BURNS & LEVINSON LLP

SECURITIES LAW UPDATE

October 2013

SEC Proposes "Pay Ratio" Disclosure Rules

On September 18, 2013, the Securities and Exchange Commission (SEC) issued a new rule proposal that would, if approved, require each affected public company to disclose the ratio of the median total annual compensation among all its company employees to the total annual compensation of its principal executive officer (the "PEO," as defined in Item 402(a)(3) of Regulation S-K).

The SEC also proposed that affected companies must tally the annual compensation of disparate types of employees, including full-time, part-time, seasonal and non-U.S. employees, in determining the median compensation among all employees.

However, the new rules would not require a specified calculation methodology for identifying the median employee in terms of total compensation, leaving it to registrants to select a methodology that is appropriate to the size and structure of their companies, and specifically permitting statistical sampling of an employee population in lieu of cumbersome, comprehensive calculations for any massive workforce.

The so-called "pay ratio" rules were proposed pursuant to requirements of Section 953(b) of the Dodd-Frank Wall Street Reform and Consumer Protection Act (the "Dodd-Frank Act"), the provisions of which were initially summarized in our July 2010 Securities Law Update, "Summary of Corporate Governance Changes in the Dodd-Frank U.S. Financial Regulatory Reform Act." That update can be found at: http://www.burnslev.com/apps/uploads/publications/Securities_Update_Dodd-Frank_July2010.pdf.

"This proposal would provide companies significant flexibility in complying with the disclosure requirements while still fulfilling the [Dodd-Frank] statutory mandate," said SEC Chairman Mary Jo White, adding, "we are very interested in receiving comments on the proposed approach and the flexibility it affords."

Following is a detailed summary of the proposed rules, which generally provide companies with guidance as to:

- Which SEC filings are subject to the pay ratio disclosure requirements;
- Which registrants are subject to the requirements;
- How the disclosure is to be expressed;
- Which employees are to be included or excluded from the process of identifying the median compensation among all employees;
- Methods that may be used by companies to identify their median compensation;
- Required disclosures related to methodologies used by a registrant;
- The timing of required disclosures; and
- The proposed compliance dates and transitional allowances.

The full text of the 162-page SEC Release no. 33-9452; 34-70443 regarding pay ratio disclosure requirements (the "Release") can be viewed at: http://www.sec.gov/rules/proposed/2013/33-9452.pdf.

Comments on the proposed rules must be submitted to the SEC by December 2, 2013. Noting that the SEC had already requested comments prior to issuing the proposals, Chairman White called attention to the roughly 260 separate public comment letters already received.

The proposed rules are expected to draw significant further comment, having been narrowly approved by a 3-2 vote. The two dissents cited the difficulties of applying the rules to global workforces, unlimited numbers of subsidiaries, and various classifications of disparate workers.

WHICH SEC FILINGS ARE SUBJECT TO PAY RATIO DISCLOSURE RULES

The proposed pay ratio disclosures would be required in annual reports on Form 10-K, registration statements filed under the Securities Act of 1933 ("Securities Act") or the Securities and Exchange Act of 1934 (the "Exchange Act") and proxy and information statements, to the same extent that the requirements of these forms require compliance with Item 402 of Regulation S-K (regarding executive compensation).

Companies would not be required to disclose pay ratio information in reports that do not require executive compensation information, such as 8-K current updates or 10-Q quarterly reports.

WHICH REGISTRANTS ARE SUBJECT TO THE PROPOSED RULES

All registrants would be subject to the proposed rules, except:

1. Emerging growth companies, which pursuant to Section 953(b) of the Dodd-Frank Act were specifically exempted from the pay ratio disclosure rules. Under Section 3(a) of the Securities Act, emerging growth companies include any issuer with less than $1 billion in gross revenues in its most recently completed fiscal year (to be indexed for inflation every five years) except for issuers that have sold common equity securities in a registered Securities Act offering on or prior to Dec. 8, 2011.
2. "Smaller reporting companies," as defined in Rule 12b-2, Rule 405 and Regulation S-K, which generally include:
   - Companies with less than $75 million in public float;
   - Companies with less than $50 million in annual revenues, if they have no public float; and
   - Certain companies that, by virtue

• continued

of an initial public offering, have within 30 days of registration, made a successful offering of less than $75 million in public float.

3. Foreign private issuers and filers under the U.S.-Canadian Multijurisdictional Disclosure System, as these issuers are not required to include Item 402 executive compensation disclosure on their Forms 20-F or 40-F.

