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SEC Proposes Rules on Pay Ratio Disclosure

On September 18, 2013, the Securities and Exchange Commission (the "SEC") approved by a three-to-two vote proposed rules (the "Proposed Rules") implementing Section 953(b) of the Dodd-Frank Wall Street Reform and Consumer Protection Act (the "Dodd-Frank Act").[1] The Proposed Rules would amend Item 402 of Regulation S-K to require disclosure of (i) the median of the annual total compensation of all employees of the issuer (excluding the chief executive officer) (the "CEO"); (ii) the annual total compensation of the CEO (or equivalent position); and (iii) the ratio of the median disclosed to the annual total compensation of the CEO. The disclosure would be required in any annual report, proxy statement or registration statement that would otherwise require executive compensation disclosure under Item 402 of Regulation S-K.

Public comments on the Proposed Rules must be received within the 60-day period following the Proposed Rules' publication in the *Federal Register*. The new pay ratio disclosure would be required for a company's first full fiscal year commencing on or after the effective date of the final rules. Therefore, if the rules become effective during 2014, the disclosure will first be required for the fiscal year ending 2015. Emerging growth companies, smaller reporting companies and foreign private issuers would be exempt from the pay ratio disclosure requirements. This Client Alert summarizes the material features of the Proposed Rules and the key issues that public companies should begin to consider in preparation for compliance.

As evidenced by more than 22,000 comment letters received by the SEC with respect to Section 953(b) of the Dodd-Frank Act, the Proposed Rules have generated significant interest from stakeholders. Proponents contend that disclosure of the CEO pay ratio is material to investors as a metric to evaluate CEO compensation and that adding compensation ratio information to the total mix of executive compensation disclosure encourages companies to consider vertical pay equity within companies and not over-rely on peer-to-peer executive compensation metrics such as benchmarking. Opponents characterize the rules as nothing more than a "name and shame game" and question the utility of the ratio as a meaningful metric for investors to make informed investment or voting decisions. They also contend that the potential costs of compliance, particularly for large companies with global operations, could be significant. In its proposing release, the SEC conceded that, depending on how Section 953(b) is implemented, the cost of compliance could be "substantial" for some registrants. Therefore, the SEC has sought to propose a rule giving companies flexibility to comply in a cost-effective manner.

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1 The full text of the Proposed Rules can be found at: http://www.sec.gov/rules/proposed/2013/33-9452.pdf

Summary of the Proposed Rules

Section 953(b) of the Dodd-Frank Act instructs the SEC to amend Item 402 of Regulation S-K to require the disclosure of (i) the median of the annual total compensation of all employees of the issuer (excluding the CEO); (ii) the annual total compensation of the CEO (or equivalent position); and (iii) the ratio of the median disclosed to the annual total compensation of the CEO. Under the SEC's flexible proposal, each company subject to this disclosure requirement would have to evaluate the annual total compensation of its entire employee base and identify a "median employee" by applying any compensation measure that is appropriate to the size and structure of the company's business.[2] Under the Proposed Rules, the company would then be required to disclose the ratio of that specific employee's annual total compensation as calculated under Item 402(c)(2)(x) of Regulation S-K to the CEO's annual total compensation. Companies would be required to provide the new pay ratio in any registration statements, proxy and information statements and annual reports that are required to include executive compensation information pursuant to Item 402 of Regulation S-K. Like other information required under Item 402 of Regulation S-K, the pay ratio disclosure would be considered "filed", not "furnished", for purposes of the Securities Act of 1933, as amended, and the Securities Exchange Act of 1934, as amended (the "Exchange Act"), and companies would be subject to the related higher standard of potential liability.

As proposed, companies could disclose the CEO pay ratio numerically or in a narrative format as a multiple showing the ratio that the CEO's annual total compensation bears to the annual total compensation of the median employee.[3] Arguably, a narrative description may be easier to understand and therefore more helpful to investors. In addition, the Proposed Rules would permit, but not require, issuers to supplement the disclosure with a narrative discussion or additional ratios for context, provided that such ratios are clearly identified, are not misleading and are not presented with greater prominence than the required CEO pay ratio. For example, if the median employee by annual total compensation for a global company is a person who is located abroad, the company may choose to also include a ratio of the CEO compensation to the compensation of the median US-based employee as part of the pay ratio disclosure to provide additional context. As part of this supplemental disclosure, companies may also find it helpful to briefly describe who the median employee is (e.g., an engineer, a sales consultant, etc.). Finally, although the Proposed Rules do not mandate where the pay ratio disclosure should appear, it is likely that companies will include the disclosure as a subsection of the Compensation Discussion and Analysis.

