

# Pay Ratio: Developments from Last Proxy Season

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## About Anthony “Tony” Eppert



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- Tony practices in the areas of executive compensation and employee benefits
  
- Before entering private practice, Tony:
  - Served as a judicial clerk to the Hon. Richard F. Suhrheinrich of the United States Court of Appeals for the Sixth Circuit
  - Obtained his LL.M. (Taxation) from New York University
  - Obtained his J.D. (Tax Concentration) from Michigan State University College of Law
    - Editor-in-Chief, Journal of Medicine and Law
    - President, Tax and Estate Planning Society

## Upcoming 2018 Webinars

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- Upcoming 2018 webinars:
  - Preparing for Proxy Season: Start Now (Annual Program) (8/9/2018)
  - Planning for an IPO: Compensation Considerations (Part 1 of 2) (9/13/2018)
  - Compensation Changes Due to Loss of EGC Status (Part 2 of 2) (10/11/2018)
  - Taxation of Equity Awards: The 101 Training Course (11/8/2018)
  - How to Negotiate Executive Employment Contracts (12/13/2018)
  
- Upcoming 2019 webinars:
  - List will be created around September 2018
  
- Sign up here: <https://www.andrewskurth.com/ExecCompWebinar>

## Our Compensation Practice – What Sets Us Apart

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- Compensation issues are complex, especially for publicly-traded companies, and involve substantive areas of:
  - Tax,
  - Securities,
  - Accounting,
  - Governance,
  - Surveys, and
  - Human resources
  
- Historically, compensation issues were addressed using multiple service providers, including:
  - Tax lawyers,
  - Securities/corporate lawyers,
  - Labor & employment lawyers,
  - Accountants, and
  - Survey consultants

## Our Compensation Practice – What Sets Us Apart (cont.)

- The members of our Compensation Practice Group are multi-disciplinary within the various substantive areas of compensation. As multi-disciplinary practitioners, we take a holistic and full-service approach to compensation matters that considers all substantive areas of compensation



# Our Compensation Practice – What Sets Us Apart (cont.)

- Our Compensation Practice Group provides a variety of multi-disciplinary services within the field of compensation, including:

## Traditional Consulting Services

- Surveys
- Peer group analyses/benchmarking
- Assess competitive markets
- Pay-for-performance analyses
- Advise on say-on-pay issues
- Pay ratio
- 280G golden parachute mitigation

## Corporate Governance

- Implement “best practices”
- Advise Compensation Committee
- Risk assessments
- Grant practices & delegations
- Clawback policies
- Stock ownership guidelines
- Dodd-Frank

## Securities/Disclosure

- Section 16 issues & compliance
- 10b5-1 trading plans
- Compliance with listing rules
- CD&A disclosure and related optics
- Sarbanes Oxley compliance
- Perquisite design/related disclosure
- Shareholder advisory services
- Activist shareholders
- Form 4s, S-8s & Form 8-Ks
- Proxy disclosures

## Design/Draft Plan

- Equity incentive plans
- Synthetic equity plans
- Long-term incentive plans
- Partnership profits interests
- Partnership blocker entities
- Executive contracts
- Severance arrangements
- Deferred compensation plans
- Change-in-control plans/bonuses
- Employee stock purchase plans
- Employee stock ownership plans

## Traditional Compensation Planning

- Section 83
- Section 409A
- Section 280G golden parachutes
- Deductibility under Section 162(m)
- ERISA, 401(k), pension plans
- Fringe benefit plans/arrangements
- Deferred compensation & SERPs
- Employment taxes
- Health & welfare plans, 125 plans

## International Tax Planning

- Internationally mobile employees
- Expatriate packages
- Secondment agreements
- Global equity plans
- Analysis of applicable treaties
- Recharge agreements
- Data privacy



