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MINI-ROUNDTABLE

CEO PAY RATIO DISCLOSURE

PANEL EXPERTS

Roger Bivans
Partner
Baker & McKenzie LLP
T: +1 (214) 978 3095
E: roger.bivans@bakermckenzie.com

Roger Bivans is a seasoned corporate and securities lawyer representing a number of public corporations and private equity fund sponsors in capital formation and strategic transactions, as well as with respect to securities regulation and corporate governance matters. He is a member of Baker & McKenzies' North America Private Equity Steering Committee, serving as chair of its cleantech industry subcommittee, and is also a member of the firm's Renewable Energy Industry Group. A frequent speaker on securities regulation, he is a former chair of the Securities Section of the Dallas Bar Association.

Arthur H. Kohn
Partner
Cleary Gottlieb Steen & Hamilton LLP
T: +1 (212) 225 2920
E: akohn@cgsh.com

Arthur H. Kohn is a partner based in the New York office of Cleary Gottlieb Steen & Hamilton LLP. Mr Kohn's practice focuses on compensation and benefit matters, including executive compensation, pension compliance and investment, employment law and related matters. Mr Kohn is distinguished by Chambers USA, The Legal 500 U.S., The Best Lawyers in America and Super Lawyers as one of the leading lawyers in the area of employee benefits and executive compensation and is recommended by PLC Which Lawyer? Yearbook. He was selected as Best Lawyers' 2014 New York Employee Benefits (ERISA) Lawyer of the Year.

Matt Ward
Managing Director
Board Advisory, LLC
T: +1 (415) 548 9000
E: matt@boardadv.com

Matt Ward is a managing director of Board Advisory, LLC. He is an attorney and CPA, and for 30 years has provided consulting services in strategic annual and long-term incentive plan design for employees of both publicly traded and private companies. Mr Ward serves clients in a variety of industries, ranging in size and complexity from small start-up enterprises to many Fortune 100 firms, with a special emphasis on growth companies. He has extensive experience with compensation planning issues resulting from private equity transactions, mergers, acquisitions, initial public offerings, leveraged buyouts, joint ventures and IP licensing.

Timothy F. Nelson
Counsel
Skadden, Arps, Slate, Meagher & Flom LLP
T +1 (617) 573 4817
E: timothy.nelson@skadden.com

Timothy F. Nelson advises public and private clients, including numerous Fortune 500 corporations, on executive compensation and benefits issues. He counsels corporations and individual executives in the negotiation and preparation of compensation arrangements, including employment agreements, option plans and termination agreements. Mr Nelson has represented both purchasers and sellers in a wide variety of corporate transactions, including mergers, asset sales, stock purchases and spin-offs. He has advised clients with respect to potential impact of 'golden parachute' termination agreements, permissible treatment of employee stock options and structure of retention and deal bonus arrangements.

RC: What are the key issues and arguments in the debate over CEO pay disclosure?

Bivans: The key issue is whether the CEO pay ratio disclosure provides useful information to investors in light of the significant costs and burdens of obtaining the data and calculating the total compensation of the 'median employee' using the methodology of Rule 402(c) of Regulation S-K, which is currently a manual exercise done only for the CEO, CFO and the three most highly compensated executive officers of the registrant. While some commentators have argued that an internal pay equity disclosure is necessary in light of ever escalating levels of CEO compensation caused by peer group comparisons, the SEC has recognised that variations in business profiles, geographies and employee base can lead to misleading comparisons. As a result, the SEC has attempted to provide a level of flexibility in implementing the regulation to ease the costs and burdens, even if the ratio may only be useful for year-over-year comparisons, if even that. The key issues can be summarised in four main categories: employees that must be included in the identification of the median; identifying the 'median employee'; determining 'total compensation'; and whether the disclosure may be 'furnished' rather than 'filed'. Most industry commentators have urged the SEC to define 'all employees' to mean all full-time employees in the US to mitigate the cost and burden of collecting the compensation information as well as enhancing the comparability of the information. The SEC declined to do so. Many industry commentators have urged the SEC to adopt a safe harbour for identifying the 'median employee' by a formula or algorithm. While the SEC has permitted registrants to use statistical sampling and other reasonable estimates for identifying the median employee, it declined to specify a safe harbour. Many industry commentators have urged the SEC to provide more discretion to determine the elements to be included in total consideration to account for variations in compensation practices in different geographies and industry groups as well as to permit the compensation of part-time, temporary and seasonal employees to be annualised to permit an apples-to-apples comparison. The SEC attempted to accommodate some of these concerns by allowing registrants to use reasonable estimates for elements of compensation, such as changes in pension values, but declined to permit the compensation of part-time, temporary and seasonal employees to be annualised. Finally, the SEC declined to permit the disclosure to be merely 'furnished'.

