Dodd-Frank Section 953(b):
Why CEO-to-Worker Pay Ratios Matter For Investors

Introduction

Section 953(b) of the Dodd-Frank Wall Street Reform and Consumer Protection Act of 2010 introduces new reporting requirements for publicly traded companies to disclose the median of the annual total compensation of all employees (except the CEO) and the ratio of CEO compensation to median employee compensation. The U.S. Securities and Exchange Commission has announced its intention to issue regulations implementing this pay ratio disclosure requirement in the fall of 2011.

This new disclosure requirement seeks to address public and investor concerns about growing levels of executive compensation. CEO pay levels have increased dramatically over the past three decades. Excessive levels of CEO pay come at the expense of shareholders who are the owners of publicly traded companies. High levels of pay also provide incentives for CEOs to take excessive risks. For example, inappropriate executive compensation packages at financial services companies have been identified as a contributor to the Wall Street financial crisis.

By requiring that public companies disclose CEO-to-worker pay ratios, the Dodd-Frank Act encourages boards of directors to consider the relationship between CEO pay and the compensation paid to other employees. This provision provides greater transparency to investors about their companies' compensation practices for rank-and-file employees. Company-specific employee compensation data is not currently available to investors under existing disclosure requirements. This disclosure will allow investors to compare employee compensation practices between companies.

CEO-to-Worker Pay Ratios Indicate CEO Pay Levels Are Excessive

In recent decades, CEO pay has grown dramatically in the United States. Between the 1930s and the 1970s, CEOs of the largest companies received approximately $1 million in total annual compensation (adjusted for inflation in year 2000 dollars).[1] During this period, the ratio of CEO-to-worker pay narrowed as workers' wages grew and CEO pay rose modestly.[2] By the 1990s CEO pay grew dramatically. *Business Week* estimated that CEO pay at the largest companies grew from 42 times the average worker's pay in 1980 to 531 times the average worker's pay in 2000.[3] In 2010, large company CEOs received $11.4 million, or 343 times worker pay, according to calculations by the AFL-CIO's Executive Paywatch website.[4]

At most publicly-traded companies, CEO pay is set by a compensation committee of the Board of Directors. These compensation committees frequently hire compensation consultants who conduct peer group analyses of what CEOs are paid at similar companies. While the CEO's final pay package may depend on company performance, compensation committees use these peer group studies to target the amount of compensation for the CEO. Chief executives

[1] Carola Frydman and Raven E. Saks, *Executive Compensation: A New View from a Long-Term Perspective, 1936-2005*, July 6, 2007, http://web.mit.edu/frydman/www/trends_frydmansaks_rfs.pdf.
[2] *Id.*
[3] *CEOs: Why They're So Unloved*, Business Week, April 22, 2002.
[4] AFL-CIO Executive Paywatch analysis of 299 companies in the S&P 500, http://www.paywatch.org.

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also use peer group pay data when negotiating their compensation packages with compensation committees.

Peer group benchmarking has contributed substantially to CEO pay inflation. Not every CEO can be paid above average, yet no CEO wants to be in the "below average" category. Boards and compensation committees likewise often want to avoid being seen as "below average," whether out of concern for company prestige or fear that the CEO will leave. Thus, as each member of a peer group of companies seeks to raise its CEO compensation above the average, the net effect is a ratcheting up of executive compensation for the entire group.[5] This spiraling effect is further exacerbated because some companies aim their compensation target at the 75th percentile,[6] while other companies choose as their peer group companies that are larger than them and have higher CEO pay to start with.[7]

What is wrong with CEOs receiving ever greater amounts of compensation? CEO pay comes out of the pocketbooks of shareholders. Top executives at large public companies now keep for themselves an average of 10% of their companies' net profits; approximately double the rate in the early 1990s.[8] Perhaps of even more concern, large compensation packages can provide an irresistible incentive for executives to make business decisions that are not in the best interests of their companies. For example, executive pay packages created an incentive for accounting fraud at Enron and Worldcom.[9] More recently, the structure of executive pay packages at Bear Stearns and Lehman Brothers have been blamed for encouraging excessive risk taking by company executives.[10]

CEO-to-Worker Pay Ratio Disclosure Will Help Limit CEO Pay

The ratio of CEO-to-worker pay has long been recognized as an important ratio. Over one hundred years ago, investment banker J.P. Morgan argued that CEO pay should not exceed 20 times the average worker's pay. Management consultant Peter Drucker would often tell his clients that "a 20-to-1 salary ratio is the limit beyond which they cannot go if they don't want resentment and falling morale to hit their companies."[11] Disclosure of CEO-to-worker pay ratios will encourage compensation committees to consider pay disparities between the CEO and company employees. As Peter Drucker famously said, "what gets measured, gets managed."

