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Day 2
Pay Ratio-Latest Developments
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Liz Dunshee: Hi everyone, welcome back. I hope you enjoyed that tribute to Marty Dunn and hope you enjoyed your lunch break or for our West Coast friends, your brunch break. We now have a quick hitting panel. At 25 minutes, they will be discussing pay ratio disclosures as well as how that's drawing greater attention to pay equity issues and human capital management. We have Mark Borges of Compensia and CompensationStandards.com, Dave Eaton of Aon, and Amy Wood of Cooley. Mark is going to kick things off with a brief discussion about calculation and disclosure trends. Mark?

Mark Borges: Thank you Liz. I guess the first thing to say here is can you believe that this is three years of CEO pay ratio? It seems to me that we'd spent as many years, if not more, worrying about this rule than it's actually been in effect, and I have to say that from a trend standpoint, it did not seem to me to be a big deal this year, except in a couple of administrative respects, which we'll talk about shortly. It seemed to me that companies have perfected the methodology that they're using for identifying the median employee if in fact they are going through the process of reidentifying a median employee for the year. I didn't see any real significant questions come up during the course of the proxy season similar to what we had in year two. I guess the thing that probably surprised me the most was the large number of companies that could use the same median employee, from all intents and purposes, but decided to reidentify a median employee anyhow. Almost as if they've decided that each year they're going to go through that exercise again.

I don't know about you Amy and Dave, but I was surprised by that. I would've thought that because it's much simpler, if you haven't had a significant change in your employee population or your employee compensation arrangements, to just use the same individual that you used before, assuming that individual is still with the company and their circumstances haven't changed. I still don't understand why it's split almost 50/50 between the companies that reidentify and the companies that don't. I don't know if either of you have any thoughts as to what could be prompting that?

Amy Wood: I saw the same thing and I also was surprised and I, you know, have theories in terms of what's prompting that. Maybe it's not necessarily black and white in terms of what exactly it means if you have a change in your employee population or compensation arrangements. Maybe there was just a little analysis fatigue and we kind of had been through the process of knowing how to determine the median, and let's just repeat that instead of think about something new. But I don't think it needs to be as difficult to think through that analysis to use the same median, at least not this proxy season. Now that may be different looking forward given what 2020 has been, but I agree that when we look at 2019, to make that conclusion, it wasn't very different for many who chose to recalculate any way and that was surprising to me.

Dave Eaton: Yeah I definitely had the same experience- split amongst the clients. Some wanted to reidentify in situations where they didn't really need to and we would tell them that. Honestly, my hypothesis on it is that it's a little bit of a game. They know what their ratio was the last two years and they said "Wow what if we change the median employee? Can we get this number a little bit lower?" It seems like a large exercise to do that but I think that was a little bit of the thinking behind it, even though it was unnecessary and not required.

Mark Borges: Well that's probably a large part of it. Some of the other things that I noted in looking at the disclosures this year in terms of trends, did not see a significant increase in the number of companies that provided a description of their median employee, that is background information on the position or where that person might be located, to put it into some kind of context. I didn't see anything indicating that companies had made material changes to their methodology. And as you may recall under the rule, if you do make a material change to the methodology for identifying the median employee, you're supposed to describe that as part of your disclosure. Where companies use the same median employee, I thought it was fairly split between those who kind of restated that methodology. I think technically if you look under the rule it says you're supposed to describe the methodology that you use. I think where companies are using the same median employee, a few of them are doing that, but probably slightly more are basically either referring back to the original proxy statement where that methodology was set out or not dealing with it at all.

In terms of the compensation measure that was used, some version of cash compensation continues to be the majority approach that's used by most companies, particularly in smaller companies in the technology sector. They tend to use total direct compensation including equity awards, but that's probably because equity awards are a standard part of their compensation program. I'm still waiting to see my first company that used the data privacy exemption. It's been out there for three years now and takes up a lot of room in the rule, but I'm not aware of anybody that's actually made use of it. I think back to all of the energy that was spent explaining to the SEC why such an exemption was necessary and it's gone by the wayside.