Ward: Probably the biggest challenge is defining who the median employee is and calculating their pay. The rule is deceptively simple at first glance, but implementation can be fraught with complexities

depending upon the company. Timing is crucial, and despite what looks like a long lead time, the wise firm would act sooner than later on this issue. Under the proposal, a company would be required to disclose the pay ratio with respect to compensation for its first fiscal year commencing on or after the effective date of the final rule. Companies would be permitted to omit this initial pay ratio disclosure from their filings until the filing of the annual report on Form 10-K for that fiscal year or, if later, the filing of a proxy statement following the end of that year, provided the proxy is filed in a timely manner – within 120 days after the end of the fiscal year. For example, if the final requirements were to become effective in 2014, a calendar-year company would be first required to include pay ratio information relating to compensation for fiscal year 2015 in its proxy statement for its 2016 annual shareholder meeting. Thankfully, the proposal would also provide a transition period for newly public companies. For these companies, initial compliance would be required with respect to compensation for the first fiscal year commencing on or after the date the company becomes subject to the reporting requirements. As a result, pay ratio disclosure *would not be required* in a registration statement on Form S-1 for an initial public offering or a registration statement on Form 10.

Kohn: US public company executive compensation practices have been the subject of vocal criticism by governance professionals, politicians, the media, unions and others for decades. There have been many attempts at regulatory fixes to mitigate the perceived problems. It is difficult to identify benefits to shareholders from most of the numerous efforts to influence compensation practices. This statement essentially proves itself – if efforts over the past decades had been successful, the continuing criticism over executive pay would be substantially muted. The key issue in the debate of the CEO pay ratio disclosure is that there is substantial reason to expect that this effort will have unintended consequences. The history of regulatory efforts in this area, together with the origin, logic and focus of this particular rule, indicate, reasonably clearly, that the compliance costs and risk of adverse unintended consequences outweigh the potential benefits.

Nelson: After the Dodd-Frank Act, which included the CEO pay ratio disclosure rules, was enacted in 2010, there was some hope among public companies and their advocates that implementation of the rule could be avoided, based on arguments that pointed out the expense expected to be involved in complying with the rule and the dubious benefit of the disclosure for investors. At this point, those hopes have largely dissipated and companies and their advisers are focused on the details regarding how the rule will be implemented, which

remain very much up in the air, pending issuance by the SEC of the final rule.

RC: In 2013, the SEC proposed new pay ratio rules, including rules governing the disclosure of CEO compensation. Could you provide a brief outline of these rules, and when companies can expect their implementation?

Ward: Under the proposed rule, practically all employees of the company must be included in identifying the median employee's annual total compensation. This includes all full-time, part-time, seasonal or temporary workers employed by the company or any of its subsidiaries as of the last day of the company's prior fiscal year. Despite concern over the compliance costs of including foreign employees in the determination, the proposed rule extends to non-US employees of the company and its subsidiaries. Workers not employed by the company or its subsidiaries, such as consultants or temporary workers employed by a third party, will not be required to be included in the determination. Again, most importantly, the proposed rule will only apply to those employees employed by the company on the last day of the company's prior fiscal year.

