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Public Company Summer/Fall To-Do List: 5 Steps Toward CEO Pay Ratio Disclosure

US public companies should be preparing now to disclose their CEO pay ratios in 2018.

For the 2018 proxy season, most public companies will be required to disclose the pay ratio between their CEO and the median compensated employee, in what is commonly known as the "CEO Pay Ratio."[1] Although the CEO Pay Ratio rules may be repealed[2] or delayed[3] in the future, they will likely remain in effect, and require disclosure, for the 2018 proxy season. Companies should be preparing this summer and fall in order to be ready. Since this disclosure will be a new addition to the proxy statement, companies should consider a dry run in advance to provide adequate time to review, consider, and make any needed changes.

5 Steps Companies Should Be Taking Now

The rules provide significant flexibility in how the CEO Pay Ratio may be calculated and disclosed. Accordingly, companies will need to discuss and decide on a number of issues as part of preparing for such disclosure.

Companies should be taking the five following steps now in order to be prepared for CEO Pay Ratio disclosure for the 2018 proxy season:

1. Form a team. Most companies will need to rely on internal teams from HR, payroll, finance, accounting, IT, legal, investor relations, and corporate communications. Outside compensation, data privacy, and IT consultants, as well as legal counsel, may also be necessary to provide expertise in interpreting and applying the rules.

2. Determine the message and audience. The proxy statement CEO Pay Ratio disclosure should be consistent with the company's overall compensation message. Although the intent of the rule is to provide investors with information regarding the CEO's pay relative to that of the median employee, companies should consider the impact of the disclosure on other constituencies, such as employees, unions, consumer advocates, or regulatory bodies. The rules' flexibility provides opportunities to arrive at a median employee with a higher or lower total compensation, correspondingly resulting in a lower or higher ratio to the CEO's pay. For example, the date that a company selects to use for determining the median employee could include more or fewer temporary or seasonal workers, resulting in a median employee with lower or higher compensation. Some companies may want a median employee with lower

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compensation in order to minimize HR issues associated with one-half of the company's employees learning that they make less than the median employee. However, other companies may prefer to select a median employee with higher compensation — because this reduces the ratio to the CEO's compensation, and because doing so could help in labor negotiations. As part of the process, the company may also want to develop an overall communication plan to employees or others.

3. Identify, gather, and process the data necessary to determine the median employee and the median employee's compensation. When making the decisions outlined below about the methodology used to identify and determine the median employee, the team should keep in mind that such methodology must be disclosed in the proxy statement. See Latham & Watkins' *Client Alerts* "New SEC Staff Guidance on CEO Pay Ratio Disclosure Rules — Determining the Median Employee" (October 31, 2016) and "SEC Adopts CEO Pay Ratio Disclosure Rules" (August 12, 2015) for more details regarding the requirements for determining the median employee and calculating the median employee's compensation. Companies will need to decide on the following data points:

- **Determine the Date Used to Determine the Median Employee and Time Period for Calculating Compensation.** The company will need to pick a median employee identification date which is within the three months prior to the end of the last fiscal year. Only employees who are employed on this date will be included, all others will be excluded. This date can significantly impact the number and types of employees included in the determination for companies (such as retailers) that may hire significant numbers of temporary or seasonal employees. Companies must also choose the time period for collecting the compensation data. This period does not need to include the date used to identify the median employee, nor does it need to be a full annual period. These key determinations can significantly affect the compensation of the median employee that is disclosed.

- **Determine Who Is Included.** In general, companies will need to identify all employees as of the identification date, wherever those employees reside. Additionally, companies may need to include independent contractors, if the company and not a third party determines the contractors' compensation. As the rules provide some flexibility for excluding employees located outside the United States, companies with such employees will need to determine whether any such employees can or should be excluded. Local counsel may need to help assess any potential data privacy issues and agreements, and if necessary, provide an opinion of counsel in order to exclude any employees under the exception in the rules for employees whose compensation may not be disclosed under local data privacy rules.

