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SEC Proposes Long-Awaited Pay Ratio Rules

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On September 18, 2013, in a 3-2 vote of commissioners cast along party lines, the Securities and Exchange Commission (the "SEC") proposed rules to implement Section 953(b) of the Dodd-Frank Wall Street Reform and Consumer Protection Act of 2010 ("Dodd-Frank").[1] Section 953(b) directs the SEC to promulgate rules to require public companies to disclose the median annual total compensation of all employees other than the chief executive officer ("CEO"), the annual total compensation of the CEO, and the ratio of these two amounts (the "pay ratio rules").[2] Total compensation is to be calculated in the same manner as in the summary compensation table.[3] The proposed pay ratio rules would provide flexibility for registrants to use statistical sampling and estimates to identify median employees and would allow registrants to determine the statistical methodology that is appropriate to their unique circumstances. The SEC reports having received over 20,000 comment letters on Section 953(b) even before announcing its proposed rules, and in the proposing release solicits public comment on a wide range of topics. In view of the many questions that remain under consideration, it seems likely that final pay ratio rules will not be adopted until sometime during 2014.

1 Release Nos. 33-9452 and 34-70443; File No. S7-07-13. SEC Chair Mary Jo White and Commissioners Luis A. Aguilar and Kara M. Stein voted in favor of the proposal. Commissioners Michael S. Piwowar and Daniel M. Gallagher voted against it.

2 Section 953(b) states that the SEC shall amend Section 402 of Regulation S-K "to require each issuer to disclose in any filing of the issuer described in Section 229.10(a) of title 17 [(proxy requirements)] . . . (A) the median of the annual total compensation of all employees of the issuer, except the chief executive officer (or any equivalent position) of the issuer; (B) the annual total compensation of the chief executive officer (or any equivalent position) of the issuer; and (C) the ratio of the amount described in subparagraph (A) to the amount described in subparagraph (B)." Total compensation, for purposes of Section 953(b) "shall be determined in accordance with section 229.402(c)(2)(x) of title 17, Code of Federal Regulations, as in effect on the day before the date of enactment of [the Dodd-Frank Act]."

3 *See* Item 402(c)(2)(x) of Regulation S-K.

Background

There has been significant debate on the merits of compelling pay ratio disclosure, as exemplified by the supporting and dissenting statements of the SEC commissioners at the open meeting on September 18, 2013. Critics argue that pay ratio disclosure would be incendiary, unclear, misleading and potentially harmful for investors, that the ratio would not take the CEO's performance into account, that compliance will be costly, and that the disclosure requirement may give a competitive advantage to registrants that are not subject to the rules (or, as discussed below, less burdened by the rules). Supporters of pay ratio disclosure counter that the information will increase transparency and help investors to assess whether companies are investing in their employees, or focusing only on compensating top executives. These supporters note that CEO pay has spiraled relative to rank-and-file employee pay. According to a study published by Bloomberg.com, average CEO compensation at the companies in the Standard & Poor's 500 Index has increased 20% since 2009, and is now 204 times that of rank-and-file employees.[4] According to the Economic Policy Institute, this ratio was just 20 to 1 in 1965.[5]

In the proposing release, the SEC notes its attempt to address the concerns of commentators and cites extensively to letters it received. The contentious nature of pay ratio disclosure and the practical challenges presented in crafting workable rules help explain the delay in the SEC's promulgating the proposal: more than three years have elapsed between the adoption of Dodd-Frank and the issuance of the SEC's proposed rules.

Summary of Proposed Pay Ratio Rules

The proposed pay ratio rules would add new paragraph (u) to Item 402 of Regulation S-K, which would require registrants to disclose the median annual total compensation of its entire employee population (other than the CEO), the annual total compensation of the CEO, and the ratio of the two.

Where Pay Ratio Disclosure is Required

The disclosure would be required in filings that mandate executive compensation disclosure under Item 402 of Regulation S-K, including annual reports on Form 10-K and registration, proxy and information statements to the extent that disclosure under Item 402 of Regulation S-K is required therein. Although Section 953(b) of Dodd-Frank could be read to require pay ratio disclosure in all SEC filings, the SEC reasons that it would not be helpful to include this disclosure as a stand-alone item in filings that do not otherwise require executive compensation disclosure, and suggests that locating the proposed rules within the existing executive compensation disclosure regime would help reduce the compliance burden.