Kohn: Section 953(b) of the Dodd-Frank Wall Street Reform and Consumer Protection Act requires the SEC to amend its executive compensation disclosure rules to require disclosure of the ratio of the CEO's 'total compensation', as disclosed in the proxy statement, to the median amount of total compensation for employees of the issuer. Under the proposed rules, all employees of the issuer and its subsidiaries, including full time, part time, temporary, seasonal and non-US employees, employed on the last day of the issuer's fiscal year, are required to be taken into account. The proposed rules provide leeway for issuers to use reasonable approaches in identifying the median employee, including statistical sampling of employee populations and estimates and varied measures of pay. Disclosure would likely first be required for calendar year companies in 2016 proxy filings relating to 2015 compensation.

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Arthur H. Kohn,
Cleary Gottlieb Steen & Hamilton LLP

Nelson: In concept, the rule is very simple. Public companies in the US – other than smaller reporting companies, foreign private issuers and emerging growth companies – are required to include in their executive compensation disclosure: the median of the annual total compensation of all the company's employees, excluding that of the company's CEO; the annual total compensation of the company's CEO; and the ratio of those two amounts. In November of 2013, the SEC released proposed rules for implementing pay ratio disclosure and solicited comment on those rules. This comment period closed in December of 2013 and many practitioners expect the final rules to be adopted sometime in 2014.

Bivans: The ratio could be expressed as '1 to 250' or as 'the CEO's annual total compensation is 250 times that of the median of the annual total compensation of all employees'. The proposed rules define 'employee' as any individual employed by the registrant or any of its subsidiaries as of the last day of the registrant's last completed fiscal year. For full-time and part-time employees who only worked for a portion of the year, because they are new hires or were on a leave of absence, their compensation may be annualised as if they worked the entire fiscal year, but a part-time employee's compensation may not be adjusted as if the employee were a full-time equivalent. Similarly, the compensation of seasonal and temporary employees may not be annualised as if they worked the entire year. The registrant then must identify the median employee. The proposed rules take a flexible approach and permit the use of statistical sampling or other statistically reasonable method. The SEC did not provide a safe harbor, which leaves registrants forced to determine an appropriate methodology based on the distribution of compensation across business or geographical units.

RC: What factors are behind the introduction of these new rules? How have they been received by businesses and investors?

Kohn: Many have argued that the principal factor behind these new rules is an attempt to embarrass corporate executives and directors, by highlighting substantial income inequalities, in order to further broad societal policy goals relating to income and wealth distribution. A contrary view is that the information is valuable to investors because it will encourage a moderation of the level of CEO pay by highlighting the effect of pay disparities on employee morale and productivity. The predominant view among businesses seems to be that the legislation was politically motivated and received inadequate attention in Congress, and that the SEC did a reasonably good job with the regulations under the circumstances. Businesses have widely noted that the SEC seemed to struggle to identify a

benefit to the rules in the cost-benefit analysis that it applied to guide its regulatory thinking. Aside from union pension plans and a small number of others, investors seem to be largely indifferent to the rules.

Nelson: The disparity between CEO compensation and that of the typical employee has long been cited by unions and other activists as illustrating what they see as unreasonable levels of executive compensation. In the eyes of its advocates, the pay ratio disclosure rules will encourage more reasonable levels of executive compensation, which they claim will have a positive impact on employee morale and productivity. I think it is fair to say that the reaction of businesses to the rules has been generally quite negative, largely based on the anticipated difficulties in collecting and analysing the data required to comply with the rules, as well as the perception that the disclosure requirements are politically motivated and of little benefit to investors. Investor reaction has been mixed, with some investors expressing the view that the disclosures will motivate greater oversight of executive compensation by boards or will help moderate executive compensation by 'shaming' companies which have excessive ratios.

