

Nasdaq Talks to...Don Kalfen of Meridian Compensation Partners about Preparing for CEO Pay Ratio Disclosure

Q: What is the CEO Pay Ratio rule and what does it require companies to do?

A: The Pay Ratio disclosure is one of several disclosures on executive compensation and related governance matters mandated under Dodd-Frank Wall Street Reform and Consumer Protection Act (“Dodd-Frank”). This mandated disclosure did not become effective with the passage of Dodd-Frank. Rather, Dodd-Frank directed the Securities and Exchange Commission (SEC) to write rules on the Pay Ratio disclosure that would include the disclosure’s effective date.

On August 5, 2015, the SEC issued a final rule on the Pay Ratio disclosure. The final rules require a public company to make the following key proxy disclosures:

- annual total compensation of the median employee of a registrant (excluding the chief executive officer);
- annual total compensation of that registrant’s chief executive officer; and
- the ratio of the annual total compensation of the median employee to the annual total compensation of the chief executive officer.

The Pay Ratio must be expressed in the form of a ratio where the median employee is equal to one or expressed narratively in terms of the multiple that the CEO’s annual total compensation bears to the median employee’s annual total compensation. For example, if the annual total compensation of a company’s CEO was \$7 million and the median employee’s total compensation was \$35,000, then the CEO pay ratio may be expressed in one of the following ways:

- the CEO’s annual total compensation is 200 times that of the median employee’s annual total compensation, or
- 1 to 200.

In addition to the foregoing disclosure, the Pay Ratio rule requires companies to make certain supporting disclosures, such as disclosing the methodology used to determine employee compensation.

Q: When will companies first disclose the Pay Ratio?

A: The Pay Ratio rule becomes effective on a company’s first full fiscal year beginning on or after January 1, 2017. For a calendar year company, this means that the initial Pay Ratio disclosure would relate to calendar year 2017 compensation and would be disclosed in the company’s 2018 proxy.

Q: What companies are subject to the Pay Ratio rule?

A: Generally, the Pay Ratio disclosure requirements apply to public companies that are required to include a summary compensation table in their proxy statements.

However, there are a few exceptions: emerging growth companies, smaller reporting companies, foreign private issuers and Multijurisdictional Disclosure System (MJDS) filers are exempt from the Pay Ratio rule.

Q: What is the purpose of the Pay Ratio rule?

A: The merits of the Pay Ratio have been vigorously debated since the enactment of Dodd-Frank. In fact, Meridian noted in its comment letter to the SEC that “the disclosure of the CEO pay ratio will provide

investors with little or no meaningful information about an issuer's executive or employee pay practices ... what value this information may have to investors is far outweighed by the administrative burden and associated costs borne by issuers in accumulating the compensation data necessary to make the CEO pay ratio disclosure." At the time the proposed rule on the Pay Ratio was issued, the two Republican SEC Commissioners concurred with this view.

In the preambles to both the proposed and final rule on the Pay Ratio, the SEC noted that neither Dodd-Frank nor the legislative history directly states the objectives or benefits of the Pay Ratio disclosure. The SEC further noted that "lack of a specific market failure identified as motivating the enactment of this provision (i.e., Dodd-Frank provision on pay ratio disclosure) poses significant challenges in quantifying potential economic benefits, if any, from the pay ratio disclosure."

In fact, the SEC was unable to identify any such benefits other than those identified by proponents of the pay ratio disclosure, which include the following:

- assisting investors in their ability to evaluate CEO compensation in the context of the company's overall business;
- providing insight into the effectiveness of board oversight;
- permitting investors to approximate employee morale and productivity;
- measuring a particular company's investment in human capital;
- addressing the broader public policy concern on income inequality; and
- offsetting the upward bias in executive pay resulting from current benchmarking practices.

We do not believe the final rule on the Pay Ratio will effectively serve any of the foregoing objectives.

