

Client Alert

Current Issues Relevant to Our Clients

September 19, 2013

SEC Proposes New CEO Pay Ratio Disclosure Rule

On September 18, 2013, in accordance with provisions of the Dodd-Frank Wall Street Reform and Consumer Protection Act of 2010 (the “Dodd-Frank Act”), the Securities and Exchange Commission (the “SEC”) proposed an executive compensation disclosure rule that, if adopted, will require public companies to calculate and disclose in certain SEC filings (1) the median annual total compensation of all employees of the company, excluding the chief executive officer (the “CEO”), (2) the annual total compensation of the company’s CEO and (3) the ratio of those two figures, such figures and ratio hereinafter referred to collectively, as the CEO pay ratio.

The proposed rule does not prescribe a specific methodology for companies to use in calculating the CEO pay ratio, but provides companies with the flexibility to determine the median annual total compensation of all employees (excluding the CEO) in a manner that best suits a company’s particular circumstances. The proposed CEO pay ratio disclosure would be required in any annual report or proxy, information or registration statement that mandates disclosure of executive compensation pursuant to Item 402 of Regulation S-K. A public company subject to the proposed rule would be required to disclose the CEO pay ratio with respect to compensation for its first fiscal year commencing on or after the effective date of the final CEO pay ratio rule. Therefore, the proposed rule will not impact the 2014 proxy season.

The proposed disclosure requirements would not apply to certain companies, including emerging growth companies, smaller reporting companies, Canadian Multijurisdictional Disclosure System (“MJDS”) filers and foreign private issuers. The SEC is seeking comment on the proposed CEO pay ratio disclosure rule described in SEC Release No. 33-9452 (the “SEC Release”), which is available [here](#).

Background

Under current SEC disclosure rules, public companies are required to disclose in certain filings extensive executive compensation-related information with respect to their CEO and other named executive officers (“NEOs”), but not with respect to other employees. Section 953(b) of the Dodd-Frank Act directs the SEC to amend Item 402 (Executive Compensation) of Regulation S-K to mandate additional executive compensation-related disclosure (i.e., the CEO pay ratio) in certain SEC filings of public companies.

Proposed CEO Pay Ratio Disclosure Rule

The SEC’s proposed CEO pay ratio disclosure rule (new Item 402(u), Pay Ratio Disclosure, of Regulation S-K) (together with corresponding instructions, the “Proposed Rule”), in addition to setting forth the CEO pay ratio, clarifies certain ambiguities in Section 953(b) and provides guidance as to how the CEO pay ratio may be calculated and disclosed. Following is a summary of certain key provisions of the Proposed Rule:

Employees Included

Section 953(b) expressly requires disclosure of the median annual total compensation of “all employees” of the company. In the Proposed Rule, the SEC broadly interprets that provision and defines “employees” to include all full-time, part-time, seasonal, temporary and non-US workers employed by the company or any of its subsidiaries (including officers other than the CEO) as of the last day of the company’s last completed fiscal year. Workers who are not employed by the company or its subsidiaries, such as independent contractors or temporary workers who are employed by a third party, are not included.

Identifying the Median Annual Total Compensation of All Employees

Section 953(b) does not set forth a specific methodology to identify the median annual total compensation of all employees of a company, nor does it require the SEC to do so in its rulemaking. In the Proposed Rule, the SEC does not specify any required calculation methodologies for identifying the median annual total compensation of all employees, but permits companies to identify the median by using a number of different methods, such as calculating total compensation for each employee under existing executive compensation rules or using reasonable estimates and/or statistical sampling. For example, the SEC Release notes that a company with a large number of employees could take a random sample of employees and determine the annual cash compensation, or any other consistently applied compensation measure (e.g., amounts reported in payroll or tax records), for those employees. Once the company identified the median employee based on the selected compensation measure applied to each employee in the sample, the company would calculate, as described below, that employee's annual total compensation in accordance with existing executive compensation rules under Item 402 of Regulation S-K and disclose that figure as part of the CEO pay ratio disclosure.

In addition, the Proposed Rule would require companies to briefly disclose and consistently apply any (1) methodology used to identify the median and (2) 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 amount. The Proposed Rule reiterates that this disclosure should be a brief overview and not include technical analyses or formulas. Further, if a company changes methodology or material assumptions, adjustments or estimates from those used in its CEO pay ratio disclosure for the prior fiscal year, and if the effects of any such change are material, the company must briefly describe the change and the reasons for the change, and must provide an estimate of the impact of the change on the median and the ratio.

