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SEC Proposes CEO Pay Ratio Disclosure

The Securities and Exchange Commission has issued a proposed rule under Section 953(b) of the Dodd-Frank Wall Street Reform and Consumer Protection Act that would require larger, U.S. SEC reporting companies to disclose the median annual total compensation of all employees (other than a company's chief executive officer), the annual total compensation of the company's chief executive officer and the ratio of median compensation to the compensation of the chief executive officer.

The implementation of the pay ratio disclosure rule has been a topic of significant controversy. Critics believe that the new disclosure will be overly burdensome and costly, and ultimately unhelpful or even misleading to investors. Supporters argue that the disclosure will be a useful addition to the mix of executive compensation information that may serve as a positive influence on pay practices at certain public companies. The SEC's proposed rule is an attempt to balance the Dodd-Frank Act's mandate and provide registrants with significant flexibility in implementation. Comments are due 60 days after publication of the proposed rule in the *Federal Register*.

The Proposed Rule

Pay Ratio Disclosure. The proposed rule would add new Item 402(u) to Regulation S-K. As mandated by Section 953(b) of the Dodd-Frank Act, the rule would require that a registrant disclose:

(A) the median of the annual total compensation of all employees of the registrant, except the principal executive officer ("PEO")¹ of the registrant;

(B) the annual total compensation of the PEO of the registrant;² and

(C) the ratio of the amount in paragraph (A) to the amount in paragraph (B), presented as a ratio in which the amount in (A) equals one or, alternatively, expressed narratively in terms of the multiple that the amount in (B) bears to the amount in (A).

¹ The proposed rule uses the term "PEO" instead of "chief executive officer" for consistency with existing Item 402 requirements. "PEO" is defined in Item 402(a)(3) as "an individual serving as the registrant's principal executive officer or acting in a similar capacity during the last completed fiscal year."

² The annual total compensation of the PEO refers to the PEO's total compensation figure disclosed in the registrant's summary compensation table.

The SEC acknowledged difficulties that registrants may face in preparing the required disclosure, including that most compensation data is not tracked for employees other than named executive officers (“NEOs”) under Item 402 of Regulation S-K, that even NEO calculations are typically prepared manually in a time consuming process and that identifying the median employee for registrants with multiple business segments and geographic locations may be difficult.

Presentation of the Ratio. The proposed rule specifies that the ratio must be expressed as a ratio in which the median of the annual total compensation of all employees is equal to one, or, alternatively, expressed narratively in terms of the multiple that the PEO total compensation amount bears to the median of the annual total compensation amount. For example, if the median of the annual total compensation of all employees of a registrant is \$45,790, and the annual total compensation of a registrant’s PEO is \$12,260,000, then the pay ratio disclosed would be “1 to 268” (which could also be expressed narratively as “the PEO’s annual total compensation is 268 times that of the median of the annual total compensation of all employees”).

No Specific Methodology Required. In order to allow the greatest degree of flexibility while remaining consistent with the requirements of the Dodd-Frank Act, the proposed rule does not prescribe a specific methodology for identifying the median employee in terms of annual total compensation for all employees. Instead, registrants are permitted to choose from several alternative methods to identify the median, including (i) calculating total compensation for each employee using Item 402(c)(2)(x) of Regulation S-K, (ii) using reasonable estimates and/or (iii) using statistical sampling. The SEC indicated that the appropriate and most cost effective methodology would necessarily depend on a registrant’s particular facts and circumstances, including such variables as:

- the size and nature of the workforce;
- the complexity of the organization;
- the stratification of pay levels across the workforce;
- the types of compensation the employees receive;
- the extent that different currencies are involved;
- the number of tax and accounting regimes involved; and
- the number of payroll systems the registrant has and the degree of difficulty involved in integrating payroll systems to readily compile total compensation information for all employees.

Using Reasonable Estimates. A registrant would be permitted to use reasonable estimates in determining any elements of total compensation of employees other than the PEO, including when disclosing the annual total compensation of the median employee identified using a consistently applied compensation measure. In using an estimate for annual total compensation (or for a particular element of total compensation), a registrant should have a reasonable basis to conclude that the estimate approximates the actual amount of total compensation (or for a particular element of compensation) awarded to, earned by or paid to those employees.

Using Statistical Sampling. A registrant would also be permitted to identify the median employee based on total compensation using either its full employee population or a statistical sample of that population. While a relatively small sample size may be suitable in certain circumstances, the appropriate size of the statistical sample would be determined by the level of variance in the compensation of the registrant's employees, with higher variance levels requiring a larger sample size. The SEC estimates that approximately half of the registrants subject to the proposed rule could use a simple random sample of employees. The other half, including registrants with multiple businesses and/or geographic locations, would need to use more complicated statistical methodologies when identifying a sample of the employee population.

Using Consistently Applied Compensation Metrics. For purposes of determining the median employee, a registrant would be permitted to use any consistently applied compensation metric, such as compensation amounts reported in its payroll or tax records (instead of the more onerous "total compensation" calculation under Item 402(c) of Regulation S-K, which requires registrants to provide extensive compensation information about the PEO and other NEOs and is not ordinarily calculated for all employees). In using a compensation measure other than annual total compensation to identify the median employee, if that measure is recorded on a basis other than the registrant's fiscal year (such as payroll or tax information), the registrant would be permitted to use the same annual period that is used to derive those amounts. If a registrant identifies a median employee based on a consistently applied compensation measure, the proposed rule would require a brief disclosure of the measure that it used. Registrants using payroll or tax records to identify the median employee would still be required to calculate the Item 402(c)(2)(x) total compensation for that median employee for the last completed fiscal year, rather than the annual period used in the payroll or tax records.

