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November 22, 2013

Securities and Exchange Commission
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Release Nos. 33-9452, 34-70443; File No. S7-07-13

Dear Securities and Exchange Commission:

Here are my comments on the Pay Ratio Disclosure Rulemaking. In summary:

1. The information is largely redundant, as CEO pay is already disclosed and typical compensation in each industry is already available from other sources.
2. Differences in business organizations make the pay ratio a clumsy yardstick for judging executive compensation, of limited usefulness to investors or activists.
3. As the information is redundant, the SEC should implement this Congressional mandate in the least costly way. Expensive data collection will not improve the quality or usefulness of the number.

[1] I am also on the boards of directors of the EDGA and EDGX stock exchanges. My comments are strictly my own and don't necessarily represent those of Georgetown University, the University of Pennsylvania, EDGX, EDGA, or anyone else for that matter.

4. The proposing release is a model of poor disclosure. The Commission should seek to be a model for disclosures that are clear communications.

Background

Section 953(b) of Dodd Frank requires issuers to disclose total CEO compensation, median employee compensation, and the ratio of the two.[2] Such disclosure is popular among some groups who view it as a way to highlight the disparity in compensation between the typical worker and the CEO. Labor activists view disclosure of the median compensation as a way to shame those public corporations that pay low wages. This is part of a larger social debate that affects not only public companies but also private ones as well.

This information is largely redundant.

CEO compensation is already disclosed for public, but not private companies. The only new information is the pay of the median employee. However, there is already pretty good information about median compensation in various industries. For example, a few seconds of Googling leads to http://www.bls.gov/oes/current/oessrci.htm. One can quickly find the average compensation in various industries by type of employment. For example, the annual mean wage for all occupations in in oil and gas extraction is $92,970 while for clothing and clothing accessory stores the number is only $25,510. Although the mean is not the same as the median, it does provide a representative number of the typical compensation for workers in a given sector. As most firms in an industry have to pay market wages to attract and retain workers, the median compensation for workers in typical firms will not stray very far from the industry average.

[2] The Act states: (b) ADDITIONAL DISCLOSURE REQUIREMENTS.—

(1) IN GENERAL.—The Commission shall amend section 229.402 of title 17, Code of Federal Regulations, to require each issuer to disclose in any filing of the issuer described in section 229.10(a) of title 17, Code of Federal Regulations (or any successor thereto)—

(A) the median of the annual total compensation of all employees of the issuer, except the chief executive officer (or any equivalent position) of the issuer;

(B) the annual total compensation of the chief executive officer (or any equivalent position) of the issuer; and

(C) the ratio of the amount described in subparagraph (A) to the amount described in subparagraph (B).

(2) TOTAL COMPENSATION.—For purposes of this subsection, the total compensation of an employee of an issuer shall be determined in accordance with section 229.402(c)(2)(x) of title 17, Code of Federal Regulations, as in effect on the day before the date of enactment of this Act.

Pay ratios are a crude yardstick of little use to investors or anyone else.

It is highly unlikely that the pay ratio will become a standard measure of financial analysis.

One potential use of a pay ratio would be to identify situations in which the CEO compensation is excessive. However, as mentioned in the proposing release, differences in the structure of a company could lead to wildly different pay ratios. For example, suppose there are two otherwise identical companies selling identical widgets and making the same amount of money and whose CEOs each earn $1 million. The only difference is that one company outsources its lower-wage manufacturing to a forced labor camp in North Korea, leaving only the most highly compensated technical and administrative employees in the company, who have a median compensation of $100,000. The CEO to median pay ratio would be 10.0. The other company did not outsource and has a median worker compensation of $50,000. This company has a CEO-to-median pay ratio of 20.0. Does this mean that the compensation of the CEO that did not outsource is twice as "excessive" as the compensation of the CEO that outsourced?

Good CEOs are worth their weight in gold. Bad ones should be fired.

The top management performers who can take average inputs and create above average outputs deserve to be well compensated for their achievements. By increasing the productivity of the resources entrusted to them, the best corporate managers provide an extremely valuable service to society. They increase the quantity of goods and services available in our society. By adding more value, they also create more jobs and more taxable revenue. Corporate compensation systems should be designed to attract the most talented people and reward them for accomplishments.

The top performers in any industry make large amounts of money. The top basketball players, the top taxpayer-funded college football coaches, the top lawyers, the top doctors, the top investment bankers, and the top entertainers all do extremely well. If the most talented executives cannot be rewarded for successfully running public companies, they will take their talents elsewhere and public company employees and shareholders will be the worse for it. I see nothing wrong with a corporation creating incentive schemes to attract the best talent and reward executives for jobs well done. A good CEO is worth at least as much to our society as a good football coach.

Situations in which highly paid executives (or taxpayer-funded football coaches) have not produced good results rightly raise the ire of workers and shareholders alike. I get particularly upset when managers who have driven a company into the ground walk away with fortunes, as happened at Fannie Mae and Freddie Mac. Unfortunately, the pay ratio calculations do not help in any way to differentiate between the many good CEOs who have earned their compensation and the few bad ones who deserve to be fired if not incarcerated.

