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THE NEW PAY RATIO DISCLOSURE

The SEC has emphasized that the pay ratio disclosure rule was not designed to facilitate comparisons across companies. The author picks up this theme and identifies five key variables that make each company's pay ratio disclosure unique. She closes with disclosure strategies to address the potential that, despite these variables, readers will use pay ratios to compare compensation practices across companies.

By Maia Gez *

With the 2018 calendar year fast approaching, it is time to focus on one of the hottest topics for the upcoming proxy season: pay ratio. A little background first: the pay ratio rule, adopted by the SEC in August 2015 to implement Section 953(b) of the Dodd-Frank Act, generally requires public companies subject to the rule to disclose the median employee's annual total compensation, the CEO's annual total compensation, and the ratio of these two amounts.

This first-of-its kind pay equity disclosure required by SEC rules will be in the spotlight and a top focus of the 2018 proxy season for public companies – as well as for others interested in the new disclosure, such as employees, labor unions, the media, investors, and proxy advisory firms. Despite previous discussions of a possible delay, the SEC, on September 21, 2017, released interpretive guidance on the pay ratio rule and stated that the rule will require compliance by public companies as scheduled in their 2018 proxy statements.

As we approach the opening act for this new pay ratio disclosure, there are growing questions as to the implications of this new disclosure, and more specifically, how various stakeholders will use and interpret it. In essence, since the CEO's pay is already disclosed by public companies in their proxy statements, there are two new data points being introduced: (1) the median employee's annual total compensation and (2) the pay ratio itself. In its recent interpretive guidance, the SEC emphasized that each company's disclosure will be unique, and the adopting release stated that the pay ratio rule "should be designed to allow shareholders to better understand and assess a particular registrant's compensation practices and pay ratio disclosures rather than to facilitate a comparison of this information from one registrant to another."

Despite the uniqueness of the pay ratio disclosure for each public company, it is attractive for readers of this new disclosure to take the easy route and begin comparing one company's ratio to another, particularly within the same industry. In fact, a survey by the largest proxy advisory firm, ISS, found that nearly 75 percent of the investor respondents indicated that they intend to compare the ratios across companies and industry sectors, and/or assess year-on-year changes in the ratio at an individual company.

Before proceeding to compare ratios across companies, it is important to consider the inherent problems with this approach. Calculating the pay ratio

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requires a number of strategic decisions by a company that significantly affect the resulting pay ratio number. Although it may be tempting to compare one company's pay ratio number to another, this means that there are a number of key variables that will make a comparison between companies' disclosures virtually impossible and ultimately, not very useful. The remaining sections of this article will describe these key variables and discuss helpful strategies for companies to consider as they approach their pay ratio disclosures.

I. KEY VARIABLES THAT MAKE EACH COMPANY'S PAY RATIO DISCLOSURE UNIQUE

(1) The employee population of each company will inevitably vary, resulting in different median employee compensation levels.

The application of the pay ratio rule's definition of "employee" results in a very unique employee population for each company. Each company must identify its own "employees," which are defined under the pay ratio rule as all individuals employed by a company and its consolidated subsidiaries (whether on a full-time, part-time, seasonal, or temporary basis) on a date that the company chooses within the last three months of its fiscal year. Any workers hired after (or who left prior to) this chosen date are not considered "employees" under the rule. Practically, this means that a retail company that hires a large number of seasonal workers on November 10th will *not* include these workers in its pay ratio calculation if it chooses October 1st as its employee population date. However, if this same company opts to use December 31 as its employee determination date, it would include such workers if they are still employed at the end of the year. Although the pay ratio rule requires each company to disclose the date for the determination of its employee population, it will be difficult for readers to grasp the intricacies of a company's hiring practices and the reasons why it chooses one date for its employee population over another. In some cases, a company may conclude that choosing a date that excludes a large number of temporary workers is appropriate because such workers are not representative of its workforce as a whole. This decision could ultimately increase the median employee's compensation and lower the company's pay ratio. In other cases, a company may be focused on the reaction of its employees to a median compensation level that could be higher than expected and instead decide that including more temporary workers is appropriate for lowering its median pay. In many other cases, the date chosen may have nothing to do with the desire to exclude or include more temporary workers – for example, a company may want to choose an earlier date in order to allow more time to calculate its pay ratio.

