Securities Law Alert

A Recap of CEO Pay Ratio Disclosures and a Look Forward

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Now that the proxy season is behind us, we have summarized the CEO pay ratio disclosures made during the first year it was required and venture a look forward to what companies can expect in this area next year.

RECAP

Below are observations from pay ratio disclosures made during the 2018 proxy season, much of which is sourced from Pearl Meyer's CEO Pay Ratio Watch as of August 3, 2018 (www.pearlmeyer.com/ceo-pay-ratio):

Ratios: The overall average CEO pay ratio was 141.2:1 (in line with expectations) and the overall average median employee pay was $82,449 (higher than many expected). The highest ratios were in the consumer goods and IT industries, while the lowest ratios were in the utilities, financial and energy sectors. As expected, the more revenue a company generated, the higher the ratio. In addition, the ratio increased as the number of employees increased.

CACM: SEC guidance gave companies significant flexibility in determining the Consistently Applied Compensation Measure when determining the median employee. Almost all companies used some form of base salary with many companies also looking to total cash compensation or annual bonuses. Few companies used statistical sampling or COLA adjustments. The de minimus exception (the exclusion of non-U.S. employees if they accounted for 5% or less of the total number of employees) was the most frequently used exemption followed by the exclusion of employees acquired in an acquisition during the year.

Supplemental Ratios: Few companies chose to disclose a supplemental ratio, but those that did were generally able to show a significantly lower ratio (42 % of the required ratio). The most used rationale of companies using a supplemental ratio was to normalize signing bonuses or special equity grants, which are often granted during a CEO transition. Excluding part-time and seasonal employees appeared to reduce the required pay ratio more than any other adjustments.

Level of Detail: Most companies only disclosed what is required and little more. Some companies did identify their median employee by location, business segment or employment status. A number of companies included a disclaimer to note that their ratio may not be comparable to ratios of other companies given the flexibility in calculating the median employee pay.

Location: The vast majority of companies placed the pay ratio disclosure after the summary compensation and related tables. Only a small percentage of companies included this disclosure within the CD&A section, confirming that it was not used in determining the CEO's pay and avoiding the certification of the ratio by the Compensation Committee.

Impact on Say on Pay: Semler Brossy found that companies with a lower CEO pay ratio generally receive a higher level of support for their Say on Pay proposal.

A LOOK FORWARD

In our own informal survey of middle market public companies, they received few, if any, inquiries from any of their constituencies such as shareholders, employees or the media. We are not aware of any companies that are considering a change in the method of determining their median employee. Even though the disclosure of CEO pay ratios went well this year, companies should not necessarily expect the same treatment in future years once comparisons from year-to-year are possible. It now appears that Congress will not repeal this aspect of the Dodd Frank Act any time soon, so companies will need to be prepared to go through this process for some time to come. Here are a few observations about next year:

Know Your Story: Companies should continue to be prepared to react to any constituency that raises concerns about their ratio. Next year shareholders and proxy advisory firms will be able to make year-to-year comparisons and will better understand ratios within industries and other categories such as company revenue. As always, companies should be prepared to answer a variety of questions, including why the ratio is so high or how the median employee compensation was calculated and how they stack up to the company's industry or region.

Median Employee: We expect that many companies will take advantage of Instruction 2 to Item 402(u) of Regulation S-K and use the same median employee for three years and calculate total compensation for that employee each year. If a reporting company uses the same median employee, it must disclose that it is using the same median employee and state that there has been no change in its employee population or employee compensation arrangements that it believes would significantly impact the pay ratio disclosure.

Supplemental Ratios: Companies may consider using a supplemental ratio more often, especially when its employee base has unique characteristics that make its ratio an outlier. Supplemental ratios may also be used more frequently when companies are changing

CEOs and must pay a significant signing bonus or make special equity grants as incentive for the new CEO to leave his or her current employment. In a few instances this year, companies provided a higher supplemental ratio, which may mean that they expect a larger than normal increase in CEO pay the following year and wish to provide a better comparison in the following year. Accordingly, supplemental ratios may become more common in the future.

Disclaimers: We expect more companies will include a disclaimer on the lack of comparability with the ratios of other companies.

Record Keeping: Companies should be sure to maintain good records of the methodologies, estimates, assumptions and exemptions used in the event that the SEC inquiries about their ratios. Such records would also facilitate annual reviews and updates in addition to serving companies well in shareholder litigation.

Investors: Institutional investors showed little interest in the ratios this year, but the CEO pay ratios may impact their votes or positions in the future. We expect that labor union pension funds will pay special attention to these ratios and use that information at heavily unionized workforces.

Proxy Advisory Firms: Although these firms did not factor these ratios into their voting recommendations this year, they may in future years. They will certainly be tracking the CEO pay ratio disclosures.

For more information on CEO pay ratio disclosures, please contact one of the attorneys in our Corporate & Securities Law Practice, including:

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