A State Treasurer Defends CEO Pay Law

Posted on March 8, 2017 by Denise Nappier

In the face of Republican attacks, Denise Nappier is defending a U.S. law requiring corporations to disclose their CEO-worker pay gaps, arguing it will provide valuable information for investors.

Denise Nappier

As Connecticut's State Treasurer, Denise Nappier manages a public pension fund with more than $30 billion in assets. It's a job she's held since 1999, so she knows a thing or two about what investor information is useful to ensure retirement security for her state's teachers and other government employees.

In 2013, Nappier was one of several state treasurers and other institutional investors to weigh in forcefully behind a Dodd-Frank financial reform provision requiring corporations to provide information on the gap between their CEO and median worker pay. But now, just as companies are about to begin calculating these pay ratios, this law is under attack from several fronts.

House Republicans would like to eliminate the pay ratio disclosure law completely, as part of a broader Dodd-Frank repeal. The powerful Business Roundtable has listed it among the 16 regulations they would most like to send to the chopping block. And now Michael Piwowar, Acting Chair of the Securities and Exchange Commission, has re-opened public comment and directed his staff to reconsider implementation of the law.

Michael Piwowar, a strong opponent of CEO-worker pay ratio disclosure, is using his current power as Acting SEC Chair to reconsider implementation of the 2010 law.

Inequality.org co-editor Sarah Anderson recently had the opportunity to ask Nappier her views about the embattled CEO-worker pay ratio disclosure law.

Why should state governments care about how corporations compensate their employees?

I have never begrudged compensation of senior management in companies with excellent performance. When the company does well, so do the shareholders. Any prudent investor should question high compensation for companies with challenges, however – especially when lackluster or poor performance arises from action taken by company management.

Specifically regarding pay ratio equity, it can be a window into how a company makes decisions that could impact its long-term sustainability.

The Connecticut Retirement Plans and Trust Funds ("CRPTF"), for which I serve as principal fiduciary, values information on CEO to worker pay disparities at publicly held companies for several reasons.

First, there is empirical evidence that higher CEO to worker pay disparities not accounted for by factors such as skill or firm size ("unexplained" pay disparity) are associated with poorer subsequent firm performance. This research is consistent with earlier work showing that higher disparities between compensation of CEOs and other named executive officers are linked to poorer performance. Thus, in at least some cases, pay disparity can have an impact on financial performance, and data on disparities can inform investment and engagement decisions.

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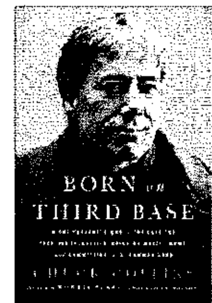

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"Our inequality materializes our upper class, vulgarizes our middle class, brutalizes our lower class."
– Matthew Arnold, English essayist (1822-1888)

More broadly, data on employee compensation would help investors better understand portfolio companies' approaches to managing their workforce, which is a key asset of nearly all companies. Underinvestment in the workforce can lead to costly operational, legal and reputational problems, while skillful human capital management fosters innovation, superior execution and competitive advantage. Although other workforce management data would also be useful in this regard, pay ratio information is an important starting point.

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Finally, pay ratio data would inform investor voting decisions on executive compensation matters. The CRPTF's guidelines include internal pay equity in the list of factors indicating that a compensation committee may not be acting in shareholders' best interests when setting executive pay.

The CRPTF has $6.7 billion invested in U.S. public equities as of December 31. Strong investment performance ensures that funds like the CRPTF can meet their obligations to beneficiaries.

After the 2001 Enron scandal, you sought accountability for the millions of dollars the Connecticut pension fund had lost as the result of the reckless and illegal behavior of that company's executives. Do you think policies which encourage narrower gaps between CEO and worker pay might help reduce this kind of dangerous executive risk-taking?

Many different factors influence the pay disparity at a particular company, so I'm reluctant to say that executive pay structures that incentivize greater risk-taking are always involved. It is clear, though, that the massive growth in disparity between worker and CEO pay has taken place over the same time period in which companies have relied much more heavily on equity-based pay arrangements such as stock options and restricted stock grants in compensating top executives.

These pay arrangements often don't do a very good job of distinguishing results due to executives' skill from those due to industry- or market-wide factors, leading to high pay for mediocre performance. At the same time, investors have suffered as a result of numerous corporate governance failures. Some, like Enron and WorldCom, have involved financial statement fraud that kept company stock prices high, benefiting executives who sold shares at inflated prices.

More recently, investors had large losses when financial firms failed to oversee risk adequately and helped cause the financial crisis. Many observers credit asymmetric equity incentives, in which executives have little or no downside risk but unlimited upside potential, and executives' freedom to sell shares obtained through equity compensation programs for increasing executives' risk appetites. Thus, it seems likely that executive compensation arrangements designed to more precisely reward superior firm performance could lead to both lower pay disparities and a more long-term orientation for executives.

The primary argument of the corporate lobby groups that are working to get rid of this disclosure rule is that complying with it is extremely burdensome and costly. How do you respond?

The SEC's final pay ratio disclosure rule struck a thoughtful balance, providing investors with the benefits of disclosure discussed above and taking into account concerns about the costs and difficulties some companies might face in generating the median worker pay figure. In response to these concerns, the SEC proposed to allow issuers to use statistical sampling or a consistently applied compensation measure, such as W-2 reportable income for U.S. employees and equivalent measures for non-U.S. employees.

As a result of the SEC's more flexible approach, one commenter reported a reduction in estimated annual compliance costs from a high of $500,000 based on the statutory language, to $15,000. Similarly, the SEC's final rule allowed companies to identify the median employee once every three years, permitted the exclusion of a de minimis number of non-U.S. employees from the definition of employee, required consideration of only employees of the issuer and its consolidated subsidiaries (and not minority-owned subsidiaries and joint ventures), and exempted consideration of non-U.S. employees if data privacy laws prohibited the issuer from obtaining or processing the relevant data. All of these changes were designed to reduce the compliance burden on issuers.

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Should it be seen as a red flag for investors to hear that a corporation has great difficulty in figuring out their median worker pay?

whose pay is at the median.

It is worrisome that some companies have such a tenuous grasp of their own labor costs that they say they are unable to identify the worker whose pay is at the median. Boards should be considering internal pay equity as well as external benchmarks when setting executive pay. A company whose systems do not allow identification of the median compensated employee will not be capable of incorporating internal pay equity considerations into the compensation-setting process. Even a company with a highly decentralized holding company structure, where subsidiaries have profit and loss responsibility, should have systems in place allowing it to produce the ratio once every three years, especially given the flexibility afforded by the SEC's final rule.

Denise Nappier has served as Connecticut's State Treasurer since 1999.

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