

SEC Proposes Rules for Pay Ratio Disclosure

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On September 18, 2013, the Securities and Exchange Commission proposed amendments to Item 402 of Regulation S-K (Item 402) under the Securities Exchange Act of 1934 (Exchange Act) that will require issuers to disclose the ratio (pay ratio) of the median compensation of all employees of the issuer – excluding the compensation of the issuer’s principal executive officer (CEO) – to the compensation of the CEO.

The SEC has decided to let issuers use reasonable approaches in identifying the median employee, including statistical sampling. For a calendar year issuer, assuming the new rules become effective in 2014, pay ratio disclosure would be required for 2016 proxy filings covering 2015 compensation. Comments on the proposed rules are due no later than December 2, 2013.

Item 402 is the principal regulation governing disclosure of executive pay in proxy statements and other SEC filings. These amendments have been proposed to comply with the Dodd-Frank Act.

Scope of Proposed Rules

The proposed rules would require an issuer’s pay ratio to be disclosed in any filing that requires executive compensation disclosure under Item 402, such as annual reports on Form 10-K, registration statements and proxy and information statements. The SEC proposes that the pay ratio disclosure should be placed in context with other executive compensation disclosure rather than on a stand-alone basis.

In addition to excluding “emerging growth companies” from this reporting requirement, as per the JOBS Act, the SEC proposes to exclude smaller reporting companies and foreign private issuers from having to provide pay ratio disclosure. Neither smaller reporting companies nor foreign private issuers are required to provide this type of compensation disclosure under Item 402.

Proposed Disclosure

What should be disclosed?

The SEC has proposed adding Item 402(u) requiring the disclosure of (A) the median of the total annual compensation of all employees other than the CEO, (B) the total annual compensation of the CEO and (C) the ratio of “A” to “B”. The proposed rule would require that the median total compensation of all employees be equal to one (1) or, alternatively, expressed as a narrative in terms of the multiple that the total compensation of the CEO officer bears to the median. For example, if the median of the total annual compensation of all employees (other than the CEO) is \$50,000 and the total annual compensation of the CEO is \$10,000,000, the pay ratio would be expressed as “1 to 200” or narratively as “the CEO’s total annual compensation is 200 times that of the median of the annual total compensation of all employees (other than the CEO).”

Which employees are included in identification of the median?

The SEC notes that the Dodd-Frank Act requires that all full-time, part-time, seasonal or temporary workers (except for the CEO) be included in the determination of the median compensation of all employees. Workers such as independent contractors or other temporary workers that are employed by a third party would not be included in the determination of the median.

What is the calculation date for determining who is an employee?

Rather than requiring issuers to monitor their workforce throughout the year, the proposal defines an employee as an individual that is employed by the issuer as of the last day of the issuer's last completed fiscal year. The SEC has proposed this calculation date so that the determination date for pay ratio disclosure is consistent with the calculation date for determining the named executive officers (the so-called NEOs) under the current Item 402 requirements.

What adjustments can be made for annualizing compensation?

The SEC proposes that issuers should be permitted to annualize the total compensation for permanent employees who did not work through the entire year. The proposed rule does not require the compensation to be annualized; it would simply allow an issuer to make the adjustment. The release notes that this adjustment would only be permitted for permanent employees, and not for seasonal or temporary workers. In addition, an issuer would not be able to annualize compensation for some permanent employees but not others; the method must be applied consistently.

How does an issuer identify the median employee?

The proposal does not specify any required methodology for identifying the median. Instead, the SEC provides instruction and guidance that would permit issuers to choose from alternative methods so long as the method is used consistently and is briefly described in the relevant filing. The release suggests methods based on reasonable estimates or statistical sampling of annual cash compensation from a random sample of employees. Once the median employee is identified, the issuer would then calculate that employee's annual total compensation in accordance with Item 402.

Whether or not a particular method is appropriate for an issuer would depend on a number of factors, such as:

- the size and nature of the workforce,
- the complexity of the organization,
- the stratification of pay levels across the workforce,
- the types of compensation the employees receive,
- the extent that different currencies are involved,
- the number of tax and accounting regimes involved, and
- the number and type of payroll systems involved.

How is total compensation determined?

The proposed rule defines total compensation by reference to the calculation of total compensation found in Item 402(c)(2)(x). Although this calculation is typically compiled manually due to the complicated nature of the requirements, the SEC notes that an issuer would only be required to calculate and disclose such information for the one identified median employee. The proposal also allows for an issuer to use reasonable estimates so long as the issuer discloses that the amount of total compensation is an estimated amount and includes a brief description of the estimation methods used.

What disclosure must be included when reporting the pay ratio?

The SEC proposes instructions requiring issuers to briefly disclose and consistently apply the methodology used to identify the median or to determine total compensation and the elements of the total compensation. The issuer must also clearly identify any amounts that have been estimated and must provide sufficient information for the reader to be able to evaluate the appropriateness of the estimates. In addition, if the issuer changes methodology from year to year, the issuer must briefly describe the change, the reason for the change and an estimate of the impact of the change if the effect of such change is material.

When must pay ratio disclosure be updated?

The SEC proposes that the time period for the pay ratio disclosure should be the same as the time period used for the issuer's other executive compensation disclosure. Therefore, an issuer would be required to calculate the total compensation for the median employee

for the last completed fiscal year. The proposed rule would require pay ratio disclosure to be updated for the most recently completed fiscal year when the issuer files its annual report or its definitive proxy statement for its annual meeting of shareholders. In any case, the pay ratio disclosure must be filed no later than 120 days after the end of such fiscal year in accordance with the instructions to Form 10-K under the Exchange Act.

Timing Considerations

The proposed disclosure requirement would arise for a current issuer's first fiscal year commencing on or after the effective date of the final rule. An issuer would be permitted to omit the initial pay ratio disclosure from its filings until the filing of its annual report for that fiscal year or the filing of a proxy statement for its next annual meeting of shareholders. In the release, the SEC notes that if the final rules were to become effective in 2014, an issuer with a fiscal year ending on December 31 would be first required to include pay ratio disclosure relating to compensation for fiscal year 2015 in its proxy statement for its 2016 annual meeting.

Final Thoughts

Like a number of commentators, we have serious doubts about the benefits of a pay ratio disclosure. Even the SEC notes that "neither the statute nor the related legislative history directly states the objectives or intended benefits of the provision." At the end of the day, a ratio of 1 to a very much larger number will tell everyone what we already know: that, for the most part, CEO pay is very high.

Some commentators have observed that a more useful comparison might involve comparing the Item 402 compensation of an issuer's CEO to the compensation of the CEOs of the "peer group" companies commonly named by issuers in the Compensation Discussion & Analysis section of a proxy statement. A table that provided that information, along with some basic performance information about revenues, income and stock price of the peer group companies, compared to the same information for the issuer, would likely convey much more useful information to shareholders.

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