

The pay ratio rule: Get ready, get going

It's time to make lemonade — boards should be thinking strategically today about how they will change their compensation programs and disclosures to mitigate the coming controversy.

BY CHARLES M. ELSON AND CRAIG K. FERRERE

The CEO to median-worker pay ratio rule, recently proposed by the SEC, has become perhaps the most controversial requirement of the new Dodd-Frank corporate governance reforms.

Until very nearly the time it became required by law, this little noted concept was absent from most progressive governance reform agendas. Nonetheless, in the crucial moments prior to the passage of Dodd-Frank, the idea gained a champion in Senator Robert Menendez, became part of the legislation, and soon after its passage found an advocate in the AFL-CIO. Despite an ongoing repeal movement, it is most likely here to stay.

It has been argued that the primary intention

of this disclosure mandate is to embarrass companies and disrupt their work cultures so that they might change their executive compensation behavior (which, frankly, to most that support this provision, means paying CEOs less and other workers more). This “shock and awe” campaign against corporate America will undoubtedly succeed on both counts. Bloomberg News has estimated that the average ratio will be 204-to-1, with some outliers, such as J.C. Penney Co., having ratios in excess of 1,000-to-1. Many boards and CEOs will be embarrassed and most companies will be disrupted to some extent by the publication of these figures. Boards should be thinking strategically today about how they will change their compensation programs and disclosure to mitigate the coming controversy.

The centrally relevant criterion

While the issue of pay disparity obviously invites the use of many frameworks for evaluation, the dialogue surrounding the new rule has focused mostly on the costs and its benefits. As an element of the SEC's disclosure regime, the centrally relevant criterion, identified by both the rule's proponents and its critics alike, has been the “materiality” of the soon-to-be public information.

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With respect to the securities laws, the SEC and the courts have customarily defined a material disclosure to be one which a reasonable person would likely find to be important to an investment or portfolio decision.

It is important to consider the merits and, hence, the materiality of the ratio disclosure because, by the SEC's estimates, this will be an expensive requirement to implement. Most companies do not have centralized payroll systems, as the Center for Executive Compensation noted in a letter to the SEC. Aggregating and compiling data from these multiple systems for the computation of the median worker's pay will be a complicated matter. Even the form in which the bill mandates that total median worker pay be disclosed, and therefore also be identified with reference to, is a form which was developed for executive compensation purposes and will thus prove foreign to the methods of calculation already in use.

An additional complication, which will impact implementation to great effect, is that the median worker must be identified from all of a company's employees, including its overseas employees

and part-time workers. The varying compensation, legal and accounting practices in different countries and locales will present a particularly onerous challenge to aggregation. In the aggregate, across approximately 3,830 registrants, the SEC has estimated a total cost of 545,792 hours of company personnel time and an additional \$72,772,200 outlay for the use of outside professional services. At the individual company level, the SEC cautions that the cost of implementation will be highly contingent on the scale and nature of operations, but at a mid-size company it foresees an estimated burden of 340 hours in the first year that the rule takes effect, 160 in the second year and 70 hours per year thereafter.

An insidious chimera

All of this great burden and expense, opponents of the requirement assert, is borne in pursuit of an insidious chimera. The ratio will not be an intelligible consequence of any factor but rather a meaningless confluence of happenstance and any one of the multitude of strategic decisions that could influence a company's wage distribution. "The pay

Sides are split, contention rules

Section 953(b) of the Dodd-Frank Wall Street Reform and Consumer Protection Act mandates that the SEC amend Item 402 of Regulation S-K to require disclosure of the ratio between the pay of a company's CEO and the pay of its median employee. This will force most U.S. public companies to calculate the total compensation of their median employee and disclose, in any proxy or information statement that requires executive compensation-related disclosure, the ratio between that figure and the total compensation of its chief executive officer.

