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Regulatory Reform 10 Years After the Financial Crisis: Dodd-Frank and Securities Law

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Summary

From 2007-2009, the United States experienced what many commentators believe was the worst economic crisis since the Great Depression. In the wake of the crisis, Congress passed the Dodd-Frank Wall Street Reform and Consumer Protection Act (Dodd-Frank) in 2010. Title IX of Dodd-Frank, entitled "Investor Protections and Improvements to the Regulation of Securities," focuses on the powers and authorities of the Securities and Exchange Commission (SEC) and authorizes the SEC to promulgate certain rules intended to enhance corporate accountability and corporate governance. This report discusses recent developments with respect to two aspects of Title IX, including legislative proposals such as the Financial CHOICE Act of 2017 (H.R. 10, 115th Cong.) that would change or repeal aspects of Title IX.

First, in February 2018, the Supreme Court issued a potentially significant decision in *Digital Realty, Inc. v. Somers*. The case involved the new SEC whistleblower program instituted by Section 922 of Dodd-Frank and resolved a dispute that had arisen among the lower courts as to the scope of individuals who could avail themselves of anti-retaliation protections provided by the Act. In *Digital Realty*, the Court held that Dodd-Frank's whistleblower protections do not apply to internal whistleblowers—that is, those who report violations within their organizations but *not* to the SEC. The dispute between the parties (and the lower courts) resulted from the tension between Dodd-Frank's definition of the term "whistleblower" and its incorporation of a reference to the Sarbanes-Oxley Act of 2002 in Section 922's anti-retaliation provision. As this report discusses, the Supreme Court's decision has potentially important implications for the enforcement of securities law, especially as Congress considers further changes to Dodd-Frank's whistleblower program.

Second, in early 2018, reporting companies began to formally comply with the SEC's "pay ratio rule." That rule was promulgated pursuant to Section 953(b) of Dodd-Frank, which requires public disclosure of the ratio between the annual total compensation of a company's median employee to the annual total compensation of its Chief Executive Officer (i.e., the company's median worker to CEO pay ratio). In promulgating the rule, the SEC adopted a largely flexible approach that it regarded as satisfying Dodd-Frank's statutory requirements while taking due consideration of the high compliance costs for companies. The report further discusses potential challenges that may be brought to the pay ratio disclosure requirement. Included in this discussion is a comparison between the pay ratio rule and the so-called "conflict minerals rule" and "resource extraction rule" the SEC previously promulgated pursuant to Dodd-Frank.

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From 2007-2009, the United States experienced what many commentators believe was the worst economic crisis since the Great Depression.[1] According to many observers, a principal cause of the crisis was the collapse of a bubble in the housing market that had developed in the early and mid-2000s.[2] As this bubble popped over the course of 2007 and 2008, many financial institutions began to experience large losses related to the subprime mortgage market.[3]

In particular, two of the nation's largest investment banks, Bear Stearns and Lehman Brothers, collapsed in 2008, leading to reverberations throughout the nation's financial markets. For instance, Lehman Brothers' bankruptcy in September 2008 led to a drop in the Dow Jones Industrial Average of more than 500 points, its worst single-day decline in seven years.[4] The fall of 2008 also witnessed the exposure of a $65 billion fraud perpetrated by Bernard Madoff, further impacting the financial markets.[5] As other large investment banks began experiencing considerable losses in value,[6] the government provided emergency funding to those institutions through the Emergency Economic Stabilization Act, signed into law in October 2008.[7] Specifically, the act created the Troubled Asset Relief Program (TARP),[8] pursuant to which the federal government would eventually disburse over $400 billion to financial institutions and the automotive industry, among others.[9]

The troubles in the financial system also spilled over to the real economy. Between the fourth quarter of 2007 and the second quarter of 2009, real GDP fell by an estimated 4.2 percent.[10] U.S. households lost an estimated 26 percent of their wealth ($17 trillion) between mid-2007 and early 2009.[11] And between January 2008 and December 2009, the economy lost an estimated 8.3 million jobs.[12]

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[1] *See* FINAL REPORT OF THE NAT'L COMM'N ON THE CAUSES OF THE FIN. AND ECON. CRISIS IN THE U.S., v (2011) [hereinafter "FINAL CRISIS REPORT"]; Jon Hilsenrath, Serena Ng & Damian Paletta, *Worst Crisis Since '30s, With No End Yet in Sight*, WALL ST. J. (Sept. 18, 2008), https://www.wsj.com/articles/SB122169431617549947.

[2] *See, e.g.*, Christopher L. Foote, Kristopher S. Gerardi & Paul S. Willen, *Why Did So Many People Make So Many Ex Post Bad Decisions?: The Causes of the Foreclosure Crisis*, *in* RETHINKING THE FINANCIAL CRISIS 136, 136-40 (Alan S. Blinder, Andrew W. Lo & Robert M. Solow, eds. 2012).

[3] FINAL CRISIS REPORT, *supra* note 1, at 279-91.

[4] BEN S. BERNANKE, THE COURAGE TO ACT: A MEMOIR OF A CRISIS AND ITS AFTERMATH 270 (2015).

[5] *See* Gregg Wirth, *Ponzi Schemes, the SEC, and the Myth of Investor Protection: A Q&A with Former SEC IG Kotz*, 18 NO. 12 WALLSTREETLAWYER.COM: SEC. ELEC. AGE 1, 1 (Dec. 2014); Felicia Smith, *Madoff Ponzi Scheme Exposes the "Myth of the Sophisticated Investor,"* 40 U. BALT. L. REV. 215, 226, 236-39 (2010).

[6] *Id.*

[7] P.L. 110-343, 122 Stat. 3765 (2008).

[8] 12 U.S.C. § 5211.

[9] Jonathan Weisman, *U.S. Declares Bank and Auto Bailouts Over, and Profitable*, N.Y. TIMES (Dec. 19, 2014), https://www.nytimes.com/2014/12/20/business/us-signals-end-of-bailouts-of-automakers-and-wall-street.html; U.S. DEP'T OF THE TREASURY, *TARP Tracker*, https://www.treasury.gov/initiatives/financial-stability/reports/Pages/TARP-Tracker.aspx (last accessed 4/12/18).

[10] Murat Tasci & Caitlin Treanor, *Labor Market Behavior during and after the Great Recession: Has It Been Unusual?*, FED. RES. BANK OF CLEVELAND (Oct. 13, 2015), https://www.clevelandfed.org/newsroom-and-events/publications/economic-trends/2015-economic-trends/et-20151013-labor-market-during-after-great-recession.aspx.

[11] William R. Emmons & Bryan J. Noeth, *Household Financial Stability: Who Suffered the Most from the Crisis?*, FED. RES. BANK OF ST. LOUIS (July 2012), https://www.stlouisfed.org/publications/regional-economist/july-2012/household-financial-stability--who-suffered-the-most-from-the-crisis#endnotes.

[12] FINAL CRISIS REPORT, *supra* note 1, at 390.

In assessing the central impetus for the economic crisis that began in late 2007, a range of views have emerged.[13] Nonetheless, one view that, as discussed below, influenced certain legal changes that resulted in the aftermath of the financial crisis concluded that the financial institutions' losses that contributed to the economic downturn were largely caused by excessively risky investments in and exposure to housing markets, including through the mortgage securitization process.[14] Relatedly, some commentators further viewed executive compensation structures during this time period as incentivizing excessive risk-taking and encouraging investments that resulted in widespread economic losses.[15]

In the wake of the financial crisis, policymakers began working on legislation to reform the financial system, and in July 2010, Congress passed the Dodd-Frank Wall Street Reform and Consumer Protection Act (Dodd-Frank or the Act).[16] The Act's stated purposes, among others, are "[t]o promote financial stability in the United States by improving accountability and transparency in the financial system, to end 'too big to fail,' to protect the American taxpayer by ending bailouts, [and] to protect consumers from abusive financial services practices."[17] Ten years after the financial crisis, Dodd-Frank's changes to the law continue to be the subject of significant litigation and debate.[18]

Title IX of Dodd-Frank, entitled "Investor Protections and Improvements to the Regulation of Securities," focuses on the powers and authorities of the Securities and Exchange Commission (SEC),[19] an independent agency created by the Securities and Exchange Act of 1934 to enforce federal securities law.[20] Title IX authorizes the SEC to promulgate certain rules intended to enhance corporate accountability and governance.[21] In the view of the Senate Report accompanying Dodd-Frank, "[s]ignificant aspects of the financial crisis involved securities."[22] Specifically, the Senate Report took the position that "[s]erious and far-reaching problems were caused by poor and risky securitization practices; erroneous credit ratings; ineffective SEC regulation of investment banks such as Lehman Brothers and broker dealers such as Madoff; and excessive compensation incentives that promoted excessive risk taking."[23] According to the

[13] *See, e.g.*, Robert E. Litan, *The Political Economy of Financial Regulation after the Crisis*, *in* RETHINKING THE FINANCIAL CRISIS 269, 270 ("There are so many alleged 'causes' of the great financial crisis of 2007 to 2008 that it is easy to lose count."); FINAL CRISIS REPORT, *supra* note 1 at 125-26, 187, 230, 255; *Dissenting Statement of Keith Hennessy, Douglas Holtz-Eakin & Bill Thomas*, *in* FINAL CRISIS REPORT, *supra* note 1, at 413-37; *Dissenting Statement of Peter Wallison*, in FINAL CRISIS REPORT, *supra* note 1, at 443-553.

[14] FINAL CRISIS REPORT, *supra* note 1, at xviii-xix, 44-45, 279-91.

[15] *See, e.g.*, Andrew Dunning, *The Changing Landscape of Executive Compensation After Dodd-Frank*, 30 REV. BANKING & FIN. L. 64, 64-66 (2010) (discussing pre-Dodd-Frank executive compensation packages' focus on achieving short-term financial goals and disconnect between executive performance and corporate value); Michael diFilipo, Note, *Regulating Executive Compensation in the Wake of the Financial Crisis*, 2 DREXEL L. REV. 258, 280-86 (2009) (discussing the manner in which executive pay practices may have encouraged decisions that led to the financial crisis).

[16] P.L. 111-203, 124 Stat. 1376 (2010) [hereinafter "Dodd-Frank"].

[17] *Id*.

[18] For a high-level overview of Dodd-Frank, see CRS Report R41350, *The Dodd-Frank Wall Street Reform and Consumer Protection Act: Background and Summary*, coordinated by Baird Webel.

[19] Dodd-Frank §§ 901-991.

[20] *See* 15 U.S.C. §§ 78d(a), 78d-5.

[21] Dodd-Frank §§ 901-991.

[22] *See* S. REP. NO. 111-176, at 36 (2010) [hereinafter "Senate Report"].

