September 19, 2013

SEC Proposes Rule on CEO Pay Ratio Disclosure

By a split vote of three to two, the Securities and Exchange Commission (SEC) has proposed rules implementing the CEO pay ratio disclosure mandated by the Dodd-Frank Act. There is a 60-day comment period.

Key provisions include:

1) Disclosure Timing – Assuming the rule is finalized next year, pay ratio disclosure will first be required during the 2016 proxy season for calendar-year companies.

2) Definition of Employee – All employees enterprise-wide including international, part-time, temporary, and seasonal as of the end of the most recent fiscal year will be included.

3) Determination of Median – Statistical sampling or other reasonable method will be allowed to narrow the number of employees for whom annual total compensation will need to be calculated. The methodology and any material assumptions, adjustments or estimates used to identify the median employee must be disclosed.

4) Pay Definition –No specific methodology is prescribed for calculating pay for purposes of determining the median employee. However, once the median employee is determined, his/her pay calculations must be in accordance with proxy disclosure rules for comparability with the approach used to calculate CEO pay.

Almost three years after being passed by Congress, yesterday the SEC proposed rules on the CEO pay ratio disclosure requirement under Section 953(b) of the Dodd-Frank Act. Notwithstanding legislative attempts to eliminate it, the provision requires that the following items be disclosed in proxy statements and certain other SEC filings: 1) median annual total compensation of all of an issuer's employees (excluding the CEO), 2) annual total compensation of the issuer's CEO, and 3) ratio of the two.

The following provides some brief context and detail on the proposed rule, with more to come after additional analysis.

Employee Definition

The SEC literally applied the statutory language of "all employees" including foreign, part-time, temporary, and seasonal, as employed at the end of the last fiscal year. The inclusion of all employees globally was somewhat surprising as this is expected to significantly increase the cost

of compliance for multi-national companies. One of the SEC Commissioners opposed to the proposal (Daniel M. Gallagher) was particularly critical of global application, indicating that the international calculations will be skewed and complicated by exchange rates, relative cost of labor and social welfare programs overseas that affect employee pay in such a manner that it appeared the intent of the rule was to "ensure as eye-poppingly high ratios as possible." Compensation for full-time new hires can be annualized; but pay for part-time, temporary, and seasonal workers cannot be normalized.

The SEC also interpreted the statute's reference to "issuer" broadly to include both the SEC reporting company and its subsidiaries, thus including within the scope of the rule all employees on an enterprise-wide basis. Accordingly, the SEC's interpretation of "issuer" is similar to the proxy statement disclosure rules' application to a "registrant and its subsidiaries."

Determination of Median Compensation

Stressing the objective of providing flexibility to address compliance concerns, the SEC will not mandate a specific methodology for calculating annual total compensation in identifying the median employee, such as total compensation as defined for proxy disclosure purposes. In what appears to be a major concession by the SEC, any "consistently applied compensation method" most appropriate for a particular company, such as payroll or tax records, can be used. Once identified, however, the median employee's total compensation for the last completed fiscal year would be calculated in accordance with the proxy disclosure rules to ensure comparability with the CEO's total compensation for the same period.

The SEC noted that the use of statistical sampling should ease the compliance burden for "low wage variance companies," but could be complicated for "high wage variance companies." As an illustration, the SEC noted that a low wage variance company may only need a sample size of 100, but that a high wage variance company may need a sample size of 1,000 and thus could be more complex.

Disclosure Details

The pay ratio must be disclosed in the same filings where regular executive compensation disclosure applies. For most SEC reporting companies, this will be the annual proxy statement, and for IPO companies it will be the registration statement. In any event, the ratio must be disclosed no later than 120 days following the end of the fiscal year. Narratives and additional ratios are permitted but not required.

Emerging growth companies, as defined in the JOBS Act, are exempt from the disclosure requirements, as are smaller companies, Canadian issuers and foreign private issuers who are otherwise exempt from the executive compensation disclosure rules. Newly public companies will have a transition period.

Opposing Views

A harsh rebuttal of the disclosure requirements by the newest SEC Commissioner (Michael S. Piwowar) set the tone for the proceedings announcing the proposed rule, lamenting that special interests have been placed ahead of the SEC's "mandate of investor protection." The SEC indicated that the objective of developing the proposed rule was to "comply with the statutory mandate," while reflecting the input from comment letters (more than 22,000) to reduce the cost of compliance.

Commissioner Piwowar strongly objected to the adoption of the ratio, referring to it as a waste of the SEC's time and resources, asserting that disclosure will: 1) "unambiguously harm investors" and provide irrelevant and potentially misleading information, 2) curtail the employment of workers by U.S. companies in low-cost labor markets internationally, and 3) place affected U.S. companies at a competitive disadvantage globally.

In contrast, Luis A. Aguilar, a Commissioner who supported the rule, thought it would provide a "valuable new perspective for executive compensation decisions."

Next Steps

As proposed, companies will have to comply with the new disclosure in any fiscal year starting on or after the date that the new rule is effective. Assuming the proposed rule is finalized next year, pay ratio disclosure would first be required for calendar-year companies during the 2016 proxy season.

Comments are due 60 days after publication of the rules in the Federal Register. Our firm intends to submit a comment letter.

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General questions about this letter can be addressed to…

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- Edward D. Graskamp in our Chicago office at 312-894-0031, email edgraskamp@fwcook.com

Specific questions should be referred to company counsel. Copies of this letter and other published materials are available on our website at www.fwcook.com.