Additional "precision" does not provide any added value to investors or activists.

Given the crude nature of the pay ratio, additional "precision" will not add any value to investors or activists. Thus, there is no use in wasting society's resources on useless bean counting to come up with a "precise" value of median pay. No matter how much effort is spent in identifying the median workers total compensation, the resulting pay ratio will not be of any additional use to investors or activists due to the fact that the ratio itself is not a useful indicator of the excessiveness of executive compensation.

Issuers have an incentive to be honest in reporting median pay, so enforcement will be easy.

The only new item of information to be disclosed is the median pay number. Some might worry that issuers will attempt to manipulate the calculation to report a high median compensation, which would lower the pay ratio of executive compensation to median compensation. However, overstating median compensation will have a direct impact on the labor force: Workers in the company receiving less than the reported number will immediately start agitating for higher salaries, leading to lowered morale and increased labor costs for the issuer. For this reason, issuers have an incentive to report accurate numbers.

Exempting smaller issuers and emerging growth companies is a good idea.

Proponents of pay ratio disclosure seem mostly concerned about putatively excessive pay at the largest companies. Indeed, large pay packages are more common in the largest and most complex companies than in smaller public companies. Exempting smaller issuers and emerging growth companies will relieve them of the burden of complying with actions targeted at larger companies. Similarly, the SEC should also permit issuers with a total executive compensation under a certain limit, say $2 million, to use even simpler methods to estimate median compensation, such as using the average compensation for their NAIC code.

The SEC should choose the least-cost compliance method.

Even though this information is redundant and of little practical value, it is popular in some quarters and Congress has decreed that it should be disclosed. Consequently, the SEC should seek to implement it in the least costly way possible. This implies the following:

- Keep the rule simple and don't waste precious SEC resources on fine tuning it. The SEC has many more important things to work on. The lengthy 162-page rule proposal is evidence that way too much staff time has been spent on this. (Let me apologize in advance for adding to the Commission's workload on this issue with my comment letter.) The SEC will continue to have difficulty justifying a budget large enough to do its job if it continues to demonstrate waste like this.[3]
- Issuers should have flexibility to estimate the median employee's total compensation in any reasonable manner, including sampling.

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[3] I continue to believe that the SEC is seriously underfunded. The total cumulative budget of the SEC since its founding in 1934 is less than investor losses from one Bernie Madoff. The SEC needs the appropriate resources to find and punish the truly bad guys. However, the misallocation of scarce SEC resources makes it hard for the SEC's budget allies to make the case that additional funding will be well spent and not squandered on lengthy paperwork exercises like this.

Annual should be a period that is approximately the same for executive compensation, but need not be exactly the same.

As the pay ratio is a very crude yardstick, there is no value added from complex calculations to make sure that the pay period for the median employee exactly matches the pay period for the CEO. For example, if hourly employees are normally paid on the 23rd of the month and salaried on the 31st, it might be extremely messy to calculate accruals at the beginning and end of the year to make the pay periods align exactly. As the median pay won't change all that much from doing such a calculation, there is no value to society from forcing issuers to conduct such calculations.

Disclosure of measure used is useless information for investors.

The rule requests a narrative description of the methodology used to estimate the median total compensation. This information is useless for investors and just adds more clutter to the SEC filings. This imposes a cost on investors who have to wade through this boilerplate to find the truly useful information. Such excessive clutter makes it even easier for investors to miss material information and for issuers to hide material items among the clutter.

Page 62 of the release states: "We are sensitive to the costs of the mandated disclosure, and we believe that additional narrative disclosure about the ratio would not, for many registrants, provide useful information for investors that would justify the costs associated with providing that additional disclosure." This is fine as far as it goes, but also be sensitive to the time of investors who have to wade through all this stuff.

Excessive detail will also distract SEC staff from examining more important items in firm filings that really are important to investors.

Only subsidiaries with readily available data should be used.

An issuer may or may not have ready access to payroll information about firms that are classified as subsidiaries. For example, an issuer may be a 49% owner of a joint venture that is controlled and managed by its joint venture partner, and it may not have routine access to the granular payroll data needed to determine whether the median employee rests within that joint venture, or what that median employee's total compensation is.

Again, given the limited usefulness of a precise "pay ratio", issuers should be permitted to use any reasonable method. Only subsidiaries for which individual compensation data are routinely available should be required to be included.

<u>Sampling is good.</u>

Sampling is a well-respected method of estimating useful numbers. Indeed, most accounting numbers are audited based on a sampling method. Sampling can reduce the cost of compliance.

