EXECUTIVE REMUNERATION PERSPECTIVE

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PAY RATIO: CEO-TO-WORKER PAY RATIO INITIATIVES GO GLOBAL

Pay ratio rules addressing the relationship between CEO pay and the pay of other employees are gaining traction around the world. Most rules are pending and would require only disclosure. But some proposals would cap CEO or other executive pay at a fixed multiple of employee pay. One, which failed to win approval in a US state (California), would have linked a company's tax rate to its pay ratio. This article summarizes currently available pay ratio statistics; disclosure rules in the US, UK, and other European Union (EU) countries; and other types of pay ratio initiatives in Switzerland, France, and some US states.

IN THIS ISSUE, ANSWERS TO:

What is behind the interest in CEO/worker pay ratios?

How have different countries addressed pay ratio disclosures?

What are the potential consequences of pay ratio disclosure?

How should companies communicate pay ratios to various stakeholders?

Will pay ratio disclosure have an impact on executive pay levels?

PAY RATIO STATISTICS

Recent media coverage of pay ratios has drawn more attention to CEO pay, potentially increasing pressure on companies to reduce it. These news reports often quote 20th-century political economist Peter Drucker, who recommended that companies adopt a policy limiting the maximum compensation of all corporate executives as a multiple of the income of the lowest-paid regular full-time employee. He stated, "The exact ratio is less important than that there should be such a ratio." His suggestions, which ranged from 15:1 to 25:1, depending on the size of the company, are significantly lower than those currently cited in the media.

Examples of pay ratio statistics mentioned in recent news reports include the following:

- A 2013 Bloomberg study of S&P 500 companies found that the average ratio of CEO compensation to that of rank-and-file workers was 204:1, up 20% since 2009. The study compared each company's CEO pay for the fiscal year ending in 2011 or 2012, as disclosed in Securities and Exchange Commission (SEC) filings, to US government data on worker compensation by industry.
- The American Federation of Labor–Congress of Industrial Organizations (AFL-CIO) Executive Paywatch website allows individuals to compare their own pay to the pay of specific company CEOs. According to the website, the 2013 CEO-to-US-average-worker pay ratio was 331:1 and the CEO-to-US-minimum-wage-worker pay ratio was 774:1.
- The UK's High Pay Centre, "established to monitor pay at the top of the income distribution," issued a report stating that FTSE 100 CEOs are now paid 130 times more than the average worker, up from 47 times in 1998.

"STATISTICS IN MEDIA REPORTS DON'T REFLECT ACTUAL PAY RATIOS OF CEOS AND THEIR COMPANIES' EMPLOYEES … STATISTICS THAT COMPARE CEO PAY TO THAT OF WORKERS IN THE SAME COMPANY MAY TELL A DIFFERENT STORY"

It is important to note that, for the most part, statistics in media reports don't reflect actual pay ratios of CEOs and their companies' employees; instead, the numbers typically compare individual CEO pay to employee pay for industries or even entire countries. The discrepancy is due to a lack of data. Although many jurisdictions require public companies to disclose CEO compensation, companies rarely disclose the median, average, or lowest pay level of their entire employee group.

Statistics that compare CEO pay to that of workers in the same company may tell a different story. A 2014 study of US commercial banks calculated ratios for individual companies, comparing each bank's CEO pay with average employee pay at the same bank. The study found ratios to be much lower — averaging about 17:1 — than those cited in the media for all industries. Although financial services industry pay ratios tend to be lower because these companies are less likely to have large numbers of lower paid workers, how much lower can't be confirmed because there is no comparable, reliable data for other industries. However, pending rules in the US and proposals in other countries will deliver additional data and increase scrutiny of these pay differentials.

LABOR UNIONS LEAD THE CHARGE

The most vocal proponents of pay ratio initiatives have been labor unions and certain investors.

AFL-CIO, Investors in the US

The AFL-CIO lobbied for pay ratio disclosure in the US, arguing that high pay disparities can hurt morale, reduce productivity, and lead to increased turnover, all of which can depress shareholder returns.

Also, shareholder proposals to cap CEO pay at a multiple — usually 99 or 100 times — of the median or average employee compensation are on the rise. Most proposals have come from Qube Investment Management and union-owned Amalgamated Bank's LongView Large Cap 500 Index Fund. To date, none has come to a vote — either the SEC has permitted targeted companies to exclude them through its no-action letter process (for example, because they relate to "ordinary business" operations) or the proposals have been withdrawn.

