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ADVISOR BLOG

The Catch 22 of the Disclosure Season: Was the Supplemental CEO Pay Ratio Worth It?

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For better or worse, the SEC's regulations implementing the CEO Pay Ratio disclosure requirement provided public companies a great deal of leeway to calculate and disclose. One of the items most deliberated with our clients was whether or not to provide a supplemental pay ratio using a different methodology from the required rules. Highlights of our analysis of data captured in mid-April indicate that:

- While few companies chose to disclose a supplemental ratio, those that did were able to show a significantly lower ratio in many cases.
- The desire to smooth out the impact of one-time or multi-year grants to a CEO was the most commonly occurring reason to provide a supplemental ratio.
- The most profound decrease from the required ratio occurred when companies provided a supplemental ratio that excluded part-time and seasonal employees.
- A number of companies provided a supplemental ratio that was greater than the required ratio, mostly likely to avoid a drastic increased ratio in 2019.

Few companies are choosing to include a supplemental ratio.

Of the first 1,039 companies to file proxies, 99 have filed a supplemental ratio.

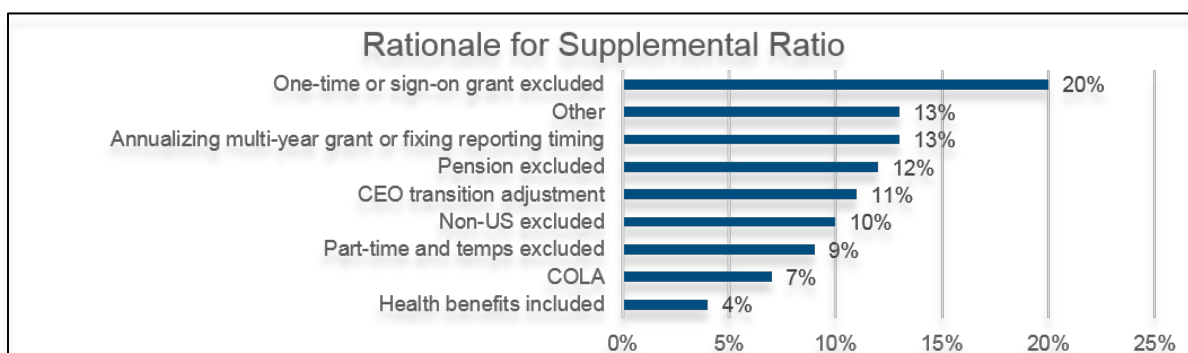
On average, the supplemental ratios are significantly lower than the required pay ratio.

Of the 99 companies that filed additional disclosures, the average of the supplemental ratios was 137:1 compared to the average of the required ratios of 329:1. Thus, on average, the supplemental ratios were only 42% of the size of the required ratios. Note that the average required ratio out of the full set of filers as of that same date was roughly 150:1, indicating that as a general matter the higher a company's required ratio, the more likely it was to disclose an additional (and for the most part, lower) ratio.

Rationale for filing supplemental ratios falls into nine general categories.

By far, the most frequently cited reason for providing a supplemental ratio has been a company's desire to neutralize the impact of a one-time special equity grant or sign-on bonus. Many companies also wanted to show a more accurate picture of typical year-over-year CEO pay and took an approach that annualized multi-year grants or captured realized or realizable pay rather than the accounting-based pay of equity awards required in the Summary Compensation Table (SCT). Normalizing the impact of CEO transitions (either in cases of mergers, new/promoted CEOs, or multiple CEOs) was another frequently cited reason for an additional ratio.

A handful a companies have utilized adjustments to take into account cost of living adjustments (COLA). Some have chosen to exclude (i) actuarial pension changes; (ii) all (not just the permitted 5%) of overseas employees, part-time, and seasonal/temporary employees; or (iii) include the value of non-discriminatory health benefits. The remainder of companies chose to calculate ratios by picking and choosing different elements of compensation (e.g., only salary, only target compensation, or only W2 value) that they thought made the most sense for their company's employee profile.

