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Pay Ratio Rules: Practical Compliance Challenges

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On July 21, 2010, in response to the financial crisis, the Dodd-Frank Wall Street Reform and Consumer Protection Act of 2010 was signed into law. In passing Dodd-Frank, legislators hoped to curb the risk-taking behaviors that were blamed, in part, on certain executive pay practices. Included in the law is Section 953(b), which directs the Securities and Exchange Commission to promulgate rules requiring that public companies disclose the median annual total compensation of all employees other than the chief executive officer, the annual total compensation of the CEO and the ratio of these two amounts (the proposed pay ratio rules).[1]

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While Section 953(b) appears simple on its face, for most public companies, especially those with global operations, the determination of the median total compensation for all employees would be very costly and likely require an overhaul of compensation data and employee record-keeping systems. Further, as the SEC suggested in its economic analysis of Section 953(b) rulemaking, the benefits of the disclosure are uncertain. There are no obvious benefits on the face of the statute, and the specific market failure or problematic pay practice that the legislators attempted to address with Section 953(b) was not made clear in the legislative record.[2]

In voting in favor of proposing pay ratio rules, the SEC instead relied on comments from supporters of Section 953(b) rulemaking, who have argued that pay ratio disclosure would allow investors to more effectively evaluate board oversight and the company's level of investment in its overall workforce[3] and that the disclosure would help to address the broader public policy issue of income inequality.[4]

The SEC finally voted to propose rules to implement Section 953(b) on Sept. 18, 2013, more than three years after the passage of Dodd-Frank, in a 3-2 vote of commissioners cast along party lines.[5] In its proposing release, the SEC reported having received more than

[1] Section 953(b) of Dodd-Frank states that the SEC shall amend § 402 of Regulation S-K ''to require each issuer to disclose in any filing of the issuer described in Section 229.10(a) of title 17 [(proxy requirements)] . . . (A) the median of the annual total compensation of all employees of the issuer, except the chief executive officer (or any equivalent position) of the issuer; (B) the annual total compensation of the chief executive officer (or any equivalent position) of the issuer; and (C) the ratio of the amount described in subparagraph (A) to the amount described in subparagraph (B).'' Total compensation, for purposes of Section 953(b), ''shall be determined in accordance with section 229.402(c)(2)(x) of title 17, Code of Federal Regulations, as in effect on the day before the date of enactment of [the Dodd-Frank Act].''

[2] Release Nos. 33-9452 and 34-70443; File No. S7-07-13, Pay Ratio Disclosure (Sept. 18, 2013), 78 Fed. Reg. 60,560 (Oct. 1, 2013) (182 PBD, 9/19/13; 40 BPR 2239, 9/24/13).

[3] *See* AFL-CIO Office of Investment, ''Dodd-Frank Section 953(b): Why CEO-to-Worker Pay Ratios Matter For Investors,'' July 18, 2011, http://www.aflcio.org/content/download/1090/9807/version/1/file/Why-CEO-to-Worker-Pay-Ratios-Matter-For-Investors.pdf.

[4] *See, e.g.*, ''AFR Applauds SEC's Release of CEO-to-Median-Worker Pay Rule,'' Americans for Financial Reform, Sept. 18, 2013, http://ourfinancialsecurity.org/2013/09/afr-applauds-secs-release-of-ceo-to-median-worker-pay-rule/.

[5] SEC Chairman Mary Jo White and Commissioners Luis A. Aguilar and Kara M. Stein, the Democratic members of the commission, voted in favor of the proposal. Republican Com-

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20,000 comment letters prior to the release of the proposed pay ratio rules.

Due to the lack of clarity on the purpose of Section 953(b) and the controversy surrounding the rulemaking to implement it, the SEC took a provisional approach in its proposed rules, soliciting from the public detailed information and statistics on the costs and benefits of the rules generally, and on each aspect of the rules specifically, with the goal of arriving at a set of rules that balances those interests.