Identifying Covered Employees

The employees considered must include any full-time, part-time, seasonal or temporary worker employed by the issuer or any of its subsidiaries in both the United States and abroad as of the last day of the issuer's fiscal year. Companies would also be permitted, but not required, to annualize total compensation for all permanent employees employed for only a portion of the covered year; however, the Proposed Rules would not permit full-time equivalent adjustments for part-time workers, annualizing adjustments for temporary or seasonal employees and cost-of-living adjustments for non-US workers. Independent contractors or "leased" workers who are employed by a third party would be excluded.

Commentators have expressed a range of concerns about capturing non-US employees in the ratio, including the potential costs associated with cross-border compliance issues, potential legal obstacles in obtaining and using personal compensation data from other countries, the value of comparing companies with substantial non-US compensation regimes to companies without offshore operations and the possibility that some issuers could attempt to structure employment arrangements to reduce the number of employees at the end of their fiscal year in order to achieve a more favorable pay ratio.

Identifying the Median Employee

To identify the median employee, issuers would have the flexibility to select a consistently applied compensation measure for employees that is appropriate to the size and structure of their business and results in a reasonable estimate of the median employee. While the SEC declined to prescribe a specific methodology, it suggested that a company with only a few employees might rely on Item 402(c)(2)(x) to determine total compensation for each employee and identify the median employee, while larger companies might instead rely on centralized payroll figures or company tax records. The SEC stated that permitting companies to identify the median employee using compensation information in the form that is maintained in their own books and records would reduce compliance costs, yet still result in a reasonable estimate of the median employee.

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2 As further discussed elsewhere in this Client Alert, the Proposed Rules allow companies to rely on statistical sampling when evaluating their employees in order to identify a "median employee".

3 For example, if the annual total compensation of a company's median employee is $50,000 and the CEO's annual total compensation is $5 million, the company could disclose the ratio as 100:1 or state that the annual total compensation of the CEO is 100 times that of the median employee compensation.

The Proposed Rules would permit issuers to determine the median employee based on the total employee population or a statistical sampling of their population. The size of the sample group and complexity of sampling used would depend on the wage variance across a particular company's workforce. For example, an issuer with higher wage variance among employees would require a larger sample than an issuer with lower wage variance. As a result, the SEC anticipates that the appropriate sample size could significantly vary by company.

Finally, issuers would be required to briefly disclose the methodology used to identify the median employee, any material assumptions, adjustments or estimates used to identify the median employee and any estimates used to determine elements of the median employee's total compensation for the purposes of calculating the required ratio. However, issuers would not be required to provide any technical analysis or formulas used to arrive at such figures.

Although the SEC expects that companies will be able to succinctly describe their methodologies in response to this requirement, some commenters are concerned that this will result in further expansion of the already broad and complex executive compensation disclosures.

Determining Total Compensation

Once a company has identified the median employee through the use of a consistently applied compensation measure, it would be required to determine the total compensation for that employee in a manner consistent with the current disclosure obligations for named executive officers under Item 402(c)(2)(x) of Regulation S-K. Item 402(c)(2)(x) requires disclosure of the total compensation including base salary, bonuses, stock and option grants, compensation from non-equity incentive plans, changes in pension value, nonqualified deferred compensation earnings and certain other forms of compensation, with extensive instructions accompanying each element of compensation included in the calculation. Therefore, under the Proposed Rules, companies using the flexible approach to identify the median employee would be required to calculate the Item 402(c)(2)(x) total compensation for that median employee for the last completed fiscal year in order to maintain consistency with other Item 402 information. Because the total compensation calculation using Item 402(c)(2)(x) would be required for only one additional employee (the median employee), the SEC declined to simplify the definition of the median employee's total compensation that would be used for calculating the ratio; however, companies would be permitted to use reasonable estimates when determining the elements of the Item 402(c)(2)(x) total compensation for the median employee (but not for the CEO).

