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SEC Proposes to Require US Public Companies to Provide CEO Pay Ratio Disclosures

The US Securities Exchange Commission ("**SEC**") has proposed amendments to Regulation S-K and Form 8-K, available here, that would require approximately 4,000 US public companies to disclose the ratio of annual compensation of its chief executive officer (CEO) to the median of annual employee compensation. This proposal implements Section 953(b) of the US Dodd-Frank Wall Street Reform and Consumer Protection Act ("**Dodd-Frank Act**"). The public comment period on this proposal will be open until December 2, 2013.

Proposed Disclosure Requirement

If adopted as proposed, US public companies subject to this disclosure requirement (each, an "**Affected Company**") would need to disclose the following in their proxy statements for their annual meetings (or in some cases, in annual reports on Form 10-K or current reports on Form 8-K, as discussed below):

- The median of annual total compensation of all employees (excluding the CEO);
- The ratio of that median to annual total CEO compensation;
- Brief overview of methodology used to identify the median employee;
- Any material assumptions, adjustments or estimates used to identify the median or to determine total compensation or any elements of total compensation, identifying any estimated amount; and
- A brief description of any changes in methodology, material assumptions, adjustments or estimates compared to those used in prior years, the reason for the change, and an estimate of the impact of the change on the median and the ratio.

An Affected Company would be permitted, but not required, to supplement these disclosures with narrative discussion or additional ratios. (Any additional ratios would need to be clearly identified and should not be presented with greater prominence than the required ratio.) We refer to these disclosures collectively as the "**Pay Ratio Disclosures**". Pay Ratio Disclosures in an Affected Company's proxy statement could be incorporated by reference into its annual report on Form 10-K as well as any registration statements.

Key highlights

The SEC's proposed pay ratio disclosures would include:

- The median of the annual total compensation of all employees (excluding the CEO)
- The ratio of that median to total annual CEO compensation
- A brief overview of methodology used to identify the median and identification of any assumptions, adjustments or estimates

Pay Ratio Disclosures would, in certain cases, be presented in annual reports on Form 10-K. An Affected Company that does not file the proxy statement for its annual meeting within 120 days after the end of its fiscal year would be required to include the Pay Ratio Disclosures in its annual report on Form 10-K (or in an amended Form 10-K).

In limited circumstances, Pay Ratio Disclosures would be presented in a current report on Form 8-K. An Affected Company that omits total CEO compensation disclosure from its proxy statement (or Form 10-K, if applicable) because CEO salary or bonus information is not calculable until a later date would be required to disclose the following in its proxy statement (or Form 10-K):

- that the Pay Ratio Disclosure is being omitted because the CEO's total compensation is not available; and
- the expected date that the total compensation for the CEO will be determined.

The SEC's proposal includes an amendment to Form 8-K that would require an Affected Company to provide Pay Ratio Disclosures in these circumstances under Item 5.02(f) of Form 8-K, which would need to be filed once the total compensation for the CEO is determined.

Which SEC filers would be required to provide Pay Ratio Disclosures?

US public companies that are required to provide summary compensation table disclosure pursuant to Item 402(c) of Regulation S-K when filing registration statements, annual reports or proxy statements with the SEC, would be required to provide Pay Ratio Disclosures. The following types of companies would not be required to provide Pay Ratio Disclosures in their registration statements, annual reports or proxy statements:

- Emerging growth companies;
- Smaller reporting companies;
- Foreign private issuers;
- Multijurisdictional Disclosure System (MJDS) filers;
- Newly public companies during a transition period (discussed below);
- Wholly-owned subsidiaries of US public companies that meet the conditions to omit executive compensation disclosure pursuant to Instruction I of Form 10-K; and
- Asset backed issuers that meet the conditions to omit executive compensation disclosure pursuant to Instruction J of Form 10-K.

In addition, Pay Ratio Disclosures would not be required for any Form S-1 or Form S-11 registration statement filed for an initial public offering (regardless of issuer size).

Calculations and methodology

As proposed, an Affected Company would be required to determine median employee compensation based on all of its and its subsidiaries' full-time, part-time, temporary and seasonal employees worldwide (excluding the CEO) as of the last day of its relevant fiscal year. (Independent contractors or temporary workers employed by a third-party would not be included in the calculation.) Affected Companies would be permitted, but not required, to annualize compensation of permanent employees who were hired during the relevant fiscal year. Annualization would not be permitted, however, for temporary or seasonal employees.

Range of reasonable methodologies contemplated. In an effort to address concerns regarding compliance costs, the SEC proposed to permit Affected Companies to select any reasonable methodology for identifying median compensation. The SEC did not specify a uniform methodology. For example, an Affected Company may choose to use:

- a statistical sample of its full employee population; or
- a consistently-applied compensation measure (such as compensation amounts reported in payroll or tax records).