20:1 in the UK

Some organizations in the UK have proposed a target pay ratio of 20:1. The Trade Union Congress (TUC) and its two largest affiliated unions, Unite and UNISON, launched the Trade Union Share Owners Group to address the unions' concerns about the gap between executive remuneration and average employee pay. TUC released the Trade Union Voting and Engagement Guidelines, which set an "aspirational" goal of a 20:1 maximum pay ratio. Currently, the guidelines apply only to funds held by TUC, Unite, and UNISON, but the trade unions may be successful in securing support from other institutional investors.

After the TUC guidelines' release, UK shareholder advisory firm Pension & Investment Research Consultants (PIRC) published new shareholder voting guidelines. These guidelines contain three new assessment measures, one of which is aligning fixed CEO pay against a 20:1 ratio with average employee remuneration.

Proxy Advisors Quiet So Far

Other than PIRC, proxy advisory firms, including Institutional Shareholder Services and Glass Lewis & Co., have yet to adopt a policy with respect to pay ratios.

DISCLOSURE REGULATIONS

The US, UK, and EU take different approaches to the disclosure of executive-employee pay relationships.

US

A proposed SEC rule, expected to be finalized this year and effective for the 2016 proxy season, would implement the Dodd-Frank Act's mandate that companies disclose the following:

- CEO's annual total compensation.
- Median employee's annual total compensation.
- The ratio of the CEO's annual total compensation to the annual total compensation of the median-paid employee.

"EXECUTIVE PAY RULES THAT CAME INTO EFFECT IN 2013 [IN THE UK] REQUIRE CERTAIN DISCLOSURES ABOUT THE RELATIONSHIP BETWEEN EXECUTIVE AND EMPLOYEE PAY."

The proposal generated thousands of comment letters, including one from Mercer, observing that few companies currently track employee compensation this way and that compiling the data will be expensive and time-consuming — especially for companies operating multiple payroll systems in different currencies — and could result in misleading disclosure.

This disclosure requirement is separate from the Dodd-Frank say-on-pay mandates already in effect, which give shareholders an advisory vote on a company's executive pay program, But the ratio could become a factor in future say-on-pay votes.

UK

Executive pay rules that came into effect in 2013 require certain disclosures about the relationship between executive and employee pay, including that remuneration reports must present a pay policy subject to a binding shareholder vote at least every three years. Although the report doesn't go as far as requiring disclosure of executive-employee pay ratios, companies must disclose the following two percentages for salary and fee payments, taxable benefits, and certain incentive payments:

- The percentage change in CEO payments from the prior financial year.
- The average percentage change in payments for all of the company's employees from the prior financial year (unless the company considers a smaller group to be a more appropriate comparator).

The regulations have already generated controversy. The High Pay Centre issued a briefing criticizing the regulations and suggesting that companies are already violating the disclosure requirement or exploiting loopholes. The briefing noted:

- The CEO/worker pay change comparison does not include long-term incentives (the largest element of CEO pay) and refers only to pay increases rather than absolute pay differences.
- Many companies do not use their whole workforce for the comparison, deeming a smaller group more appropriate, with some excluding the majority of their workers.
- A ratio between the CEO's and the lowest-paid worker's pay would be more appropriate.

EU

A proposed EU Shareholder Directive for binding say on pay would require companies' remuneration policies to explain:

- How employees' pay and employment conditions factored into the remuneration policy, including a discussion of the ratio between the average pay of executives and other full-time employees.
- Why this ratio is considered appropriate.

In "exceptional circumstances," the policy could exclude a ratio, but companies would have to explain its absence and what equivalent measures were taken. To take effect, the proposal must be adopted by the European Council and the European Parliament and implemented by all 28 EU member states.

PAY CAPS, TAXES, AND CONTRACTS

Groups in some regions are pushing for more than disclosure. But the fate of initiatives to put more teeth into pay ratios is more tenuous. For example, Swiss voters rejected a mandatory pay ratio cap.

Switzerland

A proposal to limit executive salaries to 12 times that of a company's lowest-paid employee, which initially struck a chord with the populace, was rejected in a national referendum by a near 2:1 margin. Parliament and the Federal Council had earlier opposed the referendum, warning that the restrictions would make the Swiss private sector less competitive. Switzerland already has taken a strong stance on executive pay by requiring a binding vote for shareholders on pay for top management and directors and banning sign-on and termination bonuses.

"GROUPS IN SOME REGIONS ARE PUSHING FOR MORE THAN DISCLOSURE. BUT THE FATE OF INITIATIVES TO PUT MORE TEETH INTO PAY RATIOS IS MORE TENUOUS."

France

A new French law imposes a maximum ratio of 5:1 between the largest and smallest awards of qualified free shares that may be granted to employees. Free shares are essentially restricted stock units that meet certain requirements and receive favorable tax treatment.

