THE SEC'S PROPOSED PAY RATIO DISCLOSURE RULES

Summary

On September 18, 2013, the Securities and Exchange Commission (SEC) proposed new pay ratio disclosure rules to implement Section 953(b) of the Dodd-Frank Wall Street Reform and Consumer Protection Act (Dodd-Frank Act). The proposed rules would require public companies to disclose the median of the annual total compensation of all employees (except the PEO), the annual total compensation of the PEO and the ratio of the median of the annual total compensation of all employees (except the PEO) to the annual total compensation of the PEO.

The proposed disclosures would be required in any annual report on Form 10-K, proxy or information statement, or registration statement that is required to include executive compensation disclosure pursuant to Item 402 of Regulation S-K. The proposed disclosure requirement would not apply to emerging growth companies, smaller reporting companies, foreign private issuers and companies that file reports and registration statements with the SEC in accordance with the requirements of the U.S.-Canada Multijurisdictional Disclosure System.

To address concerns from some commentators about the significant potential costs that could be involved in complying with the disclosure requirement, the SEC proposed rules that would not specify any required calculation methodologies for identifying the median employee, but would allow public companies flexibility to select a methodology that is appropriate to the size and structure of their own businesses and the way in which they compensate employees. For example, a company would be permitted to identify the median employee by using its full employee population or statistical sampling or other reasonable methods. Nevertheless, SEC Commissioners Gallagher and Piwowar, the SEC's two Republican commissioners, spoke strongly against the proposed rules, urging those that would be affected by the proposed rules to submit public comments. In his dissenting statement, Commissioner Gallagher opined that the proposed rules have "nothing to do with the SEC's mission," would be sure "to cost a lot and teach very little" and their "only conceivable purpose is to name and, presumably in the view of its proponents, shame U.S. issuers and their executives." While Commissioner Gallagher acknowledged that the Dodd-Frank Act mandates the SEC to propose pay ratio disclosure rules, he noted that the SEC "need not act on it now or soon" given that the Dodd-Frank Act does not impose any deadline by which the SEC is required to adopt these rules. In his dissenting statement, Commissioner Piwowar, opined that the "pay ratio disclosure rule will harm investors" and that "any investor that uses pay ratio disclosures to compare companies will be at best distracted from material investment information and at worst misled about the investment itself."

The proposed rules will be subject to a 60-day public comment period following their publication in the Federal Register. Under the proposed rules, public companies would be required to comply with the proposed disclosure requirement for their first fiscal year commencing on or after the effective date of the final rules. For example, if the final rules become effective in 2014, a company with a calendar year fiscal year would not be required to provide pay ratio disclosures until 2016 when it files its annual

report on Form 10-K for fiscal year 2015 or its proxy statement for its 2016 annual meeting of stockholders.

The Proposed Rules

Pay Ratio Disclosure Requirement

The SEC has proposed to add a new paragraph (u) to Item 402 of Regulation S-K that would require public companies to disclose the following:

(i) the median of the annual total compensation of all employees of the company (except the PEO);

(ii) the annual total compensation of the PEO; and

(iii) the ratio of the amount in (i) to the amount in (ii).

To remain consistent with Item 402's existing disclosure requirements, the proposed disclosure requirement refers to the "PEO" of the registrant, which is defined in Item 402(a)(3) as an individual "serving as the registrant's principal executive officer or acting in a similar capacity during the last completed fiscal year."

The proposed rules specify that the pay ratio must be expressed as a ratio in which the median of the annual total compensation of all employees (except the PEO) is equal to one or as a narrative in terms of the multiple that the PEO's annual total compensation bears to the median of the annual total compensation of all employees (except the PEO). For example, if the median of the annual total compensation of all employees (except the PEO) is $50,000, and the annual total compensation of the PEO is $10 million, then the pay ratio could be disclosed as "1 to 200" or as "the PEO's annual total compensation is 200 times that of the median of the annual total compensation of all employees (except the PEO)."

Employees Used to Identify the Median

The proposed rules would require public companies to identify the median employee of the company (that is, the single employee who is in the middle of the pay scale of all employees, with 50 percent of employees earning more and 50 percent of employees earning less) using one of a variety of methods and then calculate the annual total compensation of the employee in the same manner that is used to calculate total compensation for purposes of the summary compensation table. The identity of the median employee and the specifics of that employee's compensation (that is, how much is attributable to salary, equity awards or other benefits) would not need to be disclosed.

In determining the median employee, companies would need to consider all full-time, part-time, seasonal and temporary workers employed by the company and its subsidiaries as of the last day of the company's last completed fiscal year. The determination would include employees based outside of the

U.S. However, independent contractors and other workers who are employed by a third party would not be covered.

Some limited adjustments would be permitted whereby companies may annualize the total compensation for a permanent (but not temporary or seasonal) employee who was employed for less than the full fiscal year. These adjustments would apply, for example, to a new hire or an employee who took an unpaid leave of absence during the fiscal year. The SEC explained, however, that if such an adjustment were made for a part-time employee, the adjustment should reflect the compensation for the employee's part-time schedule over the entire year and should not adjust the part-time schedule to a full-time schedule.

Methodology for Identifying the Median

The proposed rules do not require that companies use any specific methodology for identifying the median employee. Companies would be permitted to identify the median employee by using a number of different methods, such as, (i) calculating the annual total compensation for all employees using Item 402(c)(2)(x) (that is, the same calculations used to determine total compensation for purposes of the summary compensation table); (ii) using reasonable estimates; and/or (iii) using statistical sampling.

