# WILMERHALE 

## SEC Proposes Rules for Pay Ratio Disclosure

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## Proposal for Pay Ratio Disclosure Rules

The SEC proposed an amendment to Item 402 of Regulation S-K and a conforming amendment to Form 8-K under the Securities Exchange Act of 1934 to implement the pay ratio disclosure requirements mandated by Section 953(b) of the Dodd-Frank Act.

The proposal would amend Item 402 of Regulation S-K by adding a new paragraph (u) to Item 402 requiring companies to disclose:

- the median of the annual total compensation of all company employees except the company's principal executive officer;
- the annual total compensation of the company's principal executive officer; and
- the ratio of the median of the annual total compensation of all company employees (except the company's principal executive officer) to the annual total compensation of the company's principal executive officer.

Under current SEC rules, companies are required to provide extensive information about the compensation of their principal executive officer and other named executive officers identified pursuant to Item 402(a) of Regulation S-K, but are generally not required to calculate or disclose detailed compensation information regarding other employees. The proposing release stated that the proposed rule is designed to lower the potential costs of compliance with the pay ratio disclosure requirements while remaining consistent with the statutory mandate in Section 953(b) of the Dodd-Frank Act.

## Methodology for Identifying the Median Employee

The proposed rule would not require companies to adhere to a particular methodology or specific computation parameters to identify the median employee, but rather companies would have the flexibility to choose from several options, including using reasonable estimates of annual total compensation or any other compensation measure that is consistently applied to all employees included in the calculation (such as amounts derived from company payroll or tax records).

Companies would be permitted to identify the median employee by using their full employee population or a statistical sample of the full employee population appropriate to the size and structure of the company's business and the company's method for employee compensation or other reasonable methods.

When a compensation measure other than annual total compensation is used to identify the median employee, the proposed rule would require companies to calculate the annual total compensation for the median employee. For instance, the proposed rule would permit companies to use the same annual period that is used in their payroll or tax records from which the compensation amounts are derived to identify the median employee, so long as the total compensation of the median employee so identified is ultimately calculated and disclosed pursuant to Item 402(c)(2)(x) of Regulation S-K. The proposing release acknowledged that the identification of a median employee through sampling does not necessarily require a determination of exact compensation amounts for every employee paid more or less than the median employee included in a sample and that the proposed rule would only require companies to actually calculate and disclose total compensation pursuant to Item 402(c)(2)(x) of Regulation S-K for its median employee. The proposed rule would not prescribe specific estimation techniques, confidence levels for an estimated median or what constitutes reasonable estimates or appropriate compensation measures. Rather, these determinations would depend on the company's particular facts and circumstances, which, as stated in the proposing release, may vary depending on the size and nature of the company's workforce, the complexity of the company's organization, the stratification of pay levels across the company's workforce, the types of compensation the company's employees receive, the extent that different currencies are involved, the number of tax and accounting regimes involved, the number of payroll systems the company has and the degree of difficulty involved in integrating payroll systems to readily compile total compensation information for all company employees.

## Determination of Covered Employees

For purposes of the proposed rule, "employee" would include an individual employed by the company or any of its subsidiaries as of the last day of the company's last completed fiscal year, including full-time, part-time, seasonal or temporary workers employed by the company or any of its subsidiaries on that day (including officers other than the principal executive officer). Workers who are not employed by the company or its subsidiaries, such as independent contractors or "leased" workers or other temporary workers who are employed by a third party, would not be considered "employees" under the proposed rule.

## Determination of Total Compensation

As mandated by Section 953(b) of the Dodd-Frank Act, the proposed rule would require the "total compensation" of the median employee (identified in the manner described above) to be determined according to Item 402(c)(2)(x) of Regulation S-K. "Annual total compensation" would mean the total compensation for the company's last completed fiscal year, consistent with the
calculation date used for determining the three most highly compensated executive officers under current Item 402(a)(3)(iii) of Regulation S-K.

