Proposed Pay Ratio Disclosure Rule Released by the SEC

September 20, 2013

On September 18, 2013, in a 3-2 vote, the SEC proposed a rule implementing the provision of the Dodd-Frank Act that requires U.S. public companies to disclose a ratio of their CEO's compensation to that of their median employee.[1]

The proposed rule, announced a full three years after the enactment of the Dodd-Frank Act, reflects the SEC's struggle with a statutory mandate that many view to be motivated by political interests, rather than shareholder benefit. While the proposal provides helpful flexibility in some areas, such as identifying the "median employee", it still leaves companies with the prospect that, starting with proxy statements as early as the 2016 season, they will be disclosing a ratio that will arguably form the basis for misleading comparisons.

Background and the Proposed Rule

Section 953(b) of the Dodd-Frank Act directs the SEC to amend Item 402 of Regulation S-K to require each registrant to disclose:

- the median of the annual total compensation of all employees of the registrant, except the chief executive officer (or any equivalent position) of the registrant, determined in accordance with Item 402(c);
- the annual total compensation of the chief executive officer (or any equivalent position) of the registrant; and
- the ratio of these two amounts.

The proposed rule (attached as Appendix A) implements Section 953(b) by adding a new Item 402(u) to Regulation S-K.

Effectiveness of the Proposed Rule

Q: When will the pay ratio disclosure first be required?

A: In a registrant's disclosure for the first fiscal year commencing on or after the effective date of the rule.

For most calendar year registrants filing annual proxy statements, the pay ratio is likely to be required as part of the executive compensation disclosure in proxy statements filed starting in 2016.

The proposed rule requires the pay ratio to be first prepared for the fiscal year following publication of the final rule and presented in the registrant's annual report on Form 10-K for that fiscal year, or in a proxy or information statement filed within 120 days after the end of the fiscal year.

Example. If the proposed rule becomes effective in January 2014, calendar year registrants will first provide the pay ratio disclosure for the 2015 fiscal year, either in an annual report or proxy or information statement filed in 2016.

[1] The full text of the release is available here and the SEC's factsheet is available here.

Q: Which filings must include the pay ratio disclosure?[2]

A: Any filing described in Item 10(a) of Regulation S-K that requires Item 402 disclosure.

This includes annual reports on Form 10-K, and proxy and information statements filed pursuant to the Securities Act of 1933 and the Securities Exchange Act of 1934, if these forms require Item 402 executive compensation disclosure. Generally, in registration statements, a registrant is permitted to incorporate by reference its pay ratio disclosure for the most recent fiscal period that had been included in its Form 10-K or definitive proxy statement for its annual meeting of shareholders.

Q: Which registrants are subject to the pay ratio disclosure?

A: Registrants that are required to provide summary compensation table disclosure pursuant to Item 402(c).

The following types of registrants are *exempt* from compliance with the proposed rule:

- emerging growth companies;[3]
- smaller reporting companies; and
- foreign private issuers (even those filing on Form 10-K) and MJDS filers.[4]

Q: Do any transition rules apply to new registrants?

A: Yes. Newly public companies need not provide the pay ratio disclosure until the first fiscal year beginning on or after the date the company becomes an Exchange Act filer.

The pay ratio disclosure is not required in a registration statement on Form S-1 or Form S-11 for an initial public offering or a registration statement on Form 10. Instead, a new registrant that is not an emerging growth company would first provide the pay ratio disclosure for its fiscal year beginning on or after the date the registrant becomes subject to the requirements of Section 13(a) or 15(d) of the Exchange Act. This disclosure would be provided either in its Form 10-K for such fiscal year or its proxy or information statement for such year, which must be filed no later than 120 days after the end of such fiscal year. Similarly, follow-on registration statements becoming effective after the beginning of the first full fiscal year after an initial public offering will need to include the pay ratio disclosure.

Example. If a new registrant has a calendar fiscal year and completes its IPO in October 2016, it will first provide the pay ratio disclosure in the proxy or information statement for its 2018 annual meeting of shareholders, where the disclosure would relate to its 2017 fiscal year.

The proposed rule does not include transition relief for companies that have undergone corporate transactions or business combinations; however, the SEC has requested comments on whether a registrant should be allowed to omit employees of a newly acquired entity for a post-transaction period.