[23] *Id.*

Senate Report, two main goals of Title IX were to provide investors with better protections and to give shareholders more of a voice in corporate governance.[24]

This report discusses two aspects of Title IX that have seen significant developments in early 2018. First, in February 2018, the Supreme Court rendered a potentially significant decision with respect to a new SEC whistleblower program instituted by Dodd-Frank, resolving a dispute that had arisen among the lower courts as to the scope of individuals who could avail themselves of anti-retaliation protections provided by the Act.[25] The report discusses the SEC whistleblower program, the dispute as framed by a number of U.S. Courts of Appeals, the Supreme Court's decision and reasoning, and implications of the Court's decision. Second, in early 2018, companies began their compliance with a new SEC disclosure rule mandated by Dodd-Frank, which requires them to publicly disclose the ratio between the median annual total compensation of all of their employees to the annual total compensation of their Chief Executive Officer.[26] The report discusses the SEC's adoption of the rule, the rule's operation, and potential challenges that may be brought to the pay ratio disclosure requirement now that it is in operation.

Dodd-Frank's Whistleblower Incentives and Protections: Recent Developments

To promote corporate compliance with federal securities law, Section 922 of Dodd-Frank creates a new whistleblower program at the SEC, providing both incentives and enhanced protections for securities law "whistleblowers."[27] In a ruling that narrows the scope of Section 922, on February 21, 2018, the Supreme Court issued a decision in *Digital Realty, Inc. v. Somers*.[28] Specifically, in *Digital Realty*, the Court held that Section 922's whistleblower protections do not apply to internal whistleblowers—that is, those who report violations within their organizations but *not* to the SEC. This section of the report provides background regarding the SEC whistleblower program created by Dodd-Frank and compares pre-Dodd-Frank anti-retaliation protections available to securities law whistleblowers to Section 922. It then discusses the circuit split that arose concerning whether internal reporters are protected by Dodd-Frank's anti-retaliation provisions, the Supreme Court's reasoning in *Digital Realty*, and implications of the case for securities law.

Background: Dodd-Frank's SEC Whistleblower Provisions

Section 922 of Dodd-Frank establishes new incentives and protections for whistleblowers who report certain violations of securities laws. The Senate Report accompanying Dodd-Frank pointed to factors such as "ineffective SEC regulation of Madoff Securities, Lehman Brothers and other firms" as a significant aspect of the financial crisis. Through Title IX of Dodd-Frank, the Senate Report stated, "[t]he SEC would get more power, assistance and money at its disposal to be an

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[24] *Id.*

[25] Dig. Realty Tr., Inc. v. Somers, 138 S. Ct. 767 (2018).

[26] Final Rule: Pay Ratio Disclosure, Release Nos. 33-9877; 34-75610, 80 Fed. Reg. 50,104 (Aug. 18, 2015), https://www.sec.gov/rules/final/2015/33-9877.pdf (specifying that "registrants must comply with the final rule for the first fiscal year beginning on or after January 1, 2017).

[27] 15 U.S.C. § 78u-6.

[28] Dig. Realty Tr., Inc. v. Somers, 138 S. Ct. 767 (2018).

effective securities markets regulator."[29] The report further stated, with respect to the Act's whistleblower provisions that, "[t]he SEC would have more help in identifying securities law violations through a new, robust whistleblower program designed . . . to motivate people who know of securities law violations to tell the SEC."[30] The new whistleblower program introduced by Dodd-Frank has two central aspects: (1) providing monetary incentives for whistleblowers through financial rewards, and (2) enhancing anti-retaliation protections for whistleblowers against adverse actions taken by their employers.

Financial Incentives for Whistleblowers

Under Dodd-Frank, eligible whistleblowers who voluntarily provide "original information" to the SEC,[31] resulting in a successful judicial or administrative enforcement action with monetary sanctions exceeding one million dollars, are entitled to financial awards.[32] The cash award for a qualifying whistleblower may range from 10 to 30 percent of the monetary sanctions collected in the enforcement action, to be paid from a congressionally authorized Investor Protection Fund (so as not to detract from any victims' recovery).[33] The precise amount of the award is left to the discretion of the SEC, determined based on factors such as the significance of the information to the success of the action and the degree of assistance the whistleblower provided.[34] Whistleblowers are generally defined under the statute to be individuals "who provide . . . information relating to a violation of the securities laws to the Commission, in a manner established, by rule or regulation, by the Commission."[35] Nonetheless, the incentives program does exclude some whistleblowers, including "any whistleblower who is convicted of a criminal violation related to the judicial or administrative action for which the whistleblower otherwise could receive an award under this section."[36]

The incentive program established by Section 922 of Dodd-Frank is now in its seventh year of operation.[37] The SEC reports that enforcement matters involving whistleblower information have yielded $975 million in monetary sanctions to date, much of which has been or will be returned to investors.[38] Since the program's inception through the end of September 2017, the SEC had awarded $160 million in whistleblower awards under the incentive program.[39] Moreover, the agency recently increased that figure by approximately 50% with its largest award yet—$83 million awarded to three whistleblowers in related investigations that, according to the

[29] *See* Senate Report, *supra* note 22, at 37.

[30] *Id.* at 38.

[31] For purposes of Section 922, "original information" is defined to mean information that (1) is derived from the independent knowledge or analysis of a whistleblower, (2) is not known to the SEC from any other source, unless the whistleblower is the original source of the information, and (3) is not exclusively derived from an allegation made in a judicial or administrative hearing, in a governmental report, hearing, audit, or investigation, or from the news media, unless the whistleblower is the source of the information. 15 U.S.C. § 78u-6(a)(3).

[32] *Id.* § 78u-6(b)(1).

[33] *Id.* § 78u-6(g); SEC, WHISTLEBLOWER PROGRAM: 2017 ANNUAL REPORT TO CONGRESS 29 (Nov. 15, 2017), https://www.sec.gov/files/sec-2017-annual-report-whistleblower-program.pdf [hereinafter "WHISTLEBLOWER PROGRAM REPORT"] ("No money has been taken or withheld from harmed investors to pay whistleblower awards.").

[34] 15 U.S.C. § 78u-6(b)-(c).

[35] *Id.* § 78u-6(a)(6).

[36] *Id.* § 78u-6(c)(2)(B).

[37] *See* WHISTLEBLOWER PROGRAM REPORT, *supra* note 33, at 1.

[38] *Id.*

[39] *Id.*

whistleblowers' lawyers, involved tips concerning transactions that effectively commingled customer and company funds at Merrill Lynch in violation of customer protection rules.[40]

The Financial CHOICE Act passed by the House of Representatives in June 2017 would exclude certain additional categories of whistleblowers from eligibility for a financial incentive award. As noted above, currently, the incentive program makes whistleblowers with a criminal conviction related to the underlying complaint ineligible for an award.[41] The CHOICE Act would further deny bounties to any whistleblower who was responsible for or complicit in—or who in certain circumstances failed to try to prevent—the misconduct being reported.[42] The bill defines these categories in terms of a person who (1) "procures, induces, or causes another person to commit the offense"; (2) "aids or abets another person in committing the offense"; or (3) "having a duty to prevent the violation, fails to make an effort the person is required to make."[43] Critics of the bill have noted that the legislation, in excluding a whistleblower who fails to "make an effort" to stop the complained of action, could significantly reduce the pool of potential whistleblowers and eliminate those who may be in the best position to report wrongdoing, particularly if the person is in a subordinate position to the primary wrongdoer.[44] Supporters of the provision, by contrast, argue that the program should not reward individuals who may have had a role, even passively, in the underlying wrongdoing of which they complain.[45]

Whistleblower Anti-Retaliation Provisions

Section 922 also enhanced and strengthened anti-retaliation protections for whistleblowers in several respects[46]. The SEC has brought a number of actions against employers under the anti-retaliation provisions and a rule promulgated pursuant to it.[47] For example, in its enforcement efforts, the SEC has specifically focused on provisions in separation and severance agreements that restrict former employees' ability to report securities law violations to the SEC.[48] Most relevant to *Digital Realty,* the anti-retaliation provision further authorizes a private right of action, allowing individuals who experience retaliation as a result of activity protected by Section 922 to

[40] *See* Jenny Strasburg and David Michaels, *Whistleblowers Helped SEC Bring $415 Million Settlement with Bank of America,* WALL ST. J. (Mar. 19, 2018), https://www.wsj.com/articles/whistleblowers-helped-sec-bring-415-million-settlement-against-bank-of-america-1521479445; Press Release, SEC, *SEC Announces Its Largest-Ever Whistleblower Awards* (Mar. 19, 2018), https://www.sec.gov/news/press-release/2018-44; Press Release, SEC, *Merrill Lynch to Pay $415 Million For Misusing Customer Cash and Putting Customer Securities at Risk* (June 23, 2016), https://www.sec.gov/news/pressrelease/2016-128.html.

[41] 15 U.S.C. § 78u-6(c)(2)(B).

[42] *See* H.R. 10, 115th Cong. § 828 (2017).

[43] *Id.*

[44] *See* John C. Coffee, Jr., *Hobson's CHOICE: The Financial CHOICE Act of 2017 and the Future of SEC Administrative Enforcement*, (June 22, 2017), https://www.sec.gov/spotlight/investor-advisory-committee-2012/coffee-hobsons-choice-act.htm ("[S]uch persons will be disqualified from receiving any bounty, and this could chill the incentive to later blow the whistle. Subordinates should not be seen as complicit wrongdoers simply because they do not behave as heroes.").

[45] *See* Thomas Zaccaro, Nicolas Morgan, & Kyle Jones, *Congress Faces 'CHOICE' On Future Of SEC Enforcement*, LAW360 (Sept. 27, 2017), https://www.law360.com/articles/967996/congress-faces-choice-on-future-of-sec-enforcement ("Although this provision disqualifies individuals "convicted of a criminal violation" related to the conduct at issue, it still allows individuals who caused or allowed this conduct to occur to profit from these violations. Section 828 would fix this problem . . . .").

[46] 15 U.S.C. § 78u-6(h).

[47] 17 C.F.R. § 240.21F-17(a). The relevant rule prohibits any person from "tak[ing] any action to impede an individual from communicating directly with the Commission staff about a possible securities law violation." *Id.*

[48] *See* WHISTLEBLOWER PROGRAM REPORT, *supra* note 33, 2, 6-7, 19-21.

sue their employers in federal court for reinstatement, double back pay, with interest, and compensation for litigation costs and fees.[49]

The Sarbanes-Oxley Act (SOX), enacted in 2002 in the wake of the Enron and WorldCom accounting scandals,[50] contained the most significant whistleblower protection provision in federal securities law before Dodd-Frank. Because the anti-retaliation provision in Section 922 of Dodd-Frank contains certain references to SOX, it is important to understand the pre-existing protections that were available under SOX. The 2002 law's anti-retaliation provision generally protects an "employee" who provides information regarding a suspected violation of certain securities laws to: (1) a federal regulatory or law enforcement agency, (2) a Member or Committee of Congress, or (3) "a person with supervisory authority over the employee" working for the same employer.[51] Significantly, as related to the third category, SOX also mandated that public companies' audit committees establish procedures for internal complaints and reporting of suspected abuses within the company.[52] SOX and other laws further require a company's auditors and attorneys to report suspected violations internally before reporting to an outside agency.[53] Commentators have noted that the internal reporting regime under SOX has been widely integrated into corporate compliance programs over the past 15 years.[54]

SOX allows employees who allege that they have been penalized for their reporting activity or for their assistance to law enforcement to file a complaint with the Secretary of Labor within 180 days of the alleged retaliatory conduct (or their awareness of such conduct), and they can bring an action in federal court only if the Secretary does not act on their complaint within 180 days of it being filed.[55] As for remedies, employees are entitled to reinstatement, backpay, and special damages (which may include, for example, damages for emotional injury).[56]

While SOX therefore afforded employees particular anti-retaliation protections for internal and external reporting prior to Dodd-Frank, the 2010 law provides certain more generous protections for individuals who are considered whistleblowers under that statute.[57] In contrast to SOX, Dodd-Frank does not require filing an administrative complaint before suing in court for retaliation, provides a longer statute of limitations (between six and ten years, depending on the circumstances), and offers reinstatement and *double* backpay as remedies.[58] In terms of protected activity, Dodd-Frank's anti-retaliation provision prohibits an employer from retaliating against a "whistleblower" "because of" three types of activity. First, the provision protects whistleblowers who provide information regarding securities law violations to the SEC.[59] Second, the provision also applies to whistleblowers who assist the SEC in an investigation or proceeding.[60] Third, and

[49] 15 U.S.C. § 78u-6(h)(1)(B)(i), (1)(C).

