CEO Pay Ratio*, MERIDIAN COMPENSATION PARTNERS LLC (Aug. 17, 2015), https://www.meridiancp.com/insights/news/sec-issues-final-rule-on-ceo-pay-ratio-2/ (noting that since the adoption of the finalized Pay Ratio Disclosure there has been "withering criticism" from business organizations, Republicans in Congress, and Republican SEC Commissioners); *see also* Michael S. Piwowar, Comm'r, Sec. & Exch. Comm'n, Dissenting Statement at Open Meeting on Pay Ratio Disclosure (Aug. 5, 2015), http://www.sec.gov/news/statement/dissenting-statement-at-open-meeting-on-pay-ratio-disclosure.html; Daniel M. Gallagher, Comm'r, Sec. & Exch. Comm'n, Dissenting Statement at an Open Meeting to Adopt the "Pay Ratio Disclosure" (Aug. 5, 2015), http://www.sec.gov/news/statement/dissenting-statement-at-open-meeting-to-adopt-the-pay-ratio-rule.html; The Warren Commission, *An SEC Rule on CEO Pay Designed as a Political Weapon,* WALL ST. J. (Aug. 5, 2015, 6:41 PM), http://www.wsj.com/articles/the-warren-commission-1438814488?cb=logged0.9143685468006879 (stating "[w]e have here the perfect progressive policy. Possibly wasteful and irrelevant, but to the extent it affects the behavior of corporate executives, it provides an incentive not to hire the people its sponsors claim to be helping"); Katie Johnston, *New Rule Could Fuel Debate Over CEO Pay*, BOS. GLOBE (Aug. 5, 2015), https://www.bostonglobe.com/business/2015/08/05/how-much-more-does-ceo-make-you-may-find-out/Vl5Bz6T3k3jgJNba7gzJAK/story.html ("[Pay Ratio] will impose on companies and their shareholders an extremely costly and burdensome requirement, and compel companies to disclose immaterial, if not misleading, information." (quoting Mike Ryan, Vice President of Corp. Governance, Business Roundtable)).

12. Omari Scott Simmons, *Taking the Blue Pill: The Imponderable Impact of Executive Compensation Reform*, 62 SMU L. REV. 299, 302 (2009).

13. *See generally* GARY SHORTER, CONGRESSIONAL RESEARCH SERVICE, THE "PAY RATIO PROVISION" IN THE DODD-FRANK ACT: LEGISLATION TO REPEAL IT IN THE 113TH CONGRESS 21 (2013), https://fas.org/sgp/crs/misc/R43262.pdf; *see also* Piwowar, *supra* note 11.

14. Aguilar, *supra* note 10.

15. Piwowar, *supra* note 11; *see also* Gallagher, *supra* note 11; The Warren Commission, *supra* note 11.

16. The AFL-CIO represents one of the largest voices in support of the Pay Ratio Disclosure. *See* Gallagher, *supra* note 11; *see also* Letter from Brandon J. Rees, Acting Dir., Office of Inv. for the Am. Fed'n of Labor & Cong. of Indus. Org. to Elizabeth M. Murphy, Sec'y, Sec. & Exch. Comm'n (Dec. 2, 2013) (supporting the proposed Pay Ratio Disclosure).

17. *See generally* Jill E. Fisch, *Leave it to Delaware: Why Congress Should Stay Out Of Corporate Governance*, 37 DEL. J. CORP. L. 731 (2013).

18. Piwowar, *supra* note 11. The SEC received countless comments following its initial proposal of the Pay Ratio Disclosure, and further, media sources which will be discussed in greater depth below have adopted the term "name and shame" or more simply, "corporate shaming." *Id.* This Note asserts in Sections II and V that this criticism is valid.

held companies, in an effort to force these companies to reign in executive compensation. Critics further argue that the Pay Ratio Disclosure provides no substantive value to the shareholders it purports to aid.

Moreover, marking a sea change from the traditional deference courts gave agency rulemaking under *Chevron U.S.A., Inc. v. Natural Resources Defense Council Inc.*, the D.C. Circuit has invalidated a number of SEC rules, where, in the Court's view, the SEC failed to adequately consider the statutory and economic consequences of the proposed regulation.[19] The enactment of the Pay Ratio Disclosure, coupled with its lack of tangible benefits and the D.C. Circuit's cost-benefit standard, leaves the Pay Ratio Disclosure ripe for invalidation. Finally, the SEC has been criticized for its timing in finalizing the Pay Ratio Disclosure, as Congress did not impose a deadline upon the SEC to furnish the rule as it did with many other mandates pursuant to Dodd-Frank.[20]

This Note argues that the SEC's Pay Ratio Disclosure should not survive judicial scrutiny under the requisite cost-benefit analysis standard employed by the D.C. Circuit. This Note further recommends that Congress repeal Section 953(b) of Dodd-Frank and direct the SEC to promulgate a new rule that employs the use of a soft pay cap to better combat excessive executive compensation. A soft pay cap would require the SEC to annually set a numerical percentage that restricts a company from compensating the CEO above the set percentage. Unlike a strict pay cap, which sets a hard and fast absolute restriction on compensation, the soft cap would be contingent upon two factors: (1) the average net profit of the company over the previous three years and (2) the independent compensation committee's good faith prediction regarding the future business endeavors of the company. A soft pay cap thus results in a less costly endeavor than the Pay Ratio Disclosure, as it requires the use of readily available information while better confronting executive compensation issues and maintaining capital formation, competition, and efficiency.

Part I of this Note discusses in depth the complex provisions of the Pay Ratio Disclosure and the obligations it places upon publicly held companies. Part II argues that the Pay Ratio Disclosure does not accomplish its desired effect, but instead imposes burdensome costs on registrant companies, providing no tangible benefit to shareholders. Part III analyzes the D.C. Circuit's recent decisions where the Court has invalidated SEC rules for

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19. *See* Bus. Roundtable & Chamber of Commerce v. SEC, 647 F.3d 1144 (D.C. Cir. 2011). Additionally, the D.C. Circuit invalidated SEC rules on numerous other occasions leading up to *Business Roundtable*. This Note will analyze *Business Roundtable* and two similar court decisions in Section III.

20. Daniel M. Gallagher, Comm'r, Sec. & Exch. Comm'n, Dissenting Statement of Daniel M. Gallagher Concerning the Proposal of Rules to Implement the Section 953(b) Pay Ratio Disclosure Provision of the Dodd-Frank Act 2 (Sept. 18, 2013), https://www.sec.gov/News/PublicStmt/Detail/PublicStmt/1370542558873 [hereinafter Gallagher, Additional Dissenting Statement]; *see also* The Warren Commission, *supra* note 11.

failing to adequately consider the statutory and economic consequences. Part IV asserts that the Pay Ratio Disclosure should be legally challenged and, following the recent trend, similarly invalidated on the ground that the SEC did not adequately engage in a cost-benefit analysis or consider reasonable alternatives. Part V suggests that Congress repeal[21] Section 953(b) of Dodd-Frank and direct the SEC to promulgate a new rule implementing a soft pay cap with respect to executive compensation.[22] A soft pay cap achieves a similar result that the Pay Ratio Disclosure intended, but does so in a way that reduces compliance costs and provides tangible benefits, such that it would survive judicial review under a cost-benefit analysis.

Admittedly, arguing that the federal government should delve further into the traditional corporate governance sphere is likely to be unpopular. However, this Note asserts that, although the states have historically regulated corporate governance, it is well within Congress's enumerated powers to preempt state law in favor of its own regulatory ideals. In other words, Congress acts within its enumerated powers to announce such a rule, especially where state laws have not adequately solved the issue of excessive executive compensation.