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[2] In cases where a registrant relies on Instruction 1 to Items 402(c)(2)(iii) and (iv) of Regulation S-K to omit CEO compensation information, the proposed rule allows a registrant to omit its pay ratio disclosure from its annual filing and provide its pay ratio disclosure under Item 5.02(f) of Form 8-K in the Form 8-K in which the CEO's salary or bonus is disclosed.

[3] Emerging growth companies include issuers who have completed their IPO after December 8, 2011 and that have less than $1 billion in total annual gross revenues during their most recently completed fiscal year. An issuer remains an emerging growth company until the earliest of (i) the last day of the fiscal year during which it has total annual gross revenues in excess of $1 billion, (ii) the last day of the fiscal year following the fifth anniversary of its IPO, (iii) the date upon which it has issued more than $1 billion in non-convertible debt in the last three-year period and (iv) the date upon which it becomes a "large accelerated filer."

[4] MJDS filers are registrants who make filings in accordance with the U.S.-Canadian Multijurisdictional Disclosure System.

Details of the Proposed Rule

Q: Which employees are included?

A: All employees, including non-U.S., part-time, seasonal and temporary.

The proposed rule includes all employees (including officers other than the CEO) of the registrant and its subsidiaries employed as of the last day of the registrant's fiscal year. This includes all individual employees, whether full- or part-time, seasonal or temporary, in the U.S. or outside the U.S. Service providers who are not employed by the registrant or any of its subsidiaries, such as independent contractors or leased workers, are excluded. Franchise employees are also presumably excluded.

The SEC expressed its view that Section 953(b) of the Dodd-Frank Act mandates the inclusion of all employees on an enterprise-wide basis. Comments are requested as to alternative ways to fulfill the statutory mandate, including whether it would be possible to exclude non-U.S. or part-time employees.

The proposed rule requires inclusion of all employees as of the last day of the registrant's fiscal year, even though Section 953(b) does not prescribe any particular calculation date for the determination of who should be treated as an employee. The SEC indicates that this approach should facilitate compliance, but acknowledges that this may result in disclosure that does not fully reflect a registrant's workforce (for example, if a registrant has a calendar fiscal year and a large temporary workforce in the summer). The SEC specifically seeks comments regarding whether registrants should be permitted to choose their own calculation date and, if so, whether is it likely that registrants might structure their employment arrangements to reduce the number of workers employed on the calculation date.

The SEC notes arguments that the inclusion of employees outside of the U.S. and those who are not permanent, full-time employees could distort the comparability of employee compensation to that of a CEO, and acknowledges that the inclusion of non-U.S. employees raises compliance costs and data privacy concerns. The SEC indicates that the flexibility afforded in the proposed rule should help registrants manage these compliance costs and burdens. For example, registrants could estimate the compensation of non-U.S. employees in order to manage the data privacy risks.

Q: What adjustments are permitted for employees who are not employed during the entire fiscal year?

A: Total compensation may be, but is not required to be, annualized for permanent employees (whether full- or part-time) who are not employed during the entire fiscal year, but the compensation of temporary and seasonal workers may not be annualized.

If a registrant chooses to annualize compensation, it must do so for all permanent employees. A permanent part-time employee's compensation may not be adjusted to reflect a full-time equivalent schedule. Further, cost-of-living adjustments are not permitted, including for non-U.S. employees.

Example. If a permanent part-time employee with a three-day-per-week schedule earns $900/week and is on unpaid leave for eight weeks, such employee's compensation may be annualized to reflect an additional $7,200 in total compensation. In contrast, the compensation of this employee cannot be adjusted to reflect earnings of $1,500/week, as if the employee was a full-time employee.

Q: How is the median employee determined?

A: Using any reasonable method, including the use of statistical sampling or a consistently applied compensation measure.

The proposed rule provides expansive flexibility for a registrant to choose a method for determining its median employee that fits the size, structure and compensation practices of its business. It expressly provides that registrants do not have to calculate each employee's compensation using the Item

402(c)(2)(x) standard (the method used for the disclosure of a named executive officer's total annual compensation).

While the proposed rule does not include a safe harbor calculation methodology, as was recommended by some commentators, it does indicate that a number of approaches are acceptable, including (i) statistical sampling, and (ii) the use of a consistently applied compensation measure (*e.g.*, payroll or tax records). Other reasonable methods may also be utilized. In addition, the proposed rule permits registrants to use reasonable estimates in calculating compensation measures. Although many alternatives are available, the proposed rule makes clear that using employee earnings estimates from publicly available sources (such as those available through the U.S. Department of Labor's Bureau of Labor Statistics) is not permitted. The method implemented must yield a median that is specific to the registrant.

