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Deadline Looming for Comments on SEC Proposed Rules on CEO Pay Ratio Disclosure

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The Securities and Exchange Commission (SEC) recently released its proposed rules to amend Item 402 of Regulation S-K to implement the pay ratio disclosure requirement in accordance with Section 953(b) of the Dodd-Frank Wall Street Reform and Consumer Protection Act (Dodd-Frank).

The deadline for submitting comments is December 2, 2013. This client alert summarizes the proposed rules and includes in "Annex A" ten categories of questions for which the SEC is seeking comments. A review of the SEC's questions evidences the many opportunities for providing comments and possibly influencing drafting of the final rules.

Dodd-Frank requires certain reporting companies to disclose the ratio of the median of the annual total compensation of all employees to the annual total compensation of the chief executive officer (CEO).[1]

This requirement reportedly was included in Dodd-Frank under pressure from shareholder activists and unions, public policy organizations and other groups are expected to use the pay ratio disclosure to challenge the compensation practices of companies for CEOs and senior management in general. It was added with little debate by Congress and, as one Senator noted at the time, "although provisions like this appeal to popular notions that CEO salaries are too high, they do not provide material information to investors who are trying to make a reasoned assessment of how executive compensation levels are set. Existing SEC disclosures already do this."[2]

While the proposed rules attempt to implement the pay ratio disclosure requirements in a manner that provides companies with flexibility, they still require that companies undertake a range of new inquires and analysis in connection with future SEC disclosure.

- **Disclosure Requirement**

The proposed rules would require the company to disclose (i) the median of the annual total compensation of all employees (excluding the CEO), (ii) the annual total compensation of the CEO, and (iii) the ratio of these two amounts. The proposed rules also would require disclosure of the methodology and material assumptions, adjustments and estimates used in the determination of the median or the calculation of the total compensation. The pay ratio would have to be expressed as a ratio in which the median of the annual total compensation of all employees is equal to one (e.g., 1 to 268), or, alternatively, could be expressed narratively in terms of the multiple that the CEO's annual total compensation amount bears to the median of the annual total compensation amount of all employees (e.g., "the CEO's annual total compensation is 268 times that of the median of the annual total compensation of all employees").

- **Identifying the "Median Employee"**

The proposed rules do not specify any required methodologies for identifying the median, and the SEC expressly rejected a "one-size-fits-all" approach. Accordingly, companies are free to choose between various approaches and may use reasonable estimates. Companies are permitted to determine the employees from whom the median is identified using the entire employee population, statistical sampling or other reasonable methods. [3] From this population, the "median employee" may be identified using annual total compensation or any other consistently applied compensation measure. Any methodology has to take into account employees, whether full-time, part-time, seasonal or temporary, who are employed by the registrant or any of its subsidiaries in any country (what the SEC refers to as coverage on an "enterprise-wide basis"). However, the proposed rules define an employee to include only those individuals employed as of the last day of the registrant's fiscal year (and not at any time during the year) and excludes leased workers and temporary employees employed by a third party. In instances where the employment relationship is permanent, registrants also are permitted, but not required, to annualize the total compensation for an employee who did not work for the entire year. However, the compensation of part-time employees may not be adjusted to reflect a full-time equivalent.

- **Identifying Annual Total Compensation for the "Median Employee"**

If a company identifies the "median employee" based on any consistently applied compensation measure, the proposed rules would require that the company take a second step and determine the "total compensation" of such "median employee" based on the "total compensation" standards of Item 402(c)(2)(x) of Regulation S-K[4] so as to conform with the disclosed total compensation of the CEO. However, because the "median employee" may be identified by statistical sampling, the proposed rules would permit the use of reasonable estimates to calculate the total compensation that would otherwise be disclosed under Item 402(c)(2)(x).

- **Covered Registrants and Filings**

Only those companies that are required to provide a summary compensation table disclosure pursuant to Item 402(c) of Regulation S-K would be subject to the pay ratio disclosure requirement. This would apply to companies with publicly traded equity, but also could apply to "voluntary filers" with no publicly traded equity but which have filing obligations with the SEC as a result of indenture provisions associated with debt held by institutional holders. However, registrants that are emerging growth companies (which could include portfolio companies of private equity firms that have elected voluntary filer status), smaller reporting companies, foreign private issuers and MJDS filers (e.g., Canadian issuers) would not be required to provide the pay ratio disclosure.

