# SEC Proposes Rules to Implement CEO Pay Ratio Disclosure Requirement

The Securities and Exchange Commission has taken action on the third major executive compensation-related provision of the Dodd-Frank Wall Street Reform and Consumer Protection, proposing rules to implement Section 953(b) of the Act, which requires public companies to compare and disclose the relationship between the annual total compensation of their Chief Executive Officer and the median of the annual total compensation of all their employees.

On September 18, 2013, the SEC proposed rules to implement this requirement. Comments by the public on the proposed rules must be submitted to the Commission within 60 days of their publication in the Federal Register, which we expect will take place shortly. Accordingly, comments will be due sometime in mid to late November.

This Thoughtful Pay Alert summarizes the key aspects of the proposed rules and provides our initial observations about their likely impact on technology and life sciences companies.

## Background

To enhance the mix of compensation information available to investors, Section 953(b) of the Dodd-Frank Act directs the SEC to amend Item 402 of Regulation S-K to require dis-

### Five Things Technology and Life Sciences Companies Should Know about the SEC's Proposed Rules on CEO Pay Ratio Disclosure

- **No Specific Calculation Methodology Required.** The proposed rules do not require companies to use a specific methodology to determine the median of the annual total compensation of their employees. Instead, companies would be permitted to select a methodology that is appropriate to the size and structure of their own businesses and the way they compensate employees. This may include, where appropriate, statistical sampling.
- **Must Determine Median of All Employees.** The proposed rules require companies to consider the compensation of "all" employees in calculating the median of annual total compensation. This would include full-time, part-time, temporary, seasonal, and non-U.S. employees, as well as employees of subsidiaries, as long as the employees were employed as of the last day of the company's last completed fiscal year
- **Some Flexibility in Calculating Total Compensation of Employees.** While "total compensation" is to be calculated using the SEC's executive compensation disclosure rules, when calculating the median of the annual total compensation of their employees, the proposed rules permit companies to use reasonable estimates of various compensation elements.
- **Disclosure Required in Filings That Include Executive Compensation Disclosure.** The proposed rules require companies to provide the CEO pay ratio disclosure in any filing that includes the executive compensation information required by SEC rules, including registration statements, annual reports on Form 10-K, and proxy and information statements.
- **Compliance Not Required for Most Companies until 2016 Proxy Season.** Most observers do not expect the proposed rules to be adopted and become effective until sometime in 2014. Further, the proposed rules contemplate a transition period that would allow companies to omit disclosure of the CEO pay ratio information during the first year the rules are in effect. Thus, companies with calendar year fiscal year-ends would first comply with the new rules during the 2016 proxy season with respect to 2015 compensation information. In this situation, companies with mid-year fiscal year-ends (such as June 30th or September 30th) would be required to disclose the information in their proxy statements filed in late 2015 or early 2016 with respect to their 2014 or 2015 fiscal year, as applicable.

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closure of the relationship between the annual total compensation of a company's Chief Executive Officer and its median employee.

Specifically, the provision requires public companies (other than emerging growth companies) to disclose:

- The median of the annual total compensation of all its employees except its Chief Executive Officer;
- The annual total compensation of its Chief Executive Officer; and
- The ratio of the two amounts.

Almost immediately, Section 953(b) drew criticism from the corporate community, which contended that, for many companies, particularly those with international operations, the challenges and costs of compliance would be substantial, while the benefit to investors of such information was negligible at best. The provision has generated the most comments of any Dodd-Frank Act provision for which the SEC has rulemaking responsibility, including approximately 250 individual comment letters (many of which objected to all or certain aspects of the provision), approximately 22,600 form letters supporting the provision, and a petition with approximately 85,000 signatories also supporting the provision.

Largely as a result of its other rulemaking projects under the Dodd-Frank Act and the Jumpstart Our Business Startups ("JOBS") Act, as well as recent changes in the composition of the Commission itself, it has taken over three years for the SEC to formally propose rules to implement the CEO pay ratio disclosure requirement.

## Proposed Rules

On September 18, 2013, the SEC proposed amendments to Item 402 to implement the CEO pay ratio disclosure requirement. The key aspects of the proposed amendments are summarized hereafter.

### Determination of Median Annual Total Compensation of Employees

The proposed rules do not specify any particular calculation methodology for identifying the median of the annual total compensation of a company's employees. Instead, the proposed rules allow companies to choose from several alternative methods to identify the median, so that they may use an approach that works best for their own individual facts and circumstances and that is appropriate to the size, structure, and compensation practices of their own businesses. Specifically, the proposed rules permit a company to:

- Use a methodology that uses reasonable estimates to identify the median of annual total compensation of its employees.
- Use reasonable estimates to calculate the annual total compensation or any elements of compensation for these employees.
- Determine the employees from which the median is identified using its entire employee population or a statistical sampling or other reasonable methods.
- Identify the median employee using
  - annual total compensation; or
  - any other compensation measure that is consistently applied to all employees included in the calculation (such as amounts derived from payroll or tax records).