## Quick Refresher on the Rules

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- Effective for fiscal years beginning on or after January 1, 2017, the rule requires most public companies to disclose:
  - The annual total compensation of their CEO,
  - The annual total compensation of the median employee of the issuer (excluding the CEO) and its consolidated subsidiaries,
  - A reasonable estimate of the ratio of the amount determined in the above two items,
  - The date the above was determined (which must be within the last 3 months of the last completed fiscal year), and
  - The methodologies the issuer used to identify the median employee and to calculate total compensation, including:
    - All material assumptions, COLAs and consistently applied compensation measures (“CACMs”) used to identify the median employee or to determine total compensation
    - Any estimates must be clearly disclosed
  
- The ratio may be presented numerically (e.g., 75:1) or in narrative form
  - Disclosure in the form of a percentage is not permitted as the sole form of disclosure

## Quick Refresher on the Rules (cont.)

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- Disclosure of additional ratios are permitted. However, the additional ratios:
  - Must be clearly identified,
  - Cannot be misleading, and
  - Cannot be presented with greater prominence when compared to the required pay ratios (*i.e.*, this portion of the rule is similar to the rule applicable for any supplemental table to the Summary Compensation Table)
- In designing the calculations and drafting the disclosure, issuers should expect that questions will be asked with respect to the disclosure of the median employee's total compensation
- To that end, consider adding explanatory language. For example, consider:
  - Proactively addressing differences in ratios between the issuer and its peers (*e.g.*, employees in low cost jurisdictions, seasonal and part-time employees, and differences between an issuer that both manufactures and sells a product compared to an issuer that only sells such product)
  - Providing explanatory disclosure geared towards the viewpoint of the issuer's other employees that may view the median employee's total compensation
- In terms of placement, consider having it appear immediately after the Summary Compensation Table or immediately after the Potential Payments upon Termination or Change in Control discussion/table because such placement avoids the disclosure being subject to the CD&A and the Compensation Committee's certification

## Overall Talking Points

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- According to an Equilar survey entitled “CEO Pay Ratio: A Deep Data Dive,” dated May 22, 2018 (the “Survey”), the largest pay ratios in the Russell 3,000 broken down by market cap were as follows:
  - 1,022:1 (market cap of less than \$1bb)
  - 5,908:1 (market cap of \$1bb to \$5bb)
  - 4,987:1 (market cap of \$5bb to \$10bb)
  - 2,900:1 (market cap of \$10bb to \$25bb)
  - 3,101:1 (market cap greater than \$25bb)
  
- According to the Survey, pay ratio for the Russell 3,000 increased as the issuer’s market capitalization increased, as follows:
  - Median pay ratio of 32:1 (market cap of less than \$1bb)
  - Median pay ratio of 64:1 (market cap of \$1bb to \$5bb)
  - Median pay ratio of 110:1 (market cap of \$5bb to \$10bb)
  - Median pay ratio of 128:1 (market cap of \$10bb to \$25bb)
  - Median pay ratio greater than 213:1 (market cap greater than \$25bb)
  
- Increases in pay ratios as the market capitalization increases reflects the increased pay realities relative to the CEOs, but also reflects the issuer is likely to have more employees, the latter of which tends to drive the median employee pay downward (reflected on next slide)

## Overall Talking Points (cont.)

- According to the Survey, pay ratio for the Russell 3,000 also increased as employee headcount increased, as follows:
  - Median pay ratio of 28:1 (less than 1,000 employees)
  - Median pay ratio of 67:1 (1,000 to 5,000 employees)
  - Median pay ratio of 101:1 (5,000 to 10,000 employees)
  - Median pay ratio of 155:1 (10,000 to 25,000 employees)
  - Median pay ratio of 230:1 (25,000 to 50,000 employees)
  - Median pay ratio of 290:1 (more than 50,000 employees)
  
- The pay ratio could be explained by changes in the median employee's pay. Consider that, according to the Survey, the median employee's pay within the Russell 3,000 was \$64,024, and the spread among the Russell 3,000 was as follows:
  - Median employee pay of \$91,129 (issuers with less than 1,000 employees)
  - Median employee pay of \$62,294 (issuers with 1,000 to 5,000 employees)
  - Median employee pay of \$59,579 (issuers with 5,000 to 10,000 employees)
  - Median employee pay of \$49,930 (issuers with 10,000 to 25,000 employees)
  - Median employee pay of \$52,243 (issuers with 25,000 to 50,000 employees)
  - Median employee pay of \$53,443 (issuers with more than 50,000 employees)

