

## **SEC Proposes Rule Regarding Pay Ratio Disclosure**

The Securities and Exchange Commission (“SEC”) recently proposed a new rule (the “Proposed Rule”) that would amend Item 402 of Regulation S-K (“Item 402”) to require public companies to disclose (A) the median of the annual total compensation of all their employees (excluding the principal executive officer (“PEO”)), (B) the annual total compensation of the PEO and (C) the “pay ratio” of (A) to (B).<sup>1</sup> The Proposed Rule would require such disclosure in any annual report, proxy or information statement or registration statement that requires executive compensation disclosure pursuant to Item 402.

The Proposed Rule would implement Section 953(b) of the Dodd-Frank Wall Street Reform and Consumer Protection Act (“Dodd-Frank Act”).<sup>2</sup> In connection with this rulemaking, the SEC sought comments from the public prior to releasing the Proposed Rule. As of September 15, 2013, the SEC had received over 20,000 comment letters regarding Section 953(b) of the Dodd-Frank Act. The SEC considered these comments and incorporated some into the Proposed Rule.

The key provisions of the Proposed Rule are as follows:

- *Methodology for Identifying the Median Employee.* The Proposed Rule would not require companies to utilize any particular calculation methodology to identify the median employee annual total compensation. Rather, the Proposed Rule provides companies with flexibility to select a methodology that they deem appropriate to the size and structure of their own business and the manner in which they compensate employees. Under the Proposed Rule, companies could identify the median using their full employee population, a statistical sampling of that population or any other reasonable method. A company could, for example, identify the median of its population or sample by either using (i) annual total compensation as determined under the SEC’s existing executive compensation rules or (ii) any consistently applied compensation measure, such as compensation amounts reported in its payroll or tax records.
- *Determining Total Compensation.* Once the median employee has been identified, a company would be required to calculate the median employee’s annual total compensation for the last completed fiscal year in accordance with Item 402(c)(2)(x). The Proposed Rule would, however, permit companies to use reasonable estimates in determining the annual total compensation of the median employee if necessary.<sup>3</sup>
- *Employees to Include in Identifying the Median.* Pursuant to the Proposed Rule, when calculating the median of the annual total compensation of “all employees” (other than the PEO), companies would be required to include all full-time, part-time, seasonal, temporary and non-U.S. employees (including named executive officers other than the PEO) that were employed by the company or any of its subsidiaries as of the last day of the company’s last completed fiscal year. In contrast, independent contractors, “leased” workers or other temporary workers employed by a third party would not be included. Companies would be permitted, but not required, to annualize the total compensation for

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<sup>1</sup> Securities and Exchange Commission, Release Nos. 33-9452; 34-70443; File No. S7-07-13, *Pay Ratio Disclosure* (September 18, 2013), available at <http://www.sec.gov/rules/proposed/2013/33-9452.pdf>. Item 402 currently only requires companies to provide annual total compensation information for their named executive officers, including the PEO. If adopted, the Proposed Rule would be reflected as a new Item 402(u) to Regulation S-K.

<sup>2</sup> The Dodd-Frank Act is available at <http://www.govtrack.us/congress/billtext.xpd?bill=h111-4173>.

<sup>3</sup> The Proposed Rule did not prescribe what a “reasonable estimate” would entail, although the SEC is seeking comments regarding whether further guidance is necessary.

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permanent employees who did not work for the entire year but who were employed as of the last day of the prior fiscal year (*e.g.*, new hires). Companies would not, however, be permitted to include full-time equivalent adjustments for part-time workers, annualizing adjustments for temporary and seasonal employees or cost-of-living adjustments for non-U.S. workers.

- *Disclosure and Application of Methodology, Assumptions and Estimates.* The Proposed Rule would require companies to briefly disclose and consistently apply any 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. Companies would also be required to clearly identify any estimated amounts used. In addition, if a company were to change methodology or material assumptions, adjustments or estimates from those used in the previous year, and if the effects of any such change were material, the company 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. The Proposed Rule would also allow, but not require, companies to supplement the required disclosure with a narrative discussion or additional ratios.
- *Companies Subject to the Proposed Rule.* The Proposed Rule would apply only to registrants that are required to provide summary compensation table disclosure pursuant to Item 402(c). Emerging growth companies, smaller reporting companies, foreign private issuers and MJDS filers would not be subject to the Proposed Rule.<sup>4</sup>
- *Proposed Compliance Date.* Companies that are subject to the Proposed Rule would be required to provide the relevant disclosures for their first fiscal year commencing on or after the effective date of the final rule. For example, if the final requirements were to become effective in 2014, calendar year registrants would first be required to include the new disclosures in their annual report or proxy or information statement filed in 2016 for the 2015 fiscal year. Companies would, however, be permitted to begin compliance earlier on a voluntary basis. In the case of newly public companies, initial compliance could be delayed until the first fiscal year commencing on or after the date that the company becomes subject to the reporting requirements of Section 13(a) or Section 15(d) of the Securities Exchange Act of 1934.
- *Request for Public Comments.* The SEC is seeking public comments on the Proposed Rule. The public comment period will last for 60 days after the Proposed Rule is published in the Federal Register.

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If you have any questions about the issues addressed in this memorandum or if you would like a copy of any of the materials mentioned, please do not hesitate to call or email Charles A. Gilman at 212.701.3403 or [cgilman@cahill.com](mailto:cgilman@cahill.com); Jon Mark at 212.701.3100 or [jmark@cahill.com](mailto:jmark@cahill.com); John Schuster at 212.701.3323 or [jschuster@cahill.com](mailto:jschuster@cahill.com); Glenn Waldrip at 212.701.3110 or [gwaldrip@cahill.com](mailto:gwaldrip@cahill.com); or Abigail Darwin at 212.701.3240 or [adarwin@cahill.com](mailto:adarwin@cahill.com).

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<sup>4</sup> The term “MJDS filers” refers to registrants that file reports and registration statements with the SEC in accordance with the requirements of the U.S.-Canadian Multijurisdictional Disclosure System.