US states

A few US states have proposed pay ratio legislation that would go beyond disclosure. Examples include:

- The California Senate voted down a bill that would have tied the state corporate tax rate for public companies doing business in California to the ratio between the pay of its most highly compensated executive and the pay of its median US employee.
- In Massachusetts, proposed legislation (which failed to reach the ballot because of inadequate support) would have required hospitals that accept state government funds to limit CEO compensation to 100 times the compensation of the lowest paid full-time employee who earns at least minimum wage.
- The Rhode Island Senate approved a bill that would give a preference in state contracts to companies whose CEOs do not make more than 32 times the salary of their lowest-paid employee.

Although these initiatives have had limited success, they do indicate an interest in addressing pay inequality at the state level.

POTENTIAL CONSEQUENCES

Although pay ratio disclosure is — or is almost — a "done deal" in some jurisdictions, efforts to use pay ratio disclosure to reduce executive pay may not be successful and could have unexpected consequences.

What Does a Pay Ratio Signify?

Once disclosed, how will pay ratios be interpreted? For example, is a low ratio necessarily desirable? It could mean a company has outsourced jobs to workers who are no longer on the company's payroll, which may not be viewed favorably, particularly by labor unions.

In some cases, the ratio may simply reflect typical compensation levels and structures in a given industry. For example, as discussed earlier, financial services companies, which employ highly paid workers, are likely to have lower ratios than large retail companies, which have many lower-paid hourly workers.

How and to Whom Should the Pay Ratio Be Communicated?

Pay ratio disclosures raise communication issues with shareholders, proxy advisors, the media, board members, and employees, so companies will have to address these varied audiences and their potential concerns.

- Shareholders and proxy advisors. Although it is not clear how shareholders, labor unions, and proxy advisors will use pay ratio data, ratios that are high relative to industry peers or are volatile year over year may wave a red flag and become fodder for ongoing dialogue between companies and these stakeholders.

- The media. The media has targeted pay inequity, and pay ratio figures are frequently cited to demonstrate the disparity between highly paid and lower-paid workers. Companies will need to manage their message to avoid appearing on the front page of local or national papers.

- Board members. Board members should be educated about existing or pending disclosures so they are not blindsided by either the pay ratio numbers or the disclosure requirements.

- Employees. According to recent surveys, workers vastly underestimate the current gap between executive and worker pay. One US survey found that workers estimate the gap between CEO and unskilled worker pay to be 30 to 1 but the survey estimated the actual gap at 350 to 1. Once US pay ratio data are required to be disclosed in proxy statements (most likely in 2016), workers will realize the true extent of the gap and half will discover their pay is below that of the median employee at their company. Without effective communication, this could lead to a decrease in morale and job satisfaction for many workers.

Will Disclosure Lower Executive Pay?

Disclosure of pay ratios alone may not affect executive pay levels. In fact, experience in the US with attempts to encourage pay reductions through legislation and regulation may have contributed to increases in executive pay levels. For example, US Tax Code Sections 162(m) (the million-dollar cap on deductible pay) and 280G (the golden parachute tax rules) have been blamed for making $1 million salaries and three-times-pay-severance multiples the norm. And proxy table summary compensation disclosures have been blamed for contributing to the escalation of executive pay through benchmarking.

Short of reining in executive pay, policy implications of pay ratio disclosures may include:

- Raising questions about the fairness of individual employees' pay relative to their company's median or average pay — not relative to executives, whose pay has already been disclosed in most jurisdictions.
- Fueling efforts to increase the minimum wage.
- Leading to campaigns for capping pay or penalizing companies with high pay inequity.
- Encouraging companies to adopt or enhance broad-based profit sharing plans.

"DISCLOSURE OF PAY RATIOS ALONE MAY NOT AFFECT EXECUTIVE PAY LEVELS."

Also, requiring companies to compile the data may:

- Provide more reliable information that may reduce speculation about actual ratios.
- Encourage companies to consolidate decentralized payroll/human resource information systems to more easily collect and analyze pay disparity data.
- Provide useful information about competitors' payroll structures, or the reverse — disclose information that might cause competitive harm.
- Present an additional approach to typical benchmarking for setting executive pay levels.

CONCLUSION

Heightened concerns about growing income inequality across the globe have led to closer scrutiny of the relationship between executive and employee pay. Pay ratio disclosures and limits are still in their early stages and limited in geographic scope. However, like the say-on-pay movement, they may take off in other countries and become the norm so companies should be prepared to communicate proactively with the various stakeholders that might be affected by these requirements.

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