## Overall Talking Points (cont.)

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- Notwithstanding the foregoing, pay ratios were not as high as previously predicted
  
- Per the Survey, median pay ratios per industry sector within the Russell 3,000 were as follows:
  - 142:1 (consumer goods)
  - 127:1 (services)
  - 88:1 (industrial goods)
  - 76:1 (basic materials)
  - 69:1 (technology)
  - 47:1 (utilities)
  - 46:1 (financial)
  - 46:1 (healthcare)
  - 43:1 (conglomerates)

## Overall Talking Points (cont.)

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- Keep in mind when talking to the Compensation Committee that any spread in ratios among a compensatory peer group could be explained by substantial deviations in the total compensation of each peer member's median employee
  - CEO pay within a peer group is typically uniform for the most part due to the amount of time put into setting the CEO's compensation (e.g., peer studies)
  - Though CEO pay impacts the ratio, the larger impact comes from the dramatic swings in the total compensation of one issuer's median employee compared to another issuer's median employee
  - To summarize, if there is:
    - An increase in the issuer's market capitalization generally results in a corresponding increase in the CEO's total compensation
    - But if the issuer's head count from an employee perspective is high, then an inverse relationship develops because the total compensation of the median employee would decrease
  
- So consider that, since deviations in the median employee can be the strongest driver as to why two issuers have substantially different pay ratios, any pay ratio comparison group should be comprised of issuers with similar employee demographics

## Data Privacy Exemption

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- The general rule is that if data privacy laws would be violated due to the issuer acquiring information needed to comply with the pay ratio disclosure, then the employees in such jurisdiction could be excluded. In order to comply with this exemption the issuer must:
  - Seek an exemption from the data privacy rules,
  - Receive an opinion from legal counsel that the applicable information could not be received by the issuer without violating applicable foreign privacy data laws, and
  - All employees from such jurisdiction must be excluded
- In terms of the disclosure, the issuer must:
  - Identify which jurisdictions were excluded under this exemption, including the approximate number of employees in such jurisdiction
  - Disclose that access to the applicable information would violate data privacy laws in that jurisdiction and specifically indicate how such laws would be violated
  - File as an exhibit the above referenced opinion from legal counsel
- Use of this exemption was not common (if used at all)

## De Minimis Exemption

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- The general rule is that non-U.S. employees constituting 5% or less of the issuer's total employee work force may be excluded from the median employee determination
  - However, to exclude an employee from a particular jurisdiction, all employees from that jurisdiction must be excluded
  - If the issuer excluded any employees under the data privacy exemption, then such excluded employees count towards the 5% under this de minimis exemption
  - Exclusions pursuant to this exemption requires the issuer to also disclose:
    - The approximate number of employees excluded in each jurisdiction,
    - The specific jurisdictions that were excluded, and
    - The total number of employees employed by the issuer (counting both U.S. and foreign employees without regard to any exclusions under this exemption)
- Use of this exemption was common
- According to the Survey, about 24% of all Russell 3,000 utilized this exemption



## De Minimis Exemption (cont.)

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- Example:

### Methodology for Identifying Our “Median Employee”

We determined that, as of March 31, 2018, our total employee population consisted of approximately 25,378 individuals, including our CEO. This population included both full-time and part-time employees, of which approximately 24,475 were aligned to offices in the United States of America (the “U.S.”) and 903 were aligned to offices outside of the U.S. As the population outside of the U.S. accounts for less than 5% of our total workforce, we were able to rely on the de minimis exception as permitted under Item 402(u) and exclude this population from our “median employee” calculation. This included employees in Canada (5), Germany (280), Indonesia (16), Italy (11), Japan (85), Kazakhstan (1), Republic of Korea (77), Kuwait (2), Lebanon (12), Pakistan (27), Qatar (3), the Kingdom of Saudi Arabia (120), Singapore (23), the United Arab Emirates (141), and the United Kingdom (100). After excluding this population, as well as our CEO, the resulting adjusted employee population to be used for identifying our “median employee” was 24,474

## De Minimis Exemption (cont.)

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- Another example:

We selected January 22, 2018 (approximately two weeks prior to our fiscal year end) as the date we would use to determine the employee population to be used in determining the median employee. We determined that, as of that date, we (including our subsidiaries) employed 14,328 employees, including full-time, part-time, seasonal and temporary employees. Of the 14,328 employees, 8,412 were employed outside of the United States.