The split 3-2 vote by the SEC on whether to propose this rule in the first place reflects the contentious nature of the requirement itself. Commissioner Daniel M. Gallagher released a dissenting statement that characterized the pay ratio as "another page of the Dodd-Frank playbook for special interest groups who seem intent on turning the notion of materiality-based disclosure on its head." Commissioner Gallagher asserted that the ratio would provide no benefits ("no — count them, zero — benefits that our staff have been able to discern") while imposing a significant cost burden on the affected issuers. In his view, despite the Congressional mandate, the SEC should not have moved forward on the rulemaking when it did. Commissioner Michael S. Piwowar, in an equally strong dissent, stated that the SEC "should not be spending any of its limited resources on any rulemaking that unambiguously harms investors, negatively affects competition, promotes inefficiencies, and restricts capital formation."

On the other side of the split, Commissioner Luis A. Aguilar wrote that the SEC had taken an important step in proposing the pay disparity rule

which would produce "better disclosure and accountability regarding executive compensation decisions." Commissioner Aguilar explained his view that shareholders, in response to rising pay disparity, were justified in seeking additional insight into internal pay and would enjoy the benefit of a "valuable new perspective for executive compensation decisions." Rather than shaming the Commission for acting on the pay disparity rule, as Commissioner Piwowar had, he welcomed the "important step" taken.

An astonishing number of comment letters, more than 20,000, were submitted by the public during the 90-day comment window following the proposal. A Congressional Research Service report has compiled a representative list of the pay ratio provision's critics, who are described as "business-related entities," and its supporters: "unions, civil rights groups, consumer advocacy groups, social justice groups, liberal think tanks, and others." Some investors, too, have supported the measure, including public pension funds such as CalPERS, socially responsible investment managers such as Calvert, and international investors such as the Australian Council of Superannuation Investors.

Among the provision's most conspicuous detractors are the Business Roundtable, the U.S. Chamber of Commerce, the Center on Executive Compensation (a rather vociferous critic), the New York Stock Exchange, IBM, McDonald's, and AT&T. The public disclosure of pay ratios is supported by the AARP, AFSCME, the Center for Economic Progress, the Economic Policy Institute — and, perhaps most visibly, by the AFL-CIO.

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ratio fails as a tool to compare registrants because the pay ratios of individual companies will be a unique result of each company's business structure, employee population and compensation practices," states the Center for Executive Compensation. As such, cross-company, and even intra-company across time, comparisons will be meaningless.

Investors will rely upon this disclosure only to their peril, these opponents contend. Opponents assert that, contrary to what the ratio's proponents attest, the ratio will tell investors nothing about pay disparity, being merely an arbitrary figure, and pay disparity would tell them nothing about company valuation, anyhow. To this effect, the Center for Executive Compensation stated in its comment letter that the pay ratio requirement "will provide no useful information to investors and to the extent it is used by investors at all, it is likely to be misleading and thus will be harmful to them." Moreover, opponents suggest that the ratio disclosure will shame, embarrass and disrupt companies, to the detriment of the functioning of the capital markets. The rule is a thinly veiled assault on corporate America and only promotes a social agenda contrary to the interests or likely inclinations of investors, the converse of its being a material benefit to investors, they argue.

Proponents of the new mandate argue that material new information about the compensation structure of an organization is provided by the median worker compensation figure. "This provision provides greater transparency to investors about their companies' compensation practices for rank-and-file employees. This disclosure will allow investors to compare employee compensation practices between companies," contends the AFL-CIO. Proponents argue that such information is important because there is a relationship between pay disparity, presumably identified by the CEO to median-worker pay ratio, and company factors such as employee morale, turnover, collaboration or innovation and ultimately investor return. A high ratio, to them, suggests a dysfunctional pay system, where CEO and executive excess might be causing resentment and under-performance amongst the other employees. (See sidebar, "Sides Are Split, Contention Rules," for more on how the opposing sides are lined up.)

Time for re-examination . . . now

Policy arguments aside, Congress, in the Dodd-Frank Act, said the SEC shall require companies to make the new disclosure, not that it may require it. Absent an unlikely repeal of this section of the legislation, companies will have to disclose this ratio of their CEO's compensation to their me-

dian-worker's pay. The rule will likely take effect in 2015 or 2016. It is critical then that companies begin to re-examine their compensation system design in order to avoid the negative impact of this new highly public median ratio disclosure. For many if not most companies, this ratio will be an embarrassment that is only likely to cause dissension among employees, just as those who crafted the requirement intended.

