Client Alert

September 2013

SEC Proposes CEO Pay Ratio Rules

By a 3-2 party-line vote, at an open meeting on September 18, 2013, the Securities and Exchange Commission (Commission) proposed rules to enact the CEO "pay ratio" disclosure requirement under Section 953(b) of the Dodd-Frank Act. The pay ratio provision is one of the more controversial corporate governance provisions of Dodd-Frank, with many labor unions, institutional investors and shareholder activists supporting the mandate while much of the issuer community has been concerned about its cost, immateriality and potential for misuse. The proposed rules will be open for public comment for 60 days.

Overview

Section 953(b) requires the Commission to amend Item 402 of Regulation S-K to provide for the disclosure of (A) the median of the annual total compensation of all employees of an issuer, except the issuer's CEO; (B) the annual total compensation of the issuer's CEO; and (C) the ratio between (A) and (B). For these purposes, the statute requires "total compensation" to be computed under Item 402(c)(2)(x) of Regulation S-K.[1] This provision of Item 402 is the same one issuers use in determining total compensation for the named executive officers in the annual executive compensation tables, leading to the concern about the cost and complexity of calculating the ratio if issuers are required to perform the calculation on every one of their employees.

Calculating the Ratio

Acknowledging the potential cost and complexity of calculating the ratio, the proposed rules would afford issuers considerable flexibility by not mandating any particular computational methodology.[2] Instead, under the proposed rules, issuers may choose to identify the median using their full employee population or by using statistical sampling or another reasonable method. In doing so, the proposed rules would allow issuers to choose a statistical method to identify the median that is appropriate to the size and structure of their businesses and the way in which they compensate employees. Alternatively, issuers would be permitted to calculate the annual total compensation for each employee included in the calculation (whether the entire population or a statistical sample) and the CEO using Item 402(c)(2)(x) and to identify the median using this method.[3] Issuers would also be permitted to choose to identify the median employee based on any consistently applied compensation measure (e.g., compensation amounts reported in the issuer's payroll and tax records) and then calculate the annual total

[1] Total compensation under Item 402(c)(2(x) is generally the sum of a person's salary, bonus, stock awards, option awards, nonequity incentive plan compensation, changes in pension value, nonqualified deferred compensation earnings and all other compensation, including perquisites.

[2] The full text of the proposing release is available at http://www.sec.gov/rules/proposed/2013/33-9452.pdf. The new requirements would be set forth in a new Item 402(u) of Regulation S-K.

[3] The proposed rules clarify that, for nonsalaried employees, references to "base salary" and "salary" in Item 402 may be deemed to refer instead, as applicable, to "wages plus overtime."

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compensation only for that median employee in accordance with Item 402(c)(2)(x).[4] The proposed rules would also permit issuers to use reasonable estimates in calculating the annual total compensation for employees other than the CEO, including when disclosing the annual total compensation of the median employee identified using a consistently applied compensation measure. The Commission noted it did not believe that a one-size-fits-all approach would be "prudent" in light of the wide range of issuers and the different burdens placed on them because of factors such as their type of business and the complexity of their payroll systems.

Read literally, the statute inverts the numerator and denominator of the ratio so that in a hypothetical situation where a CEO's pay is 100 times that of the median employee, the required disclosure would be .01, not 100 to 1. Accordingly, continuing this hypothetical, the proposed rules would require an issuer to disclose the pay ratio as either "1 to 100" or narratively as "the CEO's annual total compensation is 100 times that of the median of the annual total compensation of all employees." The Commission noted that an issuer would be permitted to provide additional discussion or explanation around the ratio to help better put it into perspective or provide better comparability to others in a particular issuer's industry or peer group.

Required Narrative

Issuers would be required to provide a brief narrative disclosure that is not overly technical but that explains the methodology they have selected to identify the median and total compensation as well as any material assumptions, adjustments or estimates used in those calculations. The proposing release cautions that issuers' disclosure of the methodology and material assumptions, adjustments and estimates used should provide sufficient information for a reader to be able to evaluate the appropriateness of the estimates. The narrative would also require disclosure about any material period over period changes to the selected methodology, assumptions, adjustments or estimates. The proposing release notes that like other Item 402 information, the pay ratio disclosure would be considered "filed" for purposes of the Securities Act and Exchange Act and, accordingly, would be subject to potential liabilities thereunder.