In crafting the proposed pay ratio rules, the SEC attempted to preserve the perceived benefits of Section 953(b) while giving registrants some discretion in the determination methodology for the median employee, which was designed to provide flexibility and to limit the cost and administrative burden on registrants.

In this article, we provide a summary of the proposed pay ratio rules and address some of the practical compliance challenges that companies may encounter.

Summary and Analysis of Proposed Rules

The proposed pay ratio rules would add new paragraph (u) to Item 402 of Regulation S-K. Item 402(u) that would require registrants to disclose the median annual total compensation of its entire employee population (other than the CEO), the annual total compensation of the CEO and the ratio of the two.

Where Pay Ratio Disclosure Is Required. The disclosure would be required in filings that mandate executive compensation disclosure under Item 402 of Regulation S-K, including annual reports on Form 10-K and registration, proxy and information statements to the extent that required Item 402 disclosure is presented.

While some commentators have suggested that Congress intended pay ratio disclosure to be included in every SEC filing, the commission did not present any views of commentators that argued that this was the preferred approach. The SEC instead took the more practical approach, reasoning that presenting the proposed pay ratio disclosure within the existing executive compensation disclosure framework would both provide a more relevant context for investors to review the disclosure and help limit the compliance burden for companies.

Covered Registrants The proposed pay ratio rules would apply only to those registrants that are required to provide summary compensation table disclosure under Item 402(c) of Regulation S-K. The Jumpstart Our Business Startups Act of 2012 (the JOBS Act) specifically exempts emerging growth companies from Section 953(b),[6] and Instruction 6 to the proposed pay ratio rules gives effect to that exemption.

The SEC would also exempt smaller reporting companies and foreign private issuers from the proposed pay ratio rules as these companies are not required to disclose compensation of their named executive officers pursuant to Item 402, and Section 953(b) does not require the SEC to expand the scope of companies that are subject to Item 402.

The SEC requests comment on whether smaller reporting companies and foreign private issuers should be required to provide a simpler version of the pay ratio disclosure.

Covered Employees. Section 953(b) specifically requires the disclosure of the median total compensation of all employees. The proposed pay ratio rules retain the literal meaning of this provision by requiring that the median total compensation be determined based on a measure of all of a registrant's employees, including temporary, seasonal, part-time and non-U.S. employees and those employed by direct and indirect subsidiaries of the registrant, but notably excluding independent contractors and leased employees.

The rules would permit, but not require, registrants to annualize compensation for permanent employees who were employed for less than the registrant's full fiscal year (i.e., employees hired during the year) but would not allow annualizing of compensation for seasonal or temporary employees. In addition, the proposed pay ratio rules would prohibit full-time equivalent adjustments for part-time employees and cost-of-living adjustments.

The SEC requests comment on whether there are alternative means to implement the Section 953(b) requirement that ''all employees'' be measured when determining the median employee. For instance, there may be record-keeping issues in tracking seasonal and part-time employees. Other issues may arise because the exclusion of independent contractors and leased employees from the meaning of ''all employees'' could encourage employers to engage contingent workers in place of employees, and to increase outsourcing domestically and abroad.

The SEC has also requested comment on whether to allow registrants the flexibility to make part-time and cost-of-living adjustments.

With respect to non-U.S. employees, the SEC acknowledges that data privacy laws may further complicate the ability of registrants to access payroll data for certain employees, and specifically requests comments on those laws that may impact the collection or transfer of employee data. Further, the requirement to include all non-U.S. employees could require registrants to overhaul payroll systems to reconcile the information from disconnected systems around the world.

Calculation Date and Covered Time Period. The proposed pay ratio rules would require registrants to determine the median by reference to persons actually employed as of the last day of the registrant's fiscal year, a calculation date consistent with the date used to determine the named executive officers under Item 402 of Regulation S-K.

To accommodate any registrant whose fiscal year differs from the annual period used for payroll or tax record keeping, the proposed rules would permit the registrant to use the same year that is used in the payroll or tax records from which the compensation amounts are derived. However, a registrant using payroll or tax records to identify the median employee would then be required to calculate total compensation of that median employee for the last completed fiscal year, rather than the annual payroll or tax period.