THE PROPOSED REQUIREMENTS FOR PAY RATIO DISCLOSURE

Under proposed paragraph (u) of Item 402, each nonexempt issuer of public equity or debt would be required to disclose:

- The median of the annual total compensation of all employees of the registrant, excluding the PEO;
- The annual total compensation of the PEO of the registrant; and
- The ratio of the two amounts (presented as a ratio in which the first amount equals one, or narratively in terms of the multiple that the second amount bears to the first).

With respect to the last requirement, the Release provided an example for clarification: If the median of the annual total compensation of all employees of a registrant is $45,790, and if the annual total compensation of registrant's PEO is $12,260,000, then the pay ratio disclosed would be "1 to 268." The SEC said the disclosure could also be expressed narratively as: "the PEO's annual total compensation is 268 times that of the median of the annual total compensation of all employees."

EMPLOYEES TO INCLUDE IN IDENTIFYING MEDIAN COMPENSATION

Because the Dodd-Frank Act mandates the disclosure of median annual total compensation of "all employees," the SEC proposed to mandate the inclusion of all of the following groups of employees in registrant calculations of median compensation:

- Any full-time, part-time, seasonal or temporary workers;
- Any such workers employed by any subsidiaries of the registrant;
- Any such workers employed outside of the U.S.; and
- Any officers of the registrant other than the PEO.

In contrast, workers not employed by the registrant or its subsidiaries, such as "leased workers" or independent contractors or other temp workers employed by a third party, would not be included in the calculation of median annual total compensation of "all employees."

The Release noted that many commenters raised concerns about inclusion of workers outside of the U.S. based on international variation in compensation and benefit arrangements, cost of living differences, currency fluctuations and other factors that could distort the comparability of employee compensation to that of a U.S. based PEO. But the SEC stated the mandate to include "all employees" was clear.

The Release also noted commenter concerns about the impact of local data privacy laws in foreign countries, which could make collection or transfer of data needed to calculate median compensation of all employees very difficult. The SEC acknowledged the burden, but stated that statistical sampling and other means of "estimating" median compensation should alleviate much of the anticipated difficulty of compliance.

Proposed Item 402(u)(3) would also set a calculation date for determining who is an employee and who is not. The proposed rule would define an "employee" as any individual employed as of the last day of the registrant's last completed fiscal year.

The SEC acknowledged that this approach might not adequately capture the impact of seasonal or temporary workers, but said that a "bright line" calculation date should ease compliance costs. It added that the most appropriate calculation date is one that is consistent with the calculation date for determining the named executive officers under current Item 402.

COMPENSATION CALCULATION ADJUSTMENTS FOR SOME EMPLOYEES

In response to commenter concerns about the "total annual compensation" of some employees who were not employed for a full year, the SEC stated that "we agree that in instances where the employment relationship is permanent, and not temporary or seasonal, registrants should be permitted to annualize the total compensation for an employee who did not work for the entire year, such as a new hire or an employee who took an unpaid leave of absence during the period in question.

This instruction would not permit a registrant to annualize the compensation of some employees and not others.

Whether a permanent part-time worker's compensation should be annualized would be a determination dependent on the "facts and circumstances" of each case, the SEC added.

HOW TO IDENTIFY MEDIAN COMPENSATION

Section 953(b) of the Dodd-Frank Act does not expressly set forth a methodology that must be used to identify the median total annual compensation of all employees, so the SEC concluded that it would be best to allow registrants to choose the methodologies that work best for their particular facts and circumstances, taking into account their cost constraints.

The proposed rules do not specify any required calculation methodology for identifying the median total annual compensation of all employees. Likewise, the rules do not prescribe specific estimation techniques or statistical confidence levels for an estimated median.

The SEC concluded that the "appropriate and most cost-effective methodology" will necessarily depend on a registrant's facts and circumstances, including:

- The size and nature of the workforce;
- The complexity of the organization;
- The stratification of pay levels across the workforce;
- The types of compensation employees receive;
- The extent to which different currencies are involved;
- The number of tax and accounting systems involved; and
- The number of payroll systems that are

• continued

involved which may not be easily integrated for purposes of performing calculations across groups.

Under the rules, a company would be permitted to identify the median total annual compensation of all employees based on a total compensation analysis that uses either the entire employee population or just a representative sampling of the population.

A company could also identify the median compensation in its employee population either by:

- Using annual total compensation, as determined under existing executive compensation disclosure requirements in Item 402 of Regulation S-K; or
- Using any consistently applied compensation measure, such as compensation amounts reported in payroll or tax records (which are not necessarily compliant with Item 402 executive compensation analysis).

