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SEC Proposes Pay Ratio Disclosure Rule

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On September 18, 2013, the Securities and Exchange Commission (SEC), by a 3–2 vote of the commissioners, proposed a rule to implement the pay ratio disclosure requirement in the Dodd-Frank Act of 2010. Section 953(b) of the Dodd-Frank Act directs the SEC to adopt a rule requiring public companies to disclose the ratio of the median annual total compensation of all employees other than the chief executive officer to the annual total compensation of the chief executive officer.[1]

While this new disclosure requirement may sound simple, it has long been recognized that determining this ratio raises numerous complex implementation issues, especially in calculating the median annual total compensation for all employees of a company. These issues include the treatment of part-time and seasonal employees, the inclusion of non-U.S. employees and the difficulty of applying the complex executive compensation rules in Item 402 of Regulation S-K to a company's entire workforce. After grappling with these issues and receiving over 22,000 comment letters, the SEC was finally able to propose rules more than three years after the adoption of the Dodd-Frank Act. The proposed rules will be subject to an additional comment period before the SEC can promulgate final rules.

The SEC's proposed rule would require a public company to disclose:

- The amount of the median of annual total compensation of all the company's employees other the principal executive officer;
- The amount of the annual total compensation of the principal executive officer; and
- The ratio of these two amounts.

The ratio can be expressed either numerically with the all employee amount being equal to one (e.g., the company could disclose that the ratio is "1 to 300" if the PEO's annual total compensation was 300 times the median amount) or narratively (e.g., "the PEO's annual total compensation is 300 times that of the median of the annual total compensation of all employees other than the PEO").

The SEC's proposed approach for determining median annual total compensation for all employees would truly encompass all employees, determined as of the last day of the company's last completed fiscal year, including full-time, part-time,

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temporary, seasonal, U.S. and foreign employees. It would not include independent contractors, leased workers or other temporary workers who are employed by a third party. The proposed rule also makes it clear that companies are not permitted to make full-time equivalent adjustments for part-time workers or annualizing adjustments for temporary or seasonal workers. Where an employee was not employed during the entire fiscal year and is a permanent employee, a company may annualize that employee's compensation. This would include, for example, a new hire or an employee who takes an unpaid leave of absence.

Due to the complexity for many companies of computing the median annual total compensation for all employees, the SEC provided flexibility for a company to choose a reasonable methodology that fits its circumstances, as long as the company includes a brief description of its methodology in the filing and applies the methodology consistently.

One option is to compute the total compensation of each employee and then use the median amount for the disclosure. This method may be impractical for many companies. Permissible alternatives include using reasonable estimates or statistical sampling to identify the employee with "median" compensation and then calculating that employee's annual total compensation under the requirements of Item 402(c)(2)(x) of Regulation S-K. The proposed rule does not prescribe any specific estimation techniques or sampling methodology so that a company could select the most appropriate and cost-effective methodology based on its individual circumstances. Another possible method that the SEC proposed to specifically permit is the use of cash compensation to identify the median employee (which could be based on payroll or tax records) and then calculating that median employee's annual total compensation under the requirements of Item 402(c)(2)(x) of Regulation S-K. Although the median employee's annual total compensation must be determined for the company's fiscal year consistent with the PEO's, the SEC did propose that for purposes of estimating the median employee, a company can use amounts derived from its payroll or tax records for the period that is used in those records (e.g., a calendar year).

The proposed pay ratio disclosure requirements would not apply to emerging growth companies, smaller reporting companies or foreign private issuers.

The pay ratio disclosure would be required in registration statements, proxy statements and information statements that already include executive

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compensation information pursuant to Item 402 of Regulation S-K. Most companies incorporate compensation information by reference from a proxy statement or information statement into the annual report on Form 10-K. However, if the definitive proxy statement or information statement is not filed within 120 days after fiscal year end, the Form 10-K must contain the compensation information, including the pay ratio disclosure.

A company would be required to report the pay ratio for its first fiscal year commencing on or after the effective date of the final rule. For example, if the final rule is effective during 2014, a company with a December 31 fiscal year end would first be required to disclose the pay ratio information as to its fiscal year ending December 31, 2015.

While the SEC's proposed flexible approach in determining median employee compensation is welcome and probably necessary for most public companies, it will probably undercut what little utility the rule may have. Factors such as the scope of global operations, the degree of outsourcing of work, and the degree of reliance on seasonal or part-time workers may skew the numbers of reporting companies. In all, the rule will impose significant costs for very little, if any, benefit. Among the few potential beneficiaries will likely be consulting firms who are able to assist in sampling or other methods to perform the calculations and plaintiffs' attorneys who are sure to seize upon another potential basis for disclosure claims.

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[1] The SEC rule uses the term "principal executive officer" or "PEO" to be consistent with the SEC's executive compensation regulations in Item 402 of Regulation S-K.

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