I. PAY RATIO DISCLOSURE AND THE BACKDROP OF EXECUTIVE COMPENSATION

In 2008, the United States economy suffered "its most dangerous crisis since the Great Depression of the 1930s."[23] Indeed, between 2007 and 2009 the United States witnessed the loss of 8.8 million jobs and $19.2 trillion in household wealth.[24] By the end of 2008, major economies across the world found themselves engulfed in recession,[25] including the United States, where the housing market, some of the largest institutional bodies, and the automotive industry rapidly declined.[26] The origins of the financial crisis are rooted in substandard securities regulations, namely in the housing and

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21. Because the directive for the SEC to enact rules comes from Congress, Section 953 would need to be repealed and a new statute enacted with the new directive.

22. Representative Jeb Hensarling has introduced a bill in Congress that, among a vast array of other actions, would repeal Section 953(b) of Dodd-Frank, though it does not seek to replace this section with any further directives, as this Note asserts in Part V. *See* Financial CHOICE Act, H.R. 5983, 114th Cong. § 449 (2015). Another bill, which has, at the time of publication of this Note, passed in the House, will require the SEC to engage in a mandatory cost-benefit analysis prior to rulemaking. *See generally* SEC Regulatory Accountability Act, H.R. 79, 115th Cong. §2 (2016-2017).

23. Joel Haveman, *The Financial Crisis of 2008: Year in Review 2008,* ENCYCLOPEDIA BRITANNICA (Feb. 2, 2009), http://www.britannica.com/topic/Financial-Crisis-of-2008-The-1484264.

24. U.S. DEP'T OF THE TREASURY, THE FINANCIAL CRISIS RESPONSE IN CHARTS A1 (2012), https://www.treasury.gov/resource-center/data-chart-center/Documents/20120413_FinancialCrisisResponse.pdf.

25. *See* Haveman, *supra* note 23.

26. *Id.*

mortgage markets,[27] in conjunction with misleading credit rating references that triggered a number of unsound investments.[28]

Consequently, Dodd-Frank was signed into law on July 21, 2010, as a "response to the 2008-2009 financial crisis."[29] Section 953(b) of Dodd-Frank, commonly known as the Pay Ratio Disclosure, required the SEC to craft rules "necessary to implement a requirement that public company quarterly mandatory disclosures to the agency include the ratio between the total compensation of their chief executive officer (CEO) and all other employees."[30] On September 18, 2013, the SEC released its first proposal of the Pay Ratio Disclosure, which invited the public to comment.[31] The proposal was ultimately adopted as a final rule on August 5, 2015.[32] After receiving over 287,000 comment letters,[33] the SEC adopted changes in varying degrees, but noted that the final rule was generally consistent[34] with the original proposal.

The Pay Ratio Disclosure took effect on January 1, 2017,[35] and requires registrants (i.e., publicly held companies that are subject to compensation disclosure rules) to disclose, once every three years: (1) the median of the annual total compensation of all employees of the registrant; (2) the annual total compensation of the CEO, or any equivalent executive position; and (3) a ratio of the two amounts.[36] In determining the "median employee," companies are allowed to choose their own method, based upon their own circumstances. Registrant companies are entitled to make use of statistical sampling in determining a median.[37] Further, companies are allowed to adjust for employee cost of living (provided the company has employees living throughout the United States) using reasonable estimates to determine a

27. *Id.*

28. *See* The Warren Commission, *supra* note 11.

29. SHORTER, *supra* note 13.

30. *Id.*

31. *Id.*

32. Pay Ratio Disclosure, Securities Act Release No. 9877, Exchange Act Release No. 75,610, 80 Fed. Reg. 50,104, (Aug. 18, 2015) (codified at 17 C.F.R. pts. 229, 240, 249).

33. The SEC received 1,500 individual letters, the remaining balance were received as form letters. Aguilar, *supra* note 10. Importantly, it is unclear the exact number of letters in support of or against the Pay Ratio Disclosure, however, for reasons set forth in Section IV of this Note, the comment letters prove to be important when discussing issues regarding the adoption of the Pay Ratio Disclosure.

34. Pay Ratio Disclosure, 80 Fed. Reg. at 50,110.

35. *Id.*; Michael S. Piwowar, Comm'r, Sec. & Exch. Comm'n, Reconsideration of Pay Ratio Rule Implementation 1 (Feb. 6, 2017) (stating "that some issuers have begun to encounter unanticipated compliance difficulties that may hinder them in meeting the reporting deadline" and granting a forty-five day comment period for issuers. Based on the comments received, Commissioner Piwowar further directed the staff to reconsider the implementation of Pay Ratio Disclosure entirely, which comports with the suggestion of this Note).

36. Press Release, Sec. & Exch. Comm'n, SEC Adopts Rule for Pay Ratio Disclosure (Aug. 5, 2015), http://www.sec.gov/news/pressrelease/2015-160.html.

37. *Id.*

statistical numerical.[38] The Rule requires descriptions of the registrant company's CEO and employee median compensation in "registration statements, proxy and information statements, and annual reports that must already include executive compensation information as set forth under Item 402 of Regulation S-K."[39]

Additionally, the Rule requires companies, in a brief description, to disclose the methodology employed in calculating the "median employee" income.[40] Lastly, certain employees are exempt from the median employee calculation.[41] Registrant companies may invoke a *de minimis* exception consisting of up to 5% of non-U.S. employees, and individuals employed by unaffiliated third parties or independent contractors are not considered company employees.[42] The stated purpose of the Pay Ratio Disclosure, as announced by the SEC, is to "provide shareholders with a company-specific metric that can assist in their evaluation of a registrant's executive compensation practice."[43] As discussed in the following section, issues arise because of an evident disparity between the theoretical and practical effects of placing these obligations upon registrant companies.

II. THE CONSEQUENCES OF PAY RATIO DISCLOSURE

As noted above, the Pay Ratio Disclosure is intended to promote a better understanding of the pay schemes at a specific registrant company over the course of a three-year cycle.[44] Section 951 of Dodd-Frank[45] requires an independent compensation board to propose a compensation package through proxy materials to shareholders, who then vote on proposed compensation (say-on-pay votes).[46] The mandates of the Pay Ratio Disclosure, when taken together with Section 951 give the appearance of strengthened shareholder authority, though in practice this is misleading. Importantly, while Section 951 requires a say-on-pay vote on the CEO's compensation, it is merely advisory and non-binding on the board.[47] Indeed, as critics of the Pay Ratio Disclosure have commented, since the say-on-pay-votes are not binding on the board, it is speculative at best to find a link between the Pay Ratio Disclosure and potential changes in CEO

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38. *Id.*
39. *Id.*
40. *Id.*
41. *See id.*
42. *Id.*
43. Pay Ratio Disclosure, Securities Act Release No. 9877, Exchange Act Release No. 75,610, 80 Fed. Reg. 50,104, 50,105 (Aug. 18, 2015) (codified at 17 C.F.R. pts. 229, 240, 249).
44. *See id*. at 14 (noting that companies are only required to file the CEO compensation, median employee compensation, and ratio of the two every three years).
45. Dodd-Frank, Pub L. No. 111-203, §951, 124 Stat. 1376 (2010) (codified as amended at 15 U.S.C. § 78n-1 (2012)).
46. *Id.* § 952.
47. *Id.* § 951; *see also* Ciara Torres-Spelliscy, *Corporate Democracy From Say on Pay to Say on Politics,* 30 CONST. COMMENT. 431, 440 (2015).

