Pay Ratio Compliance Is Around the Corner: Are You Ready?

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Agenda

• How Did We Get Here?
• CEO Pay Ratio
  - Overview
  - Where to Begin?
  - Key Decision Points
  - Next Steps
  - Tips & Pointers
How Did We Get Here?

• Mortgage crisis / record number of home foreclosures
• Collapse of Wall Street banks
• Main Street vs. Wall Street
• Resulted in
  - Say on Pay era
  - Dodd-Frank Wall Street Reform and Consumer Protection Act
    - 16 major areas of reform
    - Compensation-focused items
      - Say on Pay / Say on Frequency
      - CEO Pay Ratio
      - Clawbacks
      - Pay for performance disclosure
      - Hedging policy
CEO Pay Ratio - An Overview

• Disclosure rules finalized in August 2015
• Requires companies to disclose ratio of CEO pay to that of “median employee”
  - Effective for fiscal years beginning on or after 1/1/17
    - Reported in 2018 proxy statement
  - Companies are required to describe the methodology used to identify the median employee, and any assumptions, adjustments, or estimates used to identify the median employee or to determine annual total compensation of that median employee
• Implementation cost estimates are significant
  - Aggregate initial costs over $1B
  - Additional annual compliance costs over $500M
• Additional SEC guidance released in October 2016 and September 2017
CEO Pay Ratio - Where to Begin?

• Create multi-disciplinary project team including members from HR, Legal, HRIS, Payroll, Finance, Investor Relations

• Develop data collection strategy
  - Identify issues and collaborate on potential fixes

• Assess employee population and demographics
  - Domestic, international, full-time, part-time, seasonal, temporary, independent contractors

• Consider compensation programs and participation rates
  - What percentage of employees are bonus eligible?
  - Is equity widely used throughout organization?
CEO Pay Ratio - Key Decision Points

How Do I Identify the Median Employee?

- **Determination Date** to select median employee
  - Companies may select a date within the last three months of its fiscal year to determine the employee population for purposes of identifying the median employee
  - You do not need to count any individual who is not employed on that date
    - Of particular importance for companies that employ temporary or seasonal workers
  - A company may exclude any employees obtained through M&A for the fiscal year in which the transaction becomes effective
  - Once selected, you can keep the same median employee for three years
    - Unless there is a change in employee population or compensation arrangements that would result in a significant change to the pay ratio
CEO Pay Ratio - Key Decision Points

• Survey results: Determination Date

Source: CompensationStandards.com - September Survey
CEO Pay Ratio - Key Decision Points

How Do I Identify the Median Employee?

• Consistently Applied Compensation Measure (CACM)
  - SEC recognized that calculating total compensation for all employees may be difficult and/or cost prohibitive
  - CACM is any compensation measure that reasonably reflects the annual compensation of all employees
    - Examples include base salary, total cash compensation, W-2 earnings
  - Allows flexibility to utilize most appropriate measure for each company’s particular facts and circumstances
  - Companies may not exclusively use hourly pay rates as a CACM to determine the median employee
  - Company does not have to apply the CACM in the specific time period that includes the determination date
CEO Pay Ratio - Key Decision Points

How Do I Identify the Median Employee?

- CACM answers can vary

<table>
<thead>
<tr>
<th>Employee</th>
<th>Salary Only</th>
<th>Total Cash</th>
<th>W-2 Earnings</th>
</tr>
</thead>
<tbody>
<tr>
<td>1</td>
<td>$200,000</td>
<td>$250,000</td>
<td>$400,000</td>
</tr>
<tr>
<td>2</td>
<td>$150,000</td>
<td>$175,000</td>
<td>$250,000</td>
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<tr>
<td>3</td>
<td>$125,000</td>
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<tr>
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<td>$80,000</td>
<td>$125,000</td>
<td>$190,000</td>
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<tr>
<td>7</td>
<td>$75,000</td>
<td>$100,000</td>
<td>$110,000</td>
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<tr>
<td>8</td>
<td>$60,000</td>
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</tr>
<tr>
<td>9</td>
<td>$50,000</td>
<td>$65,000</td>
<td>$75,000</td>
</tr>
</tbody>
</table>

- Important to evaluate potential median employee under various CACM scenarios
CEO Pay Ratio - Key Decision Points

- Survey results: Consistently Applied Compensation Measure (CACM)

Source: CompensationStandards.com - September Survey
CEO Pay Ratio - Key Decision Points

Can I Annualize Compensation?

- Yes, companies are permitted to annualize the total compensation for a permanent employee (full-time/part-time) who did not work for the entire year, such as a new hire
  - However, companies are not permitted to make full-time equivalent adjustments for part-time employees
- Companies can’t annualize compensation for temporary or seasonal workers
CEO Pay Ratio - Key Decision Points

Can Compensation Be Adjusted to Reflect Cost of Living Differences?