Other things, supplemental pay ratios, I did see differences this year in supplemental pay ratios, but it was situational more than anything else. If a company had multiple CEOs, then obviously they might provide a supplemental pay ratio showing what the ratio would've been with the original CEO, or more than likely, taking out any special compensation that the new CEO received, who more typically was the one who was being compared against the median employee. I know we're going to talk a little bit about this in a few moments, but I saw a slight increase in contextual disclosure. Nothing approaching what the 2018 letter to the S&P 500 Index companies asking them for more background information on the pay ratio. I did not see that by any stretch and so in my estimation, this was sort of a routine year but as Amy has alluded to, it's probably the last routine year we're going to see for a while. You want to talk a little bit about the impact on Say on Pay and shareholder proposals, if at all, that you noticed with the ratio?

Amy Wood: Yeah, and I will talk a very little bit about impact on Say on Pay because I think there just hasn't been an impact on Say on Pay. I think there was nervousness about once, you know, pay ratios out there will, proxy advisory firms and institutional investors, find a way to incorporate this into their analysis and it will influence Say on Pay in a way that doesn't make as much sense. But they haven't, so the proxy advisory firms continue to note the pay ratios in their reports but they don't factor it into the Say on Pay recommendations and we're not seeing an impact. We can run statistics to try to find one but we're not seeing an impact. Shareholders aren't asking about it during engagement. So I would just say there still isn't one. Dave, do you want to talk about any shareholder proposal activity?

Dave Eaton: Yeah, sure. You know, I think yeah, we've definitely seen exactly what you're talking about in terms of no real correlation to Say on Pay. Maybe there's a broader question. What are the investors using the pay ratio for or really, I think there is an answer at least in my opinion, which is to add some level of scrutiny. Or at least identify filter companies that maybe want to scrutinize their pay practices a little bit. It's not so much about the pay ratio but maybe that indicative of some other items going on in the pay program, whether that's a **p for p (09:47)** disconnect or whether the goals are not being set at a rigorous level. Or even if they're appropriate. Things like that. Just diving in a little deeper on certain companies and you know, the way to kind of see that in some manner is through shareholder proposals and what kind of focuses around these pay ratios.

You know, there's maybe two buckets. One is you know, pay disparity between the CEO and other employees. So there's just not many proposals out there, shareholder proposals. There was about three I think in the Russell 3 this year. And you know, that's very different than pre CEO pay ratio disclosure requirements. So 2010 I think was about like two-dozen that had some ask around CEO to median employee or lowest employee worded differently at different times. But the other bucket now, which is becoming more interesting is the shareholder proposals around pay equity and not pay equity, CEO to median employee, but around gender or race or ethnicity within an organization. Shareholders are taking those issues and I think pivoting almost away from the CEO pay ratio towards that. We saw 15 shareholder proposals around that in

2019. We saw about the same number in 2020 and I think that's a very interesting development and a very interesting ask for a lot of companies.

Mark Borges: Have either of you seen much in terms of pay equity studies or an impetus on the part of companies to get engaged in that sort of coming out of pay ratio or was that perhaps something that was of its own accord evolving, anyhow, kind of concurrently?

Dave Eaton: I'll start and you know, whether there's a correlation is really the question. Because right now, the companies that seem to be receiving the shareholder proposals particularly around the pay equity calculations, they tend to be the big name companies. You know all these companies by name. They're spread across financials, tech, and some pharmaceuticals. A lot of those companies have fairly high CEO pay ratios by the nature of their businesses and structures. So whether there's a correlation that is high CEO pay ratios are the companies that are getting the majority of the focus for pay equity requests, it's hard to say right now, but it's something to keep an eye on.

