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New Proxy Requirements for 2018: Pay Ratio Disclosure Rule

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CEO Pay Ratio: Preparing for the 2018 Proxy Season

orrick

Today's Agenda

- Overview of the pay ratio rules
- Reflecting pay ratio and methodology in the proxy statement
- Issues companies may encounter in complying with the pay ratio disclosure rules and possible solutions
- Messaging employees about pay ratio
- Executive compensation tax reform updates

Pay Ratio: Background and Final Rule

- Section 953(b) of the Dodd-Frank Act directed the SEC to amend Item 402 of Regulation S-K to require each registrant who is required to provide a summary compensation table under Item 402(c) to disclose:
  - The median of the annual total compensation of all employees of an issuer, except the CEO (or equivalent position)
  - The annual total compensation of the CEO (or any equivalent position)
  - The ratio of these two amounts
- EGCs, smaller reporting companies and foreign private issuers are exempt

Pay Ratio Rules: Outline for Compliance

- Identify median employee
  - Pick determination date
  - Identify employee population
  - Apply any reasonable method, including the use of statistical sampling and/or a consistently applied compensation measure
- Disclose pay ratio and assumptions

Identifying the Median Employee: Determination Date

- The median employee must be identified from “all employees” as of a date within the last three months of the last fiscal year
- The median employee may be identified only once every three years as long as there have been no changes to the employee population or compensation arrangements that would materially impact the pay ratio disclosure
- Depending on industry, the flexibility to pick a date within the last three months might be a major factor in simplifying a company’s calculation as it could dramatically reduce the number of seasonal employees being considered
- Most companies use a month-end for their determination date because it’s easier for HR and finance to pull data

Identifying the Median Employee: Determining the Relevant Employee Population

- Who needs to be included
  - Domestic, international, part-time, temporary, and seasonal employees
  - Non-US employees may be excluded if foreign data privacy laws would be violated or they account for 5% or less of total employees
  - Independent contractors and “leased” workers may need to be included if considered employees
  - Acquired employees can be excluded for the year acquired

Identifying the Median Employee: Data Privacy Exemption

- Non-U.S. employees who are employed in jurisdictions with data privacy laws that make the registrant unable, despite its reasonable efforts, to comply with the pay ratio disclosure requirement without violating those laws may be excluded
  - Must exclude all non-U.S. employees in such jurisdictions and disclose the excluded jurisdictions, the approximate number of employees excluded from such jurisdictions, the applicable data privacy laws, how compliance with the SEC rule would violate those laws and the efforts to use or seek relief under them
  - Must obtain legal opinion from local counsel on the registrant's inability to comply, which must be filed as an exhibit to the proxy statement or annual report
- Difficult to rely on this prohibition
  - Often possible to work around data privacy consideration through collecting data on anonymous basis
  - Very few outright prohibitions on gathering and transferring non-US compensation data

Identifying the Median Employee: 5% Exemption

- A company may exclude all of its non-U.S. employees if they account for 5 percent or less of its total employee population
  - If the registrant chooses to use this exemption, it must exclude all of its non-U.S. employees
- If a company's non-U.S. employees exceed 5% of the company's total employees, it may exclude up to 5% of its total employees who are non-U.S. employees
  - If a company excludes any non-U.S. employees in a particular jurisdiction, it must exclude all non-U.S. employees in that jurisdiction
  - If more than 5% of a company's employees are located in any one non-U.S. jurisdiction, the company may not exclude any employees in that jurisdiction under this exemption
- Any non-U.S. employees excluded under the data privacy exemption must be counted against the 5% mark for the de minimis exemption
- May be particularly useful for companies with few foreign employees

Identifying the Median Employee: Independent Contractors

- For determining whether independent contractors are “employees” for purposes of calculating the pay ratio disclosure, a company may use widely recognized tests under other areas of law (e.g., the IRS determination) to determine whether an individual is an independent contractor or an employee
- This interpretation reverses a position the staff had taken in an earlier CD&I
  - Previously independent contractors who work for a third party needed to be included if the company or its consolidated subsidiaries determined their pay levels

Identifying the Median Employee: Permissible Adjustments

- Compensation for partial-year employees can be annualized
- No compensation adjustments to full-time equivalent are allowed for part-time employees
- Compensation for temporary and seasonal employees cannot be annualized
- For employees living in different jurisdictions than the CEO, COLA may be applied for identifying the median employee’s compensation

