October 9, 2013

On September 18, 2013, the SEC proposed for public comment, by a vote of three to two, a new rule to implement Section 953(b) of the Dodd-Frank Wall Street Reform and Consumer Protection Act, often referred to as the pay-ratio provision. The pay-ratio provision mandates that the SEC require most public companies to disclose, in a wide range of their SEC filings:

- the median of the annual total compensation of all employees of the company, except the CEO (that is, the point at which half the employees earn more and half earn less);
- the annual total compensation of the CEO; and
- the ratio of the two amounts above.

The SEC's proposal to implement the pay-ratio provision comes more than three years after Dodd-Frank was signed into law. It has been reported that the SEC staff was ready with a "term sheet" for a pay-ratio disclosure proposal within six months after adoption of Dodd-Frank. But even before any proposal from the SEC had surfaced, pay-ratio disclosure was the subject of extensive discussion and interest-group lobbying, including vigorous efforts by business interests opposed to the provision (as well as a couple of attempts in the House of Representatives to repeal the provision altogether). At the same time, the highly prescriptive nature of this provision of Dodd-Frank had largely stymied the SEC's ability to streamline the required analysis sufficiently to make implementation more practical. Long delays resulted.

According to the SEC, more than 20,000 comment letters were submitted on the topic of pay-ratio disclosure before the SEC had even proposed the rule. Opponents of the provision have argued that, for almost all companies, calculating the ratio would be of little value to investors, but tremendously complicated, expensive and potentially inaccurate, especially for companies with a global workforce. Compensation information for all employees has not previously been a disclosure requirement and, they contended, most companies' complex payroll and pension systems are not structured to easily accumulate and analyze all the types of data that would be required to calculate the total compensation for every employee, especially employees outside the U.S. At the SEC's open meeting to approve release of the proposal, this view was largely echoed by the two dissenters, Commissioners Gallagher and Piwowar, who viewed the proposal as expensive without providing any economic benefit; in their view, the sole purpose of the rule was to "name and shame."

Unions and other pay-ratio disclosure advocates, focusing on reports of the mounting disparity between executive and worker pay (and income inequality in general), have argued that pay-ratio information is essential to allow investors to determine if executive pay is excessive and needs to be reined in. According to the **Economic Policy Institute**, for the largest U.S. public companies, CEO pay in 2012 was more than 273 times an average worker's pay, compared to just 20 times in 1965. Providing pay-ratio data, they contended, may encourage boards, in setting executive compensation, to consider internal pay equity, not just external peer-to-peer comparisons, which, many argue, tend to inflate executive pay. They also pointed to academic studies establishing that high pay disparities between CEOs and their employees can hurt employee morale, reduce workplace productivity and lead to increased employee turnover, all consequences that can affect profitability. In addition, they contended, pay-ratio disclosure may provide some insight into the board's relationship with the CEO and help increase board accountability. In voting in favor of the proposal at the open meeting, Commissioner Aguilar maintained that shareholders "have the right to know whether CEO pay multiples reflect CEO performance."

Fortunately, in formulating its pay-ratio disclosure proposal, the SEC appears to have heard, and taken into account, much of this debate: while, as mandated by Dodd-Frank, companies will still need to include all of the components of the summary compensation table in calculating the median employee "annual total compensation," the proposed rule seeks to address cost and complexity concerns by adopting a relatively flexible approach that allows each company to choose from several options for identifying the median in the way that best suits the size, structure and compensation practices of that company.

Highlights of the proposed rule

- **All employees must be considered:** When determining the median employee, a company must consider all employees of the company and its subsidiaries, including non-U.S., part-time, temporary and seasonal workers employed as of the last day of the last fiscal year. However, companies can determine the median from among the entire employee population, a statistical sample of all employees or a pool of employees selected by another reasonable method.
- **Flexible approach to identifying median:** To identify the median, a company is not be required to calculate annual total compensation for each employee in the population or sample (although that approach is certainly permitted); instead, the company could identify the median in the population or sample based on any "compensation measure," such as W-2 wages, and then compute the annual total compensation only for that median employee.
- **Identification and consistent application of methodology and assumptions:** In their disclosures, companies will need to describe the methodology used to identify the median, as well as any material assumptions, adjustments and estimates. To reduce potential for manipulation to affect the outcome, the proposed rule requires that methodologies and material assumptions, adjustments and estimates be consistently applied.
- **Exempt companies:** Emerging growth companies are exempt, as are smaller reporting companies and certain foreign issuers. Non-EGCs filing IPO registration statements will not be required to include pay-ratio disclosure in their Forms S-1.
- **Compliance date:** Each company will be required to calculate its pay ratio for compensation for its first fiscal year that begins on or after the effective date of the final rule and disclose that information in the following year's proxy statement. That means that if the final rule becomes effective in 2014, a calendar-year company will calculate pay-ratio information for 2015 compensation, disclosing that information as part of its reporting for the 2016 proxy season.