By using two separate measures of compensation, a flexible methodology to identify the median employee and the standard methodology to determine that employee's total compensation, the Proposed Rules attempt to bridge the gap between a potentially cost prohibitive mandate and a rule without substance. However, this proposed methodology could inject more uncertainty to a ratio that commentators observe may already be of limited usefulness to investors.

Timing Considerations and Transition Periods

The pay ratio disclosure would be required in any filing by an issuer for which disclosure under Item 402 of Regulation S-K is mandated. Typically an issuer would satisfy this by including the disclosure in their Form 10-K or, if filed within 120 days following the end of the company's last fiscal year, its definitive proxy statement. For companies conducting registered offerings at the beginning of the year, the proposed instructions indicate that a company will not be required to include pay ratio disclosure with respect to its last completed fiscal year until the filing of the proxy statement for its annual meeting of shareholders.

Omission of Salary or Bonus Information and Corresponding Form 8-K Amendments

In situations where salary or bonus information for a named executive officer is not calculable as of the latest practicable date, the instructions to Item 402 of Regulation S-K permit companies to omit the disclosure in the summary compensation table provided that the company includes a footnote disclosing that fact and providing the date when the amount will be determined. Once the final amounts are determined, companies must disclose the information under Item 5.02(f) of a Form 8-K and provide a new total compensation figure for that named executive officer. The Proposed Rules permit a company relying on the above instruction for its CEO to omit pay ratio disclosure until the final total compensation of its CEO can be determined, provided it discloses that fact and the expected date that the total compensation for the CEO will be determined. The company must provide the pay ratio disclosure in the same Form 8-K filing in which the final total compensation figure is disclosed.

Proposed Compliance Date

The Proposed Rules would not affect the 2014 proxy season and would take effect for the first full fiscal year commencing on or after the effective date of the rule (e.g., for the year ending 2015 if the final rules are adopted and become effective during 2014). Further, as proposed, a company would be permitted to omit the initial pay ratio disclosure from its filings until the filing of its annual report on Form 10-K for that fiscal year or, if later, the filing of a proxy or information statement for its next annual meeting of shareholders (or written consents in lieu of a meeting) following the end of such year. New registrants would be permitted to delay compliance with the new Item 402(u) until the first fiscal year commencing on or after the date the company becomes subject to the requirements of Section 13(a) or Section 15(d) of the Exchange Act.

Practical Considerations

In light of the controversy surrounding the Proposed Rules, it is unclear when, if and in what form the final rules will be adopted. At the earliest, it is expected that pay ratio disclosure may first be required for the 2016 proxy season. Additionally, while we anticipate that companies will seek to comply with the pay ratio disclosure requirements in good faith, some commentators have observed that the CEO pay ratio figures would be very difficult for third parties to verify and have questioned to what extent the SEC would seek to verify a company's reasonable estimate of the figures. Companies that would be affected by the Proposed Rules may begin to prepare by taking the following preliminary steps:

- Review the company's pay practices and workforce composition and consider the most cost-effective methodology to identify the median employee and calculate total compensation based on the company's specific workforce composition and compensation arrangements. Large companies with international operations are likely to be most affected by the proposed disclosure requirements as such companies typically have highest pay ratio disparities and diverse employee base.

- Consider developing protocols and procedures to centralize databases that aggregate and consistently measure company-wide employee compensation data across segments, including payroll, pension and tax data. Companies with centralized record-keeping systems in place could significantly reduce the costs of compliance.

- Consider what, if any, additional information could enhance the CEO pay ratio disclosure and whether supplemental narrative disclosure or other metrics could assist investors by providing context to the required ratio. Commentators have observed that given the potential for sensationalism, companies are likely to take advantage of the instruction permitting them to include supplemental discussions to put their ratios in context. Companies are also likely to include explanations as to the reasons why their ratios may not be directly comparable to their industry peers.

- The Proposed Rules are subject to a 60-day public comment period once published in the *Federal Register.* The Proposed Rules contain 60 specific requests for comments. Companies that expect to be significantly affected by the new disclosure requirements should consider submitting detailed and data-intensive comment letters detailing their observations and estimating compliance costs.