ALERT

January 3, 2019

# CEO PAY RATIO: YEAR 2 PLANNING

The CEO pay ratio disclosure, part of the Dodd-Frank Wall Street Reform and Consumer Protection Act, requires U.S. public companies (excluding newly public companies, emerging growth companies and smaller reporting companies) to disclose the ratio of its CEO pay to that of the median employee. The disclosure became effective in 2018 and most companies have now calculated and disclosed their first CEO pay ratio, generally eliciting relatively muted internal and external reaction. The upcoming second year of pay ratio disclosure provides the challenge of deciding whether the same median employee used in Year 1 can be (or should be) used in Year 2 and assessing the implications of potential year-over-year changes in the ratio.

## Year 1 CEO Pay Ratio Recap

Year 1 CEO pay ratio disclosures revealed a wide degree of variability in both results and methodology. The Appendix to this letter presents a summary of key Year 1 pay ratio findings among the “Top 250” companies in the S&P 500.

## Preliminary Year 2 Decisions

While there is no restriction on identifying a new median employee each year, the SEC rules permit the 2017 median employee (“M2017”) to be used for up to two additional years (three total years). However, in order to use M2017 in Year 2, the company must reasonably believe that there have been no changes to the company’s employee population or compensation arrangements that would result in a “significant change” to the pay ratio disclosure.

Accordingly, there are two threshold Year 2 questions that must be addressed:

- First, what magnitude of Year 2 changes in a company’s employee population or compensation arrangements qualifies as *significant*?
- And, second, even if a company can use M2017 in Year 2, *should it*?

### *Quantifying “Significance” in Assessing Year-over-Year Change*

While there may be other ways of measuring a “significant change,” one would think the most logical approach would be to estimate how much the Year 2 pay ratio would differ if, instead of using M2017, the company uses the “true” median employee for 2018 (“M2018”). This process is necessarily an estimate—the employer is not required to identify a median employee for 2018 (having to actually determine M2018 adds back all the complexity that the SEC special rule was intended to avoid), but to assess whether the magnitude of changes to M2017's compensation or the organization significantly impact the Year 2 pay ratio. Estimating the pay ratio differential between M2017 and M2018 is thus necessarily imprecise.

For example, suppose CEO pay for 2018 is $10 million and M2017's pay in 2018 is $50,000, i.e., a ratio of 200:1. We think a logical approach to determining if there is a significant year-over-year change is to evaluate whether the company reasonably believes that, if it actually determined who M2018 was and computed his or her pay, the ratio would change by a significant percentage. So, for example, if the company considers 10% as being a significant percentage, then it should not use M2017 in Year 2 if it is reasonably likely that the pay of M2018 would result in a ratio of less than 180:1 (equivalent to pay of $55,556) or more than 220:1 (equivalent to pay of $45,456).

We are unaware of any SEC communications with respect to what level of increase/decrease constitutes a significant percentage. It is our understanding that the SEC intended that the exception that permits use of M2017 be widely available and that the SEC recognizes that the exception would not be of much value if a substantial amount of effort were required to determine if the exception applied. While a 10% benchmark appears to be a reasonable test, some practitioners take the view that, at least under some circumstances, percentage levels significantly higher than 10% may be considered acceptable.

### *Should the Company Use the Same Median Employee Again (assuming it can)?*

To avoid the time and effort of re-identifying a new median employee in Year 2, many companies will likely choose to use M2017. However, because M2017's *2018* pay will need to be disclosed, re-using M2017 as the Year 2 median employee would make it easier for employees to compare 2018 pay actions. For example, suppose M2017's pay increased by 5% in 2018. This may lead to unwanted comparisons of each person's individual pay increase to M2017 ("why did I get less in 2018 than this person?"). This issue may be particularly sensitive for companies that have a unionized workforce and/or are in the process negotiating collectively-bargained agreements. For this reason alone, a company may decide that even if they could use M2017 in 2018, there are less internal HR issues if a new median employee is selected in Year 2.

