Pay Ratio Rules: What to Do Now
Key Takeaways from Society for Corporate Governance Teleconference
April 18, 2018

Performing the Calculations:

- Don't let perfect be the enemy of good when selecting the measure of compensation used to determine the median employee— the ratio may be a "reasonable estimate." The data collection process can be cumbersome, and obtaining every requested "wish list" item can be frustrating and difficult. In 99% of the situations where some of the requested "wish list" data is unavailable, it is unlikely to have any impact on the identification of the median employee. For example, tracking down every employee's travel allowance is unnecessary (and not required), as that component of pay is unlikely to meaningfully affect the median.
- For purposes of determining the employee population, consider maximizing the *de minimis* exception, as even if you were to collect the data, the applicable non-US employees are unlikely to have had an impact on the identification of the median employee.
- The employee population data from which the median employee is determined should identify a "solid middle" (i.e., relatively equal bands of employees just above and just below the median employee), whose pay should be very close to the median employee. In such cases, the company should have a high degree of comfort it has properly estimated the median employee.
- In most cases, base salary and wages - or base salary and wages plus annual incentives - will be representative CACMs, so think twice before deciding to include long-term incentives and benefits.
- Consider using a date prior to your fiscal year-end to evaluate your employee pool and determine the median employee to avoid competing with the already-busy year-end close process (or for other reasons, e.g., workforce composition, business seasonality). Remember, however, that you will need to calculate the median employee's pay as of FYE using the Summary Compensation Table rules, and that may create some timing challenges. For example, if you pay broad-based bonuses or success-sharing payments, make sure that you can obtain those amounts for the median employee in time to include them for the proxy disclosure.

- Be forthcoming with management and the Board regarding results. Don’t try to mask a high number or ratio. As noted below, calculations vary significantly within industries, and even within peer groups, so meaningful comparisons are difficult at best.
- Ensure the documentation used to determine the median and to calculate compensation can be easily tied-out for an internal audit review.

Disclosure:

- Unless you have an unusual item that warrants disclosure of a supplemental ratio, carefully consider all of the potential implications before disclosing one. Depending on the particular circumstances, supplemental ratios may or may not garner criticism, be perceived as defensive/transparent, or position the company well for next year's disclosure.
- Additional disclosure may be useful in some situations (e.g., the CEO’s compensation was distorted by special awards, or the median employee is hourly, part-time, temporary, seasonal or a non-US employee) to provide context for investors and other readers of the disclosure.
- The vast majority of companies are including the disclosure after the change in control/termination quantification tables rather than in the CD&A, as the ratio information was not used to determine CEO/NEO pay.
- There is a wide range of median employee pay data even within the same industry, as the composition of the workforce can be (and often is) very different among companies.
- Keep abreast of what your peers disclose and how they disclose it, as it may help inform your disclosure decisions for next year. However, be careful if/when comparing your data to other companies, as size, industry, % of employees outside the US, and numerous other factors make meaningful comparisons difficult at best.
- Note that, contrary to numerous assertions floated in the media, it is statistically unlikely that wide variations in median employee pay are due to the flexibility permitted by the SEC to identify the median employee.

Communications:

- Be prepared to address employee, investor, customer, supplier and other internal and external stakeholder questions about your company's disclosure.
- Prepare anticipatory, fulsome FAQs/talking points for designated company representatives to respond to both internal and external stakeholder questions

in advance of the disclosure. Don’t forget to include FAQs/talking points in your annual meeting preparation materials.

- Make sure you have the right internal stakeholder group engaged to create any communications (internal and external) – consider including HR, IR, PR/Communications, Legal – and give the team enough time to reach consensus on content.
- In preparing the FAQs/talking points, don’t get bogged down in the legalese and detail of the rule; most audiences don’t care or won't follow.
- Don't provide any additional color to the media outside of the disclosure in the proxy.
- In considering a communications strategy, anticipatory responsive FAQs/talking points may be sufficient. Depending on your company's particular facts & circumstances, pro-active communications may be appropriate, or may be more likely to create issues where there otherwise are none.

What Next?

- Begin preparing for 2019 now. Conduct a post-mortem analysis while the process and issues are fresh, and identify potential improvements for future years - including considering the advantages/disadvantages of maintaining the same median employee. Keep track of reactions from investors and others, including proxy advisory services.
- If you are going to re-determine the median employee next year, consider how many ways you may wish to review the data (excluding certain employees/groups, etc.) at the outset, as that may influence your collection method or process.
- With the benefit of actual Year 1 experience, schedule out next year’s process in advance so that it runs more smoothly next year.
- Panelists universally agreed that, overall, the significant efforts involved in determining the ratio were not viewed as time well spent. That being said, this disclosure is likely to stay for a while, so it should be treated like any other required SEC disclosure.