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SEC Proposes Rule for Pay Ratio Disclosure

On September 18, 2013, the Securities and Exchange Commission (the “SEC”) published a proposed rule that would implement Section 953(b) of the Dodd-Frank Wall Street Reform and Consumer Protection Act by amending Item 402 of Regulation S-K to require a public company to disclose the ratio of the median compensation of its employees to the compensation of its chief executive officer (“Pay Ratio Rule”). Specifically, the proposed disclosure must include: (1) the median of the annual total compensation of all employees of the registrant, except the principal executive officer (“PEO”); (2) the annual total compensation of the PEO of the registrant; and (3) the ratio of the median compensation of all the employees to the annual compensation of the PEO. In addition, the registrant must briefly disclose any methodology used to identify the median and any material assumptions, adjustments or estimates used to identify the median or to determine total compensation.

The SEC received many comments that the proposed disclosure would not be material to investors or useful in making an investment or voting decision, as well as concern regarding increasing compliance costs. Comments supporting the Pay Ratio Rule suggest that the disclosure provides investors with insight into a registrant’s internal pay structure. Accordingly, the proposed Pay Ratio Rule was designed to lower the cost of compliance while remaining consistent with the requirements of Section 953(b).

Employee Identification

The proposed rule requires disclosure of the median annual total compensation of all employees. All employees would include any full-time, part-time, seasonal or temporary worker employed by the registrant or any of its subsidiaries, but would not include those working for the registrant through independent contractors or other third party relationships. The proposed rule does not provide carve-outs for specific categories of employee, such as non-U.S. employees or newly hired employees. As proposed, the Pay Ratio rule calculation date for determining who is an employee is the last day of the registrant’s last completed fiscal year. This bright line calculation date is consistent with the date used to determine the three most highly compensated executive officers under Item 402(a)(3)(iii) of Regulation S-K.

Calculation of the Median and Total Annual Compensation

Once a registrant has identified its employees, it must calculate the median compensation of its employees for use in the pay ratio disclosure. The SEC did not specify a required calculation method that must be used to calculate the median. Instead, the SEC proposed suggested guidance designed to accommodate an individual registrant’s size, structure and compensation practices. A registrant may opt to identify the median compensation using its full employee population or by using statistical sampling. Such estimates or statistical sampling methods would allow a registrant with a large number of employees to identify the median in a relatively cost-efficient manner. For example, a large employer could take a random sample of employees and identify the median employee based on the annual cash compensation of the employees, or any other consistently applied compensation measure. The registrant would then calculate the total annual compensation of the median employee for the pay ratio disclosure, and would not be required to calculate the total annual compensation of each employee in the sample. The proposed rule would also allow for any other reasonable method the registrant may choose.

In response to concerns that calculating some elements of annual compensation would be overly burdensome, the proposed Pay Ratio Rule would permit a registrant to use reasonable estimates to determine annual compensation or any elements of total compensation of employees other than the PEO. For example, a registrant may not have access to information needed to accurately calculate the total annual compensation of an employee that is a member of a union and that receives pension benefits from a multi-employer defined pension benefit plan.

In such a circumstance, the SEC believes it would be appropriate for a registrant to use reasonable estimates to approximate the employee's defined pension benefit for purposes of calculating annual compensation. In addition, registrants with non-U.S. employees have raised issues with regard to certain unique types of compensation given only in certain countries, such as housing. In these circumstances the SEC permits a registrant to value personal benefits on the basis of the aggregate incremental cost to the registrant. The annual compensation of a registrant's PEO would continue to be calculated in accordance with Item 402 of Regulation S-K.

The proposed disclosure would be required in all registration statements, proxy and information statements, and annual reports that require disclosure of executive compensation under Item 402 of Regulation S-K. As proposed, the Pay Ratio Rule will not apply to emerging growth companies, smaller reporting companies and foreign private issuers. Registrants would be required to begin to comply with the pay ratio rules with respect to the first fiscal year commencing on or after the effective date of the rules. The comment period will expire 60 days after the proposed rule is published in the Federal Register.

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