Securities Exchange Commission Proposes Pay Ratio Disclosure Rules

On September 18, 2013, pursuant to a mandate of the Dodd-Frank Wall Street Reform and Consumer Protection Act (Dodd-Frank), the U.S. Securities and Exchange Commission (SEC), by a 3 to 2 vote, proposed pay ratio disclosure rules.[1] The proposing release contemplates a transition period so that the initial pay ratio disclosure would be required with respect to compensation for a company's first full fiscal year that begins after the final rules are adopted. Assuming rules are adopted in 2014 (which is the assumption in the example that the SEC provided in the proposing release), the pay ratio disclosure for calendar year-end companies would be required with respect to 2015 compensation, with such disclosure first appearing in proxy statements and annual reports on Form 10-K filed during 2016.

The SEC is seeking comments on its proposed pay ratio disclosure rules. The proposing release identified 60 areas on which the SEC is requesting public input. Comments on the proposal are due by December 2, 2013.

Summary of the Proposal

Disclosure Requirement. The pay ratio disclosure proposal would add Item 401(u) to Regulation S-K, requiring public companies to disclose:

- the median of the annual total compensation of all employees, other than the chief executive officer;
- the annual total compensation of the chief executive officer; and
- the ratio of these amounts.

Filings Requiring Pay Ratio Disclosure. Generally, the pay ratio disclosure would be needed in filings that require executive compensation disclosure, such as proxy and information statements, annual reports on Form 10-K and registration statements under the Securities Act of 1933 (Securities Act) and the Securities Exchange Act of 1934 (Exchange Act), just as items of executive compensation are required to be disclosed today.

Employees Covered. The proposed disclosure covers all employees of the company and its subsidiaries as of the last day of the prior fiscal year, including employees based outside of the United States, part-time employees, temporary employees and seasonal employees. However, independent contractors, leased employees and temporary workers employed by a third party would not be included.

Companies Covered by Pay Ratio Disclosure Requirement. The pay ratio disclosure would only be required for companies that provide a summary compensation table pursuant to Item 402(c) of Regulation S-K. As proposed, smaller reporting companies, emerging growth companies, foreign private issuers and MJDS filers (*i.e.*, registrants filing under the U.S. Canadian Multijurisdictional

Disclosure System) would not be subject to the pay ratio disclosure requirement.

Identifying the Median. The proposal would permit companies flexibility to select a method for identifying the median that is appropriate to the size and structure of their businesses and compensation program. According to the proposing release, factors such as the following could be taken into account:

- the size and nature of the workforce;
- the complexity of the organization;
- the stratification of pay levels across the workforce;
- the types of compensation the employees receive;
- the extent that different currencies are involved;
- the number of tax and accounting regimes involved; and
- the number of payroll systems the registrant has and the degree of difficulty involved in integrating payroll systems to readily compile total compensation information for all employees.

While companies would be permitted to identify the median based on total compensation regarding their full employee population, they alternatively may do so by using a statistical sample or another reasonable method. The SEC indicated that "a reasonable determination of sample size would ultimately depend on the underlying distribution of compensation data."

Companies could identify the median employee based on annual total compensation as determined under existing executive compensation rules. Alternatively, companies could identify the median employee based on any consistently used compensation measure, such as compensation amounts reported in its payroll or tax records. When using a consistently applied measure, such as payroll or tax records, to determine annual compensation in order to identify the median employee, companies may use the same annual period that is used in the records from which such compensation is derived.

Once the median employee has been identified pursuant to one of the methods described above, the total compensation for the median employee would have to be calculated for the last completed fiscal year, consistent with the requirements for calculating the chief executive officer's total compensation for the same fiscal year for purposes of the summary compensation table. The total compensation as so calculated for the median employee would be used for purposes of calculating the disclosed pay ratio.

The term "median employee" is used in the instructions to proposed Item 401(u) of Regulation S-K, but it is not defined. The SEC stated in the proposing release that "[i]dentifying the median employee would not necessarily require a determination of exact compensation amounts for each employee in the sample. The registrant could exclude the employees in the sample that have extremely low or extremely high pay because they would fall on either end of the spectrum of pay and, therefore, not be the median employee." The SEC explained that "[s]ince identifying the median involves finding the employee in the middle, it may not be necessary to determine the exact compensation amounts for every employee paid more or less than that employee in the middle. Instead, just noting that the employees are above or below the median would be sufficient for finding the employee in the middle of the pay spectrum." There is no requirement to identify the median employee by name or other identifier.

Reasonable Estimates. Under the proposal, companies may use reasonable estimates to calculate annual total compensation or any element thereof for employees other than the chief executive officer. Reasonable estimates would also be permitted in the methodology used to identify the median employee. The proposed rules do not prescribe what constitutes

a reasonable basis. However, the proposing release states that "[i]n using an estimate for annual total compensation (or for a particular element of total compensation), a registrant should have a reasonable basis to conclude that the estimate approximates the actual amount of compensation under Item 402(c)(2)(x) (or for a particular element of compensation under Item 402(c)(2)(iv)-(ix)) awarded to, earned by or paid to those employees."

Adjustments. Companies would be permitted to annualize the compensation of a full-time employee who did not work the entire year, but if they do so they must annualize the compensation of all eligible employees. However, for the purposes of the proposed rules, the compensation of temporary or seasonal workers may not be annualized. Furthermore, part-time employee compensation may not be measured on a full-time equivalent basis and cost-of living adjustments may not be made for non-U.S. employees.

