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SEC's Proposed CEO Pay Ratio Disclosure Rules — Costly and Complicated

The SEC has proposed rules to implement the "CEO pay ratio" disclosure requirements under Section 953(b) of the Dodd-Frank Act.

The proposed rules would require many SEC reporting companies to publicly disclose the following information:

- the median annual total compensation of all employees of the company (excluding the CEO);
- the annual total compensation of the CEO; and
- the ratio of the median annual total compensation of all employees (excluding the CEO) to the annual total compensation of the CEO.

In an effort to address the concerns raised by comments received in advance of the proposed rules over significant compliance costs resulting from the disclosure requirements as set forth in the Dodd-Frank Act, the SEC attempted to provide companies with a certain level of flexibility when complying with the rules. Unfortunately, the rules would nevertheless impose significant and costly burdens on public companies with no obviously discernible benefits to investors.

Proposed Pay Ratio Rules

Employees included in the identification of the median. The proposed rules require the median to be determined based on the annual total compensation of "all employees" other than the CEO. The proposal defines "employee" as an individual employed by the company or any of its subsidiaries as of the last day of the company's last completed fiscal year, including full-time, part-time, temporary and seasonal workers and officers (other than the CEO). Despite the international variation in compensation arrangements and benefits, the impact of data privacy laws in various jurisdictions and the cost-of-living differences and currency fluctuations that make compensation comparisons difficult, "employee" includes non-U.S. employees.

Identifying the median. The proposed rules provide a flexible approach for the determination of the "median" and permit the use of reasonable estimates to identify the median. The SEC highlighted two alternative methods that would be permitted for this determination:

- Companies may identify the median through a sampling technique or other statistically reasonable method. The appropriate sample size would depend on the underlying distribution of compensation data. The SEC noted that there is more than one statistical sampling approach that could result in reasonable estimates of the median. Although random sampling would be the least complicated method, a company may need to draw observations from each business or geographical unit that has a unique distribution of compensation and statistically infer the company's overall median based on those observations. Employing complex statistical analyses would likely result in higher costs to companies.

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- Alternatively, companies may choose to use a consistently applied compensation measure to identify the median. The proposed rules would allow a company to determine the median based on any measure that is "consistently applied" to each employee, such as W-2 reportable wages. The SEC notes that this proposed method should be construed broadly enough to allow companies to use information that they already track and compile for payroll or tax purposes.

For purposes of identifying the median, the proposed rules permit companies to annualize the compensation of employees who were employed for less than the full fiscal year. However, adjustments with regard to temporary or seasonal employees and cost-of-living adjustments for non-U.S. workers are not permitted.

Determining "total compensation." Once a company identifies the employee with the median compensation, the company would be required to calculate that employee's total compensation in accordance with the rules applicable to executive compensation disclosure (Item 402 of Regulation S-K) and disclose that amount as part of the pay ratio disclosure. The SEC proposed the following guidelines on the determination of annual total compensation:

- *Use of reasonable estimates*. The proposed pay ratio rules permit the use of reasonable estimates in determining any elements of the employee's total compensation. For example, pension benefits under a multi-employer defined benefit pension plan may give rise to valuation difficulties and, in such case, companies may estimate an amount that approximates the aggregate change in actuarial present value of the employee's benefit.

- *Meaning of "annual."* The proposed rules provide that "annual" total compensation means total compensation for the company's last completed fiscal year, consistent with the time period used for the company's other executive compensation disclosure requirements.

- *Governmental benefits*. Amounts relating to a government-mandated pension plan generally would not be included in the employee's total compensation.

- *Perquisites and nondiscriminatory benefits*. Although not normally included in executive compensation disclosure, companies are permitted to include in the employee's annual total compensation perquisites that aggregate less than $10,000 and/or compensation under nondiscriminatory benefit plans. Including those amounts may result in lowering the ratio. If this approach is adopted by a company, the company would be required to use the same approach in determining the CEO's total compensation used in the related pay ratio disclosure and also would be required to explain any difference between the CEO's total compensation used in the pay ratio disclosure and the total compensation amount reflected in the summary compensation table. The standard executive compensation rules would apply in valuing any perquisites, such that the perquisite value would be based on the aggregate incremental cost to the company.

