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Could a First Amendment Challenge to SEC's "Pay-Ratio" Rule Rein in CSR Disclosure Mandates?

by Andrew J. Morris

In recent years, Congress and the Securities and Exchange Commission (SEC) have compelled public companies to make various disclosures that have nothing to do with investor protection—disclosures relating to the environment, human rights, and other so-called corporate social-responsibility (CSR) issues. Because these disclosure requirements amount to compelled speech, some, including SEC Commissioners, have questioned whether they run afoul of the First Amendment.[1] U.S. Supreme Court jurisprudence on compelled speech indicates that, as a general matter, social-responsibility disclosure mandates violate the First Amendment. The case law on compelled speech in the U.S. Court of Appeals for the D.C. Circuit, however, is inconsistent on compelled speech in the commercial context.

Last August, SEC issued a new CSR disclosure mandate that provides an opportunity for a constitutional challenge which could help clarify the D.C. Circuit's approach to compelled speech. This Legal Backgrounder argues that, if given the opportunity, the court should confirm that government can impose information disclosures on businesses only when necessary to advance a substantial government interest in either investor protection or preventing consumer deception—not to promote a new social cause.

The latest SEC mandate is the "pay-ratio" rule, which requires every public company to estimate and publish the ratio between the pay of its CEO and its "median" employee.[2] The rule is a product of the Dodd-Frank Act.[3] Its aim is to highlight income inequality and thus, its backers hope, to cause companies to cut CEO pay.

Also in August, the D.C. Circuit invalidated the disclosure mandate of an earlier SEC social-responsibility rule, the so-called Conflict Minerals Rule. That rule required certain companies to disclose whether they use minerals that originated in Congo. The rule's aim was to fight human-rights violations in that country. The court's 2-1 decision reflects the unsettled state of law for compelled commercial speech in the D.C. Circuit.

Contrasting Views of the Government's Ability to Compel Speech

National Association of Manufacturers v. SEC held that the conflict-minerals mandate violated companies' First Amendment right against compelled speech.[4] The *NAM* majority opinion took a robust view of the First Amendment—and properly so, in light of benchmark Supreme Court precedents dating back more than 30 years. But Judge Randolph's majority opinion contrasts sharply with the quite permissive view taken by Judge Srinivasan's dissent. The dissent's approach would, in short, remove most First Amendment limits on the government's authority to compel CSR disclosures. The dissent's receptivity to compelled speech is part of Judge Srinivasan's broader message that the First Amendment rights of commercial actors deserve very little protection.

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[1] *See, e.g.*, Commissioner Daniel M. Gallagher, Dissenting Statement at an Open Meeting to Adopt the "Pay Ratio" Rule, Aug. 2, 2015, available at http://www.sec.gov/news/statement/dissenting-statement-at-open-meeting-to-adopt-the-pay-ratio-rule.html.
[2] 17 C.F.R. § 229.402(u).
[3] Dodd-Frank Wall Street Reform and Consumer Protection Act, Pub. L. No. 111-203, § 953(b), 124 Stat. 1326, 1904 (2010).
[4] No. 13-5252, 2015 WL 5089667 (D.C. Cir. Aug. 18, 2015).

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These contrasting positions—limited vs. permissive views of the government's right to compel speech—frame the stakes in the next lawsuit. Not only will that lawsuit decide the fate of the pay-ratio rule, it may have sweeping implications for other CSR-style mandates.

Compelled Speech Jurisprudence

The usual starting point for determining whether a regulation violates the First Amendment is to identify the governing legal test. There are three possible levels of scrutiny.

1. Generally, regulation of speech receives strict scrutiny.[5]
2. But if the speech being regulated is commercial, it receives "intermediate" or "heightened" scrutiny. The Supreme Court described this level in *Central Hudson*.[6]
3. If the commercial speech fits into a certain exception, regulation of it receives a lower level of scrutiny. The Supreme Court first described this exception 30 years ago in *Zauderer*.[7]

The *Zauderer* exception arose in the context of deceptive advertising and a government requirement that the speaker correct the speech, but in the D.C. Circuit its scope is an unsettled question. The *NAM* majority opinion described the exception correctly: It should be limited to cases where compelled speech is necessary to prevent deception of consumers that occurs in voluntary advertising.[8] Yet opinions about the exception's scope vary. The most permissive view is set out in the *NAM* dissent, which would expand the exception to encompass every law that compels a corporate disclosure, whatever the subject matter. But this view rests on inventive readings of the Supreme Court's guidance in the area. A lawsuit challenging the pay-ratio rule should thus be aimed at confining the *Zauderer* exception to its proper, limited scope—which does *not* include CSR-style mandates.

Unfortunately, the significance of the different levels of scrutiny is itself muddled. The test at each level is flexible, as are many legal tests. Furthermore, judges in compelled-speech cases sometimes exploit this flexibility by pushing a test's limits so far that, whatever the level of scrutiny in theory, it becomes minimal in practice. Judge Srinivasan's *NAM* dissent, for example, takes what the Supreme Court calls "heightened" scrutiny and treats it as such a forgiving test that it would bless almost any disclosure compelled in the interest of social responsibility. This is another spot where a lawsuit challenging the pay-ratio rule could shore up the law.

