CAPflash
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# SEC Proposes CEO Pay Ratio Rules: Initial Thoughts

■ By **Rachael Holland** and **Eric Hosken**

## INTRODUCTION

On September 18th, the SEC released a proposed rule to implement Section 953(b) of the Dodd-Frank Act specifying that companies must disclose the ratio of the median employee's compensation to the CEO's compensation ("CEO pay ratio"). As anticipated, there has been much discussion, and even controversy, around the forthcoming compliance with this regulation. Key concerns have been the methodology for calculating the pay ratio, including what forms of compensation and types of employees to include in this calculation. This CAPFlash explains the proposed requirements and raises some concerns and considerations related to the new rules.

The SEC's proposed rule requires companies to disclose in their registration statements, proxy statements and other annual reports where compensation is mentioned, the following three items: 1.) The annual total compensation of its median employee, 2.) The annual total compensation of the CEO, and 3.) The ratio of the two amounts above. While this calculation seems like straightforward arithmetic, it may prove to be difficult for many companies, especially those whose operations are complex and global.

1. *Employees Included.* As a first step in the process of identifying the median employee, companies must incorporate *all* employees including full-time, part-time, temporary, non-US employees, and employees of a subsidiary, all of which have been employed on the last day of the fiscal year.

   ***CAP Comments:*** *While some commentators hoped that the rule would apply to only U.S. employees or only full-time employees, the proposed rule includes the total employee population. This will make the determination of the median employee more complicated for global employers. In addition, it may create challenges for investors in interpreting the ratio or comparing across companies, as the ratio will vary based on the number of workers employed in low wage countries or the number of part-time or temporary workers employed.*

2. *Identifying the Median Employee:* The proposed rule does not specify methodologies for identifying the median employee, aside from the requirement that all employees be considered. Instead, the proposed rule allows companies to choose a methodology for identifying the median employee in a way that is logical and appropriate for the company's size and structure. Companies can, depending on their complexity, use the median employee of the full-employee population, or rely on statistical sampling to estimate what the median employee earns.

   ***CAP Comments:*** *It is a positive sign that the SEC recognizes the complexity of determining the median employee. Unfortunately, compensation professionals will have to dedicate time and resources to understanding the potential approaches available to them and will likely have to pay external experts to conduct the analysis, particularly if they rely on statistical sampling.*

3. *Determining Compensation of the Median Employee.* One of the greatest challenges in calculating the CEO pay ratio was identifying pay for employees in a consistent manner in order to calculate median pay. The proposed rule has provided wide latitude to companies in using alternative definitions of pay for purposes of estimating the median paid

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employee (e.g., total direct compensation, total cash compensation, W-2 compensation). However, the SEC is more stringent about annualizing pay. While companies may annualize compensation for workers hired mid-year, they would not be permitted to make full-time equivalent adjustments for part-time workers.

***CAP Comments:*** *The latitude provided should simplify calculating pay in a way that facilitates identifying the median employee. The downside of the proposal is that differences in approach may make comparisons of the ratio across companies less meaningful. The limitations on annualizing compensation will result in less favorable CEO pay ratios for companies employing temporary or part-time workers.*

4. *Calculating the Ratio.* Once the median employee is identified, compensation for that employee has to be determined. The Dodd-Frank Act requires that employee total compensation would be calculated using the same methodology as required for named executive officers, a requirement that is not currently applied to non-executive employees. A key advantage of the proposed rule is that this more complicated pay calculation only needs to be done for the employee identified as "the median employee".

   ***CAP Comments:*** *This calculation should be relatively straightforward as the greatest complexity is in identifying the median employee.*

Additional aspects to this regulation would require companies to disclose methodologies, estimates and assumptions used in the calculation. As provided by the JOBS Act, the proposed rule would not apply to emerging growth companies, nor would it apply to smaller reporting companies or foreign private issuers.

## IMPLEMENTATION TIME-FRAME

Following this proposal, there will be a 60 day public comment period. Companies would be required to report the pay ratio with respect to compensation for its first fiscal year beginning after the effective date. Depending on the effective date of the final rule (2013 vs. 2014), fiscal year companies will first have to report the ratio in their 2015 or 2016 proxy statement, covering pay for the 2014 or 2015 fiscal year.

## OVERALL COMMENTS

The intent of this legislation is to raise awareness around the disparity between pay levels for top executives and the typical worker. However, from our perspective the primary outcome of the rule is an additional burden on companies to comply with this law. Companies will need to spend time and resources collecting and compiling compensation records and will likely require the assistance of technical and legal advisors to establish and implement the approach to identify the median employee. In the cost-benefit analysis section of the proposal, the SEC struggled to identify any quantifiable benefits of the rule, while the costs of compliance are fairly obvious.

The CEO pay ratio will be challenging to interpret. The ratio may vary across companies due to corporate structure and business decisions, rather than the pay philosophy of the company. For example, companies in industries that depend on part-time and seasonal workers will have a pay ratio that looks less egalitarian than a company with only a full-time workforce, regardless of whether each company pays a competitive and market-based wage to each class of employees. Moreover, for companies with concentrations of employees in one or more developing countries, this ratio will exaggerate the difference between executive and employee pay, not to mention the additional administrative responsibilities necessary to convert workers' wages abroad to US dollars. In contrast, a company that has outsourced all of its low paid administrative functions to India or China, may have a better CEO pay ratio than a company that completes these tasks in-house. While we expect that most investors will ignore the CEO pay ratio, there will likely be reporting of the ratio in the press. Companies should also monitor whether ISS and Glass-Lewis take interest in the pay ratio. While our sense is that the CEO pay ratio is not a primary concern of institutional investors, the shareholder advisory firms are active in finding new areas of executive pay to target for criticism.

## CONCLUSION

Starting now, the SEC will review comments received within the 60 day window, and comments are already being submitted. While it is unknown how such comments will be received and/or incorporated by the SEC, it is important to be thinking ahead to future disclosure and the necessary changes corporate human resources professionals will need to make to comply with the new rule.