compensation.[48] Commentators in support of say-on pay and the Pay Ratio Disclosure often cite studies showing shareholder approval in nearly ninety-nine percent of say-on-pay votes since the implementation of say-on-pay rules.[49] Although there have been isolated occurrences of shareholders voting down a compensation package, it has generally occurred from a vote by a major institutional body.[50]

Another difficultly in recognizing the "complementary" effect that the Pay Ratio Disclosure provides to existing corporate disclosure regulations arises when one views the shortcomings of say-on-pay. This is best done by way of example. Under Delaware law,[51] shareholders generally have the right to vote on the election of directors to the board at the annual stockholder meeting.[52] Similar to the say-on-pay voting, issues arise regarding shareholder votes in two ways: (1) directors often nominate themselves for re-election to the board, and as a result the slate from which shareholders are entitled to vote is determined by the directors;[53] and (2) even on the occasion that a director is not voted to the board, resulting in a vacancy, in theory the directors could then appoint that very same director, with protection under the business judgment rule, or another director that is even better aligned with the ideologies of the existing directors.[54]

Essentially, while stockholders may think their votes have an effect on executive compensation packages (and admittedly, in certain circumstances, they may),[55] directors are under no obligation to abide by the say-on-pay votes and, furthermore, directors are protected by a very high legal standard—gross negligence—under the business judgment rule[56] when they choose not to follow the recommendations or shareholder votes. Thus, the Pay Ratio Disclosure only furthers the illusion that providing company data

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48. *See* Piwowar, *supra* note 11.

49. Torres-Spelliscy, *supra* note 47.

50. *See id.*

51. *See id.* at 434 (noting Delaware's "prominent role in American Corporate Law . . . [n]early half of all public corporations in the United States are incorporated in Delaware").

52. DEL. CODE ANN. tit. 8 §§ 141, 211, 212 (2015).

53. Piwowar, *supra* note 11.

54. *See* Emerald Partners v. Berlin, 787 A.2d 85, 90 (Del. 2001) (noting under the business judgment rule, gross negligence is the requisite standard for a shareholder to succeed on behalf of the corporation in a derivative suit).

55. For example, a company that is especially conscious of how the public perceives its business conduct *may* elect to listen more closely to the shareholder vote, although the company is under no obligation to do so. However, companies that are publicly traded, but generally lack the same exposure to the public and media, may be less inclined to follow the recommendations of the shareholders, especially where the directors are shielded under the business judgment rule. *See generally* Gretchen Morgenson, *Shareholders' Votes Have Done Little to Curb Lavish Executive Pay*, N.Y. TIMES (May 16, 2015), https://www.nytimes.com/2015/05/17/business/shareholders-votes-have-done-little-to-curb-lavish-executive-pay.html?_r=1 (describing how shareholder dissents of forty percent or greater at major publicly held companies have been ineffective in altering executive compensation packages).

56. *Emerald Partners*, 787 A.2d at 90.

points to shareholders is effective, as directors may not even address these non-binding votes.

The two issues of advisory voting by shareholders and the high legal standard to overcome the business judgment rule highlight the ineffectiveness of the Pay Ratio Disclosure, when viewed in conjunction with say-on-pay votes. On one hand, it may be argued that, because shareholder approval has been consistently high for CEO compensation, the shareholders actually do approve of the compensation. On the other hand, the more realistic answer is less optimistic. Since shareholders have an immense burden of proof in a derivative action,[57] simply getting past the pleading stage is a formidable and costly challenge. It requires a shareholder to mount enough support among other shareholders to fight what may be a losing battle, and in any case, to incur costly procedural expenditures. Thus, it seems more likely that shareholders approve CEO compensation because they lack a better alternative and there may be bigger battles to fight. Furthermore, the same cost prohibitive and advisory voting issues would arise should the shareholder elect not to bring a derivative action, but rather to attempt to create a second compensation committee to rebut the veracity of the company's independent compensation committee's compensation package. Again, the shareholders will have engaged in a costly endeavor to create another independent committee, the findings of which will be advisory and non-binding.

Moreover, it is unclear whether the independent committee is itself an effective mechanism to combat executive compensation.[58] On one hand, a legitimate argument may be made that compensation committees, acting in the best interest of the company, pay high compensation due to competition, which remains important for "executive recruitment and retention."[59] If companies must compensate CEOs with large compensation packages in order to recruit CEOs due to a competitive market, then it seems that the committees are justified in paying such high amounts.[60]

However, the argument against exuberant executive compensation is that the compensation system is broken; this highlights different issues. First and foremost, there is for the reasons addressed above, a prisoner's dilemma[61] in

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57. *In re* Citigroup, Inc., S'holder Derivative Litig., 964 A.2d 106, 125 (Del. Ch. 2009) (noting that it is difficult to rebut the presumption of the business judgment rule by a showing of gross negligence).

58. Section V of this Note deals with a solution that will overcome, or at least mitigate, many of these issues.

59. *See generally* SHORTER, *supra* note 13.

60. For example, in 2014, Timothy D. Cook of Apple was paid $9.2 million, Jamie Dimon of JPMorgan Chase made $20 million, Howard Schultz of Starbucks made $21.5 million, and Phillipe Dauman received $44.3 million. *See* Andrew Ross Sorkin, *S.E.C. Has Yet to Set Rules on Tricky Pay Ratio of C.E.O.'s Pay to Workers*, N.Y. TIMES (Jan. 26, 2015, 8:17 PM), https://dealbook.nytimes.com/2015/01/26/tricky-ratio-of-chief-executives-pay-to-workers/.

61. "The prisoners' dilemma is the best-known game of strategy in social science. It helps us understand what governs the balance between cooperation and competition in business, in politics,

that, even if compensation committees resigned themselves to restricting executive compensation, another compensation committee may not do so, even if it was collectively in the best interest of corporate governance. Because it is possible for a single holdout compensation committee to retain for itself the best possible CEO in its respective industry by offering him or her more money, the collective fear of losing out prevents internal corporate cooperation. This dilemma makes it detrimental for one compensation committee to attempt to better align its corporate compensation with the wishes of shareholders or special interest groups that believe the CEO is being overcompensated.

Further, pursuant to Section 952 of Dodd-Frank,[62] compensation committees must be independent,[63] that is, "each member of the compensation committee of the board of directors of an issuer [must] be a member of the board of directors of the issuer; and independent."[64] In other words, the compensation committee naturally incorporates the board of directors, who are tasked with seeking independent consultants, to reach a fair compensation package.[65] The consultants that are brought in must be independent of the registrant company; they may not be affiliated with the registrant company, any of the registrant company's subsidiaries, or with any of the directors on the board.[66]

However, this requirement is misleading. The compensation committee and its consultants still need to be compensated by the company for their work. Moreover, it would stand to reason that if the consultants cut against the ideology of the board members who hire them, or act in ways that dissatisfy the board, then those consultants might be replaced in favor of other consultants who share similar ideologies as the CEO and board. Although this arguably guts the purpose of the compensation committee, it does not violate the Rule.[67] For example, if a shareholder were to dispute the selection of certain members to the compensation committee, the most logical response from the company would be that the members of the compensation committee *are* independent; the mere fact that the committee and its consultants share the same ideals as the entire board does not amount to gross negligence, nor should it. Thus, the compensation committee, for competitive, and perhaps more cynical, reasons, aligns itself with the board, more so than the shareholders, with the end result primarily being that an

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and in social settings." Avinash Dixit & Barry Nalebuff, *The Prisoners' Dilemma,* LIBR. OF ECON. & LIBERTY, http://www.econlib.org/library/Enc/PrisonersDilemma.html (last visited Jan. 29, 2017).