By allowing companies to choose the methods that work best for their particular facts and circumstances in identifying the median employee and calculating total compensation, the SEC is seeking to enable them to comply with the CEO pay ratio disclosure requirement in a relatively cost-efficient manner. Consistent with this approach, the proposed rules do not prescribe specific estimation techniques or confidence levels for an estimated median and, instead, rely on each company to determine what is reasonable in light of its own employee population and access to compensation data.

**Observations**. The SEC's proposal to permit flexibility in identifying the median of the annual total compensation of a company's employees represents a pragmatic decision to an intractable problem – formulating a single methodology that would work for the myriad of public companies subject to Section 953(b). While it's clear that this decision is intended to address the overarching complaint about the CEO pay ratio disclosure requirement – the cost of compliance, it is likely that global companies, as well as companies with a growing international presence, will still incur a significant investment in time and expense in generating the required employee compensation information.

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Further, it's unclear what benefits are likely to accrue to investors from the presentation of this information. Giving companies the ability to fashion their own calculation methodology potentially undermines the comparability of this information across companies. By the SEC's own admission, this could lead to misleading comparisons and unintended consequences. Thus, the SEC is faced with a true conundrum – trying to reconcile the costs of compliance with the wholly elusive benefits of the disclosure. This problem promises to be the crux of the debate on the proposed rules in the months ahead.

### Form of Presentation of Pay Ratio

One of the numerous criticisms of Section 953(b) has been its imprecision in describing how the pay ratio is to be presented. Rather than describe a presentation in which the annual total compensation of the Chief Executive Officer would be included in the numerator of the equation, with the median of the annual total compensation of all employees in the denominator, the statute appears to require the reverse. The proposed rules rectify this anomaly by permitting the ratio to be expressed in one of two ways:

- as a ratio in which the median of the annual total compensation of all employees is equal to one; or
- narratively in terms of the multiple that the Chief Executive Officer's annual total compensation bears to the median of the annual total compensation of all employees.

**Observations**. To ensure uniformity in presentation and to promote comparability, the SEC is proposing that the CEO pay ratio disclosure be presented in one of two specific ways. Thus, for example, if the median of the annual total compensation of all employees is $45,790,39 and the annual total compensation of the Chief Executive Officer is $12,260,000, the pay ratio disclosure would be "1 to 268," which may also be expressed narratively as "the Chief Executive Officer's annual total compensation is 268 times that of the median of the annual total compensation of all employees."

### Disclosure of Methodology, Assumptions, and Estimates

Under the proposed rules, companies are required to disclose the specific methodology used to identify the median of the annual total compensation of all employees, as well as any material assumptions, adjustments, or estimates used to identify the median or to determine total compensation or any elements of total compensation. Further, if a compensation measure other than annual total compensation is used to identify the median employee, a company is required to disclose the compensation measure used and calculate and disclose the annual total compensation for that median employee.

**Observations.** Given the likelihood of misinterpretation of the disclosure, we expect that some companies will seek to mitigate this problem by providing the context in which they believe the pay ratio information should be evaluated. Similar to what has occurred in the case of past disclosure rules, there may be a great deal of experimentation as companies gauge investor reactions to the disclosure and try to understand and anticipate the market response. We also expect to see the disclosure placed in a variety of locations within a company's executive compensation disclosure – the Executive Summary to the Compensation Discussion and Analysis (possibly as part of the pay-for-performance discussion), the competitive positioning discussion within the CD&A, or elsewhere in the body of the CD&A.

In its proposing release, the SEC indicates that companies will be permitted to supplement the required disclosure with a narrative discussion or additional ratios if they choose to do so. In light of the potential for misconstruing the CEO pay ratio disclosure, we expect that many companies will take advantage of this opportunity. For example, some companies are likely to view the disclosure as an additional way to present a robust analysis of their executive compensation program and make their case for their Say-on-Pay proposal. Still other companies, including those with diverse workforces (for example, a large number of lower-paid or part-time workers, or a significant international employee contingent), may choose to present a variety of pay ratios to better place the required pay ratio disclosure in context.

### Employees Covered

In interpreting Section 953(b), the SEC has construed the statute to cover employees on an enterprise-wide basis. Thus, under the proposed rules, the employees to be considered in the determination of median annual total compensation include the full-time employees of a company and any of its subsidiaries as of the last day of its last completed fiscal year, as well as part-time, seasonal, and temporary workers employed by the company and any of its

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subsidiaries as of the last day of the last completed fiscal year. This includes both U.S. and non-U.S. employees. The compensation of permanent employees who did not work for the entire year may be annualized (as long as the technique is used for all such employees), but annualization will not be permitted for seasonal or temporary workers. No cost of living adjustments will be allowed.

