

SEC Proposes Pay Ratio Rule

After more than three years and much controversy, the Securities & Exchange Commission on September 18, 2013 voted 3 to 2 to propose a rule implementing the requirement of Section 953(b) of the Dodd-Frank Wall Street Reform and Consumer Protection Act that a U.S. public company disclose the ratio of median annual total compensation of all employees to CEO total compensation.

The proposed “pay ratio” rule attempts to strike a balance between the statutory requirements and the concerns that many commenters have expressed regarding the anticipated costs of compliance. The proposal introduces much-needed flexibility regarding calculating the median annual total compensation of all employees.

Public comments are due within 60 days following the publication of the proposed rule in the Federal Register. If the proposed rule is finalized, a covered registrant would first be required to make the pay ratio disclosure with respect to the first fiscal year commencing on or after the effective date of the final rule. For example, if the rule were finalized in 2014, a covered registrant with a calendar year end would generally first make the disclosure in its proxy statement for its 2016 annual meeting of shareholders (*i.e.*, the proxy statement relating to the 2015 fiscal year).

What new disclosure is required?

The proposed rule requires disclosure of the median of the annual total compensation of all employees other than the CEO, the annual total compensation of the CEO, and the ratio of the median to the CEO’s annual total compensation. The ratio can be expressed numerically by setting median compensation equal to one (*e.g.*, 1 to 100) or narratively by stating the CEO’s compensation as a multiple of the median (*e.g.*, 100 times that of the median employee). As described below, registrants must also include certain narrative disclosure relating to the ratio calculation.

How is the pay ratio calculated?

Under the proposed rule, annual total compensation would be determined in the same manner that total compensation is calculated under Item 402(c)(2)(x) of Regulation S-K. These rules do not currently apply to non-executive officers and using them to calculate the “median of the annual total compensation of all employees” presents a challenge. Under the proposed rule, the process would be as follows:

Step 1: Identify the Relevant Group. The term “all employees” means all employees (including non-U.S. employees) of the registrant and its subsidiaries as of the last day of the registrant’s last fiscal year, including full-time, part-time, seasonal and temporary workers. In determining the median employee, the proposed rule permits the registrant to do its calculations using its actual entire employee population, a statistical sampling, or a subgroup identified by any other reasonable method.

Step 2: Identify the Median. The registrant may rank the group identified in Step 1 by annual total compensation¹ or any other compensation measure that is consistently applied to all employees included in the calculation, such as amounts derived from the registrant’s payroll or tax records.

Step 3: Determine the Annual Total Compensation of the Median Employee. Once the employee at the median has been identified, the registrant must determine his or her annual total compensation under Item 402(c)(2)(x) in the same manner it does for its named executive officers. For this purpose, registrants will be

¹ The proposed rule permits (but does not require) the registrant to annualize the total compensation of all new hires who are permanent employees (*i.e.*, not temporary or seasonal employees).

permitted to use reasonable estimates to determine total compensation or any elements of total compensation.

What narrative disclosure must accompany the pay ratio disclosure?

Registrants will be required to summarize the methodology, estimates and assumptions used in these computational steps. Material changes to the methodology or assumptions will require additional disclosure.

When must disclosure be made?

A registrant will generally be required to file the pay ratio disclosure on an annual basis at the time it makes its annual executive compensation disclosure. For most registrants, the pay ratio disclosure would be made as part of annual-meeting proxy materials (or in an amendment to its Form 10-K if the registrant does not file a proxy statement or does not file it within 120 days of the end of its fiscal year), or, if the registrant does not file a proxy statement (for example, in the case of a voluntary filer), in its Annual Report on Form 10-K.

Which registrants would be subject to the new pay ratio disclosure requirements?

All U.S. public companies making periodic reports with the SEC (including voluntary filers but excluding emerging growth companies under the JOBS Act, smaller reporting companies and certain foreign filers) would be subject to the new pay ratio disclosure rule.

A new registrant (such as a company filing a Form S-1 in connection with an initial public offering) will have a transition period before the pay ratio disclosure will be required. Such a registrant will be required to provide the pay ratio disclosure with respect to compensation for the first fiscal year commencing on or after the date the registrant becomes subject to the reporting requirements of the Securities Exchange Act.

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