For its part, the SEC in the final rule concluded that the Pay Ratio disclosure "was intended to provide shareholders with a company-specific metric that can assist in their evaluation of a registrant's executive compensation practices." However, we do not believe that the Pay Ratio will convey meaningful information to shareholders with respect to a company's executive compensation practices, any more so than comparing CEO pay to the lowest paid employee or the top-quartile paid employee. Nonetheless, many parties will draw conclusions about the appropriateness of CEO compensation based on comparative analysis of Pay Ratios across companies and across industries. However, the SEC warned in its release of the final rule that numerous factors may limit the comparability of the Pay Ratio across companies, noting further that precise comparability is not the primary objective of the final rule.

Q: Who could be interested in this type of information?

A: Regardless of its merits, the Pay Ratio disclosure will generate significant interest among a broad range of parties. The Pay Ratio disclosure is likely to draw intense media scrutiny that will pique the interest of the general public and other constituencies. More specifically, employees, institutional shareholders such as union and state pension funds, certain activist shareholders, major proxy advisors, union groups and politicians will all have varying degrees of interest in the Pay Ratio disclosure. Of course, corporate boards and managers and business competitors will also be interested in Pay Ratio disclosure. Whether and to what degree compensation committees will take into account the Pay Ratio disclosure in setting CEO pay remains to be seen.

One overlooked item regarding the Pay Ratio rule is that it also requires disclosure of the pay of a company's median employee. This is the first time that public companies will be required to disclose this type of pay data. The disclosure of median pay may cause HR headaches for many companies.

Employees will now be able to measure their own pay levels against median pay at their companies. Further, prospective recruits may size up a company based on the company's disclosed level of median pay. This may be particularly acute at companies within high paying sectors, such as technology and banking. HR will need to be prepared to address both internal pay issues and external recruiting issues that may arise due to the disclosure of median pay.

Q: Who are employees for purposes of calculating the “median” employee?

A: To determine who is the median employee, a public company must take into account individuals (i) who are employed by the company and any of its consolidated subsidiaries (all on a worldwide basis) as of a date chosen by the company within the last three months of the company's last completed fiscal year and (ii) who fall into one of the following employment classifications:

- full-time employees,
- part-time employees,
- seasonal employees, and
- temporary workers.

Subject to certain exclusions discussed below, this group of employees constitutes the employee population from which a company must identify the median employee. Employees do not include independent contractors or “leased” workers or other temporary workers who are employed by and whose pay is set by an unaffiliated third party. This exclusion would cover a self-employed individual, such as a consultant or attorney, who sets his or her own pay.

Q: What considerations go into selecting the date for purposes of developing the employee population from which to identify the median employee?

A: A company may select any date within its last fiscal quarter for purposes of developing the employee population from which to identify the median employee. The optimal date to select for developing this employee population will largely depend on the nature of a company's workforce and internal administrative processes and technology. Considerations include:

- On what date or dates during a month is it easiest to identify every employee within a company's worldwide workforce? Such date or dates will likely coincide with a company's payroll cycle. However, complexities will likely arise for companies with multi-national locations using disparate payroll systems and HRIS.
- During a company's last fiscal quarter, are there substantial changes in a company's workforce due to employment of seasonal, temporary or part-time employees or hiring of a large number permanent employees? To avoid the necessity of taking into account a large influx of employees during the fourth quarter, a company should consider selecting the earliest administratively feasible date in the fourth quarter to identify employees in its worldwide workforce.

Q: May foreign-based employees be excluded from the employee population?

A: Yes, companies may exclude certain foreign-based employees (“Non-U.S. employee”) from the employee population under a complex set of rules.