Bivans: The new rules were mandated by Section 953(b) of the Dodd-Frank Wall Street Reform and Consumer Protection Act. The SEC noted that "neither the statute nor related legislative history directly states the objectives or intended benefits of the provision or a specific market failure, if any, that is intended to be remedied". However, it recognised that commentators have emphasised that potential benefits could arise from adding pay ratio-type information to the total mix of executive compensation information when making voting decisions on 'say-on-pay' matters. The SEC did express concern that using ratios to compare compensation practices between registrants "could possibly lead to potentially misleading conclusions and to unintended consequences". The proposed rule has received over 215,000 comments, mostly in the nature of form letters from individuals. As one may expect, the reaction from public companies, accounting firms, compensation consulting firms and law firms has been negative, mostly around the area of having to include non-US employees, temporary, seasonal and part-time employees, due to the difficulty in achieving an 'apples-to-apples' comparison. A second area of comment has been for the SEC to clarify the methods of statistical sampling that would be acceptable. For example, the Society of Human Resource Management requested that the SEC adopt a safe harbour for estimating median employee compensation, such as through a formula or algorithm. The reaction from individuals, social activist investors and union pension funds has been predictably supportive, urging the SEC to make no changes to the proposed rule.

Ward: The rules, promulgated as required by the Dodd-Frank Legislation, took quite a while to come about. The SEC likely had hoped that the legislation would be repealed or amended. The pay ratio provision of the legislation came about from a longstanding criticism that CEO pay in the US was unreasonably high as a multiple of employees, especially when compared with other countries' practices. Critics used to cite Japan as an example of successful and powerful companies that managed to keep pay of the CEO at a much lower multiple of the typical worker. However, savvy observers pointed out that indirect CEO pay at Japanese companies such as numerous servants, private jets and mansions around the world was not measurable and quite considerable. Despite this, the criticism was a regular part of annual executive pay disclosure cycles ever since. After the financial collapse of 2008, the groundswell of support for anti-CEO pay legislation was unstoppable. It is safe to say that, like the SEC, businesses and investors had hoped that the legislation would be repealed or amended, but so far no such luck.

RC: What steps can firms take to prepare for the proposed rules? What guidance has the SEC provided?

Nelson: The SEC has published proposed pay ratio disclosure rules, which are not yet final. At the present time, the SEC is in the process of developing final rules, which may be a lengthy process, given that the proposed rules contained a large number of requests for comment from the SEC. However, even in the absence of final rules, companies can and should begin to think about how the data will be collected to determine employee pay. Companies with seasonal or part-time workers, employees in multiple jurisdictions paid in multiple currencies, multiple business units with potentially varying pay scales, or which otherwise have unique compensation arrangements, should begin to consider how they might address the complications in calculating employee pay resulting from those circumstances.

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> *Roger Bivans, Baker & McKenzie LLP*

Bivans: Registrants should begin polling their payroll vendors to determine the types of information that can be made available for analysis. Only after the registrant has a full understanding of the types of data that can be made available in accordance with applicable data privacy laws can the registrant begin to think about the methodology to be employed to identify the median employee. Registrants may consider overhauling their compensation programs to consolidate the number of payroll vendors and to implement a standardised compensation system across all business units and geographies. Registrants also should focus on the integration of acquisitions to ensure that payroll data can be provided in a timely manner and in a form consistent with the methodology to be selected. For registrants with a large number of employees or a complex payroll system across multiple jurisdictions, registrants may consider engaging a compensation consultant with expertise in statistical analysis to assist in devising a strategy to collect and analyse the relevant data.

Ward: We think that companies should not procrastinate on this issue and should at least run some initial calculations now to get ahead of the curve on choosing a methodology. While it is obvious for very large multinationals to address this, even a mid-sized firm with far flung operations needs to act in a timely manner. In fact, it is the small to mid-size firms that could be blindsided by waiting too long to address this calculation.

Kohn: Most importantly from an administrative perspective, businesses that utilise multiple payroll systems should begin to consider how they can merge the data from those different systems in order to identify the median level of pay of their employee population. The SEC has given businesses reasonable flexibility in defining 'pay' for this purpose. Such flexibility does not, however, solve the computing problem, which can be substantial for large global companies, arising from the need to merge the payroll data in order to determine median pay. From a policy perspective, businesses can

"Even a mid-sized firm with far flung operations needs to act in a timely manner."

Matt Ward,
Board Advisory, LLC

consider the extent to which 'pay equity' – perhaps at the management level rather than in regard to all employees of the business – can affect retention and motivation, and whether their pay programs are optimal from that perspective. Disclosure about those considerations may be useful.