Boards must react to this shocking disclosure to mitigate its negative impact. And in doing so, boards will have to justify their executive pay decisions in a wholly different manner than they presently do (see sidebar, "Outside/Inside: Peer Group Comparisons vs. Internal Pay System Protocols").

Whatever the merits of this disclosure may or may not be, proponents of the median pay reporting rule have identified an important fact with regard to the context in which CEO compensation should be analyzed. The chief executive's pay, and employee perceptions of it, does indeed profoundly affect the entire incentive structure and morale of the organization and the board must carefully consider it. A board that neglects to take this into account and structure its approach accordingly has not functioned appropriately. The sole consideration of the pay of an executive relative to his or her peers, to the neglect of the other factors, through an exclusive reliance on the peer benchmarking process, surely does not address this concern. Employees look at CEO pay from an internal perspective. (CEO pay almost always comes up in labor disputes.) Boards need to as well. A simple peer group analysis is insufficient.

In an invigorated process, which adequately responds to this disclosure development, benchmarks should be seen as merely singular data points among many other necessary factors that directors must consider. Compensation committees should use external benchmarks to inform but not to drive their decision-making process. The true drivers of an effective compensation plan should always be the unique strategic demands of the particular company. From the boardroom perspective, it is expected that the compensation committee engage in a deep consideration of the company's strategy and competitive needs with regards to what and how they pay employees and managers generally before they consider executive

OPPONENTS ARGUE THAT THE RULE IS A THINLY VEILED ASSAULT ON CORPORATE AMERICA.

Outside/inside: Peer group comparisons vs. internal pay system protocols

Today, most boards justify their decision-making process for setting executive pay by referencing the pay of other “peer” company executives. In compensation disclosures most companies will use this “peer group” to explain that their particular executive is paid commensurately with others and that therefore the board has acted reasonably in setting compensation figures. However, now that they must publish the corresponding figure for median worker pay, companies will be forced to explain executive compensation decisions in a very different context. Rather than looking externally, to other executives, they will have to address the relation of pay to internal compensation dynamics.

Besides investors, a company’s own employees are the most important consumer of proxy statements and annual reports. The information that is conveyed and the impression that is imparted have the potential to greatly affect how employees — whether middle management or assembly-line workers — view the company’s mission, purpose and integrity. An employee’s perception of these reports will affect their confidence in the enterprise long term. Done well, an annual report can help solidify employee commitment and facilitate a highly functioning organization. Done poorly, however, the reporting and the substance can become fodder for discontent and disillusion, creating broad-based dissension.

Employees will pay particular attention to this antagonistic pay-disparity ratio. Moreover, pay comparisons to other executives will not provide an adequate justification of board decision making as far as this important constituency is concerned. Such explanations will only inflame the pre-existing broad-based concerns about preferential treatment and meritless reward for executives. Peer group references to other executives will only serve to reinforce the common notion of a clubby and back-scratching boardroom culture.

Rather, boards and compensation committees will have to work closely with their human resources professionals to design and explain executive pay around internal company compensation system proto-

col. All employees understand that as one is successful and promoted within the enterprise, pay goes up concurrently. It must be communicated that executive pay, and the CEO-to-median-worker ratio, are ultimately the result of this dynamic internal incentive structure and not of “political” or unfair treatment. This, instead of simple reference to other executives, will make executive pay disclosures relatable and palpable to more employees. Additionally, if done correctly, by communicating the character of the incentive structure of the organization, and valorizing the potential rewards to long-serving and successful employees, this disclosure may in fact provide positive benefits.

A company’s response to this rule needs to involve more than just a change of approach with regards to proxy disclosures. The aforementioned peer groups are not just utilized to explain pay but are also heavily relied upon in setting it too. In a mechanistic fashion companies will target the total value of a CEO’s compensation to a specified percentile, or benchmark, almost always at the 50th percentile or above. This process has become a substitute for a careful board consideration of the company’s internal compensation dynamics and, in effect, drives the decision-making process.