Furthermore, one of the key differences in employment practices between companies is the varying use of independent contractors. Under the SEC's recent September guidance, a company may now "apply a widely recognized test under another area of law that [it] otherwise uses to determine whether its workers are employees." In other words, a company may now exclude any workers that it considers to be independent contractors under IRS rules or another widely recognized test that it already uses to categorize such workers. In the same vein, the recent SEC guidance confirms that companies can rely on existing internal records to determine their employee populations. In other words, if a company has employment or payroll records that identify its employees, it may use and rely on those records to identify its employees for purposes of the pay ratio rule. In essence, the SEC is focusing on what already exists and what is already used by companies for them to be able to easily identify their employee populations.

The recent September guidance on independent contractors was a noteworthy change in direction for the SEC, with the result being that the new guidance permits companies to defer to their existing treatment of independent contractors and avoid the need to break new legal ground in identifying their employee populations for the new pay ratio disclosure. In practice, this also means that a company with a large independent contractor population may end up with a much smaller (and potentially higher paid) employee population than a company that has fewer independent contractors and that instead opts to hire temporary or seasonal employees. It also means that there is no longer one standard determination process under the pay ratio rule to evaluate whether independent contractors should be excluded – for example, some companies may rely on

IRS standards, while others may rely on employment law or other legal standards in foreign countries. There may also be additional companies that still decide to rely on the determination process included in the pay ratio rule itself, which companies were required to use before the September guidance. Under this process, a company would include independent contractors whose pay the company determines but exclude those independent contractors whose pay is determined by an unaffiliated third party.

(2) There is **not** *one way to calculate the pay ratio: each company may determine its own methodology and can opt to use exemptions, adjustments, and assumptions that another company may decide* **not** *to use.*

In addition to differences in employee populations, one company's ratio may greatly differ from another company's ratio solely because of the exemptions that it decides to use in order to exclude employees from its employee population. For example, for purposes of the pay ratio rule, a company may omit any employees that became its employees as the result of the acquisition of a business for the fiscal year in which the transaction became effective. This means that a company that acquired businesses in 2017 may exclude the employees that became its employees in 2017 as a result of these acquisitions from its pay ratio calculations for the 2018 proxy statement. The goal of this "acquisition" transition period under the pay ratio rule was to allow a particular company sufficient time to incorporate the payroll, compensation, and recordkeeping structures for the employees of the newly acquired entity. The effect, however, is that a company that engages in one or more large or numerous acquisitions in 2017 may opt to exclude a significant number of employees that another company may opt to include.

Another exemption that is likely to be commonly used and result in differences for each company's resulting ratio is the *de minimis* exemption. Under this exemption, a company can opt to exclude non-U.S. employees who constitute up to five percent of its total workforce, as long as it excludes all non-U.S. employees from a particular jurisdiction. A company that uses this exemption may lower its ratio (and increase its median employee compensation) by opting to exclude employees from lower paid jurisdictions. On the other hand, if a company is focused on the reaction of its employees to a median compensation level that could be higher than expected, it may instead use the *de minimis* exemption to exclude non-U.S. employees from higher paid jurisdictions and thereby lower its median employee compensation (and increase its ratio). Yet a third company may decide *not* to use the *de minimis* exemption at all, or may *not* be able to use this exemption because over 5 percent of its workforce is in the same foreign jurisdiction. Therefore, each company's strategy may differ and affect the comparability of pay ratios across companies.

(3) Each company has the flexibility to choose a suitable compensation measure fitting its own compensation practices for identifying its median employee.