## Additional Considerations

### *Assuming a Company Wishes to Use M2017 in 2018, What Must it Validate?*

There is no SEC guidance or practitioner consensus on the analysis a company must undertake to determine if it can use M2017 in 2018. Our discussions with practitioners and employers have suggested that, at least pending additional SEC guidance, the general approach appears to be to conclude that M2017 can be used if (1) M2017's pay is not significantly different in 2018 than in 2017 and (2) the company's overall employee structure and composition was not significantly different in 2018 than in 2017. Of course, the words "significantly different" are inherently vague, but some of the factors that we have seen considered are the following:

- *Has M2017's pay gone up or down by an amount significantly more than the general level of pay increases?* If so, this would suggest the need to determine a new median employee.

- Note that there are two alternative approaches in this case—re-run the test for 2018 or, as permitted by the regulations, choose a new median employee from 2017 whose compensation is “substantially similar” to M2017 (presumably this is a reference to 2017 compensation).

- *Have there been significant acquisitions or divestitures?* If the answer is yes, this suggests the need for a new median employee unless the characteristics of the added or removed employees were similar to those of the remaining employees. Note, however, that the regulations provide that an employer may elect to exclude employees that become its employees as a result of a business combination or acquisition in the year of the transaction, provided that, the pay ratio disclosure identifies the acquired business that is being excluded and the number of excluded employees.
- *Has the employee population significantly changed in a way that might affect the pay distribution?* It is easier to state this concept than to apply it, but the general idea is to look at the number of employees in different job categories to see whether there are significant changes in the relative percentages, for example, sales vs. manufacturing vs. technology vs. administrative. Another approach might be to look at salary grades. For example, if M2017 was in salary grade 10 in both 2017 and 2018, and 2018 staffing activities added/removed a comparable number of employees below and above grade 10, then a company may reasonably conclude that population changes alone are not material enough to have altered the likely location of the median employee.
- *Has one class of employees had compensation increases significantly different than other classes?* Companies generally strive to have relatively similar compensation increases (as a percentage of pay) across different job categories. This inquiry might become relevant, if, for example, a tight job market required a significant group of employees to receive pay adjustments higher than the general company level of pay adjustment.
- *De Minimis Exclusion.* To the extent employees from a particular foreign country were excluded in Year 1 because the country’s employees were excludible under the 5% de minimis test (allowing employers to exclude employees from a country where that country’s employees represent less than 5% of total employees), are the Year 1 country exclusions still applicable for Year 2?

In assessing how much time and expense should be incurred in answering these questions, it is interesting to note that only minimal disclosure is required if the employer decides to continue using M2017. The regulations state that “if there have been no changes that the registrant reasonably believes would significantly affect its pay ratio disclosure, the registrant shall disclose that it is using the same median employee in its pay ratio disclosure and describe briefly the basis for its reasonable belief. For example, the registrant could disclose that there has been no change in its employee population or employee compensation arrangements that it believes would significantly affect the pay ratio disclosure.” We anticipate seeing many proxy statements next year parroting this safe harbor disclosure.

### *How to Handle Multiple Year 2 CEOs (if applicable)?*

If multiple CEOs served in 2018, companies are faced with the same choice as in 2017: combine pay for all CEOs (for the time each served as CEO) or annualize pay for the CEO in place on the median employee identification date.

- Combining pay for all CEOs may overstate the typical CEO pay "run-rate" for the company, given the potential to include severance and new-hire payments.
- Annualizing pay may produce a number more reflective of go-forward CEO pay. Note, however, that annualizing CEO pay can have complexity around the treatment of items such as perquisites and equity awards and the SEC has not provided specific guidance on how to annualize discrete elements of CEO pay.

### *Any Investor Issues to be Proactively Addressed?*

Companies who received specific feedback from stakeholders on their 2017 CEO pay ratio disclosure may address this in the 2018 disclosure; however, we expect companies to remain concise in their pay ratio disclosures and refrain from broader commentary on their pay programs.

Recently, several companies received a form letter from a large investor consortium requesting additional supplemental disclosure related to CEO pay ratio. The letter does not require a response. The largest institutional investors (Blackrock, Fidelity, Vanguard, State Street, etc.) were not part of the consortium and we are unaware of any evidence that they are seeking additional disclosure requested in the letter.

