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TRENDS & ISSUES

# Why the CEO Pay Ratio Misses the Mark


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"Does it matter that a company is a 400:1 in its CEO pay ratio versus to a 20:1 or 10:1?"

Not really.

I was asked the question in a recent interview for the NPR program The Takeaway. Host John Hockenberry and I discussed the ins and outs, the common arguments, and the assumptions for the new SEC disclosure rule as he appropriately tried to make sense of it for his audience. But therein lies the problem – *this disclosure requirement simply doesn't make sense and it's unlikely to have the impact intended by the legislators who put it in place.*

Politics, ideologies, and moral arguments aside, the rule has been fundamentally flawed from the outset. As part of the Dodd-Frank Act of 2010 (DFA), the mandate for public companies to disclose the difference between the total pay of the CEO and the organization's median paid employee – illustrated in a ratio – was presumably adopted in order to provide more information to investors. The general belief being that new and additional investor information could lead to better shareholder engagement and stronger governance with a higher degree of accountability on the part of corporations. The rule was adopted on the coattails of and in reaction to the excesses that triggered the 2007 financial crisis.


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So let's break it down from there. What might be the possible benefits for investors?

- **Peer comparisons** – Comparing CEO pay ratios between companies is likely not relevant in any meaningful way, taking into account highly variable business sizes, life cycles, workforce distribution, etc.
- **Providing shareholders with more information on which to base their say-on-pay vote** – There is already a fulsome discussion in most proxies on the relationship of pay and performance and the rationale for pay decisions at the top. A statistically questionable ratio does not provide a meaningful basis upon


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which to vote, and in fact may result in negative votes despite a completely reasonable and well-justified pay program.

- **Generally providing new, additional information on compensation** – CEO compensation (as well as other the other top executives) already must be disclosed.

If more and/or better information on CEO pay isn't forthcoming as a result of the new rule, what *is* new? For the first time, companies will be identifying their median employee and disclosing that person's total compensation. And what exactly does that tell investors about the performance, health, and future prospects of a public company? Probably nothing. Especially given the flawed nature of the calculations.

Shareholders also aren't expected to glean much useful information when it comes to peer company comparisons within an industry and certainly not looking across industries. Every company will have drastically different ratios because every company has drastically different workforces. The SEC has even suggested numerous sample considerations in identifying the median employee, such as size and nature of a company's workforce; organizational complexity; differing types of employee compensation; currency, tax, and accounting differences; and more.

The real interest in this number is likely to come from the company's general employee population. The new information is, after all, about *them* and where they fall above or below their median coworker. That an employee is generally paid far less than the CEO is not news, but suddenly, there will be a much more applicable comparison point and this has the potential for far-reaching impact on the workforce. How companies – particularly HR departments, where the bulk of the burden is likely to fall – will handle new, global communication demands will be critical.

The rule simply doesn't fulfill its original intention to help investors or even the public at large. As I said to Hockenberry, the idea some have that disclosure of this pay ratio is going to dramatically impact the way CEOs are paid may be a little off. If it's too simplistic and meaningless a data point to provide investors with useful information, it therefore cannot possibly be a mechanism for balancing far more complicated issues such as income distribution.

Here's what we know the CEO pay ratio rule is likely to accomplish: create confusion, mistrust, communication issues, and disengagement within a workforce; cost extraordinary amounts of money unnecessarily (actually a detraction from investors' interests); and generate attention-grabbing headlines. These headlines will fuel debate, but not necessarily a productive one about either the protection of investors' economic interests or about much broader social issues that many hope to address.

## About the Author

Deborah Lifshey is a Managing Director in the New York office of Pearl Meyer and head of the firm's Technical Services Team. She specializes in advising clients on compensation matters from a legal perspective, including securities disclosure, taxation, and corporate governance issues.

## About Pearl Meyer

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