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DISCLOSURE

SEC's Proposed CEO Pay Ratio Rules Provide Companies With Flexibility to Satisfy Dodd-Frank Mandate

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On September 18, 2013, the Securities and Exchange Commission ("SEC"), following a narrow three-to-two vote of the SEC commissioners, proposed new rules[1] to require the disclosure by public companies of the ratio of CEO pay to median employee pay. The pay ratio disclosure, mandated by Section 953(b)[2] of the Dodd-Frank Wall Street Reform and Consumer Protection Act ("Dodd-Frank"), has been the topic of extensive commentary and debate, both in favor and against such disclosure, since the time that Dodd-Frank was signed into law by President Obama over three years ago. Prior to the issuance of the proposed rules, the SEC had received more than 20,000 public comment letters relating to Section 953(b).[3] This article summarizes the background leading up to the SEC's proposal and analyzes the key features of the CEO pay ratio disclosure rules as proposed.

Background

Section 953(b) of Dodd-Frank directs the SEC to amend its executive compensation disclosure rules to require public companies to disclose (1) the median of the annual total compensation of all employees, other than the CEO; (2) the annual total compensation of the CEO; and (3) the ratio of the median employee annual

[1] Pay Ratio Disclosure, SEC Release Nos. 33-9452; 34-70,443 (proposed Sept. 18, 2013) (to be codified at 17 C.F.R., pts. 229, 249), *available at* http://www.sec.gov/rules/proposed/2013/33-9452.pdf.

[2] Dodd-Frank Wall Street Reform and Consumer Protection Act, Pub. L. No. 111-203, sec. 953(b), 124 Stat. 1376, 1904 (2010).

[3] Comments on Executive Compensation: Title IX Provisions of the Dodd-Frank Wall Street Reform and Consumer Protection Act, http://www.sec.gov/comments/df-title-ix/executive-compensation/executive-compensation.shtml.

total compensation to the CEO annual total compensation. Section 953(b) specifies that the total compensation of an employee should be determined in accordance with existing SEC executive compensation disclosure rules governing the preparation of the "summary compensation table," the table included in the annual Form 10-K or proxy statements of public companies in which they describe the compensation of their top five most highly compensated executives, including the CEO (the "named executive officers"). Under those rules, total compensation consists of numerous components, including salary, bonus, stock and option awards, long-term incentive pay, changes in pension value and perks, each of which is calculated in the specific manner required by the SEC.

Since Dodd-Frank's enactment, Section 953(b) has been the subject of intense scrutiny and debate and has garnered a significant amount of media attention. Supporters of the mandated disclosure, including unions and labor advocates, claim the CEO pay ratio constitutes material information for investors, particularly in light of the widely reported increase in income disparity in the United States between CEO pay and that of rank-and-file workers and the corresponding impact such disparity may have on employee morale and productivity (and thus corporate profitability).[4]

In contrast, business organizations, major law firms, and other pay ratio opponents (including certain House Republicans who have sought to repeal Section 953(b) in its entirety),[5] argue that the pay ratio would provide little to no insight for investors regarding comparable pay practices at public companies, because the data used will primarily correlate to the size and composition of a company's workforce, rather than to the size of the CEO's pay or the company's financial performance. In this regard, opponents note that, even within a single industry, median employee pay can vary based on numerous factors, including differences in organizational structures, geographical distribution of employees and degree of reliance on seasonal and outsourced workers. Opponents also argue that any benefit to investors from the pay ratio disclosure is far outweighed by the difficulties and time-consuming exercise of calculating median employee pay, especially for companies with large diverse workforces, multiple payroll and other compensation systems and global operations.

Proposed Pay Ratio Rules

Although the proposed rules largely track Section 953(b), the SEC notably declined to propose a specific pay ratio calculation methodology. Overall, the proposed rules took into consideration the views of many commentators that the cost of compliance with the Dodd-Frank disclosure requirements could be substantial for many companies. The proposed rules provide some flexibility to companies by allowing them to choose to identify the median in a manner that is appropriate for the size and structure of their businesses and compensation structures, using their entire employee population, statistical sampling, or another reasonable method. The proposed rules would also permit companies to use reasonable estimates in calculating annual total compensation (including components thereof) for employees other than the CEO.

Nevertheless, the proposed rules were sharply criticized by the two dissenting SEC commissioners, with Commissioner Michael Piwowar stating that the rule "unambiguously harms investors, negatively affects competition, promotes inefficiencies, and restricts capital formation." Several key aspects of the proposed pay ratio rules are discussed in greater detail below.