Thus, a registrant could use any form of total direct compensation (such as annual salary, hourly wages or other performance-based pay) to first identify an employee of median compensation.

However, once the employee of median compensation has been identified, a registrant must then calculate the total annual compensation for that employee in accordance with the definition of "total annual compensation" set forth in the executive compensation disclosure rules (specifically, Item 402(c)(2)(x) of Regulation S-K).

The SEC took note of the fact that the annual period used for payroll or tax record-keeping can sometimes differ from the registrant's fiscal year, and therefore, it issued proposed instructions to its rules that would permit a registrant to use the same annual period that is used in payroll or tax recordkeeping for purposes of determining the employee with the median amount of total annual compensation.

Commenters also proposed that registrants be permitted to calculate a final pay ratio disclosure using employee earnings estimates available through the U.S. Department of Labor's Bureau of Labor Statistics, but the SEC explicitly rejected that idea, stating that it was not useful to compile and disclose already publicly available information.

HOW TO DETERMINE TOTAL COMPENSATION

Under the proposed rules, "annual total compensation" for the employee having the median total compensation among all employees would be calculated based on that employee's compensation for the last completed fiscal year of the disclosing registrant, consistent with the time period used for its other Item 402 disclosures. Item 402 requires companies to provide extensive compensation information about the CEO and other named executive officers who are compensated differently from other employees.

Some commenters suggested that registrants be permitted to use "reasonable estimates" to determine the present value of various elements of total compensation for the median employee that might not normally apply to executives, and the SEC approved their suggestion.

Thus, the Release specifically noted that it would be appropriate for a registrant to use "reasonable estimates" in determining an amount that approximates the annual aggregate change in actuarial present value of an employee's defined pension benefit plan for purposes of complying with Item 402 requirements.

The SEC also clarified that it would allow companies to use reasonable estimates when appropriate for:

- Calculating any element of total compensation; and
- Calculating the annual total compensation of the employee who has the median total compensation among all employees.

Acknowledging that some registrants may need clarity as to how to treat government-mandated pension plans for purposes of calculating an employee's total compensation, the SEC added that in most cases, the value derived from government-mandated plans would not be included under current rules. The SEC noted that this would be particularly true where the employee ultimately receives a pension benefit from the government and not the employer.

Some commenters questioned whether Item 402 would permit a registrant to capture the value of various compensation components that individually would be valued at less than $10,000, noting that the current executive compensation disclosure rule allows for discounting of perquisites and benefits valued below this figure. The SEC responded that this exclusion is "permissive rather than mandatory," allowing registrants to include personal benefits that aggregate less than $10,000 in value (a sum that could be material to the compensation tally for an employee of median compensation).

DISCLOSURES REGARDING METHODOLOGIES

Given the need for investors to understand how a registrant arrived at its pay ratio disclosures, the SEC proposed to add instructions to the new rules, clarifying that registrants must briefly disclose and consistently apply any methodology used to identify the employee with median total compensation, as well as any material assumptions, adjustments or estimates used to identify that employee, or to determine their total compensation or any elements of their total compensation.

Under the instructions, registrants must also clearly identify any amount arrived at by using reasonable estimations, and they must consistently apply any material assumptions, adjustments and estimates.

The SEC did not propose any requirements for a narrative discussion beyond the proposed brief description of the calculation methodology where estimation techniques have been used.

However, as with other disclosures, the SEC noted that registrants are permitted to supplement required disclosures if they choose to do so, and they may present additional ratios to supplement the required ratio if they feel it helps an investor to understand the relevant data. But the additional ratios or data should not be presented "with greater prominence than the required ratio," the SEC warned.

TIMING AND TRANSITION MATTERS

Section 953(b) of the Dodd-Frank Act did not specify a date when registrants would

• continued

be required to comply with the pay ratio disclosures. So the SEC proposed that a registrant be required to comply with the proposed pay ratio disclosure rules for the registrant's first fiscal year commencing on or after the effective date of any final rulemaking.

Some commenters additionally urged that the pay ratio disclosure not be required to be updated for the most recently completed fiscal year until the registrant files its relevant proxy statement for its annual meeting of shareholders.

The SEC agreed, issuing a proposed instruction stating 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 the filing of a definitive proxy or information statement relating to an annual meeting of shareholders, provided that updated pay ratio information must, in any event, be filed as provided in Form 10-K not later than 120 days after the end of such year.