Applying the D.C. Circuit's Current *Zauderer* Test to the Pay-Ratio Rule

If the pay-ratio rule is challenged in the D.C. Circuit, a conscientious panel of judges would apply the most relevant and recent precedent from the circuit, which is Judge Randolph's majority opinion in *NAM*. If the judges on the panel did so faithfully, they would acknowledge that, because the pay-ratio rule does not address advertising, the higher level of scrutiny should apply.

Although Judge Randolph applied the *Central Hudson* level of scrutiny, he also offered an "alternative" ground[9] for the court's decision. That alternative ground demonstrated that the Conflict Minerals Rule did not pass muster even under the less-stringent version of the *Zauderer* test articulated by the D.C. Circuit in *American Meat Institute v. USDA*.[10] It would thus be prudent to similarly assess the pay-ratio rule under the D.C. Circuit's reading of *Zauderer*, with a focus on the three most relevant elements of that test: that the rule's means are reasonably effective in advancing the rule's ends, that the required disclosure is "purely factual," and that the disclosure is "uncontroversial."

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[5] *See Brown v. Entm't Merchs. Ass'n*, 131 S. Ct. 2729, 2738 (2011).
[6] *Central Hudson Gas & Elec. Corp. v. Pub. Serv. Comm'n of N.Y.*, 447 U.S. 557, 573 (1980).
[7] *Zauderer v. Office of Disciplinary Counsel*, 471 U.S. 626, 651 (1985).
[8] *Id.* at *1 (quoting *Zauderer*, 471 U.S. at 651), *3-4 (collecting Supreme Court authorities).
[9] *Id*. at *4 (references omitted).
[10] 760 F.3d 18 (D.C. Cir. 2014) (en banc).

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The means-ends effectiveness requirement. To satisfy the effectiveness requirement, the government must show that the disclosure mandate actually will advance the goal of the regulation. In the conflict-minerals case, for example, the government could not show that the disclosure mandate would actually improve conditions in Congo, so the mandate failed this requirement.[11]

The pay-ratio rule should suffer the same fate, because SEC offered no convincing evidence that "shaming" companies will cause them to cut CEO pay. To the contrary, some academic research indicates the rule is more likely to backfire by causing CEO pay to *increase*.[12] Worse, as explained below, SEC itself warns that the pay-ratio figure may actually mislead investors, an effect obviously antithetical to the purpose of securities regulation. And despite the rule's ineffectiveness, it imposes costs that are huge. SEC estimates that companies would have to spend about $1.3 billion to implement the rule, followed by more than $500 million every year after that.

The "purely factual" requirement. The pay-ratio rule also should fail the "purely factual" part of the test. To begin, the ratio itself—the idea of juxtaposing CEO pay and median pay to show the contrast—is not factual information about financial performance. It is an assertion about economics and ethics that is loaded with ideological preconceptions: that a business is a zero-sum activity, that CEO pay takes money out of the pockets of other employees, and that, therefore, a company "overpaying" the CEO deserves moral censure. One can choose to agree with these views or not, but they are neither objective nor testable. They are not "facts."

SEC likely will say that the ratio itself is an actual number, so it is an objective fact. But even that is not so. The figure is at best an estimate, as the SEC repeatedly acknowledges,[13] and no standard exists to govern the estimation process. Identifying "median" employee compensation, even in theory, is not mere arithmetic. It requires a sprawling exercise that is extraordinarily complex and that companies have not previously had reason to attempt. Most significant here, it requires numerous value judgments, which are necessary in order to assign dollar amounts to the widely varied compensation packages provided to employees working in many roles and in many countries' compensation systems. Those value judgments are not governed by any numerical standard.

Yet any legitimate financial disclosure is governed by some such standard—Generally Accepted Accounting Principles, for instance—or a specific definition set out in a regulation. But the pay-ratio rule provides nothing of the sort. It does the opposite, permitting companies to come up with their ratios using any "reasonable method."[14] In fact, SEC took the unprecedented step of stating that pay-ratio figures would *not* be comparable from one company to another.[15] It even warned that making any comparisons could be—this is SEC's word—"misleading."[16] In the world of SEC reporting, this is unheard of. SEC's warnings should raise eyebrows for several reasons, but at minimum they show that the pay ratio is not "factual" in the sense typically required for an SEC filing.

Worse, SEC takes advantage of this unusual situation by rigging the rule to advance the pay-unfairness agenda. For example, it requires companies to include part-time and seasonal employees in their figures—but *without* annualizing the employees' earnings.[17] This skews the median to a lower-level employee, thus inflating the reported pay gap. The requirement is not defensible on any financial-reporting principle; to the contrary, it looks much like the kind of manipulation SEC's Enforcement Division routinely punishes. This finagling has significance beyond the pay-ratio rule. It shows the kind of games agencies are tempted to play if they can compel disclosures that are based on vague CSR notions, rather than grounded in established regulatory standards.

