
SEC releases guidance on pay ratio disclosure rules

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In brief

The 2010 Wall Street Reform and Consumer Protection Act (Dodd-Frank Act) included a provision requiring public companies to disclose the pay gap between chief executives and rank-and-file employees. The pay ratio calculation compares the annual total compensation of the chief executive officer (CEO) to the median of the annual total compensation of all employees. Annual total compensation includes base salary, bonuses, stock and option awards, long-term cash incentive pay, change in pension value, non-qualified deferred compensation earnings and certain other compensation, including perquisites. While the concept appears to be simple, it is riddled with complexities in determining pay amounts across a broad workforce, particularly for global employers. For this reason specific guidance has been delayed, and public companies have yet to be required to disclose this ratio in their proxy filings.

The US Securities and Exchange Commission (SEC) has now released proposed pay ratio rules. These rules are subject to public comments, which are due within 60 days of their publication in the Federal Register. The regulations are to be effective for fiscal years commencing after final rules are published, so they will not affect the 2014 proxy season.

In detail

Background

The Dodd-Frank Act includes a provision that requires all public companies to calculate the median compensation of all employees other than the CEO and disclose that number, as well as the ratio of the median employee pay to total compensation of the CEO, as part of the companies' filings with the SEC. The proposed disclosure would be required in any annual report, proxy or information statement or registration statement that requires executive compensation disclosure.

Observation

Compliance with this requirement may be extremely difficult for most companies to satisfy, in part because compensation of non-US employees must be included in the calculation.

General guidance

The new requirement has been added to the SEC's rules for reporting the compensation of the top-paid officers on public companies' proxies, annual reports and registration statements. The SEC has proposed to add a new subsection (u) to Item 402 of

section S-K of the SEC regulations to govern the pay ratio requirements. In general, the concepts already in place for determining executive pay have been incorporated into the determination of the median compensation of all employees, which must be compared to the compensation of the principal executive officer (PEO).

Observation

The proposed rules use the defined term PEO instead of the term CEO. The PEO is as an individual serving as the principal executive officer or acting in a similar capacity

during the last completed fiscal year. The change in terminology was added to simplify compliance for companies.

A two-step process will be required. First, the employee whose compensation is the median of the compensation of all employees (the 'median employee') is determined, using any reasonable definition of compensation for all of the company's employees (or a reasonable sample of the total employee population). Once the median employee has been identified, the company must calculate that employee's annual total compensation using the rules that apply to the disclosure of executive pay in Item 402 and disclose that amount as part of the pay ratio disclosure.

The proposed rules state that companies can determine the median either based upon all employees or using a sampling methodology consistent with the company's size and structure. However, the SEC does not intend to prescribe a specific sampling approach. Rather it will leave it to companies to develop an approach that they believe provides an accurate representation of their median compensation. Companies must disclose the methodology used and any estimates applied in the determination of the median.

Observation

Although the SEC is providing companies significant latitude, the SEC did not relieve them of what many believe to be the two most onerous and potentially misleading calculations. The proposed rules do not allow companies to exclude part-time workers. They also do not permit employers to exclude employees based in foreign countries from the calculation.

Finally, these disclosure rules only apply to public companies who otherwise file a summary compensation table pursuant to Item 402(c). This will exempt foreign private issuers, emerging growth companies and certain 'Smaller Reporting Companies' from the pay ratio disclosures

Employee defined

The term employee includes full-time, part-time, seasonal and foreign employees who are employed at year-end consistent with the calculation date for determining named executive officers under current Item 402 requirements.

Observation

It appears that the sampling approach must include a cross section of employees inclusive of these various working classes, which will require multinational companies to gather data that may incorporate a wide variety of disparate compensation items denominated in multiple currencies. Companies may be able to simplify the variety of data required to be gathered globally by basing the sampling on a simple definition of pay, such as taxable income or wages, as discussed below.

