

Client Alert

SEC Issues Proposed CEO Pay Ratio Rule

EXEQUITY

Independent Board and
Management Advisors

On September 18, 2013, more than three years after the Dodd-Frank Wall Street Reform and Consumer Protection Act (Dodd-Frank Act) became effective,¹ the Securities and Exchange Commission (SEC) issued a proposed rule to implement the mandate contained in Section 953(b) of the Dodd-Frank Act. Given the significant controversy regarding the implementation issues, costs, and benefits of the requirement, it is no wonder the SEC took its time before issuing its proposed rule. According to the SEC release,² the SEC already received a significant number of comments on this proposal even before issuing the proposed rule—260 unique comment letters, 22,600 form comment letters, and a petition with 84,700 signatories.³

All that time did not help the SEC come up with a one-size-fits-all method for companies to determine the median annual total compensation of all employees other than the CEO. Depending on your point of view, this may be either a positive or negative. Instead, the SEC decided to give companies the **flexibility** to figure out their own method of determining the median annual total compensation of all employees, including identifying a median employee using a statistical sample and/or an alternative compensation measure. Simply put, but not simply implemented, proposed Item 402(u) (the proposed “Pay Ratio Disclosure Rule”) would require companies to disclose:

- A. The median of the annual total compensation of all employees of the registrant, except the Principal Executive Officer (PEO⁴);
- B. The annual total compensation of the PEO; and
- C. The ratio of A to B by either (1) treating “A” as equal to “1,” or (2) expressing narratively as the multiple that “B” bears to “A.”

Collectively, A, B, and C are referred to as the Pay Ratio Disclosures.

Exequity Comment: *In order to make these calculations, companies must first determine the employee population. There are three choices: use the entire employee population, a statistical sample, or other reasonable methods. Once the employee population is determined, the median annual total compensation must be calculated.*

¹ The Dodd-Frank Act became effective July 21, 2010.

² *Pay Ratio Disclosure*, SEC Release 33-9452; 34-70443 (File No. S7-07-13) (Pay Ratio Disclosure Release).

³ Pay Ratio Disclosure Release, footnote 9.

⁴ While Section 953(b) of the Dodd-Frank Act requires the ratio with respect to “the chief executive officer (or any equivalent position),” the term PEO replaced CEO in the proxy disclosure rules related to executive compensation in the 2006 update and the SEC decided it was appropriate to make the Pay Ratio Disclosure Rule also use PEO.

Companies have two choices: they can use annual total compensation as defined for purposes of the Summary Compensation Table disclosure, with the flexibility to utilize estimates, or another compensation measure (e.g., salaries, salaries plus bonus, W-2 earnings). We anticipate that few companies will use the Summary Compensation Table definition of annual total compensation to determine the median employee. Rather, we expect most companies will use an alternative compensation measure, such as W-2 earnings (or its non-U.S. equivalent), to determine the median employee. If an alternative compensation method is used, this only identifies the median employee and annual total compensation must be calculated for that one employee (using the Summary Compensation Table method).

The SEC clearly tried to address registrants' concerns regarding the feasibility and cost of determining the median annual total compensation of all employees. Nevertheless, for many companies, particularly larger, complex, or global organizations, the calculations will be time-consuming and costly. The SEC estimated that of 4,000 registrants that will be subject to the rule, approximately 50% have an organizational structure which would allow the registrant to use a simple random sampling method. Of these companies, the majority would still have a sample size of 500 or more. The remaining 50% have multiple business and/or geographical segments. For these companies, statistical sampling will be much more difficult.

The table below presents key questions and answers with respect to the proposed Pay Ratio Disclosure Rule:

