AFL-CIO

AMERICA'S UNIONS

American Federation of Labor and Congress of Industrial Organizations

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March 22, 2017

Michael S. Piwowar
Acting Chairman
U.S. Securities and Exchange Commission
100 F Street, NE
Washington, DC 20549-1090

Re: Reconsideration of Pay Ratio Rule Implementation

Dear Mr. Piwowar:

On behalf of the American Federation of Labor and Congress of Industrial Organizations (the "AFL-CIO"), I am writing to express our continued strong support for Section 953(b) of the Dodd-Frank Wall Street Reform and Consumer Protection Act of 2010 and the U.S. Securities and Exchange Commission's August 5, 2015 rule implementing this provision. The pay ratio rule will provide investors with material information on employee compensation as well as provide greater context to investors for deciding how to cast "say-on-pay" advisory votes on executive compensation.

The AFL-CIO is the umbrella federation of U.S. labor unions, including 55 unions representing 12.5 million members. Union sponsored and Taft-Hartley pension and employee benefit plans hold $667 billion in assets. Union members also participate directly in the capital markets as individual members and as participants in pension plans sponsored by corporate and public-sector employers. The retirement savings of America's working families depend, in part, on public companies having responsible compensation practices for their chief executive officers and all other employees.

The SEC's pay ratio rule is carefully balanced between giving companies considerable flexibility in complying with the disclosure requirement while still providing investors with reliable and accurate information. The SEC's final rule reduces compliance costs by permitting companies to statistically sample their workforce or use other reasonable methods to identify their median employee. The median employee may only need to be identified once every three years, and may be identified within the last three months of a company's fiscal year. Finally, non-U.S. employees may be exempted to comply with country data privacy laws or when non-U.S. employees make up less than five percent of a company's total workforce.

The SEC adopted the pay ratio rule five years after enactment of the Dodd-Frank Act of 2010, and companies are not required to comply until they file their proxy statements in 2018. Any further delay in implementing the pay ratio rule will cause considerable hardship to investors who plan to incorporate pay ratio information into their proxy voting analysis. For example, the AFL-CIO Proxy Voting Guidelines urge voting fiduciaries to consider "[a]re the overall amounts of executive pay reasonable relative to company peers, what the company pays its other employees, and the value added by individual executives."[1] Pay ratio disclosure will provide a valuable metric for monitoring how these compensation levels change over time.

There is evidence that investors consider the relationship of CEO pay to other employee pay when casting say-on-pay votes if the data is disclosed. A 2016 study of commercial banks found that companies with the largest pay ratios experienced "disproportionately greater shareholder dissatisfaction" on say-on-pay votes.[2] Unlike most industries, commercial banks are already required to disclose aggregate compensation data that enables investors to calculate average employee pay. This same study concluded that investors "appear to scrutinize the firm's overall compensation structure, not just that of executives" when voting on say-on-pay.[3] The SEC's pay ratio rule will enable investors to apply similar analysis to all of their portfolio companies.

Pay ratio disclosure provides investors with an alternative metric to assess the reasonableness of CEO pay within each particular company.[4] At present, CEO pay levels are set based on a peer group analysis of what other CEOs are paid. Over time, the use of peer group analysis leads to a ratcheting up of CEO pay levels.[5] Pay ratio disclosure will encourage consideration of internal compensation practices rather than relying on peer group analysis alone. As permitted by the SEC's pay ratio rule, boards of directors can disclose supplemental information to provide context and explain to shareholders why their company's pay ratio is appropriate. As observed by the U.K. government's Green Paper on Corporate Governance Reform, "[s]hareholders could then take a more informed view on whether pay levels are proportionate and reasonable."[6]

Pay ratio disclosure will also provide investors with greater insight into the human capital management strategies of their portfolio companies. For many companies, employee compensation is frequently the single largest expense. Moreover, many companies state that "our employees are our greatest asset." Yet few companies provide meaningful disclosure of how this asset is managed, including how employee compensation is allocated over their workforce. According to a MSCI study, companies with higher pay ratios had lower profitability compared

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[1] AFL-CIO, *AFL-CIO Proxy Voting Guidelines*, 2012, page 12. Available at: http://www.aflcio.org/Corporate-Watch/Capital-Stewardship/Proxy-Voting
[2] Steven S. Crawford and Karen K. Nelson, *Mind the Gap: CEO-Employee Pay Ratios and the Shareholder Say on Pay Votes,* January 2016. Available at: https://www8.gsb.columbia.edu/faculty-research/sites/faculty-research/files/CNR%20Jan2016%20(002).pdf
[3] *Id.*
[4] James Cotton, "Toward Fairness in Compensation of Management and Labor: Compensation Ratios, A Proposal for Disclosure," *Northern Illinois University Law Review*, 1997.
[5] Elson, Charles and Craig Ferrere, "Executive Superstars, Peer Groups, and Overcompensation: Cause, Effect, and Solution," *Journal of Corporation Law*, Vol. 38, No. 3, Spring 2013.
[6] U.K. Department for Business, Energy and Industrial Strategy, *Green Paper on Corporate Governance Reform,* November 2016, page 30.

with peers with narrower pay gaps over a 5-year period between 2009 and 2014.[7] This outperformance by companies with lower pay ratios suggests that pay ratio data is material.

