Ballard Spahr LLP

The Legal Intelligencer

With 2 Proxy Seasons Gone By, What Have We Learned From Pay Ratio Disclosures?

September 11, 2019

By Katayun I. Jaffari and Jessica DuBois

It was two years ago that the Securities Exchange Commission (SEC) issued guidance that implemented the pay ratio disclosure requirement promulgated by the Dodd-Frank Wall Street Reform and Consumer Protection Act of 2010 (the Dodd-Frank Act). Under the Dodd-Frank Act and the SEC guidance, companies are required to disclose, as a ratio, a comparison of the annual total compensation of the chief executive officer (CEO) and that of the company's "median" employee. Public companies voiced their concerns as to how to calculate the ratio leading up to the effectiveness of the disclosure requirement. The SEC responded with its guidance by relaxing certain aspects of the disclosure rule. It has now been two years since the disclosure requirement has been effective. Many have suggested that the result of the pay ratio disclosure is data that is both difficult to compare across companies and not helpful to shareholders in determining whether employees are fairly compensated.

A review of the data from the past two proxy seasons seems to suggest certain trends. First, a company's capitalization, number of employees, and industry type seem to be key factors in determining how high or low a pay ratio is. Second, as anticipated, high pay ratios have made headlines. Although the headlines have not necessarily affected employee compensation directly, the results seem to have led to efforts to legislate pay. There are suggestions that the ratios have also affected employee morale and customer choices. Thus, regardless of whether a pay ratio disclosure assists a shareholder to determine if compensation is appropriate, it has had some effect.

THE DATA

Derived from widely cited surveys published by Equilar, Inc. and Pearl Meyer & Partners, LLC (Pearl Meyer) with Main Data Group, among others, the first year of pay ratio disclosures revealed lower pay ratios than predicted and previously estimated by groups such as the AFL-CIO. The studies also demonstrated that pay ratios have increased between the 2018 and 2019 proxy seasons. The 2018 disclosures showed an average pay ratio of 144 to 1 and a median pay ratio of 70. The highest pay ratio disclosed was 5,908 to 1 and the lowest was 0. Disclosures in 2019 have yielded an increased average pay ratio of 172 to 1 and a median pay ratio of 72. The highest ratio is 40,668 to 1 (Tesla) and the lowest is 0. A pay ratio of 0 results when a CEO receives no compensation.

Compensation consultants who have analyzed the pay ratio disclosures over the last two years have determined that a company's capitalization, revenue and employee count are positively correlated to pay ratio. Greater capitalization, more revenue, and a higher employee headcount are determinative of a high pay ratio. The 2018 disclosures show that companies with under $300 million in revenue have a pay ratio of 32 to 1, whereas companies with $3 billion to $10 billion in revenue

have a pay ratio of 289 to 1. Similarly, companies with higher market capitalization have higher pay ratios. Of the Russell 3000 companies, those with a market capitalization of less than $1 billion have a pay ratio of 32 to 1, whereas companies with a market capitalization of more than $25 billion have a pay ratio of 213 to 1.

Employee headcount, in particular, seems influential in the size of a pay ratio. Larger companies often have more diversified workforces, such as employing more part-time and temporary employees, all of whom must be counted when determining the "median" employee. These employees will have lower total annual compensation. Thus, fewer full-time employees will negatively affect the median employee's compensation and result in a higher pay ratio. According to Pearl Meyer, in 2018, companies with under 500 employees had a pay ratio of 36 to 1, and those with more than 10,000 employees had a pay ratio of 337.3 to 1. According to Equilar the 2018 data demonstrated that the median pay ratio of the Russell 3000 companies was less than 28 to 1 on the low end for companies with employee counts of 1,000 or less, and 290 to 1 on the high end for companies with more than 50,000 employees.

As expected, certain industries also have predictably high pay ratios, such as consumer goods and consumer services. The high ratio may be a function of the type of workforce employed in these industries, which is often part-time. In 2018, the median pay ratio in the consumer goods industry was 142 to 1 and in 127 to 1 in the consumer services industry. Certain industries, such as utilities and health care, had median employee compensation over $100,000 and a low pay ratio as a result.

