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Meridian Client Update

SEC Staff Issues Analysis on Proposed Pay Ratio Disclosure Rule

On June 4, 2015, the Securities and Exchange Commission ("SEC") staff released a report that analyzed the potential effects of excluding different percentages of employees on the CEO pay ratio calculation.

Under the SEC's proposed pay ratio disclosure rule, a company would be required to disclose the ratio of the CEO's compensation to the median employee compensation. In calculating the median employee compensation, a company **must** consider **all** employees including non-U.S., part-time, temporary and seasonal employees (refer to Meridian's Client Update dated September 25, 2013 for more information on the SEC's proposed pay ratio disclosure rule). Many commenters on the proposed rule have recommended that certain groups of employees be excluded from the determination of the median employee compensation (e.g., see Meridian's comment letter to the SEC, dated December 2, 2013. "We recommend that the Commission define Covered Employees to solely mean those individuals who are ***full-time*** permanent employees of the registrant or any of its subsidiaries on the last day of the registrant's fiscal year (other than the CEO).")

To assist the SEC in developing final rules regarding the CEO pay ratio disclosure, the SEC staff of the Division of Economic Risk Analysis ("Staff") issued a report showing the projected effect of excluding up to 20% of employees from the calculation of the CEO pay ratio **("Report")**. The Report did not consider the impact of excluding specific categories of employees due to the Staff's acknowledged lack of comprehensive data on the distribution of employee compensation within categories.

The Staff found that the impact of excluding certain employees from the CEO pay ratio calculation will vary in magnitude depending on (1) whether the excluded employees are paid above or below the median for the overall distribution of employee compensation, (2) the percentage of employees excluded from the determination of the median employee compensation and (3) the dispersion of pay around the mean pay level. Based on the indicated percentage of excluded employees, the following summary of the Staff's findings shows the projected range in the percentage increase/decrease in the CEO pay ratio based on relatively low to relatively high dispersion of pay around the mean with relatively high dispersions resulting in larger increases/decreases:

Percentage of Employees Excluded	All Excluded Employees Paid Below Median (Projected Range in % Decrease in CEO Pay Ratio)	All Excluded Employees Paid Above Median (Projected Range in % Increase in CEO Pay Ratio)
5%	-1.6% to -3.4%	1.6% to 3.5%
10%	-3.1% to -6.7%	3.2% to 7.2%
15%	-4.6% to -9.9%	4.8% to 11.0%
20%	-6.1% to -13.0%	6.5% to 15.0%

The foregoing projections are not based on actual employee pay data derived from affected companies. Rather, the Staff based these projections on a statistical analysis that used aggregated statistics from published studies on distribution of pay (e.g., pay data derived from the U.S. Bureau of Economic Analysis) and other assumptions. As a result, the SEC Staff notes that its projections ***"may result in over- or underestimating the magnitude of the effect [of excluding employees]."***

Meridian comment. The Staff's analysis raises a number of interesting points. First and foremost, the analysis indicates the SEC's potential receptivity to excluding categories of employees from the calculation of the CEO pay ratio, at least up to 20% of the total worldwide workforce. Based on the Staff Report, if the SEC concludes that the exclusion of a category of employees would not have a material effect on the calculation of the CEO pay ratio, presumably the SEC would be inclined to allow for such exclusion in the final rule.

For example, if the SEC pegs a change of more than 5% in the CEO pay ratio as material, the SEC could potentially allow companies to exclude nearly 10% of their workforce. However, even the exclusion of 20% of employees would result in relatively modest changes in the CEO pay ratio, at least in nominal terms. At the high end of the Staff's projections, an exclusion of 20% of employees whose pay is below the median would result in a decrease in the pay ratio by approximately 13%. That means a CEO pay ratio of 100 to 1 (prior to the exclusion) would change to 87 to 1. Similarly, an exclusion of 20% of employees whose pay is above the median would result in an increase in the pay ratio by approximately 15% (i.e., a CEO pay ratio of 100 to 1 (prior to the exclusion) would change to 115 to 1). Arguably, these ratios would still provide investors adequate insights into the relationship between CEO pay and median employee pay.

The other interesting point raised by the Staff Report is whether its issuance suggests that the SEC is nearing adoption of a final rule on the CEO pay ratio. One potential scenario is that the SEC may indeed be close to adopting a final rule, subject to its consideration of comments on the Staff's Report. This could potentially mean the SEC adopts a final rule before the close of this year. However, the SEC may also be awaiting completion of the Staff's cost-benefit analysis of the proposed rule. Such an analysis is critical to the SEC's final rulemaking on the CEO pay ratio disclosure in order to mitigate the potential of the final rule being struck down by a federal court (as was the case with the SEC's final rule on proxy access). Whether this analysis has been completed or is still in progress is unknown.

The SEC has requested that interested parties submit comments on the Staff Report no later than July 6, 2015.

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The ***Client Update*** is prepared by Meridian Compensation Partners' Technical Team led by Donald Kalfen. Questions regarding this Client Update or executive compensation technical issues may be directed to Donald Kalfen at 847-235-3605 or dkalfen@meridiancp.com.