Summary of the proposed rule

The pay-ratio provision

What exactly will we be required to calculate?

As described above, the pay-ratio provision requires each company to calculate:

- the median of the annual total compensation of all employees of the company, except the CEO;
- the annual total compensation of the CEO; and
- the ratio of the two amounts above.

Companies may express the pay ratio either numerically or in narrative form, but, in either case, the median of the annual total compensation of all employees must be presented as equal to one (*e.g.,* "1 to 200" or "CEO total compensation is 200 times that of the median of the annual total compensation of all employees").

Employees to be considered in the calculation

Which employees are covered by the term "all employees"? What about part-time employees, non-U.S. employees or employees of subsidiaries?

Dodd-Frank expressly requires disclosure of the median of the annual total compensation of "all employees," and the proposed rule defines "all employees" to include all full-time, part-time, seasonal and temporary employees, including foreign employees, on the last day of the company's last completed fiscal year. The proposed rule does not provide any accommodation to address concerns regarding cross-border compliance issues for multi-national companies (*e.g.*, data privacy issues, international variations in compensation arrangements, cost-of-living differences and currency fluctuations) and related costs. Nor does the proposed rule permit full-time annualization of part-time, seasonal or temporary employee compensation to address concerns regarding the distortions of comparing full-time compensation with part-time compensation.

The rule covers employees on an enterprise-wide basis, just like the approach taken for executive compensation disclosure. Accordingly, it includes employees of any subsidiary of the company, defined broadly to include any affiliate controlled by the company directly or indirectly through one or more intermediaries, rather than just wholly owned subsidiaries.

Independent contractors, "leased" workers or other temporary workers who are employed by a third party (*e.g.*, if the company pays a fee to a management company or employee-leasing agency that supplies workers) are not included in the definition of "all employees."

Observations and commentary

- The broad definition of "all employees" will likely present the greatest challenge for most companies. At the SEC open meeting to consider the proposal, Commissioner Gallagher took issue with the definition of "employee" to be used in calculating the ratio, criticizing the inclusion of temporary, seasonal and part-time employees without requiring annualization of their compensation. In addition, he contended that including employees of subsidiaries, especially on a global scale, ignored the variances of cost of labor and cost of living in foreign countries. In his view, the only purpose of the exercise must be "to ensure the most eye-poppingly huge ratios possible." The majority of the SEC Commissioners, however, believed that the inclusion of all employees, including non-U.S. employees, was "consistent with the statute." Undoubtedly, comments submitted by the Senator responsible for inserting the pay-ratio provision into Dodd-Frank were particularly persuasive in that regard: he wrote that by "all employees of the issuer," he "intended that to mean both full-time and part-time employees, not just full-time employees. [He] also intended that to mean all foreign employees of the company, not just U.S. employees."
- Some commenters suggested that companies be allowed to present separate pay ratios covering U.S. and non-U.S. employees, which they believed could mitigate concerns that inclusion of a non-U.S. workforce in the pay-ratio calculation could distort the disclosure. Although the proposal requires disclosure of a single ratio covering both foreign and domestic employees, the proposed rule does permit companies, in their discretion, to present additional ratios to supplement the required ratio, so long as the supplemental ratios are clearly identified, not misleading and not presented with greater prominence than the required ratio. Assuming that the definition of "all employees" remains the same in the final rule, companies with significant employee populations located outside the U.S. may want to provide one or more additional ratios that separate the foreign and domestic workforces, along with additional narrative explaining the implications.
- The requirement to cover "all employees" in the calculation does not mean that, to derive the median, companies must calculate total compensation for every employee; rather, it means that the employee population from which the median is identified or, if a statistical sample or other smaller group is used, the employee population from which that sample or group is drawn, must include all temporary, seasonal, part-time and foreign employees as of the end of the fiscal year.

Performing the calculation

What is included in "total compensation"?

"Total compensation" has the same meaning as in the compensation disclosure rules that apply to named executive officers. Accordingly, "total compensation" includes not just cash compensation, but also the value of stock options and other equity awards, the aggregate change in pension value and nonqualified deferred compensation earnings and the value of certain other compensation, including personal benefits. For non-salaried employees, references in the existing rules to "base salary" and "salary" will refer instead to "wages plus overtime," as applicable.

What does "annual" mean in this context?

The proposed rule defines "annual" total compensation as the total compensation for the last completed fiscal year, consistent with the executive compensation disclosure rules.