Companies are permitted, but are not required, to exclude benefits under non-discriminatory plans, as well as perquisites and personal benefits that aggregate less than $10,000, from the compensation they include in the summary compensation table for named executive officers. In the proposing release, the SEC recognized that excluding benefits such as health care and employee discounts from the annual total compensation of employees could render the pay ratio less meaningful because such benefits, relative to wages, add significant economic value for average employees. The proposing release noted that companies have the discretion to "include personal benefits (and perquisites in the case of employees that are executive officers) that aggregate less than $10,000 and compensation under non-discriminatory benefit plans in calculating the annual total compensation of employees." However, in order to be consistent, the SEC specified that total compensation of the chief executive officer used in the related pay ratio disclosure "would also need to reflect the same approach to these items as is used for employees." In addition, companies would need to explain any difference between the total compensation of their chief executive officer used in the pay ratio disclosure and the total compensation amounts of their chief executive officer reflected in the summary compensation table.

Disclosures. The pay ratio itself could be expressed numerically (as in "1 to 268") or narratively (as in "the total annual compensation of the chief executive officer is 268 times that of the median of annual total compensation of all other employees.")

The only required narrative disclosure would be a brief, non-technical overview of the methodology used to identify the median, and any material assumptions, adjustments or estimates used to identify the median or to determine total compensation or elements of total compensation. Such disclosure should provide sufficient information to enable readers to evaluate the appropriateness of the estimates, but there is no need to disclose detailed formulas.

If statistical sampling is used, both the size of the sample and the estimated whole population should be disclosed, as well as material assumptions used in determining sample size. The disclosure should identify the sampling methods used and, to the extent applicable, how the method deals with separate payroll, such as from different geographic areas or business segments. If a company changes methodology, material assumptions, adjustments or estimates from those used in a prior pay ratio disclosure, and the effects of the change are material, the change and the reasons for the change must be described, together with an estimate of the impact on the change on the median and the ratio.

Companies would have to clearly identify any estimated amounts. If a company uses a consistently applied compensation measure to identify the median employee, it would have to

disclose the measure used. The proposing release gave as an example of this "We found the median using salary, wages and tips as reported to the U.S. Internal Revenue Service on Form W-2 and the equivalent for our non-U.S. employees."

Companies would be permitted to include additional disclosures if they would like to do so. If companies choose to include any additional ratios, they must be clearly identified and not misleading. Additional ratios should not be presented with greater prominence than the required pay ratio.

IPOs. Companies do not have to include pay ratio disclosure in their initial public offering registration statements. Instead, they can delay this disclosure until their first fiscal year commencing on or after the date they become subject to the requirements of Section 13(a) or Section 15(d) of the Exchange Act.

Other Technical Requirements. The pay ratio disclosures would be "filed," not "furnished," and therefore would be subject to certifications by the chief executive officer and the chief financial officer.

As proposed, the pay ratio disclosure would not need to be updated throughout the year; it would only have to be calculated once a year, as of fiscal year-end. Companies may wait to update their pay ratio disclosure until they file their Form 10-K, or, if later, their definite proxy statement for their annual meeting of shareholders. Accordingly, registration statements may be filed and declared effective under the Securities Act at the beginning of a fiscal year without updating the pay ratio previously disclosed.

If chief executive officer salary and bonus is to be disclosed in a Form 8-K because it is not calculable at the time the proxy statement is filed, the pay ratio disclosure may also be disclosed in the Form 8-K.

Practical Considerations

- Public companies will not be required to include pay ratio disclosures in their proxy statements for the upcoming 2014 proxy season.
- Even with the various options available to companies for calculating median employee annual total compensation under the proposed rules, many companies may nevertheless find it challenging and costly to gather the required information. Therefore, the employees of public companies who would be tasked with assembling the information to make the proposed disclosure should read the proposing release carefully. They should reflect on what they would need to do to make the required calculation and discuss what problems may arise. Based on this analysis, they should determine whether they want to submit comments to the SEC on this proposal, detailing anticipated difficulties and offering alternative suggestions.
- While the SEC tried to craft its proposed pay ratio disclosure rules so that they would not create a violation of any country's laws, if a multinational public company is aware that compliance with the SEC's pay ratio disclosure rules would cause a violation of laws of another jurisdiction, such as privacy laws, it should consider providing specific comments to the SEC on this point so that the SEC has the opportunity to address the issue before it adopts final pay ratio disclosure rules.
- Although pay ratio disclosure is not imminently required, public companies may want to evaluate their payroll and other compensation recordkeeping systems for advance planning purposes, to preliminarily develop strategies for future compliance and consider how they would update their disclosure controls and procedures for pay ratio disclosure once finalized.

If you have any questions regarding the pay ratio disclosure rules, please contact the author of this Legal Update, ***Laura D. Richman****, at* ***+1 312 701 7304****, or any of the lawyers listed below or any other member of our Corporate & Securities group.*

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Endnote

[1] Available at http://www.sec.gov/rules/proposed/2013/33-9452.pdf.

trade; intellectual property; real estate; tax; restructuring, bankruptcy and insolvency; and wealth management.

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