Identifying the Median Employee: CACM

- A company may identify the median employee using annual total compensation (i.e. compensation that would appear in the summary compensation table) or any other compensation measure that is consistently applied to all employees (“CACM”) included in the calculation, such as information derived from the company’s tax and/or payroll records
- The SEC has elaborated in a CD&I that any measure that reasonably reflects the annual compensation of employees could serve as a CACM; that is any measure that would yield a similar median to what a company would get by reviewing total compensation
- The appropriateness of any measure will depend on the company’s particular facts and circumstances

Identifying the Median Employee: CACM

- What this means:
  - Depending on circumstances, “base pay,” “base pay plus overtime,” “total cash compensation” or “taxable wages could be a CACM
  - Bonuses and equity awards could be excluded if they won’t change the median
  - However, using an hourly or annual pay rate alone is not an appropriate CACM because using rates regardless of whether an employee worked the entire year and/or full time doesn’t reflect the compensation profile of the company and would have the effect of a full-time adjustment

Identifying the Median Employee: Measurement Period

- Companies should use a measurement period that permits easy data collection
- Can use partial year as long as it accurately reflects compensation for the full year
- Can use 12 month period that runs over 2 fiscal years
- The SEC has stated in a CD&I that using year old data is permitted but shouldn’t be used unless there hasn’t been significant changes to employee population and compensation arrangements

Identifying the Median Employee: Estimates, Assumptions, Adjustments and Statistical Sampling

- The use of estimates, assumptions, adjustments and statistical sampling to calculate the pay ratio will not result in an SEC enforcement action unless the disclosure is made without a reasonable basis or not in good faith
- Shifts the burden of proof from companies to the SEC itself to demonstrate that the approach taken was without a reasonable basis or was in bad faith
- However, it’s not clear how this impacts any potential private litigation

Identifying the Median Employee: Common Methods of Determining Sample Size

- Methods for identifying the median employee
  - Use entire universe
  - Statistical sampling
  - Applying reasonable estimates

Identifying the Median Employee: Entire Universe

- Calculate the pay for every single eligible employee to find the true population median
- May make the most sense for smaller companies without multiple international jurisdictions as it’s the easiest to defend approach
- Cons:
  – May be difficult with a decentralized payroll system
  – Onerous calculation for a large number of employees
  – Multiple international jurisdictions creates additional challenges

Identifying the Median Employee: Statistical Sampling

- The SEC provides some examples of the sampling methods that could be appropriate to use (alone or in combination), depending on the company's circumstances:
  - **Simple random sampling:** Drawing at random a certain number or proportion of employees from the entire employee population
  - **Stratified sampling:** Dividing the employee population into strata, e.g., based on location, business unit, type of employee, collective bargaining agreement, or functional role and sampling within each strata
  - **Cluster sampling:** Dividing the employee population into clusters based on some criteria, drawing a subset of clusters, and sampling observations within appropriately selected clusters; cluster sampling may be conducted in one stage or multiple stages
  - **Systematic sampling:** The sample is drawn according to a random starting point and a fixed sampling interval, every nth employee is drawn from a listing of employees sorted on the basis of some criteria)

Identifying the Median Employee: Reasonable Estimates

- The Staff provided the following examples of situations in which companies may use reasonable estimates under the appropriate facts and circumstances:
  - Analyzing the composition of the company's workforce (by geographic unit, business unit, employee type)
  - Characterizing the statistical distribution of compensation of the company's employees and its parameters
  - Calculating a consistent measure of compensation and annual total compensation or elements of the annual total compensation of the median employee
  - Evaluating the likelihood of significant changes in employee compensation from year to year
  - Identifying the median employee
  - Identifying multiple employees around the middle of the compensation spectrum
  - Using the mid-point of a compensation range to estimate compensation

Identifying the Median Employee: Using Internal Records

- Companies may use their internal records to determine the 5% of the workforce used to apply the *de minimis* exception for foreign employees
- They may also use internal records for the consistently applied compensation measure used to identify the median employee, even if those records do not include every element of compensation, such as equity awards
- Implies that the use of internal records, which can include human resources information systems, can be used to determine annual compensation using the CACM chosen by the company