- **Determine What Compensation to Use.** The rules do not mandate a specific methodology for defining the compensation used to identify the median employee. Therefore, companies will need to identify what compensation they will use to determine their median employee. The company can use total annual compensation, as calculated in the proxy statement summary compensation table for named executive officers, or any other consistently applied compensation measure (CACM) as long as that measure reasonably reflects the annual compensation of the employees. What is an appropriate CACM will depend upon the company's employee population and available pay data. Based on SEC guidance, the CACM could be (1) base pay only, (2) base pay plus cash bonus, (3) total cash compensation plus equity, (4) any combination of the foregoing, or (5) compensation as reported for tax purposes. Companies should consider other points, including whether to: annualize compensation for those employees who are employed less than the full year, make cost of living adjustments for those living outside of the United States, and what exclusions or adjustments to make for employees whose employment is affected by mergers and acquisitions. Companies may be able to reduce their costs significantly by using

statistical sampling methodologies to limit the population and necessary data. Separate decision points are whether to use such a methodology, what that methodology should be, and whether this process would be less costly and cumbersome than other methods and whether it can be explained as being a reasonable approach by the company.

4. Decide how and where in the proxy statement to present the CEO Pay Ratio disclosure and prepare a mockup of the disclosure. Companies will need to decide how to present the CEO Pay Ratio in the proxy statement, whether as a basic ratio (*i.e.*, 1:300) or as a narrative of the multiple (*i.e.*, 300 times larger than the median). Although the rules require a description of the methodology used to calculate the CEO Pay Ratio, companies should also consider whether or not to add additional contextual information to help explain the ratio and/or the methodology used as part of a company's broader communication plan. Although determining the CEO Pay Ratio may appear a mere number-crunching exercise, the messaging and engagement that should be part of communicating that ratio may be equally important, especially when this disclosure is included for the first time.

5. Determine the corporate governance process and an appropriate timeline for completing the process. The CEO Pay Ratio disclosure is required as part of Item 402 of Regulation S-K, and as such is covered by Part III of Form 10-K and subject to the SOX certification by the CEO and CFO. Since this will be a new disclosure, companies should preview the process, methodology, disclosure controls, and proposed disclosure with the compensation committee (and especially the chair of the committee), the CEO and CFO, and other members of the management team in advance. Management should consider providing the compensation committee with an overview of the CEO Pay Ratio issues process, and a mockup of the proposed disclosure at the fall committee meetings to obtain input prior to finalizing the calculations and drafting the proxy disclosure. Of course, the company should document all decisions made and why it considers the methodology used to be reasonable and compliant with the rules.

Anything Else Companies Should Worry About?

If a company will not be able to file its proxy statement within 120 days after the end of its 2017 fiscal year, then the CEO Pay Ratio disclosure will need to be included in a company's Form 10-K. This may accelerate the disclosure process and influence which CACM the company will use.

Several states have proposed additional surtaxes or fees for companies with a CEO Pay Ratio that exceeds a certain amount. Several local governments, such as the City of Portland, also have, or are contemplating, adopting similar measures. These taxes may be an additional item for companies to consider when developing a CEO Pay Ratio strategy.

Which Companies Do Not Need to Worry About the Rules?

Emerging growth companies, smaller reporting companies, foreign private issuers, registered investment companies or US-Canadian Multijurisdictional Disclosure System filers are exempted from the CEO Pay Ratio disclosure requirement. Additionally, companies that have recently gone public must first provide the disclosure with respect to compensation for the first fiscal year after the fiscal year in which the company first becomes public.

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Endnotes

[1] Item 402(u) of Regulation S-K.

[2] Final CHOICE Act of 2017 (H.R. 10) would repeal the CEO Pay Ratio rule requirement and has been passed by the House of Representatives on June 8, 2017. The Senate Committee on Banking, Housing and Urban Affairs held hearings on July 13, 2017, but has taken no further action.

[3] The SEC has solicited comments on the costs and burdens of complying with the CEO Pay Ratio rules as part of President Trump's executive order to review burdensome regulations. Most of the more than 14,000 comments received were form letters in

favor of the rule, with only 15% being critical of the rule. .Any action to delay the rule will not be taken until the two current vacancies on the Commission are filled. Accordingly, action to delay the rule is uncertain to occur.