Expression of the pay ratio. The proposed rules would require the ratio to be expressed as a ratio in which the median of the annual total compensation of all employees is set to one or, alternatively, expressed narratively in terms of the multiple that the CEO's total compensation amount bears to the median of the annual total compensation amount. The SEC provided the following example: If the median of the annual total compensation of all employees of a company is $45,790, and the annual total compensation of the company's CEO is $12,260,000, then the pay ratio disclosed would be "1 to 268" (which could also be expressed narratively as "the CEO's annual total compensation is 268 times that of the median of the annual total compensation of all employees").

Accompanying disclosure. Companies would be required to briefly disclose any methodologies and estimates used. Companies that use statistical sampling to determine the median would be required to disclose the size of the sample and the estimated size of the whole population, any material assumptions used in determining the sample size, which sampling method (or methods) it used and, if applicable, how the sampling method deals with separate payrolls such as geographically separated employees or other issues arising from multiple business or geographic segments. If companies choose to use a consistently applied compensation measure, they must briefly describe the measure that they choose to use. The SEC provided the following disclosure example: "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." Further, if a company changes its methodology or material assumptions, adjustments or estimates from those used in the previous period, and if the effects of such change are material, the company must briefly describe the change, the reasons for the change and must provide an estimate of the impact of the change on the median and the ratio.

Filings subject to pay ratio disclosure. As proposed, the pay ratio disclosure would be required in any filing that requires executive compensation disclosure because the SEC views the pay ratio information as "another metric to evaluate executive compensation." Therefore, the proposed pay ratio disclosure would be required in annual reports, proxy statements, information statements and registration statements that otherwise require Item 402 disclosure. Like other executive compensation disclosure, the pay ratio disclosure would be considered "filed" for purposes of securities law and would be subject to potential liabilities thereunder.

Updating pay ratio disclosure. The proposed rules do not require a company to update its pay ratio disclosure for the most recently completed fiscal year until it files its annual report on Form 10-K or, if later, its proxy or information statement for its next annual meeting of shareholders (or written consents in lieu of such a meeting), except that the pay ratio disclosure must be updated and filed no later than 120 days after the end of the fiscal year. For example, if a company files a registration statement shortly after the end of the company's fiscal year, it would not be required to calculate and disclose a new, updated pay ratio in that registration statement.

Omitting compensation information. Pursuant to Instruction 1 to Items 402(c)(2)(iii) and (iv) of Regulation S-K, in the event a company omits disclosure of the CEO's salary or bonus in the summary compensation table because it is not yet calculable, the company also may omit the pay ratio disclosure until those elements of the CEO's total compensation are determined, and would provide its pay ratio disclosure in the same filing under Item 5.02(f) of Form 8-K in which the CEO's salary or bonus is disclosed.

Companies excluded. Emerging growth companies, smaller reporting companies and foreign private issuers are proposed to be exempt from the pay ratio disclosure requirements. Private companies that go public initially would be exempt from the proposed new rules, but would be required to provide the pay ratio disclosure for the first fiscal year commencing on or after the date of the initial public offering.

Compliance timeline. Companies would be required to provide pay ratio disclosure for the first fiscal year commencing on or after the effective date of the final rules. Assuming the SEC adopts the final rules in 2014, the proposed compliance timeline would require companies with a December 31st fiscal year end to first disclose the pay ratio information in their proxy or information statements for their 2016 shareholder meetings, based on 2015 compensation. The SEC noted that the long transition period is necessary for companies to implement and test any systems to be used to identify median annual total compensation of employees.

Recommended Actions

Submit comments. Companies are encouraged to submit feedback to the SEC. The SEC has made a number of requests for comment. In particular, comments are sought as to whether the proposed rules are sufficient in addressing the practical difficulties of data collection and whether there are other alternative approaches consistent with Section 953(b) that could provide the pay ratio disclosure information at a lower cost. Commissioner Michael Piwowar requested that companies submit compliance cost estimates, including the assumptions made by companies in calculating the potential cost and detail as to the rationale underlying such assumptions. Comments are due by December 2, 2013.

Consider which method to use. Given the significant time and costs associated with developing the pay ratio disclosure, companies should begin considering an appropriate method for identifying the median that would work best for their own facts and circumstances. Careful consideration is particularly important for companies that have multiple business and/or geographical segments that maintain separate payroll systems and whose median calculation would be especially complicated. In light of the disclosure requirements with respect to methodology, assumptions and estimates, particularly with respect to any year-to-year changes, companies should carefully consider the ramifications of all the available alternatives before choosing a methodology.

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A copy of the proposing release for the rules is available on the SEC's website at http://www.sec.gov/rules/proposed/2013/33-9452.pdf.