Regulation Review

Final SEC Pay Ratio Rule

AUGUST 6, 2015

On Wednesday, the Securities and Exchange Commission (SEC) voted 3-2 to finalize its Pay Ratio Disclosure rule. The rule implements Section 953(b) of Dodd-Frank and requires companies to disclose “the ratio of the median of the annual total compensation of all employees to the annual total compensation of the chief executive officer.” At $1.8 billion in total costs, it is the 5th most expensive Dodd-Frank final rule. While SEC claims to have made improvements from its proposed version, serious questions remain regarding the necessity and true purpose of the rulemaking.

Proposed Rule:

- Total Costs: $218 Million
- Annual Paperwork Burden: 545,792 Hours

Final Rule:

- Total Costs: $1.8 Billion
- Annual Paperwork Burden: 2,367,573 Hours
- Difference: *Increased Costs 900 percent and Increased Paperwork 430 percent*

ANALYSIS

The increase in costs from proposed to final is about as dramatic as one will find in any rule. However, this is largely because in the proposed version, SEC did not provide quantified costs beyond those associated with the paperwork burden. After reviewing comments from various stakeholders, the Commission was able to produce estimates of $1.3 billion in initial costs and $526 million in each following year. The majority of this burden falls on companies with employees in foreign countries by forcing them to collect, analyze, and calculate data from a series of foreign jurisdictions, a complicated and confusing process.

The paperwork burden also increased by a wide margin. The primary difference is the additional burden facing companies that file 10-K reports with SEC. Although the number of respondents and responses is relatively stable compared to the proposed rule, the per-response burden increases the overall figure. The proposal claimed that the additional 10-K burden amounted to, on average, 190 hours per report. The final version pegs that figure at 663 hours, approximately 3.5 times the previous estimate.

For a rule of this magnitude, one would think that SEC has a legitimate reason to promulgate this rule. Other than being a statutory requirement under Dodd-Frank, there are few tangible benefits to justify the rule’s skyrocketing burdens. Identical to the proposed version, SEC cannot quantify any of the benefits. The main qualitative benefit they cite is that it would “enhance the executive compensation information available to shareholders.” However, this claim is wholly based on an extremely loose reading of congressional intent, with all but cursory attempts at identifying its merits independently. Much of this information already exists from independent sources.

SEC’s main rationale for this benefit follows:

> We also think it is important to observe that, despite our inability to quantify the benefits, Congress has directed us to promulgate this disclosure rule. Thus, we believe it reasonable to rely on Congress’s determination that the rule will produce benefits for shareholders and that its costs (which we discuss further below) are necessary and appropriate in furthering shareholders’ ability to meaningfully exercise their say-on-pay voting rights. Because Congress expressly directed us to undertake this rulemaking, we do not believe it would be appropriate to second-guess its apparent conclusion that the benefits from this rule justify its adoption.

Yet, if one merely checks the immediately preceding page of their “analysis,” they will find the remarkably tenuous foundation for this claim:

> Although Congress neither expressly identified in Section 953(b) a specific market failure intended to be addressed by the new disclosure requirement nor expressly stated the specific objectives and intended benefits of Section 953(b), we nonetheless believe that the context in which the provision appears provides useful evidence of Congress’ purpose in enacting the provision.

SEC’s core argument for this rule is that because Congress, in some vague, contextual manner, believes this rule will help shareholders make “better” decisions, we agree. And furthermore, this whole exercise in mandating the collection of already available data is apparently so beneficial as to balance out roughly $1.8 billion in costs. As Commissioner Daniel Gallagher notes in his dissent, dropping the reporting requirement for foreign employees could have saved $788 million.

At nearly $2 billion in total costs, this rule stands as one of the most notable financial regulations in recent years. It is the 5th most expensive finalized Dodd-Frank rule (or 4th most if one discounts the remanded “Conflict Minerals” rule) and the most expensive financial services rule in 2015 so far. It pushes total Dodd-Frank costs close to $35 billion, with more than 67 million paperwork burden hours. The rule’s impact speaks for itself, even if its rationale or purported benefits do not.