The result has been executive pay practices that are increasingly disconnected from the internal contextual factors that should otherwise shape and influence their development. However, in order to respond effectively to this new disclosure in a manner that will be acceptable to employees and avoid dissension, companies will need to incorporate these factors and concerns. Companies will have to move away from the rote application of peer benchmarking and percentile targeting and engage in a more holistic approach to setting pay. As such, the ratio disclosure could be the impetus for a sea change in compensation practice (one which we have advocated before — see “What Is a CEO Worth? Don’t Look to Peers,” *Directors And Boards*, Third Quarter 2011.) This change will ultimately benefit the compensation area and, through that, corporate America greatly.

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pay specifically, so that they will be better able to anchor their decision-making process internally and aim for a consistent and optimal approach. In doing so, they can explain the pay disparity ratio in its proper, and more palatable, context.

A rational relationship

Specific factors concerning the enterprise’s particular competitive positioning and its enterprise-wide compensation plan are critical to the design of executive pay. For instance, a company’s success may be dependent upon the retention and motivation of highly talented engineers who are often promoted to or in the line of succession to the chief

executive officer and other senior management positions. Executive compensation amounts and design in such a company should be rationally related to and consistent with that particular internal pay-scale structure. Likewise, when making decisions about the step-up in pay amounts when an individual is promoted to a senior management position or about the year-over-year changes in pay amounts for merit or otherwise, an appropriate guide and ample precedent can and should be identified from within the other “levels” of the organization itself. The operation of these step-up and annual merit adjustments should then form the base line for ongoing pay-amount determina-

tions. This simple logic will be immediately recognizable and relatable to other employees throughout the organization, who will be therefore more accepting of executive pay practices.

Review of an executive's compensation should be done in this manner, being related to the context of the organization as a whole. The executive is, after all, an employee of the corporation. His or her pay should be considered as an extension of the infrastructure that governs the rest of the company's wage structure. Internal consistency, or pay equity, throughout the organization, up to and including the CEO, should be a natural and reasonable objective. The board should not consider executive pay separately from the structures that govern compensation of other employees; rather, its design should be structured upon the same foundations and precepts.

An executive's participation in bonus pools in kind with other employees may be helpful in inducing this mindset, for instance. Board ratification of the executive's contract should not be viewed singularly; it is an implicit examination and approval of the entire organization's wage and incentive structure. The most effective contract is one that is consistent with the structure and values of the corporation. Current peer grouping practice assumes that internal pay consistency must succumb to the external market-based conception of executive to peer-executive pay parity. We believe these market concerns are overblown; we have argued in earlier work that because much of a CEO's skills are firm-specific and nontransferable between companies, they rarely move and hence a strict and aggressive peer benchmarking is not only undesirable but unnecessary. Rather than succumbing to a false sense of "market capture," boards can, and should, use their discretionary authority to restore internal consistency.

The final step

Only when the compensation committee has satisfied itself that such an analysis has been accomplished should it consider peer groups and external benchmarks. This final step will serve as a sanity, or "reasonability," test. Following this confirmation exercise, the compensation committee could then use its power of discretion to adjust the compensation figure — up or down — for a variety of reasons, such as those relating to pressing market conditions.

But, again, the process should begin and end with very careful consideration of the particular demands and the pay structure of the company. Boards are elected for their judgment, and empowered with discretion, which it is their duty to exercise in a thoughtful manner that is consistent with the company's compensation-related values.

Opponents of the pay-ratio disclosure rule have focused, with some validity, on the negative impact of the requirement. However, this mandate could nonetheless collaterally affect positive change on the existing executive compensation regime. By focusing on internal metrics rather than the specious methodology of the "peer group," a board can create truly effective compensation schemes for CEOs that promote and enhance, rather than frustrate, the general worker commitment for effective operation and success of the enterprise. ■

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