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SEC Proposes Rule on Required CEO Pay Ratio Disclosure

Organizations affected by the proposed rule, which may take effect for the 2016 proxy season, should consider submitting comments to the SEC.

On September 18, in order to implement the mandated disclosures under section 953(b) of the Dodd-Frank Wall Street Reform and Consumer Protection Act (Dodd-Frank), the U.S. Securities and Exchange Commission (SEC) proposed amendments to the existing executive compensation disclosure rules.[1] Section 953(b) of Dodd-Frank instructed the SEC to amend existing rules under Item 402 of Regulation S-K to require disclosure relating to the relationship of the CEO's compensation to that of the median employee.[2] The SEC's proposed rule will require most listed companies to disclose the following:

- The median of the annual total compensation of all employees, excluding the CEO
- The annual total compensation of the CEO
- The ratio of these two amounts

The SEC contemplates that its proposed rule may be effective for the 2016 proxy season. We expect, however, that the SEC will receive many adverse comments on the proposed rule, despite the flexibility that the rule is intended to permit, because the calculation of the median compensation will be burdensome—particularly for large multinational companies.

Methodology of the Proposed Rule

Which employees would an issuer have to take into account when determining the compensation of all employees?

All employees—including full-time, part-time, temporary, seasonal, and non-U.S. employees—would have to be included in the issuer's calculation of the median compensation. The determination would take into account those employees who are employed as of the last day of the issuer's fiscal year and would include those employed by the issuer or any of its subsidiaries.

The proposed rule does not exclude any *de minimis* compensation arrangements. Issuers would be permitted (but not required) to annualize the total compensation paid to a permanent employee who was not employed for the entire year, such as new hires (but, if the company were to annualize the compensation of such an employee, it would have to annualize it for all such employees). However, pay for part-time, temporary, or seasonal workers would not be permitted to be annualized. Issuers would be required to include non-U.S. employees in the median compensation calculation notwithstanding the impact on salaries of foreign currencies and different pay scales in

1. View the proposed rule at http://www.sec.gov/rules/proposed/2013/33-9452.pdf. The new CEO pay ratio disclosure requirement will be set forth in new Item 402(u) of Regulation S-K.

2. As a matter of strict mathematics, the statute seems to have reversed the desired comparison of CEO compensation versus median employee compensation. One estimate put that ratio at about 231:1 as of 2011. *See* "The ratio of CEO to worker compensation: Are they worth it?" *The Economist*, *Graphic detail* (May 8, 2012), http://www.economist.com/blogs/graphicdetail/2012/05/ratio-ceo-worker-compensation. Of course, that comparison did not use the SEC's current proposed methodology and was calculated using 2011 data. Based on 2011 and 2012 data when available, Bloomberg estimated the ratio at 204:1 for the S&P 500. *See* Elliot Blair Smith & Phil Kuntz, "CEO Pay 1,795-to-1 Multiple of Wages Skirts U.S. Law," *Bloomberg* (Apr. 30, 2013), http://www.bloomberg.com/news/2013-04-30/ceo-pay-1-795-to-1-multiple-of-workers-skirts-law-as-sec-delays.html.

foreign countries.

How is the median employee's compensation determined under the proposed rule?

The proposed rule does not specify a required methodology for identifying a median employee for purposes of the compensation analysis. Instead, the proposed rule would allow issuers to select a methodology that is appropriate for the specific size and structure of the issuer's business and the way it compensates employees.

The SEC provided the following nonexhaustive list of methodologies that an issuer would be able to elect to use in determining its median employee:

- Use of a statistical sample of an issuer's entire employee population[3]
- Use of the total amount of annual compensation paid to an issuer's entire employee population, as determined under Regulation S-K
- Use of any "consistently applied compensation method," such as compensation amounts reported in an issuer's payroll or tax records (e.g., Forms W-2)

How is total compensation determined?

Once a median employee is identified, the proposed rule would require that the issuer calculate the median employee's total compensation using the definition of "total compensation" in Item 402(c)(2)(x) of Regulation S-K to ensure comparability with the CEO's total compensation over the same period. The proposed rule would permit issuers to use reasonable estimates to calculate the following:

- The annual total compensation of all employees
- Any element of the median employee's annual total compensation
- The annual total compensation of the median employee

What disclosure is required?

An issuer's pay ratio disclosure would have to be included in the same filings that are required to include executive compensation information under Item 402 of Regulation S-K (e.g., certain registration statements, proxy and information statements for the election of directors, and annual reports on Form 10-K for companies that cannot incorporate the disclosure in a proxy statement into Form 10-K). As part of the disclosure, issuers would be required to outline the methodology used to identify the median employee and total compensation, as well as any material assumptions, adjustments, or estimates used. This disclosure would be required to enable a reader to evaluate the appropriateness of the estimates. If any "consistently applied compensation methods" were used or estimates were made, issuers would be required to disclose this information and explain any changes in the methods or in any material assumptions, adjustments, or estimates. Narratives and additional ratios would be permitted, but not required, in the disclosure.

What to Expect Next

An issuer would be required to report the pay ratio with respect to compensation for its first fiscal year commencing on or after the effective date of the final rule. Accordingly, the proposed rule **will not affect the 2014 proxy season**, but, if finalized as proposed, in 2014, it would be generally effective for the 2016 proxy season (addressing 2015 pay data). For newly public companies, initial compliance would be required with respect to compensation for the first fiscal year commencing on or after the date the issuer becomes subject to the reporting requirements. The proposed rule would not apply to emerging-growth companies, smaller reporting companies, foreign private issuers, or issuers that file reports and registration statements with the SEC in accordance with the requirements of the U.S.-Canadian Multijurisdictional Disclosure System.

3. Page 119 of the proposed rule provides information from the Bureau of Labor Statistics as to statistical sampling in certain industries, including Motor Vehicle Manufacturing, Electric Power Generation, and Coal Mining. Although the sampling size for these industries may not be appropriate for a particular company in such industries, it may serve as a useful starting point and reference for such companies if they choose this methodology.

The proposed rule is now subject to a 60-day public comment period. Notwithstanding the SEC's proposed helpful and flexible approach, issuers with a significant number of employees and/or international operations may still need to collect a massive amount of data in order to comply. Further, the development of the specific categories of compensation data required by Item 402 of Regulation S-K for the median employee may present challenges to many issuers. Critics have already attacked the Dodd-Frank statutory provision as providing little useful information to investors compared to its presumably substantial cost of implementation. In contrast, a number of executive compensation commenters have noted that the mandatory annual disclosure of the CEO pay ratio will help to slow the rate of increase in CEO compensation.

We suggest that issuers try to determine the costs of implementing the SEC's proposed amendments and submit comment letters to the SEC explaining any concerns about the proposed rule and suggesting any revisions that would reduce implementation costs. If commenters estimate that significant costs will be incurred to comply with the proposed amendments, the SEC may develop an alternative pay ratio that would achieve Congress's objective. For example, a functionally equivalent pay ratio may be calculated if it were based on the average taxable compensation of full-time U.S. employees and the CEO's taxable compensation.

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