<p>How do we have to disclose the pay ratio?</p>	<p>The proposed rule indicates the pay ratio can be disclosed either as a number (e.g., 1 to 100) or in narrative form (e.g., the PEO's annual total compensation is 100 times that of the median of the annual total compensation of all employees) if expressed as a multiple that the PEO's annual total compensation bears to the median of the annual total compensation of all the employees except the PEO.</p>
<p>Who is an employee for purposes of the proposed Pay Ratio Disclosure Rule?</p>	<ul style="list-style-type: none"> • An employee is anyone employed by the registrant or any of its subsidiaries, including any U.S. or foreign, full-time, part-time, seasonal, or temporary worker employed by the registrant or any of its subsidiaries. • Independent contractors, "leased" workers, and other temporary workers who are employed by a third party are not covered.
<p>As of what date do we determine who is an employee for purposes of the Pay Ratio Disclosure Rule?</p>	<p>The determination of who is an employee for purposes of the Pay Ratio Disclosure Rule is made as of the last day of the registrant's last completed fiscal year.</p> <p><i>Exequity Comment: Thus, seasonal or temporary workers not employed as of the last day of the last completed fiscal year would not be included.</i></p> <p><i>Using the last day of the fiscal year maintains consistency with the date used for the determination of who are the three most highly compensated executive officers under Item 402(a)(3)(iii) for the Summary Compensation Table.</i></p>
<p>How is annual total compensation determined?</p>	<p>Annual total compensation is determined in the exact same manner in which it is calculated for purposes of disclosure in the Summary Compensation Table.</p>

Do we have to determine annual total compensation for each of our employees and then figure out the median?

No. While this method is permitted, the proposed rule provides several other methods for determining the median, which are likely to be utilized more frequently.

Equity Comment: *Opting to determine the **annual total compensation for all employees** other than the PEO to calculate the median may introduce time constraints depending on when a company determines annual bonus amounts. For example, if a company does not determine annual bonuses until late in the first quarter of the following year, it may not have enough time to run the calculation and determine the median amount before the proxy filing deadline.*

What methods can be used to determine the median annual compensation of all employees?

- The proposed Pay Ratio Disclosure Rule **does not require** a particular method for determining the median. Instead, the instructions indicate companies can use a methodology that uses reasonable estimates to identify the median.
- Furthermore, in determining which employees will be used to identify the median, a company may use (1) its **employee population** or (2) **statistical sampling or other reasonable methods**.
- In identifying the **median employee**, a company may use (1) annual total compensation (compensation determined in accordance with the Summary Compensation Table rules) or (2) any other compensation measure consistently applied to all employees included in the calculation, such as amounts derived from a company's payroll or tax records.

"Median employee?" I thought the rule was asking for the median annual total compensation of the employees other than the PEO?

This is one example where the SEC is permitting flexibility. Recognizing it is not economically feasible to calculate the annual total compensation of all employees and derive the median, the SEC is allowing companies to determine the median employee using statistical sampling and/or a compensation measure other than annual total compensation. However, once the median employee is identified, annual total compensation must be calculated, but only for that one employee.

Equity Comment: *We expect many companies, particularly large and/or global employers, will use W-2 wages (or its non-U.S. equivalent) and a statistical sample to determine the median employee. This ability to simply identify a **median employee** and then calculate that median employee's annual total compensation should somewhat lighten the burden in complying with the Pay Ratio Disclosure Rule.*

What additional disclosure, beyond the ratio, is required?

- Registrants must **briefly disclose** and consistently apply any **methodology** used to identify the median and any **material assumptions, adjustments, or estimates** used to identify the median or to determine total compensation or any elements of total compensation—and registrants must identify any estimated amount as such.
- Where a compensation measure other than annual total compensation is used (e.g., salary, wages, and overtime for the fiscal year, W-2 Box 1 or similar amounts, etc.), the company must (1) disclose the **compensation measure used** and (2) calculate and disclose the **annual total**

compensation for that **median employee**. The SEC has indicated this disclosure as well as any disclosure about the method used to determine the **median employee** should be brief. The proposed Pay Ratio Disclosure Rule provides that in disclosing the methodology and material assumptions, adjustments, and estimates used, a company should provide sufficient information for a reader to be able to evaluate the appropriateness of the estimates.

- If statistical sampling is used, the proposed rule indicates the disclosure might need to include the size of both the sample and the estimated whole population, any material assumptions used in determining the sample size, which sampling method (or methods) was used, and, if applicable, how the sampling method deals with separate payrolls such as geographically separated employee populations or other issues arising from multiple business or geographic segments.