The proposed rule would allow companies to use reasonable estimates when calculating the annual total compensation or any element of annual total compensation for the median employee. In using an estimate for annual total compensation or for an element of total compensation, the company should have a reasonable basis to conclude that the estimate approximates the actual amount of compensation under Item 402(c)(2). For instance, a company would be permitted to use reasonable estimates in determining an amount that reasonably approximates the aggregate change in actuarial present value of an employee's defined pension benefit under a union members' multi-employer defined benefit pension plan for purposes of Item 402(c)(2)(viii), since employers generally do not have sufficient access to information from the plan administrator to calculate the aggregate change in actuarial present value of the accumulated benefit of an individual employee under such a plan. A reasonable basis would depend on the facts and circumstances of the company. Where companies determining the pay ratio choose to include certain personal benefits and perquisites in the calculation of total compensation for employees that would ordinarily be excluded from the calculation of a principal executive officer's total compensation, companies would be required to use the same approach to such items when calculating the principal executive officer's total compensation for the pay ratio disclosure. Any difference between the principal executive officer's total compensation used in the pay ratio disclosure and the total compensation amounts reflected in the summary compensation table would need to be explained.

Companies would be permitted, but not required, to annualize the total compensation for all permanent employees (other than temporary or seasonal employees) that were employed by the company for less than the full fiscal year, such as new hires or permanent employees on an unpaid leave of absence. If a company elects to annualize the total compensation for employees, it must do so for all eligible employees. In contrast, the proposed rule would not permit full-time equivalent adjustments for part-time workers, annualizing adjustments for temporary and seasonal workers or cost-of-living or other adjustments for non-US workers.

Disclosure of Ratio, Methodology, Assumptions, Adjustments and Estimations

Under the proposed rule, the appropriate form of disclosure for the pay ratio would be as a ratio in which the median of the annual total compensation of all employees except the principal executive officer is equal to one or, alternatively, the ratio may be expressed narratively as the multiple that the amount the annual total compensation of the company's principal executive officer bears to the median of the annual total compensation of all company employees. The proposing release provided an example of a company with an annual total compensation of \$45,790 and \$12,260,000 for its median employee and principal executive officer, respectively. In this instance, the pay ratio disclosed would be " 1 to 268 " or, as expressed narratively, "the principal executive officer's annual total compensation is 268 times that of the median of the annual total compensation of all employees."

In addition, the proposed rule would require companies to briefly disclose the methodology used to identify the median and any material assumptions, adjustments or estimates used to identify the median or to determine total compensation or any elements of total compensation. In addition, companies would be required to consistently apply such methodology, assumptions, adjustments or estimates and to clearly identify any estimated amounts in their disclosure. Such disclosure should consist of a brief overview containing sufficient information for a reader to be able to evaluate the appropriateness of the methodology, assumptions, adjustments or estimates, but does not need to provide technical analyses or formulas.

The proposing release provided an example of appropriate disclosure where statistical sampling is used. Companies using statistical sampling should disclose the size of both the sample and the estimated whole population, any material assumptions used in determining the sample size, which sampling methods are used and, if applicable, how the sampling method deals with separate payrolls such as geographically separated employee populations or other issues arising from multiple business or geographic segments. Also, if a company changes the methodology, material assumptions, adjustments or estimates used for the prior fiscal year and the effects of any such change are material, the company must provide a brief description of the change, the reasons for the change and an estimate of the impact of the change on the median and the ratio.

## Voluntary Additional Disclosure

Other than the required brief description of methodology, material assumptions, adjustments or estimates and the expression of the pay ratio described above, the proposed rule would not require companies to provide a narrative discussion of the ratio, the median or any supplemental information. However, companies would be permitted to voluntarily supplement the required disclosure with a narrative discussion or additional ratios so long as any additional ratios are clearly identified, are not misleading and are not presented with greater prominence than the required ratio.

## Companies Subject to the Proposed Rule

The pay ratio disclosure requirements proposed by the SEC would apply to only those companies that are required to provide summary compensation table disclosure pursuant to Item 402(c) of Regulation S-K. Consistent with Section 102(a)(3) of the Jumpstart Our Business Startups Act, the proposed rule would not apply to emerging growth companies. In addition, the proposed rule would not apply to smaller reporting companies, since such companies are not required to calculate compensation in accordance with Item 402(c)(2)(x) or to include all of the types of compensation required to be included in total compensation under Item 402(c)(2). Foreign private issuers that file annual reports and registration statements on Form 20-F and US-Canadian Multijurisdictional Disclosure System filers that file annual reports and registration statements on Form 40-F would also not be subject to the proposed rule since Forms 20-F and 40-F do not require Item 402 disclosure. Foreign private issuers that file annual reports on Form $10-\mathrm{K}$ would also not be subject
to the proposed rule and would continue to be able to satisfy Item 402 requirements by following the requirements of Items 6.B and 6.E. 2 of Form 20-F.