• Yes, companies can apply a cost-of-living adjustment to the compensation measure used to identify the median employee
  - If a company applies this adjustment, it is required to use the same adjustment in calculating the median employee’s annual total compensation
  - Companies using this adjustment will also need to disclose a separate, unadjusted ratio in which the median employee is selected and CEO pay ratio is calculated using unadjusted data
Can I Exclude International Employees?

- Yes, if non-U.S. employees make up 5% or less of total employee population
  - If a company excludes any non-U.S. employee in a particular country, it must exclude all employees in that country
  - The number of employees excluded and the jurisdictions in which they are employed must be disclosed

- Yes, if non-U.S. employees are employed in a jurisdiction with data privacy laws that make the company unable to comply with the rule
  - Company must first seek an exemption from the applicable data privacy regulations
    - Required to obtain a legal opinion from counsel on the inability of the company to obtain or process the information necessary for compliance with the rule without violating the jurisdiction’s laws or regulations governing data privacy
  - Companies must list excluded jurisdictions, identify the specific data privacy law or regulation which prevents compliance, explain how complying with the pay ratio violates these laws and the approximate number of employees exempted
CEO Pay Ratio - Key Decision Points

Statistical Sampling: What is It?

• Sampling is a technique in which only some of the population is studied to estimate characteristics of the entire population

• SEC guidance references a number of sampling methods that could be appropriate to use (alone or in combination), but companies are not limited to these specific sampling techniques
  - Simple random sampling – Drawing at random a certain number or proportion of employees from the entire employee population
  - Stratified sampling – Dividing the employee population into strata, e.g., based on location, business unit, type of employee or functional role and sampling within each strata
  - Cluster sampling – Dividing the employee population into clusters based on some criterion, drawing a subset of clusters, and sampling observations within appropriately selected clusters;
  - Systematic sampling – Sample is drawn according to a random starting point and a fixed sampling interval, every nth employee is drawn from a listing of employees sorted on the basis of some criterion
CEO Pay Ratio - Next Steps

I Have Identified the Median Employee, Now What?

• Calculate the annual total compensation of the median employee in accordance with the total compensation calculation used for named executive officers in the proxy Summary Compensation Table

<table>
<thead>
<tr>
<th></th>
<th>Salary</th>
<th>Bonus</th>
<th>Stock Awards</th>
<th>Option Awards</th>
<th>Non-Equity Incentive Plan Compensation</th>
<th>Nonqualified Deferred Compensation Earnings</th>
<th>All Other Compensation</th>
<th>Total</th>
</tr>
</thead>
<tbody>
<tr>
<td>CEO</td>
<td>$1,000,000</td>
<td>$0</td>
<td>$3,000,000</td>
<td>$2,000,000</td>
<td>$1,000,000</td>
<td>$0</td>
<td>$100,000</td>
<td>$7,100,000</td>
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<td>Median Employee</td>
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<td>$20,000</td>
<td>$0</td>
<td>$0</td>
<td>$0</td>
<td>$15,000</td>
<td>$130,000</td>
</tr>
</tbody>
</table>

CEO Pay Ratio Calculation:

\[
\frac{\text{CEO Total Compensation}}{\text{Median Employee Total Compensation}} = 55
\]

\[
\frac{7,100,000}{130,000} = 55
\]
CEO Pay Ratio - Next Steps

I Have Estimated the Pay Ratio, What Else Do I Need to Think About?

• Socialize estimates with senior management, Board of Directors/Compensation Committee

• Provide a road map for future calculations
  - Document methodology, estimates, adjustments

• Develop internal and external talking points
  - Consider potential reactions and considerations of employees, shareholders, media, labor unions

• Draft required disclosures
  - Remember to disclose that the pay ratio is a reasonable estimate calculated in a manner that is consistent with the regulations
CEO Pay Ratio - Tips & Pointers

- Use the KISS rule: Keep It Simple
  - Don’t overcomplicate things
- Pay attention to your company’s facts and circumstances
- Make sure all decisions and processes are documented, reasonable and defensible
- Selecting a CACM
  - Cash is king
  - Try several different approaches
- Non-U.S. Workers
  - Weigh benefits of exclusions vs. required additional disclosure
- Independent Contractors
  - Are they employees?
  - W-2 vs. 1099s
CEO Pay Ratio: Tips & Pointers

• Statistical sampling
  - Is it worth it? Are many companies using it?

• Value of personal benefits can be included (up to $10,000)
  - Anything added to median employee must be added for CEO as well

• Cost of living adjustments can be made
  - May not be attractive since you need to disclose unadjusted ratio as well

• Managing fallout & unintended consequences
  - External vs. Internal

• Disclosure
  - Don’t go overboard in the narrative