Covered Registrants

The proposed rules would cover only those registrants required to provide summary compensation disclosure under Item 402(c) of Regulation S-K. The Jumpstart Our Business Startups Act of 2012 (the "JOBS Act") specifically exempts

[4] Bloomberg.com, "Top CEO Pay Ratios," published April 30, 2013. Available at http://go.bloomberg.com/multimedia/ceo-pay-ratio/ and http://www.bloomberg.com/news/2013-04-30/ceo-pay-1-795-to-1-multiple-of-workers-skirts-law-as-sec-delays.html.

[5] Economic Policy Institute, "CEOs made 231 times more than workers did in 2011," published 2012. Available at http://www.epi.org/news/ceos-231-times-workers-2011/.

emerging growth companies from Section 953(b),[6] and Instruction 6 to the proposed rules gives effect to that exemption. The SEC would also exempt smaller reporting companies and foreign private issuers on the theory that these companies are not required to disclose compensation of their named executive officers pursuant to Item 402 and that Section 953(b) does not require the SEC to expand the scope of companies that are subject to Item 402.

Covered Employees

The proposed rules require that the median total compensation be determined based on a measure of all of a registrant's employees, including temporary, seasonal, part-time and non-US employees and those employed by direct and indirect subsidiaries of the registrant, but, notably, excluding independent contractors and leased employees. While the proposed rules would allow registrants to use statistical sampling to determine the median employee among all employees (further discussed below), the release makes it clear that the rules would not allow similar flexibility in determining the universe of employees from which the median must be determined.[7] The rules would allow, but not require, registrants to annualize compensation for permanent employees employed for less than the registrant's full fiscal year (i.e., employees hired during the year) but would not allow annualizing of compensation for seasonal or temporary employees. The rules would also prohibit full-time equivalent adjustments for part-time employees and cost-of-living adjustments.

The SEC has requested comment on whether to allow the flexibility to make part-time and cost-of-living adjustments and whether to include leased employees, as the exclusion of leased employees has the potential to encourage outsourcing both domestically and abroad. The SEC has also requested information on data privacy laws and regulations that may impact the collection or transfer of employee data.

Calculation Date and Covered Time Period

The proposed rules would require registrants to determine the median by reference to those employed as of the last day of the registrant's fiscal year, a calculation date consistent with the date used to determine the named executive officers under Item 402 of Regulation S-K. To accommodate any registrant whose fiscal year differs from the annual period used for payroll or tax recordkeeping, for purposes of estimating the median employee only, the proposed rules would permit the registrant to use the same year that is used in the payroll or tax records from which the compensation amounts are derived; however, a registrant using payroll or tax records to identify the median employee would then be required to calculate total compensation of that median employee for the last completed fiscal year.

Identifying the Median

In response to concerns that calculating the annual total compensation of all of a registrant's employees under the Item 402 rules would be unduly burdensome if not impossible, the proposed rules require instead a comparison of the compensation of a "median employee" to the compensation of the company's CEO. The SEC, moreover, has proposed a flexible approach for identifying the median employee and determining median total compensation. The proposed rules would give registrants discretion to determine a methodology for identifying the median employee appropriate to their size and structure, including the use of statistical sampling, random sampling, reasonable estimates of total compensation or a reasonable determination of the median employee through a review of more readily identifiable figures, such as total direct compensation (including salary, hourly wages and any performance-based pay). A flexible approach would allow

[6] *See* JOBS Act Section 102(a)(3). Our related publications on the JOBS Act are available at http://www.shearman.com/jobs-act-signed-into-law/.

[7] We note that registrants may encounter tracking issues in complying with the requirement to include seasonal and part-time employees.

registrants to seek to reduce costs and fit each registrant's unique circumstances, as long each registrant consistently applies its chosen methodology.