[5] Thomas A. DiPrete, Greg Eirich, and Matthew Pittinsky, *Compensation Benchmarking, Leapfrogs, and The Surge in Executive Pay*, November 23, 2009, http://www.columbia.edu/~tad61/frog11232009.pdf. *See also* Charles Elson and Craig Ferrere, *Punting Peer Groups: Resolving the Compensation Conundrum*, BNA Corporate Governance Report, May 2, 2011.
[6] *See e.g.,* Abercrombie and Fitch, 2010 Proxy Statement, page 39.
[7] Cari Tuna, *Picking Big 'Peers' to Set Pay, Executive Compensation Is Often Skewed by Comparisons*, The Wall Street Journal, August 17, 2009.
[8] Lucian Bebchuk and Yaniv Grinstein, *The Growth of Executive Pay*, Oxford Review of Economic Policy, Vol 21 (2005).
[9] Janice Kay McClendon, *Bringing the Bulls to Bear: Regulating Executive Compensation to Realign Management and Shareholders' Interests and Promote Corporate Long-Term Productivity* (Winter 2004). Wake Forest Law Review, Vol. 39, No. 4, 2004.
[10] Lucian Bebchuk, Alma Cohen, and Holger Spamann, *The Wages of Failure: Executive Compensation at Bear Stearns and Lehman 2000-2008*, Yale Journal on Regulation, Vol. 27, 2010, pp. 257-282.
[11] The Drucker Institute, Comment Letter to the SEC on Section 953(b) of Dodd-Frank, February 17, 2011, http://thedx.druckerinstitute.com/wp-content/uploads/2011/02/SECcomment.pdf.

In 1997, James Cotton, a law professor at Texas Southern University who previously spent 25 years in IBM's Corporate Law Department, published an article calling for disclosure of CEO-to-worker pay ratios as a way to bring context and a degree of reasonableness to executive pay packages.[12] Investors recognize that the pay relationship between CEOs and company employees is important. For example, the Council of Institutional Investors recommends that compensation committees consider the "goals for distribution of awards throughout the company" and "the relationship of executive pay to the pay of other employees" as factors in developing their executive pay philosophy.[13]

Measuring CEO-to-worker pay ratios will encourage companies to compensate their CEOs as part of a team. Jim Collins, who served as a lecturer at the Stanford Graduate School of Business before starting his own consulting firm, conducted an exhaustive survey to identify companies that are truly "great," defined as those which generated, over fifteen years, cumulative stock returns that exceeded the market by at least three times. Of the nearly 1,500 companies that Collins surveyed, not one of the "great" companies had a high-paid, celebrity CEO.[14] Such celebrity CEOs turn a company into "one genius with 1,000 helpers," taking focus away from the motivation and creativity needed from all of a company's employees.[15]

It is for this reason that investment analysts have begun calling for enhanced disclosure requirements to enable comparisons of CEO pay to the key company expenditures that actually drive a company's success, such as compensation for other employees and research and design.[16] Moody's Investors Services, for instance, has noted that sharp imbalances between CEO pay and that of other key personnel may suggest a weak board and poor decision-making.[17] Additional disclosures, such as the CEO-to-worker pay ratio, will allow analysts to perform fuller assessments of companies, giving shareholders more information to make informed decisions.[18]

The Ratio of CEO-to-Worker Pay Is Material Information

The ratio of CEO-to-worker pay can affect the performance of companies. Because CEO pay levels are publicly disclosed, employees can easily compare their pay to their CEO. It is well documented 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.[19] Extreme disparities between CEO and employee pay have been shown to produce significant

