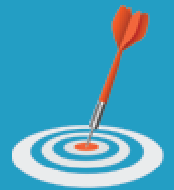
GOVERNANCE & ACCOUNTABILITY INSTITUTE'S

TO THE POINT™

Timely News, Insights & Perspectives on Corporate Sustainability, Responsibility & Citizenship



September 2017

Governance & Accountability Institute shares timely news, insights and perspectives with corporate managers in key topic areas:

- *Corporate Citizenship,*
- *Corporate Responsibility,*
- *Corporate Sustainability,*
- *Community Affairs, and*
- *Sustainable Investing.*

To the Point! is a fee-based educational resource for corporate executives and managers distributed each month with periodic brief updates for critical items.

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IT'S H-E-R-E NOW: SEC Guidance on CEO-Employee Pay Rule Clarified in Interpretive Guidance. Your Company Should Be Prepared for First Quarter 2018 Disclosures and Beyond!

Issue 2.1

Prepared September 27, 2017

Way back when, as the ***Dodd-Frank*** legislation was passed, a provision was included that called for public companies to annually disclose the ratio of compensation for the CEO (presumably the highest paid) and for the median compensation (of all employees). Was it going to be 100-to-1? 400-to-1? More?

This was one of the most broadly contentious provisions of Dodd-Frank (signed into law July 21, 2010, officially as the ***Dodd-Frank Wall Street Reform and Consumer Protection Act*** – Public Law 111-203 / H.R. 4173).

Ever since that summer now seven years behind us, corporate sector lobbyists have battled to roll back sections of, or the entirety of D-F.

As with other financial reform initiatives in the Congress (like ***Sarbanes-Oxley*** in 2002), there are many titles and sections in the legislative package. In D-F, Title IX – Investor Protections and Improvements to the Regulation of Securities — there is a Subtitle E 4.9.5: Accountability and Executive Compensation. And within that…

There is the familiar requirement for (at least every three years) shareholders to vote on the company's executive compensation. And this: Shareholders must be informed…of the median of the annual compensation of all employees of the issuer, except the CEO…the annual total compensation of the median of the annual total with the total CEO compensation…

In 2015, the ***Securities & Exchange Commission*** did adopt a rule to implement the D-F legislation but there was great pushback by industry and the can was kicked down the road.

And here we are today: The SEC staff finally has issued "Interpretive Guidance" on the Pay Ratio Rule! Public companies will begin making pay ratio disclosures early in 2018 (for companies with Fiscal Years beginning January 1, 2017).

- The SEC last week said it was seeking ways to reduce costs and burdens for issuers while preserving what is perceived to be the purpose and benefits of statutorily-mandated disclosure.
- Disclosure may be determined by the company with appropriate methodologies used to identify the median employee and calculate the median employee's annual total compensation.
- Disclosure may be based on a company's "reasonable belief, reasonable estimates, assumptions, and reasonable efforts to prepare the disclosures…"
- We can see the general counsel office and outside lawyers working in their offices to fashion "reasonableness" in the coming disclosures. And, investors and stakeholders can be said to be bracing themselves for disclosures they will take issues with in 2018 and beyond. – and their reaction to same.

The SEC acknowledges that pay disclosures may "involve a degree of imprecision." The SEC will provide some leeway — at least in the initial wave of disclosures — "unless the disclosure was made or reaffirmed without a reasonable basis or was provided other than in good faith."

The SEC recognizes that most U.S. public companies are in some way (or a big way) "multinationals," with employees based outside the United States. Employees outside the U.S. may be exempted if they comprise 5% or less of the total of U.S. and non-U.S. employees.

For purposes of enforcing the rule, SEC applies "employee" to individuals employed by the company and its consolidated subsidiaries. Excluded: independent contractors or "leased" workers provided to the company by a third party. Comments to the SEC when the Rule was passed questioned the term, "employee" — SEC says a test might be guidance published by the Internal Revenue Service.

There were many people and organizations weighing with their opinions
over the recent years. These included the **Financial Services Roundtable; The Insurance Coalition; National Association of Manufacturers; Society for Corporate Governance; the law firm Davis Polk & Wardwell LLP; the Business Roundtable**.

This is where we are today: The Pay Ratio Disclosure moves ahead; the first data

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will be coming into the public view in the first quarter of 2018.

Company executives and managers may find a ho-hum reaction to their published ratio; others in leadership may come under fire for such things as allegations (or evidence of) CEO over-payment and accompanying company under-performance (a frequent refrain from activist investors).

The Glassdoor Economic Research Blog in August 2015 (as the SEC rule was first announced) published a list of Companies (like Discovery Communications and Chipotle, with 1,900-to-1 and 1,500-to-1 ratios respectively) and down to Prudential (with about 500-to-1 ratio). You can see it at: https://www.glassdoor.com/research/ceo-pay-ratio

Across all companies, the average CEO pay was reported at that time to be $13.8 million and the average worker pay, $77,900 — for a ratio of 204-to-1.

There is a comprehensive commentary on all of this from **Harvard Law School Forum on Corporate Governance and Financial Regulation.** Read "Behavioral Implications of the CEO-Employee Pay Ratio" to educate yourself and your colleagues at: https://corpgov.law.harvard.edu/2017/04/19/behavioral-implications-of-the-ceo-employee-pay-ratio

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