Example of Brief Disclosure of Compensation Measure

Used: “We determined the median using salary, wages, and tips as reported to the U.S. Internal Revenue Service on Form W-2 and the equivalent for our non-U.S. employees.”⁵

Exequity Comment: *Based on the brief disclosure request for describing methods employed in complying with the Pay Ratio Disclosure Rule, if a company does utilize statistical sampling, it may have a harder time briefly describing its methodology. Additionally, we expect the SEC may focus on those companies that indicate they used statistical sampling and make some follow-up requests, especially given the SEC’s lack of information disclosed in the Pay Ratio Disclosure Release as to how these methods could actually be employed.*

Will supplemental disclosures be permitted?

Companies will be permitted to supplement the required disclosure with a narrative discussion if they choose. Companies are also permitted to present additional ratios to supplement the required ratio. As with other disclosure requirements, however, any additional ratio must be clearly identified and not misleading, and should not be presented with greater prominence than the required ratio.

Exequity Comment: *We expect many companies to take advantage of this “permission” and anticipate they will provide ratios that provide greater context for their business, e.g., excluding foreign, seasonal, or temporary workers, and/or explaining why a supplemental metric is more comparable than the one required (or why the required metric is not comparable).*

⁵ Pay Ratio Disclosure Release, Section II.C.3., Identifying the Median, pp. 45–46.

What period of time is covered by “annual total compensation”?

The company’s last completed fiscal year.

Exequity Comment: *This is intended to ensure that the determination of annual total compensation for all employees other than the PEO is done using the same time frame as that used in the Summary Compensation Table for the PEO’s total compensation.*

Can pay be annualized?

- Total compensation for all **permanent** employees (full-time or part-time) that were employed less than the full fiscal year can be annualized. Examples cited by the proposed rule where annualization would be appropriate include employees hired during the last fiscal year or employees that miss work as a result of medical leave.
- Total compensation of temporary or seasonal workers cannot be annualized and the pay of part-time workers cannot be annualized to a full-time equivalent.

Are there any special considerations in determining annual total compensation for the *median employee* or all employees other than the PEO?

- **Cost-of-living or pay parity adjustments** for employees outside of the U.S. are **not permitted**.
- If an employee is a **union member** and entitled to benefits under a **multi-employer defined benefit pension plan**, a company should use reasonable estimates to determine the amount that reasonably approximates the aggregate change in the actuarial present value of such an employee’s defined pension benefit.
- In most cases, **amounts relating to a government-mandated pension plan** would **not be included** in an **employee’s total compensation** because the arrangement likely will not qualify as a company “retirement plan,” i.e., a plan in which the company pays a specified amount at retirement that is not tied to the investment performance of the contributions funding the plan.
- The method for determining total compensation **might understate the overall compensation paid to employees** who are not executive officers because the rules were designed to capture the differences between regular employees and executive officers, e.g., non-discriminatory and certain *de minimis* benefits are excluded from the Summary Compensation Table. However, the SEC staff indicated that these exclusions are permissive rather than mandatory. Therefore, companies would be permitted to include personal benefits and perquisites that aggregate less than \$10,000 and compensation under non-discriminatory benefit plans in calculating the annual total compensation of employees. But, if a company does so, it must be consistent with its approach in calculating the PEO’s total compensation and must then explain any difference between the PEO’s total compensation used in the Pay Ratio Disclosures and the total compensation amounts reflected in the Summary Compensation Table.

How should we handle compensation paid in a foreign currency?

The instructions to the proposed Pay Ratio Disclosure Rule do not directly address the foreign currency issue. We expect foreign currency conversions to be one of the assumptions that must be made in coming up with the Pay Ratio Disclosures. As such, it may need to be described in the accompanying narrative disclosure if it is a material assumption. The easiest thing may be to use a method consistent with the company's current financial reporting, i.e., how it currently handles salary, bonus, and other amounts paid in foreign currencies.

Can we change our method for determining the median employee from year to year?

Companies would be permitted to change their methodology, material assumptions, adjustments, or estimates from year to year. However, if such a change is made, and it has a material effect, the company must briefly describe the change and the reasons for it as well as provide an estimate of the impact of the change on the median and the ratio.

What filings have to include the Pay Ratio Disclosures?