62. Dodd-Frank, Pub. L. No. 111-203, § 952, 124 Stat. 1376 (2010) (codified as amended at 15 U.S.C. § 78j-3 (2012)).

63. *Id.*

64. *Id.*

65. *Id.*

66. *Id.*

67. Listing Standards for Compensation Committees, 17 C.F.R. pts. 229, 240 (July 27, 2002).

independent compensation committee will not aid in restricting executive compensation.

Lastly, pursuant to Dodd-Frank, the compensation committee is under no obligation to adhere to the recommendations proffered by the consultants.[68] The odd result of this provision is that on the one hand, the board of directors does not trigger a violation by employing consultants that comport with their ideology. On the other hand, the board may shield itself from criticism by utilizing individuals that offer a more conservative compensation approach, which the compensation committee can disregard while still maintaining that consultants were sought for advice.

The costs of complying with the Pay Ratio Disclosure present one of the most highly contested issues surrounding the Rule. The estimated amount of compliance cost is $1.3 billion dollars in initial compliance for all registrant companies,[69] and ongoing costs of $526 million dollars.[70] The SEC estimated the cost of compliance at $1.3 billion in its public release of the finalized pay disclosure, asserting that per registrant the cost of compliance, especially in larger companies, may reach $368,159.[71] If the Pay Ratio Disclosure produced tangible benefits, perhaps this cost would be understandable, and quite possibly acceptable. However, the minimal tangible effect, in conjunction with the compliance costs, makes the Pay Ratio Disclosure untenable. Given that say-on-pay[72] provides less than desirable, and in fact illusory authority to shareholders, a rule like the Pay Ratio Disclosure, which provides company-specific metrics to shareholders to aid in an advisory vote, results in a glaring disconnect between burden and benefit to both the company and its shareholders. Thus, if say-on-pay produces inadequate results to restrict executive compensation, by logical extension the complementary Pay Ratio Disclosure is equally inadequate.

The Pay Ratio Disclosure, independent of its complimentary reliance upon say-on pay, is insufficient in achieving its own stated goals. The stated purpose of the Rule, as noted, was "to provide shareholders with a company-specific metric that can assist in their evaluation of a registrant's executive

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68. Dodd-Frank, § 952.

69. Piwowar, *supra* note 11; *see also* Pay Ratio Disclosure, Securities Act Release No. 9877, Exchange Act Release No. 75,610, 80 Fed. Reg. 50,104 (Aug. 18, 2015) (codified at 17 C.F.R. pts. 229, 240, 249). The SEC in its announcement of the finalized Pay Ratio Disclosure discusses various estimated costs of compliance. It does not come to a definite number, but generally agrees with the $1.3 billion estimate, equating to $368,159 per registrant. *See* IKE BRANNON, CTR. FOR CAPITAL MKTS., THE EGREGIOUS COSTS OF THE SEC'S PAY-RATIO DISCLOSURE REGULATION (2014), http://www.centerforcapitalmarkets.com/wp-content/uploads/2013/08/Egregious-Cost-of-Pay-Ratio.pdf.

70. Gallagher, *supra* note 11.

71. Pay Ratio Disclosure, 80 Fed. Reg. at 50,105.

72. Say-on-pay is the result of Section 951 of Dodd-Frank, requiring that a shareholder vote be given on executive compensation packages, that shareholders vote on the frequency of the compensation vote, and that shareholders authorize "golden parachute" provisions. Dodd-Frank, § 951.

compensation practice."[73] Indeed, a company-specific metric provides data to shareholders that is incomparable to any other publicly held company.[74] Thus, although shareholders may have the impression that their CEO is being overpaid, the pay ratio data fails to provide data points that helpfully ascertain appropriate compensation.

Moreover, based on how a company calculates the median income, scenarios arise where shareholders receive distorted depictions of the true ratio.[75] The SEC's inclusion of a *de minimis* exception, which excludes five percent of non-U.S. employees in the calculus of the median employee income, "[introduces] a non-scientific and uninstructed comparison that ignores the variances in the costs of labor, and the costs of living in widely disparate economies worldwide."[76] Additionally, former SEC Commissioner Daniel M. Gallagher asserted in his dissent to both the proposed and final Pay Ratio Disclosure that the SEC might be better served in constructing a rule that is narrowed to only U.S. employees.[77] Commissioner Gallagher reasoned that the proper course of action would have been to supplant the *de minimis* exception with a wholesale exception to employees outside the United States.[78] On one hand, Commissioner Gallagher asserts that this would result in savings of approximately $788 million in compliance costs;[79] however, there is a necessary trade-off.

Despite the fact that, in Commissioner Gallagher's opinion, "[the SEC] already provide[s] a wealth of good comparable data to investors about executive pay,"[80] removing non-U.S. employees from the calculus would have detrimental consequences. For example, if non-U.S. employees do not count towards the ratio, there would be little to stop the CEO or corporate boards from allocating all of their domestic employees abroad.[81] Effectively, in one fell swoop, the ratio would be destroyed. Or worse, a company could re-allocate all of its employees, excluding the top ten percent of highest paid employees, so as to reflect a much closer, albeit deceptive, ratio. The end result presents less than desirable outcomes from both perspectives and underscores the ineffectiveness of the Pay Ratio Disclosure. Either

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73. Pay Ratio Disclosure, 80 Fed. Reg. at 50,105.

74. Gallagher, *supra* note 11, at 3 (noting that pay ratio data is "low quality, non-comparable data of use only to certain investors who has idiosyncratic reasons for wanting it").

75. Michael S. Piwowar, Comm'r, Sec. & Exch. Comm'n, Additional Dissenting Statement at Open Meeting on Pay Ratio Disclosure 3–7 (Aug. 7, 2015), https://www.sec.gov/news/statement/additional-dissenting-statement-on-pay-ratio-disclosure.html [hereinafter Piwowar, Additional Dissenting Statement]; *see also* Gallagher, *supra* note 11.

76. Gallagher, Additional Dissenting Statement, *supra* note 20.

77. Gallagher, *supra* note 11; Gallagher, Additional Dissenting Statement, *supra* note 20

78. Gallagher, *supra* note 11; Gallagher, Additional Dissenting Statement, *supra* note 20.

79. Gallagher, *supra* note 11.

80. *Id.*

81. Ike Brannon & Sam Batkins, *The Meaninglessness of the SEC Pay Disclosure Rule,* REGULATION, Spring 2014, at 9, 10, https://object.cato.org/sites/cato.org/files/serials/files/regulation/2014/4/v37n1-11_1.pdf#page=6.

companies must pay an additional $788 million in compliance costs to incorporate what is at best an arbitrary *de minimis* exclusion,[82] which ultimately can be manipulated,[83] or pay substantially less money and receive numbers that still have the potential of being massively manipulated.[84] As this Note suggests, rather than attempt to amend the Pay Ratio Disclosure in piecemeal fashion, resolving the issue of excessive executive compensation would be best achieved by supplanting the Pay Ratio Disclosure with a soft pay cap.

The SEC and Congress have been further criticized for implementing the Pay Ratio Disclosure as a deceptive political mechanism designed to appease progressives.[85] Pay Ratio Disclosure provides a shield to the SEC behind which the federal government has been able to indirectly involve itself in regulating the inner sanctum of corporate governance. The Pay Ratio Disclosure appears on its face to be purely a disclosure rule. However, the effect of say-on pay, in conjunction with Section 952 and the Pay Ratio Disclosure, reflects an outcome where shareholders are given illusory authority, easily overcome by the registrant company. However, pursuant to the Pay Ratio Disclosure, the information must still be filed with the SEC.[86] Thus, because the financial data is brought to public light, Congress and the SEC intended to "name and blame" corporations into self-adjusting pay to conform to a more agreeable social standard, rather than to actually supply useful information intended to inform shareholders.[87]

On one hand, Congress and the SEC, through this strategy, seek to remedy what has often been a popular notion that corporate executives are overcompensated, and the facts concerning the large pay disparity between corporate executives and the employees who work for them.[88] However, this also seems like a furtive approach for two reasons: (1) it has the effect of shifting the burden of pressuring these perceived powerhouse boards into lowering the CEO compensation onto people who lack the real authority to enforce such a change; and (2) it becomes somewhat of an irony that the

82. Piwowar, Additional Dissenting Statement, *supra* note 75.

83. *Id.*

84. *See infra* Part V.

