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The CEO-to-Employee Pay Ratio Rule: Begin Thinking About Messaging Now

With the end of summer quickly approaching, it looks increasingly likely that companies will need to disclose the ratio of median annual compensation of employees to that of chief executive officer compensation (the “Pay Ratio Rule”) in their 2018 proxy statements. Although complying with the requirements of the rule is a challenging data collection exercise, the pay ratio presents a unique opportunity for companies to disclose additional information, narratives and metrics that highlight a positive message regarding a corporation’s commitments to its workforce and compensation practices. Below are four considerations for companies as they compile and disclose information around the pay ratio that can help turn a reporting obligation into an opportunity.

1. Consider the entire range of stakeholders who will review your pay ratio disclosure

Since say-on-pay became a requirement in 2011, leading companies have used an investor lens to determine how to position disclosures and practices around executive compensation. The disclosure of the pay ratio will arguably lead to companies spending more time describing, and in some cases defending, their pay practices to a broader range of stakeholders including employees, unions and the media. Companies whose pay ratios materially exceed that of peers should be prepared for increased media and investor scrutiny, including the potential for “vote no” campaigns by public pension or labor funds. In addition, the pay ratio may heighten the risk of workforce morale and retention concerns in light of the ease of comparing median compensation both internally and at peer companies.

2. Consider how your operations may differ from your competitors and what data is under your control

Pay ratios are expected to be high on an absolute basis for many companies, but a good deal of public analysis will likely focus on peer comparisons. This may present challenges for companies that have similar market capitalizations or customer bases but different operational and organizational structures. For example, a vertically integrated company with a large number of employees involved in manufacturing would likely have a significantly different pay ratio than one that relies on suppliers and has a higher proportion of employees in professional positions.

Given the one-size-fits-all nature of the pay ratio, companies should prepare now to determine what decisions under their control will produce the most accurate figure. Examples of inputs under company discretion include:

- Selecting the date on which the employee population is measured (any day within the last three months of the applicable fiscal year);
- Whether to exclude up to 5 percent of non-U.S. employees;
- Whether to exclude employees obtained in a business combination for the fiscal year in which the transaction becomes effective; and
- Whether to use statistical sampling.

In all instances, issuers should be prepared to explain the rationale for its choice of metrics when engaging with investors, beyond what is already disclosed in the proxy statement.

3. Consider disclosing additional ratios that may provide greater context

Under the legislation that created the Pay Ratio Rule, companies are statutorily required to disclose the ratio of CEO pay to median employee pay. However, the regulation does not prevent companies from providing additional ratios as long as they are not displayed more prominently than the required ratio, are not misleading and are accompanied by a description as to why they are relevant. Companies should consider that investors will expect information provided in the first year to be disclosed in subsequent years for comparison and tracking.

One supplementary disclosure for consideration is using an alternative measure of CEO compensation such as realized pay. This metric may be appropriate in situations where the median employee is not granted any long-term or equity-based compensation, thus providing a comparison between actual take-home compensation for the CEO and company employees. Companies contemplating this approach will need to carefully consider how option exercises and other decisions taken by the CEO in the current and future years may impact alternative pay calculations.

Another approach would examine how workforce dynamics impact the ratio. Companies may want to examine the median employee of just U.S.-based employees or annualize seasonal or temporary workers, especially if it can demonstrate that a significant number of those workers are not interested or available for full-time employment. Alternatively, companies may consider excluding a geographic or operating segment of the company, especially if they can make the case that certain business units are not relevant to the pay ratio.

4. Consider highlighting validating messages

While supplemental pay ratio disclosures would, by design, include descriptions about their relevance and appropriateness, companies should also consider providing narratives that highlight positive approaches to employee compensation and workforce development. Topics for consideration could include:

- A clear explanation of how workforce structure ties to long-term value creation purposes;
- A textual explanation of how the employee structure affects the pay ratio;
- Overall job creation figures;
- The percentage of employees paid above benchmark wages such as the minimum wage; or
- Opportunities for advancement or programs geared toward developing the careers of lower-wage employees such as education programs or scholarships.

Companies may also want to consider highlighting the career path of the CEO or other executive officers if they have benefited from long tenure at the company or similar programs or company investments.

Takeaways for issuers

The first year of the pay ratio is likely to create a great deal of disclosure noise for companies, regulators and investors alike. As with any new regulatory requirement, it may take time for all stakeholders to understand how to interpret data points. But given the amount of attention that has been focused on the Pay Ratio Rule, this new disclosure is likely to have important, and possibly unforeseen, implications for engagement regarding compensation as well as the potential to impact proxy voting decisions. Companies should take proactive steps to frame a positive corporate narrative that takes into account the sum total of efforts to build, invest and compensate their entire workforce.

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