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SEC Proposes Pay Ratio Disclosure Rule

The Commissioners of the SEC voted 3-2 on September 18, 2013 to propose regulations (the “Proposed Rules”)¹ implementing the mandate of Section 953(b) of the Dodd-Frank Wall Street Reform and Consumer Protection Act (the “Dodd-Frank Act”)² to require disclosure by a reporting company of the median annual total compensation of all its employees (excluding the company’s principal executive officer (“PEO”)) and the ratio of that median to the annual total compensation of the PEO. This memorandum summarizes the requirements of the Proposed Rules.

The principal noteworthy aspects of the Proposed Rules are:

- **Date of compliance.** Disclosure would likely first be required for calendar year companies in 2016 proxy filings relating to 2015 compensation.
- **Identifying the median employee.**
 - All employees of the issuer and its subsidiaries, including full time, part time, temporary, seasonal and non-US employees, employed on the last day of the issuer’s fiscal year are required to be taken into account.
 - Compensation is permitted to be annualized in specified circumstances, but not for part time, seasonal or temporary employees. Cost-of-living adjustment for non-US employees is not permitted.
 - The Proposed Rules provide leeway for issuers to use reasonable approaches in identifying the median employee, including statistical sampling of employee populations and estimates and measures of pay, rather than requiring the calculation of each employee’s total compensation as defined for proxy reporting purposes.
- **Reporting the ratio.**
 - Once the median employee is determined, the amount of that employee’s total annual compensation and the pay ratio must be calculated in the manner dictated for total compensation in the Summary Compensation Table. However, any compensation permitted to be

¹ SEC Release No. 33-9452, available at <http://www.sec.gov/rules/proposed/2013/33-9452.pdf>.

² Dodd-Frank Wall Street Reform and Consumer Protection Act of 2010, Pub. L. No. 111-203, Title IX, Subtitle E, § 953(b), 124 Stat. 1904 (2010), available at <http://www.gpo.gov/fdsys/pkg/STATUTE-124/pdf/STATUTE-124-Pg1376.pdf>.

excluded from annual total compensation for that purpose, such as benefits under plans available to all employees, may be added back into the ratio calculation in order to capture benefits that may comprise an important part of a rank-and-file employee's compensation.

In connection with the vote, the Commissioners expressed widely divergent views regarding the benefit of the Proposed Rules and the interpretive approach to Section 953(b) employed by the SEC staff. The SEC staff stressed the flexibility it had built into the Proposed Rules, to the extent possible under its statutory mandate, in order to contain the costs of compliance. Both speakers at the open meeting and the text of the proposing release asked for extensive, detailed and robust commentary on the Proposed Rules. Indeed, the proposing release requests comments on topics as broad as alternative ways of meeting the statutory mandate of Section 953(b) and any effect of the Proposed Rules on efficiency, competition and capital formation. The comment period for the Proposed Rules closes on the 60th day following the date of their publication in the Federal Register.

Proposed Rules

What issuers will be subject to the proposed pay ratio disclosure requirement?

The Proposed Rules amend Regulation S-K of the Securities Exchange Act of 1934, as amended (the "Exchange Act"), adding new Item 402(u). Other than emerging growth companies, which are exempted by statute, any issuer required to include a Summary Compensation Table in its public filings pursuant to Item 402(c) will have to include the pay ratio disclosure. Smaller reporting companies and foreign private issuers are not subject to the requirement.

What employees are within scope for the determination of median compensation?

All employees of the issuer and its subsidiaries³, including full time, part time, temporary, seasonal and non-US employees, employed on the last day of the issuer's fiscal year are within scope. Independent contractors and leased employees are not included. The proposing release recites in some detail the arguments contained in comment letters received regarding Section 953(b) for and against excluding non-US employees, non-full time employees or employees of non-consolidated subsidiaries. The SEC staff opted to include all employees, as set forth in the statute, providing instead flexibility in the method for determining the median employee for purposes of the pay ratio disclosure.

How is the employee with the median annual compensation to be determined?

The Proposed Rules do not dictate the method by which the median employee is to be determined. Instead, the Proposed Rules provide leeway for issuers to decide the most suitable and cost-effective methodology, including using assumptions, adjustments and estimates based

³ For purposes of the Proposed Rules, the term "subsidiaries" means affiliates controlled by the registrant directly or indirectly through one or more intermediaries, as set forth in the definition of "subsidiary" under both Rule 405 of the Securities Act of 1933, as amended (the "Securities Act") and Exchange Act Rule 12b-2.

upon each issuer's own facts and circumstances. The proposing release does, however, outline certain necessary considerations related to the choice of methodology.⁴

In order to determine the group of employees from which the median will be identified, an issuer may use either its entire employee population or a subset determined through statistical sampling "or other reasonable methods." The proposing release provides examples of alternative methods that may be employed to allow for cost efficiency while still satisfying the statutory mandate. The Economic Analysis section of the proposing release in particular contains a discussion regarding the usefulness (or lack thereof) of statistical sampling by issuers.

