SEC Publishes Proposed Rules for the Implementation of the Pay Ratio Disclosure

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OVERVIEW

Among the many executive compensation related items included in the Dodd-Frank Wall Street Reform Act of 2010 (the Dodd-Frank Act), one of the most heavily debated and anticipated was the Pay Ratio Disclosure, or Section 953(b). This ratio, designed to illuminate the relationship between total reported compensation for a CEO and the median employee of the company (not including the CEO), sounds simple in concept, but generates a number of complex challenges. These challenges explain much of the two year delay in moving forward with the rule.

However, on September 18th, following a tight 3 to 2 vote, the SEC issued a set of proposed rules to the public for comments. The SEC press release, along with the complete rule proposal is available online here:

- http://www.sec.gov/News/PressRelease/Detail/PressRelease/1370539817895#.Ujt9wtLktvA

While the proposed rules are not final, and there are some unanswered questions as to the potential timing of their implementation, this proposal provides solid insights into the direction of the SEC's thinking. Absent persuasive public commentary, it is certainly possible the rules could be finalized in this format.

KEY CONSIDERATIONS

Based on our review of the rule proposal, we believe there are a number of significant issues companies should immediately consider, especially if they intend to participate in the comment period provided by the SEC. Key issues include:

- **Comment Period** – The proposed rules will begin a 60-day comment period once published in the Federal Register. As of September 24, the rules had not yet been published. Assuming the rules are published in the Federal Register within two weeks, the 60-day comment period would end at the beginning of December.
- **Rule Timing** – The proposed rules contain a very long implementation timeline. As proposed, they would not become applicable until the first fiscal year following approval of final rules, and the pay ratio disclosure would not need to be completed until the later of the filing of the 10-K or proxy for that year. In other words, if the rules were approved on January 15, 2014, they would become applicable for the first fiscal year commencing after that date. For a calendar year company, that would mean that they would apply to calendar/fiscal year 2015, and would need to be reported in either the 10-K or proxy that was filed in 2016.
- **Public Company Application** – The Pay Ratio Disclosure will apply to all public companies with the exception of emerging growth companies, smaller reporting companies and foreign private issuers. Note, this rule applies to all companies, not just financial institutions.

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- **Pay Ratio Disclosure** – The proposed rule states that a company has a choice as to how it can publish the ratio. It can publish the ratio of total compensation of all employees of the company except the CEO to the total compensation of the CEO where the total compensation of all employees equals one, e.g., "1 to 55". Or, the company can publish the ratio as a narrative, e.g., "the PEO's annual total compensation is 55 times that of the median of the annual total compensation of all other employees". Note that PEO is the principal executive officer, or typically the CEO.

  The proposed rules state that the pay ratio should be placed with other executive compensation items such as the summary compensation table and the compensation discussion and analysis (CD&A). In addition, the assumptions utilized in developing the pay ratio disclosure need to be disclosed. Last, if there are changes in methodology from year-to-year, the changes need to be disclosed. In the end, the expectation is that this will result in the CD&A section becoming yet longer upon implementation.

- **Defining Employees** – The proposed rule states that all employees, whether full-time, part-time, permanent or seasonal must be included in the pay ratio calculation. Further, the proposed rule uses an end-of-fiscal-year employment identification date for determining who needs to be included in the mix. This wrinkle is not specified in the Dodd-Frank Act itself, and may cause an issue for some employers.

- **Determining the "Median Employee"** – The proposed rules create some significant leeway for companies to determine who is the median employee. It was originally assumed that companies would have to effectively calculate "proxy pay" for all employees and then determine the median employee from that calculation. However, the proposed regulations allow companies to apply some shortcuts, referring in the proposed regulations to "statistical sampling or other reasonable methods", although the Commission refused to provide either approved specific methodologies or safe harbor sampling techniques in determining who constitutes a median employee.

  Unanswered at this time is what requirements will need to be met for a company to be considered as using a valid statistical sampling. This lack of safe harbor provisions is especially troubling given that the SEC affirmed the fact that the information contained in the pay ratio would be considered as "filed" rather than "furnished", thereby attaching significantly greater legal liability to the number.

  Ironically, by introducing significant (and still undefined) flexibility into the pay ratio calculation, the SEC also opens the door for criticism of the effectiveness of pay ratios. If companies use widely different methodologies for sampling and calculating pay, then there is little value in comparing pay ratios across companies.

- **Global Companies** – When originally passed by Congress, there was serious discussion as to whether the SEC would provide any exclusion for non-US workers. The argument being that differences in mandated benefit structures and compensation laws around the globe made considering pay ratios across borders a significant challenge. However, the SEC release makes it clear that all workers are to be covered, regardless of location.

  The Commission acknowledged that this could cause data privacy issues, especially in the European Union (EU), and asked for specific comments on the burden this might create. For our part, we believe the inclusion of non-US

workers could potentially reduce the usefulness of these pay ratios for comparing multi-national companies. If for example, you have two companies of similar size, and with similar CEO pay, but one company has employees concentrated in high-wage nations, and the other in low-wage nations, what information is actually conveyed by the ratio?

OTHER DODD-FRANK RULES

With the publication of the Pay Disclosure Ratio, this shows progress on one Dodd-Frank Act disclosure. We are still awaiting proposed rules for Clawbacks (Section 954) and the Pay versus Performance Exhibit (Section 953(a)), which apply to all public companies. Financial institutions are still awaiting final rules on incentive compensation reporting (Section 956) which were initially proposed in 2011.

To connect with a McLagan representative to discuss the Pay Ratio Disclosure, please contact:

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