Employees Included in Identification of the Median. Section 953(b) specifically requires disclosure of the median of the annual total compensation of "all employees." Commentators have been split in their views of whether any pay ratio disclosure should take into account workers located outside of the United States or employees who are not permanent, full-time employees. Pay ratio critics argue that cost-of-living and currency variations affecting foreign compensation arrangements could distort pay ratios for global companies and that including seasonal or other part-time employees will inflate ratios for certain industries, such as retail, regardless of CEO pay. Proponents claim that excluding such employees from the calculation would be contrary to Congress' intent and diminish the meaningfulness of the pay ratio.

Although the SEC acknowledged the compliance cost and comparability concerns for including non-U.S. employees in the identification of the median, under the proposed rules, the median would cover all employees (other than the CEO), without carve-outs for categories of employees. The SEC did, however, offer some relief to companies by proposing a bright-line calculation date for determining covered employees—the proposed rule defines "employee" as an individual employed on the last day of a company's last completed fiscal year. This proposed calculation date would eliminate the need to monitor changes in a company's workforce throughout a fiscal year for purposes of the pay ratio disclosure and is consistent with the calculation currently used to determine a company's named executive officers for compensation disclosure purposes. The proposed rules would also permit, but not require, companies to annualize compensation for all permanent (but not temporary or seasonal) employees who were employed for the full fiscal year.

Identifying the Median Employee. The proposed rules provide flexibility with respect to the method that a company may use to identify its median employee, i.e., the employee in the middle of the pay scale. Despite the possibility raised by some commentators that the SEC could require an average rather than a median amount to reduce costs of compliance, the SEC declined, similar to its interpretation of "all employees," to propose a measure that is contrary to the specific language of Section 953(b).

The SEC did, however, determine that Section 953(b) does not set forth a methodology for identifying the me-

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[4] *See* Elliot Blair Smith & Phil Kuntz, *CEO Pay 1,795-to-1 Multiple of Wages Skirts U.S. Law*, Bloomberg, Apr. 30, 2013, http://www.bloomberg.com/news/2013-04-30/ceo-pay-1-795-to-1-multiple-of-workers-skirts-law-as-sec-delays.html; Lawrence Mishal & Natalie Sabadish, *CEO Pay in 2012 was Extraordinarily High Relative to Typical Workers and Other High Earners*, Econ. Pol'y Inst., Issue Brief No. 225 (June 26, 2013), *available at* http://www.epi.org/files/2013/ceo-pay-2012-extraordinarily-high.pdf.

[5] *See* Burdensome Data Collection Relief Act, H.R. 1135, 113th Cong. (2013), *available at* http://beta.congress.gov/bill/113th/house-bill/1135.

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dian, nor does Section 953(b) direct the SEC to adopt a specific methodology for doing so. To offer the greatest degree of flexibility, the SEC therefore chose not to propose a required calculation methodology. Rather, the proposed rules would permit companies to identify the median employee by reference to all employees captured by the ''employee'' definition discussed above or, alternatively, through the use of a sampling technique or other statistically reasonable method.

In the case of sampling, the SEC declined to endorse any specific sampling approach, noting only that the size of a sample population needed for reasonable sampling may be less than 100 or more than 1,000, depending on a company's overall distribution of compensation. Under either approach, a company would be able to identify a median employee (representing the boundary between the highest paid 50 percent and the lowest paid 50 percent) based on any consistently applied compensation measure, such as cash compensation, total direct compensation or compensation amounts reported in payroll or tax records, including compensation that is reported to the IRS on Form W-2 and any foreign equivalent. If using payroll or tax records (which the SEC purposefully did not define or limit), a company would be able to use the same annual period that it uses in such records, rather than its fiscal year, to the extent such periods differed. The proposed rules additionally permit the use of reasonable estimates to identify the median employee; however, the SEC declined to prescribe what a reasonable estimate might entail.

Determination of Total Compensation. Once a company identifies the median employee utilizing the flexible approach described above, the proposed rules then require the company to calculate the total compensation for the company's last fiscal year for that employee (and only that employee) using the more complex rules that are currently used to calculate total compensation for the CEO and other named executive officers. Unlike the CEO total compensation calculation, however, companies would be permitted to use reasonable estimates to determine the value of any compensation element that is required to be taken into account by such rules, so long as there is a reasonable basis to conclude that such estimates approximate the actual amount of compensation paid to the median employee. By permitting reasonable estimates in making such calculation, the SEC hopes to eliminate, or at least minimize, any valuation issues (including with respect to certain pension plan arrangements and foreign employee benefits) that do not typically arise in the executive context.

