

September 20, 2013

## SEC Publishes CEO Pay Ratio Proposal

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### **Will Not Affect 2014 or, Most Likely, 2015 Proxy Seasons; Issuers May Use Sampling and Reasonable Estimates to Determine Median; Ratio Must Include All Full-Time, Part-Time, Temporary, Seasonal and Non-U.S. Employees**

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#### **SUMMARY**

On Wednesday, the SEC published the text of its proposed rule, adopted that morning by a three-to-two vote, requiring U.S. public companies to disclose:

- the median annual total compensation of all employees of the issuer other than the CEO;
- the annual total compensation of the CEO; and
- the ratio of those two amounts.

Disclosure would be required with respect to the first fiscal year starting on or after the effective date of the final rule; accordingly, the rule will not affect the 2014 proxy season and likely will not affect the 2015 proxy season. The proposed requirement would not apply to foreign private issuers, smaller reporting companies or emerging growth companies under the JOBS Act, and newly public companies would not be required to comply until after their first full fiscal year as a reporting company.

Notable highlights of the ratio calculation include:

- *All* employees (including full-time, part-time, temporary, seasonal and non-U.S. employees) must be included in determining the median employee.
- In determining the median employee, an issuer may select a methodology that is appropriate to its size, structure and compensation practices. This could include, for example, statistical sampling or consistently applied compensation measures (such as payroll or tax records).
- The issuer would then calculate the median employee's total compensation in accordance with current SEC rules (but could include perquisites and non-discriminatory benefits that would be excludable from total compensation in the Summary Compensation Table).
- Issuers may use reasonable estimates when calculating annual total compensation or any element of total compensation of the median employee.

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- The disclosure must briefly describe the methodology used to determine the median employee and any material assumptions, adjustments or estimates used to identify the median employee or to determine total compensation.

Comments on the proposal are due 60 days after the proposal text is published in the Federal Register. The SEC has specifically requested quantitative information as to costs and benefits of the proposed rule and any alternatives suggested by commenters.

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### BACKGROUND

Section 953(b) of the Dodd-Frank Wall Street Reform and Consumer Protection Act (“Dodd-Frank”) directs the SEC to amend Item 402 of Regulation S-K to require disclosure of (1) the median of the annual total compensation of all employees of the issuer, except the issuer’s CEO (or the equivalent); (2) the annual total compensation of the issuer’s CEO (or the equivalent); and (3) the ratio of those amounts. Total compensation is determined in accordance with Item 402(c)(2)(x) of Regulation S-K as in effect on July 20, 2010 (the day before Dodd-Frank was enacted), which captures base salary, bonuses, stock and option grants, non-equity incentive plan compensation, change in pension value, nonqualified deferred compensation earnings and certain other compensation, including perquisites. The Section does not specify how the median is to be determined, nor does it specify a timeline for SEC rulemaking.

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### PROPOSED RULE

In its release,<sup>1</sup> the SEC noted that they received approximately 22,860 comment letters and a petition with approximately 84,700 signatures in response to Section 953(b) of Dodd-Frank. Recognizing that pay ratio disclosure may have significant potential costs for the nearly 4,000 companies that would be subject to the rule, the SEC stated that the proposal was designed to lower the cost of compliance while remaining consistent with Dodd-Frank requirements. The SEC has specifically requested comments that are accompanied by supporting data and analysis, particularly quantitative information as to costs and benefits, and alternative proposals where appropriate.

### DISCLOSURE LOCATION AND TIMING

***Location of Disclosure.*** The release proposes to add Item 402(u) to Regulation S-K, which would require issuers to include the pay ratio disclosure in any annual report, proxy or information statement or registration statement that requires executive compensation disclosure under Item 402. For most issuers, this means the disclosure will appear only in the annual proxy statement, and will be incorporated by reference into the Form 10-K and registration statements on Form S-3.

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<sup>1</sup> See Pay Ratio Disclosure, Rel. Nos. 33-9452, 34-70443 (Sept. 18, 2013), *available at* <http://www.sec.gov/rules/proposed/2013/33-9452.pdf>.

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The proposal would allow issuers to present the pay ratio either as a numerical ratio where the median compensation is 1 (“X to 1”) or as a multiple in narrative form (“CEO pay is X times the median employee pay”).

**Timing.** Issuers would need to comply with the proposed rule with respect to the first fiscal year commencing on or after the effective date of the final rule. So if the final rule becomes effective in 2013, a calendar year issuer would first be required to include pay ratio information relating to compensation for fiscal year 2014 in its proxy or information statement for its 2015 annual meeting of shareholders. If the issuer does not file this statement within 120 days of the end of the fiscal year, it would need to include the pay ratio disclosure in its Form 10-K or an amendment thereto. The pay ratio disclosure would need to be updated each year when the issuer files its proxy or information statement relating to an annual meeting of shareholders (or, if the statement is not filed within 120 days of fiscal year-end, be included in its Form 10-K or amendment thereto).<sup>2</sup>

**Transition Period for New Registrants.** The pay ratio disclosure would not be required in a registration statement on Form S-1 for an initial public offering or registration statement on Form 10. For newly public companies, the disclosure requirement would apply with respect to compensation for the first fiscal year starting on or after the date the issuer becomes subject to the reporting requirements of Section 13(a) or Section 15(d) of the Securities Exchange Act of 1934.

**Exempt Companies.** The proposed requirements are limited to issuers that are required to provide Summary Compensation Table disclosure pursuant to Item 402(c) of Regulation S-K. Foreign private issuers, Multijurisdictional Disclosure System (or MJDS) filers, smaller reporting companies and emerging growth companies under the Jumpstart Our Business Startups Act are exempt from the requirement.