[50] Jeffrey Golan and Chad Carder, *15 Years of SOX: The WorldCom and Enron Securities Cases*, LAW360 (July 31, 2017), https://www.law360.com/articles/947479/15-years-of-sox-the-worldcom-and-enron-securities-cases.

[51] 18 U.S.C. § 1514A.

[52] 15 U.S.C. § j-1(m)(4)(B).

[53] *See id.* §§ 78j-1(b), 7245.

[54] Michael W. Peregrine, *Corporate Compliance and the Legacy of Sarbanes Oxley*, NYU LAW COMPLIANCE & ENF'T BLOG (Aug. 3, 2017), https://wp.nyu.edu/compliance_enforcement/2017/08/03/corporate-compliance-and-the-legacy-of-sarbanes-oxley/.

[55] 18 U.S.C. § 1514A.

[56] *Id.*

[57] 15 U.S.C. § 78u-6(a)(6).

[58] *Id.* § 78u-6(h).

[59] *Id.* § 78u-6(h)(1)(A)(i).

[60] *Id.* § 78u-6(h)(1)(A)(ii).

most relevant to *Digital Realty*, the anti-retaliation provision further specifies that it protects whistleblowers who "mak[e] disclosures that are required or protected under [SOX]," among other laws.[61]

Table 1 provides a comparison between the anti-retaliation provisions in SOX and Dodd-Frank.

Table 1. Comparing the Anti-Retaliation Provisions in SOX and Dodd-Frank

	SOX	Dodd-Frank
Who Qualifies for the Anti-Retaliation Protections	**Employee** of public company who: (1) provides information relating to alleged securities fraud violations to: (A) a federal regulatory or law enforcement agency, (B) A Member or Committee of Congress, or (C) a person with supervisory authority over the employee working for the same employer; or (2) files, testifies in, or participates in a proceeding relating to an alleged violation of any rule or law relating to alleged securities fraud violations.[62]	**Whistleblower** who: (1) provides information to the SEC in accordance with Section 922; (2) initiates, testifies in, or assists in any investigation or judicial or administrative action of the SEC basedupon or related to such information; or (3) makes disclosures that are required or protected under [SOX], this chapter . . . and any other law, rule, or regulation subject to the jurisdiction of the SEC.[63]
Exhaustion Requirement	**Yes**; Must file a complaint with Secretary of Labor prior to suing in federal court[64]	**No**
Statute of Limitations for Private Right of Action	**180 days** Complaint with Secretary of Labor: Not later than 180 days after the date on which the violation occurs (or after the date on which the employee became aware of the violation)[65] Federal court complaint: Within 180 days of filing the complaint with the Secretary of Labor, if the Secretary has not issued a final decision[66]	**6-10 years** Not more than 6 years after the date on which the violation occurred; or Not more than three years after the date when facts material to the right of action are known or reasonably should have been known to the employee, but in no circumstances more than 10 years after the date on which the violation occurs[67]

[61] *Id.* § 78u-6(h)(1)(A)(iii).

[62] 18 U.S.C. § 1514A(a).

[63] 15 U.S.C. § 78u-6(h)(1).

[64] 18 U.S.C. § 1514A(b)(2)(D).

[65] *Id.*

[66] *Id.* § 1514A(b)(1)(B).

[67] 15 U.S.C. § 78u-6(h)(1)(B)(iii).

	SOX	Dodd-Frank
Remedies Available	All relief necessary to make the employee whole, including: (1) Reinstatement; (2) **Back pay**, with interest; (3) **Special damages**, including litigation costs and fees.[68]	Relief for an individual prevailing in an action brought under Section 922 shall include: (1) Reinstatement; (2) **Double back pay**, with interest; (3) Litigation costs and fees.[69]

Source: Created by CRS.

Digital Realty and the Scope of Dodd-Frank's Whistleblower Protections

Dispute Regarding Interpretation of Dodd-Frank's Anti-Retaliation Provision

The third category of protected activity under Dodd-Frank, which includes the reference to SOX, does not itself suggest that the whistleblower needs to have made any disclosures *to the SEC* in order to recover.[70] And because SOX, in turn, protects an employee from retaliation for internal reporting,[71] it seems plausible that the Dodd-Frank provision could encompass internal reporters. However, the definition of the term "whistleblower" in Section 922 of Dodd-Frank complicates reaching a conclusion that internal whistleblowers are protected under the Act. The definition refers to individuals who provide "information relating to a violation of the securities laws *to the Commission*, in a manner established, by rule or regulation, by the Commission,"[72] suggesting that an individual must report to the SEC to benefit from the subsection's protections.

This tension between Dodd-Frank's definition of the term "whistleblower" and its incorporation of SOX in the anti-retaliation provision is at the heart of *Digital Realty*. That case began when Paul Somers, as a Vice President at Digital Realty, a publicly traded real estate investment trust,[73] complained internally to the company's management regarding alleged securities law violations.[74] Digital Realty fired Somers soon afterwards, an adverse action that Somers alleged violated Section 922.[75] Somers filed a lawsuit in the U.S. District Court for the Northern District of California, which dismissed the suit because he did "not report any alleged law violations to the SEC."[76] On appeal to the U.S. Court of Appeals for the Ninth Circuit (Ninth Circuit),[77] the appellate court ruled that Somers was entitled to sue under Dodd-Frank, even though he did not

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68 18 U.S.C. § 1514A(c).

69 15 U.S.C. § 78u-6(h)(1)(C).

70 *Id.* § 78u-6(h)(1) (protecting whistleblowers who "mak[e] disclosures that are required or protected under the Sarbanes-Oxley Act of 2002 (15 U.S.C. 7201 et seq.), this chapter, including section 78j-1(m) of this title, section 1513(e) of title 19, and any other law, rule, or regulation subject to the jurisdiction of the Commission").

71 18 U.S.C. § 1514A(a)(1)(C).

72 15 U.S.C. § 78u-6(a)(6) (emphasis added).

73 Digital Realty Trust, Inc. and Digital Realty Trust, L.P., Annual Report (Form 10-K) (Mar. 1, 2018), https://www.sec.gov/Archives/edgar/data/1297996/000129799618000026/dlr12311710k.htm.

74 Somers v. Dig. Realty Tr., Inc., 850 F.3d 1045, 1047 (9th Cir. 2017).

75 *Id.*

76 Somers v. Dig. Realty Tr., Inc., 119 F. Supp. 3d 1088, 1094 (N.D. Cal. 2015).

77 For purposes of brevity, references to a particular circuit in the body of this report (e.g., the Ninth Circuit) refer to the U.S. Court of Appeals for that particular circuit.

take the additional step of reporting his concerns to the SEC.[78] The Second Circuit reached the same result in a similar case in 2015.[79] But the Fifth Circuit took a different view in 2013, ruling that a "whistleblower" must have reported a complaint to the SEC in order to recover under Dodd-Frank's whistleblower provisions.[80] These decisions created a circuit split over the proper reading of Dodd-Frank, setting the stage for Supreme Court review.

The lower court in *Digital Realty* reasoned that Section 922's specific reference to SOX, and the overall purpose of the statute, indicated Congress's intent to protect internal whistleblowers as well as those who report to the SEC.[81] Specifically, the Ninth Circuit reasoned that a strict application of the "whistleblower" definition would effectively read the third category of protected activity of the anti-retaliation provision out of the statute because that class of protected individuals would be narrowed to the point of meaninglessness.[82] In implementing the Dodd-Frank anti-retaliation provision through regulations, the SEC had defined the term "whistleblower" to encompass internal whistleblowers, explaining that a more limited reading would chill employees' use of valuable internal reporting processes.[83] The Ninth Circuit agreed with the Second Circuit that the SEC's reading of the anti-retaliation provision was entitled to deference under *Chevron* principles,[84] even if the statute's definition of the term "whistleblower" cast some doubt on that interpretation.[85]

The Fifth Circuit, on the other hand, ruled in *Asadi v. G.E. Energy (USA), L.L.C.* that in order to qualify as a "whistleblower" under Dodd-Frank, an individual must report a suspected violation to the SEC.[86] In analyzing the statutory language, the Fifth Circuit determined that the reference to SOX in the anti-retaliation provision does not expand the definition of a "whistleblower" and concluded that it would be inappropriate to read the words "to the Commission" out of the definition.[87] The Fifth Circuit hypothesized at least one scenario in which the third category of Dodd-Frank whistleblower protections would apply under a more limited reading of the definition. Specifically, the appellate court reasoned that an employee who reports both internally *and* to the SEC, but is retaliated against only "because of" the internal report (e.g., if the employer was unaware of the report to the SEC) would qualify as a "whistleblower" under the Fifth Circuit's interpretation of Section 922.[88] The Fifth Circuit further reasoned that the anti-retaliation scheme for internal reporting that exists under SOX would essentially be rendered "moot" if the Dodd-Frank anti-retaliation provisions were to apply because whistleblowers would be more inclined to take advantage of Dodd-Frank's stronger protections.[89]

[78] *Somers,* 850 F.3d at 1050-51.

[79] *See* Berman v. Neo@Ogilvy LLC, 801 F.3d 145 (2d Cir. 2015).

[80] *See* Asadi v. G.E. Energy (USA), L.L.C., 720 F.3d 620 (5th Cir. 2013).

[81] *Somers*, 850 F.3d at 1049-50.

[82] *Id.* at 1049.

[83] *See* 17 C.F.R. § 240.21f-2; SEC, INTERPRETATION OF THE SEC'S WHISTLEBLOWER RULES UNDER SECTION 21F OF THE SECURITIES EXCHANGE ACT OF 1934, 80 Fed. Reg. 47,829, 47,830 (Aug. 10, 2015).

[84] *See* Chevron, U.S.A. v. Natural Resources Defense Council, Inc., 467 U.S. 837, 842-44 (1984) (holding that courts should defer to an agency's "construction of the statute which it administers" as long as the statute is ambiguous and the agency regulations are "based on a permissible construction of the statute"). For more on the *Chevron* doctrine, see CRS Report R44954, *Chevron Deference: A Primer*, by Valerie C. Brannon and Jared P. Cole.