How to measure compensation

Under the proposed rule, the median employee can be identified using any reasonable definition of compensation. The SEC has not provided specific guidance on the components of compensation, such as the use of actuarial concepts for retirement plan compensation or the methodology used for valuing share based compensation across the included workforce. Further, the chosen approach need not take into account each and every source of pay as long as the method is consistently applied and properly disclosed. An example used in the proposed rules

provides a method based simply on wages. Companies are permitted, but not required, to annualize compensation of employees who are not employed for the entire year, such as permanent new hires. The compensation of part-time and seasonal employees may not be annualized in determining the median employee.

Once the median employee is determined, that employee's compensation is to be determined using the Item 402 concepts that are to be used in reporting executive compensation.

Where compensation may be difficult to determine or where labor laws might prevent dissemination of employee specific data, the proposed regulations permit a company to estimate that compensation.

Statistical methodology

The proposed rules allow a company to choose statistical methods to identify the median employee that are consistent with the company's size and structure. Various methods will undoubtedly be used. The proposed rules do not assert specific guidelines for methods to be used nor for matters like margins of error or levels of statistical significance. The rules clearly anticipate that sampling methods would be used for employee subsets and that these might recognize general pay differences across different segments such as countries or business units. Individual pay data for entire cohorts may be excluded if their pay is so high or low that they would not include the overall median.

Companies are required to disclose in a concise summary the methodology used and any estimates applied in the determination of the median. Material changes to these approaches, and

their rationale and impact, are to be disclosed in the year of the change.

Pay ratio

Once the median employee's compensation has been calculated, the company must disclose the ratio of that compensation to the PEO's total compensation. The proposed rules require that the ratio be expressed using the median employee's income as '1' or expressed narratively as the multiple that the PEO's total compensation bears to the median of the annual total compensation of all employees. For example, if the median of the annual total compensation of all employees determined pursuant to the regulations is \$45,790, and the annual total compensation of the PEO is \$12,260,000, then the disclosure can either provide the pay ratio of '1 to 268' or a description that 'the PEO's annual total compensation is 268 times that of the median of the annual total compensation of all employees.

Next steps and effective date

The proposed effective date of the rules is the company's first fiscal year commencing after the effective date of the final regulations. As proposed, companies would be permitted to omit this initial pay ratio disclosure from its filings until the filing of its annual report on Form 10-K for that fiscal year or, if later, the filing of a proxy or information statement for its next annual meeting of shareholders (or

written consents in lieu of a meeting) following the end of that year. Companies may voluntarily comply prior to that time.

Thus, if the final requirements were to become effective in 2014, a registrant with a fiscal year ending on December 31 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 (or written consents in lieu of such a meeting). If the company does not file its proxy or information statement within 120 days of the end of 2015 (i.e., April 30, 2016), it would need to include its initial pay ratio disclosure in its Form 10-K for 2015 or an amendment to that Form 10-K, which would be due in the first quarter of 2016.

The rules acknowledge that it may be difficult for companies to make this determination prior to the time that the proxy is finalized. As a result there is leniency in publishing this ratio, allowing companies to publish the ratio after the proxy is published.

Observation

The SEC is seeking comments on the proposal and will undoubtedly be deluged with comments that continue to express displeasure about the effort required to compile the sampling results. Final rules will not be

promulgated until all comments have been analyzed, although it appears the SEC is hoping to finalize the rules sometime this year.

Other legislative possibilities

H.R. 1135, the Burdensome Data Collection Relief Act, was approved by the US House of Representatives Committee on Financial Services in June. The bill would repeal the pay ratio disclosure requirement. It has been cleared for Senate consideration, but there is no Senate counterpart legislation yet. Most policymakers believe it is unlikely to receive consideration by the Senate in the current legislative environment.

The takeaway

The proposed regulations will impose significant burdens on public corporations to determine the median employee and that employee's compensation. The SEC is working to finalize these rules swiftly. Companies should make an initial review of information systems soon to determine how these calculations can be made, the statistical analysis they will use and the impact of local law for multinational entities, among other issues. Employers should consider whether to submit comments to the SEC on specific issues or recommendations to make the disclosure less burdensome.

Let's talk

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