Once a company has calculated the total annual compensation for the median employee, it would then be required to disclose such amount, along with the CEO's total annual compensation and a ratio (which may be expressed narratively as a multiple) of the median employee amount to the CEO amount.

Disclosure of Methodology, Assumptions and Estimates. The proposed rules would require companies to disclose the methodology used to identify the median and any material assumptions, adjustments or estimates used to identify the median or to determine total compensation. The proposed rules make clear that a succinct discussion, rather than a detailed, technical one, would satisfy this requirement. If a company uses a sampling technique, the SEC expects it to disclose the size of the sample as compared to the entire employee population, any material assumptions used to determine sample size, the sampling method used and how such method accounted for separate payrolls or significant issues arising from multiple business or geographical segments, if applicable. Consistent with the approach taken by the SEC in other disclosure contexts, the proposed rule would require companies to briefly describe and explain the reasons for any changes in methodology or material assumptions, adjustments or estimates from the prior year's calculations, to the extent the effects of such changes are material.

By proposing only a brief discussion of pay ratio methodology, assumptions and estimates, the SEC appears to be somewhat sensitive to the additional costs associated with mandating a more extensive narrative of the pay ratio components or the inclusion of supplemental information regarding compensation structures and polices, neither of which is required by the text of Section 953(b). It is likely, however, that the length (and therefore cost) of such disclosure will vary significantly between companies depending on the methodology used and the number of estimates involved. In addition, in some cases, companies may choose to provide supplemental information to provide context for a high ratio. The SEC made it clear that the inclusion of supplemental information, including additional ratios (as long as clearly identified as such and not presented with greater prominence than the required ratio), is permitted.

Next Steps and Transition Period

The proposed rules are subject to a 60-day comment period and, as such, remain subject to modification. The proposing release alone contains approximately 70 requests for comments (which in many cases consist of multiple subparts) that cover each of the key elements discussed above as well as some of the more technical aspects of the proposed rules. In his dissenting statement, Commissioner Daniel Gallagher specifically urged investors, public companies and others impacted by the proposal to submit ''detailed, data-heavy comments.''[6]

Assuming a substantial number of comments will be submitted, final pay ratio disclosure rules are unlikely to be adopted until 2014. Under the proposed transition period, companies would be required to comply with the pay ratio disclosure rules for the first fiscal year beginning after the effective date of the rules. If the final rules are adopted in 2014, a company with a calendar year fiscal year would thus be required to include the disclosure in its Form 10-K or proxy statement filed in 2016 (referencing 2015 fiscal year information). In proposing a lengthy transition period, the SEC recognized that many companies, particularly those with multiple payroll systems, will need a long transition period, coupled with a ''test year,'' to implement systems necessary to identify and verify the median of the annual total compensation of all employees.

[6] Daniel M. Gallagher, Comm'r, SEC, Dissenting Statement of Commissioner Daniel M. Gallagher Concerning the Proposal of Rules to Implement the Section 953(b) Pay Ratio Disclosure Provision of the Dodd-Frank Act (Sept. 18, 2013), *available at* http://www.sec.gov/News/Speech/Detail/Speech/1370539815919.

Conclusion

While the merits of the SEC proposed rules will continue to be debated, public companies should expect that they will be subject to these rules in some form, likely no earlier than the 2016 proxy season. While these rules may be subject to court challenge, we believe that it is unlikely that a court challenge to these rules would be successful (in contrast to the proxy access rules adopted by the SEC, which were successfully challenged in court in 2011), both because the SEC has devoted additional resources to conducting its economic cost-benefit analysis with respect to these rules and because this rule is mandated by Dodd-Frank (unlike the proxy access rules, which Dodd-Frank authorized, but did not require).

When these rules come into effect, it is unclear how they will be utilized by institutional investors or proxy advisory firms or will otherwise impact the stockholder voting landscape. We expect that most institutional investors will find the rules to be of limited utility, and that most institutional investors, as well as proxy advisory firms, will continue to give greater focus to another internal pay equity metric, the ratio of CEO total compensation to the total compensation of other named executive officers.

Nevertheless, whether or not any significant changes are made to the final rules, we believe that these rules likely are here to stay, and public companies should begin to consider how they will comply with the rules' mandates, while being mindful that certain details of the rules could be altered in the final rulemaking process. For example, public companies may want to begin to give consideration regarding their ability to calculate median total employee compensation utilizing their current payroll systems and/or what statistical sampling techniques they might utilize under the rules, particularly public companies that have large or transnational operations. In addition, public companies that will be impacted by the proposed rules should give consideration to submitting comments on aspects of the rules relevant to them, such as whether foreign or seasonal workers should be taken into account in connection with the calculation of the total median employee compensation.

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