[85] *Somers*, 850 F.3d at 1047, 1050.

[86] Asadi v. G.E. Energy (USA), L.L.C., 720 F.3d 620 (5th Cir. 2013).

[87] *Id.* at 626-27, 628.

[88] *Id.* at 627-28.

[89] *Id.* at 628.

The Supreme Court's *Digital Realty* Decision

In ruling in favor of Digital Realty and resolving the circuit split, the Supreme Court unanimously held that the definition of "whistleblower" provided "an unequivocal answer" that resolved the case, affirming the principle that "[w]hen a statute includes an explicit definition, we must follow that definition."[90] The Court distinguished the case from prior instances in which it did not hold a statutory definition to control because, unlike those cases, the results in *Digital Realty* would not be incongruous with Congress's regulatory scheme.[91] Namely, the Court emphasized several times throughout its opinion that the purpose of the enhanced whistleblower provision was "to motivate people who know of securities law violations *to tell the SEC*," quoting Dodd-Frank's Senate Report.[92] Moreover, the Court rejected Somers's arguments that requiring reporting to the SEC to qualify as a "whistleblower" would lead to results incompatible with Congress's intent.[93] For example, echoing the Fifth Circuit's reasoning, the Court reasoned that the Dodd-Frank anti-retaliation provision's reference to SOX would still be meaningful under the narrower definition because it would protect those who report *both* internally and to the SEC, but incur retaliation for the internal report.[94] The Court observed that such a scenario may in fact be commonplace because, as data from the SEC presented to the Court showed, approximately 80% of those receiving SEC whistleblower awards in 2016 had indeed reported internally before making their complaints to the SEC.[95]

Implications of *Digital Realty*

With regard to the ruling's impact on the enforcement of federal securities law, *Digital Realty* eliminated a potential avenue of relief for internal whistleblowers, a population which, according

[90] Dig. Realty Tr., Inc. v. Somers, 138 S. Ct. 767, 776-77 (2018) (quoting Burgess v. United States, 553 U.S. 124, 130 (2008)).

[91] *Id.* at 778. Specifically, the Court distinguished two prior Supreme Court decisions that had been raised by Somers. In the first case, *Lawson v. Suwannee Fruit & Steamship Company*, the Court found that applying the statutory definition of the term "disability" to the worker compensation provision at issue in *Lawson* would have caused "obvious incongruities in the language" of the statute and "destroy[ed] one of the major purposes" of the provision. 336 U.S. 198, 201-02 (1949). However, in *Digital Realty*, the Court rejected Somers's argument that a reading of the anti-retaliation provision to exclude internal reporting was at odds with congressional intent or the overall statutory scheme. *Digital Realty*, 138 S. Ct. at 778. Second, in contrast to *Utility Air Regulatory Group v. EPA*, where the Court held that the term "air pollutant" had a narrower meaning in one portion of the Clean Water Act than its statute-wide definition (because that the term was routinely interpreted with a "narrower, context-appropriate meaning" throughout individual portions of the statute, including by the EPA), 134 S. Ct. 2427, 2439 (2014), in *Digital Realty* the definition of "whistleblower" was located within Section 922 of Dodd-Frank itself and stated that it was applicable to the entire section. *Dig. Realty*, 138 S. Ct. at 778 (citing 15 U.S.C. § 78u-6(a)(6)).

[92] *See, e.g., Dig. Realty*, 138 S. Ct. 777, 780 (quoting S. REP. No. 111-176, at 37 (2010)). The citation to the Senate Report prompted significant debate amongst the concurring justices in *Digital Realty*. Justice Thomas, joined by Justices Alito and Gorsuch, wrote separately regarding their disagreement with the Court opinion's reliance on the Senate Report in interpreting the definition of whistleblower. *Id.* at 783 (Thomas, J., concurring in part and concurring in the judgment). They "join[ed] the Court's opinion only to the extent it relies on the text of Dodd-Frank," elaborating that the language of a statute enacted by Congress—rather than potentially unreliable documents explaining congressional intent—should ultimately control. *Id.* Justice Sotomayor, on the other hand, authored another concurring opinion, joined by Justice Breyer, in which she argued that it is appropriate to look to legislative history as an interpretive aid, "even when, as here, a statute's meaning can clearly be discerned from its text." *Id.* (Sotomayor, J., concurring). In such cases, Justice Sotomayor contended, inquiries into legislative intent can confirm and enhance the Court's understanding of the language. *Id.*

[93] *Id.* at 779-80 (majority opinion).

[94] *Id.* at 779.

[95] *Id.*

to recent SEC and other statistics, appears to be historically larger than the pool of external whistleblowers.[96] The *Digital Realty* decision clarifies that internal reporters must rely on the protections in SOX, which, as discussed above, are in significant respects less advantageous than those provided under Dodd-Frank. While internal and external whistleblower reporting are each still protected under federal law, some commentators note that the decision, particularly when combined with large incentive awards coming out of the SEC whistleblower program, tips the scale towards incentivizing reporting of securities law violations to the authorities rather than deferring to public companies' internal compliance efforts, [97] which some commentators argue will lead to greater risk of noncompliance with federal law.[98]

Digital Realty's ultimate impact on corporations that are subject to Dodd-Frank's whistleblower provisions is unclear. In supporting the petitioner's arguments in *Digital Realty*, notable *amici* like the U.S. Chamber of Commerce favored the narrower "whistleblower" definition because, in its view, an expansive definition encompassing internal reporters would have increased costs for companies faced with more whistleblower actions in federal court, while spurning internal and administrative processes set up by SOX that it argued are often more efficient in weeding out non-meritorious claims.[99] Nonetheless, while *Digital Realty* will protect public companies against federal lawsuits under Dodd-Frank from internal whistleblowers, there may be other externalities created by the decision. Specifically, because, as commentators have noted, the Court's ruling may have the practical effect of increasing whistleblower reports made directly to the SEC over attempted internal resolutions, the ruling could potentially lead to increased regulatory action and greater costs for companies.[100] Whether these costs outpace any increased litigation costs that could have resulted from a different ruling in *Digital Realty* remains to be seen.

Dodd-Frank Pay Ratio Disclosure Rule: Recent Developments

Section 953(b) of Dodd-Frank directs the SEC to promulgate a rule requiring reporting companies[101] to disclose in certain public filings the ratio of (a) the median annual total compensation of all of its employees (i.e., the median employee's compensation) to (b) the annual

[96] *See* WHISTLEBLOWER PROGRAM REPORT, *supra* note 33, at 17 (noting that 83% of whistleblower award recipients reporting to the SEC in 2017 who were employees or former employees of the subject entities first reported their complaints internally); *see also* ETHICS RES. CTR., INSIDE THE MIND OF A WHISTLEBLOWER: A SUPPLEMENTAL REPORT OF THE 2011 NATIONAL BUSINESS ETHICS SURVEY 2 (2012), http://www.corporatecomplianceinsights.com/wp-content/uploads/2012/05/inside-the-mind-of-a-whistleblower-NBES.pdf (estimating that only one in six whistleblowers "ever chooses to report externally.").

[97] *See* Dunstan Prial, *Incentives Get Weaker For Internal Whistleblower Reporting,* LAW360 (March 23, 2018), https://www.law360.com/articles/1025665/incentives-get-weaker-for-internal-whistleblower-reporting.

[98] *See* Stephen Kohn, *Digital Realty Trust v. Somers May Kill Corporate Compliance*, LAW360 (Sept. 21, 2017), https://www.law360.com/articles/964208/digital-realty-trust-v-somers-may-kill-corporate-compliance.

[99] Brief for United States Chamber of Commerce as Amicus Curiae Supporting Petitioner at 9-11, Digital Realty, Inc. v. Somers, 138 S. Ct. 767 (2018) (No. 16-1276).

[100] Dustin Prial, *Companies May Find High Court Whistleblower Ruling Costly*, LAW360 (Feb. 21, 2018), https://www.law360.com/securities/articles/1014744/companies-may-find-high-court-whistleblower-ruling-costly.

[101] Section 953(b) specifies that companies must disclose the pay ratio in SEC filings required under 17 C.F.R. § 229.10(a), which include registration statements and annual and quarterly financial reports, among others. For ease of reference, this report may refer to companies subject to these rules as "reporting companies" or "registrants" (the term employed by the SEC in the final pay ratio disclosure rule, 17 C.F.R. § 229.402(u)).

total compensation of its chief executive officer.[102] The SEC adopted the final pay ratio disclosure rule (the Rule)[103] on August 5, 2015 by a 3-2 vote of the Commissioners.[104] The vote followed a notice and comment process which drew nearly 300,000 comment letters[105] following release of the proposed rule in September 2013.[106] Because the SEC required compliance with the Rule to begin for the first fiscal year beginning on or after January 1, 2017,[107] the first wave of companies made their pay ratio disclosures earlier this year in annual statements and in proxy materials in advance of annual shareholder meetings. While the first major disclosure (in which Honeywell reported a 333:1 pay ratio)[108] drew considerable media attention,[109] companies have disclosed a very wide range of ratios to date.[110]

Background: Dodd-Frank's Accountability and Executive Compensation Provisions

The pay ratio provision is contained within Title IX of Dodd-Frank, in a subtitle concerning "Accountability and Executive Compensation." This subtitle includes several provisions geared towards transparency and shareholder involvement in matters of executive compensation.[111] Perhaps most notably, Section 951, the so-called "say on pay" provision, requires that shareholders be given the opportunity to cast advisory votes as to executive compensation at annual shareholder meetings at least once every three years.[112] Moreover, Section 953(a)

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[102] *See* Dodd-Frank § 953(b) ("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).").

[103] 17 C.F.R. § 229.402(u). The rule was an addition to Item 402 of the SEC's Regulation S-K.

[104] Dennis R. Honabach and Mark A. Sargent, *The Final "Pay Ratio Disclosure Rule,"* PROXY RULES HDBK. § 4:25, (2017).

[105] Final Rule: Pay Ratio Disclosure, Release Nos. 33-9877; 34-75610, 80 Fed. Reg. 50,104, 50,108 (Aug. 18, 2015), https://www.sec.gov/rules/final/2015/33-9877.pdf [hereinafter "Adopting Release"].

[106] Proposed Rule: Pay Ratio Disclosure, Release Nos. 33-9452; 34-70443, Fed. Sec. L. Rep. P. 80356 (Sept. 18, 2013), https://www.sec.gov/rules/proposed/2013/33-9452.pdf.

[107] Adopting Release, *supra* note 105, at 1.

[108] Honeywell International Inc., Preliminary Proxy Statement (Schedule 14A) (Feb. 16, 2018), https://www.sec.gov/Archives/edgar/data/773840/000093041318000526/c89618_pre14a.htm.