85. *See* The Warren Commission, *supra* note 11.

86. Pay Ratio Disclosure, Securities Act Release No. 9877, Exchange Act Release No. 75,610, 80 Fed. Reg. 50,104, 50,105 (Aug. 18, 2015) (codified at 17 C.F.R. pts. 229, 240, 249); *see also* Letter from Alexander M. Cutler, Chair, Corp. Governance Comm., Bus. Roundtable to The Honorable Elizabeth M. Murphy, Sec'y, Sec. & Exch. Comm'n 3 (Dec. 2, 2013), https://www.sec.gov/comments/s7-07-13/s70713-565.pdf (requesting an amendment to the Pay Ratio Disclosure, in that the material be considered "furnished" rather than filed").

87. Piwowar, *supra* note 11; *see also,* Brannon & Batkins, *supra* note 81; Gallagher, *supra* note 11; *see also* Peter Schoeder, *Disputed Rule Intended to Shame CEOs,* THE HILL (Feb. 2, 2012, 10:30 AM), http://thehill.com/business-a-lobbying/208161-disputed-rule-intended-to-shame-ceos.

88. *See* Steven C. Caywood, *Wasting the Corporate Waste Doctrine: How the Doctrine Can Provide a Viable Solution in Controlling Excessive Executive Compensation*, 109 MICH. L. REV. 111, 112–13 (2010).

regulator demands transparency from the corporations and attempts to accomplish that end by becoming opaque itself in providing an underhanded political mechanism, rather than announcing and instituting legislation that reveals its true intent.[89] As Commissioner Gallagher stated in his dissenting statement, with respect to the SEC:

> The goal is to convince the public that the Commission is doing all it can reasonably do to help issuers reduce costs – that is that the Commission is pushing at the sides of the box, while staying in its confines. But the Commission here is a mime; the box is imaginary.[90]

Thus Congress decided that, rather than take an affirmative step in regulating corporate compensation[91]—biting the bullet on an issue that would undoubtedly be highly partisan and open it to criticism—it would couch its underlying intention in behind rules centered on disclosure, with the hope that public backlash would solve the issue. In fact, this has resulted in a rule that likely will likely be invalidated under the cost-benefit analysis utilized by the D.C. Circuit,[92] and further does not actually remedy the issues surrounding executive compensation. Lastly, one might plausibly infer from the Pay Ratio Disclosure the social aim of restricting executive compensation as a means of achieving greater compensation parity with the common, everyday employee of the respective company. However, based upon the SEC's own stated goals, parity in compensation as between the executive and employee was never the intended result. Yet for the reasons stated above, a policy-based message serves the purpose with respect to Congress's attempt to reduce costs at the executive level in an attempt to prevent another financial crisis.

III. THE D.C. CIRCUIT AND COST-BENEFIT ANALYSIS

The D.C. Circuit's decision in *Business Roundtable v. SEC*[93] marked "the third time within the past six years that the D.C. Circuit struck down an SEC rulemaking for failure to adequately consider the statutory and economic impacts of proposed regulation."[94] Where the requirement for the SEC to adequately consider the statutory and economic impacts of proposed

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89. *See* Gallagher, *supra* note 11.

90. *Id.*

91. This Note argues in Section V that such an action is well within Congress's enumerated powers to do so, and furthermore, has successfully done so in other securities regulation areas.

92. *See generally* Chamber of Commerce v. SEC, 412 F.3d 133, 136 (D.C. Cir. 2005); Am. Equity Inv. Life Ins. Co. v. SEC, 613 F.3d 166, 171 (D.C. Cir. 2010); Bus. Roundtable & Chamber of Commerce v. SEC, 647 F.3d 1144 (D.C. Cir. 2011).

93. *Bus. Roundtable & Chamber of Commerce*, 647 F.3d at 1144.

94. Garrett F. Bishop & Michael A. Coffee, *A Tale of Two Commissions: A Compendium of the Cost-Benefit Analysis Requirements Faced by the SEC & CFTC,* 32 REV. BANKING & FIN. L. 565, 595 (2012).

regulation comes from is a source of debate in and of itself.[95] Some commentators assert that the obligation stems from the judicial power granted in Section 706 of the Administrative Procedure Act (APA) to invalidate rules where there is a finding that the rulemaking was "arbitrary and capricious, an abuse of discretion or otherwise not in accordance with the law."[96] SEC Commissioner Michael S. Piwowar further stated that, "[w]hen engaging in informal rulemaking, the Securities and Exchange Commission . . . must satisfy three procedural requirements under the Administrative Procedure Act . . . general notice of the proposed rulemaking, an opportunity for interested persons to participate in the rulemaking, and a concise statement of the basis and purpose of the rules adopted after consideration of the relevant matter presented."[97]

The D.C. Circuit began this trend in *Chamber of Commerce v. SEC*,[98] where the SEC was challenged on a finalized rule provision requiring that, in order to engage in actions otherwise prohibited by the Investment Company Act,[99] mutual funds had to have a board with no less than seventy-five percent independent directors and an independent chairman (the Mutual Fund Rule).[100] The D.C. Circuit held that "the Commission did violate the APA by failing adequately to consider the costs mutual funds would incur in order to comply with the conditions, and by failing adequately to consider a proposed alternative to the independent chairman condition."[101] In the Court's view, the most problematic aspect of the Mutual Fund Rule was that the SEC claimed that it was "without a reliable basis for determining how funds would choose to satisfy the [condition] and therefore it [was] difficult to determine the costs associated with electing independent directors."[102] Thus, the Court reasoned, "uncertainty may limit what the Commission can do, but it does not excuse the Commission from its statutory obligation to do what it can to apprise itself–and hence the public and the Congress–of the economic consequences of a proposed regulation before it decides whether to adopt the measure."[103] The general rule that flowed from this decision is that an SEC rulemaking cannot survive judicial scrutiny, nor can the SEC excuse itself from engaging in a real cost-benefit analysis, by simply stating it had "no reliable basis" for assessing the cost of its rules.[104]

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95. Donna M. Nagy, *The Costs of Mandatory Cost-Benefit Analysis in SEC Rulemaking*, 57 ARIZ. L. REV. 129, 133– 49 (2015).

96. 5 U.S.C. § 706(2)(A) (2012).

97. Piwowar, Additional Dissenting Statement, *supra* note 75, at 1.

98. Chamber of Commerce v. SEC, 412 F.3d 133, 133 (D.C. Cir. 2005).

99. *See generally* Investment Company Act of 1940, Pub. L. No. 76-768, 56 Stat. 798 (2012) (codified as amended at 15 U.S.C. § 80a (2012)).

100. *Chamber of Commerce*, 412 F.3d at 136.

101. *Id*.

102. *Id.* at 143.

103. *Id.* at 144.

104. *See* Bishop & Coffee, *supra* note 94, at 581.