Identifying the Median Employee. In response to concerns that calculating the annual total compensation of all of a registrant's employees under the Item 402 rules would be unduly burdensome, if not impossible, the

missioners Michael S. Piwowar and Daniel M. Gallagher voted against it.

[6] *See* JOBS Act, Section 102(a)(3).

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proposed pay ratio rules would require instead a comparison of the compensation of a ''median employee'' to the compensation of the company's CEO. The SEC, moreover, has proposed a flexible approach for identifying the median employee and determining median total compensation.

The proposed rules would give registrants discretion to determine a methodology for identifying the median employee appropriate to their size and structure, including the use of statistical sampling, random sampling, reasonable estimates of total compensation or a reasonable determination of the median employee through a review of more readily identifiable figures, such as total direct compensation (including salary, hourly wages and any performance-based pay). This flexible approach would allow registrants to seek to reduce costs and tailor the calculations to fit each registrant's unique circumstances, as long as each registrant consistently applies its chosen methodology.

In the proposing release, the SEC acknowledges that the costs of compliance may vary greatly among registrants based on a number of factors, including their size and complexity, the nature of their workforce and operations, the location of their operations and the level of integration of their payroll systems and employee data.

The SEC suggests that registrants in industries having low wage variances (e.g., the motor vehicle manufacturing and coal mining industries) may have appropriate sample sizes of less than 100 employees. In contrast, industries having high wage variances (e.g., the spectator sports and motion picture and video industries) may have minimum appropriate sample sizes of more than 1,000 employees. The determination of appropriate sample sizes would be further impacted by the existence of multiple businesses or geographic segments.

The SEC acknowledges that the proposed pay ratio rules may place a disproportionately higher burden on large multinational companies and companies that operate across multiple industries. In addition, the requirement to include temporary and seasonal workers could potentially skew the median employee's compensation lower. Nevertheless, the SEC reasons that, overall, the use of sampling would benefit registrants and help to minimize costs.

The SEC also acknowledges that introducing flexibility in the proposed pay ratio rules may reduce the comparability of the required disclosure across registrants. More generally, the SEC recognizes that, even within the same industry, comparability from registrant to registrant will be impaired by the use of different business models (e.g., franchise or company-owned chains), the differences in cost of living and labor in different countries and other factors.[7] The SEC reasons that pay ratio disclosure will nonetheless be useful to investors in evaluating the CEO's pay within the context of his or her own company. Further, the SEC notes that mandating a particular methodology for identifying the median employee would not necessarily improve the comparability of the disclosure across different companies because of the many other factors that would affect the ratio.

Instead of requiring all registrants to conform to a single methodology for determining the median, the proposed pay ratio rules would require each registrant to consistently apply a particular methodology. According to the SEC, this would provide clarity and add a level of predictability to the ratio, and help to guard against the risk of manipulating the methodologies to reach a more favorable ratio. A consistently applied methodology would also be useful to investors and other parties interested in tracking trends in a registrant's pay ratio over time.

The initial challenge for registrants will be to determine the most suitable methodology that could be consistently applied going forward. As explained above, the appropriate methodology will depend on a number of factors specific to the registrant. For example, statistical sampling might not be appropriate where the pay mix among comparable employees is highly variable. In such a situation, the risk of arriving at inconsistent pay ratios from year to year will be high. Instead, a registrant in this situation might go as far as implementing a system to track the compensation of all employees and determining median compensation consistent with a literal interpretation of Section 953(b).

Helpfully, as noted above, the rules would allow registrants to first identify the median employee using estimates of total compensation or through a review of more readily identifiable figures, such as total direct compensation. Registrants therefore have the option to use W-2 wages (with or without statistical sampling) to determine the median employee.

Regardless of the chosen methodology, most registrants will likely need to implement some new systems and internal control procedures to track, process and verify the relevant compensation and employee data.

