

PREPARING FOR PAY RATIO DISCLOSURE

The CEO pay ratio mandate will present messaging challenges for many companies in 2018.

BY TED ALLEN

More than seven years after the passage of the Dodd-Frank Act, U.S. companies are preparing for one of the law's most controversial and costly provisions – the CEO pay ratio disclosure rule.

The pay ratio mandate will bring significant external and internal messaging challenges for many companies when they disclose their first pay ratios during the 2018 proxy season. The new rule may prove especially daunting for firms in retail, hospitality, and other sectors that have comparably more low-wage employees.

While human resources teams and compensation consultants at many issuers have started the process of collecting salary data and undertaking company-specific determinations to identify the median employee based on compensation, there has been less attention on how to communicate the ratio to investors, employees, and other stakeholders. (For more details on the rule, please see “Pay Ratio 101” on page 20).

“Companies need to approach pay ratio disclosure in a holistic and comprehensive manner,” said David Calusdian, president at Sharon Merrill Associates, who is a NIRI National

Board member. “They need to communicate proactively with key stakeholders, especially employees. Disclosing a ratio and waiting for the fallout can have negative consequences.”

Hala Elsherbini, senior vice president at Halliburton Investor Relations & Communications, said: “Our advice to clients would be to prepare management and the board with potential questions, strategize on responses, and develop a keen focus on employee relations, since the pay ratio rule will likely have implications on employees who may fall under the median threshold.”

“It’s a delicate situation, and there are varying inputs from company to company that could skew the ratio and how that compares to peers,” said Elsherbini, who also is a NIRI Board member.

Don’t Count on Repeal

While the U.S. House of Representatives approved the Financial CHOICE Act, which includes a repeal of the pay ratio mandate, it appears unlikely that this bill will advance in the Senate, where the Republicans hold a narrow 52-to-48 seat majority. Senate Banking Committee Chair Michael Crapo (R-Idaho) has



said he will try to move a narrower reform bill that can attract bipartisan support, but that may not happen until early 2018. Pay ratio disclosure has been a major priority for labor unions and their Democratic allies, so it's uncertain whether a pay ratio repeal bill could win the 60 votes needed in the Senate to overcome an expected filibuster.

Corporate groups have asked the Securities and Exchange Commission to delay or scale back the rule to reduce compliance costs, but it remains to be seen whether the SEC, which still has two commissioner vacancies, will tackle this contentious issue before the 2018 proxy season. [As of press time in mid-September, the SEC had not acted on this issue.]

Chris Wightman, a partner at CamberView Partners, a corporate governance advisory firm, said it's increasingly unlikely that the SEC will block the pay ratio rule this year. "We are advising clients to be prepared," he said.

Investor Concerns

Calusdian said the IR aspect of the pay ratio rule is "relatively straightforward," because many investors have been analyzing compensation data since the arrival of Say-on-Pay votes at U.S. companies in 2011. "From an investor perspective, the support of a CEO's pay is often directly proportional to the company's performance and the returns to investors," Calusdian observes.

The large index fund managers, including Vanguard and BlackRock, have not disclosed publicly how they will evaluate pay ratio disclosures when making proxy voting decisions. "A big question is how will these investors think about pay ratio when it comes to voting on Say-on-Pay or compensation committee members?" Wightman said.

At the same time, he expects that public pension funds and labor investors, which have urged the SEC not to delay this rule, will scrutinize pay ratio disclosures closely. The two major U.S. proxy advisory firms, ISS and Glass Lewis, have not yet released new voting guidelines indicating how they will analyze pay ratio disclosures, but their proxy reports likely will include pay ratios as a data point.

In addition, companies with early spring annual meetings will have a greater challenge in 2018, as they won't know how their ratios compare with most of their industry peers, or whether the ratios are impacting proxy voting by investors.

"There are a lot of unknowns, so companies should be mindful of the potential pitfalls as the compliance date approaches," Wightman said.

Under the SEC rule, companies may include additional pay ratios (e.g., based only on full-time, U.S. employees) or other

information to provide context about its pay practices. In a recent memo to clients, CamberView suggested that companies could provide a ratio based on the CEO's realized compensation (i.e., "take home" pay) or disclose more information about its workforce (such as their geographic locations or the percentage of seasonal or part-time employees).

