Re: Proposed rule on Pay Ratio Disclosure Section 953(b) of the Dodd Frank Act
Date: June 18, 2014

Dear Mr. O'Neill and Ms. Powalski:

As a professor of accounting who is concerned about the social implications of the information provided by corporations, I feel compelled to write you a second time. I am motivated to write by my recent reading of two very different works. Dr. Thomas Piketty’s *Capital in the 21st Century* provides an extensive historical examination of the role of capital and labor in the wealth distribution in developed countries, primarily in North America and Europe and in Japan. Dr. Picketty carefully and exhaustively explores and analyzes governmental records to discern, educe, and elucidate key patterns. He notes that “what primarily characterizes the United States at the moment is a record level of inequality of income from labor (probably higher than in any other society at any time in the past, anywhere in the world, including societies in which skill disparities were extremely large,” (p. 265). He adds that the unprecedented wage inequality we are currently seeing in the US is due primarily to the “emergence of extremely high remunerations at the summit of the wage hierarchy, particularly among top managers of large firms,” (p. 298). So something extraordinary is occurring in US corporate boardrooms; one would think such a phenomenon needs explaining and disclosing.

The second work I read was a report sent to you on May 22nd, 2014 by the Center for Capital Markets Competitiveness, which presents two arguments against Section 953(b) of Dodd-Frank. The first is that the cost of compliance is “egregious”; the second is that the law’s main purpose is to “shame” corporations. A corollary to the second argument is that there is no benefit obtained from the rule.

The SEC has determined that executive compensation reflects the quality of corporate governance and therefore shareholders and the public have an interest in this issue. Thus, the SEC has required disclosure and the disclosure requirements have increased over the years, as CEO pay has become more complex. Section 953(b) of Dodd-Frank reflects legitimate concerns arising since the latest financial crisis about risk-sharing and about whether what Adam Smith called the “grand bargain” is still being honored. That is, do all employees who contribute to the success of a company enjoy the perquisites of success? JP Morgan’s member newsletter in 2011 said that increased profits were due primarily to decreased labor costs. Such a statement, especially during a period of rising CEO salaries, would indicate rather wide-spread violation of the grand bargain. On the down side, when firms make risky decisions, are CEOs or workers (and - in the recent crisis – displaced and under-water homeowners) the ones who bear the costs?

When researchers attempt to explain or account for the unprecedented level of executive compensation, they cannot rely on the traditional economic argument of marginal productivity of labor. Even the Center admits that the relationship of firm profits long-term to CEO performance is “difficult to discern.” Professors Marianne Bertrand and Sendhil Mullainathan have published research exploring the relationship of CEO pay to various financial metrics and conclude that
often CEOS are paid “for luck.” Others attribute the very high compensation to the cozy (and far from independent) relationship of Boards of Directors and CEOs and fall back on Adam Smith’s observation that high pay represents the exercise of power and influence, rather than just deserts based on individual exceptional effort, skill, intelligence, or creativity. Work by the Economic Policy Institute showing a strong correlation between market indices and CEO pay implies that individual effort is not driving high compensation as much as general markets trends are, an indication that CEOs are collecting economic rents. Of course CEOs work hard, as do other employees, whose remuneration has not increased commensurately with firm success or general market trends. US CEOs earn multiples of over 200 times what their own firms’ employees earn. That multiple is much higher than found in other nations, even though companies in other nations are as productive, as profitable, and face similar challenges.

The rapidly increasing CEO compensation combined with very slowly-increasing or stagnant average wages creates problems that concern many members of society. Extreme inequality is associated with many social problems, some outlined by Richard Wilkinson and Kate Pickett in The Spirit Level. Economists worry that a sinking middle-class will fail to support the economic growth needed for a healthy economy. To the extent money carries political weight, we weaken the ability of a broad range of people to speak and be heard in the political arena. So this unprecedented increase in the compensation of a small group of people who are well-connected to the people deciding their compensation is seen by many researchers as problematic for a variety of reasons.