At a high-level, these rules permit Non-U.S. employees to be excluded from the employee population under the following circumstances:

- If Non-U.S. employees comprise 5% or less of a company's worldwide workforce, a company may exclude all (but not less than all) Non-U.S. employees from its employee population.
- If a company's Non-U.S. employees exceed 5% of a company's worldwide workforce, then a company may exclude Non-U.S. employees to the extent the excluded employees do not exceed 5% of its worldwide workforce. If Non-U.S. employees from a given foreign jurisdiction are excluded from a company's worldwide workforce under this exclusion, then all Non-U.S. employees must be excluded from that jurisdiction, provided that the 5% limit is not breached.
- A company may exclude from its employee population Non-U.S. employees if the collection of such employees' pay data would violate local jurisdiction data privacy laws, provided that certain other requirements are met. If a company excludes any Non-U.S. employees in a particular foreign jurisdiction due to data privacy laws, it must exclude all Non-U.S. employees in that jurisdiction. This exclusion is not subject to the above 5% limitation. However, Non-U.S. employees excluded under the data privacy exemption count against the 5% limit, and significant additional proxy disclosures are required to support the data privacy claim for exclusion.

To take advantage of the 5% exclusion, companies will need to start accumulating and analyzing data on the number of non-U.S. based employees by foreign jurisdiction. With regard to the data privacy laws, companies will need to confer with outside counsel to determine if such laws effectively bar the accumulation and transmission of data to the U.S. for purposes of identifying the median employee.

Q: Are there other circumstances under which a company may exclude employees from the employee population?

A: Yes, a company may exclude individuals who became its employees as the result of a business combination or acquisition of a business for the fiscal year in which the transaction becomes effective.

Q: What factors should companies consider in determining whether to use their total employee population or a statistical sampling, as allowed under the rule?

A: A company may identify the median employee from:

- its entire worldwide employee population; or
- a portion of the worldwide employee population determined under statistical sampling techniques and/or any other reasonable method.

Key considerations in determining whether to use worldwide employee population or a sample include the following:

- The size of the workforce.
- The complexity of the organization.
- The stratification of pay levels across the workforce.
- The types of compensation paid to employees.
- The extent that compensation is paid in different currencies.
- The number of tax and accounting regimes that cover employee compensation.
- The number of payroll systems a company has and the degree of difficulty involved in integrating payroll systems to readily compile compensation information for all employees.

Generally, multi-national companies with large worldwide workforces, payroll systems and complex pay structures are the companies most likely to take advantage of statistically sampling to develop the pool of employees from which to identify the median employee.

Q: How do companies identify the median employee?

A: The cornerstone of the Pay Ratio rule is the identification of the median employee (which constitutes the vast majority of the work required). The identification process will be the most time consuming and costly aspect of public companies' compliance with the new disclosure rule. However, the SEC has included in the Final Rule two provisions that are intended to mitigate compliance time and costs: (i) triennial identification of median employee and (ii) simplified methodologies to identify the median employee.

Generally, companies will only need to identify the median employee once every three years and to calculate total compensation for that employee each year, subject to certain limitations.

As previously noted, a company may identify the median employee from one of the following pools of employees:

- entire worldwide employee population; or
- a portion of its entire population determined under statistical sampling techniques and/or any other reasonable method.

Once the employee pool is determined, a company will need to determine the compensation of each employee in the pool in order to identify the median employee. For this purpose, the Pay Ratio rule does not mandate that companies use a specific defined measure for employee compensation (e.g., taxable wages) or specific methodology for estimating employee compensation. Rather, companies may use any one of the following measures or techniques to develop employee compensation levels:

- Annual total compensation based on the proxy rules applicable to the determination of total compensation for a company's named executive officers. However, we believe very few companies, if any, will choose this method for determining compensation of each employee in the employee pool.
- A compensation measure consistently applied to all employees, such as base salary or W-2 wages. The appropriateness of any measure will depend on the company's particular facts and circumstances, including other elements of total compensation awarded to employees. By way of example, the SEC staff's recent guidance on the Pay Ratio rule notes that total cash compensation could be a consistently applied compensation measure unless the company also distributed annual equity awards widely among its employees.