Covered Employees

The proposed rules would apply to all full-time, part-time, temporary, seasonal and overseas employees of an issuer and all its global subsidiaries. On the other hand, workers who are not employed by the issuer or its subsidiaries, such as independent contractors or "leased" workers or other temporary workers who are employed by a third party, would not be covered. Issuers would be permitted to annualize pay for full-time employees who have worked less than a full year (such as new hires and those who have taken extended leave), but they would not be permitted to annualize pay for temporary, seasonal or part-time employees to approximate full-time equivalent status.[5] Issuers would also not be permitted to normalize, through cost of living adjustments or otherwise, pay of non-US employees so as to provide comparability to US wages and account for fluctuating currency exchange rates. The proposed rules, however, define "employee" as an individual employed as of the last day of the issuer's last completed fiscal year. Thus, seasonal, temporary and any other employees not on the payroll on the last day of the fiscal year need not be included in the pay ratio calculation.

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[4] Presumably, this accommodation is intended to reduce the potential cost of applying the Item 402 methodology to the entire employee population.

[5] Depending on the facts and circumstances, the proposing release notes it could be appropriate for an issuer to annualize the compensation for a permanent part-time worker who has worked only a portion of the year, and uses the example of an employee who is permanently employed for three days a week and who took an unpaid leave of absence under the Family and Medical Leave Act. In such a case, the proposing release notes that the adjustment should reflect compensation for the employee's part-time schedule over the entire year, but should not adjust the part-time schedule to a full-time equivalent schedule.

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Covered Filings

Although Section 953(b) could be read to mandate that the pay ratio disclosure be made in “any filing,” the proposed rules would limit disclosure to annual reports on Form 10-K, registration statements under the Securities Act and Exchange Act, and proxy and information statements, to the same extent that the requirements of these forms otherwise require Item 402 disclosures. Because the ratio would be calculated at the end of the fiscal year, the proposed rules clarify that issuers need not update the ratio more than once per year.

Exempt Companies

The JOBS Act amended Section 953(b) to exclude emerging growth companies from the requirement to make the pay ratio disclosure. Likewise, under the proposed rules, smaller reporting companies and foreign private issuers filing Forms 20-F or 40-F would also be exempt from disclosure.

Transition

Given the timeline for a typical Commission rulemaking and the controversial nature of this proposal, we do not believe it likely that final rules will be adopted in time for the 2014 proxy season. The proposing release indicates that if the final requirements were to become effective sometime in 2014, an issuer with a fiscal year ending on December 31 generally would be first required to report on fiscal year 2015 results and include pay ratio information in its proxy or information statement for its 2016 annual meeting of shareholders (or written consents in lieu of such a meeting). For newly public companies that do not qualify as emerging growth companies, assuming the proposed requirements become effective in 2014, the proposing release uses the example of an issuer with a fiscal year ending on December 31 that completes its initial public offering in October 2016. Such an issuer would not be required to include any pay ratio information in its registration statement on Form S-1 or S-11. The newly public company would then not be required to include pay ratio disclosure in any filing until it files its definitive proxy or information statement for its 2018 annual meeting of shareholders (or written consents in lieu of such a meeting), which would include pay ratio disclosure relating to 2017 compensation amounts. Issuers may begin compliance earlier on a voluntary basis.

Conclusion

Although the Commission’s accommodations to the calculation methodology may come as a relief to some members of the issuer community, that flexibility will have the side effect of further eroding comparability of the pay ratio between companies and across industries. The Commission all but concedes as much at various points in the proposing release, which motivated the two dissenting commissioners to decry the entire pay ratio disclosure scheme as one that will simply be used by special interest groups to “name and shame” corporate CEOs.

The proposing release seeks public comment on all facets of the proposed rules, and, in particular, the Commission has implored the public to provide data on the costs of calculating the ratio, particularly if statistical sampling techniques are employed. We encourage companies, either individually or through their trade associations, to weigh in on the proposed rules, file comment letters and seek meetings with the commissioners and Commission staff in an effort to refine the Commission’s proposed approach. In particular, companies should consider commenting on the practicality, cost, potential complexity and any operational challenges of the various calculation methods contemplated by the proposed rules.

To provide data to the Commission, companies may wish to do mock calculations of the pay ratio using the different methodologies described in the release. How difficult would it be to do so? What computational challenges did you face? Would you have had to engage consultants or other outside advisers to facilitate sampling or otherwise complete the calculation? What would the estimated costs be, both internally and externally, to complete the ratio? How many hours would the calculation take? Are

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there qualities unique to the company's workforce (e.g., pay scale, benefit packages, geographic concentration, international operations) that would make the calculation more difficult? How comparable would the ratio of your company likely be to your competitors and others in the company's compensation peer group? The more useful information is supplied to the Commission, the better equipped it will be to tailor final rules.

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