Disclosure Requirements: Disclosing the Ratio

- Required disclosure is as follows with total compensation determined in accordance with the rules for the proxy Summary Compensation Table:
  – The median of the annual total compensation of all employees of an issuer, except the CEO (or equivalent position)
  – The annual total compensation of the CEO (or any equivalent position)
  – The ratio of these two amounts
- Median non-CEO compensation must be set to “1” and may be disclosed in ratio or narrative form
  – E.g., CEO pay ratio of “50 to 1,” “50:1,” or “CEO’s annual total compensation is 50 times that of the median annual total compensation of all other employees”

Disclosure Requirements: Disclosing the Methodology

- Must disclose the determination date but rational for date not required
- Must briefly describe the methodology used to identify the median employee, including a description of any material assumptions, adjustments, estimates, or methodology changes
- If non-US employees are excluded, disclose the jurisdiction(s) excluded, the number of employees excluded from each jurisdiction, and total number of US and non-US employees with and without the excluded employees
  - Additional disclosure required for privacy exemption
- If proxy total compensation is not used to identify the median employee, disclose the reasonable compensation measure (e.g., taxable wages, total cash) applied
- Must disclose material features of sampling in a way that shows methodology is reasonable
  - Although not required, can disclose confidence level and margin of error

Disclosure Requirements: Disclosing the Methodology

- If a COLA adjustment was used to identify the median employee's compensation and quantify their adjustment, a company must disclose the median employee's jurisdiction, describe the COLA adjustment, and provide the median employee total compensation and pay ratio without the adjustment
  - This could result in an unadjusted median employee and COLA adjusted median employee
- If multiple CEOs in a year, a company must disclose the basis for CEO compensation
  - Companies may either (i) combine the compensation of each person who served as the CEO based on the time served as CEO **or** (ii) include the compensation for the person who was serving as CEO on the determination date and annualize his or her compensation
- If employees are excluded because of a business combination, a company must disclose the approximate number of employees being omitted and identify the acquired business that is being excluded

Disclosure Requirements: Other Considerations

- Supplemental disclosure and additional pay ratios are allowed to explain the effect of including part-time, seasonal, and temporary employees
- Can disclose that pay ratio is an estimate
- Cannot disclose median employee's personal information but can describe position and tenure
- Mitigate litigation risk by:
  - Avoiding detailed pay assumptions
  - State when estimates are being used
  - Have litigation counsel review

Sample Disclosure

For 2017, our last completed fiscal year, the median of the annual total compensation of all employees of our company (other than our CEO), was $[____]; and the annual total compensation of our CEO was $[____]. Based on this information, for 2017 the ratio of the annual total compensation of our CEO to the median of the annual total compensation of all employees was [___] to 1.

We excluded employees from countries [____] from our calculation. They constituted [__]% of our total employee population, which consisted of approximately [_____] individuals, determined as of our [_____] determination date. Our employee population, after taking into consideration these adjustments consisted of approximately [_____] individuals. Of these employees, approximately [_____] individuals are full-time (or full-time equivalent) employees, with the remainder employed on a part-time (less than [_____] hours per week) basis. [_____] of our employees (approximately [_____] individuals) are located in [_____].

To identify the "median employee" from this employee population, we conducted a stratified statistical sample of our employee population as of [_____], 2017. We conducted an analysis using a sample of [_____] employees, with this group selected to represent the demographics of our employee population reflected above. To determine our median employee, we also used a definition that was not total compensation and instead chose [____]. Using this methodology, we determined that the "median employee" was a full-time, salaried employee located in [_____]. [For purposes of this disclosure, we applied a [____] to U.S. dollars exchange rate of [____] on [____] to the compensation elements paid in [____].] However, with respect to the annual total compensation of the "median employee," we identified and calculated the elements of such employee's compensation for 2017 in accordance with the requirements of Item 402(c)(2)(x) of Regulation S-K.