As permitted by the SEC rules, from that group of employees we excluded all employees who were employed in the following countries (a total of 694 employees): Australia (238 employees), Brazil (103 employees), Russia (329 employees) and Singapore (24 employees). The total number of excluded employees equaled approximately 4.8% of the total employee population as of January 22, 2018, resulting in a total employee population of 13,634 that was used in determining the median employee.

## Recent Acquisition Exemption

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- The general rule is that if the issuer acquired a company during the fiscal year that is being disclosed, then the employees of such acquired company may be excluded from the pay ratio calculations
- However the issuer must still disclose the approximate number of employees being excluded

## Consistently Applied Compensation Measure

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- For purposes of identifying the median employee, any CACM may be used provided such measure reasonably reflects the annual compensation of the employees
- According to the Survey, the most common CACMs within the Russell 3,000 were:
  - Cash compensation (approx. 40% of the issuers)
  - Total annual compensation (approx. 26% of the issuers)
  - W-2 income (approx. 21% of the issuers)
  - Taxable income (approx. 4.1% of the issuers)
  - Gross income (approx. 3.4% of the issuers)
  - Total rewards (approx. 2.7% of the issuers)
  - Payroll (approx. 2% of the issuers)
  - Other (approx. 0.5% of the issuers)
- For issuers that included equity within their calculations, use of the grant date fair value of the award was more prevalent (as opposed, for example, to using the value of the award that vested during that year)

## Consistently Applied Compensation Measure (cont.)

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- Example:

We utilized total cash compensation as our consistently applied compensation measure to identify our median employee. For this purpose, we defined total cash compensation as base wages plus any incentives (bonuses or commissions), and did not annualize any employees who were employed less than a full year and we did not make any adjustments, assumptions or estimates. For employees outside the United States, we converted cash compensation to U.S. dollars using the March 1, 2018 exchange rate

## Identifying the Median Employee

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- The issuer is permitted to identify the median employee by using reasonable estimates, statistical sampling or any other reasonable method
  - According to the Survey, approximately 3% of the Russell 3,000 utilized statistical sampling
  
- With respect to the median employee, only a small percentage of the issuers disclosed:
  - Whether the median employee was employed on a part-time or full-time basis
  - The geographic location of the median employee
  - The business unit within which the median employee worked

## Calculating Total Compensation

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- The calculation of Total Compensation must be performed in the same manner that Total Compensation is calculated for purposes of the Summary Compensation Table
- And if the CEO position turned over during the fiscal year, then the issuer is permitted to either:
  - Aggregate the total compensation paid to both CEOs, or
  - Annualize the total compensation for the individual serving as the issuer's CEO on the measurement date
- An example of an annualization and the related disclosure is contained on the next slide

## Calculating Total Compensation (cont.)

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- Example:

During fiscal 2018, Mr. [Elton] served as our CEO until October 1, 2017, at which time Mr. [John] became our CEO and served in such capacity for the remainder of fiscal year 2018. As permitted by SEC rules, we chose to use the annual total compensation of Mr. [John] to calculate our pay ratio. We determined Mr. [John's] annual total compensation for fiscal 2018 was \$\_\_\_\_\_, which, as required by SEC rules, includes his annualized base salary, bonus and certain recurring perquisites for fiscal 2018. Because we are required to annualize his base salary, Mr. [John's] annual total compensation for purposes of this pay ratio is greater than the total compensation reported for him in our 2018 Summary Compensation Table.

