



## SEC Releases Proposed CEO Pay Ratio Rules

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After nearly three years, on September 18, 2013, the SEC issued proposed rules for one of the most contentious executive compensation provisions of the Dodd-Frank Act – CEO pay ratio disclosures.

The proposed rules require disclosure of:

- the median annual total compensation of all employees excluding the Principal Executive Officer (*typically, this is the Chief Executive Officer and we will refer to the Principal Executive Officer as the CEO throughout this Viewpoint*);
- the annual total compensation of the CEO;
- a ratio of the two figures; and
- any methodology, assumptions, adjustments and/or estimates used in determining the ratio.

The SEC's release is quite lengthy and contains an extensive discussion of the various aspects of the disclosures and how comments received to date have influenced deliberations within the SEC. It would appear that the flexibility embedded in the proposed rules is an acknowledgement of the practical difficulties companies will face in implementing the provisions – as well as the apparent difficulty the SEC faced in attempting to reach a consensus.

The proposed rules attempt to moderate the implementation burden by providing issuers a reasonable amount of discretion to employ sampling and other simplifying methodologies in complying with the requirement. However, we perceive this flexibility as increasing the initial implementation burden (as companies consider the reasonableness of the various methodologies) while simultaneously reducing the

comparability and already-questionable value of pay ratio disclosures to investors.

The SEC has requested comments on more than 50 questions relating to the proposed rules. Comments will be accepted for up to 60 days following publication in the Federal Register.

### Key Takeaways

- *The SEC has issued proposed rules for the CEO pay ratio disclosures required by Dodd-Frank*
- *The proposed rules require the disclosure of a ratio of CEO to median employee compensation, calculated in accordance with Summary Compensation Table (SCT) requirements*
- *In determining the median employee, all employees are to be considered, including part-time, seasonal, temporary and non-US workers*
- *The issuer may use sampling or other reasonable methods to identify the median employee and may also use definitions of pay that are not consistent with SCT requirements – but only for purposes of identifying the median employee*
- *Potential variations in methodologies used by issuers to comply with the proposed rules would lessen the cross-company comparability of the disclosures to investors interested in the statistic*
- *For companies with calendar fiscal years, the proposed rules would not require disclosure any sooner than the 2015 proxy season and are more likely to be effective for the 2016 proxy season*

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The remainder of this Viewpoint provides highlights of the proposal and our brief commentary on key provisions of the proposed rules.

### ***Required Disclosures***

The Proposed Rules add a new Item 402(u) to Regulation S-K that sets forth the pay ratio disclosure requirements mandating that companies disclose the following:

- the median annual total compensation of all employees (other than the CEO);
- the annual total compensation of the Principal Executive Officer;
- a ratio of the two figures; and
- any methodology, assumptions, adjustments and/or estimates used in determining the ratio.

As written, the original legislative language would have required issuers to disclose the ratio of the median total pay of all non-CEO employees to the total compensation paid to the CEO. This formulation would result in a fraction (e.g., the ratio of \$40,000 non-CEO pay to \$400,000 CEO pay being 1/10) which, the SEC concluded, would not be very clear to, or useful for, stockholders. Therefore, in the proposed rules the SEC provides issuers the ability to report the ratio using an alternative formulation that would allow a comparison of CEO pay to the median of non-CEO pay (e.g., the ratio of CEO pay to non-CEO pay being “10 to 1”). In addition, companies may present additional ratios as supplemental disclosures.

As discussed further below, the proposed rules provide issuers some discretion in the determination of the median employee. To provide investors with adequate information about the disclosed ratio, the proposed rules would require issuers to describe the methodology used to determine the median employee and any material assumptions, adjustments, sampling techniques or estimates used in computing the ratio.

### ***Determining the Median Employee***

Consistent with the original legislation, when determining compensation of the median employee, the issuer must consider all individuals employed by the company on the last day of its most recently completed fiscal year. This would include all employees of the company or any of its subsidiaries, including non-U.S. employees, part-time employees, temporary and seasonal employees.

The proposed rules attempt to provide issuers some relief in complying with this provision. Specifically, in determining the median employee, issuers may employ reasonable methodologies and estimates including:

- Using a statistical sampling of their (and their subsidiaries’) employees (or other reasonable methods of making this determination) rather than having to compute the compensation for all of their employees.
- Using total compensation or any other compensation method consistently applied to all employees included in the calculation, such as amounts derived from (and their subsidiaries’) payroll or tax records (such as W-2 income).
- Annualizing the compensation of permanent employees (including part-time employees) in making the relevant calculations. Compensation of temporary or seasonal workers may not be annualized for these purposes.

Despite the SEC’s attempts to provide relief to issuers, we expect this aspect of the proposal will continue to present significant challenges to many issuers. In particular, we would expect many issuers to feel compelled to evaluate the effectiveness of alternative methodologies of identifying the median employee prior to the initial compliance date.

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### ***Compensation of the Median Employee***

Once the “median employee” has been determined, his or her compensation (for purposes of determining the ratio) must be computed in the same manner as is used for the CEO in developing the summary compensation table (SCT) disclosure.

In the proposing release, the SEC acknowledges that the SCT compensation figures were developed specifically for executives and may not be easily adaptable to other employees. While the SEC elected not to use a modified definition of compensation, the proposed rules do provide issuers the ability to use reasonable estimates for purposes of measuring total compensation of the median employee. This might be relevant, for example, in estimating the value of pension or other benefits received by the median employee.

The rules also briefly discuss the treatment of “other compensation” amounts. Compensation disclosures for the CEO allow for the exclusion of certain limited elements of compensation that aggregate less than \$10,000 in value and provided under non-discriminatory plans. Such amounts may be material to any estimate of compensation for the median employee. The proposed rules permit issuers to include “other compensation” in the estimate of compensation for the median employee, but require that CEO compensation amounts are calculated on a consistent basis (i.e., including “other compensation” for both the median employee and the CEO). Additionally, the value of government-mandated pension plans is not to be considered in the estimate of compensation for the median employee or the CEO, which may present a significant issue for issuers with multinational workforces.

### ***Effective Date***

The SEC has proposed requiring issuers to begin to comply with the rules beginning with the first fiscal year commencing on or after the effective date of the final rule. Assuming the final rule becomes effective in early 2014, for most companies this would require compliance beginning with disclosures relating to its 2015 fiscal year, which would generally be filed with the SEC in early 2016.

### ***Registrants Subject to the Proposed Rules***

As proposed, the disclosure requirements would not apply to all issuers. Smaller Reporting Companies, Emerging Growth Companies, Foreign Private Issuers and companies subject to U.S. – Canadian Multijurisdictional Disclosure rules are each exempt from the disclosure requirements.

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*This Viewpoint is intended to inform compensation committees, executives and compensation professionals about developments that may affect their companies and should not be relied on as providing specific company advice, or as a substitute for legal, accounting or other professional advice.*

*General questions about this Viewpoint can be directed to Ben Stradley in our Dallas office at 972 379 7468 or by email at [bentham.stradley@paygovernance.com](mailto:bentham.stradley@paygovernance.com).*