Covered companies would be required to include the pay ratio disclosure in any filing that requires executive compensation disclosure under Item 402 of Regulation S-K. Thus, the disclosure would be required in proxy statements, annual reports on Form 10-K, registration statements and information statements, to the extent these filings require compliance with Item 402. Like other Item 402 information, the pay ratio disclosure would be considered "filed" (not merely "furnished"), and therefore could give rise to liability for misrepresentations under the Federal securities laws.

- **Compliance Date**

The proposed rules would require companies to comply with the new rules in the first fiscal year beginning on or after the effective date of the final rules. Calculation of the ratio would be required once per year (as of the end of the registrant's fiscal year) and would not need to be disclosed until the filing of the registrant's annual report on Form 10-K for the last completed year or, if later, the filing of a proxy statement after such year-end, but in no event later than 120 days after the end of the registrant's fiscal year. A transition rule would permit a new registrant to provide the disclosure in the fiscal year beginning on or after the date the company becomes a covered registrant.

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If you have any questions as to how the proposed rules may impact your business, please do not hesitate to contact your Proskauer attorney or any member of our Employee Benefits, Executive Compensation & ERISA Litigation Practice Center.

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Annex A

Selected Questions from the SEC's Request for Comments on the Proposed Rules

Covered Filings

Should the SEC require the pay ratio disclosure only in filings in which Item 402 disclosure is required or should the proposed rules be expanded to forms that do not currently require Item 402 disclosure? (Question 1)

Do registrants need any additional guidance about which filings would require the proposed pay ratio disclosure? (Question 2)

Covered Registrants

Should the SEC revise the proposal so that smaller reporting companies would be subject to the proposed pay ratio disclosure requirements or, in the alternative, should smaller reporting companies be required to provide a modified version of the pay ratio disclosure? (Question 4)

What modifications would be needed to address the different reporting requirements that foreign private issuers and MJDS filers have for executive compensation disclosure in order to require pay ratio disclosure? (Question 5)

Covered Employees

Are there alternative ways to fulfill the statutory mandate of covering "all employees" that could reduce the compliance costs and cross-border issues raised by commentators? For example, would it be consistent with the statute to permit registrants to exclude non-U.S. employees from the calculation of the median? (Question 7)

Should the rule covering employees of a registrant's subsidiaries be limited only to subsidiaries that consolidate their financial statements with those of the registrant? (Question 11)

Should the rule be limited to employees that are employed directly by the registrant (excluding employees of its subsidiaries)? (Question 12)

Does the proposed inclusion of all employees raise competition concerns? If so, are there some industries or types of registrants that would be more affected than others? (Question 15)

Is it appropriate to allow registrants to annualize the compensation for non-seasonal, non-temporary employees who have only worked part of the year, as proposed? (Question 21)

For those that annualize, should the registrant be required to discuss the number or percentage of employees for which compensation was annualized? (Question 23)

Should the SEC allow full-time equivalent adjustments for part-time employees and temporary or seasonal employees, as recommended by some commenters? (Question 24)

Privacy Concerns

How would the proposed flexibility afforded to all registrants (i.e., selecting a method to identify the median, the use of statistical sampling or other reasonable estimation techniques and the use of consistently applied compensation measures to identify the median employee) impact any potential costs and burdens arising from local data privacy laws? (Question 9)

Are there applicable local data privacy laws that would prohibit the collection or transfer of data necessary to calculate the annual total compensation of an employee or group of employees or the identification of a median employee using a consistent compensation measure? (Question 10)

Could a registrant's competitors infer proprietary or sensitive information about the registrant's business operations, strategy or labor cost-structure from the proposed pay disclosure? (Question 68)

Note – The SEC expressly stated that commentators did not provide information about privacy laws sufficient to analyze the impact of the proposed rules; accordingly, privacy issues (including foreign data privacy laws) are an area of particular interest to the SEC.