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[12] James Cotton, *Toward Fairness in Compensation of Management and Labor: Compensation Ratios, A Proposal for Disclosure*, Northern Illinois University Law Review, 1997.
[13] Council of Institutional Investors, Corporate Governance Policies, September 29, 2010, http://www.cii.org/CouncilCorporateGovernancePolicies/.
[14] Jim Collins, *Good to Great: Why Some Companies Make the Leap . . . and Others Don't*, (HarperBusiness, 2001).
[15] Interview with Jim Collins, *Great Answers to Good Questions*, Fast Company, August 31, 2001.
[16] Jack T. Ciesielski, *S&P 500 Executive Pay: Bigger Than . . . Whatever You Think It Is*, The Analyst's Accounting Observer, Vol 20, No. 7, May 23, 2011. For additional commentary from Mr. Ciesielski, see *Paychecks as Big as Tajikistan*, The New York Times, June 18, 2011.
[17] Moody's Corporate Governance, *Key Governance Features of Investment Grade North American Independent Exploration and Production Issuers*, September 2007.
[18] *See e.g.* Editorial, *The Real Say on Pay*, New York Times, September 1, 2010, arguing that investors need company-specific data on CEO to worker compensation ratios in order to facilitate analyses of the effects that pay structures have on company performance and the broader economy.
[19] *See e.g.* Jeffrey Pfeffer, *Human Resources from an Organizational Behavior Perspective: Some Paradoxes Explained*, Journal of Economic Perspectives, Vol. 21 (2007).

deterioration in the quality of products produced by employees.[20] A recent study demonstrated that in companies where CEO compensation is strongly disproportionate to that of other employees, the negative impacts extend at least ten levels down the chain of command, resulting in higher employee turnover and lower job satisfaction.[21] Another study found that firms with high levels of CEO pay relative to other top executives have reduced performance.[22]

Although the evidence suggests that CEO-to-worker pay ratios have an impact on employee performance, this does not mean that there is a single "one-size-fits-all" ratio that is optimal for all companies. Some research does document benefits to company performance from pay stratification amongst employees.[23] Yet, these effects taper off and become harmful to companies once pay stratification becomes too extreme.[24] The impacts of pay disparities are particularly strong in industries based on technology, creativity, and innovation.[25] These sectors are crucial to America's future economic success, and they depend significantly on the ability of employees to collaborate, share ideas, and function effectively as teams, all of which are damaged by extreme differentials in compensation amongst employees.[26]

Companies with high levels of employee morale have outperformed their competitors. In 1998, *Fortune Magazine* began to publish an annual ranking of the "100 Best Companies to Work for in America." This list was based on extensive surveys that asked employees about the fairness of their companies' compensation policies, their attitudes towards management, whether they felt respected at work, and their overall job satisfaction. Starting in 1998, $100,000 invested in a weighted index of the "Best Companies to Work for in America" would have grown to about $240,000 as of 2009, compared with only $150,000 in value for the same money invested in the stock market as a whole.[27] That's an average of 4.1% better performance per year, according to a recent study by Alex Edmans, Assistant Professor at the University of Pennsylvania's Wharton School of Business.[28] Given that executive pay disparities impact employee morale, and that employee morale impacts company performance,

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[20] Douglas Cowherd and David Levine,*Product Quality and Pay Equity Between Lower-Level Employees and Top Management*, Administrative Science Quarterly, Vol. 37 (1992).
[21] 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), finding the same effects stretching down at least five levels down the chain of command.
[22],Lucian Bebchuk, Martijn Cremers, and Urs Peyer, *The CEO Pay Slice*, September 2010, forthcoming in the *Journal of Financial Economics*.
[23] *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).
[24] Nils Braakmann, *Intra-Firm Wage Inequality and Firm Performance – First Evidence From German Linked Employer-Employee-Data*, February 14, 2008, http://www.uni-graz.at/socialpolitik/papers/Braakmann.pdf.
[25] *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.
[26] 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).
[27] *Investing in Happy Workers, Profiting from Happiness*, The Economist, February 17th, 2009.
[28] Alex Edmans, *Does the Stock Market Fully Value Intangibles? Employee Satisfaction and Equity Prices*, Journal of Financial Economics, March 30, 2011.

investors have every reason to consider the ratio of CEO to median worker compensation to be a highly material metric informing their investment decisions.