Filings Where Disclosure Is Required and Proposed Compliance Date

The proposed rule would require companies subject to the rule to include pay ratio disclosure in any filing described in Item 10(a) of Regulation S-K to the extent such filing requires executive compensation disclosure under Item 402 of Regulation S-K. This includes registration statements under the Securities Act of 1933 and the Exchange Act, proxy and information statements and annual reports on Form 10-K.

A company subject to the proposed rule would first be required to report the pay ratio disclosure with respect to compensation for its first fiscal year commencing on or after the effective date of the final rule. If the final rule were to become effective in 2014, a company with a fiscal year ending on December 31 would be first required to include pay ratio disclosure relating to the 2015 fiscal year in its proxy or information statement for its 2016 annual meeting of shareholders (or written consents in lieu of such a meeting). In the event the company does not file its proxy or information statement within 120 days of the end of 2015, it would be required to file its initial pay ratio disclosure in its Form 10-K for fiscal year 2015 or an amendment to that Form 10-K. A company with a fiscal year ending on December 31 that is not subject to the proxy rules or does not file a proxy or information statement in connection with an annual meeting of shareholders would also be required to include pay ratio disclosure relating to the 2015 fiscal year in its Form 10-K for fiscal year 2015, which would be due in the first quarter of 2016.

The proposed rule would provide a transition period for newly public companies, requiring initial compliance with respect to compensation for the first fiscal year commencing on or after the date the company becomes subject to the requirements of Section 13(a) or 15(d) of the Exchange Act (pay ratio disclosure would not be required in a registration statement on Form S-1 or S-11 for an initial public offering or a registration statement on Form 10). Companies would be permitted to begin compliance earlier on a voluntary basis. The proposed rule would not contain any additional transition period for compliance after a company ceases to qualify as an emerging growth company.

For both companies that would be subject to the proposed rule and newly public companies, the company would not be required to disclose its pay ratio disclosure for a particular fiscal year in any filing until the filing of its annual report on Form 10-K for such fiscal year or, if later, the filing of a definitive proxy or information statement relating to its next annual meeting of shareholders (or written consents in lieu of such a meeting) following the end of such fiscal year so long as such pay ratio disclosure is filed not later than 120 days after the end of such fiscal year.

A company that makes a filing after the end of its last completed fiscal year and before the filing of its Form 10-K or proxy or information statement must include or incorporate by reference the pay ratio disclosure for the fiscal year prior to the last completed fiscal year in such filing. In addition, the proposed rule would provide that where a company omits summary compensation table disclosure
of the salary or bonus of the principal executive officer because such information is not calculable as of the latest practicable date, the company must also omit pay ratio disclosure until those elements of the principal executive officer's total compensation are determined and provide the pay ratio disclosure in the same filing under Item 5.02(f) of Form 8-K in which the principal executive officer's salary or bonus is later disclosed. In such a case, the company must disclose that the pay ratio disclosure is being omitted because the principal executive officer's total compensation is not calculable until the principal executive officer's salary or bonus is determined and disclose the expected date that the total compensation for the principal executive officer is expected to be determined. The Form 8-K disclosure regarding pay ratio would only be triggered once the salary or bonus of the principal executive officer becomes calculable in whole, not in part.

Consistent with other Item 402 information, the pay ratio disclosure would be considered "filed" for purposes of the Securities Act and Exchange Act and, as such, would be subject to potential liability under both Acts.

The comment period for the proposed rule will be open for 60 days from publication of the proposing release in the Federal Register.

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[^0]:    ${ }^{1}$ Release Nos. 33-9452; 34-70443; File No. S7-07-13 (hereinafter "proposed rule") available at http://www.sec.gov/rules/proposed/2013/33-9452.pdf.