We believe the overwhelming majority of companies will choose this method for determining the compensation of each employee in the employee pool. For many companies, the use of W-2 wages will be the easiest and least complex method for determining U.S. based-employee compensation. For foreign-based employees, there may be no equivalent to W-2 wages. Nonetheless, the Pay Ratio rule contemplates that taxable wages (or other consistently applied compensation measures) may be defined differently across jurisdictions and may include different annual periods. Accordingly, a company may determine employee compensation

based on a measure that is defined differently across jurisdictions and may include different annual periods as long as within each jurisdiction, the measure is consistently applied.

- Total compensation or any element of total compensation developed through a company self-determined statistical sampling or estimation techniques, provided that such sampling or estimation techniques are applied on a consistent basis.

Recent SEC staff guidance also liberalizes the period over which a company must determine employee compensation. This period may be less than a full year or may be a company's prior fiscal year provided that there has not been a change in the company's employee population or employee compensation arrangements that would result in a significant change of the pay distribution among its workforce.

Once a company determines the compensation of each employee in the employee pool, the company would then identify which employee received compensation at the median of all employees.

Q: How can companies make cost of living adjustments to employee compensation in identifying the median employee?

A: A company may (but is not required to) make cost-of-living adjustments to the compensation of employees who reside in jurisdictions other than the jurisdiction in which the company's CEO resides. The adjustments to employee compensation should reflect the cost of living in the jurisdiction in which the CEO resides.

When a company chooses to make a cost-of-living adjustment, the company will be required to identify the median employee with and without using the cost-of-living adjustment. It is a near certainty that this requirement will identify two different median employees with different annual total compensation. Separate Pay Ratios must be developed and disclosed with respect to each median employee.

Q: After the median employee is identified, how do companies develop the Pay Ratio disclosure?

A: A company must undertake the following to develop the Pay Ratio disclosure:

- The median employee's annual total compensation must be calculated pursuant to the proxy disclosure rules for calculating a named executive officer's total compensation. This means each of the elements of compensation subject to disclosure in a company's summary compensation table must be computed for the median employee.

A company may (but is not required to) include personal benefits that aggregate less than \$10,000 and compensation under non-discriminatory benefit plans (e.g., health and welfare arrangements) in calculating the annual total compensation of the median employee, provided that these items are also included in calculating the CEO's annual total compensation.

- The CEO's total annual compensation must equal the sum of the following items:
 - the CEO's total compensation as disclosed in the company's summary compensation table;
 - the value of personal benefits of less than \$10,000 if the value of such benefits is included in the median employee's total annual compensation; and
 - the value of compensation under non-discriminatory benefit plans if the value of such compensation is included in the median employee's total annual compensation.

- The Pay Ratio is based on the relationship between the median employee’s total annual compensation and the CEO’s total annual compensation based on the above calculations.

Q: How and when should a company present this data – are there circumstances when a company should consider making disclosure before it’s required, for instance, in response to questions from investors or the press?

A: The Pay Ratio rule does not specify the placement of the Pay Ratio and related disclosures within a company’s proxy (or annual report or registration statement to the extent such filings include disclosures on named executive officer compensation). We believe that these disclosures could properly appear as a free-standing section within the company’s annual proxy. However, in the release of the Final Pay Ratio rule, the SEC observed that “the most meaningful way to present pay ratio disclosure is in context with other executive compensation disclosure, such as the Summary Compensation Table ... and the Compensation Discussion and Analysis..., rather than provided on a stand-alone basis.”

We anticipate most companies will include the Pay Ratio disclosures as part of their Compensation Discussion and Analysis section of their annual proxy.

We anticipate that very few companies will disclose their Pay Ratio prior to its inclusion in the proxy.

Q: Outline some considerations in developing the messaging and narrative around a company’s disclosure, for instance, if the ratio is a big number. How can a company manage that?