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[11] Indeed, it appears the regulation has made the situation in the Congo measurably worse. *See, e.g.*, Dominic P. Parker and Bryan Vadhein, *Resource Cursed or Policy Cursed? U.S. Regulation of Conflict Minerals and the Rise of Violence in the Congo*, June 2, 2015, available at http://aae.wisc.edu/dparker5/papers/DRCConflictWP2015.pdf.

[12] *See* SEC Commissioner Michael Piwowar, Additional Dissenting Comments on Pay Ratio Disclosure, section V. (Aug. 7, 2015) (citing academic studies).

[13] *See* SEC Release No. 33-9877 (Aug. 5, 2015) (Adopting Release), *passim*.

[14] *Id.* at 287 (Instruction 4 to Item 402(u) ("Methodology and use of estimates")) and 99-123.

[15] *See, e.g., id.* at 12, 51-52.

[16] *See* SEC Release No. 33-9452 (Sept. 18, 2013) at 93.

[17] Adopting Release at 289 (Instruction 5 to Item 402(u) ("Permitted annualizing adjustments")).

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The "uncontroversial" requirement. This part of the First Amendment analysis gets to the heart of why CSR mandates are constitutionally offensive: because they force companies to adopt viewpoints they may oppose.

A statement is controversial if it is "disputed.[18] Companies dispute the message inherent in the pay-ratio rule. The rule's point is to let the public "know which corporations are fueling the yawning gap between rich and poor," as thousands of activist-generated form letters preached to SEC.[19] Not surprisingly, companies object to being forced to endorse these premises—being forced, in effect, to make public confessions of complicity in social injustice. As SEC Chair Mary Jo White summarized the disagreement, "The pay ratio rule has been controversial, spurring a contentious and, at times, heated dialogue." To say that views are divided, she said, "is an obvious understatement." [20]

No CSR mandate can pass the "noncontroversial" requirement. That is why the dissent in *NAM* avoids the entire issue by eliminating this requirement from its novel version of the *Zauderer* test.

Applying the *NAM* dissent's permissive view

The prevailing uncertainty surrounding compelled speech in the D.C. Circuit creates a significant risk that the next panel of judges to review a CSR mandate—whether it is the pay-ratio rule or another disclosure requirement—may find the *NAM* dissent's reasoning more compelling and therefore part company with Judge Randolph's majority decision. It is thus important to analyze Judge Srinivasan's opinion and explain how it is at odds with Supreme Court free-speech jurisprudence.

Judge Srinivasan sweeps away the first question asked in the D.C. Circuit's application of *Zauderer*: Are the rule's means reasonably effective at advancing the rule's ends? He first reasons that *every* disclosure mandate is effective by definition—because every mandate causes companies to disclose new information. To address the expectation that a mandate should have an actual real-world effect, the dissent accepts assurances from the government that the rule will, in fact, have the desired effect.[21] This means, of course, that every rule will be deemed effective. Under that approach, as long as a rule is deemed effective, the cost of compliance is not a significant consideration. The cumulative effect of these steps is to give every CSR mandate a free pass on the effectiveness requirement—thereby eliminating the requirement from the governing test as a practical matter.

Judge Srinivasan also sets a low threshold for the "factual" requirement, though he does not nullify it altogether. It is clear, however, that under the dissent's approach this requirement will not trip up many CSR mandates.

Finally, the dissent entirely eliminates the "uncontroversial" requirement by re-casting it as a mere explanation of the "factual" requirement. That is, Judge Srinivasan limits the meaning of "controversy" to an empirical test of "simple factual accuracy."[22] This move turns a blind eye to the very purpose of CSR disclosures—to send a moral or politically charged message. In so doing, this fiction frees the government to compel disclosure on any topic, no matter how political or how hotly disputed. In fact, once the dissent has finished its work, no principle remains to limit the state's ability to mandate CSR disclosures.

The Pay-Ratio Decision and Beyond

The *NAM* dissent thus illustrates the high stakes in the next lawsuit over a CSR mandate. If that lawsuit is decided along the lines of the *NAM* dissent, it could open the floodgates to more CSR mandates—and accelerate the politicization of the SEC's disclosure regime. On the other hand, if the court in that case properly reins in CSR mandates, it can restore the traditional limits on state power set out in the Supreme Court's settled decisions on compelled speech.

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[18] *NAM*, 2015 WL 5089667 at *6.

[19] Quoted in Michael Piwowar, Dissenting Statement at Open Meeting on Pay Ratio Disclosure (Aug. 5, 2015).

[20] Statement at Open Meeting on Security-Swap Rules Under Title VII and on Pay Ratio Disclosure Rule (Aug. 5, 2015).

[21] *NAM,* 2015 WL 5089667 at *22.

[22] *Id*. at *16.

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