The D.C. Circuit next invalidated an SEC rule in *American Equity Investment Life Insurance Co. v. SEC*.[105] In this case, a challenge was brought against SEC Rule 151A, which declared that a contract regulated as an annuity under state insurance law does not qualify as an "annuity contract" under the Securities Act,[106] effectively excluding fixed indexed annuities from being annuity contracts.[107] Here, the SEC argued that it was not required under the Securities Act to engage in a cost-benefit analysis.[108] The D.C. Circuit, however, thought differently and stated that the SEC's argument was flawed, because when the SEC issued the rule it conducted an analysis, and never stated it was not required to.[109] The Court then opined that the SEC must defend its analysis "on that basis it employed in adopting the analysis."[110]

Furthermore, the Court stated, "[t]he lack of clarity resulting from the 'uncertain legal status' of the financial product is only another way of saying that there was not a regulation in place prior to the adaptation of Rule 151A . . . [t]he SEC cannot justify the adoption of a particular rule based solely on the assertion that the existence of a rule provides greater clarity to an area that remained unclear."[111] Taken in conjunction with the *Chamber of Commerce* holding, the D.C. Circuit definitively held that the SEC cannot engage in arbitrary rulemaking and that the SEC must engage in a meaningful cost-benefit analysis to gauge whether a rule is in fact arbitrary. Thus, the SEC, in defending a legal challenge, cannot skirt these requirements by simply not engaging in a cost-benefit analysis and later arguing that they were under no obligation to do so.

In *Business Round Table v. SEC*,[112] the D.C. Circuit invalidated SEC Rule 14a, the "Proxy Access Rule,"[113] stating that the SEC did not appreciate the intensity with which issuers would oppose shareholder nominees.[114] According to the Court, the SEC had "no basis beyond mere speculation" when it concluded the rule would be cost effective,[115] had relied on insufficient empirical data,[116] had improperly discounted costs, did not

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105. *See generally* Am. Equity Inv. Life Ins. Co. v. SEC, 613 F.3d 166 (D.C. Cir. 2010).

106. *See generally* Securities Act of 1933, Pub. L. No. 73-22, 48 Stat. 74 (2012) (codified as amended at 15 U.S.C. § 77a (2012)).

107. *Am. Equity Inv. Life Ins. Co.*, 613 F.3d at 171–72; *see* Bishop & Coffee, *supra* note 94, at 582.

108. *Am. Equity Inv. Life Ins. Co.*, 613 F.3d at 171–72; *see* Bishop & Coffee, *supra* note 94, at 582.

109. *See* Chamber of Commerce v. SEC, 412 F.3d 133, 144 (D.C. Cir. 2005).

110. Bishop & Coffee, *supra* note 94, at 583.

111. *Am. Equity Inv. Life Ins. Co.*, 613 F.3d at 177.

112. *See generally* Bus. Roundtable & Chamber of Commerce v. SEC, 647 F.3d 1144 (D.C. Cir. 2011).

113. Bishop & Coffee, *supra* note 94, at 595–96.

114. *Id.* at 596.

115. *Id.* at 596–97.

116. *Id.*

properly gauge the effect on shareholders with special interests,[117] and was inconsistent in estimating the character of shareholder nominations.[118] Thus, the D.C. Circuit invalidated the Proxy Access Rule as arbitrary and capricious, and held that the SEC failed to engage in a proper cost-benefit analysis and failed to adequately consider the statutory and economic consequences of the proposed regulation.[119]

Lastly, in what may be considered a quasi-victory for the SEC, the D.C. Circuit, in *National Association of Manufacturers v. SEC*,[120] held that the SEC rule in question survived the cost-benefit judicial scrutiny.[121] Section 1502 of Dodd-Frank[122] directed the SEC to "issue regulations requiring firms using 'conflict minerals' to investigate and disclose the origins of those minerals."[123] The goal of the SEC "Conflict Minerals Rule"[124] at issue was to devise a congressional response to the Congo War,[125] where armed forces used the sale of minerals to finance their combat operations.[126]

The finalized Conflict Minerals Rule required a three-step analysis.[127] Step one required a firm to determine whether or not the rule pertained to that firm.[128] For example, the rule would not apply to those firms that did not require the minerals as "necessary to the production or functionality of their products."[129] The final rule also did not include a *de minimis* exception; thus firms that dealt with conflict materials, even in small amounts, were subject to the rule.[130] Step two required an issuer to "conduct a 'reasonable country of origin inquiry,'"[131] and step three required an issuer to "exercise due diligence on the source and chain of custody of its conflict materials."[132] If after performing due diligence (step two) an issuer still had reason to believe its conflict minerals originated in a country covered by the Conflicts Mineral Rule, it would then be required to file a Conflict Minerals Report, which would "describe both [the issuers] due diligence efforts, including a private

117. *Id.* at 598.

118. Am. Equity Inv. Life Ins. Co. v. SEC, 613 F.3d 166, 171 (D.C. Cir. 2010); *see* Bishop & Coffee, *supra* note 94, at 598.

119. *Am. Equity Inv. Life Ins. Co.*, 613 F.3d at 171; *see* Bishop & Coffee, *supra* note 94, at 597–98.

120. *See generally* Nat'l Ass'n of Mfrs. v SEC, 748 F.3d 359 (D.C. Cir. 2014).

121. *Id.*

122. Dodd-Frank, Pub. L. No. 111-203, § 1502, 124 Stat. 2213 (2010) (codified as amended at 15 U.S.C. § 78m (2012)).

123. *Nat'l Ass'n of Mfrs.*, 748 F.3d at 363 (citing 15 U.S.C. § 78m(p)(1)(A)).

124. *See* Conflict Minerals, 77 Fed. Reg. 56,274, 56,284–85 (Sept. 12, 2012) (codified at 17 CFR pts. 240, 249, 249(b)).

125. *Nat'l Ass'n of Mfrs.,* 748 F.3d at 363.

126. *Id.* at 362–63.

127. *Id.* at 363.

128. *Id.*

129. *Id.*

130. *Id.*

131. *Id.* at 363–64 (quoting Conflict Minerals, 77 Fed. Reg. 56,274, 56,311 (Sept. 12, 2012) (codified at 17 CFR pts. 240, 249, 249(b))).

132. *Id.* at 364 (quoting Conflict Minerals, 77 Fed. Reg. at 56,320).

sector audit and those products that have 'not been found to be DRC conflict free.'"[133]

A challenge was brought against the Conflict Mineral Rule, with the D.C. Circuit holding that "[t]he Commission did not act arbitrarily and capriciously by choosing not to include a *de minimis* exception,"[134] because the factual context provided to the Court highlighted that conflict minerals were ordinarily used in very small quantities.[135] Further, the Court held the due diligence requirement was not arbitrary and capricious,[136] because "the Commission wanted issuers who encounter red flags to 'learn[] the ultimate source of their conflict materials.'"[137] Thus, "a good faith inquiry does not resolve the Commission's concerns."[138] The Court further held that "[t]he Commission did not erroneously assume that its interpretation was compelled by Congress,"[139] and agreed with the SEC that the rule was "rational," because, insofar as the SEC is concerned, it seldom had been required to deal with such a task and could only be effectively responsible to know what it knows.[140] In other words, the SEC, from a cost-benefit perspective, did not have adequate data to quantify the costs associate with the rule.[141] Thus, the Court supported the Commission on its cost-side analysis,[142] holding that, with respect to the costs of compliance, "[t]he Commission exhaustively analyzed the final rule's costs."[143]

Although the SEC was able to overcome the cost-benefit analysis requirement in *National Association of Manufacturers*,[144] the Pay Ratio Disclosure presents distinctly different issues than did the Conflict Minerals Rule. The issue of executive compensation is surely rooted in the realm of socially desirable goals; however, the CEO executive compensation in a publically traded company, no matter how egregious that compensation is, pales in comparison to the issues the Conflict Minerals Rule sought to resolve. The Conflict Minerals Rule, if validated, had the potential, and indeed intention, to save the lives of human beings in the Congo, whereas the Pay Ratio Disclosure seeks only to provide for a more informed stockholder vote. Additionally, there is a distinct disparity between the required information in the Conflict Minerals Reports and the information the SEC

