Portfolio Media. Inc. | 860 Broadway, 6th Floor | New York, NY 10003 | www.law360.com
Phone: +1 646 783 7100 | Fax: +1 646 783 7161 | customerservice@law360.com

Inside The SEC Pay Ratio Disclosure Proposal

Law360, New York (September 20, 2013, 9:05 AM ET) -- On Sept. 18, 2013, the U.S. Securities and Exchange Commission proposed a rule that would require most public companies to disclose, annually, the ratio of the median of the annual total compensation of all of the company's employees to the annual total compensation of the company's principal executive officer.[1] This rule is mandated by Section 953(b) of the Dodd-Frank Wall Street Reform and Consumer Protection Act, which was enacted in 2010.

In explaining her support for the rule, SEC Chairwoman Mary Jo White stated that the proposed rule provides companies with the flexibility to control the costs of compliance, while fulfilling the statutory mandate of the Dodd-Frank Act. However, two commissioners dissented, citing, among other things, a concern that the rule does little to advance the SEC's core mission of investor protection.

The comment period on the proposed rule ends 60 days after the proposing release is published in the Federal Register.

The Proposed Rule

The proposed rule would require annual disclosure of (i) the median annual total compensation of all employees other than the principal executive officer (the "PEO"), (ii) the annual total compensation of the PEO and (iii) the ratio of the two amounts.[2] Consistent with Section 953(b) of the Dodd-Frank Act, "total compensation" would be calculated in accordance with Item 402(c)(2)(x) of Regulation S-K.[3] When reporting the ratio of these two figures, the amount in clause (i) would be expressed as "1," or, alternatively, the ratio could be expressed narratively as the multiple that the amount in clause (ii) bears to the amount in clause (i). For example, if the median annual total compensation of all employees is $40,000 and the annual total compensation of the PEO is $6 million, the ratio would be expressed as "1 to 150" or, alternatively, "the PEO's annual total compensation is 150 times the median annual total compensation of all other employees."

This new disclosure would be required in a company's annual report on Form 10-K, registration statements under the Securities Act of 1933 (the "Securities Act") and the Securities Exchange Act of 1934 (the "Exchange Act"), and proxy and information statements, to the extent such forms require executive compensation disclosure pursuant to Item 402 of Regulation S-K.[4] As discussed below, the pay ratio disclosure would need to be accompanied by a brief description of the methodology, including any material estimates and assumptions, used by the company to calculate the median annual total compensation of all employees.

As proposed, the required pay ratio disclosure would be calculated once per year, as of the end of the company's fiscal year, and would not need to be disclosed until the filing of the company's annual report on Form 10-K for that last completed fiscal year or, if later, the filing of a definitive proxy statement relating to its next annual meeting of shareholders after such year-end. In all cases, however, the year-end pay ratio disclosure must be disclosed within 120 days after the end of the company's fiscal year.[5]

Determining the Median Annual Total Compensation of All Employees

The proposed rule would not mandate a specific methodology for calculating the median annual total compensation of all employees; rather, each company would have discretion to use the most appropriate method of calculation based on the size and structure of its business and the way it compensates employees. Whichever methodologies are used, the proposed rule would require the calculation to cover all persons (other than the PEO) employed by the company or any of its subsidiaries on the last day of the most recent fiscal year, wherever located in the world, including full-time, part-time, seasonal and temporary employees.[6]

One way for a company to determine the median annual total compensation of all employees other than the PEO is to determine the total compensation of each employee in accordance with Item 402(c)(2)(x) of Regulation S-K, and then identify the median value (i.e., the point between the lower half and the upper half of the range of values). Recognizing that certain elements of total compensation under Item 402(c)(2)(x) require complicated calculations, the SEC has proposed to allow companies to use other methodologies that make use of reasonable estimates to identify the median, as well as reasonable estimates to calculate any of the elements of total compensation (other than for the PEO).