[109] *See, e.g.*, Jena McGregor, *As Companies Reveal Gigantic CEO-to-Worker Pay Ratios, Some Worry How Low-Paid Workers Might Take the News*, WASH. POST (Feb. 21, 2018), https://www.washingtonpost.com/news/on-leadership/wp/2018/02/21/as-companies-reveal-gigantic-ceo-to-worker-pay-ratios-some-worry-how-low-paid-workers-might-take-the-news/?noredirect=on&utm_term=.83eb25a5d659.

[110] *Compare, e.g.,* Aptiv PLC, Definitive Proxy Statement (Schedule 14A) (Mar. 12, 2018), https://www.sec.gov/Archives/edgar/data/1521332/000119312518079291/d527278ddef14a.htm (disclosing a pay ratio of 2,526:1), *with* Dorchester Minerals, L.P., Preliminary Proxy Statement (Schedule 14A) (Feb. 26, 2018), https://www.sec.gov/Archives/edgar/data/1172358/000143774918003337/dmlp20180223_pre14a.htm (disclosing a pay ratio of 0.9:1).

[111] Dodd-Frank §§ 951-957.

[112] *Id.* § 951. The SEC adopted rules implementing the "say-on-pay" provision in 2011. *See* 17 C.F.R. § 240.14a-21(a). Title IX of Dodd-Frank further contains provisions requiring enhanced compensation structure reporting (Dodd-Frank § 956), that directors serving on a board's compensation committee be independent (Dodd-Frank § 952), and the clawback of executive incentive compensation that result from the firm's issuing erroneous financial statements that later need to be restated in compliance with accounting standards (Dodd-Frank § 954).

mandates that issuers further make an executive "pay versus performance" disclosure in their annual proxy statements,[113] which would require disclosure of executive compensation alongside the company's total shareholder return as a measure of performance.[114]

Title IX's legislative history arguably reflects that the law's various provisions on executive compensation were propelled by the view that compensation arrangements incentivized risky behavior by executives, contributing to the 2007-2009 financial crisis.[115] While the legislative history for Dodd-Frank's pay ratio disclosure provision is sparse, the SEC, in adopting the Rule, concluded that a major purpose of the Rule is to better enable shareholders to cast their "say on pay" votes.[116] This conclusion finds a measure of support in the legislative history for the rest of the subtitle, most notably, the "pay versus performance" disclosure requirements found in Section 953(a) of the Act.[117] The Senate Report's discussion of the "pay versus performance" disclosure specifies that the rule is intended to "show[] the relationship between executive compensation and the financial performance of the issuer" as a metric to assist shareholders in their evaluation of executive pay.[118] The Senate Report further states that the Committee on Banking, Housing, and Urban Affairs believed that the disclosure will "add to corporate responsibility as firms will have to more clearly disclose and explain executive pay" and "allow shareowners to evaluate the performance of the compensation committee and board in setting executive pay, to assess pay-for-performance links and to optimize their role of overseeing executive compensation through such means as proxy voting."[119] The legislative history of the "pay versus performance" provision could be viewed as providing insights into the meaning of its neighboring provision concerning the pay ratio disclosure.[120]

The SEC Commissioners who voted on the Rule, public commenters, and other commentators have differed in how they have interpreted the motivations for and value of the pay ratio disclosure rule. Former SEC Chairwoman Mary Jo White recognized that "[t]o say that the views on the pay ratio disclosure requirement are divided is an obvious understatement,"[121] while former SEC Commissioner Luis Aguilar remarked that the requirement is either "a boon or a

[113] Dodd-Frank § 953(a).

[114] The SEC proposed a rule implementing the "pay versus performance" provision in April 2015, followed by a notice and comment period. *See* Press Release, SEC, *SEC Proposes Rules to Require Companies to Disclose the Relationship Between Executive Pay and a Company's Financial Performance* (Apr. 29, 2015), https://www.sec.gov/news/pressrelease/2015-78.html. However, no further action has been taken, and the rule was placed on the SEC's "long term" agenda in its Regulatory Flexibility Agenda released in January 2018. *See* Regulatory Flexibility Agenda, 83 Fed. Reg. 2022 (Jan. 12, 2018).

[115] Senate Report, *supra* note 22, at 36 ("Serious and far-reaching problems were caused by . . . excessive compensation incentives that promoted excessive risk taking. . . .").

[116] Adopting Release, *supra* note 105, at 9.

[117] For more on the use of legislative history in statutory interpretation, see CRS Report R45153, *Statutory Interpretation: Theories, Tools, and Trends*, by Valerie C. Brannon, at 35-40.

[118] Senate Report, *supra* note 22, at 135.

[119] *Id.*

[120] *See, e.g.*, Sprint Telephony PCS, L.P. v. County of San Diego, 311 F. Supp. 2d 898, 907-08 (S.D. Cal. 2004) (finding legislative history of surrounding provisions of statute, as well as of section more generally, persuasive in interpreting statutory provision); *cf.* EEOC v. Commercial Office Prods. Co., 486 U.S. 107, 116, 121 (1988) (noting that an interpretation of one provision in a statute can be supported by the legislative history of other, related sections of the same statute); *see also* Danskin, Inc. v. Comm'r, 331 F.2d 360, 361 (2d Cir. 1964) (looking to "language and legislative history of a related section" of the tax code to assist in determining classification of expenditures at issue).

[121] Mary Jo White, *Statement at Open Meeting on Security-based Swap Rules Under Title VII and on Pay Ratio Disclosure Rule*, SEC (Aug. 5, 2015), https://www.sec.gov/news/statement/statement-at-open-meeting-on-sbs-and-pay-ratio-disclosure.html.

bane, depending on one's perspective."[122] In addition to helping to inform "say on pay" votes, some public commenters noted that they supported the Rule because they believed it would deter executive pay practices that led to the financial crisis, and that the Rule would reduce inequitable wealth distribution in the United States.[123]

By contrast, the dissenting Commissioners issued statements in which they argued that the Rule would have no apparent shareholder benefits,[124] especially given the information already available on CEO pay.[125] The dissenting Commissioners viewed the Rule as merely a "name and shame" exercise,[126] pointing unfavorably to an AFL-CIO statement indicating that the organization believed that "[d]isclosing this pay ratio will shame companies into lowering CEO pay."[127] One of the dissenting Commissioners expressed concern about further steps that may be taken at various levels of government, such as state efforts to tie their corporate tax rates or awards of public contracts to company pay ratios.[128] Other commenters focused on the costs of compliance with the Rule.[129] In this regard, the SEC estimated that initial compliance costs would total approximately $1.3 billion, given, for example, the complexities involved in collecting payroll and accounting information for all relevant employees, particularly those residing in other countries.[130]

What Does the Pay Ratio Disclosure Rule Entail?

The pay ratio disclosure rule requires that reporting companies disclose the ratio of their median worker's pay to their CEO's pay in certain public SEC filings, including registration statements, proxy and information statements, and annual reports.[131] Certain issuers are exempted from the Rule, including emerging growth companies[132] and smaller reporting companies.[133] In setting forth the "formula" for the pay ratio calculation, as discussed in more detail below, the SEC opted

[122] Luis A. Aguilar, *The CEO Pay Ratio Rule: A Workable Solution for Both Issuers and Investors*, SEC (Aug. 5, 2015), https://www.sec.gov/news/statement/statement-on-open-meeting-on-pay-ratio-aguilar.html.

[123] Adopting Release, *supra* note 105, at 20-21.

[124] *See* Michael S. Piwowar, *Dissenting Statement at Open Meeting on Pay Ratio Disclosure*, SEC (Aug. 5, 2015), https://www.sec.gov/news/statement/dissenting-statement-at-open-meeting-on-pay-ratio-disclosure.html [hereinafter "Piwowar Dissenting Statement"]. This comment was generally echoed by various public commenters. Adopting Release, *supra* note 105, at 23 (discussing the comments filed by various commenters).

[125] *See* Daniel M. Gallagher, Dissenting Statement at an Open Meeting to Adopt the "Pay Ratio" Rule, SEC (Aug. 5, 2015), https://www.sec.gov/news/statement/dissenting-statement-at-open-meeting-to-adopt-the-pay-ratio-rule.html [hereinafter "Gallagher Dissenting Statement"].

[126] *See* Piwowar Dissenting Statement, *supra* note 124.

[127] *See* Gallagher Dissenting Statement, *supra* note 125.

[128] *Id.* n. 22 & 23.

[129] Adopting Release, *supra* note 105, at 23-24.

[130] *Id.* at 194-203.

[131] Dodd-Frank § 953(b); 17 C.F.R. § 229.10(a). According to the SEC's Adopting Release, "in addition to potential liability under Section 18 of the Securities Exchange Act, 15 U.S.C. § 78r, "registrants that fail to comply with the final rule could . . . be violating Exchange Act Sections 13(a) and 15(d), as applicable, and would also be subject to potential liability under Exchange Act Section 10(b) and Rule 10b-5, promulgated thereunder, for any false or misleading material statements in the information disclosed pursuant to the rule." Adopting Release, *supra* note 105, at 146-47; 15 U.S.C. §§ 78m, 78o, 78j; 17 C.F.R. § 240.10b-5.

[132] 17 C.F.R. § 229.402(u), Instruction 8.

[133] *Id.*, Instruction 7.

for a largely flexible approach that it regarded as being compliant with applicable statutory requirements while taking due consideration of compliance costs.[134]

Annual Total Compensation of All Employees

Calculation of Annual Total Compensation. Issuers are already required to use particular standards in calculating and disclosing executive pay, which the SEC has set forth in Item 402(c) of Regulation S-K.[135] Section 953(b) of Dodd-Frank and the Rule specify that the same method should be used to determine the "annual total compensation" of an employee for purposes of calculating the pay ratio disclosure.[136] Registrants are permitted to use reasonable estimates of annual total compensation, other than for the CEO.[137]

Employees. The statutory language in Dodd-Frank states that the median worker-CEO pay ratio is to be calculated using the annual total compensation of "*all* employees of the registrant."[138] The Rule therefore takes an inclusive approach, requiring registrants to include part-time, temporary or seasonal employees, as well as employees situated in the U.S. or abroad, employed by the company or any of its consolidated subsidiaries in its calculations.[139] Annualizing the pay of part-time or temporary/seasonal employees—that is, to reflect full-time or full-year equivalents—is not permitted, although the pay of a permanent employee who only worked part of the year (e.g., a new hire) may be annualized.[140] The "employee" definition does not include contractors that are employed by and whose compensation is determined by an unaffiliated third party.[141]

As to foreign employees, in recognition of certain difficulties that may arise in including such workers' compensation in the pay ratio calculation, the Rule provides for two potential exemptions:

- *Data Privacy Exemption*: A registrant may exclude employees located in countries whose data privacy laws make it impossible to obtain, process or disclose workers' compensation information without violating the data privacy laws of that country. To rely on this exemption, the registrant needs to have first made reasonable efforts to obtain the information, including under applicable exemptions to the privacy laws, and must file a legal opinion supporting their non-disclosure.[142]
- *De minimis Exemption*: A registrant may also exclude up to 5% of its non-U.S. employees. If certain employees in a particular non-U.S. jurisdiction are excluded, all employees from that jurisdiction need to be excluded without

[134] Adopting Release, *supra* note 105, at 9.