Pay Ratio: Placement of Disclosure

- Pay ratio disclosure doesn’t need to be included in the CD&A or accompany say on pay proposal
- Don’t recommend linking pay ratio disclosure to say on pay proposal if it may have a negative impact on say on pay proposal
- May make sense to include after required compensation tables

Common Pay Ratio Issues: Temporary Employees

- What counts as a temporary employee?
  - For example what about temporary employees who are not working on the determination date but have not been formally terminated?
- No clear guidance on this point
- Consider whether they are still entitled to benefits or are deemed to be terminated for other purposes

Common Pay Ratio Issues: Very High Pay Ratio due to Employee Demographics

- What to do if the company's demographics skew the pay ratio?
  - For example, majority of workforce is temporary or seasonal or are based in countries with a lower cost of living
- May need to use a CACM if including or excluding particular elements causes the median to be much higher or lower than it would be if total compensation is used
- Describe position of median employee if helpful (for example temporary retail employee)
- Use alternative pay ratios excluding such employees
- Consider using COLA adjustment for employees in foreign jurisdictions when majority of employees are employed outside of the U.S. and generally have low compensation

Common Pay Ratio Issues: Median Employee Has Anomalous Characteristics

- If the annual total compensation calculated in accordance with Item 402 of Regulation S-K for the identified median employee results in anomalous characteristics, companies can choose another employee with substantially similar compensation based on the compensation measure used, rather than using a new measure
- When selecting an employee, a company should keep in mind that this employee’s compensation will be used for a three-year period

Common Pay Ratio Issues: Multiple CEOs

- The pay ratio rules provide that if a company has multiple CEOs during the year, the company may either (i) combine the compensation of each person who served as the CEO based on the time served as CEO **or** (ii) include the compensation for the person who was serving as CEO on the determination date and annualize his or her compensation
- The rules don’t clarify how to quantify equity awards that are granted to an existing employee who is promoted to CEO before that employee becomes CEO
  - In the absence of further guidance, it would be reasonable to include the full value of the pre-CEO equity awards since that is how such awards would be reported in the summary compensation table and any grants made after becoming a CEO would likely take into account any prior grants
- It’s very likely that the CEO’s total compensation number—and the pay ratio—will be unusually high in CEO transition years; additional disclosure recommended

Common Pay Ratio Issues: Non-US Workers' Pay Elements

- Compensation elements are often different outside of the United States and may affect CACM
- Solutions
  - Only include elements of compensation that are common among employment groups such as salary, bonus and equity compensation, provided it wouldn't substantially impact selection of median employee (for example when it represents a small portion of the employees' compensation)
  - Exclude a de minimis numbers of workers to simplify analysis when it makes sense to do so

Planning for Employee Reactions

- Communicating pre-proxy filing
  – Discuss how compensation for the workforce aligns with the company's values, culture, future growth plans to help employees better understand why they may fall above or below the median to mitigate the risk of employees being “surprised” and making unwarranted assumptions
- Communicating post-filing
  – Once ratio of peer companies is disclosed, consider integrating information into messaging to employees
  – Pay is most often not just about dollars in a paycheck and employees will need to hear more about about what makes their pay package fair compared to peer companies that may have different pay ratios

Planning for Employee Reactions

- Telling a broader story about the workforce could offset some of the uncomfortable metrics with additional measurements
- For example:
  - Is there a large equity component?
  - Does the company's ESPP discount stand out above other companies?
  - Are there other benefits that need to be considered in understanding the overall package – including the parts not incorporated into the Pay Ratio calculation?
    - For example: overtime pay, paid time off, and the value of both financial and nonfinancial benefits, like flexible scheduling

Executive Compensation Tax Reform Updates

- The performance-based exception will be repealed under the Senate and House Bill and more executive officers, including the principal financial officer, will be subject to the $1 million deduction limitation
- The $1 million deduction limitation will apply to taxable years beginning in 2018 to *any* individual who was a §162(m) covered employee during any prior taxable year beginning after December 31, 2016, thereby eliminating a corporation's existing ability to deduct amounts paid during and following the year of employment termination
- The Senate bill would grandfather "written binding contracts" in effect on November 2, 2017 that are not materially modified thereafter
- These tax rules would be effective for tax years beginning after December 31, 2017

Executive Compensation Tax Reform: Impact

- While corporations will not receive a tax deduction for performance-based cash and equity incentives in excess of the $1 million deduction limitation that are not grandfathered, institutional shareholders will likely (1) continue to push corporations to adopt such awards to ensure that compensation is tied to performance and (2) continue to view the exercise of positive discretion negatively (i.e. paying out awards when performance goals are not satisfied)
- However, without the need to meet the performance-based exception, corporations will have more discretion in how performance formulas are structured and awards are paid out

Thank You

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