The ratio of CEO to median employee compensation is material to investors as an indicator of wage dispersion within a company. For decades, economists have studied the relative merits of egalitarian versus hierarchical compensation structures. For example, one economic theory (known as "tournament theory") suggests that having a highly paid CEO might motivate other executives to work harder and rise to the top. Others, such as management guru Peter F. Drucker, have argued that CEOs should not be paid more than a certain ratio of employee pay to maintain group cohesion and teamwork. Disclosure of CEO to median employee pay ratios will give investors more information on how companies approach these human resource questions.

Pay ratios are also an indicator of the impact that CEO pay has on employee morale and productivity, which can affect the performance of companies. Economic research has found that organizations with a high disparity of pay between top earners and those at the bottom suffer a decline in employee morale and commitment to the organization.[8] Extreme pay ratios can produce a significant deterioration in the quality of products produced by employees.[9] The negative impacts of high pay ratios extend down the chain of command, resulting in higher employee turnover and lower job satisfaction.[10] A recent Glassdoor study found that "higher CEO compensation is statistically linked to lower CEO approval ratings on average."[11]

Because pay ratios can affect employee performance, a company's internal pay ratio is an important financial metric for investors to monitor and evaluate. A reasonable pay ratio sends a positive message to the workforce that the contributions of all employees are valued. While some research documents benefits to company performance from pay stratification amongst employees,[12] these effects taper off and become harmful to companies once pay stratification becomes too extreme.[13] The impacts of pay disparities are particularly strong in industries based

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[7] Samuel Block, *Income Inequality and the Intracorporate Pay Gap*, MSCI, April 2016. Available at https://www.msci.com/www/research-paper/income-inequality-and-the/0337258305

[8] *See e.g.* Jeffrey Pfeffer, *Human Resources from an Organizational Behavior Perspective: Some Paradoxes Explained*, Journal of Economic Perspectives, Vol. 21 (2007).

[9] Douglas Cowherd and David Levine, *Product Quality and Pay Equity Between Lower-Level Employees and Top Management*, Administrative Science Quarterly, Vol. 37 (1992).

[10] Matt Bloom and John Michel, *The Relationships Among Organizational Context, Pay Dispersion, and Managerial Turnover*, Academy of Management Journal, (2002). *See also* James Wade, Charles O'Reilly III, and Timothy Pollock, *Overpaid CEOs and Underpaid Managers: Fairness and Executive Compensation*, Organization Science (2006).

[11] Glassdoor, *What Makes a Great CEO?,* August 24, 2016. Available at: https://www.glassdoor.com/research/studies/what-makes-a-great-ceo/

[12] *See e.g.* Daniel Dinga, Syed Akhtarb and Gloria L. Ge, *Effects of Inter- And Intra-Hierarchy Wage Dispersions on Firm Performance in Chinese Enterprises*, The International Journal of Human Resource Management, Vol. 20 (2009).

[13] Nils Braakmann, *Intra-Firm Wage Inequality and Firm Performance – First Evidence From German Linked Employer-Employee-Data*, February 14, 2008. Available at: http://www.leuphana.de/fileadmin/user_upload/Forschungseinrichtungen/ifvwl/WorkingPapers/wp_77_Upload.pdf.

on technology, creativity, and innovation.[14] These sectors depend significantly on the ability of employees to collaborate, share ideas, and function effectively as teams.[15]

Finally, higher levels of median employee compensation may indicate that a company is making investments in its workforce. Higher employee compensation is an indicator that a company pays "efficiency wages," i.e., more than the minimum level needed so that the company can attract the best qualified employees and improve employee productivity.[16] The knowledge, skills and motivation of employees has great importance in today's high performance workplaces.[17] For firms whose success depends on their employees' abilities, higher levels of median employee compensation may drive a business strategy to improve company performance.

For all of these reasons, pay ratio disclosure is material to investors. As pay ratio information becomes publicly available, investors will be able to make more informed proxy voting and investment decisions. This transparency will facilitate market efficiency and help allocate capital to companies that create good, high paying jobs. We urge the SEC to comply with Section 953(b) of the Dodd-Frank Act by not delaying implementation of the pay ratio rule. If the AFL-CIO can be of further assistance, please contact me at [redacted] or [redacted].

Sincerely,

Brandon J. Rees
Deputy Director, Office of Investment

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[14] *See* Phyllis Siegel and Donald C. Hambrick, *Pay Disparities Within Top Management Groups: Evidence of Harmful Effects on Performance of High-Technology Firms*, Organization Science, Vol. 16 (2005). *See also* Aneika L. Simmons, *Organizational Justice: A Potential Facilitator or Barrier to Individual Creativity*, Doctoral Dissertation, Texas A&M University, December 2006.
[15] Phyllis Siegel and Donald C. Hambrick, *Pay Disparities Within Top Management Groups: Evidence of Harmful Effects on Performance of High-Technology Firms*," Organization Science, Vol. 16 (2005).
[16] *See e.g.,* George Akerlof and Janet Yellen, Eds., *Efficiency Wage Models of the Labor Market*, Cambridge University Press, Cambridge UK (1987). See also George Akerlof, *Labor Contracts as Partial Gift Exchange*, Quarterly Journal of Economics, Vol 97 (1982).
[17] *See* Alex Edmans, *Does the Stock Market Fully Value Intangibles? Employee Satisfaction and Equity Prices*, Journal of Financial Economics, March 30, 2011.