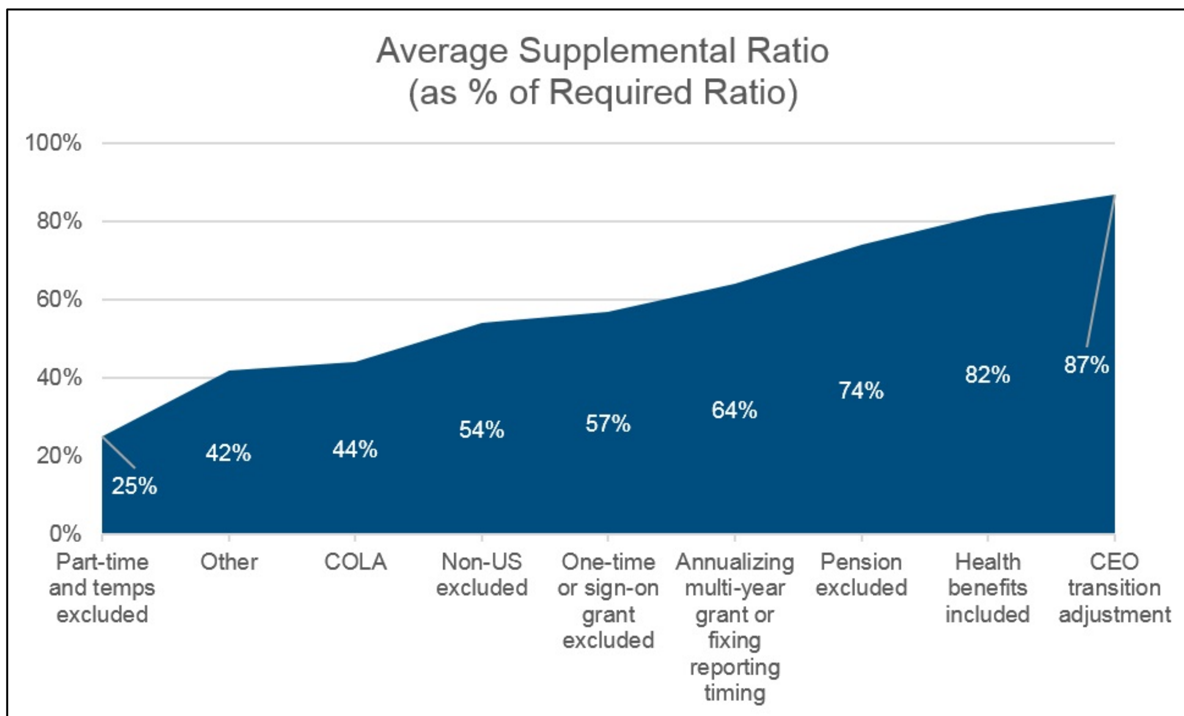


Impact of reduction varied by rationale.

The extent to which a supplemental ratio showed a marked reduction from the required ratio seemed to vary by rationale for the additional disclosure. By far, those companies that excluded part-time and temporary workers reduced their ratios the most—on average the supplemental ratio was only 25% of the required ratio in those cases (and in an extreme case, only 5% of the required ratio). Companies were also able to significantly reduce their

ratios by applying COLA (44%), excluding overseas employees (54%), or cherry picking certain elements of compensation (42%).

While excluding one-time awards and annualizing multi-year grants may have been the most common rationales for providing an additional ratio, these had a lesser impact on reducing the average ratio (taking it to 57% and 64% of required ratio, respectively).



Factors that seemed to have the least impact on the required ratio were excluding pensions, including non-discriminatory health benefits, or including some sort of adjustment for transitioning CEO positions.

Some supplemental ratios were higher than required ratios.

Out of the 99 companies filing supplemental ratios, 14 actually filed a supplemental ratio *higher* than the required one. In the majority of these cases, the additional ratio was provided to explain the impact of a transitioning CEO role. These companies explained that the sum of outgoing and incoming CEO pay or annualized SCT values for a new CEO would not reflect a consistent ratio year over year given the uniqueness of the first year in the role.

Some ratios also went up when companies annualized a one-time equity award that had been granted in 2015, 2016, or was scheduled for 2018 and thus did not hit the 2017 SCT. A few companies excluded the value of the actuarial increases or decreases in pension for the CEO and/or median employee explaining that those numbers tended to be inconsistent and variable year over year.

While filing higher ratios may seem counterintuitive, these companies are likely anticipating their ratios will spike in 2019 and are strategically providing a higher supplemental ratio now to avoid future negative perceptions about their year-over-year pay.

Was it worth it?

In our experience, while all of our clients had an opportunity to file an additional ratio, most chose not to, absent a compelling reason. Many clients took a “less is more” approach to the disclosure overall, waiting to see how comparisons pan out after this first full proxy season is over. Many also viewed the additional disclosure as a double edged sword—while overall the populist messaging of a lower ratio may have been a short-term goal, any benefit reaped from the lower ratio was surely overshadowed by the required ratio and possible negative inferences one may draw from the alternate ratio discussion (e.g., “If we don’t pay attention to part-time or overseas employees, or CEO mega-grants, our ratio looks decent.”). We suspect, however, that supplemental ratios may become more prevalent next year when year-over-year company specific comparisons are under the microscope.

Source: 2018 Main Data Group

About the Author

Deborah Lifshey is a managing director in the New York office, where she specializes in advising clients on compensation matters from a legal perspective including securities disclosure, taxation and corporate governance issues, negotiation contracts, and reasonableness opinion letters. She is a graduate of the Industrial and Labor Relations School at Cornell University and the University of Florida College of Law, and served as a federal clerk for the Honorable Judge Susan H. Black on the Eleventh Circuit Court of Appeals. Prior to joining Pearl Meyer, Ms. Lifshey practiced at Fried, Frank, Harris, Shriver & Jacobson, where she specialized in executive compensation, ERISA matters, and corporate transactions, and at Holland and Knight, where she specialized in employment litigation matters.

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