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SEC Proposes Rules for Pay Ratio Disclosures

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On September 18, 2013, pursuant to Section 953(b) of the Dodd-Frank Wall Street Reform and Consumer Protection Act (the Dodd-Frank Act), the Securities and Exchange Commission (the Commission) proposed a new rule that would require public companies to disclose the ratio of the compensation of its principal executive officer (PEO) to the median compensation of all its employees. In order to satisfy the mandate of Section 953(b), the Commission proposed to amend existing Rule 402 of Regulation S-K to add a new subsection (u) which would require companies to disclose: (1) the median of the annual total compensation of all its employees except the PEO, (2) the annual total compensation of its PEO and (3) the ratio of the two amounts (the Pay Ratio).

The proposed rule comes only after significant delay during which time the Commission sought and received well over 20,000 comment letters. Section 953(b) is one of the most controversial provisions of the Dodd-Frank Act, with many commenters questioning the purpose of the required disclosure and its value relative to the potential compliance costs. The Commission stated that its objective in framing the proposed rule was to comply with the mandate of the Dodd-Frank Act, while allowing for sufficient flexibility in terms of approach to minimize potential compliance costs. The debate on the merits of the proposed rule and the extent to which the Commission's proposal meets its stated objectives of balancing competing concerns is likely to continue during the comment period for the rule proposal. The proposing release sets forth 60 questions upon which the Commission seeks specific comment, in addition to a call for general comments.

Determining the Median of Annual Total Compensation of All Employees other than the PEO

The proposed rule does not specify a particular methodology for identifying the median of all employees in terms of annual total compensation. Rather, it allows companies to select a methodology that is appropriate to the size and structure of their own businesses and the way they compensate employees. For example, a company could identify the median employee based on an analysis of its full employee population or a statistical sample of that population. Furthermore, a company could identify the median of the entire population or the statistical sample using annual total compensation as determined under existing executive compensation rules or using any consistently used compensation measure, such as compensation amounts reported in its payroll or tax records.

Once a company identifies the median employee through its chosen methodology, it would then be required to calculate the annual total compensation for that median employee in accordance with the definition of "total compensation" in existing Item 402(c)(2)(x) of Regulation S-K. "Annual total compensation" for these purposes would be "total compensation" for the last completed fiscal year. The proposal would allow companies to use reasonable estimates in the calculation of annual total compensation or any element of total compensation of the median employee.

In the proposing release, the Commission stated its belief that allowing a company to choose a methodology that works best for its particular facts and circumstances will help issuers to comply with the disclosure requirements in a relatively cost-efficient manner while still achieving the purpose of Section 953(b). Likewise, the Commission chose not to prescribe what a "reasonable estimate" would entail because it believes that would necessarily depend on the registrant's particular facts and circumstances. The proposed rules also do not prescribe specific estimation techniques or confidence levels for an estimated median because the Commission believes that each company will be in the best position to determine what is reasonable in light of its own employee population and access to compensation data.

The Commission's proposing release defines "all employees of the registrant" to include all employees (including full-time, part-time, temporary, seasonal and non-U.S. employees) that are employed by the company or any of its subsidiaries as of the last day of the company's prior fiscal year. Companies would be permitted, but not required, to annualize the total compensation for a permanent employee who did not work for the entire year, such as a new hire. However, companies would not be permitted to make full-time equivalent adjustments for part-time workers, annualizing adjustments for temporary and seasonal workers, or cost-of-living adjustments for non-U.S. workers. Only individuals employed at year end would be covered — accordingly, this approach would not capture seasonal or temporary employees not employed at year end. Additionally, independent contractors, "leased" workers and other temporary workers employed by a third party would not be covered.

The inclusion of non-U.S. workers, as opposed to limiting the definition to U.S. employees, will continue to be the topic of significant debate, as multinational companies have already raised concerns about compliance costs, difficulties in applying and determining Item 402 elements of compensation for non-U.S. employees, data privacy laws and other cross-border compliance issues. In the proposing release, the Commission stated its belief that these concerns were mitigated by the flexibility afforded to companies in the proposed rule.

Annual Total Compensation of the PEO and Presentation of the Pay Ratio

Under the proposed rule, the annual total compensation of the PEO would be determined in the same manner under Item 402(c)(2)(x) as it currently is calculated. The Pay Ratio would be the ratio of (A) the median of the annual total compensation of all employees of the registrant, except the PEO (as determined by a company's chosen methodology) to (B) the annual total compensation of the PEO. The Pay Ratio would be presented as a ratio in which the amount in (A) equals one or, alternatively, expressed narratively in terms of the multiple that the amount in (B) bears to the amount in (A).

Disclosure of Methodology, Assumptions, and Estimates

Under the proposed rule, companies would be required to briefly disclose the methodology used to identify the median of all employees, and any material assumptions, adjustments or estimates used to identify the median or to determine total compensation. If a company identifies a median employee based on a consistently applied compensation measure, the proposed rule would require disclosure of the measure that it used. Also, companies would be required to clearly identify any amounts that are estimated. If the methodology or material assumptions, adjustments or estimates are changed from year to year and the effects of any such changes are material, the disclosure must also briefly describe the change, the reasons for the change and the estimated impact in order to promote year-over-year comparability. Companies would be permitted but not required to supplement the required disclosure with a narrative discussion or additional ratios if they choose to do so. The Commission noted that when statistical sampling is used, companies should disclose the size of the sample relative to the estimated whole population, any material assumptions used in determining the sample size, the sampling methods used and how the sampling took into effect separate payrolls.

The Companies and Filings to which the New Disclosures Apply

Companies would be required to describe the Pay Ratio information in registration statements, proxy and information statements, and annual reports that must already include executive compensation information as set forth in Item 402 of Regulation S-K. However, companies would not be required to disclose the Pay Ratio information in reports that do not require executive compensation information such as current and quarterly reports. Companies would not be required to update their disclosure for the most recently completed fiscal year until the company files its proxy or information statement for its annual meeting of shareholders (or annual report for companies that do not file proxy or information statements for annual meetings). The proposed rule would not apply to emerging growth companies, smaller reporting companies or foreign private issuers.

Proposed Compliance Date and Transition Period for Newly Public Companies

A company 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. Thus, for instance, if the final rule were to become effective in 2014, a typical company with a December 31 fiscal year end would first be required to provide the Pay Ratio disclosure with respect to its compensation for the 2015 fiscal year presented in its proxy or information statement for the 2016 annual meeting of shareholders. The proposed rule would also provide a transition period for newly public companies. For these companies, initial compliance would be required with respect to compensation for the first fiscal year commencing on or after the date the company becomes subject to Commission reporting requirements.

Comment Period

The proposal will be subject to a 60-day public comment period once it is published in the Federal Register.

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