
SEC Proposes Pay Ratio Disclosures

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The Securities and Exchange Commission (SEC) has proposed rules under the Dodd-Frank Act to require public companies to disclose the ratio of the annual total compensation of their principal executive officer (PEO) to the median annual total compensation of all employees (Proposed Rules).

As directed by Section 953(b) of the Dodd-Frank Wall Street Reform and Consumer Protection Act, the Proposed Rules would amend Item 402 of Regulation S-K to require issuers to disclose:

- the median of the annual total compensation of all employees of the issuer, excluding the PEO;
- the annual total compensation of the PEO; and
- the ratio of the median disclosed to the annual total compensation of the PEO (e.g., 1 to 50).

The pay ratio disclosure would be required in all filings that require disclosure of executive compensation matters under Item 402 of Regulation S-K, including annual reports, proxy statements, information statements and certain registration statements. Emerging growth companies, smaller reporting companies and foreign private issuers would be exempt from this rule.

Assuming that the rules are finalized and adopted in 2014, these disclosures would be required no later than 120 days after the end of fiscal year 2015—for most issuers, either in the proxy statements for their 2016 annual meetings or on Form 10-K or an amendment to Form 10-K. However, a new registrant filing a registration statement on Form S-1 would not be required to provide these disclosures until the year after it becomes a public reporting company.

Covered Employees

For calculation purposes, issuers would be required to consider all full-time, part-time, seasonal and temporary workers employed by the issuer and its subsidiaries as of the last day of the prior fiscal year, irrespective of whether such employees are located in the U.S. or abroad. Independent contractors and other persons employed by third parties would be excluded from consideration.

The Proposed Rules permit issuers to annualize the compensation of permanent employees employed for less than the entire fiscal year. However, neither “full-time” adjustments for part-time, temporary or seasonal employees, nor cost-of-living adjustments for non-U.S. workers, are permissible.

Identifying the Median Employee

The SEC refused to set a bright line methodology for identifying the median employee. Instead, the Proposed Rules allow issuers to select a methodology that best fits their size, structure and compensation practices and permit issuers to use compensation information already maintained on their books and records. For example, if appropriate, an issuer could determine the median employee based on salary, wages and tips reported to the U.S. Internal Revenue Service on Form W-2 and the equivalent for non-U.S. employees. Other methods, such as statistical sampling and the use of reasonable estimates, are permitted so long as the selected compensation measure, when consistently applied, provides a reasonable estimate of median employee compensation.

Median Employee Total Compensation

After determining the median employee, issuers would be required to calculate the median employee’s total compensation in accordance with Item 402(c)(2)(x) of Regulation S-K. Item 402(c)(2)(x), which currently only applies to PEOs and certain named officers, requires consideration of a person’s base salary, bonuses, stock and option grants, compensation from non-equity incentive plans, changes in pension value, nonqualified deferred compensation earnings and certain other forms of compensation. While the SEC refused to simplify the total compensation calculation for the median employee, the Proposed Rules would allow issuers to use reasonable estimates for the value of elements of compensation that are not available with respect to the median employee.

In some cases, strict application of the Item 402(c)(2)(x) methodology to an employee that is not an executive officer might produce results that seem distorted, for example by excluding perquisites under \$10,000. Under the Proposed Rules, issuers may include items of compensation that might normally be excluded from the figures in the summary compensation table, as long as they do so for both the PEO and the median employee. In such a case, the issuer should explain any differences from the calculation used for the table and that used for the pay ratio disclosure.

Methodologies

Additionally, the Proposed Rules require a presentation of the methodologies, assumptions and estimates relied upon to identify the median employee and the estimates used to determine the median employee’s total compensation.

Practical Considerations

The Proposed Rules are open for public comment through December 2, 2013. Despite receiving and considering over 22,000 comment letters prior to releasing the Proposed Rules for public comments, the SEC embedded within the Proposed Rules 60 particular requests for comments, more than 55 of which are directed at specific and, in most cases, controversial elements of the proposals. Accordingly, it is difficult to anticipate what the final rules will require.

Although the Proposed Rules are expected to have the greatest impact on large multinational companies due to, among other things, the number of employees, variations in international payment practices, payment disparities among employees in different countries and the range of laws governing the collection and reporting of employment data, we suggest that all public reporting companies begin making preparations to review their employment structures, plan for data collection and begin considering what methodologies they would use to make the determinations required under the Proposed Rules. Since the Proposed Rules allow issuers to make supplemental disclosures, including additional ratios if desired, issuers should also consider what supplemental disclosures might provide helpful context for investors.

If you have any questions about the content of this alert, please contact the Pillsbury attorney with whom you regularly work, or the authors below.

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