Identifying the "Median Employee"

Should there be further guidance on the use of reasonable estimates in identifying the median or, in the alternative, should the proposed rules expressly disallow reasonable estimates? (Question 26)

What compensation measure would registrants likely use for the purpose of identifying the median employee? How would that measure compare to total compensation calculated under Item 402(c)(2)(x)? (Question 28)

Should the SEC, as proposed, permit registrants to use the time period that is used for payroll or tax recordkeeping when identifying the median employee based on consistently applied compensation measures, whether or not the time periods correspond with the last completed fiscal year or the tax year? (Question 29)

Determination of Annual Total Compensation

Should the requirements provide instructions or should the SEC provide additional guidance about how to apply the definition of total compensation under Item 402(c)(2)(x) to employees who are not executive officers? (Question 34)

Do registrants need further guidance on the permitted use of reasonable estimates in determining total compensation (or specific elements of total compensation) for employees other than the CEO in accordance with Item 402(c)(2)(x)? (Question 35)

Is it likely that the proposed requirements would affect the types of compensation that registrants provide to employees and, if so, what would that impact be? (Question 37)

Methodology, Assumptions and Estimates

Should the SEC require registrants to disclose information about the methodology and material assumptions, adjustments or estimates used in identifying the median or calculating annual total compensation for employees, as proposed? (Question 38)

Should the SEC require registrants to disclose additional narrative information about the pay ratio or its components, or factors that give context for the median, such as employment policies, use of part-time workers, use of seasonal workers, outsourcing and off-shoring strategies? (Question 40)

Should the SEC require registrants to disclose additional metrics about the total compensation of all employees (or of the statistical sample if one is used), such as the mean and the standard deviation, as a supplement to the required disclosure? (Question 41)

Date of Disclosure

Should the SEC, as proposed, require the pay ratio disclosure to be updated no earlier than the filing of a registrant's annual report on Form 10-K or, if later, the filing of a proxy or information statement for the registrant's annual meeting of shareholders (or written consents in lieu of such a meeting), and in any event not later than 120 days after the end of its fiscal year? (Question 43)

Is the proposed timing workable for registrants? Does it provide enough time after the end of the fiscal year for companies to identify the median of the total compensation of all employees for that year? (Question 44)

Is the proposed instruction appropriate in instances where registrants are relying on Instruction 1 to Items 402(c)(2)(iii) and (iv) with respect to the salary or bonus of the CEO that is not yet determinable? (Question 45)

Transition Matters

Should the transition periods be different for different types of registrants? If so, what transition periods should apply to which registrants? (Question 53)

Should the SEC provide a transition period for business combinations? If so, what should the transition be? (Question 54)

Does the proposed transition period for compliance by new registrants provide sufficient time (or, alternatively, too much time) for these companies to be able to comply? (Question 56)

General Comments

Are there any presentation issues on which companies need guidance or that should be clarified in the pay ratio disclosure requirements? (Question 6)

Should the pay ratio disclosure be deemed "filed" rather than "furnished"? (Question 50)

Are there alternatives to the proposals the SEC should consider that would satisfy the requirements of Section 953(b) of the Dodd-Frank Act? (Question 60)

Would it be necessary for registrants to change their systems or other employee compensation records in order to track the information needed to comply with the proposed pay ratio rules? (Question 62)

What impact would the proposed rules have on capital formation? How could the rules be changed to promote capital formation or to mitigate any negative effect on capital formation resulting from the rules, while still satisfying the mandate of Section 953(b)? (Question 69)

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Comments may be submitted by any of the methods listed below. All submissions should refer to File Number S7–07–13.

Electronic Comments

• Use the SEC's Internet comment form (http://www.sec.gov/rules/proposed.shtml);

• Send an email to rule-comments@sec.gov. Include File Number S7–07–13 on the subject line; or

• Use the Federal Rulemaking ePortal (http://www.regulations.gov).

Paper Comments

• Send paper comments to Elizabeth M. Murphy, Secretary, Securities and Exchange Commission, 100 F Street NE.,Washington, DC 20549–1090.

[1] The proposed rules use the term "principal executive officer" in lieu of "CEO" for consistency with the Item 402 executive compensation disclosure terminology.

[2] Senate Report No. 111-176, Dodd-Frank Act § 956 (Statements of Senator Shelby).

[3] The proposed rules require a "succinct description" about the methodology and material assumptions, adjustments and estimates used by the company.

[4] Such measure includes salary, bonus, stock awards, option awards, non-equity incentive plan compensation, non-qualified deferred compensation earnings and all other compensation.

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