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SEC Proposes Pay Ratio Disclosure Rules Under the Dodd-Frank Act

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On September 18, 2013, the Securities and Exchange Commission (the "SEC") proposed rules that would require U.S.-based public companies to disclose the pay gap between their chief executive officers and their median rank-and-file employees. Issuers had feared onerous administrative burdens, but received significant flexibility (described below) that ultimately seems to present the greatest challenges for multi-national employers having de-centralized payroll systems.

Specifically, the SEC approved for public comment proposed amendments to Item 402 of Regulation S-K (the "Proposed Amendments")[1] in order to implement Section 953(b) of the Dodd-Frank Wall Street Reform and Consumer Protection Act (2010), which requires U.S.-based public companies to make what the SEC refers to as the "pay ratio" disclosure.[2]

Summary of the Proposed Amendments

The following chart provides a summary of the Proposed Amendments that are discussed in more detail below, with the full text available here:

Companies Subject to Proposed Rules	All SEC-registered, public companies are subject to the proposed rules, except: ▪ emerging growth companies (as provided for in the JOBS Act); ▪ smaller reporting companies; and ▪ foreign private issuers.
Pay Ratio Disclosure	Under the proposed Item 402(u) of Regulation S-K, companies are required to disclose: ▪ the median of the annual total compensation of all company employees, excluding the principal executive officer; ▪ the annual total compensation of the company's principal executive officer; and ▪ the ratio of the median of the company's employee compensation to its principal executive officer compensation.

Employees Covered	For calculating the median of the company's employee compensation, companies should include employees in the following categories **as of the last day of the company's prior fiscal year**: ▪ full-time; ▪ part-time; ▪ seasonal; ▪ temporary; and ▪ non-U.S. based.
Annualized Pay	In calculating the median of the registrant's employee compensation: ▪ Companies may annualize the compensation of permanent employees who did not work for the entire year (e.g., new hires). ▪ Companies may not annualize the compensation of part-time, seasonal or temporary employees.
Flexible Methodology for Determining the Median Employee	The proposed instruction 2 to Item 402(u) provides a flexible approach for determining the median employee. A company may use any methodology so long as it consistently applies "reasonable estimates to identify the median and . . . to calculate the annual total compensation or any elements of total compensation for employees other than the [principal executive officer]." In doing so, companies may choose to evaluate their entire employee population, use statistical sampling or use other reasonable estimation methods.
Filings Covered	Under the proposed rules, companies would be required to file (not "furnish") pay ratio disclosure in the following filings that require compensation disclosure under Rule 402: ▪ registration statements; ▪ proxy and information statements; and ▪ annual reports on Form 10-K.
Implementation of Pay Ratio Disclosure	Companies will be required to provide the pay ratio disclosure in their first annual report on Form 10-K or, if later, proxy or information statement following the end of the company's first full fiscal year after the SEC releases final rules. Newly public companies will be provided a similar transition period, allowing them to avoid pay ratio disclosure in filings related to their initial public offerings.

Public Comment

The SEC is currently seeking public comments on the Proposed Amendments, which should be submitted within 60 days after their publication in the Federal Register. To that end, the SEC encourages interested individuals to submit comments on any aspect of the Proposed Amendments,

other matters that might have an impact on the amendments, and any suggestions for additional changes. Securities attorneys within Paul Hastings are working with different employers and trade associations for the purpose of submitting comments, and will be glad to work with any concerned employers. Anyone desiring further information should contact their Paul Hastings contact or Mark Poerio, who co-chairs the firm's executive compensation practice.

Our Advice for Issuers

If adopted in substantially their current form, the Proposed Amendments will require that U.S. public companies develop a consistent methodology for determining the median employee compensation for pay ratio disclosure purposes. This will undoubtedly take considerable time and resources to integrate data systems to come up with a workable methodology.

Nevertheless, the SEC has indicated flexibility in the methods by which issuers make their determinations. This is reminiscent of the introductory period in 2007 when the SEC for the first time required an issuer's proxy statement to include a Compensation Discussion & Analysis (CD&A). At that time, we counseled issuers to avoid the "bleeding edge" in the sense of making good faith compliance efforts, but within reasonably practical parameters. They could then observe best practices in the first year, and make smart adjustments in response. That strategy seems right with pay ratio disclosures, in the sense that a good faith rudimentary calculation in the first year should be cost-effective and allow room for refinements depending on practices that emerge.

More about the Proposed Amendments

Section 953(b) of the Dodd-Frank Act directed the SEC to amend Item 402 of Regulation S-K to require U.S. public companies to make expanded compensation disclosure covering:

- the median of the annual total compensation of all employees of a registrant, except the principal executive officer of the registrant;
- the annual total compensation of the principal executive officer of the registrant[3]; and
- the ratio of the median of the annual total compensation of all employees of a registrant to the compensation of the principal executive officer.

The Proposed Amendments would not apply to emerging growth companies,[4] smaller reporting companies[5] and foreign private issuers.[6]

Flexible Methodology for Identifying the Median and Employees Covered

Identifying the Median. The Proposed Amendments do not expressly set forth a methodology that must be used to identify the median employee compensation. The SEC believes that even a registrant with a large number of employees should be able to provide the proposed disclosure in a relatively cost-efficient manner based on **statistical sampling, reasonable estimates, and the use of any other consistently applied compensation measure to identify the median**. For instance, an employer with a large number of employees could take a random sampling of its employees and determine the annual cash compensation, or any other consistently applied compensation measure, for those employees. Identifying the median employee would not necessarily require a determination of exact compensation amounts for each employee in the sample. The registrant could exclude the employees in the sample that have extremely low or extremely high pay because they would fall on either end of the spectrum of pay and, therefore, not be the median employee.

