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SEC Proposes Rules Mandating Pay Ratio Disclosure

September 19, 2013

On September 18, 2013, the U.S. Securities and Exchange Commission proposed amendments to Item 402 of Regulation S-K to require issuers to disclose the median annual total compensation of all employees and the ratio of that amount to the annual total compensation of the issuer's principal executive officer. This rule proposal was mandated by Section 953(b) of the Dodd-Frank Wall Street Reform and Consumer Protection Act.

According to Keith Higgins, Director of the Division of Corporation Finance, the proposed rules are designed to comply with the statutory mandate of the Dodd-Frank Act while addressing the concerns expressed by numerous commenters about the costs of complying with this new requirement. He noted that the rule proposals reflect the view that it is appropriate to give issuers flexibility in designing and developing the disclosure that the statute requires.

The new rules would not prescribe a method for calculating median annual employee compensation; rather, each issuer subject to the new requirement would be permitted to choose whether to determine median annual employee compensation by determining total compensation for each employee or by using a method such as statistical sampling. In general, the proposed rules would require a subject issuer to:

- Choose a methodology that is appropriate to its size, business structure, and its manner of compensating its employees; and

- Use that methodology to either (i) calculate the annual total compensation of the employees included in the calculation and identify the median of those amounts or (ii) identify the median employee based on a consistently applied compensation measure and then calculate the annual total compensation for that employee under Item 402.

The proposed amendments to Item 402 would require an issuer to disclose the median of the annual total compensation of all employees of the issuer other than the principal executive officer, the annual total compensation of the issuer's principal executive officer, and the ratio comparing the two amounts. The new disclosure requirement is complicated by the difference between the tax and accounting standards that issuers generally use to record employee compensation and SEC rules regarding the manner in which issuers are required to calculate total compensation of named executive officers, such as the principal executive officer.

Determining Median Annual Total Compensation of All Employees

The proposed rules would allow an issuer to choose a statistical method to identify the median employee that works best for its own facts and circumstances. For example, an issuer would be permitted to identify the median employee using its full employee population or by using a statistical sample of that population. The size of a reasonable statistical sampling will depend on the underlying distribution of compensation across employees and may be further complicated for issuers with multiple business lines or geographical units. The SEC estimates that the appropriate sample size for issuers with a single business or geographical unit using a simple random sampling method will vary between 81 and 1,065 employees across industries, with the average estimated sample size close to 560 employees. For issuers with multiple business lines or geographical units, statistical sampling may require more steps and other assumptions.

Whether using the full population of employees or a statistical sample, an issuer would be permitted to:

- Calculate annual total compensation using Item 402(c)(2)(x) for each employee included in the calculation and then use those amounts to identify the median annual total compensation; or
- Identify the median employee based on any consistently applied compensation measure, such as amounts reported in its payroll or tax records, and then calculate and disclose the annual total compensation as determined under Item 402(c)(2)(x) for that median employee.

Issuers may use reasonable estimates in calculating the annual total compensation -- or any element of annual total compensation -- for employees other than the principal executive officer, including when disclosing the annual total compensation of a median employee that was identified using a consistently applied compensation measure.

Important Terms in the Proposed Rules

All Employees

Section 953(b) of the Dodd-Frank Act requires disclosure of the median of the annual total compensation of all employees. For purposes of the proposed rules, “all employees” would include full-time, part-time, temporary, seasonal, U.S., and non-U.S. employees employed by the issuer and any of its subsidiaries as of the last day of the issuer’s last-completed fiscal year.

Annual Total Compensation

Employee total compensation should be determined pursuant to Item 402(c)(2)(x), as specified by Section 953(b) of the Dodd-Frank Act. Under the proposed rules, “annual total compensation” would mean total compensation for the last-completed fiscal year, consistent with existing Item 402 disclosure requirements. Issuers would be permitted, but not required, to annualize the total compensation for a permanent employees who did not work for the entire year, such as a newly hired employees. In contrast, the proposed rules would not allow full-time equivalent adjustments for part-time employees, annualizing adjustments for temporary and seasonal employees, or cost-of-living adjustments for non-U.S. employees.

Disclosure of Methodology Used

The proposed rules would require issuers to disclose the methodology they used to determine the median annual employee compensation. Issuers would also be required to disclose any material assumptions, adjustments, or estimated amounts that are used to determine total compensation. If an issuer identifies a median employee using a consistently applied compensation measure, it would be required to identify the measure that it used; however, such disclosure would not be required to include a discussion of data analyses or formulas. Issuers would be permitted -- but not required -- to supplement the required disclosure with a narrative discussion or additional ratios.

Further, if an issuer changes the methodology or material assumptions, adjustments, or estimates from those used in the previous period and if the effect is material, the issuer would be required to briefly describe the change, the reasons for the change, and provide an estimate of the impact of the change on the median and the ratio.

When Disclosure Is Required

The proposed rules would require the pay ratio disclosure in any annual report, proxy or information statement, or registration statement that

requires executive compensation disclosure pursuant to Item 402. The proposed rules would require an issuer to include the peer ratio disclosure for the most recently completed fiscal year in its annual report for that completed fiscal year or when it files its proxy or information statement for its annual meeting of shareholders, provided that the proxy or information statement is filed no later than 120 days after the end of that fiscal year.

Exemptions

The JOBS Act amended Section 953(b) of the Dodd-Frank Act to provide that “emerging growth companies” will be exempt from the pay ratio disclosure requirements. In addition, under the proposed rules, these disclosure requirements would only apply to those issuers that are required to provide compensation disclosure pursuant to Item 402(c); accordingly, the proposed rules would not apply to smaller reporting companies, foreign private issuers that file on Form 20-F, or Canadian issuers that file on Form 40-F.

As proposed, newly public issuers would not be required to comply with the pay ratio disclosure requirement for the first fiscal year commencing on or after the date the issuer becomes subject to the reporting requirements.

Comment Period

The proposed rules will be open for comment for a period of 60 days from the date of publication in the Federal Register. In particular, the SEC is seeking comments on realistic estimates of the cost of complying with this disclosure requirement -- including assumptions made and rationales for choosing one methodology or calculation method over another -- and investors' views on whether or not this disclosure requirement will harm investors by restricting capital formation. The full text of the proposing release is available [here](#). Comments on the proposed rules may be submitted [here](#).

Anticipated Implementation of the Proposed Rules

It is anticipated that issuers will be required to provide pay ratio disclosure with respect to compensation for its first fiscal year commencing on or after the effective date of the final rule.

If you have any questions regarding this client alert, please contact any of the lawyers in the Capital Markets Group listed below.

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