CtW Investment Group

Elizabeth M. Murphy
Secretary
U.S. Securities and Exchange Commission
100 F St. NE
Washington, DC 20549-1090

Re: Pay Ratio Disclosure, File No. S7-07-13

Dear Ms. Murphy,

On behalf of the CtW Investment Group, I am writing to express strong support for the U.S. Securities and Exchange Commission's proposal requiring disclosure of the CEO-to-median-employee-pay-ratio ("CEO Pay Ratio") as mandated by Section 953(b) of the Dodd-Frank Wall Street Reform and Consumer Protection Act. As stewards of long-term shareholder value and advocates for sustainable investing, we also believe the CEO Pay Ratio disclosure will provide shareholders with currently-unavailable information that will promote efficiency, competition, and capital formation in several ways:

1. The empirical literature in psychology, human resource management, and organization management strongly support the conclusion that higher levels of pay inequality (or "dispersion") are associated with lower levels of employee engagement, morale, and tenure and lead to worse organizational performance.
2. Empirical work by economists strongly suggests that the increases in CEO pay over the past three decades primarily take the form of rents rather than competitively determined returns to a factor of production. Consequently, investors have little reason to be concerned that reductions in executive pay in general would have any negative impact on their investment returns.
3. Our own analysis of estimated CEO Pay Ratios and long-term shareholder returns for S&P 500 companies clearly indicates that companies with high estimated CEO Pay Ratios perform worse than companies with low CEO Pay Ratios over the following five years. This negative relationship holds for 9 of the 10 major industry segments of the S&P 500 index, and a multivariate regression analysis indicates that *for every increase in the CEO Pay Ratio of 10 (i.e. from 200 to 210), cumulative excess total shareholder returns over the following five years fall by 1.5 percentage points (150 basis points).*

The CtW Investment Group works with pension funds sponsored by unions affiliated with Change to Win, a coalition of unions representing five million members, to enhance long-term shareholder returns through active ownership. Members of CtW affiliates participate in Taft-Hartley plans with over $250 billion in assets. Like many institutional investors, the CtW Investment Group believes that setting executive compensation is one of the most telling and transparent functions of the board. Thus compensation disclosure is important not only in its own right, but in the ability it offers shareholders to better evaluate and hold accountable board members.

How Pay Dispersion Undermines Firm Performance

In contrast to the simplistic but widely held view that large differences in pay within an organization merely reflect differences in the contributions of individual employees, or will incentivize employees to improve their performance, for more than 25 years researchers in psychology, human resource management, and organization management have found that typically the opposite relationship holds in practice: firms with high levels of internal pay dispersion suffer from lower employee engagement, lower morale and satisfaction, and lower productivity. We provide a brief bibliography of works in these fields in Appendix I of this letter. In short, this literature has consistently found that firm-level systems of pay determination have a large impact on employee engagement, turnover, productivity, and overall firm performance, and that these effects vary depending on

- The level of pay received by an employee, such that already highly paid employees respond less to a pay increase of a given size than do lower paid employees.
- The perceived fairness of pay decisions is crucial in generating positive effects from changes in pay practices.
- Employees view the fairness of pay primarily in relative terms, that is, by comparing their own pay and effort to those of other workers including supervisors, managers, and executives.

Researchers in these fields have found, for instance, that retailers which pay higher wages are perceived as providing substantially better customer service, experience lower levels of turnover, and also encounter substantially lower levels of employee theft.[1] Nevertheless, many of the researchers in these fields have found that despite the accumulation of evidence linking within-firm pay fairness to positive company-wide performance, in practice many firms do not implement high-performance pay and management practices and suffer high levels of employee dissatisfaction.[2] Several studies have shown that even publicly available data on employee satisfaction, such as the "100 Best Companies To Work For In America" list published by Forbes, is apparently not incorporated into stock market prices even though the firms making this list materially out-perform their peers on both a short- and long-term basis.[3] This finding suggests both that the management of human capital is a key determinant of company performance, and that investors currently have too little information concerning crucial human capital management practices, such as company-level pay dispersion.

As the authors of a review of this literature note: "Because how people feel about their pay is a result of comparative processes, organizations with huge variance between executive and employee pay practices are likely to be populated with workers eagerly awaiting opportunities to

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[1] Zeynep Ton, "Why Good Jobs Are Good for Retailers" *Harvard Business Review*, January 2012.; Clara Xiaoling Chen and Tatiana Sandino, "Can Wages Buy Honesty? The Relationship Between Relative Wages and Employee Theft" *Journal of Accounting Research*, vol. 50, no. 4, 2012.

[2] Jeffrey Pfeffer, "Human Resources from an Organizational Behavior Perspective: Some Paradoxes Explained" *Journal of Economic Perspectives*, vol. 21, no. 4, Fall 2007.