Amy Wood: Yeah and I think probably the emphasis on pay equity would've started independently and is here independently of the pay ratio issue and disclosure. But I will say that often times I see when a pay ratio is being presented to a board or a comp committee and in a description of the work that went into it, some questions being asked that then veer more into more of a pay equity discussion, and it may be that that's what leads to a pay audit that's separate entirely from the pay ratio disclosure, but an equal pay audit that is really intended to look at whether gender or ethnicity or racial pay gaps exist that can't properly be supported by differences in experience, roles, responsibilities, or individual performance. So as a completely separate thing that type of equal pay audit sometimes stems from the discussion presenting the pay ratio to the comp committee. Usually though, that's happening independently and the company is driving that simultaneously in my experience. But I think that analysis, the equal pay audit, now we're getting into looking at the relationship between pay and the variables that are assumed to influence pay and really looking at how those decisions are made and whether the company has objective policies in place to make those compensation decisions, how much discretion is involved. And this is at a level below the level that the comp committee is usually involved in determining comp and making these type of decisions. But now is very involved in most cases and from a human capital management oversight perspective, so that's potentially one link for these two things to be discussed together.

Mark Borges: Well if this were a normal year, I think we'd probably end the discussion right about now by saying things have sort of settled down, we have a routine, companies are following it, everyone seems to have mastered compliance with the identification of the median employee, they're satisfied with the quality of their disclosure, the location in the proxy statement, and it's just one more pay item that now gets added to the checklist. But of course, 2020 isn't a normal year for a couple of reasons. It wouldn't have been a normal year absent the pandemic because it's year four, which means that you can no longer use the same median employee that you've used the last three years as your median employee, unless it just happens to be that that person just continues to be the median employee. But you've got to go through the exercise of reidentifying a median employee. Any thoughts about that, Amy, in terms of what companies are going to need to do?

Amy Wood: Yeah, and for some companies, this is year four, but for other companies, either for any number of reasons maybe it's not year four, including it's one of those companies you spoke about at the beginning, Mark, who identified a new median this year because they chose to. So we've been alluding to this the whole time just to make sure that it's clear for everybody. We're talking about the requirement that you identify the median once every three years unless you're required to do it more often if you reasonably believe that changes in your employee population or your employee compensation arrangements would reasonable result in a significant change in your pay ratio disclosure. So that's the test that we were talking about of some companies skipping over in this 2020 proxy season and we were surprised to see that. But I think it's a lot more interesting when you look at 2020 and the pandemic-related changes that many companies have experienced where there probably have been changes in employee populations or compensation arrangements that could trigger the need to reidentify a median employee, even if you're not otherwise in year four. So we're looking at things like furloughs, layoffs, cash conservation strategies, and all of the other things that we've been dealing with this year from a compensation company-wide perspective.

I think for companies that are in that scenario and we are determining a new median employee for 2020 either because it's year four or because we did that analysis and we need to even though it's not year four. Things to keep in mind are just considering choosing somebody whose pay is likely to be representative in 2020 but also look ahead to 2021. So if in 2020 there's still something somewhat temporary in place and you anticipate making some changes in '21, think about that and any future actions that are likely to occur so that you maximize the chance to use that three-year rule going forward. That might mean that you're choosing an employee whose pay did change significantly this year and it's expected to change again next year. That tracks the employee population as opposed to someone who's steadier year-to-year, which would've been the prior thinking before we went into this more volatile year.

Mark Borges: Yeah, one kind of side note that I want to make sure that I mention, because I encountered it a couple of times this year. We have so far focused on the change in the median employee. What I didn't appreciate until we began working with clients this year, is that the people charged with making this determination and doing the disclosure or the calculation, may themselves have changed, and you may be working with a whole different crew of people who aren't familiar with the methodology that has been used in the past, and are in fact, asking you "How do we do this because we don't have any records indicating how we found our median employee the first year." So it's one thing to keep in mind if there has been a turnover in personnel or there's been a change in location of the responsibilities for this particular disclosure, that you begin looking now to make sure that you have a record of the methodology that you used previously so that you can go through the process of using that methodology again if this is year four for you, or if you have for one of the other reasons you've sighted, the need to reidentify the median employee. I sort of thought this was something that would be burned into our minds and we would never forget, but obviously that's not the case, and one of the things that I struggle with sometimes with working with clients, particularly when we're reconstructing the methodology, is making sure that it's consistent with the methodology that we've used before so that we don't run into a disclosure issue and that we're not doing something significant that's different in terms of identifying the median employee from the approach that we used in prior years. Were you going to say something?