In the proposing release, the SEC acknowledges that the costs of compliance may vary greatly among registrants based on a number of factors, including their size and complexity, the nature of their workforce and operations, the location of their operations and the level of integration of their payroll systems and employee data. The SEC suggests that registrants in industries having low wage variances (e.g., the motor vehicle manufacturing and coal mining industries) may have appropriate sample sizes of less than one hundred employees. In contrast, industries having high wage variances (e.g., the spectator sports and motion picture and video industries) may have minimum appropriate sample sizes of more than 1,000 employees. Appropriate sample sizes would be further affected by the existence of multiple businesses or geographic segments. The SEC acknowledges that the proposed pay ratio rules may place a disproportionately higher burden on large multinational companies and companies that operate across multiple industries. In addition, including temporary and seasonal workers could potentially skew the median employee's compensation lower. Nevertheless, the SEC reasons that, overall, the use of sampling would help to minimize costs and the time necessary to identify the median.

The SEC also acknowledges that the flexibility of the proposed rules could reduce the comparability of the required disclosure across registrants. More generally, the SEC recognizes that, even within the same industry, comparability from registrant to registrant will be impaired by the use of different business models (e.g., franchise or company-owned chains), the differences in cost of living and labor in different countries and other factors.[8] The SEC reasons that pay ratio disclosure would nonetheless be useful for investors in evaluating the CEO's pay within the context of his or her own company even if it has limited utility as a benchmark for compensation levels among companies. Further, the SEC notes its belief that mandating a particular methodology for identifying the median employee would not necessarily improve the comparability of the disclosure across different companies because of the many other factors that would affect the ratio.

Instead of requiring all registrants to conform to a single methodology for determining the median, the proposed pay ratio rules would require the consistent application of a particular methodology by each registrant. According to the SEC, this would provide clarity and add a level of predictability to the ratio, and would help to guard against the risk of manipulation of the methodologies to reach a more favorable ratio.

The SEC requests comments on whether the flexible approach proposed would be fair and workable, whether this approach would in fact help to reduce the cost and other burdens of providing the disclosure and whether any alternative approaches would better address the challenges relating to collecting data. For example, the SEC requests comment on whether requiring two separate pay ratios, one using US employees and the other using non-US employees, would be useful for investors. The SEC is also requesting comments on the estimated costs of compliance and whether the utility of the disclosure would justify the costs.

The proposed rules do not provide guidance on how a registrant should calculate the pay ratio if the methodology used to identify the median employee points to multiple individuals; a registrant that uses only salary and wages to identify the median, for instance, might identify more than one employee at the median level. Whether a registrant in this situation

[8] For instance, the pay ratio for companies with significant numbers of part-time and seasonal employees may be inflated when compared to other companies, while companies that outsource low-paying work or rely heavily on independent contractors may benefit from an artificially low ratio. Further, a company with employees primarily located in countries where wages are generally lower may appear to have an inflated ratio when compared to a company whose employees are primarily located in the United States.

would be required to calculate total compensation in accordance with Item 402(c) for all employees at this level remains to be seen.

Total Compensation

Once a registrant has identified the median employee, it would be required under the proposed rules to determine that employee's total compensation in accordance with Item 402(c) (the rules governing the summary compensation table). However, to address the concern of some commentators that calculating certain elements of total compensation in accordance with Item 402(c), such as benefits, pensions and equity compensation, would be overly burdensome,[9] the SEC included in the proposed rules the option to use "reasonable estimates" to calculate the annual total compensation or any elements of total compensation for employees other than the CEO.

Item 402 allows registrants to omit disclosure of benefit plans and perquisites of named executive officers that are, in the aggregate, valued at less than $10,000. In the context of CEO compensation, such amounts are unlikely to have a material impact on the total compensation reported; for average employees, on the other hand, benefits (e.g., tax-exempt health benefits, transportation/parking benefits, education assistance) may constitute a meaningful portion of the employee's overall compensation package and excluding them may tend to understate median compensation. Under the proposed rules, in calculating total compensation of the median employee, a registrant could elect to include benefit plans and perquisites that are equal to less than $10,000 as long as comparable benefits paid to the CEO are included in the determination of the CEO's total compensation. In that case, any difference between the total compensation of the CEO used for the pay ratio and that used in the summary compensation table would also need to be disclosed.