[3] Alex Edmans, "Does the Stock Market Fully Value Intangibles? Employee Satisfaction and Equity Prices" *Journal of Financial Economics*, vol. 101, no. 3, 2011.; Alex Edmans, "The Link Between Job Satisfaction and Firm Value, With Implications for Corporate Social Responsibility" Academy of Management *Perspectives*, November 2012.; Roger J. Best, "Employee Satisfaction, Firm Value, and Firm Productivity" Working Paper University of Central Missouri Spring 2008.

move to other organizations."[4] With the disclosure provided by Section 953 (b), investors will for the first time be in a position to incorporate this crucial information into their investment decisions.

The Potential Costs of The CEO Pay Explosion

With the rapid increase in executive pay, both on an absolute basis, relative to economy-wide average worker pay, and relative to corporate profits, over the past several decades, many investors have sought to engage companies around their pay practices and ensure that executive pay is limited to the amount necessary to ensure the long-term performance necessary for pension funds to provide promised benefits. As these efforts have won the support of more investors over time, many commentators have warned that limits on executive pay will come at a severe economic cost, implying that extremely high executive pay is necessary in order to produce the investment returns that shareholders desire.

However, economists studying the CEO pay explosion have instead concluded that most of the relative increase in executive pay over the past three decades cannot be ascribed to competitive market returns for managerial talent.[5] Instead, the evidence suggests that public company executives enjoy extra-competitive returns, or rents. In conventional economic theory, a rent represents a private return stemming from some divergence between the (admittedly unrealistic) assumptions of economic theory and the practical realities of real economic institutions. Such "divergences" include monopolies, barriers to entry, and externalities, among many others. This conclusion suggests that, if in fact the disclosures provided by Section 953(b) do induce more investors to insist on limiting executive pay, this will result in increased, rather than reduced, economic efficiency.

The key pieces of evidence cited by these economists include:

- CEO pay has increased sharply compared to the incomes earned by other highly-educated, and highly-skilled professionals, including doctors, lawyers, professional athletes, and movie stars.[6]
- When CEOs lose their jobs (for instance following a bankruptcy), and are unable to find another CEO position, they suffer very large loss in future earnings. If CEO pay strictly represented a competitive factor payment, economists would expect the CEO's next-best-alternative to provide pay very close to (in the simple model, identical to) their pay as a CEO.[7]
- A number of highly successful companies, including Southwest Airlines, Costco, and Whole Foods Markets, pay their executives far below the level of their competitors and have done so for many years. Moreover, CEOs of US-based companies are paid far more

[4] Sara L. Rynes, Barry Gerhart, and Kathleen A. Minette, "The Importance of Pay In Employee Motivation: Discrepancies Between What People Say And What They Do" Human Resource Management, Winter 2004, Vol. 43, No. 4, pg. 390.

[5] Josh Bivens and Lawrence Mishel, "The Pay of Corporate Executives and Financial Professionals as Evidence of Rents in Top 1 Percent Incomes" Journal of Economic Perspectives, vol. 27, no. 3, Summer 2013.

[6] Bivens and Mishel op.cit., citing Steven N. Kaplan, "Executive Compensation and Corporate Governance in the US: Perceptions, Facts, and Challenges" Martin Feldstein Lecture given July 10, 2012. Note that Bivens and Mishel interpret Kaplan's findings differently that Kaplan himself.

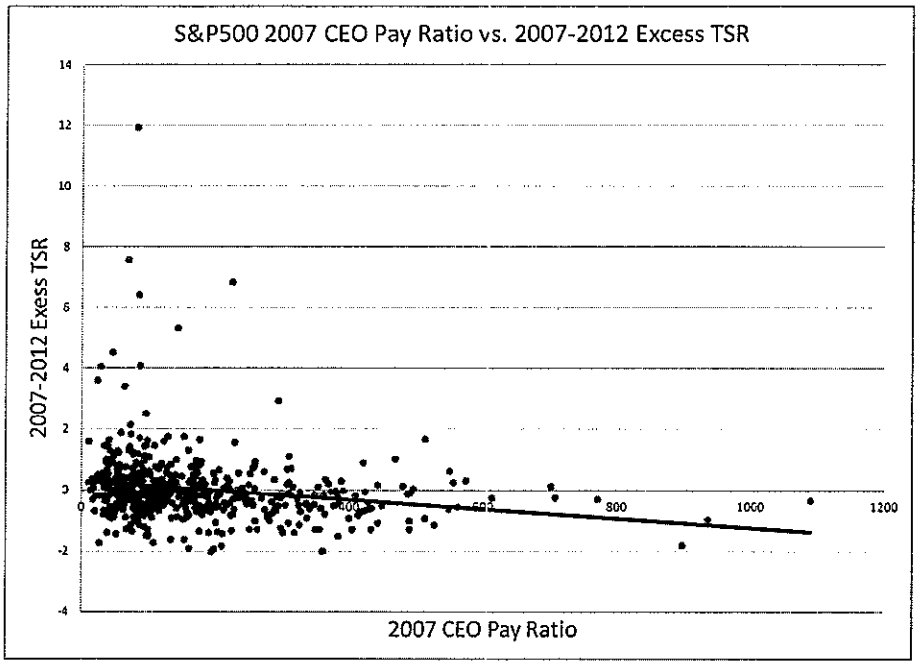
[7] B. Espen Eckbo, Karin S. Thorburn, Wei Wang, "How costly is corporate bankruptcy for top executives?" Tuck School of Business Working Paper No. 2012-109. September 1, 2012.