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133. *Id.* (citing Conflict Minerals, 77 Fed. Reg. at 56,322, 56,320; 15 U.S.C. § 78m(p)(1)(A)(ii) (2012)).
134. *Id.* at 366.
135. *Id.*
136. *Id.* at 367.
137. *Id.*
138. *Id.*
139. *Id.* at 368.
140. *Id.* at 368–69 (quoting Motor Vehicle Mfrs. Ass'n v. State Farm Mut. Auto. Ins. Co., 463 U.S. 29, 43 (1983)).
141. *Id.* at 369.
142. *Id.* at 369.
143. *Id.*
144. *Id.*

requires in its Pay Ratio Disclosures.[145] Finally, unlike the conflict minerals issue, rulemaking surrounding executive compensation as it relates to registrant companies is an area in which the SEC certainly can be said to have expertise in regulating and, thus, a more stringent cost-benefit analysis should be required.

IV. COST-BENEFIT ANALYSIS OF THE PAY RATIO DISCLOSURE

Given the recent trend in the D.C. Circuit, should the Pay Ratio Disclosure be challenged it likely would not survive judicial scrutiny. In the SEC's release of the finalized Pay Ratio Disclosure, the SEC stated, "Congress did not expressly state the specific objectives or intended benefits of Section 953(b), and the legislative history of the Dodd-Frank Act also does not expressly state the Congressional purpose underlying Section 953(b)."[146] The SEC, in announcing the proposed Pay Ratio Disclosure, "failed to identify any objective goal, or benefit that the Commission believed the rulemaking was intended to accomplish."[147] Further, Commissioner Piwowar notes that, "[r]ather than stating [the Commission's] thinking on Section 953(b)'s objectives, the Proposing Release merely obliquely indicated that [the Commission's] proposal was intended to achieve 'what [they] believe to be the potential benefits . . . .'"[148]

Additionally, criticisms have been levied, with SEC Commissioners Piwowar and Gallagher leading the charge,[149] specifically arguing that once the SEC decided what objective Section 953 was intended to accomplish, it failed to publicly disclose the information prior to adoption of the Rule.[150] Moreover, "[t]he Commission failed to consider what the quantitative effects of providing flexibility would be on the accuracy of the pay ratio,"[151] and acted "arbitrarily and capriciously when it defined 'employee' to exclude contract workers only if they are employed by an unaffiliated third party." [152] In other words, while the costs of the Rule, as noted above, were clearly explicated, the SEC has failed to identify the requisite benefit to coincide with its costs.

As Commissioner Piwowar points out, should a corporation retain, for example, a solo practitioner, the compensation that attorney receives would come directly from the company, thus classifying the attorney as an employee, when in fact, the attorney is not. Further, by extrapolation, this

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145. *See supra* Part II.
146. Pay Ratio Disclosure, Securities Act Release No. 9877, Exchange Act Release No. 75,610, 80 Fed. Reg. 50,104, 50,105 (Aug. 18, 2015) (codified at 17 C.F.R. pts. 229, 240, 249).
147. Piwowar, Additional Dissenting Statement, *supra* note 75, at 1.
148. *Id.*
149. *Id.*
150. *Id.* at 2.
151. *Id.*
152. *Id.* at 4.

applies to others who do not get paid by third parties, but are not traditionally thought of as employees of the company.[153] In the aggregate, this type of classification has the potential to again skew the data, leading to what Commissioner Gallagher referred to as "eye-poppingly huge ratios."[154]

Lastly, the SEC has faced withering criticism for its decision to implement the Pay Ratio Disclosure, when many, such as Commissioner Gallagher, have argued:

> [w]e must, therefore, acknowledge as another cost of the rule the decision *not* to do something else, something more pressing, something that would have yielded discernible benefits – a JOBS Act rulemaking to address the ongoing employment crisis in this country, perhaps, or something – *anything* – to do with the financial crisis – maybe, for example, the Dodd-Frank section 939A rulemaking that is years overdue.[155]

While it cannot be expected that the SEC exhaust every possible scenario with respect to rulemaking benefits, it is unfortunately clear that the SEC promulgated a rule in which the benefits at best could be considered minimal and further had a high coinciding cost.

The SEC created the Division of Risk, Strategy, and Financial Information in September of 2009,[156] as a means to implement cost-benefit analyses so as to comply with the judicial requirements.[157] Unfortunately, as it regards the Pay Ratio Disclosure, the SEC got the financial analysis correct in being able to fully disclose the cost associated with the rule, but failed to engage in any real meaningful cost-benefit analysis anywhere else. Furthermore, while a high cost may be tolerable, if that cost was heavily analyzed and there seemed to be some benefit implicit in the end, the Pay Ratio Disclosure would probably survive. However, the Rule presents a different scenario, one in which there is a high cost and little tangible benefit. The conclusion thus indicates that the Pay Ratio Disclosure should and will be invalidated.

V. MOVING FORWARD: AMENDING 953(B) AND IMPLEMENTING A SOFT PAY CAP

Given this Note's argument that the Pay Ratio Disclosure is an inadequate mechanism to confront the issues of executive compensation,

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153. *Id.* at 5.

154. Gallagher, Additional Dissenting Statement, *supra* note 20 (noting that this list could include freelance journalists, photographers, artists commissioned to produce artwork, doctors and physicians at publicly held hospitals, and cyber security consultants).

155. *Id.*

156. Bishop & Coffee, *supra* note 94, at 599.

157. An additional, but previously unmentioned, facet of the CHOICE Act is the statutory override of Chevron Deference in favor of a statutorily mandated cost benefit analysis on agency rulemaking. *See* Financial CHOICE Act, H.R. 5983, 114th Cong. § 612 (2015).

coupled with highly partisan resistance to federal regulation of corporate governance, the next logical step in addressing the issue is providing a workable solution for both ends of the argument. This Note suggests that Congress affirmatively immerse itself in executive pay.

There have been arguments contrary to this position, which assert that the federal government should stay out of corporate governance, because state laws are better equipped to handle the intricacies and respond more efficiently to the changing scenarios presented in corporate governance.[158] However, state law has refrained from doing so, mainly by allowing corporate boards to determine pay, with the afforded protection of the business judgment rule.[159] Thus, even if state law is better equipped to respond to issues such as compensation, where the state law has not responded at all, federal regulation may be necessary.

Further, even if it is assumed for the purposes of argument that state law is better equipped to handle corporate governance issues, the suggestion of a federal regulation is not harmful. Federal legislation could serve as the starting point from which state law could then align itself. Under this theory, as the federal regulation becomes more and more outdated, the state laws could improve upon the foundation provided by federal regulations, thus still accomplishing the goal of dealing with executive compensation issues.

A secondary challenge to federal intervention in corporate governance is that it may violate principles of federalism, an argument that was raised against the say-on-pay provisions.[160] However, "[a]ny concern about congressional authority to regulate corporations has long been put to rest. Under the increasingly liberal interpretation of the Commerce Clause, Congress' power is understood to be very broad, and clearly corporations (even very small ones) affect interstate commerce . . . "[161] Thus, Congress is acting on "firm Commerce Clause ground."[162] Therefore, this Note recommends that Congress repeal Section 953(b) of Dodd-Frank and direct the SEC to promulgate a meaningful compensation rule in the form of a soft pay cap.