Determination of Total Compensation

As mandated by Section 953(b), the median annual "total compensation" of all employees for purposes of the CEO pay ratio is to be calculated in accordance with Item 402(c)(2)(x) of Regulation S-K (which rule is currently used to calculate NEO, including CEO, total compensation for disclosure in the "Total" column of the Summary Compensation Table typically found in a company's proxy or information statement). The Proposed Rule, however, would permit the use of reasonable estimates to calculate the annual total compensation or any element of total compensation for employees (other than for the CEO). As proposed, a company would also be permitted to calculate "total compensation" for all employees, but would only be required to calculate and disclose such information for the median employee.

The annual "total compensation" of the company's CEO for purposes of the CEO pay ratio would be the CEO's total compensation figure appearing in the company's Summary Compensation Table.

Disclosure of CEO Pay Ratio

As proposed, the CEO pay ratio disclosure rule specifies that the ratio must be expressed (1) as a ratio in which the median annual total compensation of all employees is equal to one or (2) in narrative form in terms of the multiple that the CEO total compensation figure bears to the figure for median annual total compensation of all employees. For example, if the median annual total compensation of all employees of a company is \$50,000 and the annual total compensation of the company's CEO is \$10,000,000, the CEO pay ratio disclosed would be "1 to 200" or, as expressed in narrative form, "the CEO's annual total compensation is 200 times that of the median annual total compensation of all employees."

Companies would also be permitted, but not required, to supplement the required disclosure with a narrative discussion or additional ratios.

What Should I Do Now?

The SEC seeks comment generally on the proposed CEO pay ratio disclosure rule and economic considerations (including the potential costs to and increased burden on companies to implement and effectuate the Proposed Rule) and, more specifically, on the nearly 70 questions the SEC poses throughout the SEC Release. Written comments should be sent to Elizabeth M. Murphy, Secretary, Securities and Exchange Commission, 100 F Street, NE, Washington, DC 20549-1090. Comments may also be submitted by email to rule-comments@sec.gov or through the SEC's website at <http://www.sec.gov/rules/proposed.shtml> or the Federal Rulemaking ePortal at <http://www.regulations.gov>. All comments should refer to SEC File No. S7-07-13 in the subject or reference line and must be received by the SEC on or before the 60th day following publication of the SEC Release in the Federal Register (we estimate that such 60th day will occur in late November or early December 2013).

In addition, companies should begin considering what methodology they might use to calculate the "median annual total compensation of all employees of the company (excluding the CEO)" component of the CEO pay ratio. Further, companies

may want to contemplate the potential ramifications, if any, of disclosing their CEO pay ratio should the Proposed Rule be adopted. For example, a company might consider how, if at all, the disclosure of such ratio could (1) affect employee morale (should the ratio expose significant income inequality) or (2) become a public relations issue (as it is uncertain how stakeholders, including shareholders, customers, suppliers, other business partners and regulators, will use and respond to the ratio).

If the proposed CEO pay ratio disclosure rule is adopted, companies may want to consider analyzing (a) their ratio compared to that of their peers and be prepared, if necessary or desired, to further explain in certain public filings (e.g., proxy statement) any notable variance (should the company have a particularly low or high ratio compared to that of its peers) and (b) for internal purposes, the ratio of total compensation for the CEO to that of other NEOs at the company and peer companies (while not required, those ratios may provide a competitive perspective on executive compensation).

Congressional Action to Repeal CEO Pay Ratio

On June 19, 2013, the US House Committee on Financial Services advanced a bill (H.R. 1135, the “Burdensome Data Collection Relief Act”) that would repeal the CEO pay ratio provisions of the Dodd-Frank Act, as the bill’s sponsor has asserted that Section 953(b) creates an “unclear and burdensome reporting requirement” that is “unworkable and costly to implement.” The bill will next be voted upon by the US House of Representatives. As of the date of this Client Alert, however, there is no set date for such vote.

For More Information

To discuss any of the topics covered in this Client Alert, please contact an attorney in our Corporate and Securities Group or visit us online at chapman.com.

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