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General questions about this summary can be addressed to the following individuals:
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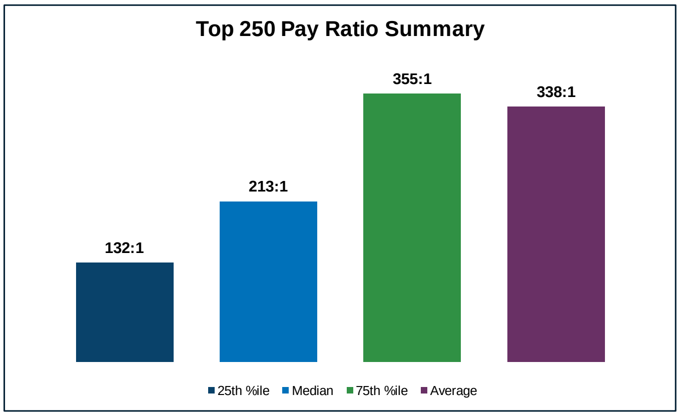
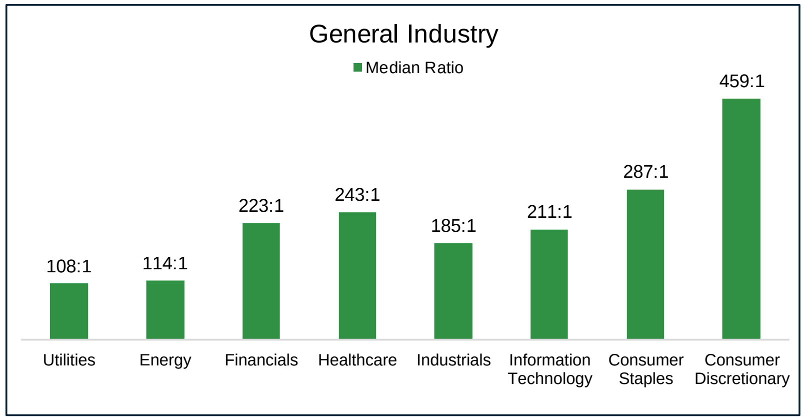
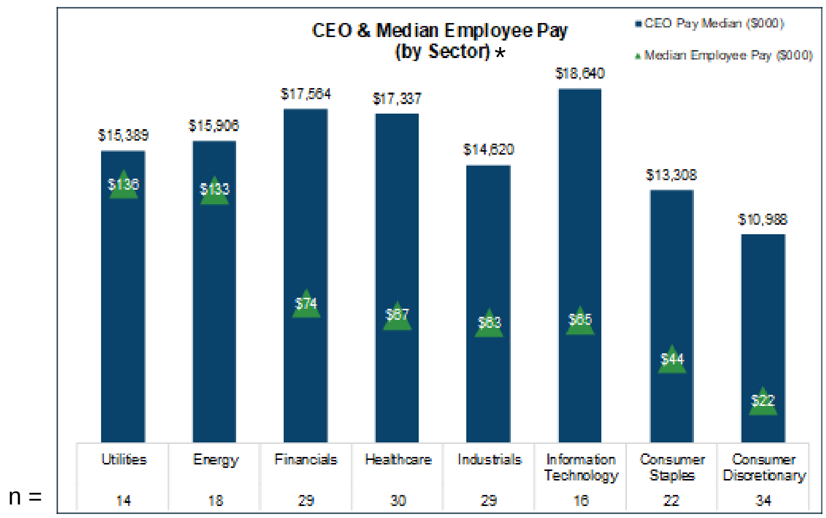
Copies of this summary and other published materials are available on our website at www.fwcook.com.

## **Appendix: Year 1 CEO Pay Ratio Summary Observations** (Top 250 Companies in S&P 500 n=215)




*Sectors with less than 10 data points are excluded

| Use of 5% De Minimis Exemption | Value of Healthcare Benefit Included in Ratio |
|---|---|
| 49% | 21% |

| Provided Alternative Ratio | Pay Ratio Disclosure Located After Termination Tables |
|---|---|
| 10% | 78% |

| Consistently Applied Compensation Measure "CACM" [1] | Prevalence |
|---|---|
| Total Cash | 30% |
| W-2 | 24% |
| Salary | 19% |
| Total Pay | 19% |
| Other | 8% |

[1]CACM: method used to identify median employee within a company's employee base