RC: In determining pay ratios, companies must first determine the salary of the 'median employee'. What methods can firms use to determine this value? What sampling methods have been approved by the SEC?

Bivans: The SEC has not approved of any specific sampling method. It can be expected that what is considered to be a 'reasonable' method will be developed over time through the SEC' s review and comment process as it gains more experience and data after evaluating the initial wave of disclosures. Based on the examples cited by the SEC in its proposed rulemaking release, it can be expected that the SEC will be looking for a sampling method that produces a 95 percent confidence interval with a 0.5 percent margin of error. In preparing the SEC's economic analysis of the proposed rule, the SEC, using data from the Bureau of Labor Statistics, determined that the appropriate sample size to achieve the desired level of confidence and margin of error for registrants with a single business and geographical unit varied between 81 and 1065 across industries with the average estimated sample size close to 560. The SEC noted that for the approximately 50 percent of registrants with multiple business units, statistical sampling could involve multiple steps and assumptions. Any alternative approach would require drawing observations from each business or geographical unit from a unique distribution of compensation and statistically inferring the registrant's overall median based on the observations drawn.

Ward: The SEC permits public companies to select a methodology for identifying the median employee under the proposed rule. The proposed rule does not set forth a methodology that must be used to identify the median employee and permits companies the ability to select the method that works best for their own facts and circumstances. For example, the company could identify the median by calculating the total compensation per employee under existing executive compensation rules or through a statistical sampling of its employee population. To address commenter concerns about the compliance costs of calculating total compensation per employee under existing executive compensation rules, the SEC will also permit the usage of a 'consistently applied compensation measure' in identifying the median. For example, companies could identify a median employee by using more readily available methods such as total direct compensation – such as annual

salary, hourly wages or other performance-based pay – or cash compensation and then calculate that median employee's total compensation in accordance with executive compensation rules. Compensation for a permanent employee who did not work a full year – such as a new hire or an employee who took an unpaid leave of absence – would be permitted but not required to be annualised. However, the company would not be permitted to annualise compensation for temporary or seasonal workers. The company would be given the flexibility to measure compensation by choosing a method that best reflects the way it pays its employees, as long as that method is consistently applied.

Kohn: The proposed rules provide leeway for issuers to use reasonable approaches in identifying the median employee, including statistical sampling of employee populations and estimates of pay, rather than requiring the calculation of each employee's total compensation as defined for proxy reporting purposes. Issuers may use the proxy definition of 'total compensation' or any other compensation method consistently applied, such as amounts derived from payroll or tax records, to identify the median pay level. Compensation is permitted to be annualised in specified circumstances, but not for part time, seasonal or temporary employees. Cost-of-living adjustment for non-US employees is not permitted.

Nelson: The SEC has signalled in the proposed rules that there will be flexibility with respect to determining median employee compensation. No specific methodology is required by the proposed rule. Companies may identify the median using their full employee population, a statistical sampling or another reasonable method. Annual compensation may be calculated for each employee in the calculation, or the company may identify the median employee using any consistently applied compensation measure and then calculate that employee's annual total compensation in the same manner as such calculation is required to be made with respect to the company's executive officers. Companies should keep in mind that in any event the methodology will have to be reasonable, consistently applied and disclosed to shareholders. Also, because no specific methodology is prescribed, investors comparing pay ratios of different companies may not be making an 'apples to apples' comparison, a fact that may be important in managing the public relations aspects of the new disclosure.

RC: What impact do you believe the new rules will have on business practices, particularly in terms of structuring compensation packages? Do you expect the rules to significantly impact levels of executive pay?

Ward: We don't believe the rules will have any meaningful impact whatsoever on pay levels for CEOs or median workers. The flexibility for companies in choosing methodologies and determining the median employee's pay essentially renders peer-to-peer comparisons useless, even in industries with very close comparability of firms, such as oil companies, airlines, and so on. When coupled with the cost to comply, hopefully there will eventually be support for repealing the legislation. We have had clients estimate they will need to add full-time equivalent employees just to gather this data.