Requirement to Disclose Methodology and Material Assumptions. Registrants would be required to identify any estimated amounts and provide a brief overview disclosing the methodology used to identify the median employee, and any material assumptions, adjustments or estimates used to identify the median employee or to determine total compensation. The release states that it is not necessary, however, to provide technical analyses or formulas. Registrants would be permitted, but not required, to supplement the pay ratio disclosure with a narrative discussion, and may present additional ratios to

supplement the required pay ratio (but any such additional ratios should be clearly identified and not misleading, and should not be presented with greater prominence than the required ratio).

Updating Pay Ratio Disclosure. Registrants would be required to provide the pay ratio disclosure in any SEC filing that requires Item 402 compensation disclosure, including annual reports on Form 10-K, registration statements under the Securities Act and the Exchange Act, and proxy and information statements. Registrants would not be required to update pay ratio disclosure more than once a year.

Permitted Omission of Disclosure Where PEO Pay Is Not Yet Available. In instances where PEO compensation is not yet available, and the registrant takes advantage of Instruction 1 to Item 402(c)(2)(iii) and (iv) of Regulation S-K to omit disclosure of salary and bonus to the extent not calculable as of the latest practicable date, a registrant may disclose that the pay ratio required by Item 402(u) is not calculable until the PEO salary or bonus is determined, disclose the date that the PEO's actual total compensation is expected to be determined and provide its pay ratio disclosure in the same filing under Item 5.02(f) of Form 8-K in which the PEO's salary or bonus is disclosed. Although a filing on Form 8-K is triggered under Item 5.02(f) when the omitted salary or bonus becomes calculable in whole or in part, the pay ratio information would be required only when the salary or bonus becomes calculable in whole (which would avoid the need for multiple updates to the pay ratio disclosure until the final total compensation amount for the PEO is known).

Special Rules and Definitions. For purposes of the pay ratio calculation, the registrant would calculate the annual total compensation for the median employee in accordance with Item 402(c). The proposed rule clarifies that references to "named executive officer" in Item 402 may be deemed to refer instead to "employee," and references to "base salary" and "salary" may be deemed to refer instead to "wages plus overtime."

Under the proposed rule, "annual total compensation" would be defined to mean total compensation for the last completed fiscal year. Where the employment relationship is permanent, and not temporary or seasonal, registrants would be permitted (but not required) to annualize total compensation for employees who did not work for the entire fiscal year, such as a new hire or an employee who took an unpaid leave of absence. Registrants would not be permitted to annualize some eligible employees and not others. However, full-time equivalent adjustments for part-time workers, annualizing adjustments for temporary and seasonal workers, or cost-of-living adjustments for non-U.S. workers would not be permitted.

"Employee" or "employee of the registrant" would be defined to mean any individual employed by the registrant or any of its subsidiaries as of the last day of the registrant's last completed fiscal year. This includes any full-time, part-time, seasonal or temporary worker (including officers other than the PEO), and also includes non-U.S. workers. In the case of non-U.S. workers, the SEC acknowledged the potential impact of data privacy regulations, particularly in the European Union, and concluded that the ability to

estimate compensation of affected employees should address this concern. Workers who are not employed by the registrant or its subsidiaries, such as independent contractors or “leased” workers or other temporary workers who are employed by a third party, would not be covered. For example, if a registrant pays a fee to another company (such as a management company or an employee leasing agency) that supplies workers to the registrant, and those workers receive compensation from that other company, those workers would not be counted as employees of the registrant for purposes of the proposed rule.

Effectiveness and Applicability of the Proposed Rule

Generally. The SEC is proposing to require that a registrant comply with proposed Item 402(u) with respect to compensation for the registrant’s first fiscal year commencing on or after the effective date of the proposed rule, and a registrant would be permitted to omit this initial pay ratio disclosure until the filing of its annual report on Form 10-K for that fiscal year or, if later, the filing of a proxy or information statement for its next annual meeting of shareholders (or written consents in lieu of a meeting). Thus, if the final requirements were to become effective in 2014, a registrant with a fiscal year ending on December 31 would first be required to include pay ratio information relating to compensation for fiscal year 2015 in its proxy or information statement for its 2016 annual meeting of shareholders. Registrants would also be permitted to begin compliance earlier on a voluntary basis.

Scope. The proposed rule would not apply to foreign private issuers that file on Form 20-F, Canadian issuers that file on Form 40-F, or smaller reporting companies (as defined in Item 10(f)(1) of Regulation S-K). The proposed rule also would not apply to emerging growth companies (as defined in the JOBS Act).

Transition for New Registrants. New registrants would be permitted to delay compliance, so that pay ratio disclosure would not be required in a registration statement on Form S-1 or S-11 for an initial public offering or a registration statement on Form 10. Instead, such a registrant would be required to first comply with proposed Item 402(u) with respect to compensation for the first fiscal year commencing on or after the date the registrant becomes subject to the requirements of Section 13(a) or Section 15(d) of the Exchange Act, and could omit initial pay ratio disclosure from its filings until the filing of its Form 10-K for such fiscal year or, if later, the filing of a proxy or information statement for its next annual meeting of shareholders (or written consents in lieu of a meeting) following the end of such fiscal year, but in any event the initial pay ratio disclosure would be required to be filed as provided in General Instruction G(3) of Form 10-K not later than 120 days after the end of such fiscal year.

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For a copy of the pay ratio proposal, see <http://www.sec.gov/rules/proposed/2013/33-9452.pdf>.

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This memorandum is not intended to provide legal advice, and no legal or business decision should be based on its content. Questions concerning issues addressed in this memorandum should be directed to:

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