Statistical sampling is put forth as a method that could assist registrants with a large number of employees in determining the median in a relatively cost-efficient manner. The proposed rule does not mandate a particular estimation technique or confidence level for an estimated median, although the proposal acknowledges that compensation variance in a registrant's workforce can impact the necessary sample size. For many registrants, a sampling approach more complicated than simple random sampling would be necessary, and registrants are required to disclose their methodologies.

For registrants that choose to use a consistently applied compensation measure, the proposed rule provides a number of examples of acceptable compensation measures, including wages, total annual cash compensation, total direct compensation, and payroll and tax records, as well as total compensation calculated pursuant to Item 402(c)(2)(x). It is not required that the compensation measure used include data that covers the same one-year period as the registrant's fiscal year. For example, a registrant with a July 1 – June 30 fiscal year could use employee tax record data for the prior calendar year.

The SEC has requested comments with respect to many specific aspects of the median determination, including whether the proposed rule should instead be more prescriptive.

Q: What must be disclosed?

A: The (i) annual total compensation of the registrant's median employee and the CEO,[5] *(ii) ratio of the two amounts and (iii) methodology, material assumptions, adjustments and estimates used in the calculations.*

The proposed rule requires that the ratio be expressed either (i) as a ratio with the median employee compensation being "one" or (ii) narratively in terms of the multiple the CEO's compensation represents in respect of the median employee's compensation.

Example. If the median employee's annual total compensation is $40,000 and the CEO's annual total compensation is $8 million, the ratio could be described as "1 to 200" or "the CEO's compensation is 200 times the median of all employees' annual total compensation."

Registrants must also briefly describe the methodology and material assumptions, adjustments and estimates used in the calculation of the median and total annual compensation of employees, as well as any changes in methodology or assumptions from year to year. The SEC indicates that the description should be brief and does not need to be overly detailed or technical, and might include information on

[5] The proposed rule uses the term "principal executive officer" for consistency with the Item 402 requirements, which term includes any individual serving in the capacity as the registrant's principal executive officer during the last completed fiscal year. The result is that, if a registrant has more than one CEO during its last completed fiscal year, then theoretically, the pay ratio for each of these CEOs would need to be disclosed, although we expect clarification will be requested in the final rule.

statistical sampling like sample size, methods and how the sampling deals with separate business or geographic segments, currency translations and the annualizing of a newly hired permanent employee's compensation.

Registrants are permitted (but not required) to supplement the required disclosure with a narrative description, and with additional ratios, so long as any additional ratios are clearly identified, are not misleading and are not presented with greater prominence than the required ratio. This voluntary disclosure may be important to registrants who feel their numbers are skewed due to their structure or business model, such as registrants with significant numbers of non-U.S., part-time or seasonal employees. However, registrants may conclude that attempting to explain the pay ratio could implicitly lend unwarranted credence to this single data point, and will therefore simply let it stand for itself.

Q: How is "annual total compensation" for the median employee determined?

A: In the same manner as used for the summary compensation table.

While the proposed rule permits broad flexibility in the compensation measure used to identify the median employee, once the median employee is identified, it requires the median employee's compensation to be re-quantified based on "annual total compensation" determined in the same manner used under Item 402(c)(2)(x) for named executive officers (*i.e.*, the "Total" column in the registrant's summary compensation table). Accordingly, the median employee's and the CEO's "annual total compensation" for disclosure purposes includes the sum of the dollar value of:

- base salary (or if applicable, wages plus overtime compensation);
- bonus or other non-equity incentive plan compensation;
- the grant date fair value of stock awards and option awards;
- changes in pension and nonqualified deferred compensation earnings; and
- all other compensation, in each case, earned, granted or accrued during the registrant's most-recently completed fiscal year.

However, in recognition that the elements of compensation of the median employee may differ from named executive officers, the proposed rule permits registrants to use reasonable estimates in calculating annual total compensation of the median employee, where appropriate. If estimates are used, the registrant must provide a brief description of the estimates. The SEC notes that estimates may be appropriate in determining the value of multiemployer pension plan benefits and certain unique benefits provided to non-U.S. employees under local law or custom, although the proposed rule does not permit the inclusion of governmental benefits under local law, even if funded by employer tax payments (*e.g.*, mandatory government pensions or social healthcare).