To calculate the pay ratio, we divided our CEO's annual total compensation by our median employee's annual total compensation.

We believe that our pay ratio for fiscal 2018 was impacted by our hiring Mr. [John] during such fiscal year. As described in the CD&A, in addition to the compensation granted to and earned by Mr. [John] during fiscal 2018 for his services as CEO, his annual total compensation for fiscal 2018 reflects a signing bonus in connection with his employment agreement, as well as a special stock option grant with an above-market exercise price and a time-vesting restricted stock unit grant, which was in addition to our usual stock option grant. The inclusion of these one-time additional items for Mr. [John] significantly increased his annual total compensation for fiscal 2018, and, consequently, our pay ratio for fiscal 2018.



## Disclaimers

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- It is common to see disclaimers used by issuer's in their pay ratio disclosure to highlight that, because of the differences in the methodologies of the issuer and members of its compensatory peer group, pay ratio should not be used as a basis of comparing the issuer against the ratio of its compensatory peer group
- If favorable in result, should the issuer disclose that its median employee has compensation higher than that of the Bureau of Labor Statistics

- Example:

The pay ratio reported above is a reasonable estimate calculated in a manner consistent with SEC rules, based on our internal records and the methodology described above. The SEC rules for identifying the median compensated employee allow companies to adopt a variety of methodologies, to apply certain exclusions and to make reasonable estimates and assumptions that reflect their employee populations and compensation practices. Accordingly, the pay ratio reported by other companies may not be comparable to the pay ratio reported above, as other companies have different employee populations and compensation practices and may use different methodologies, exclusions, estimates and assumptions in calculating their own pay ratios.

## Location of the Disclosure

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- The largest percentage of issuers placed their pay ratio disclosure immediately after the Potential Payments upon Termination or Change in Control
- The next most common location was immediately after the Summary Compensation Table

## Supplemental Pay Ratios

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- Supplemental ratios are permitted so long as the supplemental disclosure is not as prominent as the required disclosure
  - According to the Survey, approximately 9% of the Russell 3,000 disclosed a supplemental pay ratio
- Supplemental ratios are lower than the required ratio. Issuers provided varying reasons for the supplemental ratios, including:
  - Mega grant of an equity award, or a special performance grant of an equity award, was intended to cover multiple years, and therefore is redacted in the supplemental disclosure
  - Changes in pension value
  - To compare base salary only
- Interesting is that the purpose of the supplemental pay ratio for some issuers was to increase the median employee pay level (which correspondingly lowered the ratio). For example:
  - Some issuers excluded non-U.S. employees from the supplemental ratio
  - Some issuers excluded part-time and temporary employees from the supplemental ratio calculation

## Supplemental Pay Ratios (cont.)

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- Example:

### Adjusted CEO Compensation

As discussed in footnote 6 to the “Summary Compensation Table”, Mr. [Walker’s] CEO Compensation for fiscal 2018 included \$[\_\_\_\_\_] expensed by the Company for the final installment of a cash incentive award paid by RemainCo under the RemainCo Spin-Off Compensation Plan. For a description of such plan, please see the disclosure contained in Company’s proxy statement for the 2016 annual meeting of stockholders, dated [\_\_\_\_\_] 2016, under “Additional Executive Compensation Information — RemainCo Spin Off Compensation Plan”. RemainCo, not the Company, made the associated cash payment to Mr. [Walker], and this expense to the Company will not recur next year.

While we are required to report this compensation expense in the “Summary Compensation Table”, it is not a component of Mr. [Walker’s]’ compensation that was approved by our Compensation Committee nor is it a part of our executive compensation program. In the interest of providing readers with a more accurate view of the current pay ratio, and to provide a more accurate basis for comparison of our pay ratio in future years, removing this cash incentive expense adjusts reported CEO Compensation to \$2,811,626. Based on the foregoing, the adjusted pay ratio is 40.9 to 1.

## Don't Forget Next Month's Webinar

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- Title:
  - Preparing for Proxy Season: Start Now (Annual Program)
  
- When:
  - 10:00 am to 11:00 am Central
  - August 9, 2018