than their Canadian, Australian, European, or Japanese counterparts, and have been for many years.[8] Nevertheless, firms based in these other countries neither experience greater difficulty recruiting and retaining executives, nor in generating long-term investor returns comparable to those of US-based companies.[9] The sustained success of both US-based and foreign-based low-payers in recruiting and retaining executives supports the conclusion that high levels of executive pay are unnecessary.

High CEO-Pay Ratios Lead to Worse Shareholder Returns

In order to better understand the impact of high ratios between CEO pay and the pay of a company's typical employee on long-term investors, we undertook an analysis of data on companies currently included in the S&P 500, the methodology of which we explain in Appendix II.

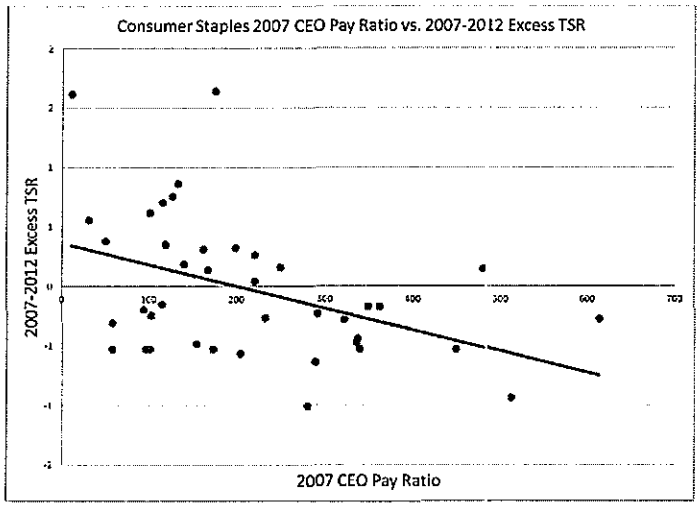
First, we found that there was a clear negative correlation between the estimated CEO Pay Ratio in 2007 and excess return over the subsequent five year period, as shown below:



Second, we examined the correlations between excess return and CEO Pay Ratios for the 10 industry segments into which the S&P 500 index constituents are divided. We show below the scatter plot for the Consumer Staples segment, which includes many companies where workers deal directly with consumers. This segment showed the strongest negative correlation between the 2007 CEO Pay Ratio and subsequent performance:

[8] Martin J. Conyon, et. al., "The Executive Compensation Controversy: A Transatlantic Analysis" FONDAZIONE RODOLFO DE BENEDETTI, February 13, 2011.

[9] http://www.slate.com/articles/business/moneybox/2013/07/american_ceo_pay_u_s_executives_are_paid_way_more_than_foreigners.html



Third, we constructed a multivariate regression equation to test both the statistical significance of this negative relationships and to determine if this relationship held when other variables associated with long-term performance are taken into account. Our model included variables representing market capitalization (since smaller companies typically outperform larger companies) and the market-capitalization-to-book-value ratio (since companies with high market capitalizations relative to book value are frequently hypothesized to be overpriced). The full results of the regression are presented in Appendix III: in summary we found that *for every increase of 10 (i.e. from 200 to 210) in the CEO Pay Ratio, the cumulative excess total shareholder return over the following five years declined by 1.5 percentage points or 150 basis points.* This relationship is statistically significant at above the 99.5% level, and the entire model explains approximate 24% of the total variance in cumulative excess total shareholder returns for current S&P 500 index members over the 2007-2012 period.

Conclusion

Our analysis clearly indicates that the CEO Pay Ratio is valuable information that is materially relevant to investment decisions, including voting decisions shareholders must make for the companies in their portfolios. This information is not generally accessible through other sources, and can be proxied by publicly available data only imprecisely and with considerable effort. Finally, it is evident from the research undertaken by scholars in multiple fields that the paucity of information concerning pay dispersion within companies has impeded shareholders' ability to systematically incorporate human capital management into their investment decisions, thereby limiting the effectiveness of the public capital markets in allocating resources.

Please act swiftly to adopt the final rule implementing Section 953(b) of the Dodd Frank Act. Investors will benefit from this disclosure in proxy voting on executive compensation and in making investment decisions based on workforce considerations. Thank you for taking our views into consideration for your final rulemaking.