### COVERED EMPLOYEES

Under the proposed rule, “all employees” employed by the issuer and any of its subsidiaries (including officers other than the CEO) as of the last day of the fiscal year must be included in the calculation. “All employees” includes full-time, part-time, seasonal, temporary and non-U.S. employees. The definition would also include employees of a newly acquired entity. Independent contractors or “leased” or other temporary workers who are employed by a third party would not be included. The SEC acknowledged that costs of compliance would disproportionately fall on companies with large, multinational workforces with multiple business segments.

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<sup>2</sup> General Instruction G(3) of Form 10-K allows the information required by Part III of Form 10-K (including information required under Item 402 of Regulation S-K) to be incorporated by reference from the issuer’s definitive proxy statement filed pursuant to Regulation 14A or definitive information statement filed pursuant to Regulation 14C if that statement involves the election of directors and is filed no later than 120 days after the end of the fiscal year.

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Issuers may, but are not required to, annualize compensation for permanent employees who did not work for the full fiscal year, such as new hires or employees who took an unpaid leave of absence (e.g., leave under the Family and Medical Leave Act or active military duty). Full-time equivalent adjustments for part-time workers, annualizing adjustments for temporary and seasonal workers, and cost-of-living adjustments for non-U.S. workers would not be permitted.

### IDENTIFYING THE MEDIAN

The proposed rule does not specify any required calculation methodology for identifying the median, but allows each issuer to select a methodology that is appropriate for its size, structure and compensation practices. Issuers would be able to use all or a combination of the following:

- **Statistical sampling.** Issuers would be permitted to use their full employee population or a statistical sample of that population. The proposed rule does not prescribe specific estimation techniques or confidence levels, although (as discussed below) any material assumptions, adjustments or estimates used would need to be briefly described. The SEC noted that a reasonable determination of sample size would depend on the underlying distribution of compensation data around the mean.
- **Consistently applied compensation measure.** Issuers would be permitted to use annual total compensation as determined under Regulation S-K or any other consistently applied measure such as payroll or tax records. The proposed rule would also permit the issuer to use the same annual period that is used in the payroll or tax records (as opposed to the issuer's fiscal year).
- **Reasonable estimates.** Issuers would be permitted to use reasonable estimates in identifying the median. The SEC declined to prescribe what a reasonable estimate would entail, stating that it would depend on the issuer's particular facts and circumstances.

### DETERMINATION OF TOTAL COMPENSATION

Once the issuer identifies the median employee based on the methodology selected, the issuer would then determine the ratio and other disclosure based on the annual total compensation of that employee as calculated in accordance with Item 402(c)(2)(x) of Regulation S-K for the fiscal year. The release notes that this rule has not substantively changed since the adoption of Dodd-Frank, and that the SEC expects to address the impact on the proposed rule of any future amendments to Item 402(c)(2)(x) if and when such amendments are considered.

In calculating annual total compensation for the median employee (or any element of total compensation), issuers would be permitted to use reasonable estimates that approximate the actual amount of compensation awarded to, earned by or paid to the employee.

The existing compensation rules permit the exclusion from "total compensation" of perquisites that total less than \$10,000 and personal benefits under non-discriminatory plans (such as group life or healthcare benefits).<sup>3</sup> The proposing release states that, because these exclusions are permissive, not mandatory,

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<sup>3</sup> The SEC notes that accrued pension benefits from a government-mandated defined benefit pension plan would *not* be included in total compensation.

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an issuer would be permitted to *include* these amounts in the total compensation of the median employee (provided that the issuer similarly includes the applicable amounts in CEO compensation for purposes of the ratio, and explains the deviation from the Summary Compensation Table amounts). We anticipate that many companies would, in fact, determine to include these benefits in the median employee compensation, since these benefits will in many cases be a significant component of total compensation.

### DISCLOSURE OF METHODOLOGY, ASSUMPTIONS AND ESTIMATES

Under the proposed rule, the issuer must briefly disclose 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 element of total compensation). Any estimated amounts would need to be clearly identified as such. The SEC stated that the disclosure should be designed to provide information for a reader to be able to evaluate the appropriateness of the estimates, although technical analyses or formulas are not necessary. If an issuer changes its methodology or material assumptions, adjustments or estimates from year to year, and if the effects of the change are material, the issuer would be required to briefly describe the change, the reasons for the change and provide an estimate of the impact of the change on the median and the ratio.

The proposed rule would permit, but does not require, issuers to supplement the required disclosure with a narrative discussion of the pay ratio, the median or any supplemental information about employee compensation structures and policies that could provide context for or explain the ratio.

### OTHER MATTERS

The release also proposes to amend Item 5.02(f) of Form 8-K to address the situation where an issuer omits salary or bonus information for the CEO from the Summary Compensation Table because that information is not available until a later date.<sup>4</sup> The proposed rule would permit the issuer to omit pay ratio disclosure until those elements are determined and to provide the pay ratio disclosure in the same filing under Item 5.02(f) of Form 8-K in which the CEO's salary or bonus is disclosed.

The SEC also clarified that the pay ratio disclosure would be deemed "filed" and not "furnished". Accordingly, an issuer would be subject to liability under Section 18 of the Exchange Act for false or misleading disclosure unless it can establish that it acted in good faith and had no knowledge that the disclosure was false or misleading.

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<sup>4</sup> Instruction 1 to Items 402(c)(2)(iii) and (iv) provide that if the amount of salary or bonus earned in a given fiscal year is not calculable through the latest practicable date, a footnote must be included to the Summary Compensation Table disclosing that the amount is not calculable and providing the date that the amount is expected to be determined. Such amount must then be disclosed in a filing under Item 5.02(f) of Form 8-K.

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