In addition, the proposed rule permits the voluntary inclusion of certain compensation elements that registrants are allowed to omit from the summary compensation table (*e.g.*, health benefits, employee discounts, tuition reimbursements and other employee benefits provided under a non-discriminatory plan or perquisites and other personal benefits with an aggregate value of less than $10,000).[6] If these elements of compensation are included in the median employee's annual total compensation, then they

[6] Including amounts related to benefits such as healthcare could provide a more accurate view of the total value of the compensation provided to the median employee because for many employees health and welfare benefits are an important part of their total compensation packages.

must also be included (to the extent applicable) in the CEO's annual total compensation for purposes of the pay ratio disclosure.[7]

Implications and Observations

The flexibility provided in the proposed rule addresses some of the concerns raised by registrants regarding compliance costs and burdens of the pay ratio disclosure. However, the proposed rule does not appear to provide meaningful opportunity for registrants to account and adjust for several key aspects of their workforce structure and business model, including:

- the impact of multiple business lines with varying types of job functions;
- the use of part-time, temporary and seasonal employees;
- global operations with significant numbers of non-U.S. employees and variable labor costs across jurisdictions; and
- the fact that large components of CEO "annual compensation" are actually subject to future vesting and performance hurdles.

As a result, certain companies and industries may yield significantly higher pay ratios. The SEC acknowledges that the flexibility of the proposed rule reduces comparability across registrants, stating that "using the ratios to compare compensation practices between registrants without taking into account inherent differences in business models, which may not be readily available information, could possibly lead to potentially misleading conclusions and to unintended consequences."

Given the numerous open questions and alternatives raised by the SEC, registrants should consider submitting comments to the SEC directly or through an industry group. Registrants may also want to start to consider what methodologies and assumptions they might use to determine their median employee and that employee's annual total compensation. Or, considering the vagaries of the rulemaking process and the uncertainties of the inevitable litigation that will challenge any rule that is adopted, registrants may prefer to go back to their businesses and wait for the dust to settle.

[7] If registrants elect to include these additional items in annual total compensation, this may cause a discrepancy between the total CEO compensation reported in the summary compensation table and the total CEO compensation reported for pay ratio purposes, although this is not impermissible and would be understood from a reading of the brief description of the methodology used.

If you have any questions regarding the matters covered in this publication, please contact any of the lawyers listed below or your regular Davis Polk contact.

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§ 229.402 (Item 402) Executive Compensation

(u) Pay ratio disclosure. (1) Disclose:

(i) The median of the annual total compensation of all employees of the registrant, except the PEO of the registrant;

(ii) The annual total compensation of the PEO of the registrant; and

(iii) The ratio of the amount in paragraph (u)(1)(i) of this Item to the amount in paragraph (u)(1)(ii) of this Item. For purposes of the ratio required by this paragraph (u)(1)(iii), the amount in paragraph (u)(1)(i) of this Item shall equal one, or, alternatively, the ratio may be expressed narratively as the multiple that the amount in paragraph (u)(1)(ii) of this Item bears to the amount in in paragraph (u)(1)(i) of this Item.

(2) (i) For purposes of this paragraph (u), the total compensation of employees of the registrant (including the PEO of the registrant) shall be determined in accordance with paragraph (c)(2)(x) of this Item 402. In determining the total compensation, all references to "named executive officer" in this Item 402 and the instructions thereto may be deemed to refer instead, as applicable, to "employee" and, for non-salaried employees, references to "base salary" and "salary" in this Item 402 and the instructions thereto may be deemed to refer instead, as applicable, to "wages plus overtime."

(ii) For purposes of this paragraph (u), annual total compensation means total compensation for the registrant's last completed fiscal year.

(3) For purposes of this paragraph (u), employee or employee of the registrant means an individual employed by the registrant or any of its subsidiaries as of the last day of the registrant's last completed fiscal year. This includes any full-time, part-time, seasonal or temporary worker employed by the registrant or any of its subsidiaries on that day (including officers other than the PEO).

