September 27, 2013

Key Takeaways for McDowall Associates Clients:

1. The Dodd-Frank Act includes a requirement that publicly traded companies disclose their CEO pay ratios to their shareholders.
2. The *CEO pay ratio* is the ratio between the median of the annual total compensation for all employees of a company to the annual total compensation of the CEO.
3. The Securities and Exchange Commission has released a proposed rule for implementing the CEO pay ratio requirement.

What is Happening with CEO Pay Ratios?

Much focus has been placed in the business press on the “CEO pay ratio”. Some proponents seem to believe that the resulting embarrassment will lead boards of directors to place internal (i.e. downward) limits on the CEO’s compensation, notwithstanding the competitive market. Other proponents might want to use the CEO pay ratio to help put pressure on companies to increase the compensation of the typical worker relative to that of the CEO, notwithstanding the cost implications.

What do we mean by the “CEO pay ratio”? Suppose for example that the median of the annual total compensation of all employees of a company is $50,000 and that the annual total compensation of a S&P/TSE60 CEO is $7,000,000. The CEO pay ratio would be “1 to 140” (i.e. the CEO’s annual total compensation is 140 times that of the median of the annual total compensation of all employees).

While currently not required or common practice in Canada, the Securities and Exchange Commission (SEC) in the U.S. is in the process of implementing the Dodd-Frank Wall Street Reform and Consumer Protection Act’s (Dodd-Frank) requirement that publicly traded companies subject to the SEC proxy circular disclosure rules provide their shareholders each year with:

- the median of the annual total compensation of all their employees except for their CEOs,
- the annual total compensation of their CEOs, and
- the ratio of two amounts.

After pondering the initial round of public comments on this requirement, the SEC realized that calculating the median compensation would be a

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4. The CEO pay ratio requirements of the Dodd-Frank Act can be very difficult to implement depending on a company's particular facts and circumstances.
5. The SEC's proposal attempts to address these complexities (e.g. How is the median employee determined? How is total compensation determined?)

challenge for many companies to implement in practice. Interestingly, on September 18, 2013 the SEC released a *162 page* document on how it proposes to require companies to meet the Dodd-Frank CEO pay ratio rule. The SEC acknowledged that the appropriate and most cost effective methodology for complying with the Dodd-Frank CEO pay ratio rule would necessarily depend on a company's particular facts and circumstances, including, among others, such variables as:

- the size and nature of the workforce;
- the complexity of the organization;
- the stratification of pay levels across the workforce;
- the types of compensation the employees receive;
- the extent that different currencies are involved;
- the number of tax and accounting regimes involved; and
- the number of payroll systems the company has and the degree of difficulty involved in integrating payroll systems to readily compile total compensation information for all employees.

The complexities involved in implementing a CEO to median employee pay ratio disclosure requirement are illustrated by some of the following questions that the SEC proposals attempt to address:

- How should the median employee be determined?
    - Could a large company use estimates or a statistical sample?
    - How can other countries' data privacy laws be taken into account?
    - Should the selection of the median employee and the corresponding compensation calculations be made as of a fixed date, such as the fiscal year end?
    - How should part-time, occasional and seasonal employees be taken into account? Should their pay be annualized?
    - What about employees who worked only part of the year and were not on the payroll on the calculation date?
    - Do employees of subsidiaries of the parent company have to be included in determining the median employee?

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[1] http://www.sec.gov/rules/proposed/2013/33-9452.pdf

    - Should permanent employees who are on unpaid leaves of absence or on disability be included? If so, how?
    - Should the pay of new hires during the year be annualized?
    - Should the compensation of temporary or seasonal employees be annualized?
- How should the median annual total compensation of the employees be determined?
    - Could total compensation for the median employee be based on the company's income tax records rather than be calculated using the standard accounting rules?
    - If the median employee is a member of a multi-employer defined benefit plan, how should the value of the benefits be calculated if the company does not have ready access to the required information?
    - What if the median employee happens to participate in a unique compensation plan only offered in or required by a foreign country?
    - Should government mandated benefits be included or excluded?
    - Should the total compensation of the CEO be the same total compensation required to be reported in the Summary Compensation Table (SCT) that would include the prospective value of equity awards granted in the year and in the US the change in the actuarial value of defined benefit pension plan credits during the year?
    - Should the full value of the CEO's perquisites be included even if they are below the SCT disclosure threshold (i.e. $10,000 in the US, and the lesser of $50,000 and 10% of salary in Canada)?
    - How precise does the methodology ultimately have to be?
- How should foreign exchange rates be taken into account?
- How can companies that have multiple payroll and human resource systems come up with the required information?
- How should the median employee selection and the compensation valuation methodology be disclosed to the shareholders? How much detail is necessary?

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6. The SEC does not believe precise comparability or conformity of CEO pay ratio disclosures amongst companies is achievable (or even an objective of the legislation as written).
7. The final rule will likely come into effect for fiscal years commencing 2014 and, if so, the first disclosures will occur in 2015.
8. Most Canadian companies will not be subject to the CEO pay ratio disclosure requirement, but should monitor the situation in the U.S.

The calculations would have been much easier if average compensation could be used instead of median compensation, and/or if the ratio could be determined on an effective hourly rate basis rather than on annual total compensation, but Dodd-Frank does not give the SEC sufficient flexibility to do so.

Interestingly, the SEC does not believe that precise comparability or conformity of disclosure from company to company is necessarily achievable due to the variety of factors that could cause the ratio to differ, nor does the SEC believe that precise conformity or comparability of the ratio across companies is one of the Dodd-Frank Act objectives.

The SEC has asked for public comment on its proposals for a 60 day period. The final rule will likely come into effect for fiscal years commencing 2014, with the result that the first disclosures will occur in 2015.

It should be noted that most Canadian companies that are listed on a U.S. stock exchange as well as in Canada are considered "foreign private issuers" (FPIs) by the SEC.[2] FPIs do not have to comply with the US executive compensation disclosure rules, and thus in turn will not be required to disclose their CEO pay ratios.

In addition, the Canadian Securities Administrators (CSA) decided not to include a CEO pay ratio disclosure requirement when they last updated their executive compensation disclosure rules in July 2011, despite the requests of several commentators. Nevertheless, publicly traded Canadian companies should monitor CEO pay ratio disclosure requirements in the U.S. and elsewhere.

[2] A non-U.S. company will qualify as a "foreign private issuer" for SEC purposes if

1. 50% or less of its outstanding voting securities are held by U.S. residents; *or*
2. if more than 50% of its outstanding voting securities are held by U.S. residents and *none* of the following three circumstances applies:
    - the majority of its executive officers or directors are U.S. citizens or residents;
    - more than 50% of the issuer's assets are located in the United States; or
    - the issuer's business is administered principally in the United States.

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