[135] 17 C.F.R. § 229.402. Reporting companies had not previously been required to disclose median employee pay.

[136] Dodd-Frank § 953(b) ("[T]he 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."); 17 C.F.R. § 229.402(u)(2)(i). Item 402(c)(2)(x) includes the following components of an executive's compensation, to be disclosed in a summary table: salary, bonus, stock awards, option awards, non-equity incentive plan compensation, change in pension value and non-qualified deferred compensation earnings, and all other compensation.

[137] 17 C.F.R. § 229.402(u), Instruction 4.

[138] Dodd-Frank § 953(b) (emphasis added).

[139] 17 C.F.R. § 229.402(u)(3); Adopting Release, *supra* note 105, at 45, 49-50.

[140] 17 C.F.R. § 229.402(u), Instruction 5.

[141] *Id.*

[142] *Id.* § 229.402(u)(4)(i).

> violating the 5% maximum.[143] Any exclusion of non-U.S. employees under this exemption must be disclosed, including the jurisdiction(s) and approximate number of employees at issue.[144]

Overall, the Rule's definition of "employee" is quite broad. In his dissenting statement, one of the Commissioners, Daniel Gallagher, stated that he would have limited the definition to full-time U.S. employees, arguing that the SEC had the authority to interpret the statutory language in such a manner.[145] One difficulty voiced by registrants has been that the "employee" definition under the Rule does not match up in all respects with the definition of "employee" for other purposes under the law,[146] making it difficult to use existing records and classification systems as a basis for pay ratio calculations. In particular, commenters and registrants were concerned that the Rule appeared to define "contractor" more narrowly than that term is traditionally defined under employment and tax law.[147] However, more recent SEC guidance has clarified that registrants may use their existing payroll and tax records as a basis for determining their employee pool, at least for purposes of excluding independent contractors.[148]

Identifying the Median Employee and Providing Additional Information

Method of Identifying the "Median Employee." Under the SEC pay ratio rule, the registrant may choose a "reasonable method" to identify the median employee that is appropriately tailored to their business, including using reasonable estimates both to identify the median employee and to calculate the annual total compensation of employees (other than the CEO).[149] Such methods may include using a statistical sampling of employees or any consistently applied compensation measure (e.g*.,* using payroll or tax records),[150] even if those records do not include every element of annual total compensation.[151] Regardless, registrants must disclose the methodology that they use in their public filing.[152]

Calculation Date. A registrant is able to select a determination date within the last three months of a company's fiscal year for identifying the median employee.[153] While the initial proposed rule contained a date certain (i.e., the last date of the company's fiscal year), the Rule departed from the proposal due to considerations such as disproportionate effects the date certain may have on registrants who employ a large portion of seasonal workers at the end of the year.[154] The Rule also

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[143] A company with less than 5% non-U.S. employees that excludes any non-U.S. employees from their calculation must exclude all foreign employees. *Id.* § 229.402(u)(4)(ii).

[144] *Id.*

[145] *See* Gallagher Dissenting Statement, *supra* note 125. Moreover, for example, the National Retail Federation has argued that including part-time workers distorts the ratio in their industry, given that "about 30% of retail workers are classified as part-time." National Retail Federation, *SEC Pay Ratio Rule*, https://nrf.com/advocacy/policy-agenda/sec-pay-ratio-rule.

[146] SEC, INTERPRETATION: COMM'N GUIDANCE ON PAY RATIO DISCLOSURE, RELEASE NOS. 33-10415, 34-81673, 3 (Sept. 21, 2017), https://www.sec.gov/rules/interp/2017/33-10415.pdf [hereinafter "COMM'N GUIDANCE"].

[147] *See, e.g.*, IRS, PUBLICATION 15-A EMPLOYER'S SUPPLEMENTAL TAX GUIDE (2018), https://www.irs.gov/pub/irs-pdf/p15a.pdf.

[148] COMM'N GUIDANCE, *supra* note 146, at 3.

[149] 17 C.F.R. § 229.402(u), Instruction 4.

[150] *Id.*

[151] COMM'N GUIDANCE, *supra* note 146, at 3.

[152] 17 C.F.R. § 229.402(u), Instruction 4(5).

[153] *Id.* at Instruction 1.

[154] *Securities Regulation – Dodd-Frank Wall Street Reform and Consumer Protection Act – SEC Finalizes Regulations* (continued...)

incorporated a flexible date in order to leave sufficient time for companies to conduct the disclosure calculations at year-end.[155] The date chosen must be disclosed in public filings, and if companies change the date used from one year to the next, they must describe the reason for the change.[156]

Calculation of Median Every Three Years. Registrants need to identify the median employee every three years, rather than every year, if "during a registrant's last completed fiscal year there has been no change in its employee population or employee compensation arrangements that it reasonably believes would result in significant change to its pay ratio disclosure."[157] The pay ratio disclosure itself (including that median employee's compensation and the CEO's compensation), however, must be calculated each year.[158]

Cost of Living Adjustments. In identifying the median employee and calculating their annual total compensation, the registrant may adjust the annual total compensation of its employees in jurisdictions other than the jurisdiction in which the CEO resides to account for the cost of living in the CEO's jurisdiction. If such adjustments are used, the registrant must also disclose in its public filings non-adjusted figures for the median employee's annual total compensation and the pay ratio.[159]

Additional information. Registrants are permitted, but not required, to supplement the pay ratio disclosure required by the Rule with additional information or supplemental ratios, such as, for example, a version of the ratio using only U.S. employees.[160] The supplemental information cannot be misleading or displayed with more prominence than the mandated ratio.[161]

The main practical problem identified with the Rule's flexible approach is that the resulting pay ratio figures may not necessarily allow for easy "apples to apples" comparisons between companies, potentially making it a less useful metric for shareholders.[162] However, the SEC explicitly stated in formulating the Rule that it believed the ratio should be "designed to allow shareholders to better understand and assess *a particular registrant's compensation and pay ratio disclosures* rather than to facilitate a comparison of this information from one registrant to another."[163] In any event, commentators have begun to advise, given that public analysis may indeed focus on comparisons to peer companies, that registrants take advantage of permitted methods to contextualize their disclosure (such as providing additional ratios or information) and carefully consider how to use their permitted discretion under the Rule,[164] suggesting that certain

(...continued)

Requiring Companies to Disclose Pay Ratio Between the CEO and Median Employee, 129 HARV. L. REV. 1144, 1147 (Feb. 2016) [hereinafter "HARV. L. REV."]. Some argue, however, that this flexibility does appear to leave such companies a way to potentially "skew" the median to exclude seasonal workers that would otherwise be included in the Rule's definition of "employee." *See* Adopting Release, *supra* note 105, at 55.

[155] Adopting Release, *supra* note 105, at 56.

[156] 17 C.F.R. § 229.402(u), Instruction 1.

[157] *Id.* at Instruction 2.

[158] *Id.*; *see id.* § 229.402(a).

[159] *Id.* at Instruction 4(4).

[160] Adopting Release, *supra* note 105, at 30.

[161] 17 C.F.R. § 229.402(u), Instruction 9.

[162] *See, e.g.*, HARV. L. REV., *supra* note 154, at 1149.

[163] Adopting Release, *supra* note 105, at 12 (emphasis added).

[164] *See, e.g.*, David Martin, *The CEO-to-Employee Pay Ratio Rule: Begin Thinking About Messaging Now*, BLOOMBERG LAW (Aug. 7, 2017), https://www.bna.com/ceotoemployee-pay-ratio-n73014462845/.

best practices may develop over time. However, the lack of purely comparable ratios among registrants may factor into potential challenges relating to the Rule,[165] although this would likely also need to be weighed against the cost savings to registrants that are gained from having greater flexibility in applying the rule.[166]

Potential Challenges to the Pay Ratio Rule

Given the split of opinions regarding the pay ratio rule highlighted through the SEC's adoption of the Rule, public comments, and further commentary, the pay ratio rule may become the subject of a challenge in court.[167] Potential challenges to the Rule would likely be based on requirements for agency rulemaking under the Administrative Procedure Act (APA) and securities law requirements for SEC rulemaking.[168] Under the APA, a court can "hold unlawful and set aside agency action, findings, and conclusions found to be . . . arbitrary, capricious, an abuse of discretion, or otherwise not in accordance with law."[169] Under this standard, a court may invalidate agency determinations that fail to "examine the relevant data and articulate a satisfactory explanation for its action including a 'rational connection between the facts found and the choice made.'"[170] Under federal securities laws, the SEC is also required to "consider, in addition to the protection of investors, whether the action will promote efficiency, competition, and capital formation."[171] These two principles often work in tandem in a court's assessment of rulemaking by the SEC.[172] Several areas of potential challenge, identified by the dissenting Commissioners or other commentators, are discussed below.

First, one dissenting Commissioner, Michael S. Piwowar, posited that the SEC acted in an arbitrary and capricious manner in not adequately considering the quantitative impact of certain flexible approaches permitted under the Rule on the accuracy or quality of the pay ratio disclosure.[173] Specifically, Commissioner Piwowar questioned the effect of allowing for different methodologies in determining the median employee and the allowance for a 5% de minimis exception for foreign workers, among other aspects of the Rule.[174] In his view, the SEC should have assessed whether these allowances would result in material deviations from a strict "annual total compensation" approach under Item 402.[175] The SEC's Division of Economic and Risk Analysis did, however, perform a study to analyze the potential effects on the pay ratio

165 *See infra* "Potential Challenges to the Pay Ratio Rule."

166 *See id.*

167 *See, e.g.*, HARV. L. REV., *supra* note 154, at 1151.

168 As discussed in the next section, the First Amendment may be a further ground for challenge, based on the D.C. Circuit's 2015 decision invalidating a portion of the so-called "conflict minerals rule." *See infra* "Other SEC Disclosure Rules under Dodd-Frank."

169 5 U.S.C. § 706(2)(A).

170 Motor Vehicle Manufs. Ass'n v. State Farm Auto Mutual Ins. Co., 463 U.S. 29, 43 (1983) (quoting Burlington Truck Lines v. United States, 371 U.S. 156, 168 (1962)); *see generally* CRS Report R44699, *An Introduction to Judicial Review of Federal Agency Action*, by Jared P. Cole.

171 15 U.S.C. §§ 77b(b), 77c(f).

172 *See, e.g.,* Business Roundtable v. SEC, 647 F.3d 1144, 1148 (D.C. Cir. 2011).

173 *See* Michael S. Piwowar, *Additional Dissenting Comments on Pay Ratio Disclosure*, SEC (Aug. 7, 2015), https://www.sec.gov/news/statement/additional-dissenting-statement-on-pay-ratio-disclosure.html [hereinafter "Piwowar Additional Dissenting Statement"].

