

# CLIENT UPDATE

## SEC PROPOSES CONTROVERSIAL CEO-TO-WORKER PAY RATIO DISCLOSURE RULE

### NEW YORK

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The SEC has approved a proposed rule, implementing the requirements under Section 953(b) of the Dodd-Frank Act, requiring companies to disclose the median of the annual total compensation of all employees of the company and the ratio of that median to the annual total compensation of its CEO. While it is easy to debate whether the benefit of such a rule to investors justifies the cost and complexity of assembling the required data, the SEC has offered registrants alternative methods of compliance that may make the process far less burdensome than could have been the case. And perhaps most importantly, as a practical matter, calendar year registrants will likely not need to comply with the rule until at least 2016.

The proposed pay ratio disclosure would be required in any annual report, proxy or information statement or registration statement that requires executive compensation disclosure under Item 402 of Regulation S-K. However, the proposed rule would not apply to smaller reporting companies, foreign private issuers and emerging growth companies, and would not be required in IPO disclosure.

### WHO IS THE MEDIAN EMPLOYEE?

As mandated by Dodd-Frank, the proposed rule requires disclosure of the median of the annual total compensation of all “employees” (meaning the annual total compensation of the employee at the compensation median).

While the annual total compensation of the median employee is required to be calculated under the same rules applicable for CEO compensation in the summary compensation table, the SEC has offered greater flexibility in determining the median employee. In an effort to reduce the costs and burdens of the rule, the SEC will permit companies to choose from several alternative methods to identify the median employee for purposes of calculating the pay ratio, including statistical sampling, calculating total compensation for each employee using Item 402(c)(2)(x) (the rules required for CEO annual total compensation disclosure), using “reasonable estimates” or using payroll or tax records. Issuers may also use reasonable estimates to calculate annual total compensation for the median employee. If the payroll or tax records used to determine the median employee are kept on a non-fiscal year basis (i.e., a calendar or other year), the issuer can use such other basis for determining the median employee (although the compensation would still have to be determined on a fiscal year basis). Thus, registrants can use their internal payroll records or tax records to identify the median employee without having to calculate the compensation of all of its employees using the total compensation methodology required for reporting the compensation of executive officers under Item 402.

The proposed rule does not prescribe what a “reasonable estimate” would entail because that would necessarily depend on the company’s particular facts and circumstances, including such variables as the size of the workforce, extent of different currencies involved, types of compensation that employees receive and the number of tax and accounting regimes involved. Companies would be required to disclose the methodology used, and any material assumptions, adjustments or estimates used to identify the median or to determine total compensation.

The proposed rule defines “employees” as all full-time, part-time, seasonal or temporary workers employed by the registrant or any of its subsidiaries (including officers other than the CEO) as of the last day of the registrant’s last completed fiscal year. Companies are permitted to annualize the total compensation for “permanent employees” (meaning those employees who are not seasonal or temporary) who did not work for the entire fiscal year, such as new hires or those who took an unpaid leave of absence. Companies, however, cannot make full-time equivalent adjustments for part-time workers, annualize adjustments for temporary or seasonal employees, or make cost-of-living adjustments for non-U.S. workers. In addition, companies cannot annualize some eligible employees and not others.

By permitting, but not requiring, companies to annualize compensation for certain employees, and by allowing for substantial variation in the method of calculating the median, the pay ratio disclosure will not be comparable across companies. Given

substantial variation in company circumstances and the impossibility of a uniform methodology, conformity of disclosure is unachievable and the disclosure of a pay ratio may not provide investors with a significant tool to evaluate CEO compensation. But perhaps this is a tacit acknowledgment by the SEC that this pay ratio provides little, if any, valuable information to investors, and therefore doesn't justify the Herculean effort and excessive expense that a strict application of Dodd-Frank's mandate would require.

#### **WHEN WILL THIS RULE GO INTO EFFECT?**

Initial compliance would be required with respect to compensation for the first fiscal year commencing on or after the effective date of the rule. Thus, companies likely will not have to report this pay ratio for several years. It is highly doubtful that the final rule would be adopted before 2014. Therefore, for calendar year companies, the first fiscal year after adoption would likely be 2015, resulting in disclosure of the pay ratio in 2016.

As proposed, a company would be permitted to omit this initial pay ratio disclosure from its filings until the filing of its annual report on Form 10-K for that fiscal year or, if later, the filing of a proxy or information statement for its next annual meeting of shareholders following the end of such year. The disclosure would not be required in connection with initial public offerings and new issuers would not have to comply until the first fiscal year commencing on or after the company's initial registration becomes effective.

Comments are due within 60 days from the proposal's publication in the Federal Register. Given the significant level of interest this provision generated prior to the rule proposal (with over 20,000 comment letters), it is likely that many comments will be submitted during the comment period, and may result in further delaying implementation of the final rule.

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Please do not hesitate to contact us with any questions.

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