Instructions to the proposed rule set forth two specific, alternative methodologies that companies may use to identify the median employee — statistical sampling, and a consistently applied compensation measure other than "total compensation." We believe that the proposed rule would not foreclose the possibility of a company using other methodologies, if such methodologies use reasonable estimates and are appropriate in light of the company's facts and circumstances.

Statistical Sampling

The SEC proposes to permit a company to identify the median employee by analyzing only a statistical sampling of the total employee population, as long as the sampling method used is reasonable. The SEC notes that what constitutes a reasonable sampling methodology (including sample size) will depend on a variety of factors, such as the variance of underlying compensation distributions (i.e., how widely employee compensation is spread out or distributed around the mean), and variation in the type of employees across business units and geographical regions. Within a chosen employee sample, the SEC notes that companies could remove from the sample employees that have extremely high or extremely low pay, since the search for the median focuses on identifying the employee in the middle of the range.

Consistently Applied Compensation Measures Other than Total Compensation

The proposed rule would also permit companies to identify the median employee not by calculating "total compensation" for all employees, but by using any other compensation measure that is consistently applied to all employees included in the calculation, such as salary and wages or comparable amounts derived from the company's payroll or tax records. The proposing release states that companies are in the best position to select the appropriate compensation measure to use for this purpose based on their own facts and circumstances. The proposed rule also provides that, where the annual period for payroll or tax recordkeeping is different from the company's fiscal year, the company may nevertheless use its payroll and tax information to identify the median employee.

Calculating Total Compensation

After the median employee has been identified (whether through a review of compensation information for the entire employee pool or through an estimation process using statistical sampling), the company would then need to calculate the "total compensation" of the median employee in accordance with Item 402(c)(2)(x) of Regulation S-K. Since this would likely be a hypothetical employee if sampling was used to identify the median, the proposed rule would allow companies to use reasonable estimates to calculate any of the elements of total compensation for such employee. Such estimates might be especially useful when calculating items such as the grant date value of stock awards and option awards or change in pension value.

Additional Disclosure Regarding Methodologies Used

The proposed rule would require companies to "briefly" disclose (and consistently apply) any methodology used to identify the median, as well as any material assumptions, adjustments or estimates used to identify the median, or to determine total compensation or any element of total compensation. Further, any amounts that are estimates would be required to be clearly identified.

More specifically, in the proposing release the SEC stated that if statistical sampling is used, a company would be required to disclose the size of both the sample and the estimated entire employee population, any material assumptions used in determining the sample size, which sampling method (or methods) is used and, if applicable, how the sampling method deals with separate payrolls such as geographically separated employee populations or other issues arising from multiple businesses or geographic segments.

Further, where a company uses a compensation measure other than annual total compensation to identify the median employee, the company would be required to disclose the compensation measure used and calculate and disclose the annual total compensation for that median employee. If a company changes methodologies or material assumptions, adjustments or estimates from those used in a previous period, and if the effects of any such change are material, the company 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.

Issuers Not Subject to Proposed Rule

As proposed, the pay ratio disclosure rule would not apply to the following categories of issuers (none of which currently are subject to the disclosure obligations of Item 402(c) of Regulation S-K):

- Emerging growth companies (as defined in Section 3(a) of the Exchange Act)[7];
- Smaller reporting companies (as defined in Item 10(f)(1) of Regulation S-K);
- Foreign private issuers (as defined in Rule 405 under the Securities Act) that file annual reports and registration statements on Form 20-F[8]; and
- Companies that file annual reports and registration statements on Form 40-F in accordance with the U.S.-Canadian Multijurisdictional Disclosure System.