Elsherbini stressed the importance of tying a company's pay ratio disclosures to its other compensation messaging. "Key message points to investors should include the company's approach to compensation, reiterating its general philosophy on compensation and how this incentivizes and supports its growth and strategic initiatives across its employee base," she noted.

Employees and Other Stakeholders

One of the biggest challenges for companies will be the impact of the pay ratio disclosure on employee morale and retention. Many workers will be surprised to learn that they are getting paid less than the median employee at their company. Calusdian said companies should be prepared to communicate about the ratio and should be already engaging with their workforce.

"Everything is company specific and you need to provide that context to employees before disclosure of the ratio. If you have built up support among employees, then the ratio should become less of an issue," he observed.

CamberView advises companies to consider providing "validating messages" that highlight their approaches to compensation and workforce development. For instance, a company could provide data on job creation efforts or programs to promote the advancement of low-wage employees. "Now is the time for companies to start thinking about how to measure the totality of compensation and benefits beyond cash and equity that aren't captured by the ratio," said David Martin, a principal with CamberView.

Companies also need to be ready for negative news coverage from business press, trade publications, and local news outlets. Journalists likely will focus on the headline number of the pay ratio, rather than assess a company's overall pay practices, and may make inappropriate comparisons with local firms in other sectors with different pay scales.

"Companies should be proactive and prepared to provide context around the sum total of efforts to build, invest, and compensate the entire workforce" said Martin.

In a 2016 commentary in *Forbes*, crisis communications expert Richard Levick warned that "the pay ratio rule will effectively provide critics with a potent new weapon to shame

Pay Ratio 101

The CEO pay ratio disclosure rule was mandated by Section 953(b) of the Dodd-Frank Act, and the Securities and Exchange Commission voted 3-2 to adopt a final rule in 2015. This mandate does not apply to smaller reporting issuers, emerging growth companies, or foreign private issuers.

While many companies have focused on the calculation of the pay ratio, which will prove costly for large or multi-national issuers, the rule will result in significant communication challenges for companies that expect to report higher ratios.

Here are key provisions of the rule:

- Companies must provide pay ratio disclosures for their first fiscal year that starts on or after January 1, 2017, which means that companies with calendar fiscal years will make their first disclosures in their proxy statement during the spring of 2018.
- Under the rule, companies must disclose: 1) the annual total compensation of their CEO; 2) the median of the annual total compensation received by all other employees; and 3) the ratio between those two numbers.
- Notwithstanding comment letters from NIRI and other business groups, the SEC did not exclude part-time, seasonal, or temporary employees from the pay ratio calculation. Independent contractors and leased workers may be excluded, provided that their compensation is set by an independent third party.
- Companies are required to include non-U.S. employees in their calculation, but they may exclude employees who reside in foreign jurisdictions where it would not be feasible to obtain salary information without violating local data privacy laws. In addition, there is a *de minimis* provision that allows companies to omit 5 percent of their foreign employees based on data privacy or any other reason.
- In determining the median employee, companies may select any date within the last three months of their fiscal year.
- Companies may wait three years before calculating a new pay ratio, unless there is a change in its employee population that would result in a significant change in its ratio.
- Companies may use statistical sampling in calculating the pay ratio, but they must disclose their methodology used in calculating that number.
- Companies may provide additional pay ratios or other disclosures beyond the pay ratio required by Section 953(b).

individual companies they see as bad actors. It's like digging your own grave in the hot summer sun.”

Another concern for companies will be additional taxes they could face based on their SEC pay ratio disclosures. The city of Portland, Oregon, adopted a 2016 ordinance that would impose a 10 percent surcharge on its business income tax rate for companies that disclose CEO pay ratios that exceed 100 to 1.

Lawmakers in Illinois, Rhode Island, Minnesota, Connecticut, and Massachusetts also have proposed bills to levy new taxes or fees based on pay ratios, according to the law firm of Andrews Kurth.

Opportunity for IR Teams

One silver lining of the pay ratio mandate is that will provide IR professionals an opportunity to provide input and collaborate more closely with legal, the corporate secretary, HR, corporate communications, and senior management as they prepare their company's messaging around this disclosure.

“[Pay ratio] is an IR issue at the very heart of it, but it affects so many other stakeholders and it will enable IR to expand its sphere of influence,” Calusdian said. [IR](#)

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