All Employees. The Proposed Amendments require disclosure of the median of the annual total compensation of "all employees." Consistent with that mandate, an "employee" includes any full-time, part-time, seasonal or temporary worker employed by the registrant or any of its (U.S. and non-U.S.) subsidiaries. In addition, the Proposed Amendments define "employee" as an individual employed as of the last day of the registrant's last completed fiscal year, which is consistent with the calculation date for the determination of the three most highly compensated executive officers under Item 402(a)(3)(iii) of Regulation S-K. However, companies would not be required to include independent contractors, "leased" workers or other temporary workers who are employed by a third party as part of "all employees." Accordingly, workers supplied to the registrant by a third-party management company or leasing agency for a fee would not be deemed "employees."

The Proposed Amendments permit, but do not require, a registrant to annualize total compensation for permanent employees who did not work for the entire year, such as new hires or employees who took unpaid leaves of absence during the period. On the other hand, a registrant may not annualize total compensation for part-time, seasonal or temporary employees.

Determination of Total Compensation

The Proposed Amendments define "total compensation" by reference to Item 402(c)(2)(x) of Regulation S-K. A registrant would be permitted to identify the median employee in a variety of ways and then must determine and disclose the median employee's total compensation in accordance with Item 402(c)(2)(x). Further, the Proposed Amendments define "annual total compensation" to mean total compensation for the last completed fiscal year, consistent with the time period used for the other Item 402 disclosure requirements. For non-salaried employees, "base salary" and "salary" as used in Item 402 may be referred to as "wages plus overtime."

Reasonable Estimates. The Proposed Amendments permit the use of reasonable estimates to determine the value of the various elements of total compensation for employees, other than the principal executive officer. For example, in the case of certain pension benefits, valuation of such benefits can be difficult as employers may not have access to the information from pension plan administrators that would be needed to calculate the value of such benefits. In this instance, the SEC believes it to be appropriate for a registrant to use reasonable estimates in determining the value of such pension plan.

Personal Benefits. The Proposed Amendments permit companies to exclude personal benefits, such as healthcare, education assistance and parking benefits, in the calculation of total compensation as long as such benefits in the aggregate are less than $10,000. However, to remain consistent, the calculation of the principal executive officer's total compensation would need to reflect the same approach for the median employee.

Disclosure of Methodology, Assumptions, and Estimates

Methodology. As described above, in order to allow companies the greatest degree of flexibility, the SEC does not set forth a required methodology to identify the median employee. Therefore, the SEC has proposed instructions for a brief disclosure of the methodology, and any material assumptions, adjustments and estimates used in the calculation of the median employee. A registrant's disclosure should provide sufficient information to allow a reader to evaluate the appropriateness of the methodology, estimates and assumptions used. The SEC is of the view that the appropriate and most cost effective methodology would necessarily depend on a registrant's particular facts and circumstances, including, among others, 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.

Changes to the Methodology. If a registrant materially changes the methodology or material assumptions, adjustments or estimates from those used in the previous period, the registrant must briefly (i) describe the change, (ii) describe reasons for the change and (iii) provide an estimate of the impact of the change on the median and the ratio. The SEC expects that a succinct description of the methodology and material assumptions, adjustments and estimates used would not be overly burdensome and would be more informative for investors.

Transition for Newly Public Companies

Newly public companies, excluding emerging growth companies, smaller reporting companies, and foreign private issuers, will be required to comply with the proposed amendment for the first fiscal year commencing on or after the date the registrant becomes subject to the reporting requirements.

Compliance Date

The SEC has proposed that a registrant is not required to include pay ratio disclosure with respect to its last completed fiscal year until the filing of its annual report for that last completed fiscal year or, if later, the filing of a definitive proxy or information statement relating to an annual meeting of shareholders (or written consents in lieu of such a meeting). Updated pay ratio information must, in any event, 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. As an example, a registrant would not be required to disclose pay ratio information relating to compensation for fiscal year 2014 until its definitive proxy or information statement for its 2015 annual meeting of shareholders.[7] Issuers, such as master limited partnerships, that are not required to hold annual meetings and thus are not subject to the proxy rules and the filing of annual proxy statements would have to include pay ratio disclosure for fiscal 2014 in the Form 10-K for such year.

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If you have any questions concerning these developing issues, please do not hesitate to contact any of the following Paul Hastings lawyers:

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[1] The Proposed Amendments include a conforming amendment to Item 5.02(f) of Form 8-K under the Securities Exchange Act of 1934 (the "Exchange Act").

[2] The Proposed Amendments are described in the SEC's Release "Pay Ratio Disclosure," SEC Release 33-9452 (Sept. 18, 2013), currently available at: http://www.sec.gov/rules/proposed/2013/33-9452.pdf.

[3] A principal executive officer is defined under 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."

[4] Defined under Section 3(a) of the Exchange Act.

[5] Defined under Item 10(f)(1) of Regulation S-K.

[6] Foreign private issuers that file annual reports and registration statements on Form 20-F and MJDS filers that file annual reports and registration statements on Form 40-F would not be required to provide the proposed pay ratio disclosure, because those forms do not require Item 402 disclosure. The term "MJDS filers" refers to registrants that file reports and registration statements with the Commission in accordance with the requirements of the U.S.-Canadian Multijurisdictional Disclosure System.

[7] In the Proposed Release (see footnote 3 above), the SEC clarified that for purposes of the Securities Act of 1933, as amended, and the Exchange Act, the pay ratio disclosure will be considered "filed" and not "furnished".