A: Companies are not required to provide any explanation around the Pay Ratio. However, we believe that many companies will make volitional disclosures that will provide context for or further explain the Pay Ratio and the methodology used to develop it. The first year of the disclosure will be the most problematic to develop appropriate messaging on the Pay Ratio disclosure due to the absence of any historical disclosures. Nonetheless, depending on a company’s particular circumstances, the following key points may be relevant to disclose:

- a general description of the Pay Ratio;
- the effect of including foreign-based employees in the development of the Pay Ratio and other unique factors that may materially bear on the Pay Ratio;
- a discussion on a company’s overall pay philosophy beyond the executive level (e.g., that the company aims to pay competitive compensation at each level of the organization);
- the Compensation Committee’s determination that CEO compensation is appropriate and competitive; and
- the Compensation Committee’s view that the Pay Ratio is not a meaningful tool for evaluating the appropriateness of CEO compensation on both an internal and external basis.

Q: What can companies do now to prepare?

A: Until the fourth quarter of 2017, for a calendar year company it is too early to determine a CEO pay ratio that complies with the Dodd-Frank requirements and the SEC rule on the pay ratio disclosure. A calendar year company is required to determine the covered employee population from which to derive the pay ratio as of a company-selected date occurring in its fourth quarter. Only after this determination has been made may a company calculate a compliant CEO pay ratio.

However, we suggest companies undertake the following planning steps during the current calendar year, and into the start of 2017 to get ahead of the curve:

Identify covered entities (and covered jurisdictions) and means of data collection. A company should identify each covered entity (i.e., every consolidated entity for financial statement purposes), the jurisdiction(s) of the entity and the means of collecting applicable employee pay data from each entity. This, importantly, includes how the company will collect data (e.g., via the company's country specific HRIS system, by hand input on paper documents, etc.), and determine currency conversions.

Determine employee exclusions. Once covered entities are identified and how pay data will be collected, a company should determine if any employees from covered entities may be excluded from the covered employee population (e.g., 5% exclusion of non-U.S. employees, countries where data privacy laws raise issues, independent contractors, etc.). In this regard, a company should consider retention of legal counsel to determine the extent to which non-U.S. employees may be excluded by reason of data privacy laws.

Determine covered employee population. Next a company should determine whether the median employee should be identified from the entire covered employee population or a subset of the employee population based on statistical sampling techniques. A company may need to retain a statistician to determine the appropriate sampling techniques.

Agree upon pay definition for determining median employee. A company should then determine how pay will be defined for purposes of identifying the median employee and to what extent pay may be annualized for certain categories of covered employees. Note, the pay definition for this purpose could be W-2 reported pay, base salary, or other consistently applied measure.

Conduct a simplified calculation based on U.S. employees only. A company should determine sample CEO pay ratio based solely on its U.S. employee population or a subset of this population. This will help a company further refine its processes for developing its CEO pay ratio disclosure and help to surface issues for resolution. Finally, this may provide some indication as to what will be the disclosed CEO pay ratio, and create a more informed expectation on how a company may need to develop disclosures regarding the pay ratio.

Q: Finally, will the incoming Trump administration repeal the CEO pay ratio?

A: President-elect Trump's specific view on the CEO pay ratio are not known. However, Mr. Trump's view on Dodd-Frank are clear: The President-elect will seek the repeal or sweeping reformation of Dodd-Frank. This could result in the repeal of the CEO pay ratio along with the other Dodd-Frank disclosure mandates. Further, over the past several years, Congressional Republicans have routinely introduced bills to repeal the CEO pay ratio. Despite these hopeful signs, at this point it would be premature to write-off the Pay Ratio rule. It may be well into the Summer of 2017 before the fate of Dodd-Frank and its various disclosure mandates start to become clear. Until then, we are advising companies to operate under the assumption that the Pay Ratio will go into effect in 2017, with initial public disclosure in 2018.