Similarly, the SEC noted that companies are not required to use a specific compensation measure to identify the median employee. The proposed instructions permit a company to identify the median employee based on any consistently applied compensation measure, such as finding the median by using amounts reported to the U.S. Internal Revenue Service on Form W-2 and/or the equivalent for non-U.S. employees.

Companies would be required to disclose the methodology and any material assumptions, adjustments or estimates used to identify the median. For example, when statistical sampling is used, companies should disclose the size of both the sample and estimated whole population. Estimated amounts should also be clearly identified as such. Companies, however, are not required to disclose technical analyses or formulas.

Calculating Annual Total Compensation

Companies would be required to calculate the annual total compensation of the median employee in the same manner that is used in the total compensation column of the summary compensation table, as set forth in Item 402(c)(2)(x). This calculation includes salary, bonus, stock awards, option awards, non-equity incentive plan compensation, change in pension value and nonqualified deferred compensation earnings and all other compensation. Companies would only be required to calculate and disclose annual total compensation for the median employee and the PEO. As previously noted, companies may determine who is the median employee by using any consistently applied compensation record. However, annual total compensation would need to be calculated for the last completed fiscal year, rather than the annual period used in the consistently applied compensation record.

In calculating total annual compensation of named executive officers for purposes of Item 402(c), companies are generally allowed to exclude benefits provided on a non-discriminatory basis to all

employees (for example, healthcare) and to exclude perquisites and personal benefits if the total value of all perquisites and benefits for the named executive officer is less than $10,000. Such benefits may represent a more significant part of the compensation of the median employee than that of a named executive officer. The SEC noted that such exclusions are permissive and that companies may include such benefits in calculating the annual total compensation of the median employee so long as they also include such benefits in the calculation of the PEO's annual total compensation for purposes of the ratio and disclose that they have been included.

Where to Include the Disclosures

The proposed disclosures would be required to be included in any annual report, proxy or information statement or registration statement that is required to include executive compensation disclosure pursuant to Item 402 of Regulation S-K. Pay ratio information with respect to the company's last completed fiscal year is not required to be disclosed until the filing of its annual report for that last completed fiscal year or, if later, the filing of a definitive proxy or information statement relating to its next annual meeting of shareholders following the end of such fiscal year; provided that, the required disclosure must, in any event, be filed not later than 120 days after the end of such fiscal year.

Practical Concerns

Potential Liabilities

Like other Item 402 disclosures, the pay ratio disclosure would be considered "filed" for purposes of Section 18 of the Securities Exchange Act of 1934 and incorporated by reference into registration statements filed under the Securities Act of 1933 and, accordingly, would be subject to potential liabilities thereunder. Furthermore, the disclosure will be covered by the PEO and PFO certifications required under the Sarbanes-Oxley Act of 2002.

Companies with a Global Workforce

Public companies that have a significant number of employees located outside the U.S. may face some difficulties in complying with the proposed rules. For example, due to foreign data privacy laws there may be difficulties obtaining compensation data for non-U.S. employees. In addition, no adjustments may be made to compensation to account for purchasing power parity statistics. Lastly, the proposed rules do not address how to handle currency conversions when assessing the global workforce except that such conversions should be performed consistent with conversions for non-U.S. named executive officers under Item 402(c).

Under the proposed rules, public companies would be permitted to include additional ratios to address the disparities inherent in comparing the compensation of a U.S.-based PEO to a global workforce so long as such additional information is not confusing to investors and not more prominent than the required disclosure. For example, companies could also include a ratio comparing the median of the annual total compensation of only U.S. full-time employees to the annual total compensation of the PEO.

Preparing for the New Disclosure

Compliance with the proposed pay ratio disclosure rules may result in significant costs for public companies, particularly large multinational corporations that maintain multiple and complex payroll, benefits and pension systems that are not structured to easily analyze and aggregate the necessary data. Although the effectiveness of the final rules is not yet imminent and the proposed rules are expected to generate a significant number of comments, public companies should start considering possible methodologies that they could use to identify the median employee and any other significant steps they would need to take in order to gather the information required to comply with the proposed pay ratio disclosure requirement.

ABOUT CURTIS

Curtis, Mallet-Prevost, Colt & Mosle LLP is a leading international law firm. Headquartered in New York, Curtis has fifteen offices in the United States, Mexico, Europe, the Middle East and Central Asia. Curtis represents a wide range of clients, including multinational corporations and financial institutions, governments and state-owned companies, money managers, sovereign wealth funds, family-owned businesses, individuals and entrepreneurs.

For more information about Curtis, please visit www.curtis.com.

Attorney advertising. The material contained in this Client Alert is only a general review of the subjects covered and does not constitute legal advice. No legal or business decision should be based on its contents.

FOR FURTHER INFORMATION, CONTACT:

ROMAN A. BNINSKI
e-mail: rbninski@curtis.com
tel: +1 212 696 6113

VALARIE A. HING
e-mail: vhing@curtis.com
tel: +1 212 696 6943

WILLIAM CANDELARIA
e-mail: wcandelaria@curtis.com
tel: +1 212 696 6061

RAYMOND T. HUM
e-mail: rhum@curtis.com
tel: +1 212 696 8801

LAWRENCE GOODMAN
e-mail: lgoodman@curtis.com
tel: +1 212 696 6099

JEFFREY N. OSTRAGER
e-mail: jostrager@curtis.com
tel: +1 212 696 6918