Further, the SEC expressly states that independent contractors, "leased" workers, or other temporary workers who are employed by a third party are not considered to be employees for purposes of the proposed rules.

Finally, by defining an employee as an individual employed as of the last day of a company's last completed fiscal year, the proposed rules establish a date for calculating the total compensation of the relevant employees which is consistent with the approach that is used to determine the three most highly-compensated executive officers for purposes of the executive compensation disclosure rules.

**Observations**. Although companies should welcome the SEC's decision to allow each company to select its own methodology for calculating the median of annual total compensation, its proposal to include all employees, regardless of status or location, will likely dampen their overall enthusiasm for the new disclosure requirement. Over the past three years, companies have lobbied vigorously for the SEC to limit the disclosure requirement to a company's U.S employees; preferably full-time employees.

For global companies, as well as growth-oriented companies with expanding international operations, the need to consider non-U.S. employees in the calculation could lead to significant challenges – and may lead them to rethink their workforce composition. At the extreme, this aspect of the proposed rules could encourage some companies to further "outsource" their work to avoid the fallout from disclosure of a relatively high CEO pay ratio (or at least to enable them to show a more lower ratio).

With respect to the cost of compliance, the SEC appears to implicitly acknowledge this issue through its extended "transition" period before compliance, which is intended to allow companies time to develop and test the systems needed to capture the necessary compensation data. Further, the SEC's decision to establish a single calculation date for determining who is an employee eliminates the burden of having to monitor workforce changes throughout the year. Since this approach also may lead to the omission of seasonal or temporary workers who are not employed at the end of the fiscal year, the SEC is soliciting comments on the impact that this will have on the utility of the required disclosure, as well as whether it may cause companies to structure their compensation arrangements to reduce their workforce before year-end.

### Definitions of "Total Compensation" and "Annual Total Compensation"

To ensure congruity in the presentation of the required information, the proposed rules require companies to calculate the total compensation of their employees using the same rules which apply to the calculation of the total compensation of their named executive officers for purposes of completing the Summary Compensation Table. Further, the proposed rules permit companies to use reasonable estimates to calculate the annual total compensation – or any specific element of total compensation – for its employees (other than its Chief Executive Officer).

**Observations**. One of the many criticisms of Section 953(b) has been its proposition that "total compensation" be calculated based on the SEC's executive compensation disclosure rules "as in effect on the day before the date of enactment of the [Dodd-Frank] Act." Interpreted literally, this would mean applying these rules as they existed on that date, ignoring subsequent revisions and enhancements. Fortunately, the SEC has exercised its judgment with respect to this aspect of the statute, proposing that the calculation be based on the current version of the executive compensation disclosure rules, which it states has not been substantively amended since the Dodd-Frank Act was signed into law. Interestingly, the SEC indicates that it expects to address the impact on the proposed rules of any future amendments to the definition of "total compensation" if and when any such future amendments are considered.

In addition, while companies have been able to develop cost-effective methods for determining the total compensation of their named executive officers, who consist of only a handful of employees, applying the SEC's rules to all, or a significant portion, of their entire workforce is likely to prove daunting, particularly for certain compensation elements. For example, companies that offer pension benefits to their employees are likely to face challenges in determining the aggregate change in actuarial present value of the accumulated benefits of a particular employee, Further

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complexities may arise in connection with other types of pay and benefits, such as personal benefits (for example, housing) offered or required in certain countries only, government-mandated pension plans, healthcare and welfare benefits, employees discounts, and similar forms of compensation. While the SEC is proposing to allow companies wide latitude to use reasonable estimates, where appropriate, to determine total compensation, this may prove challenging, particularly where such pay or benefits represents a significant portion of workers' overall pay – calculating such amounts will be expensive and time-consuming, while omitting or estimating such amounts may render the pay ratio less meaningful.

Finally, "annual total compensation" is to be the total compensation of a company's employees and its Chief Executive Officer for the last completed fiscal year. Thus, the required pay ratio for a given fiscal year will be based on the total compensation reported for the Chief Executive Officer for the last completed fiscal year in the Summary Compensation Table included in its definitive proxy statement (or annual report on Form 10-K) and the annual total compensation for the last completed fiscal year calculated for its employees as of the end of the previous fiscal year. This approach also ensures that the disclosure would not need to be updated more than once a year.

### Filings Subject to Disclosure Requirement and Timing of Disclosure

The proposed rules require a company to include the CEO pay ratio disclosure in any filing for which the executive compensation disclosure specified in Item 402 of Regulation S-K is required, which includes:

- an annual report on Form 10-K as required by the Securities Exchange Act of 1934;
- registration statements filed under the Securities Act of 1933 and the Exchange Act;
- proxy or information statements filed under the Exchange Act.

