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ADVISOR BLOG

CEO Pay Ratio Disclosure Round Two: Top 10 Things to Worry About

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Most of us have made it through the first round of CEO Pay Ratio disclosures with minimal bruises. Now it's time to sit back and coast for Round 2, simply doing a copy and paste from last year's narrative, right? After all, the SEC permits companies to use the same identified median employee for the next two years.

Not so fast. While much of the anxiety surrounding implementation of new regulations is in our past, we still need to focus and be prepared for some changes for the upcoming 2019 proxies. Here are our top ten things to think about as proxy season approaches.

1. Was there a material change in your workforce or compensation programs?

If there has been a change in your employee population or compensation arrangements, the rules require that companies go through the painstaking process of re-identifying a new median employee. Whether or not these changes would have a material impact on the workforce or compensation systems is likely to be a judgement call as the guidance provides no bright-line test for that determination. For example, if a company has an acquisition in 2018 and the workforce increases by 20%, is that a material change that warrants identification of a new median? What if all of those newly acquired employees are part-time or overseas workers who most certainly fall at the low end of the compensation skew? Companies will need to carefully analyze changes of these nature with a facts and circumstances lens.

2. Did you have an acquisition in Year 1 and exclude acquired employees?

Last year, the SEC rules allowed companies to exclude from the median identification exercise those employees who were acquired in 2017. However, those companies that took advantage of this exception (nearly 8% of filers) are required to re-examine their workforce in this second year to determine whether including those employees would result in a significant change in the workforce (see above) that would in turn require re-identifying the median employee.

3. Did you have an acquisition in Year 1 and exclude acquired employees?

Companies will need to make a plan in the event that the Year 1 median individual terminated employment or had a significant change in circumstances (e.g., low bonus due to poor performance or significant change to base salary due to promotion or demotion). Some companies planned ahead for this scenario in the first year by identifying a range of 10-20 potential employees that could reasonably be substituted for the Year 1 identified employee. There are a variety of factors that may influence whether or not one up or one down on the list are appropriate (e.g., whether or not such individuals are located in the same country as the Year 1 identified employee), so companies will need to focus on the facts and circumstances of their situations closely.

4. Should you change your methodology?

Now that we have had the benefit of nearly 4,000 disclosures to review in our spare time, we may have come across disclosures of our peer companies or others that seem to have a better or preferred methodology. Maybe you used statistical sampling last year but now realize most companies were not doing the same. Maybe you excluded certain overseas workers but your peers did not. We believe as a general matter, absent a compelling reason to do otherwise, use the same median employee and methodology as in previous years. Calling attention to a changed methodology may call attention to your disclosure and trigger analysis of whether you did it right the first time around and/or whether you're trying to cover up an adverse change.

5. Should you change your disclosure at all?

After reading those nearly 4,000 other proxies, you may find yourself with a case of pay ratio disclosure envy and want to change the way your disclosure reads or is presented. Again, absent a compelling reason to do so (see our next two considerations), we would recommend retaining the same format and flow from 2018. With the SEC issuing **zero** comment letters on this disclosure requirement last year, it appears that every registrant has so far made a good faith attempt to comply and did (at least in the eyes of the SEC). Even proxy advisors and institutional investors didn't complain about the disclosures, and if anything, said there was too much information. Why open yourself up to scrutiny by changing what has already worked?

6. Did you have a material swing in CEO pay or resulting ratio?

In certain cases, it may be beneficial to provide additional context if there are big changes in the ratio with a specific rationale. For example, there may be a new or outgoing CEO with sign-ons or outgoing packages. Perhaps there was a multi-year grant issue in one of the two years that caused the swing. In such cases, an additional explanation could be helpful.

7. Did any constituency or the media have a reaction to the disclosure?

As anticipated, the new disclosures had no material impact on investment advisor voting and there was almost no correlation with say-on-pay. The SEC didn't issue comment letters and there seemed to be very little backlash from employees who now understand what the median employee earns. Nor did the new disclosure provide any new fodder for labor unions. While most of us thought there could be a media frenzy, we saw little traction in the major newspapers and only fleeting excitement at the local levels. That being said, some companies may feel the need to respond to any perceived negative feedback. This will be another facts-and-circumstances call, but absent a critical need to respond, we would recommend keeping the disclosure simple.

8. Do you want to compare yourselves to general averages or the now-known peer ratios?

While our advice so far has been wishy-washy fact dependent, we think there's a clear answer on this one. There is zero integrity in comparing your calculation to those of others as the flexible assumptions and methodologies render it an apples to oranges comparison. As we've said (preached) before, CEO Pay Ratios should not be a driving factor in executive compensation decision-making or philosophy, so we see no need to discuss such a comparison in the proxy.

9. Be consistent in your Year 2 analysis.

Remember that similar to Year 1, whatever steps you take in Year 2 should set the stage for your methodologies going forward. For example, if you determine that a 15% change in population or compensation does not warrant identification of a new median, you should stick to this methodology in Year 3.

10. Remember what you need to do even if you do nothing.

Best case scenario for all of us is the ability to use the same median employee from last year and not make waves. Of course, there will still be some legwork in that the SEC requires you to recalculate the annual total compensation from the Summary Compensation Table for 2018 for the CEO and median identified employee, and the new ratio between the two. It also requires you to affirmatively state that the company reasonably believes that there have been no changes that would significantly affect your pay ratio calculation and briefly state the reason for this belief. The SEC's guidance suggests that simply stating that there was no change in population or compensation arrangement would suffice as an adequate rationale.

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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