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SEC Pay-Ratio Rule Spotlights CEO Compensation

By Allen Smith 8/5/2015

Pay transparency has just been elevated to the next level.

Chief executive officer (CEO) pay at public companies is to be compared with the median total compensation of all other employees, including U.S. and non-U.S., full-time, part-time, temporary and seasonal, thanks to a Securities and Exchange Commission (SEC) rule adopted along party lines by a 3-2 vote.

Companies must put the CEO-employee pay ratio in registration statements, proxy and information statements, and annual reports. Companies may supplement the required disclosure with a narrative discussion or additional ratios. But any additional discussion and ratios would need to be clearly identified and not presented with greater prominence than the required pay ratio.

Controversial Rule

The U.S. Chamber of Commerce Center for Markets Competitiveness President and CEO David Hirschmann issued a statement criticizing the final pay-ratio rule, which takes effect Jan. 1, 2017, “as a favor to union lobbyists who misguidedly think it will help their organizing efforts.”

Calling the rule ”more harmful than helpful,” Hirschmann noted that “At best, pay ratio is a misleading, politically inspired and costly disclosure that fails to provide investors with useful, comparable data. For example, a domestic company might have a better pay ratio than a multinational company due to legal, currency or cost-of-living differences, creating a situation that is like trying to compare baseball to basketball stats when it’s a whole different ballgame.”

But in a letter to the commission, government watchdog Public Citizen said that “There is abundant reason for shareholders” to be able to evaluate CEO pay in the context of a CEO-employee pay ratio. It observed that the percentage of corporate profits spent on senior executive pay doubled from 5 percent in 1990 to 10 percent in 2010. “The pay ratio can also open a window into less tangible issues, such as morale, as a wide pay gap can translate into productivity problems at a corporate entity. It is natural to express anger at pay inequity.”

And Public Citizen noted that Peter Drucker, a well-known management consultant, “advised clients that a 20-to-1 salary ratio is the limit beyond which they cannot go if they don’t want resentment and falling morale to hit their companies.”

At the SEC’s open meeting on pay ratio, commission Chair Mary Jo White noted, “To say the views on the pay-ratio disclosure requirement are divided is an obvious understatement.”

The commission has received more than 287,400 comment letters, she said, “with some asserting the importance of the rule to shareholders as they consider the issue of appropriate CEO compensation and investment decisions, and others asserting that the rule has no benefits and will needlessly cause issuers to incur significant costs.”

But the Dodd-Frank Act requires the commission to issue a pay-ratio rule, and even though there was no specific deadline for the rule’s adoption, that fact “does not diminish the agency’s obligation to act,” she asserted.

White described the rule as “carefully considered and calibrated” and said it “will provide shareholders with additional company-specific information that they can use when considering a company’s executive compensation practices, an important area of corporate governance.”

Certain Exceptions

While the pay-ratio rule's application is surprisingly broad in some respects, such as its application to part-time workers, it does provide some exceptions for non-U.S. employees because of privacy laws abroad that are more strict than in the United States.

A company may exclude non-U.S. employees from the determination of its median employee in two circumstances.

First, it may exclude non-U.S. employees that are employed in a jurisdiction with data privacy laws that make the company unable to comply with the rule without violating those laws. The company would be required to obtain a legal opinion from counsel on the inability of the company to obtain or process the information necessary for compliance with the rule without violating the jurisdiction's laws or regulations governing data privacy.

Second, up to 5 percent of its non-U.S. employees, including any non-U.S. employees excluded using the data-privacy exemption, may be excluded.

If a company excludes any non-U.S. employee in a particular jurisdiction, it must exclude all non-U.S. employees in that jurisdiction, according to the final rule.

Also, certain public companies do not have to comply with the rule, noted Andrew Liazos, an attorney with McDermott, Will & Emery in Boston. Exempted public companies include emerging growth companies, smaller reporting companies and foreign private issuers.

The rule applies to those companies with market caps in excess of $75 million, unless they fit into one of these exemptions, said David Rubenstein, a partner with accounting firm WeiserMazars in New York City. So, as an emerging growth company, Facebook would not have to deal with this, for example.

While there may be legislative and judicial challenges to the final rule, Liazos said public companies covered by the rule "probably need to start going forward" to comply. DIfferent approaches for identifying median employee pay are possible, but it's important to select the right approach. If a company wants to change methods later, it won't be enough to say the CEO-employee pay ratio looks too high, he cautioned.

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http://www.shrm.org/legalissues/federalresources/pages/sec-pay-ratio-rule.aspx