<u>But no cost-benefit analysis is given for the proposed sample sizes.</u>

The proposed release provides a table with appropriate sample sizes for companies that wish to use sampling. The proposed sample sizes are based on various assumptions about the statistical distribution. I was impressed by the sheer quantity of quantitative effort used to guesstimate the sample sizes, and ponder whether such quant resources would have been better allocated to more important Commission needs. Nevertheless, there is no justification at all for the assumptions with regard to the appropriate error rate or confidence interval, let alone a cost benefit analysis. I am concerned that the displayed sample sizes will become *de facto* requirements without the proper analysis, as an issuer would have to hire an expensive statistician to justify any different numbers.

<u>Impact on protection of investors</u>

The Commission is required by law to consider the impact of proposed rules not only on consumer protection, but also on efficiency, competition, and capital formation. The proposing release does not even discuss protection of investors. However, this rule does nothing to protect investors so there is not much to discuss. One could argue that the pay ratio disclosure would make it easier to alert investors to excessive executive compensation, but executive compensation is already disclosed, so there is little new information here. Also, since the information will be buried in obtuse filings, the average retail investor probably won't even notice it.

<u>Impact on efficiency</u>

By imposing costs on issuers with little or no public benefit, this proposal clearly hurts the efficiency of the U.S. economy. However, Congress has decreed that it should be done, so the Commission should use its discretion to implement the rule in the least bad manner, and to use its section 36 exemptive authority as Congress intended it to be used.

<u>Impact on competition</u>

Compliance with this rule raises the fixed cost of being a public company. With a higher breakeven level, this creates still more incentives for companies to merge and to get larger, thus harming competition. As discussed above, Congress has given the order and it is up to the Commission to do it in the least bad way.

<u>Impact on capital formation</u>

As this rule imposes costs on public companies but not private ones, it is likely to tip the balance further away from the public markets. The alarming decrease in the number of public US companies is a sign that our markets have not been receptive to smaller public companies. Adding more burdens to public companies but not private ones adds yet another reason for the companies to remain or go private. This withering of the public markets creates fewer choices for growing companies to access needed capital, and fewer exit opportunities for venture capital investors.

This crisis in capital formation is one of the things that led Congress to pass the JOBS Act subsequent to Dodd-Frank. Since there is little or no record of Congressional intent on the pay ratio requirement, the Commission should take its cue from the more recent Congressional actions to take concrete steps to reduce compliance burdens for public companies, especially smaller ones. This more recent statement of Congressional intent implies once again that this regulation should be implemented in the least cost manner.

The text of the proposal sets a poor model for disclosure.

I can appreciate the lawyerly desire to build a bulletproof record in order for a proposed regulation to withstand legal challenges. However, merely repeating the same text over and over again is not likely to be persuasive to any competent judge. Excessive repetition does not indicate a thorough job; it indicates bad writing as well as bad thinking. Excessive repetition makes readers think that there is little real content and the writer is trying to cover up a weak argument. Merely repeating the same text over again does more than annoy the reader, it makes is much easier for the reader to miss important points. It also makes it easier for the writer to hide important points.

Once again, the rule filing is excessively redundant. The phrase "as discussed" appears 23 times. In particular, the economic analysis and Paperwork Amplification Act sections repeat earlier sections in too much detail. The first page of the Economic Analysis section on page 84 contains no new information; it is just a restatement of the proposal. As if someone who has read through the first 83 pages hasn't figured out the proposal? The footnotes on the second page of the analysis refer to earlier sections of the same document. As discussed above, excessive repetition annoys the reader, obfuscates important points, imposes costs on writers, readers, Commissioners, and judges alike, and makes one think that the writers are trying to cover up a weak argument.

I believe that the Commission's economic analyses would be much more judicially bulletproof if they contained more readable analysis with cogent economic logic and less boilerplate repetition of earlier sections. This will make them much more persuasive as to the soundness of their economic conclusions.

The SEC should make its required disclosures – rule filings –models of good communication.

As an investor, I frequently read 10-Ks, 10-Qs, 8-Ks, and proxy statements. Most of the verbiage is redundant boilerplate. However, it takes time and effort for investors and analysts to wade through all this stuff. Often, the material is so repetitive that it is easy to overlook the important points. This drives up costs for investors and results in poorer understanding in the marketplace. Over the last decade, the length of the average 10-K has increased dramatically, driving up the costs to investors of interpreting the obfuscatory "disclosure."

The Commission seems to confuse "disclosure" with communication. Just spewing more obfuscating ink on a page does not convey the important information to the reader. The Commission should strive to find ways of improving its own communications such as rule proposals so that it can provide better guidance on issuers' required disclosures.[4]

One thing that would help would be to follow the practice of some state legislatures such as Virginia for proposed legislation. When displaying the text of a modified rule, the entire rule should be stated in full, with additions *italicized* and deletions in ~~strikeout~~ text.

If you have any questions, feel free to email or call me.

Respectfully submitted,

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[4] With regards to required disclosures by issuers, boilerplate should be relegated to a standard disclosure form like the *Characteristics and Risks of Standardized Options* document given to options investors. This would cut the size of required filings (especially proxy statements) substantially, resulting in large savings of time and trees.