174 *Id.*

175 *Id.*

calculation of excluding different percentages of employees.[176] For example, it concluded that an exclusion of 5% of employees could result, under certain assumptions, in a 6.9% range of deviation,[177] which the SEC analyzed and believed to confirm that the 5% exclusion for non-U.S. employees would have de minimis effects on the ratio calculation.[178]

Second, a plaintiff may challenge possible deficiencies in the SEC's analysis of the costs and benefits of the Rule. Under the APA and securities law principles, the D.C. Circuit has vacated rules where it found the SEC "acted arbitrarily and capriciously for having failed . . . adequately to assess the economic effects of a new rule."[179] While the SEC estimated the cost of compliance with the Rule at $1.3 billion, some argue, for example, that it should have further assessed the costs of specific portions of the Rule, such as the cost of allowing a flexible calculation date within three months of the end of the fiscal year.[180] At least one commentator is further critical that the SEC did not seek to quantify the *benefits* of the Rule in order to perform a quantitative cost-benefit analysis.[181] In this vein, courts have imposed different, situation-specific requirements concerning the extent to which an agency needs to have sought to quantify *benefits* of a proposed rule.[182]

Third, some have suggested that the Rule may also be vulnerable to challenge due to the SEC's lack of investor testing evaluating how investors planned to use the pay ratio information.[183] As pointed out by a dissenting Commissioner, Section 912 of Dodd-Frank allows specifically for such testing,[184] stating that "[f]or the purpose of evaluating any rule or program of the Commission . . . the Commission may . . . engage in such temporary investor testing programs as

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[176] *See* SEC DIV. OF ECON. AND RISK ANALYSIS, POTENTIAL EFFECT ON PAY RATIO DISCLOSURE OF EXCLUSION OF DIFFERENT PERCENTAGES OF EMPLOYEES AT A RANGE OF THRESHOLDS (June 4, 2015), http://www.sec.gov.comments/s7-07-13/s70713-1556.pdf [hereinafter "JUNE 4 ANALYSIS"]; SEC DIV. OF ECON. AND RISK ANALYSIS, EXTENSION OF THE ANALYSIS OF THE POTENTIAL EFFECT ON PAY RATIO DISCLOSURE OF EXCLUSION OF DIFFERENT PERCENTAGES OF EMPLOYEES AT A RANGE OF THRESHOLDS (June 30, 2015), http://www.sec.gov.comments/s7-07-13/s70713-1559.pdf.

[177] JUNE 4 ANALYSIS, *supra* note 176.

[178] *See* Adopting Release, *supra* note 105, at 74-75, 228-29.

[179] Business Roundtable v. SEC, 647 F.3d 1144, 1148 (D.C. Cir. 2011) (vacating rule requiring companies to include information on certain shareholder nominees in its proxy materials because SEC did not adequately assess costs to companies in doing so, including costs of the company's challenges to shareholder nominees); *see* Chamber of Commerce of U.S. v. SEC, 412 F.3d 133, 143 (D.C. Cir. 2005) (vacating rule requiring that mutual funds have 75% independent directors to engage in certain types of transactions otherwise prohibited by the Investment Company Act because agency failed to consider costs of compliance to mutual funds); *see also* Am. Equity Inv. Life Ins. Co. v. SEC, 613 F.3d 166, 177 (D.C. Cir. 2010) (vacating rule bringing fixed indexed annuities under the SEC's regulation because SEC did not adequately explain its reasoning regarding purported positive effects on competition, efficiency or capital formation, asserting only that the benefits of clarity of regulation and required disclosures to investors would have such impacts).

[180] *See, e.g.,* HARV. L. REV., *supra* note 154, at 1151; *see Business Roundtable*, 647 F.3d at 1148.

[181] HARV. L. REV., *supra* note 154, at 1151; *see* Adopting Release, *supra* note 105, at 176 ("While we believe that the pay ratio disclosure may provide an informational benefit to shareholders in their say-on-pay voting, we are unable to quantify this benefit.").

[182] *Compare, e.g.,* Nat'l Assoc. Manufs. v. SEC, 748 F.3d 359, 369 (D.C. Cir. 2014), *overruled on other grounds by* American Meat Institute v. U.S. Dept. of Agric., 760 F.3d 18 (D.C. Cir. 2014), (rejecting argument that, under the securities laws, the SEC, in promulgating conflict minerals rule, should have sought to quantify the benefits of the rule), *with Am. Equity Investments*, 613 F.3d at 177 (vacating an SEC rule which would have provided additional disclosures and information to investors regarding fixed indexed annuities, and criticizing the SEC for not assessing the current baseline of investor information available and whether an increase in such information would be efficient).

[183] HARV. L. REV., *supra* note 154, at 1149.

[184] Piwowar Dissenting Statement, *supra* note 124.

the Commission determines are in the public interest or would protect investors."[185] Without empirical testing, observers argue that it is impossible to know whether investors anticipated or wished to use the pay ratio for direct comparison purposes among registrants, which would make the flexible aspects of the Rule more problematic.[186] In *Chamber of Commerce v. SEC*, however, the D.C. Circuit declined to vacate a rule for the SEC's failure to develop empirical data to assess the benefits of a mutual fund having independent (as opposed to inside) chairpersons of their boards of directors, recognizing that "an agency need not–indeed cannot–base its every action on empirical data."[187]

Legislatively, the Financial CHOICE Act passed by the House of Representatives in June 2017, which repeals many Dodd-Frank provisions, would also eliminate the pay ratio provision in Section 953(b) of Dodd-Frank.[188] A repeal is not contemplated, however, by the version of the Economic Growth, Regulatory Relief, and Consumer Protection Act passed by the Senate in March 2018.[189] At the Commission level, on February 6, 2017, the SEC called for further comments on difficulties in complying with the Rule so that the SEC staff could promptly "reconsider" its implementation,[190] but it is currently unclear what, if any, action the SEC will take in response to the further comments.

Comparing the Pay Ratio Rule with Other SEC Disclosure Rules Under Dodd-Frank

Apart from the disclosures required by Title IX, Dodd-Frank requires the SEC to promulgate and enforce certain other disclosure rules, which may provide further insight on how the pay ratio rule would be considered if challenged. Specifically, Title XV, entitled "Miscellaneous Provisions," provides for the so-called "conflict minerals"[191] and "resource extraction" rules.[192] These rules generally require disclosures regarding, respectively, the source of certain minerals used in a company's products and payments made to governments relating to commercial natural resource development.[193] Each of the rules was intended to prompt social and political change in foreign countries,[194] with the "conflict minerals" rule addressing the impact of mineral extraction on

[185] 15 U.S.C. § 77s(e).

[186] HARV. L. REV., *supra* note 154, at 1149.

[187] *Chamber of Commerce*, 412 F.3d at 142 ([A]lthough we recognize that an agency acting upon the basis of empirical data may be more readily able to show it has satisfied its obligations under the APA . . . we are acutely aware that an agency need not–indeed cannot–base its every action upon empirical data; depending upon the nature of the problem, an agency may be 'entitled to conduct . . . a general analysis based on informed conjecture.'") (citations omitted). Note, however, as noted above, the court in *Chamber of Commerce* did invalidate the relevant rule due to the SEC's lack of consideration of costs. *Id.* at 143.

[188] *See* H.R. 10, 115th Cong. § 857 (2017). Individual bills have also been introduced in past Congresses to repeal the provision. *See* H.R. 414, 114th Cong. (2015); S. 1722, 114th Cong. (2015).

[189] *See* S. 2155, 115th Cong. (2018).

[190] Michael S. Piwowar, *Reconsideration of Pay Ratio Rule Implementation,* SEC (Feb. 6, 2017), https://www.sec.gov/news/statement/reconsideration-of-pay-ratio-rule-implementation.html.

[191] Dodd-Frank § 1502.

[192] *Id.* § 1504.

[193] 17 C.F.R. §§ 240.13p-1, 249b.400.

[194] *See, e.g.*, Nat'l Ass'n of Manufs. v. SEC, 800 F.3d 518, 522 (D.C. Cir. 2015) [hereinafter "*NAM II*"] (noting that the SEC acknowledged in the rulemaking process that the conflict minerals rule is "directed at achieving overall social benefits" and is not "intended to generate measurable, direct economic benefits to investors or issuers," making the regulatory requirements "quite different from the economic or investor protection benefits that our rules typically strive to achieve.").

armed conflict in the Democratic Republic of the Congo (DRC) and the "resource extraction" rule aimed at reducing government corruption in resource-rich nations. Over the past several years since being promulgated by the SEC, the two rules have been met with some skepticism by courts. Nonetheless, as discussed below, distinctions exist between these disclosure rules and the pay ratio disclosure rule that may make a true comparison inapt.

Conflict Minerals Rule

The conflict minerals rule was intended to address "the exploitation and trade of conflict minerals originating in the Democratic Republic of the Congo . . . helping to finance conflict characterized by extreme levels of violence . . . and contributing to an emergency humanitarian situation therein."[195] The rule requires companies that manufacture products that include tin, tungsten, tantalum, or gold as necessary components to conduct a reasonable "country of origin inquiry" for these minerals.[196] If the minerals originated in the DRC or adjoining countries, the rule requires the further step of conducting due diligence to determine the minerals' source and chain of custody, to be disclosed on a Form SD (or specialized disclosure report).[197] While not affecting these first two parts of the rule, the D.C. Circuit has ruled that another part of the regulation—one that required companies to state whether the relevant minerals in their supply chains were "DRC conflict free," "not found to be DRC conflict free," or "DRC conflict undeterminable"—violated the First Amendment in a challenge brought in *National Association of Manufacturers v. SEC ("NAM")*.[198]

As an initial matter, the *NAM* case presented the question of what level of First Amendment scrutiny a court should apply to compelled speech like the conflict minerals rule.[199] While courts generally apply strict scrutiny to content-based compelled speech,[200] an intermediate level of scrutiny applies to commercial speech under the test set forth by the Supreme Court in *Central Hudson Gas & Electric Corp. v. Public Service Commission*.[201] To overcome a First Amendment challenge, *Central Hudson* requires a "substantial" government interest that is "directly and materially advanced" by a "narrowly tailored" restriction on speech.[202] As a further caveat, however, the Supreme Court has also ruled in *Zauderer v. Office of Disciplinary Counsel* that a rule regulating a lawyer's deceptive advertisement merited an even lower level of scrutiny.[203] The

[195] Dodd-Frank §1502(a) (codified at 15 U.S.C. § 78m).

[196] 17 C.F.R. §§ 240.13p-1, 249b.400 (Form SD).

[197] 17 C.F.R. § 249b.400.

[198] *NAM II*, 800 F.3d at 525-27, 530. The court entered final judgment in the suit, ending the case, in April 2017. NAM v. SEC, No. 1:13-cv-00635, 2017 WL 3503370 (D.D.C. Apr. 3, 2017). Note that the SEC had already stayed the portion of the rule requiring that companies label their products as "DRC conflict free," "not found to be 'DRC conflict free,'" or "DRC conflict undeterminable" in 2014 pending a final outcome in the case. Press Release, SEC, *SEC Issues Partial Stay of Conflict Minerals Rules* (May 2, 2014), https://www.sec.gov/news/press-release/2014-89.