Median Employee Pay Data Is Also Valuable For Investors

Section 953(b) requires that companies disclose the median compensation level of all company employees. Because mathematical averages are skewed by high levels of executive pay, the disclosure of median employee compensation levels will best represent the compensation received by a typical company employee. This information will provide investors with valuable insight to how their companies compensate their employees. For many companies, the cost of employee compensation and benefits is the company's largest expense. However, few companies provide their investors with any disclosure of how this compensation is allocated across their workforce.[29]

There are a variety of reasons why median employee pay levels are material to investors. Fundamentally, higher wages suggest that a company is making strategic investments in human capital, something not as readily apparent based on existing corporate disclosures. Human capital was less important 100 years ago, when workers performed simple tasks with easily measurable outputs. In such situations, the knowledge and motivation of employees was relatively unimportant.[30] Modern tasks are more difficult to quantify and assess, and require more nuanced skills.[31] For firms whose business success depends on such tasks, the increased motivation and decreased turnover that come from higher wages and more equitable pay structures can be crucial.[32]

It is this investment in human capital that has been a key factor, amongst others, in allowing Costco to outperform Wal-Mart, even while paying an average of $17/hour instead of $10/hour to employees in similar positions.[33] Similarly, higher pay levels may indicate 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.[34] Relatively higher levels of median employee compensation may also make it easier to retain workers and reduce employee turnover. Finally, higher employee pay levels likely indicate that a company employs a workforce that is relatively highly skilled. As pay information becomes publicly available, investors will be able to make more informed investment decisions based on more accurate assessments of companies' investments in human capital.

Some critics of Section 953(b) have argued that investors will be misled by CEO-to-worker pay disclosure. To be sure, companies in different industries will disclose different pay levels and ratios. A Wall Street investment bank will likely have very different employee compensation numbers compared to a retail department store company. Yet the same

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[29] Notable examples of companies that have voluntarily disclosed employee compensation data to their investors include MBIA and Whole Foods. Other companies such as El Paso and Intel disclose that they consider pay equity issues when setting executive compensation.
[30] Alex Edmans, *Does the Stock Market Fully Value Intangibles? Employee Satisfaction and Equity Prices*, Journal of Financial Economics, March 30, 2011.
[31] *Id.*
[32] *See* the research of scholars such as Matt Bloom, Charles O'Reilly, and others, cited above.
[33] *See* Wayne Cascio, *Decency Means More than "Always Low Prices": A Comparison of Costco to Wal-Mart's Sam's Club,* Academy of Management Perspectives, Vol. 20, August 2006.
[34] *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).

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argument could be made with regards to a company's debt-to-equity ratio, gross profit margin, return on equity, or any number of other financial ratios. The point of disclosure is not to give a single figure that completely describes a company, but to provide another data point that helps investors get a fuller understanding of their company's compensation practices.

Companies are free to supplement their Section 953(b) disclosures with their own narrative discussion of their workforce compensation practices. For example, a company that has many employees offshore could provide a compensation breakdown of its U.S. and international workforces. Companies that have a large number of part-time employees could provide a compensation breakdown of their full-time and part-time employees. Compensation consultant firm Radford has recommended that their clients offer more specific data and fuller explanations of their compensation structures and strategies.[35] The Securities and Exchange Commission could also require this type of supplemental disclosure under the Securities Exchange Act of 1934.

Conclusion

Section 953(b) of the Dodd-Frank Wall Street Reform and Consumer Protection Act of 2010 is valuable to investors for many reasons. Most importantly, CEO-to-worker pay ratio disclosure will encourage a moderation of the level of CEO pay by highlighting the effect of pay disparities on employee morale and productivity. These disclosures will give investors context to assess whether compensation is being awarded broadly across the entire company or concentrated at the top. Furthermore, CEO-to-worker pay disclosure will help investors identify companies that are likely to have satisfied and motivated workforces, and those that are investing in their human capital, both of which have been shown to be reliable indicators of profitable and successful companies.

[35] Radford Consulting, *Dodd-Frank Act: The Importance of Putting CEO Pay Multiples Into Context*, November 16, 2010.