

Executive Compensation and Securities Alert: SEC Proposes Rule to Disclose CEO-to-Worker Pay Ratio (“Pay-Ratio Rule”)

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Fenwick
FENWICK & WEST LLP

On September 18, 2013, the Securities and Exchange Commission (“SEC”) narrowly voted in favor of proposing a rule that would require public companies to compare their chief executive officer’s compensation with that of all of its employees and disclose this pay ratio in certain public filings. This new disclosure requirement is mandated by the 2010 Dodd-Frank Act under Section 953(b).

A more detailed summary of the proposed rule is in a Fact Sheet provided by the SEC and is available here: <http://www.sec.gov/News/PressRelease/Detail/PressRelease/1370539817895>. The full text of the proposed rule is available here: <http://www.sec.gov/rules/proposed/2013/33-9452.pdf>.

Effective Dates

Pay ratio disclosure is expected to first be required in 2016 proxies. Specifically, under the proposed rule, a public company would need to comply with disclosure for the company’s first fiscal year commencing on or after the effective date of the rule. Thus, assuming the rule becomes effective in 2014, a company with a December 31 fiscal year would first be required to make the pay ratio disclosure in its proxy for the 2016 annual meeting of shareholders with respect to its 2015 fiscal year compensation.

Newly public companies will receive a transition period under the proposed rule and would be required to first comply with respect to compensation for the first fiscal year commencing on or after the date the company is subject to reporting requirements.

Background – New Disclosure Requirement

Dodd-Frank Act Section 953(b) directs the SEC to amend existing rules to require the disclosure of the following:

1. The median of the annual total compensation of all employees of the company;
2. The annual total compensation of the chief executive officer; and

3. The ratio of the median of the total compensation of all employees of the company to the annual total compensation of the chief executive officer of the company.

The proposed rule implements Section 953(b) by proposing rules relating to this disclosure.

Overview

Scope of Proposed Rule

The proposed rule would only apply to companies required to provide executive compensation disclosure pursuant to Item 402(c) of Regulation S-K. Under JOBS Act Section 102(a)(3), emerging growth companies will not be required to disclose the pay ratio. In addition, smaller reporting companies and foreign private issuers are not covered by the proposed rule.

In general, pay ratio disclosure must be provided in filings currently requiring executive compensation disclosure, and the pay ratio disclosure would be required in Form 10-K, registration statements and proxy and information statements, to the same extent these forms require compliance with Item 402 of Regulation S-K. In practice, for most companies covered by the proposed rule, this will be the annual proxy statement.

Employees Covered by the Proposed Rule

Under the proposed rule, practically all employees of the company must be included in identifying the median of the annual total compensation. This includes all full-time, part-time, seasonal or temporary worker employed by the company or any of its subsidiaries as of the last day of the company’s prior fiscal year. Despite concern over the compliance costs of including foreign employees in the determination, the proposed rule extends to non-U.S. employees of the company and its subsidiaries. Workers not employed by the company or its subsidiaries, such as consultants or temporary workers employed by a

third party, will not be required to be included in the determination. Again, most importantly, the proposed rule will only apply to those employees employed by the company on the last day of the company's prior fiscal year.

Identifying the Median and Calculating Total Compensation

STEP 1: Determine the median employee.

The SEC permits public companies to select a methodology for identifying the median employee under the proposed rule. The proposed rule does not set forth a methodology that must be used to identify the median employee and permits companies the ability to select the method that works best for their own facts and circumstances. For example, the company could identify the median by calculating the total compensation per employee under existing executive compensation rules or through a statistical sampling of its employee population. To address commenter concerns about the compliance costs of calculating total compensation per employee under existing executive compensation rules, the SEC will also permit the usage of a "consistently applied compensation measure" in identifying the median. For example, companies could identify a median employee by using more readily available methods such as total direct compensation (e.g., annual salary, hourly wages or other performance-based pay) or cash compensation and then calculate that median employee's total compensation in accordance with executive compensation rules. Compensation for a permanent employee who did not work a full year (e.g., a new hire or an employee who took an unpaid leave of absence) would be permitted but not required to be annualized. However, the company would not be permitted to annualize compensation for temporary or seasonal workers. The company would be given the flexibility to measure compensation by choosing a method that best reflects the way it pays its employees, as long as that method is consistently applied.

STEP 2: Determine the annual total compensation of the CEO and the median employee.

Annual total compensation would be calculated in accordance with the definition of "total compensation"

in Item 402(c)(2)(x) of Regulation S-K. "Annual total compensation" refers to total compensation for the last completed fiscal year of the company. Prior to the proposed rule, commenters recommended that companies be able to use reasonable estimates in determining the value of total compensation in order to lower compliance costs. The SEC believes that the use of reasonable estimates is consistent with Dodd-Frank Act Section 953(b) and accordingly, the proposed rules permit the use of reasonable estimates in determining any elements of the total compensation of employees (excluding the CEO).

STEP 3: Determine the ratio of median employee to CEO.

While Section 953(b) requires the calculation of the pay ratio to be calculated by dividing (a) the CEO's annual total compensation by (b) the median employee's annual total compensation, the SEC will permit the pay ratio to be disclosed in a more user friendly format as follows:

CEO to median employee equals XXX to 1

Additional Disclosure Required

Companies will be required to disclose methodologies used in identifying the median of the annual total compensation of all employees and any material assumptions, adjustments or estimates used to identify the median or to determine total compensation or elements of total compensation. Any estimates made by the company must be clearly identified. The aim of this disclosure should be to provide enough information for a reader to be able to evaluate the appropriateness of the estimates and methodology. Supplemental disclosures, such as narrative discussions and other ratios are permitted, but not required by the proposed rule.

Next Steps

The proposed rule will be under a 60-day comment period from the public once it is published in the Federal Register which we expect to be in the next week.

Fenwick & West Comments – The SEC has provided flexibility with respect to the proposed application of the Pay Ratio Rule. However, there are a number

of data collection issues that will affect a public company's ability to gather the needed information under the proposed rule. We recommend that public companies consult with their respective internal accounting group now to determine the costs and difficulties associated with collecting the data and performing the calculations required by the proposed rule, and where appropriate, provide comment to the SEC with respect to compliance costs during the 60-day comment period.

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