To more accurately reflect the employment relationship, companies may choose to annualize compensation paid to full-time or part-time employees who were not employed during the entire fiscal year, but only if the employment relationship is permanent and not temporary or seasonal. For example, the compensation of a new hire or an employee who took an unpaid leave of absence during the year could be annualized. Compensation for part-time employees may not be annualized to reflect a full-time equivalent schedule, but may be annualized to reflect the part-time schedule. If a company chooses to annualize compensation, the company must annualize the compensation of all permanent eligible employees who were employed during only a portion of the fiscal year.

To identify the median, do we need to calculate the annual total compensation of all employees?

Not necessarily. The proposed rule permits a company to use the company's entire employee population, a statistical sample or a pool selected by another reasonable method to choose a smaller group of employees for purposes of identifying the median. If statistical sampling is used, the sample size needed could depend on how widely employee compensation is spread out or distributed around the mean, as well as variations in the types of employees across business units and geographical locations.

Once the employee pool has been determined, how do we identify the median employee?

Under the proposal, a company may use one of two methodologies:

- calculate the annual total compensation in accordance with the existing executive compensation disclosure rules for each employee in the pool (whether the entire population or a statistical sample), and then identify the median; or
- identify the median employee in the pool based on any "compensation measure," such as total direct cash compensation or W-2 reported wages, that is consistently applied to all employees in the calculation and then compute the annual total compensation only for that median employee.

In applying either methodology, a company could choose not to calculate annual total compensation precisely for those employees in the pool with extremely high or extremely low pay—who are obviously not at the median—so long as it is noted that they are above or below the median.

Will we be allowed to use estimates?

Yes. The proposal allows companies to use reasonable estimates in identifying the median and in calculating the annual total compensation for employees other than the CEO. For example, estimates could be employed where precise individual data may not be available in connection with multi-employer defined benefit pension plans or because of local data privacy laws. Companies should have a reasonable basis to conclude that any estimates approximate the actual amounts of compensation, which will depend on the particular facts and circumstances.

Observations and commentary

- Because the existing executive compensation disclosure rules were crafted to apply to executive compensation, they capture components of compensation more likely to apply to executives and exclude components such as benefits under non-discriminatory plans (*e.g.,* health insurance) available to all employees, and perquisites (*e.g.,* employee discounts) that aggregate less than $10,000. As one commenter noted, the components excluded may actually provide substantial economic and recruiting value for non-executive employees, and exclusion of these components could understate the real compensation of the broad workforce, making the pay-ratio disclosure less meaningful. However, the SEC noted, because those exclusions are permissive, rather than mandatory, companies have the discretion to include those components in calculating the annual total compensation of employees, so long as the same components were also included in calculating CEO compensation and the company explained any difference between CEO total compensation used in the pay-ratio disclosure and the amounts reflected in the summary compensation table.

- While a relatively small sample size would be appropriate in certain situations, a reasonable determination of sample size depends in part on how widely compensation is distributed around the mean. According to observations at the open meeting by the staff chief economist, for companies with a low variance, the sample population size might be less than 100; for companies with a high variance, the sample size may be more than 1,000. The SEC's economic analysis assumes that any statistical sampling would be a "true random sampling" that is not biased by region, occupation, rank or other factor. In the SEC's economic analysis, the appropriate sample size for companies with a single business or geographical unit varied between 81 and 1,065 across industries, with the average estimated sample size close to 560.
- An "other compensation measure" could be one that is recorded on a basis other than the company's fiscal year, such as one derived from its payroll or tax records, if consistently applied to all employees in the calculation. However, the company must still calculate and disclose annual total compensation of the median employee and the CEO for the last completed fiscal year.
- Each company's choice of the appropriate methodology will depend on the particular facts and circumstances, including the following variables identified by the SEC:
- 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 company has and the degree of difficulty involved in integrating payroll systems to readily compile total compensation information for all employees.
- The SEC recognized that allowing companies the flexibility to use various estimates and to select a methodology—such as using an "other compensation measure" or permissive annualization—for identifying the median would impair comparability across companies and was subject to the risk that companies could try to distort results to achieve a particular objective. However, the SEC believes that the need for flexibility outweighs the need for comparability and that the risk of manipulation would be mitigated by requiring that any compensation measure used be consistently applied.
- Assuming adoption of the rule as proposed, each company will probably want to explore the various methodologies available to calculate the median to see which is most efficient and effective as applied to that company, keeping in mind the need to maintain consistency and avoid distortion of the data. Companies that want to examine the impact of statistical sampling but do not have statistics expertise in-house may need to look to outside consultants for that purpose.

Additional disclosure

Do we need to disclose our methodology and assumptions?