Under a soft cap the SEC would mandate annually that CEOs receive compensation in an amount not to exceed "X" percent of the companies' net income. This would accomplish the end that Congress ultimately seeks under the Pay Ratio Disclosure, but devoid of the extensive costs, in that the information required to furnish to the SEC would in theory be information the company already maintains. Under this theory, a company would be

158. *See generally* Fisch, *supra* note 17.

159. *Id.* at 746.

160. Torres-Spelliscy, *supra* note 47, at 446 (quoting CTS Corp. v. Dynamics Corp. of Am., 481 U.S. 69, 89 (1987)) ("No principle of corporation law and practice is more firmly established than a State's authority to regulate domestic corporations, including the authority to define the voting rights of shareholders.").

161. Fisch, *supra* note 17, at 737.

162. Torres-Spelliscy, *supra* note 47, at 448–50.

required to disclose its average net profit for the previous three years, which is information all companies should have readily available. Next, the compensation committee, under Section 952[163] (subject to enforcement by the SEC Division of Enforcement) would, engaging the use of consultants and the board, use predictive analytics to project a range of net income for the coming annual year, derived from reports by analysts within the company and research reports from third party analysts. From the estimate, the CEO would be entitled to the "X" percent that the SEC announces for that year. Logistically, the compensation committee would formulate a range of predicted company net profit from which it would then apply a percentage as directed by the SEC, which percentage represents the maximum compensation permissible for the CEO, for that year.

Importantly, this would not dis-incentivize CEOs from performance—it would do the opposite. As the company's net income grows, so too would the pay the CEO receives. Thus, this theory does not fall prey to counterarguments levied against strict pay caps that are thought to be overly intrusive.[164] Here, the CEO would be incentivized to ensure the company succeeds, as the CEO compensation would be directly tied to that success. Additionally, under this theory the CEO would be more closely aligned with the stockholders, whose investment value would rise in lockstep with the compensation afforded to the executive. There are, of course, factors to consider, particularly in the market, which may present a scenario where the particular company endures a difficult financial period. However, under a soft pay cap scheme, the CEO would still be entitled to the last numerical compensation afforded to him or her as of the last valuation.

Thus, analysts taking part in the modeling of the companies' net profit in the current period and forecasting for the future would be able to assess those factors, namely, whether or not the downturn is a market event, not solely attributable to the company, and more importantly, whether or not the downturn is expected to be short or long term. In the event the downturn is short term, it would be reasonable to leave the compensation as is. Alternatively, if the downturn is thought to be long term, the compensation committee can adjust the compensation to reflect the lesser value of the company. One import of the soft pay cap is directly aligned with deterring company-specific actions that would effectuate such a downturn. In other words, it is in the best financial interest of the executive to take actions that are for the betterment of the company, while still allowing flexibility for the incurrence of a certain level of risk.

Another issue that might arise from a strict pay cap, though one that does not arise under this theory, is that often pay caps reflect only one of many

163. Dodd-Frank, Pub L. No. 111-203, § 952, 124 Stat. 1376 (2010) (codified as amended at 15 U.S.C. § 78n-1 (2012)).

164. Caywood, *supra* note 88, at 127.

forms of compensation, namely salary.[165] They do not take into account alternative forms of compensation, such as stock options.[166] However, under this theory, accounting for an executive's entire compensation is possible, without the potential issue of the government being "overly intrusive and punitive."[167]

For example, if the maximum percentage allowable was twenty percent and the predicted net income of the company was $1 million, the CEO for that year would be entitled to no more than $200,000. Further, if the compensation committee awarded the CEO $200,000 in salary, then there is no issue—except that the CEO would not be entitled for that year to receive stock options in lieu of payment.[168] However, if the committee and the board were to issue 50,000 shares of stock priced at $1 per share, set to vest at a given time during the year, the committee would pay the CEO no more than $150,000 dollars in salary, plus other compensatory payments, such as bonuses, insurance, etc. If in Year 2 the stock price rose to $2, effectively making them worth $100,000, it does not follow that the CEO's pay would decrease. In fact, it would increase along with the increase in the stock price, as the increase in price signals an increase in net profit. Therefore, the CEO's compensation would increase, but at a rate that is tenable and understandable to the stockholders. However, taken to the other end, where a company is accused of materially misleading its shareholders by announcing unsupported and excessive predictions to pad the pocket of the CEO, such companies would certainly be subject to SEC Division of Enforcement investigation.

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165. *Id.*

166. *Id.*

167. *Id.* The obvious fear associated with a "hard" or "strict" pay cap is that the regulatory body, here the SEC, establishes a limit on pay that executives cannot exceed. Thus, in effect the regulatory body controls the salary of individuals and "decouples pay from performance." A soft pay cap however, does not require a strict adherence to a numerical salary, but rather encompasses all forms of compensation to provide a closer alignment between the long-term health of the company and executive, while maintaining a backstop to short term superfluous compensation. Additionally, there remains a concern that the regulatory body in strictly regulating compensation, will result in executives seeking to relocate outside of the United States, where they may be entitled to higher compensation, resulting in harm to United States companies. However, again, under a soft cap, while compensation may be minimally restricted in the present, the future presents endless opportunity to increase compensation tied to the increasing health of the company. *Id.*

168. However, it would theoretically be possible for the CEO to receive stock options that would vest at a future date, provided those stock options and their estimated value are accounted for in the following year's salary for that CEO. An example of this would be to say, in year one, the CEO is entitled to no more than $200,000, but received $200,000 in salary, and 1,000 stock options. The stock options would be impermissible if the vesting date occurred in the same annual period that the $200,000 vested. However, if the stock vests at a later period, the CEO would be entitled to them, if the value of the vesting stock is deducted from the CEO's allowable salary. Thus, if the stocks were to vest in the middle of year two, and were valued at $5 each, and the CEO for that year was entitled to $250,000, the maximum allowable compensation would be $250,000, less the vesting date price of the previous year's stock option, or $245,000.

CONCLUSION

The SEC undoubtedly formulated the Pay Ratio Disclosure in good faith, in an attempt to corral the ever-increasing compensation packages afforded to CEOs of publicly held companies. However, the SEC left much to be desired in affirmatively contesting the issue of executive compensation. The failure of Pay Ratio Disclosure to provide the authority for a shareholder to effect changes in compensation practices as a company makes the Pay Ratio Disclosure problematic, but workable. Providing shareholders with non-comparable company metrics with respect to the compensation of the median employee comparative to the CEO, coupled with insufficiencies in how to properly determine a "median employee," make the Pay Ratio Disclosure untenable, especially when the high compliance costs to each company are considered. Further, in the likely occurrence that the Pay Ratio Disclosure is challenged legally, it will fail to survive the necessary judicial scrutiny of a cost-benefit analysis.

Congress should thus repeal Section 953(b) of Dodd-Frank, removing the directive of Pay Ratio Disclosure, and direct the SEC to formulate a soft pay cap system. The soft pay cap provides an opportunity to receive bipartisan support and longevity. A soft pay cap provides a middle ground compromise to an otherwise contentious issue. By allowing the SEC to intervene in executive compensation, a soft pay cap would provide a backstop to excessive compensation, but still allow an executive to steadily increase their salary based on company success. An added benefit of a soft cap system is that the executive and the shareholders are more closely aligned in their collective interests. Importantly, a soft pay cap would not create further burdens in the way the Pay Ratio Disclosure does; rather it would require the utilization of information companies already keep on hand. A soft pay cap thus provides a middle ground, promoting a more efficient regulation and the freedom of capital formation. Though at first glance a soft pay cap might be unwanted, such a system provides the greatest middle ground in achieving a system of compensation that allows executives, shareholders, and society to feel comfortable in this area of corporate law.

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