I will not repeat the arguments for disclosure, which have been well analyzed by many others, but I would like to comment on the inanity of the Center’s report. The authors provide no information on how they conducted their survey and why or how they selected the 118 firms from the 3800 firms that are subject to Dodd-Frank. The Center tells us that only 25 of the 37 companies that operate in fewer than 10 countries provided a cost estimate; the Center tells us that only 12 of the 20 companies that have more than 100 “data systems” provided a cost estimate. The Center tells us that “there is a strong chance that many companies have no firm grasp on what the SEC’s pay ratio will cost.” But this agnosticism does not cause the Center any uncertainty. Instead, they offer the “back of the envelope”guesstimates their respondents submitted as if we should consider the figures reliable and credible. The authors provide no information on how any single firm arrived at its estimate. The authors reveal their bias in the title of the report, immodestly claiming to provide evidence that compliance with Section 953(b) would impose “egregious” costs. They complain that compliance would require companies to organize and synthesize the “arcane” world of their own payroll systems! I have worked as an auditor. International firms do pose some complex challenges in compiling and aggregating information, but many of the challenges are met regularly and annually during audits, when firms present a set of highly aggregated financial statements. As a side-note, if this report had been submitted to me as partial completion of a course, I would have required the students to resubmit before I would assign a grade.

Having been in public accounting and in higher education, I have watched over the years as corporations respond to every new disclosure requirement with alarmist exaggerations about the cost of implementation and even more alarmist, catastrophic predictions of the failure of the capitalist system this disclosure will precipitate. Yet, many years later, the US stock market is at high levels, despite burgeoning and more complicated disclosure requirements. The Center’s report is another example of unjustified Henny Penny talk of major costs, which will cause the sky (and the market) to come tumbling down.
The Center said several times that the purpose of the rule is not to provide information, but rather to “shame” companies. Understanding the motives of others is always difficult, so I’ll pass quickly over the obvious truth that of course the Center does not know the inner motivations of the Congress or the SEC. That said, why is the Center so focused on the idea of “shame.” Do they in fact think there is something shameful about CEO compensation rising so quickly while workers are laid off and receive lower wages in real terms? Financial reports are not supposed to be window-dressing; they are supposed to include the good, the bad, and the ugly. If the firms and Boards have defensible reasons for paying CEOs more in this country than they are paid in other countries, more in this era than they were paid relative to average workers forty years ago, they can explain that. If the reasons are good and sound, people will hear them. The Center says comparisons will be difficult. They are already. Determining income for an insurance company involves many assumptions, models, accruals, estimates that differ radically from those made by a manufacturer. Comparability is never pure and never simple. But making comparisons is the responsibility of the investor. Firms cannot dictate which choices investors make.

Finally, the Center asserts that there is no benefit to this disclosure. The benefits of more information are difficult to quantify, but that does not mean benefits do not exist. More investors these days consider the social and ethical implications of their investments. Localities are giving larger and larger tax abatements and incentives to companies. Therefore citizens who do not invest but simply live in an area where a company operates tax-free have interests in how firms pay their workers. Recent studies show that Wal-mart, for instance, imposes significant costs on local communities because it pays workers so little. Information on how workers are paid impacts investor decisions and local government negotiations with firms considering relocation. Shareholders have voted against proposed compensation packages, even though the vote is only precatory. The Dodd-Frank pay disclosure rule provides information on what economists call a merit good. Those are, in fact, difficult to quantify, but they are essential to our quality of life.

I hope you will resist the opposition to this rule and continue moving towards implementation. I understand that the implementation may be difficult, but that the firms have resisted efforts by Congress members to make implementation simpler, which shows that complexity and cost are not the issues the opponents truly object to. What appears to bother them most is that people will have more information on which they can make decisions. And isn’t providing more information what the SEC is about?

Respectfully,

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