The SEC requests comments on whether its flexible approach would be fair and workable and help to reduce the cost and other burdens of providing the disclosure. The SEC is also requesting detailed information on the estimated costs of compliance and whether the utility of the disclosure would justify the costs.

The proposed pay ratio rules do not provide guidance on how a registrant should calculate the pay ratio if the methodology used to identify the median employee points to multiple individuals. A registrant that uses only salary and wages to identify the median, for instance, might identify more than one employee at the median level. A registrant in this situation may then be required to calculate total compensation in accordance with Item 402(c) for all employees at this level to finally arrive at the median.

Total Compensation. Once a registrant has identified the median employee, it would be required under the proposed pay ratio rules to determine that employee's total compensation in accordance with Item 402(c) (the rules governing the total compensation figure provided in the summary compensation table). Registrants are not currently required to disclose this information for nonexecutive employees.

To address some commentators' concern that it would be overly burdensome to calculate certain ele-

[7] For instance, the pay ratio for companies with significant numbers of part-time and seasonal employees may be inflated when compared with other companies, while companies that outsource low-paying work or rely heavily on independent contractors may benefit from an artificially low ratio. Further, a company with employees primarily located in countries where wages are generally lower may appear to have an inflated ratio when compared with a company whose employees are primarily located in the U.S.

ments of total compensation in accordance with Item 402(c), such as benefits, pensions and equity compensation, the SEC included in the proposed pay ratio rules the option to use ''reasonable estimates'' to calculate the annual total compensation or any elements of total compensation for employees other than the CEO.

This proposed approach to the calculation of total compensation is especially welcomed for registrants that maintain defined benefit plans, where the present value of benefits can be difficult to calculate.

Disclosure Methodologies. Registrants would be required under the proposed pay ratio rules to briefly disclose the methodology used and any material assumptions, adjustments or estimates used to identify the median or determine total compensation or any elements of total compensation. Instruction 2 of the proposed rules clarifies that only a ''brief overview'' is required for the disclosure. The SEC notes that an ''overly technical'' analysis could be dense and confusing to investors. The proposed rules would allow for reasonable supplemental information, including additional pay ratios (i.e., comparing pay of other employee groups), as long as the supplemental information is clearly designated as supplemental and would not confuse investors.

Finally, the proposed pay ratio rules require that registrants disclose any material changes to the methodology or material assumptions, adjustments or estimates. If changes result in a material change to the ratio, the proposed rules would require the registrant to describe the reason for the change and provide an estimate of the impact of the change on the median and the ratio. As with the requirement that registrants use a consistent methodology, this requirement is intended to prevent a registrant from manipulating methodologies to reach a more favorable ratio.

Proposed Transition Period. The SEC would require registrants to begin to comply with the pay ratio rules with respect to the first fiscal year commencing on or after the effective date of the rules. The disclosure would then need to be included in the registrant's Form 10-K, proxy statement or registration statement no later than 120 days after the end of the relevant fiscal year. Thus, if the pay ratio rules were to go into effect in 2014, a registrant with a fiscal year ending Dec. 31 would first be required to comply with the rules with respect to the 2015 fiscal year and would be required to include the disclosure for the first time in its Form 10-K, proxy statement or registration statement filed in 2016.

For newly public companies that are not emerging growth companies, the proposed pay ratio rules would require initial compliance with respect to compensation for the first fiscal year commencing on or after the date the registrant becomes subject to the reporting requirements under the Securities Exchange Act of 1934.

In proposing a long transition period, the SEC acknowledged that registrants would benefit from a longer period to test different methodologies for determining the median.

Disclosure to Be Deemed 'Filed.' The proposed pay ratio rules provide that the pay ratio disclosure would be considered ''filed'' for purposes of liability under the Securities Act of 1933 and the Exchange Act and is therefore subject to the certification requirements of sections 13(a) and 15(d) of the Exchange Act.[8]

The Debate

There has been significant debate on the merits of compelling pay ratio disclosure, as exemplified by the supporting and dissenting statements of the SEC commissioners at the open meeting on Sept. 18, where the SEC considered and voted to approve the proposed pay ratio rules.

