CEO PAY RATIO – WINTER IS COMING

By Ian Keas, Todd Henke and Chris Crawford

"Winter is coming" – a household phrase for those familiar with the Game of Thrones television series and book adaptation. Applied in the context of corporate issuers – CEO Pay Ratio is coming! Are you prepared? Are you familiar with how to run the calculation? Do you know where you plan to include in the proxy in 2018? With ratio-related chatter in the marketplace beginning to crescendo, we have put together some observations and recommendations to consider as we move toward to the pay ratio deadline.

WHAT IS THE CEO PAY RATIO?

As a component of the Dodd-Frank financial reform law, most public companies will be required to report a ratio of pay from the CEO to median employee in their proxy statements and any other filings that require an executive compensation disclosure under Item 402 of Regulation S-K. Companies not subject to the rule include foreign private issuers, multijurisdictional disclosure system filers, emerging growth companies and smaller reporting companies.

WHAT'S THE LATEST ON THE RULE?

In the time since the rule was finalized, we have seen (i) thousands of comment letters, both in support and opposition of the rule, from businesses and market experts on executive compensation and corporate governance delivered to the SEC, (ii) comments from business groups challenging the necessity of the rule and its actual impact, (iii) commitments by politicians along partisan lines to dismantle the law, (iv) a Trump administration move in to the White House, (v) the Financial CHOICE Act (H.R. 10) proposed in, and passed by, the House, and (vi) a directive by acting chair of the SEC Michael Piwowar to reconsider the pay ratio rule's implementation. While one might view these events as indications that a repeal, delay or limitation of the rule was on the way, the political world has numerous irons in the fire (healthcare reform, tax reform, election-related investigations, etc.) that continue to monopolize the attention of both elected officials and media, in effect impeding any further actions on the pay ratio rule.

Further, we have followed a couple of different storylines that may provide a glimpse into the future of the potential for delaying previously adopted rules.

- The Department of Labor's controversial fiduciary duty rule, while subjected to a review of the rule per a Trump executive order, went into partial effect on June 9, 2017. As it stands today, the rule will be fully implemented on January 1, 2018.
- During the Obama administration the EPA issued new emission standards and compliance rules that originally called for monitoring programs to be implemented June 3, 2017 and rules to go into effect August 2, 2017. Following the transition to the Trump administration, the EPA stayed the June 3rd deadline for 90 days as it sought to reconsider the rules, and then in June of this year proposed a two-year stay of the standards. But like a Wimbledon rally, the U.S. Court of Appeals in D.C. knocked the effectiveness of the rule back across the net by striking down the 90 day stay.
- Efforts to implement an additional tax on issuers that exceed certain ratio thresholds (see Massachusetts, Minnesota, Portland, and Rhode Island legislation).

So what does this mean for the fate of the pay ratio rule? While the instances above involve different regulatory bodies, the main takeaway we have in each scenario is the difficulty the new political environment has in delaying the implementation of a previously adopted rule.

INITIAL CALCULATION CONSIDERATIONS

Given the latest status on the pay ratio rule, companies that are subject to the rule should be currently conducting (or already completed) their due diligence on the different ways to calculate the ratio ahead of the opening of the period within which they can run the median employee identification (October 1). While L&A is available to assist clients in working through the various methods to determine the best approach, we wanted to provide some initial considerations to refer to in the event the internal discussions have not yet taken place.

- As noted above, the employee population selected for the calculation can be determined at any time in a company's last fiscal quarter.
- Once identified, the same median employee can be utilized in the calculation for three years. Companies do not need to conduct an additional analysis in the interim absent significant changes to the employee population or compensation involved in the calculation that would significantly impact the ratio.
- Certain companies are not subject to the rule: Smaller Reporting Companies, Emerging Growth Companies, New IPO Companies.
- Certain employees are excluded: leased workers, independent contractors - employees of subsidiaries that are not "consolidated subsidiaries," and international employees (all that are employed in jurisdictions with data privacy laws and/or employees that make up a maximum of 5% of the total employee population.
- Various approaches to identifying the median employee are acceptable, utilizing populations that may include all employees, a statistical sampling of employees, a consistently applied compensation measure, or reasonable estimates in calculating compensation measures.
- The ratio is a comparison of total direct compensation, utilizing the same methodology as is used for the Summary Compensation Table.
- Cost of Living Adjustments are permissible.

EARLY TRENDS

In reviewing a number of early adopters of disclosures, we noted some trends in both the ratios and how they are disclosed:

- Ratios disclosed range from 6:1 to almost 80:1, initially indicating ratios much lower than some talking heads predicted early on.
- Ratios are being disclosed both within and outside of the CD&A. Some companies are including the disclosure in the narrative to the Summary Compensation Table, while a minority of companies summarized the ratio in the proxy summary.
- While supplemental disclosures are permitted, few early adopters have taken such steps. This trend may shift as more companies disclose and market benchmarks potentially develop.

HOW WE CAN HELP

While we do not anticipate the disclosure of ratios to provide benefit to investors or good governance process in the future, we do acknowledge there is substantial cost that companies are projecting to take on in order to gain compliance. Aggregate initial costs are estimated to be nearly $1.3 billion, with additional ongoing annual costs of $526 million. The cost-benefit relationship there does not seem to make sense!

To help save time and dollars, consider reaching out to L&A's CEO Pay Ratio specialists, Messrs. Todd Henke and Ian Keas, to assist in the development of the ratios and how to disclose within the proxy.

In the event you have not initiated the CEO Pay Ratio discussion internally, or would like independent third-party observations and recommendations, Longnecker & Associates is here to help. L&A's internal experts have evaluated the rule, understand the various alternatives available, and keep abreast of market updates to help save our clients time and money. Please contact us at info@longnecker.com or touch base with your lead consultant to inquire further.

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