Any filing described in Item 10(a) of Regulation S-K requiring executive compensation disclosure under Item 402 of Regulation S-K must include the Pay Ratio Disclosures. Therefore, the Pay Ratio Disclosures would be required in **annual reports on Form 10-K, registration statements** under the Securities Exchange Act, and **proxy and information statements**, to the extent that the requirements of these forms require compliance with Item 402. Therefore, for companies that incorporate their Item 402 disclosures into their Form 10-K annual reports by reference to their proxy statements, the Pay Ratio Disclosures would be included in their proxy statement.

When do the Pay Ratio Disclosures need to be updated?

Companies will not have to update the Pay Ratio Disclosures until they file their next annual report (but can include the disclosure in the next proxy statement if the compensation disclosures are incorporated by reference into the annual report and the proxy is filed in a timely manner). So, the Pay Ratio Disclosures are intended to be updated annually. Thus, filings made after year-end that are required to include Item 402 disclosures, e.g., registration statements, are not required to update the disclosure until the 10-K or proxy filing. The prior year Pay Ratio Disclosures would be disclosed in those filings.

What if we do not know our PEO's salary or bonus when we file our proxy? Do we still have to provide the Pay Ratio Disclosures?

If a company does not know the PEO's salary or bonus at the time it files a form with a Summary Compensation Table, a company can delay including the Pay Ratio Disclosures until it files the Form 8-K providing the missing PEO salary and/or bonus amount. The subsequent Form 8-K then would contain the missing PEO salary and/or bonus amount as well as the disclosures required by the Pay Ratio Disclosure Rule.

<p>Which companies have to comply with this Pay Ratio Disclosure Rule?</p>	<ul style="list-style-type: none"> • Only companies subject to Item 402(c) requirements will be required to comply with the Pay Ratio Disclosure Rule. • As a result, the following companies will not have to comply with the Pay Ratio Disclosure Rule: emerging growth companies under JOBS Act Section 102(a)(3), smaller reporting companies,⁶ foreign private issuers that file annual reports and registration statements on Form 20-F, and companies that file reports and registration statements in accordance with the requirements of the U.S.-Canadian Multijurisdictional Disclosure System.
<p>Will the Pay Ratio Disclosures be “filed” or “furnished?”</p>	<p>The proposed rule makes clear the Pay Ratio Disclosures will be filed for purposes of the Securities and Exchange Act, and therefore would be subject to potential liabilities thereunder.</p>
<p>When will the Pay Ratio Disclosure Rule become effective?</p>	<p>The SEC has proposed that companies would have to comply with Item 402(u) beginning with the first fiscal year commencing on or after the effective date of the rule, and companies would be permitted to exclude the initial Pay Ratio Disclosures from filings until the filing of its annual report on Form 10-K for that fiscal year.</p> <p>Timing Example: If the final rule becomes effective in 2014 (hypothetical stated in the proposed rule), calendar-year companies would include the Pay Ratio Disclosures in its Form 10-K filed with respect to 2015 in early 2016 or in its proxy statement or information statement for its 2016 annual meeting of shareholders.</p>
<p>When will the final rule likely be issued?</p>	<p>While the proposed rule uses 2014 as a hypothetical year in which the final rule is issued, it is possible that it could be earlier or later. However, it is unlikely to be earlier as that would necessitate the final rule being issued by December 31, 2013 in order for calendar-year companies to have to comply with it in 2015 filings. It is also unlikely to be later than 2014 as the adoption of the Pay Ratio Disclosure Rule seems to be a focus of the SEC Chair and a political issue which will likely prevent the consideration of the proposed rule dragging beyond 2014. Thus, we believe the most likely date for rule finalization is the first quarter of 2014.</p>
<p>I have comments on this proposal, what should I do?</p>	<p>The SEC is soliciting comments on a large number of questions it posed in the Pay Disclosure Ratio Release (over 60 questions). Companies will have 60 days from the date that the Release is published to submit comments to the SEC on this proposed rule. Comments can be submitted electronically using either the SEC’s comment form (available at http://www.sec.gov/rules/proposed.shtml) or by email sent to rule-comments@sec.gov (include “File Number S7-07-13” in the subject line). Comments must be received by November 17, 2013.</p>

⁶ As defined in Item 10(f)(1) of Regulation S-K, e.g., had a public float of less than \$75 million or public float of \$0 and annual revenues of less than \$50 million, etc.



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