Supporters of pay ratio disclosure (typically individuals, institutional investors and unions) argue that the information will increase transparency and help investors assess whether companies are investing in their employees or focusing only on compensating top executives. In addition, supporters view pay ratio disclosure as a way to counter the effect of the use of peer benchmarking, a measure of CEO pay that has received wide acceptance as a helpful gauge of the reasonableness of executive pay but that has also been blamed for CEO pay inflation in recent years.[9] These supporters note that CEO pay has spiraled relative to rank-and-file employee pay.[10] Supporters also note that consistently successful companies may not have the most highly paid CEOs, suggesting that pay structures can have an effect on company performance, perhaps due to higher employee morale and a greater sense of teamwork.[11]

Critics counter that pay ratio disclosure could be misleading, that the ratio would not affect the CEO's or the registrant's performance, that compliance may be costly and that the disclosure requirement could give a competitive advantage to registrants that are not subject to the rules.

As noted above, in formulating the proposed pay ratio rules, the SEC sought to address the concerns raised in the numerous comment letters that it received. An even stronger response is expected to the specifics of the proposed rules. Because of the strong views both in favor of and against the rules, the SEC is likely to again spend time considering the comments that it receives over the next several weeks. Companies are encouraged to express their concerns with the rules, particularly with respect to anticipated costs and burdens that

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[8] Section 18 of the Exchange Act imposes liability for material misstatements or omissions for ''filed'' disclosure. ''Furnished'' disclosure under Regulation FD, which prohibits selective disclosure, such as the disclosure of certain market information made to institutional investors, does not attract liability under Section 18. Sections 13(a) and 15(d) govern periodic and current reporting by registrants.

[9] *See* AFL-CIO Office of Investment, *supra*, note 3, p. 2. As explained by the AFL-CIO, ''[n]ot every CEO can be paid above average, yet no CEO wants to be in the 'below average' category.'' The AFL-CIO further argues that the problem is compounded when companies choose peers that are larger in size.

[10] *See* Bloomberg.com, ''Top CEO Pay Ratios'' (April 30, 2013), at http://go.bloomberg.com/multimedia/ceo-pay-ratio/ and http://www.bloomberg.com/news/2013-04-30/ceo-pay-1-795-to-1-multiple-of-workers-skirts-law-as-sec-delays.html. According to the study, average CEO compensation at the companies in the Standard & Poor's 500 Index has increased 20 percent since 2009, and is now 204 times that of rank-and-file employees. *See also* Economic Policy Institute, ''CEOs made 231 times more than workers did in 2011'' (May 2, 2012), which states that this ratio was just 20 to 1 in 1965. At http://www.epi.org/news/ceos-231-times-workers-2011/.

[11] *See* AFL-CIO Office of Investment, *supra* note 3, pp. 4-6.

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would be imposed. The public comment period on the proposed rules will expire Dec. 2.

First Steps

Revising the proposal to address these comments is likely to further delay the issuance of final rules. Because of the significant potential burden of the pay ratio rules, companies should nevertheless begin thinking about possible methodologies to comply with the rules in light of their businesses' specific circumstances. In light of the challenges analyzed above, we believe a registrant's determination of the most appropriate methodology will likely be a lengthy and costly process as it considers alternate compliance methodologies.

To prepare for implementation of the pay ratio rules, companies could, for example:

- review their different payroll and employee data systems and determine the payroll and employee information available from non-U.S. subsidiaries,
- experiment with different sampling methods,
- identify the compensation and benefit programs available globally,
- consider the extent to which the annual pay of employees (particularly seasonal employees and others that are difficult to track) are captured by existing systems and
- consider the compensation measure (e.g., base salary or other direct compensation) most appropriately used to determine the median employee by each registrant.

Lastly, registrants should consider adding their voice to the comments on the proposed pay ratio rules to the extent they have particular concerns.