Amy Wood: The only other thing I would add on that in sort of discussing the difference from the prior years, one specific requirement along those lines is if you choose a different determination date than you've used in the past, you need to say that and you need to provide a brief explanation of the reason that you did that. That's something for companies that were reidentifying median employees within that first three-year period, we tended to want to avoid, and I think this is a different year. It might make sense to change it for good reason that we end up disclosing. So if we made some pandemic-related changes this year and there's some more to do by the end of the year, that might mean bringing employees back, that might mean letting employees go. Be thoughtful about choosing that date again with the idea being that if we can get that date right in a way that will tee us up to then be able to use that same median for the next couple years. That could be an advantage.

Mark Borges: Yeah that's a good point. There are three things that I think that have arisen as a result of the pandemic which are going to potentially complicate the calculation of your disclosure this year. One of them is if you've laid people off and your employee population is different than it was in the past, and that impacts the determination date that you use. That's something to be thinking about right now depending upon how your company has handled its dealings with its employees and whether it's brought some of those people back, whether those people have been laid off permanently, whether the size of your organization is now significantly different than it was a year ago. I think in the past we focused mostly on growth or change in size because of acquisitions and dispositions, but I think this year, simply the change in population because of furloughs and layoffs could have a significant impact on the determination of the median employee.

The other thing to keep in mind, too, is how to characterize your furloughed employees. I remembered that there was a C and DI that talked about furloughed employees. I went back and read it and found out that it doesn't tell you how to determine whether someone is a furloughed employee or not. That that's a characterization that is determined on a company-by-company basis. So if you've got employees who have been furloughed, which I take to mean that they're not working on a temporary-basis, but they're still employees, perhaps for healthcare reasons, you need to be thinking about how you're going to handle those employees, both from the standpoint of what their status is as well as the determination of their compensation.

I wrote on my blog a few weeks ago about Darden Industries, which was a restaurant company that furloughed 80% of its employees for a significant period of time, but then treated all of those individuals as employees, using the compensation that it paid them during the period that they were on furlough as part of their compensation for the year. So that is going to be an issue that I think companies are going to have to look at. I think when we go back and look at our employee population this year, you're going to have to be looking at the different classifications of the individuals that you have identified as employees, you're going to have to be looking and making determinations about their pay, and that may make it difficult to use the same consistently applied compensation measure that you've used in the past, depending upon what your facts and circumstances are. So those are two things that I think are going to complicate the process a little bit beyond what we would've normally expected for this and that's something that you could probably start thinking about now, because I don't think you want to wait until after the beginning of the year to begin looking at something that could be a fairly complex issue.

Liz Dunshee: Good point Mark and unless anyone has anything else to add, I will let you end there. So seeing nobody jumping in, I will say thank you to Mark, Amy, and Dave. Mark, it's funny that you mentioned that issue about employee turnover amongst the people who are making the calculations, because I distinctly remember you making that same point a few years ago when pay ratio first came into effect and suggesting that people keep very good records about how you're making the calculation, and I guess everybody should've listened to you and should continue to listen to you on that.

Mark Borges: So start looking through your files for that record because hopefully it's there somewhere.

Liz Dunshee: Right, exactly. I do also want to plug- I know you guys touched on pay equity and shareholder proposals and things like that, and I do want to plug a webcast that we're having on CompensationStandards.com on November 19th about pay equity and what compensation committees need to know about that. So tune in to that for more detailed information on that topic. One other housekeeping note is for the CLE codes for these sessions, you do need to enter your name in the chat box to the right of the viewer in order to see those codes. Then you can either click on the link above the viewer or copy and paste the link in that announcement into a different tab, in order to enter the code. The code for this session was turtle if you didn't get a chance to enter that. So you can go to that link about now and enter that. We now have a break until 1:45 P.M. Eastern Time and then you can join us back here for the How to Handle

Negative Proxy Advisor Recommendations Panel. Just go to the agenda and click into that session, and I will see you all then. Thanks.

Mark Borges: Thank you.

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