In order to identify the median employee from among its employees, a company may use annual total compensation (calculated in accordance with Item 402(c)(2)(x) of Regulation S-K) or a consistently applied compensation measure selected by the company. The choice of measure to identify the median provides companies with flexibility and permits the use of a readily available measure based on a company's existing internal records. It also means that one company's process for identifying its median (for example, by relying on base salary alone) will differ greatly from another company's process (for example, by relying on total gross compensation). The interpretive guidance of the SEC does set some limits on this flexibility – namely, the guidance states that the measure should still reasonably reflect employees' annual compensation and that it should provide a reasonable alternative to annual total compensation. Despite this limitation and the requirement to disclose the measure used in the proxy statement, it will be difficult to gauge the effect of different tactics. One company may choose a measure that is closer to annual total compensation than another company – and yet a third company may opt to use annual total compensation instead. Depending on this choice of compensation measure, the median compensation level could shift up or down, thereby significantly affecting the resulting pay ratio. Readers of the new pay ratio disclosure will have no way to measure how the median would have been different if companies in a particular industry had instead used the same compensation measure to identify their median employees.

Because of this flexibility to choose a compensation measure, there will not be one meaning for the term "median employee" between companies. It also means that, despite the language in the rule stating that all companies must provide the "median of the annual total compensation of all employees" – companies will instead be identifying the median of their uniquely chosen compensation measure for all employees and then calculating the annual total compensation for this median employee.

(4) A company can determine whether or not to add widely available health and other benefits to its median compensation.

Once a company identifies its median employee, it must calculate the median employee's annual total compensation in accordance with Item 402(c)(2)(x) of Regulation S-K. Annual total compensation under this rule specifically excludes from the calculation non-discriminatory benefits available to all employees (such as health benefits). However, the pay ratio rule gives companies the flexibility to add this compensation to annual total compensation for their pay ratios. If a company decides to use this option and add in non-discriminatory benefits, it must add in the same benefits for the CEO's compensation and explain the differences with the CEO's compensation disclosed in the Summary Compensation Table (elsewhere in the proxy statement).

This option of whether to include or exclude benefits that are available generally to all employees is yet another factor that lessens the comparability of pay ratios among companies. A company that provides significant benefits to all employees and includes their value in the median employee's compensation will have higher median compensation than if it decided to exclude these benefits.

(5) A company's CEO pay will inevitably vary year by year.

Because annual total compensation in the pay ratio for the median employee and for the CEO must be calculated in accordance with Item 402(c)(2)(x) of Regulation S-K, there are aspects of the calculation that can affect the comparability of pay ratios. For example, in order to calculate annual total compensation, the grant date fair value of equity grants must be included in the same year that the equity is granted, even if the equity has not vested and no compensation has actually been received. In practice, this means that a company that awards a particularly large equity grant to a CEO in one year may have a much higher pay ratio than in a subsequent year. The comparability of ratios between companies and fiscal years will therefore be affected by the particular compensation year for a company's CEO.

In addition to the five issues listed above, there will be a myriad of other factors that affect the comparability of pay ratios, including but not limited to the particular reasonable estimates and assumptions that a company decides to use and the particular location of its employees in the world (including within the United States, where cost of living varies from location to location).

II. STRATEGIES AS COMPANIES APPROACH THEIR PAY RATIO DISCLOSURES

As companies prepare the drafts of their pay ratio disclosures, there are several key strategies to consider in light of the potential that readers will attempt to compare the pay ratios of different companies.

(1) Emphasize uniqueness of disclosure in the proxy statement.

Companies can help to explain the uniqueness of their pay ratios with several tools. For one thing, a company should consider clearly stating in its proxy statement that its pay ratio is not comparable to other companies' pay ratios. In addition, as required by the pay ratio rule itself, a company should describe any of the material assumptions and estimates related to its ratio. A company should also consider touching on any key points that could make its ratio materially different from other companies' ratios, particularly in its own industry. For example, if a company has a large number of temporary workers that could lower median pay, while its competitor instead uses independent contractors for these services, the company could consider describing its temporary workforce. Meanwhile, if the competitor that has a significant independent contractor population excludes these contractors based on its reliance on a widely recognized legal standard, it should consider describing this exclusion from the employee population as a material assumption for its disclosure.