Yes. Companies will need to disclose the methodology used to identify the median, as well as any material assumptions, adjustments and estimates. The disclosure must be sufficiently detailed to allow readers to evaluate appropriateness, but the SEC emphasizes that companies should avoid "dense" technical analyses or formulas. To reduce potential for manipulation to affect the outcome, the proposed rule requires that methodologies and material assumptions, adjustments and estimates be consistently applied. If a company changes methodology or material assumptions, adjustments or estimates from those used in its pay-ratio disclosure for the prior fiscal year and the effects of the change are material, the company must also briefly describe the change and the reasons for the change, and provide an estimate of the impact of the change on the median and ratio.

Location of disclosure

Where do we need to disclose the pay-ratio information?

The disclosure is required in annual reports on Form 10-K and in proxy and information statements and registration statements requiring executive compensation disclosure. The proposed rule does not add any requirements to include pay-ratio disclosure in any filings that do not already require executive compensation disclosure.

The pay-ratio information needs to be updated only annually in the proxy statement or Form 10-K. If a company is required to disclose pay-ratio information prior to the time when an annual update is due, the company must include or incorporate by reference its pay-ratio disclosure for the most recently completed fiscal year. For example, if a company with a calendar year fiscal year is required to file a proxy statement requiring executive compensation disclosure in October 2016, the company would not be required to update its pay-ratio disclosure as of that date. Rather, the company would include or incorporate by reference the pay-ratio disclosure in the company's annual proxy statement or annual report filed earlier in 2016.

Observations and commentary

- Because companies do not need to update their pay-ratio disclosures for the most recently completed fiscal year until filing their annual meeting proxy statements, a company could request effectiveness of a registration statement (and make other filings that include executive compensation disclosure), even after the end of its fiscal year and prior to filing its annual meeting proxy statement, without the obstacle of needing to calculate new pay ratios.
- The proposed rule requires that pay-ratio disclosure be "filed" rather than "furnished," thus subjecting companies to potential liabilities under the Securities Act and Exchange Act. Some commenters expressed concerns that "filing" would subject them to liability for information that they would not be able to verify (particularly for large multinational corporations that may have difficulty determining and verifying compensation paid overseas), and thus advocated that pay-ratio information be deemed "furnished" instead. While the SEC acknowledged these potential issues, the SEC ultimately determined that the flexibility that the proposed rule would afford companies in identifying the median (e.g., use of reasonable estimates) as described above, was sufficient to mitigate these concerns.

Companies subject to the rule

Are there any exemptions?

The following companies, which are subject to limited executive compensation disclosure requirements, are exempt from the proposed pay-ratio disclosure:

- emerging growth companies;
- smaller reporting companies; and
- foreign private issuers filing on Form 20-F and companies that file reports and registration statements with the SEC in accordance with the requirements of the U.S.-Canada Multijurisdictional Disclosure System.

Timing

When do we need to comply? Will we need to provide this information in our next proxy statement?

Most companies will not be required to disclose their pay-ratio information until the 2016 proxy season. As proposed, each company will be required to calculate its pay ratio for compensation for its first fiscal year that *begins* on or after the effective date of the final rule and disclose that information in the following year's proxy statement. This means that if the final rule becomes effective in 2014, a calendar-year company will calculate pay-ratio information for 2015 compensation, disclosing that information as part of its reporting for the 2016 proxy season. Similar to the requirements for proxy statements, the pay-ratio disclosure must be filed no later than 120 days after the end of the fiscal year. Accordingly, if a company with a fiscal year ending on December 31 does not file its annual proxy statement by April 30, 2016, the company would need to amend its Form 10-K to include pay-ratio information for 2015.

What do we do if we don't have all of the necessary bonus information by the due date?

In certain circumstances, companies may omit disclosure in the summary compensation table of the salary or bonus of a named executive officer where the amount is not yet calculable. In that situation, the proposed rule allows the company to delay filing its pay-ratio disclosure and instead allows the company to report the omitted pay-ratio disclosure in the same Form 8-K as the omitted salary or bonus information.

On the horizon

Comments on the proposal are due by December 2, 2013. It remains to be seen whether a new wave of comments protesting the cost and complexity involved in these broad calculations will cause the SEC to further moderate its stance on any issues. Another variable that may have an impact on the practical application of the proposed rule is whether proxy advisory firms, such as ISS and Glass Lewis, and institutional stockholders will profess an interest in the result. Historically, these firms have been primarily interested in the ratio of CEO pay to other named executive officers. Whether these firms will formulate policies to review and analyze pay-ratio disclosure as part of reviewing a company's executive pay practices in connection with its say-on-pay proposal and the election of compensation committee members, or otherwise express any concern regarding internal employee pay equity, is, for now, an open question.

If you have any questions about this *Alert,* please contact one of your Cooley team members or one of the attorneys identified above.

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