Instruction 1 to Item 402(u). Updating for the last completed fiscal year. Pay ratio information (*i.e.*, the disclosure called for by paragraph (u)(1) of this Item) with respect to the registrant's last completed fiscal year is not required to be disclosed until the filing of its annual report on Form 10-K for that last completed fiscal year or, if later, the filing of a definitive proxy or information statement relating to its next annual meeting of shareholders (or written consents in lieu of such a meeting) following the end of such fiscal year; provided that, the required pay ratio information must, in any event, be filed as provided in General Instruction G(3) of Form 10-K (17 CFR 249.310) not later than 120 days after the end of such fiscal year. In any filing made by a registrant after the end of its last completed fiscal year and before the filing of such Form 10-K or proxy or information statement, as applicable, a registrant that was subject to the requirements of paragraph (u) of this Item for the fiscal year prior to the last completed fiscal year shall include or incorporate by reference the information required by paragraph (u) of this Item for that prior fiscal year.

Instruction 2 to Item 402(u). Methodology and use of estimates. (i) Registrants may use (A) a methodology that uses reasonable estimates to identify the median and (B) reasonable estimates to calculate the annual total compensation or any elements of total compensation for employees other than the PEO.

(ii) In determining the employees from which the median is identified, a registrant may use (A) its employee population or (B) statistical sampling or other reasonable methods.

(iii) A registrant may identify the median employee using (A) annual total compensation or (B) any other compensation measure that is consistently applied to all employees included in the calculation, such as amounts derived from the registrant's payroll or tax records. In using a compensation measure other than

annual total compensation to identify the median employee, if that measure is recorded on a basis other than the registrant's fiscal year (such as payroll or tax information), the registrant may use the same annual period that is used to derive those amounts. Where a compensation measure other than annual total compensation is used to identify the median employee, the registrant must (A) disclose the compensation measure used and (B) calculate and disclose the annual total compensation for that median employee.

(iv) Registrants must briefly disclose and consistently apply any methodology used to identify the median and any material assumptions, adjustments or estimates used to identify the median or to determine total compensation or any elements of total compensation, and registrants must clearly identify any estimated amount. This disclosure should be a brief overview; it is not necessary to provide technical analyses or formulas. If a registrant changes methodology or material assumptions, adjustments or estimates from those used in its pay ratio disclosure for the prior fiscal year, and if the effects of any such change are material, the registrant shall briefly describe the change and the reasons for the change, and shall provide an estimate of the impact of the change on the median and the ratio.

Instruction 3 to Item 402(u). Permitted annualizing adjustments. A registrant may annualize the total compensation for all permanent employees (other than those in temporary or seasonal positions) that were employed by the registrant for less than the full fiscal year (such as newly hired employees or permanent employees on an unpaid leave of absence during the period).

Instruction 4 to Item 402(u). PEO compensation not available. A registrant that is relying on Instruction 1 to Item 402(c)(2)(iii) and (iv) in connection with the salary or bonus of the PEO for the last completed fiscal year, shall disclose that the pay ratio required by paragraph (u) of this Item is not calculable until the PEO salary or bonus, as applicable, is determined and shall disclose the date that the PEO's actual total compensation is expected to be determined. The disclosure required by paragraph (u) of this Item must then be disclosed in the filing under Item 5.02(f) of Form 8-K (17 CFR 249.308) that discloses the PEO's salary or bonus in accordance with Instruction 1 to Item 402(c)(2)(iii) and (iv).

Instruction 5 to Item 402(u). Transition period. A registrant must comply with paragraph (u) of this Item with respect to compensation for the first fiscal year commencing on or after the date the registrant first becomes subject to the requirements of Section 13(a) or 15(d) of the Exchange Act (15 U.S.C. 78m or 78o(d)), and may omit such pay ratio disclosure from any filing until it the filing of its annual report on Form 10-K for such fiscal year or, if later, the filing of a proxy or information statement relating to its next annual meeting of shareholders (or written consents in lieu of such a meeting) following the end of such year, provided that, such pay ratio disclosure must, in any event, be filed as provided in General Instruction G(3) of Form 10-K (17 CFR 249.310) not later than 120 days after the end of such fiscal year.

Instruction 6 to Item 402(u). Emerging growth companies. A registrant is not required to comply with paragraph (u) of this Item if it is an emerging growth company as defined in Section 3(a) of the Exchange Act (15 U.S.C. 78c(a)).