CRS Reports & Analysis

Legal Sidebar

SEC's New Rule on CEO Pay Ratio

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On August 5, 2015, the Securities and Exchange Commission (SEC) approved by a vote of 3-2 a controversial new rule requiring publicly traded companies to disclose the ratio of the annual pay of the chief executive officer (CEO) to the median annual pay of all of the company's employees. The rule was issued pursuant to section 953(b) of the Dodd-Frank Wall Street Reform and Consumer Protection Act (Dodd-Frank). Prior to the rule, SEC regulations required companies to disclose considerable information about CEO compensation, but not a comparison with median employee compensation. The new rule directs the SEC to amend any existing executive compensation disclosure rules to require companies to disclose: 1. the median of the annual total compensation of all of the company's employees, except for the CEO; 2. the annual total compensation of its CEO; and 3. the ratio of the two amounts. The new rule is to become effective on January 1, 2017.

The rule has several provisions. For example, the pay ratio must be disclosed in registration statements, proxy statements, and annual reports, but not in certain other reports, such as quarterly reports. A company may select the methodology for identifying its median employee and the employee's compensation, so long as the methodology is reasonable, and must describe the methodology that it uses. The rule allows companies to determine the median employee pay once every three years. Companies are allowed to exclude non-U.S. employees from the formula if the data privacy laws or regulations of foreign countries do not allow companies to disclose the compensation. Certain small companies (e.g., a company with a public float of less than $75 million) and investment companies do not have to comply with the new rule.

Legal challenges to the rule are very possible and may be based on arguments that have been used to challenge other recent SEC rules. For example, an April 2014 decision (*NAM v. SEC*) by the U.S. Court of Appeals for the District of Columbia Circuit (D.C. Circuit) gave a partial victory to the National Association of Manufacturers and the Business Roundtable when it struck down as violating the First Amendment the part of the SEC's rules on conflict minerals disclosures (implementing section 1502 of Dodd-Frank) that required companies to label certain products as having "not been found to be conflict free." The D.C. Circuit stated that "[b]y compelling an issuer to confess blood on its hands, the statute [and its implementing regulation] interferes with that exercise of the freedom of speech under the First Amendment." (For more on the case and about other conflict minerals issues, see CRS Report R43639.) In 2011, the D.C. Circuit struck down the SEC's proxy access rules in a case brought by the Business Roundtable and the Chamber of Commerce on the basis that the SEC had not performed an adequate cost-benefit analysis. Challenges to the SEC's executive compensation rule may also involve the First Amendment (for example, by challenging the rule as serving no purpose other than requiring a company to shame itself publicly, as in *NAM v. SEC*), inadequate cost-benefit analysis, and perhaps other Administrative Procedure Act issues, such as alleging that the SEC's action is arbitrary and capricious.

There is also congressional interest in prohibiting required pay ratio disclosures. H.R. 414, introduced on January 20, 2015, and referred to the Committee on Financial Services, would repeal section 953(b) of Dodd-Frank and make ineffective any regulations issued pursuant to the provision.