Compliance Date and Transition Issues

Companies would first be required to provide pay ratio disclosure for the first fiscal year commencing on or after the effective date of the proposed rule. Given that the comment period for the proposed rule terminates 60 days after the proposing release is published in the Federal Register, and based on the expected quantity and detail of comment letters to be submitted on the proposed rule[9], we believe it will be challenging for the SEC to adopt a final rule before the end of 2013. Assuming effectiveness of the pay ratio rule in 2014, we expect Dec. 31 fiscal year reporting companies to first have to disclose pay ratio information, relating to the 2015 fiscal year, in their proxy statements for their 2016 annual meeting of shareholders.[10]

Conclusion

Although the Dodd-Frank Act mandated pay ratio disclosure, the statute set no deadline for the SEC to act, and there are legitimate questions about the usefulness of the proposed disclosure to investors. In this respect, the proposed rule is, arguably, yet another example of Congress using the SEC to advance public policy goals not squarely rooted in the SEC’s historic mission of protecting investors.

Further, despite steps taken by the SEC to reduce compliance costs for companies, the proposed rule would, if enacted, certainly increase the costs and time required for companies to accurately prepare executive compensation disclosure required by Item 402 of Regulation S-K, including the likely need for many companies to retain outside advisers to assist in the statistical sampling and compilation process.

—By David H. Engvall and Brian K. Rosenzweig, Covington & Burling LLP

David Engvall is a partner and Brian Rosenzweig is a special counsel in the securities and capital markets practice group at Covington & Burling. Engvall is in the firm's Washington, D.C., office and Rosenzweig is in the firm's New York office. They advise public company clients and underwriters on a wide variety of SEC compliance and disclosure matters and capital markets transactions.

[1] Pay Ratio Disclosure, Rel. No. 33-9452 (Sep. 18, 2013), which can be obtained at http://www.sec.gov/rules/proposed/2013/33-9452.pdf.

[2] The new requirement would be set forth in new Item 402(u) of Regulation S-K.

[3] Item 402(c)(2)(x) of Regulation S-K generally provides that "total compensation" is the sum of an individual's salary, bonus, stock awards, option awards, non-equity incentive plan compensation, change in pension value, nonqualified deferred compensation earnings, and all other compensation, including perquisites.

[4] As with other executive compensation disclosures, pay ratio disclosure will be deemed "filed" and not "furnished" for purposes of liability under the Securities Act and Exchange Act.

[5] A company requesting that the SEC declare effective a registration statement after the end of its fiscal year but before it has filed its proxy statement for its annual meeting of shareholders will not be required to include updated pay ratio disclosure in order to have its registration statement declared effective. But, such companies must include or incorporate by reference in the registration statement their pay ratio disclosure (if it was required) for the fiscal year prior to the last completed fiscal year.

[6] The proposed rule would allow, but not require, companies to annualize the compensation of permanent employees that were not employed for the entire fiscal year, such as new hires (but if the company annualizes the compensation of any such employees, it must annualize it for all such employees). However, the proposed rule would not permit full-time equivalent adjustments for part-time workers, annualizing adjustments for temporary or seasonal employees, or cost-of-living adjustments for non-U.S. workers. The SEC contends that such adjustments could reduce comparability of disclosure across companies.

[7] An emerging growth company is one with total annual gross revenues of less than $1 billion during its most recently completed fiscal year; provided it did not publicly sell any of its common equity securities before Dec. 8, 2011.

[8] In addition, foreign private issuers that file annual reports on Form 10-K will continue to be able to satisfy Item 402 requirements by following the requirements of Items 6.B and 6.E.2 of Form 20-F and would not be required to make pay ratio disclosure.

[9] As of Sept. 15, 2013, the SEC had received approximately 22,860 comment letters and a petition with approximately 84,700 signatories in connection with Section 953(b) of the Dodd-Frank Act.

[10] IPO issuers that do not qualify as emerging growth companies will be permitted to omit pay ratio disclosure from a registration statement on Form S-1 or S-11, and will be required to first disclose pay ratio information for the first fiscal year commencing on or after the date the issuer becomes subject to the requirements of Section 13(a) or Section 15(d) of the Exchange Act.