Thus, if the final rules were to become effective in 2014 (a reasonable assumption), then a registrant with a fiscal year ending on December 31, 2014 would be first required to include pay ratio information relating to compensation for fiscal year 2015 in its proxy or information statement for its 2016 annual meeting of shareholders. The SEC proposed this longer-than-usual transition period given the long period of time it could take a company to prepare to identify the numbers. The SEC stated: "We understand that this time would likely be needed by large, multinational registrants and any registrants that currently do not have a centralized, consolidated payroll, benefits and pension system that captures the information necessary to identify the median. We expect that it will take registrants one full reporting cycle to implement and test any necessary systems."

The proposed rules also include instructions that would permit new registrants via initial public offerings to further delay compliance. For them, pay ratio disclosure would not be required in a registration statement for an initial public offering (via Form S-1, S-11 or Form 10). Instead, such registrants would be initially required to comply with the proposed pay ratio disclosures only with regard to the first full fiscal year commencing on or after the date the registrant becomes subject to the requirements of Section 13(a) or Section 15(d) of the Exchange Act. Per the SEC's example, if the proposed requirements become effective in 2014, a company completing its IPO in October 2016 that has a fiscal year ending December 31, 2015 would first be required to include pay ratio disclosure in its definitive proxy or information statement for its 2018 annual meeting, which would include pay ratio disclosure relating to 2017 compensation amounts.

Explanatory Notes:

This update is intended to call your attention to various proposed rule changes of possible interest and relevance to you, but it is not intended to constitute a legal opinion or definitive summary of all changes and information that could be material to you.

Please contact a member of the Securities Law Group at Burns & Levinson if you have any questions about these rule changes or if you want to learn more about our expertise in this area.

• continued

Burns & Levinson's Securities Law Group represents public and private companies, underwriters and investment banks, venture capital and investment funds, real estate investment funds, investment advisors, broker-dealers, stockholder groups and individuals in public and private securities offerings and transactions, SEC, FINRA and stock exchange compliance, corporate governance, fund formation and offerings, SEC enforcement and securities litigation.

THE SECURITIES LAW GROUP

Josef Volman - Co-Chair
617.345.3895 | jvolman@burnslev.com

Andrew Merken - Co-Chair
617.345.3740 | amerken@burnslev.com

If you have any questions regarding this Burns & Levinson Securities Law Update, please contact one of the individuals named above.

If you would like to be added to or removed from the mailing list for Burns & Levinson Securities Law Updates or other Burns & Levinson publications, please call 617.345.3000 or send your name and email address to clientservices@burnslev.com.

ABOUT BURNS & LEVINSON'S SECURITIES LAW GROUP

Burns & Levinson's attorneys have extensive experience representing public and private issuers, stockholder groups and individual investors. Our attorney team counsels clients on IPOs and follow-on offerings of equity, debt and other securities (including shelf registration takedowns), corporate acquisitions involving registered and restricted stock, mergers and acquisitions where one or both parties are publicly traded, private investment in public equity (PIPE) transactions, private placements, venture capital financings, and complex securities law transactions and issues, including corporate governance/ Sarbanes-Oxley and SEC and stock exchange reporting and compliance.

In the securities compliance area, we advise our clients on corporate governance/Sarbanes-Oxley and SEC and stock exchange reporting and compliance. Specifically, we assist our clients in fulfilling their ongoing SEC and stock exchange reporting obligations, managing sensitive disclosure issues internally and with industry analysts, preparing proxy statements and handling stockholder meetings, structuring employee benefit plans and executive compensation packages under the SEC's "short-swing profit" reporting and liability rules, effecting re-sales of securities in the public trading markets under the SEC's Rule 144, and advising boards of directors and board committees concerning the requirements and restrictions imposed on their actions by the securities laws and corporate governance laws such as Sarbanes-Oxley. We have served as special securities counsel to the Boards and Audit Committees of publicly traded companies looking for opinions or advice of counsel other than their regular outside counsel.

We have counseled clients both domestic and international, from emerging growth companies to large public companies, and are positioned to provide clients with timely, expert, efficient and cost effective advice that they need to meet their business objectives. We take a practical and proactive approach to the rapidly changing securities disclosure and corporate governance laws, providing our clients with timely updates, identifying specific situations in which the new laws will impact particular clients either operationally or structurally, and working with clients to implement the changes that are either required or advisable to comply with the new regulatory schemes and investor sentiment.

Underwriters and Investment Banks

Our attorneys also represent underwriters in initial and follow-on public offerings and investment banks in private placements and mergers and acquisitions.

This communication provides general information and does not constitute legal advice. Attorney Advertising. Prior results do not guarantee a similar outcome.
© 2013 Burns & Levinson LLP. All rights reserved.