Sincerely,

Dieter Waizenegger
Executive Director

Appendix I: Research on Pay Dispersion and Organizational Performance

David Card, Alexandre Mas, Enrico Moretti, and Emmanuel Saez, "Inequality At Work: The Effect Of Peer Salaries On Job Satisfaction" NBER Working Paper 16396, September 2010.

Jeffrey Pfeffer, "Human Resources from an Organizational Behavior Perspective: Some Paradoxes Explained" *Journal of Economic Perspectives*, vol. 21, no. 4, Fall 2007.

Charles A. O'Reilly, James Wade, and Tim Pollack, "Overpaid CEOs and Underpaid Managers: Equity and Executive Compensation" Stanford Business Library Research Paper #1410.

Roger J. Best, "Employee Satisfaction, Firm Value, and Firm Productivity" Working Paper University of Central Missouri Spring 2008.

Jeffrey Pfeffer, "Building Sustainable Organizations: The Human Factor" Academy of Management *Perspectives*, February 2010.

Zeynep Ton, "Why Good Jobs Are Good for Retailers" *Harvard Business Review*, January 2012.

Sara L. Rynes, Barry Gerhart, and Kathleen A. Minette, "The Importance of Pay In Employee Motivation: Discrepancies Between What People Say And What They Do", *Human Resource Management*, Winter 2004, vol. 43, no. 4.

Clara Xiaoling Chen and Tatiana Sandino, "Can Wages Buy Honesty? The Relationship Between Relative Wages and Employee Theft" *Journal of Accounting Research*, vol. 50, no. 4, 2012.

Alex Edmans, "Does the Stock Market Fully Value Intangibles? Employee Satisfaction and Equity Prices" *Journal of Financial Economics*, vol. 101, no. 3, 2011.

Alex Edmans, "The Link Between Job Satisfaction and Firm Value, With Implications for Corporate Social Responsibility" Academy of Management *Perspectives*, November 2012.

James B. Wade, Timothy G. Pollack, Joseph F. Porac, and Scott D. Graffin, "Star CEOs Benefit or Burden?" *Organizational Dynamics*, vol. 37, no. 2, 2008.

Rakesh Khurana, "The Curse of the Superstar CEO" *Harvard Business Review*, September 2002.

Appendix II: Regression Methodology

Our dependent variable, Excess_Return, is the total shareholder return between January 1, 2007 and December 31, 2012 for each company currently in the S&P500, minus the sector benchmark return for the same period. The sector benchmark return is the market capitalization weighted total shareholder return for each of the 10 sectors into which the S&P500 is divided: Consumer Discretionary, Consumer Staples, Energy, Financials, Health Care, Industrials, IT, Materials, Telecommunications, and Utilities.

Our independent variable of primary interest, CEO_Pay_Ratio, was calculated following the methodology introduced by journalists Elliot Blair Smith and Phil Kuntz from Bloomberg to estimate the annual pay and benefits of the median employee based on industry specific pay data collected by the US government. We computed the ratio between this pay figure and the total compensation reported on the proxy statement for the CEO (or highest paid executive, if the CEO was not typically the highest paid) for fiscal year 2007 for each company currently in the S&P 500.

The scatterplots shown on pages 4 and 5 of this letter display our Excess_Return variable on the Y axis and our CEO_Pay_Ratio variable on the X axis. We have prepared scatterplots and corresponding correlation statistics for each of the other 9 S&P 500 segments not displayed in the letter.

Three companies currently in the S&P 500 (ADT Corp., TripAdvisor Inc., and Zoetis, Inc.) did not begin trading until 2012 at the earliest, and so were excluded from this analysis.

Our ordinary least-squares regression analysis included two additional independent variables: Market_Capitalization, the January 1, 2007 market capitalization of each current member of the S&P500, and Market_to_Book, the ratio of the January 1, 2007 market capitalization to the January 1, 2007 (or closest available date) book value for each company. The regression model took the form of $\text{Excess\_Return} = \alpha + \beta\text{CEO\_Pay\_Ratio} + \gamma\text{Market\_Capitalization} + \delta\text{Market\_to\_Book} + \varepsilon$.

Appendix III: Regression Results

Regression Statistics	
Multiple R	0.488916724
R Square	0.239039563
Adjusted R Square	0.234408972
Standard Error	1.019540894
Observations	497

	Coefficients	*Standard Error*	*t Stat*	*P-value*
Intercept	0.071649423	0.074997789	0.955353807	0.339867016
CEO Pay Ratio	-0.001588877	0.000326897	-4.860482913	1.57644E-06
Market Capitalization	3.23893E-06	9.28033E-07	3.490101424	0.00052616
Market to Book	0.016991319	0.001593802	10.66087051	5.09346E-24