[199] *NAM v. SEC*, 748 F.3d 359, 370-72 (D.C. Cir. 2014) [hereinafter "*NAM I*"]

[200] *See* Turner Broad. Sys., Inc. v. FCC, 512 U.S. 622, 642 (1994) (We "apply the most exacting scrutiny to regulations that suppress, disadvantage, or impose differential burdens upon speech because of its content."); Wooley v. Maynard, 430 U.S. 705 (1977) ("We must . . . determine whether the State's countervailing interest is sufficiently compelling to justify requiring appellees to display the state motto on their license plates."); Frudden v. Pilling, 742 F.3d 1199, 1207 (9th Cir. 2014) ("Because [school uniform policy] compels students to endorse a particular viewpoint, strict scrutiny applies—that is, inclusion of the written motto on the . . . uniform shirts must be 'a narrowly tailored means of serving a compelling state interest.'").

[201] 447 U.S. 557, 564-66 (1980).

[202] *See NAM I*, 748 F.3d at 372 (citing *Central Hudson*, 447 U.S. at 564-66).

[203] 471 U.S. 626, 651 (1985).

D.C. Circuit in *NAM* applied *Central Hudson's* intermediate test to the conflict minerals rule in a 2014 decision, reasoning that the *Zauderer* test only applied to cases involving corrections to deceptive advertising.[204] But, an *en banc* (i.e., full court) panel of the D.C. Circuit overruled that portion of the *NAM* decision in 2015 in *American Meat Institute v. U.S. Department of Agriculture*, holding that *Zauderer* scrutiny can apply in broader circumstances to disclosures required to serve other government interests.[205]

In light of *American Meat Institute*, the D.C. Circuit reevaluated its initial *NAM* decision.[206] In a 2015 decision, a three-judge panel of the D.C. Circuit still held that *Central Hudson* scrutiny applied to the conflict minerals rule because it viewed *Zauderer* as still being limited to cases at least involving voluntary advertising.[207] However, the court further justified its decision under *Zauderer's* level of scrutiny given the "flux and uncertainty of the First Amendment doctrine of commercial speech."[208] In a *Zauderer* analysis, a court looks to whether the speech at issue is effective in meeting an adequate government objective and whether the compelled language is of a "purely factual and uncontroversial" nature.[209] The D.C. Circuit determined that neither Congress nor the SEC had attempted to determine whether or to what extent the conflict minerals disclosure would "in fact alleviate" the humanitarian crisis in the DRC.[210] It also concluded that the labels required by the rule went beyond the presentation of purely factual, uncontroversial information, instead requiring issuers to use language that may imply that their products were "ethically tainted."[211]

As with the conflict minerals rule, any First Amendment challenge to the pay ratio disclosure rule would likely raise as an initial matter the question of what level of scrutiny applies. The pay ratio disclosure does not directly relate to advertising, as the *NAM* court would require for *Zauderer* scrutiny,[212] suggesting that *Central Hudson* may apply to the pay ratio rule. On the other hand, the *American Meat Institute en banc* ruling's broader view of when *Zauderer* scrutiny applies could suggest an application to "factual and uncontroversial" disclosures mandated by the government for purposes beyond advertising.[213] Moreover, prior to *NAM,* the D.C. Circuit recognized that the federal "government's powers to regulate the securities industry" subject the "exchange of information regarding securities" to a more "limited First Amendment scrutiny."[214] Nonetheless, the precise contours of that limitation or how it would apply to the pay ratio rule are not perfectly defined.[215]

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204 *NAM I*, 748 F. 3d at 372.

205 Am. Meat Institute v. U.S. Dept. of Agric., 760 F.3d 18, 22-23 (D.C. Cir. 2014).

206 *NAM II*, 800 F.3d at 522-23.

207 *Id.* at 524.

208 *Id.*

209 *Id.* at 525, 527.

210 *Id.* at 525-27.

211 *Id.* at 530.

212 *Id.* at 522-23.

213 *See* Am. Meat Institute v. U.S. Dept. of Agric., 760 F.3d 18, 22-23 (D.C. Cir. 2014); *see also NAM II*, 800 F.3d at 533 (Srinivasan, J., dissenting).

214 *See, e.g.*, SEC v. Wall St. Publ'g Inst., 851 F.2d 365, 372-73 (D.C. Cir. 1988).

215 *See NAM I*, 748 F. 3d at 372 (concluding that *Wall Street Publishing* did not apply to evaluation of conflict minerals rule and further stating that "[i]t is not entirely clear what would result if *Wall Street Publishing* did apply to this case.").

In terms of its stated goals and the nature of the disclosure required, the pay ratio rule does share certain similarities with the rule upheld in *American Meat Institute*. In *American Meat Institute*, the court upheld against a First Amendment challenge a Department of Agriculture regulation requiring meat producers to disclose "country of origin" information for their meat products. The court held that the relationship between the rule's means and its ends—"enabling customers to make informed choices based on characteristics of the products they wished to purchase"—was adequate under *Zauderer*.[216] The purpose behind the rule at issue in *American Meat Institute* may be viewed by a court as similar to the SEC's stated goal of providing further information to investors,[217] in a manner that uses seemingly neutral numerical figures. On the other hand, there are reasons why the rule might be viewed as similar to conflict minerals rule at issue in *NAM.* For instance, with some viewing the underlying purpose of pay ratio rule to be "naming and shaming,"[218] the nature of the disclosure at issue with the pay ratio rule could be viewed as being more value-laden than factual and uncontroversial like the rule at issue in *American Meat Institute*.

Since the D.C. Circuit's decision in *NAM*, the SEC has issued statements announcing that it is reevaluating the conflict minerals rule[219] and that it will *not* take enforcement action against companies that comply with the rule's country of origin inquiry requirements, but forgo the second step of conducting further due diligence if the source of the minerals is found to be the DRC or adjoining countries.[220] The Financial CHOICE Act of 2017 would repeal the section of Dodd-Frank authorizing the conflict minerals rule.[221] However, the rule is not addressed by the Economic Growth, Regulatory Relief, and Consumer Protection Act passed by the Senate.[222]

Resource Extraction Rule

Section 1504 of Dodd-Frank directs the SEC to promulgate a rule requiring companies to disclose payments they make to the U.S. or foreign governments relating to the commercial development of oil, natural gas, or minerals.[223] The purpose of the rule was to increase transparency and combat global corruption, addressing the "mineral curse" often experienced by resource-rich nations whose governments may divert funds obtained from resource extraction and development

[216] *Am. Meat Institute*, 760 F.3d at 24-26 ("[B]y acting only through a reasonably crafted disclosure mandate, the government meets its burden of showing that the mandate advances its interest in making the 'purely factual and uncontroversial information' accessible to the recipients . . . . [T]his particular method of achieving a government interest will almost always demonstrate a reasonable means-ends relationship, absent a showing that the disclosure is 'unduly burdensome' in a way that 'chill[s] protected commercial speech.'") (internal citations omitted).

[217] Adopting Release, *supra* note 105, at 9.

[218] Gallagher Dissenting Statement, *supra* note 125 ("We've seen from our Conflict Minerals rule that naming-and-shaming rules can fall afoul of the First Amendment, and so the question is raised in my mind whether pay ratio disclosures are constitutional.").

[219] Public Statement, Acting Chairman Michael S. Piwowar, *Reconsideration of Conflict Minerals Rule Implementation* (Jan. 31, 2017), https://www.sec.gov/news/statement/reconsideration-of-conflict-minerals-rule-implementation.html.

[220] Public Statement, SEC Division of Corporate Finance, *Updated Statement on the Effect of the Court of Appeals Decision on the Conflict Minerals Rule* (April 7, 2017), https://www.sec.gov/news/public-statement/corpfin-updated-statement-court-decision-conflict-minerals-rule ("[T]he Division of Corporation Finance has determined that it will not recommend enforcement action to the Commission if companies, including those that are subject to paragraph (c) of Item 1.01 of Form SD, only file disclosure under the provisions of paragraphs (a) and (b) of Item 1.01 of Form SD.")

[221] *See* H.R. 10, 115th Cong. § 862 (2017).

[222] *See* S. 2155, 115th Cong. (2018).

[223] Dodd-Frank § 1504 (codified at 15 U.S.C. § 78m(q)).

without accountability to their citizens.[224] As discussed below, the rule was vacated by a court in 2013 before being legislatively repealed in early 2017.

In 2013, the federal district court for the District of Columbia vacated an initial version of the resource extraction rule.[225] The court concluded that the SEC had misinterpreted the statutory language of Dodd-Frank as requiring issuers to *publicly* disclose the reports of their government payments, as opposed to simply filing them with the SEC.[226] The court further found that the SEC acted "arbitrarily and capriciously" in violation of the APA in not providing for any exemptions to the disclosure rule.[227] For example, industry participants had advocated for an exemption as to countries in which disclosing payments would be illegal under foreign law, claiming they would otherwise need to exit the market in those countries, losing billions of dollars.[228] While the SEC believed that any exemptions would undermine the rule's purpose, the court focused on Congress's specific authorization for exemptions[229] as well as the statutory text's focus on practicability[230] in rejecting the SEC's argument.

The SEC passed another version of the rule in 2016, which again required public disclosure but allowed companies to apply for exemptions on a case-by-case basis.[231] However, the rule was revoked by Congress under the Congressional Review Act[232] via a joint resolution of disapproval, which the President signed in February 2017.[233] Unless Section 1504 of Dodd-Frank itself is repealed, however, the SEC retains the power to formulate a rule that is not "substantially the same" as the revoked version.[234] Nonetheless, the SEC has not identified doing so as a priority.[235] The Financial CHOICE Act would repeal Section 1504 altogether,[236] but such a repeal is not included in the Economic Growth, Regulatory Relief, and Consumer Protection Act passed by the Senate.[237]

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224 *See id.;* Andrew L. Magner, *Drilling for Disclosure: Resource Extraction Issuer Disclosure and* American Petroleum Institute v. SEC, 40 J. CORP. L. 521, 523 (2015).

225 *See* Am. Petroleum Inst. v. SEC, 953 F. Supp. 2d 5 (D.D.C. 2013).

226 *Id.* at 11. For example, because another provision in Section 1504 provided for the SEC making public a *compilation* of data collected under the rule, as opposed to individual companies' reports, the court favored a reading of the statute that the individual reports themselves need not be made public. *Id.* at 17-19.

227 *Id.* at 20.

228 *Id.* at 21.

229 *See* 15 U.S.C. § 78l(h).

230 *See, e.g.,* 15 U.S.C. § 78m(q)(2)(E) (providing that the rule should support the government's efforts to promote international transparency "to the extent practicable").

231 Final Rule: Disclosure of Payments by Resource Extraction Issuers, Exchange Act Release No. 34-78167, 81 Fed. Reg. 49359 (July 27, 2016).

232 5 U.S.C. §§ 801-808.

233 P.L. 115-4, 131 Stat. 9 (Feb. 14, 2017).

234 5 U.S.C. § 801(b)(2).

235 The rule was placed on the SEC's "long term" agenda in its Regulatory Flexibility Agenda released in January 2018. *See* Regulatory Flexibility Agenda, 83 Fed. Reg. 2022 (Jan. 12, 2018).

236 *See* H.R. 10, 115th Cong. § 862 (2017).

237 *See* S. 2155, 115th Cong. (2018).

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