Once an Affected Company has identified its median employee using a reasonable methodology of its choice, it would be required to calculate that employee's total annual compensation in the same manner as used for calculating total annual compensation for named executive officers for presentation in the summary compensation table (*i.e.*, in accordance with Item 402(c)(2)(x) of Regulation S-K). Because Item 402 primarily addresses executive compensation, the SEC's proposal provides several clarifications to address potential difficulties in applying these requirements to an employee that is not an executive officer and is paid an hourly wage and overtime (instead of salary and bonus).

Reasonable estimates would be permitted. Affected Companies would be able to use reasonable estimates to calculate annual total compensation or any element of total compensation for any employee other than the CEO. The ability to use reasonable estimates may help multinational companies based in the United States manage the compliance costs associated with making Pay Ratio Disclosures when they maintain multiple and complex payroll, benefits and pension systems (including systems maintained / administered by third parties).

Non-US data privacy concerns. Non-US data privacy regulations may impact the collection or transfer of non-US employee compensation data by multinational companies based in the United States. For example, an Affected Company with employees in the European Union would likely need to ensure compliance with EU data privacy regulations in transmitting personally identifiable human resources data of EU employees to internal HR information system networks in the United States or to third-party payroll, pension and benefits processors outside of the European Union. (A client briefing providing an introduction to the European Union's data privacy regime is available here.) Similarly, the SEC acknowledged that data privacy laws of other jurisdictions, such as Peru, Argentina, Canada and Japan, may be implicated by the gathering of data for purposes of the proposed Pay Ratio Disclosures. If the cross-border transfer of employee compensation data for employees in certain jurisdictions were prohibited by, or unduly burdensome under, local data privacy laws, it would be possible for an Affected Company to rely on reasonable estimates. The SEC has requested information from commenters about the specific impact that non-US data privacy regulations would have on collecting or transferring data needed to comply with the proposed disclosure requirements.

Compliance timing

An Affected Company would be required to provide its initial Pay Ratio Disclosures for the first fiscal year that begins after the effective date of the disclosure requirement. For example, if it were to be finalized and become effective in April 2014, an Affected Company with a December 31 fiscal year end would be required to provide its initial Pay Ratio Disclosures for 2015 in the proxy statement for its 2016 annual meeting of shareholders.

Phase-in for newly public companies. A company would not be required to provide Pay Ratio Disclosures in its registration statement on Form S-1 or Form S-11 for its initial public offering ("**IPO**"). It would be required to provide its initial Pay Ratio Disclosures with respect to its first fiscal year that begins after the completion of its IPO. For example, a newly public company (that is not an initial growth company or a foreign private issuer) with a December 31 fiscal year end that completes its IPO in September 2016 would be required to present its initial Pay Ratio Disclosures for 2017 in the proxy statement for its 2018 annual meeting of shareholders.

Limited exception for updating disclosures in registration statements. An Affected Company would not be required to include Pay Ratio Disclosures with respect to its last completed fiscal year if it files a registration statement after the end of its fiscal year but before it files Pay Ratio Disclosures in its annual proxy statement or Form 10-K. For example, if an Affected Company with a December 31 fiscal year end included Pay Ratio Disclosure regarding 2015 in its proxy statement for its 2016 annual meeting of shareholders and then filed an automatically effective shelf registration statement on Form S-3 on February 1, 2017, it would be permitted to incorporate by reference the proxy statement's Pay Ratio Disclosure for 2015 in its Form S-3. It would not need to provide updated Pay Ratio Disclosures for 2016.

Liability implications

Despite requests made by several commenters, the SEC declined to propose that the Pay Ratio Disclosures be deemed "furnished" for liability purposes. The Pay Ratio Disclosures would instead be deemed to be "filed." As a result of this classification, an Affected Company would be subject to potential liability for false or misleading statements pursuant to Section 18 of the US Securities Exchange Act of 1934, as amended, unless it can prove that it acted in good faith and had no knowledge that the statement was false or misleading. Depending on the type of filing in which the Pay Ratio Disclosures are presented or incorporated by reference, other US anti-fraud liability provisions could also apply. In addition, the Pay Ratio Disclosures would be covered, like other executive compensation disclosures, by the CEO and CFO certifications provided for Exchange Act filings under the Sarbanes-Oxley Act of 2002.

Conclusion

The SEC has proposed amendments to Item 402 of Regulation S-K (and related amendments to Form 8-K) that would require approximately 4,000 US public companies to disclose the ratio of their CEO's annual total compensation to their median employee's annual total compensation. Foreign private issuers and emerging growth companies would not be required to comply, and newly registered companies would benefit from a transition period. While the SEC has proposed significant flexibility in making the required calculations, the cost of compliance could disproportionately affect US companies with large workforces and global operations, especially those that would face compliance burdens related to non-US data privacy regulations.

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