(2) Prepare to communicate uniqueness of disclosure.

In addition to disclosure inside the proxy statement, a company should be prepared to communicate with stakeholders and explain why and how its pay ratio is unique to its own facts and circumstances and why it should not be compared to other companies' ratios. These explanations should shift the focus from the pay ratio number itself to the employee compensation practices and strategies that foster career growth and broader employment for larger numbers of workers. Overemphasis on the pay ratio number for a company could lead to strategies that have the very opposite effect of fostering career growth and employment for workers (by, for example, encouraging a company to use more independent contractors rather than hire temporary employees with opportunities for growth at the company).

Furthermore, a company should consider communications with its employees that enable them to fully understand all of the various compensation elements that are included in the median employee's annual total compensation, as well as any decisions by the median employee that affect annual total compensation, such as the median employee's level of contributions to a 401(k) plan or the median employee's receipt of health or dental benefits. By way of example, the annual total compensation of an employee that maxes out on employer-matching contributions to a 401(k) plan and opts into all company benefits could be much greater than the annual total compensation of another employee that contributes much less to the same 401(k) plan and opts out of such benefits. Enabling employees to understand these differences will be key for them to fully comprehend the median employee's annual total compensation.

(3) Emphasize the difference between the pay ratio and the say-on-pay vote through placement of disclosure.

The say-on-pay vote (required by Rule 14a-21 of the Exchange Act and adopted pursuant to Section 951 of the Dodd-Frank Act) is a vote seeking shareholder approval of the compensation of a company's *named executive officers* (the CEO, CFO, and a company's three other highest-paid executive officers). Say-on-pay proposals therefore focus on approving senior executive officer pay – not on the compensation for employees of a company at large, the median compensated employee, or the gap between the CEO and the median employee's pay. Furthermore, a company's existing executive compensation disclosure that is explicitly subject to the say-on-pay vote under SEC rules provides compensation information on named executive officers and describes how this pay was determined. This executive compensation disclosure (which is in the Compensation Discussion & Analysis, the executive compensation tables, and accompanying narrative of a proxy statement) that is explicitly subject to the vote typically does *not* describe the pay of company employees outside of this very senior executive officer group. Furthermore, it is unlikely that a compensation committee of a public company will factor in the median employee's pay or the pay ratio when determining the pay for senior executives.

Although the adopting release states that the pay ratio "provides new data points that shareholders may find relevant and useful when exercising their [say-on-pay] voting rights," there was no explicit mention of the say-on-pay vote in the SEC's interpretive guidance issued in September, and there has been a recent de-emphasis on the connection between pay ratio and say-on-pay in the public discourse. In fact, the proxy advisory firm Glass Lewis recently came out with the following guidance:

> *"Glass Lewis intends to display the pay ratio as a data point in our Proxy Paper in 2018. At this time, however, we do not intend to incorporate the pay ratio into our assessment and analysis of Say-on-Pay proposals. We recognize that this data point might provide valuable additional information to shareholders on a company's pay practices; however, we do not believe that this information is material for our analyses of the structures by which, and the disclosures of how, companies pay their NEOs."*

In order to support this disconnect between say-on-pay and pay ratio, companies should carefully consider the location of their pay ratio disclosure in their proxy statements. By placing the disclosure *outside* of the very sections that are explicitly subject to the say-on-pay vote (in other words, outside of the CD&A, executive compensation tables, and related narrative), a company is signaling to its investors and the proxy advisory firms that it agrees that the pay ratio information is indeed not material to an analysis of the compensation for its named executive officers.

With these items in mind, companies should be carefully crafting their disclosure as the pay ratio rule takes center stage for the 2018 proxy season. In drafting disclosure and preparing FAQs for communications with employees, investors, and others, companies should be considering how to effectively control the message regarding their pay ratios and clearly communicate the uniqueness of their own pay ratio disclosures. ■