USE OF THE PAY RATIO RULE'S FLEXIBILITY

The SEC provided guidance to simplify and somewhat relax requirements before the first pay ratio disclosures were to be disclosed in 2018. We had predicted that the guidance would provide a company "significant latitude" in determining the pay ratio through the use of reasonable estimates, assumptions and methodologies and statistical sampling and of internal records. While SEC guidance arguably made calculating the pay ratio a simpler task, studies compiling pay ratio disclosure data show that not all of the leniencies were utilized.

A key part of the flexibility is the use of reasonable estimates, assumptions and methodologies, including statistical sampling, in pay ratio calculations. According to a Pearl Meyer survey, only 2% of companies used statistical sampling in 2018; 1% did not disclose; and 97% used the entire employee population. According to Equilar and Pearl Meyer, 25% of companies, however, did use the de minimis exclusion which permitted them to exclude up to 5% of their non-U.S. employees when determining the median employee. This is informative because it appears that having a high number of non-U.S. employees is also determinative of a high pay ratio.

Companies did choose to avail themselves of the SEC's relaxed rule regarding consistently applied compensation measures (CACM). This rule permits companies to choose only certain aspects of an employee's total compensation to measure employee pay. For example, even if employees regularly receive equity awards as part of their compensation, this relaxed rule permits a company to use cash compensation or base salary as the measure. According to Equilar, over 40% of the Russell 3000 companies used cash compensation as the CACM.

Although similar data is not yet available for the 2019 pay ratio disclosures as is for the 2018 data presented above, it does appear that CEOs' median compensation has increased 7% between 2017 and 2018 to $12 million, while median employee pay has increased by less than half that percentage. Also, it is reported that no companies have chosen to provide comparisons between their pay ratio and peer companies' pay ratios. This fact is not surprising given the little value comparisons hold at this time. With the extent of flexibility afforded companies to calculate compensation and to determine who is an employee, comparing pay ratios often means comparing dissimilar measurements of compensation. The SEC itself warned against making such comparisons.

THE IMPORTANCE OF PAY RATIO DISCLOSURES GOING FORWARD

While pay ratios themselves may not provide adequate information to inform judgments about whether executive compensation is "fair" or "appropriate," the information can feed concerns about income inequality and wage stagnation. Many commenters suggest that these fears may lead to problems with employee morale, consumer choice and even legislation targeting executives' pay. Pay ratio data is being widely shared. For example, the AFL-CIO publishes a list that spans 105 web pages listing the pay ratios of public companies. The page states: "Company pay ratio data is important. It shows which companies are investing in their workforce to create high-wage jobs. The table below shows how companies pay their CEOs relative to their workforce." As more ratios are disclosed over time, companies will be better able to analyze whether this information leads to changes in workplace morale and consumer choice.

With regards to legislative efforts, several state and local jurisdictions have considered enacting regulations to tie corporate income taxes to pay ratios. At this time, only Portland, Oregon, has a "pay ratio surtax" in effect, which assesses a 10% surtax on "publicly traded companies that are subject to the business license tax in the city of Portland" for pay ratios that are at least 100 to 1. If a company's CEO makes equal to or greater than 250 times the "median worker," the surtax is 25%. San Francisco, California has recommended a similar tax for the November 2019 ballot. If approved by voters, the San Francisco tax would start at 0.1% for pay ratios that are 100 to 1, and increase by one-tenth of a percent for each 100 point increase in the pay ratio. Bills have been introduced but not passed in the legislatures of Connecticut, Illinois, Massachusetts, Minnesota and Rhode Island.

Whether employees and customers will make "changes" in their lives and whether the new legislative efforts will pass is to be seen. It is prudent for companies to consider that their pay ratios are being studied and that their effect may not necessarily be on the shareholders but rather employees, customers and even legislators.

Katayun I. Jaffari is a partner in Ballard Spahr's business and transactions department and a member of the securities, life sciences/technology, energy and project finance, and mergers and acquisitions/private equity practice groups. She counsels public and private companies in the areas of corporate governance and securities law and compliance, including reporting requirements under NYSE and Nasdaq regulations. She can be reached at jaffarik@ballardspahr.com or 215.864.8475.

Jessica DuBois is an associate in the firm's business and transactions department and a member of the employee benefits and executive compensation and labor and employment practice groups. She can be reached at duboisj@ballardspahr.com or 612.371.2416.

Reprinted with permission from *The Legal Intelligencer.* © 2019 ALM Media Properties, LLC.
Further duplication without permission is prohibited. All rights reserved.