Kohn: I do not expect these rules to significantly impact levels of executive pay. I am concerned that they will lead to increased litigation based on claims of either misleading disclosure or incorrect calculations. I believe that there is a small but significant risk that over time these rules will encourage businesses to take steps to improve the optics of their ratios that will have adverse consequences for employment practices. Longstanding and generally applicable fiduciary standards of substantive and procedural conduct under state corporate law have proven adequate to legally protect the interests of shareholders from the agency problems inherent in corporate governance for US public companies in a wide variety of contexts. I believe that these principles are also largely adequate to ensure as a matter of law that public companies adopt appropriate governance practices in respect of executive compensation. I believe that simple disclosure requirements in respect of material information contribute to assuring that shareholders can monitor and effectively protect their interests.

Nelson: The pay ratio rules will have an immediate public relations impact, for which companies should be prepared. A company with a high CEO to worker pay ratio will face criticism, especially if the company's performance has lagged in relation to the market or its peers. As to whether this rule will significantly impact levels of executive pay, it is hard to say at this point. The new world of executive compensation, with say on pay

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and increased shareholder activism, has already provided powerful incentives for companies to tie compensation to company performance and I suspect that correlation will continue to be the focus of investors, even after implementation of pay ratio disclosure.

Bivans: The new rules are not expected to have a material impact on structuring compensation packages, and the SEC acknowledged as much in its economic analysis. The rules could, however, provide sufficient motivation for registrants to consolidate their payroll vendors to seek to obtain consistent data reports and export capabilities and perhaps to standardise their compensation practices across business and geographical units to the maximum extent possible. In addition, registrants may seek to rapidly integrate new acquisitions to quickly achieve a common payroll and compensation system for recently acquired companies.

RC: What final advice can you offer to companies on the proactive steps required to address the issue of CEO pay ratio disclosure in today's business world?

Kohn: Generally, companies should develop an approach to and process for CEO pay decisions that engenders a level of trust and responsibility between the CEO and the compensation committee that pay levels will be appropriate in light of performance over the long term. Carefully consider steps to avoid being an outlier, even steps that neither the compensation committee nor management might consider to be ideal from a compensation perspective at a given moment in time. Ensure that the compensation committee adopts practices that require members to be informed and deliberative about pay decisions. Reach out to appropriate constituencies, including particularly large shareholders, to ensure that they understand the compensation committee's priorities and strategies. Spend the time and effort to ensure that disclosure is carefully tailored to minimise litigation risks.

Nelson: Companies should begin to estimate what their pay ratio disclosure will look like, and try to develop a sense of how it will look in comparison to the company's peer group. The pay ratio disclosure will be one more ingredient in the overall mix of compensation disclosure and companies should be prepared to address it in the context of explaining the philosophy and thought process used in the development of their overall executive compensation program. One area which companies may want to focus on is addressing the level of employee compensation. A company that is comfortable with its CEO compensation program may also want to make the case that its employee compensation program is also appropriate. This could involve consideration of employee attrition

levels and overall compensation expense as compared to its peer group. Putting the company's employee compensation program in context may help the company more effectively make the case that compensation levels are appropriate at all levels of the organisation.

Bivans: It can never be too soon for registrants to begin a top-down review of existing compensation and payroll practices to determine the best, most cost-effective, method of identifying the median employee. Armed with this data, registrants may take a proactive approach to reducing the complexity of their existing compensation and payroll systems to permit a more meaningful approach to determining internal pay equity.

Ward: The SEC has provided great flexibility in applying the proposed new rules in each specific company. However, there are still going to be data collection issues and meaningful choices to be made in carrying out the calculations and choosing a methodology. We recommend that companies exercise the due diligence up front to form a task force of accounting and compensation professionals from both inside and outside the company to make the most well-informed choices. Thereafter, the annual calculation will be much easier and subject to change only to comply with rule changes or industry trends in making the calculation. R&C

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KEY CONTACT

Matt Ward
Managing Director
San Francisco, CA, US
T: +1 (415) 548 9000
E: matt@boardadv.com