Disclosure of Methodologies

Registrants would be required under the proposed rules to briefly disclose the methodology used and any material assumptions, adjustments or estimates used to identify the median or determine total compensation or any elements of total compensation. Instruction 2 of the proposed rules clarifies that only a "brief overview" is required for the disclosure; the SEC notes that an "overly technical analysis" could be dense and confusing to investors. The proposed rules would allow for reasonable supplemental information, including additional pay ratios (i.e., comparing pay of other employee groups), as long as the supplemental information is clearly designated as supplemental and would not confuse investors.

Finally, the proposed rules require that registrants disclose any material changes to the methodology or material assumptions, adjustments or estimates. In the event that changes result in a material change to the ratio, the proposed rules would require the registrant to describe the reason for the change and provide an estimate of the impact of the change on the median and the ratio. As with the requirement that registrants use a consistent methodology, this requirement is intended to guard against the risk that a registrant would manipulate methodologies to reach a more favorable ratio.

Proposed Transition Period

The SEC proposes that registrants would be required to begin to comply with the pay ratio rules with respect to the first fiscal year commencing on or after the effective date of the rules. As explained above, the disclosure would then need to be included in the registrant's Form 10-K, proxy statement or registration statement no later than 120 days after the end of the relevant fiscal year. Thus, if the pay ratio rules were to go into effect in 2014, a registrant with a fiscal year ending

[9] Companies with multiple payroll systems at different locations might find it particularly challenging to standardize compensation information.

December 31 would first be required to comply with the rules with respect to the 2015 fiscal year and would be required to include the disclosure for the first time in its Form 10-K, proxy statement or registration statement filed in 2016.

For newly public companies, the proposed rules would require initial compliance with respect to compensation for the first fiscal year commencing on or after the date the company becomes subject to the reporting requirements under the Securities Exchange Act of 1934 (the "Exchange Act").

Timing for Disclosure

The proposed rules generally would require that the disclosure be updated annually, at the time of the filing of the registrant's annual report on Form 10-K or, if later, the filing of a proxy or information statement for the registrant's annual shareholder meeting, but not later than 12o days after the end of the registrant's fiscal year. However, if the registrant omits salary or bonus information for the CEO in reliance on Instruction 1 to Item 402(c)(2)(iii) and (iv) because the amounts are not calculable at the time of filing, the proposed rules would permit the registrant to provide the pay ratio disclosure in the same filing in which the CEO's initially omitted compensation information is disclosed.

Disclosure to be Deemed "Filed"

The proposed rules provide that the pay ratio disclosure will be considered "filed" for purposes of liability under the Securities Act of 1933 and the Exchange Act and is therefore subject to the certification requirements of Sections 13(a) and 15(d) of the Exchange Act.[10]

Conclusion

Due to the continuing controversy surrounding the pay ratio disclosure and the many topics on which the SEC has solicited comment, we expect that the SEC will receive thousands of comments on the proposed rules. The process of revising the proposal to address these comments is likely to further delay the issuance of final rules. Because of the significant potential burden of the pay ratio rules, companies should nevertheless begin thinking about possible methodologies to comply with the rules in light of the companies' specific circumstances and business models. In light of the challenges analyzed above, we believe that a company's determination of the most appropriate methodology will likely be a lengthy and costly process as it considers alternate compliance methodologies. To prepare for implementation of the pay ratio rules, companies could, for example, review their different payroll and employee data systems and determine the

[10] Section 18 of the Exchange Act imposes liability for material misstatements or omissions for "filed" disclosure. "Furnished" disclosure under Regulation FD, such as the disclosure of certain market information made to institutional investors, does not attract liability under Section 18.

payroll and employee information available from non-US subsidiaries, experiment with different sampling methods, identify the compensation and benefit programs available globally and consider the compensation measure (e.g., base salary or other direct compensation) to determine the median employee. No action is required, however, until the SEC adopts final rules.

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