

One Minute Memo[®]



SEC Releases Proposed Regulation on CEO Compensation Ratio Disclosure

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On September 18, 2013 the Securities and Exchange Commission (the "SEC") proposed new regulations to satisfy the mandate of Section 953(b) of the Dodd-Frank Wall Street Reform and Consumer Protection Act. The proposed regulations would require a company providing disclosure pursuant to Item 402 of Regulation S-K to calculate and state the median annual compensation of all of its employees, excluding the Chief Executive Officer (the "CEO"), and the ratio of the CEO's annual compensation to such median employee annual compensation.

Proposed Rule

The proposed rule requires the reporting company to disclose:

- A. the median of the annual total compensation of all employees of the company, except the principal executive officer of the company (represented by an actual employee receiving the company's median compensation package);
- B. the annual total compensation of the principal executive officer of the company; and
- C. the ratio of the median employee's compensation to the principal executive officer's compensation, presented as a ratio in which the median employee's compensation equals one or, alternatively, expressed narratively in terms of the multiple that the amount of the principal executive officer's compensation bears to the amount of the median employee's compensation.

The determination and calculation of the annual total compensation of all employees may pose a significant hurdle. Currently under U.S. GAAP, payroll and employee expenses are reported as a component of sales, general & administrative or other expenses in the income statement and are not broken out as a separate line item, so compiling this information on a granular level may be a significant challenge for companies with a large number of employees.

Calculation Methodology

While the SEC has stated that it is allowing a flexible approach to determining the annual total compensation of all employees, because it "do[es] not believe that the precise comparability or conformity of disclosure from registrant to registrant is necessarily achievable due to a variety of factors which could cause the ratio to differ," it has provided certain guidelines.

“Total annual compensation” of the median employee must be disclosed the same way that total annual compensation of the CEO is disclosed (i.e. Item 402(c)(2)(x)). However, in determining the identity of the median employee (again, an actual company employee), the registrant company may use other means and methodology such as W-2 payrolls and statistical sampling. When calculating the total annual compensation of all employees, a company is not allowed to make any adjustment or to annualize for part-time or seasonal workers. In addition, no cost of living adjustments may be made for employees working in foreign jurisdictions. Thus, part-time, flex-time, seasonal and certain foreign employees will drive down the total employee compensation on a per employee basis. In addition, accurately valuing and calculating certain types of compensation, particularly in foreign jurisdictions, such as housing, creates another set of challenges. Workers who are not “employees” of the company or its subsidiaries, such as independent contractors or “leased” workers, would not need to be included in total annual employee compensation.

Once a company adopts a reasonable method for calculating the annual compensation of all employees other than the CEO, it must identify the median (not the average) employee. The company must then provide the Item 402(c)(2)(x) disclosure for such employee. The methodology used to determine the median employee should be consistently applied over the entire employee population and from year to year.

Other Disclosure Requirements

In addition to providing the data stated in the proposed rule, the SEC also requires full disclosure of the calculation methodology used by the company, including sample size, assumptions made and sampling method used, if applicable. This disclosure is intended to ensure that investors understand the context of the pay ratio disclosure and enable the investor to make its own assessment of the methodology used by the company, and to ensure the same methodology is applied from year to year. It is clear that the SEC does not think that a company to company or industry sector comparison will be valuable with this newly required information, thus the ability to compare a company’s ratio year over year seems the likely goal of such disclosure.

Although we are currently in the comment period, the SEC has already reviewed over 22,000 comments and responded to several of such comments in this proposal.

Application of the Rule

The proposed rule will only apply to filings which currently call for executive compensation information under Item 402 of Regulation S-K, such as Form 10-K, registration statements and proxy statements. Also, the SEC explicitly stated that foreign private issuers, emerging growth companies and smaller reporting companies will not be subject to these new regulations. Also, the calculation of which employee is considered the median employee shall consider not just the company’s employees but all of the company’s subsidiaries’ employees as well.

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