One benefit of this approach is that a company that files its definitive proxy statement within 120 days after the end of the last completed fiscal year will be able to take advantage of the SEC's "forward incorporation by reference" technique; thereby receiving credit for including the information in its annual report on Form 10-K as along as it physically including the disclosure in its definitive proxy statement for its next Annual Meeting of Shareholders following the end of such fiscal year.

**Observations**. Another criticism of Section 953(b) has been the apparent requirement that the CEO pay ratio disclosure be included in any securities law filing. The SEC has taken a narrower – and more practical – reading of the statute to mean that the disclosure be included in filings that require the presentation of executive compensation information pursuant to Item 402 of Regulation S-K.

Further, in deference to the time required to compile the information necessary to complete the executive compensation disclosure for the last completed fiscal year and to further reduce compliance burdens and costs, an annual report on Form 10-K or registration statement filed after fiscal year-end, but before the executive pay information is available, will not need to include the CEO pay ratio disclosure.

### Companies Subject to Disclosure Requirement

The proposed rules apply to companies subject to the reporting requirements of the Exchange Act, except for companies that qualify as "emerging growth companies," smaller reporting companies, and foreign private issuers.

**Observations**. As stipulated in the JOBS Act, which was signed into law in April 2012, "emerging growth companies" (that is, companies with annual revenues of less than $1 billion as of the end of their last completed fiscal year) are statutorily exempt from compliance with the CEO pay ratio disclosure requirement. In addition, the SEC has construed Congressional intent with respect to the scope of Section 953(b) by reading the statute to contemplate exempting smaller reporting companies and foreign private issuers from the disclosure requirement.

### Transition to Disclosure Requirement

The proposed rules require companies to comply with the CEO pay ratio disclosure requirement with respect to the compensation for their first fiscal year commencing on or after the effective date of the final rules.

**Observations**. To give companies adequate time to implement and test any necessary systems changes to capture the required median employee compensation information, the SEC is proposing a long transition period. As proposed, companies will be required to comply with the new rules

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with respect to the compensation for their first fiscal year commencing on or after the effective date of the final rules. For example, if the new rules are adopted in early 2014, companies with fiscal year-ends as early as June 30 and thereafter will be subject to the CEO pay ratio disclosure requirement with respect to the compensation of their Chief Executive Officer and employees for fiscal 2015. These companies would then be required to include the CEO pay ratio disclosure in the definitive proxy statement (or annual report on Form 10-K, as applicable) for that year, which would be filed in the second half of 2015 or the beginning of 2016. Companies with calendar year fiscal year-ends will not be subject to the CEO pay ratio disclosure requirement until the 2016 proxy season (with respect to the compensation paid in 2015).

### Comment Period

The SEC is soliciting comments from the public on the proposed rules for 60 days from the date that they are published in the Federal Register. Assuming such publication by early next week, the comment period is likely to run until mid to late November.

## Final Observations

Of the various executive compensation-related disclosure provisions of the Dodd-Frank Act, the CEO pay ratio disclosure requirement has turned out to be the most controversial. Given that the Dodd-Frank Act also included the mandatory shareholder advisory vote on executive compensation (the so-called “Say-on-Pay” vote), this is truly notable. And, while the SEC has attempted to respond to each of the numerous criticisms that have been leveled against Section 953(b) since its enactment, it’s apparent that the proposed rules do not completely address the principal complaint to the provision – that determining the annual total compensation for the median employee will be difficult and costly without providing any apparent benefit to investors. In particular, global companies are unlikely to be persuaded that the cost-benefit equation for the disclosure requirement has been adequately addressed.

Thus, we expect that, like the pre-proposal period, the next few months will generate a lively debate over the merits – and benefits – of the proposed rules. In the aftermath of its failed “proxy access” rulemaking, and with these issues in mind, the SEC has undertaken an extensive economic analysis (over 50 pages) of the CEO pay ratio disclosure requirement to help justify the approach reflected in the proposed rules. Consequently, the coming debate will contest the economics, as well as the substance, of the requirement.

It’s also worth noting that some form of legislative intervention remains possible. In June, the House Financial Service Committee approved the "The Burdensome Data Collection Relief Act" (H.R. 1135), which would repeal Section 953(b). While, in the current environment, this bill could win approval from the House of Representatives, its fate in the Senate is problematic. Nonetheless, given its tumultuous history, the final chapter of this provision may not yet have been written.

## Need Assistance?

Compensia has extensive experience in helping companies understand how the corporate governance and executive compensation-related disclosure provisions of the Dodd-Frank Act will affect the design, operation, and disclosure of their executive compensation program. If you would like assistance in analyzing how the proposed rules are likely to impact your executive compensation disclosure, or if you have any questions on the subjects addressed in this Thoughtful Pay Alert, please feel free to contact Mark A. Borges. ■

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