As discussed further below, the amount of median compensation and the pay ratio must be calculated in the manner dictated for annual total compensation in the Summary Compensation Table by Item 402(c) in respect of the issuer's last fiscal year. However, for purposes of identifying the median employee, the issuer may use other compensation measures so long as they are consistently applied to all employees, for example, payroll or tax records. In addition, if the compensation measure used is based on an annual period other than the fiscal year of the issuer (such as employees' calendar tax year), the median employee determination may be made by reference to the compensation reported with respect to such other annual period. In response to commenters' concerns about data privacy laws limiting the ability to transmit personally identifiable human resources data and other constraints on an issuer's ability to identify and quantify compensation for each employee on an enterprise-wide basis, the Proposed Rules also permit issuers to use reasonable estimates of compensation (or items of compensation) of employees in order to identify the median employee.

Lastly, in respect of permanent employees of the issuer who were not employed for the entire year (e.g., new hires or employees on unpaid leave), compensation is permitted to be annualized. However, certain adjustments are specifically prohibited to be made to workers' compensation, e.g., full-time equivalent adjustments for part time employees, annualization for seasonal or temporary employees or cost-of-living adjustments for non-US employees.

Issuers will need to briefly disclose the methodology and all material assumptions, adjustments or estimates used to identify the median employee or to determine total compensation or any particular element. If the issuer changes its methodology or other material factors from those used in the prior fiscal year, and there is a material effect on the result, the issuer must disclose the change, the reason for it and an estimate of the impact on the amount of median compensation and pay ratio.

⁴ The proposing release states that consideration relevant to the choice of methodology should include the size and nature of the workforce, the complexity of the organization, the stratification of pay levels across the workforce, the types of compensation the employees receive, the extent that different currencies are involved, the number of tax and accounting regimes involved, and the number of payroll systems the issuer has and the degree of difficulty involved in integrating payroll systems to readily compile the total compensation information for all employees.

What must be disclosed?

Once the median employee is determined, his or her compensation for the fiscal year must be calculated in the manner required by Item 402(c)(x) and disclosed together with annual total compensation of the PEO and the ratio between the two.⁵ However, in response to commenters, the proposing release makes clear that any compensation permitted to be excluded from annual total compensation under Item 402, such as benefits under plans available to all employees, may be added back into the calculation in order to capture benefits that may comprise an important part of a rank-and-file employee's compensation.⁶

The Proposed Rules correct a much maligned error in the statute by clarifying that the ratio may be presented either as a ratio of median pay to PEO pay or alternatively as PEO pay as a multiple of median pay.

What filings must contain the proposed pay ratio disclosure?

The pay ratio disclosure for an issuer's most recent fiscal year must be included in the issuer's Annual Report on Form 10-K for the fiscal year, or, if later, the proxy or information statement relating to the annual shareholders' meeting following the end of the fiscal year, provided that in any event the information must be provided within 120 days following the end of the fiscal year. In addition, for any filing requiring disclosure pursuant to Item 402 of Regulation S-K, which covers Forms 10-K, registration statements, and proxy and information statements, the disclosure must be included or incorporated by reference. In the event of any filing after the end of a fiscal year and prior to the filing of the annual report or proxy or information statement containing the updated disclosure, an issuer may include or incorporate by reference the information for the fiscal year prior to the most recently completed fiscal year.

The proposing release makes clear that, like the other disclosures required by Item 402, the pay ratio disclosure is to be "filed" and not "furnished" for purposes of liability under the Securities Act and the Exchange Act and PEO/PFO certifications required by the Sarbanes-Oxley Act of 2002.

What is the compliance date for pay ratio disclosure for existing issuers?

An existing issuer will be required to comply with the new pay ratio disclosure rules in its first fiscal year commencing on or after the effective date of the final rules and would not be required to include the disclosure in any filing until its Annual Report on Form 10-K for such fiscal year, or if later, proxy or information statement for its annual meeting (or written consent in lieu of meeting) following the end of such fiscal year (but no later than 120 days after the end of such fiscal year).

⁵ The Proposed Rules refer to "the" PEO and do not address how the requirements would apply to issuers with more than one PEO.

⁶ Any such changes must also be made to the compensation of the PEO and explained in the disclosure.

What is the transition period for pay ratio disclosure for new issuers?

Under the Proposed Rules, pay ratio disclosure would not be required to be included in a registration statement on Form S-1 or Form S-11 for an initial public offering or a registration statement on Form 10. A newly reporting company would instead be required to make the pay ratio disclosure in respect of its first fiscal year commencing on or after the date it becomes a reporting company and would not be required to include the disclosure in any filing until its Annual Report on Form 10-K for such fiscal year, or if later, proxy or information statement for its annual meeting (or written consent in lieu of meeting) following the end of such fiscal year (but no later than 120 days after the end of such fiscal year). For example, assuming the Proposed Rules become effective in 2014, a company that completes its initial public offering in October 2015 would not be required to include the pay ratio disclosure until it files its proxy statement for its 2017 shareholders meeting, which would include the pay ratio disclosure relating to 2016 compensation. Issuers that completed their initial public offerings in 2013 or 2014, assuming the Proposed Rules become effective in 2014, would generally be required to include the disclosure in proxy statements filed for their 2016 meetings, which would relate to 2015 compensation.

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Please call any of your regular contacts at the firm or any of the partners and counsel listed under Employee Benefits or Corporate Governance in the Practices section of our website (www.cgsh.com) if you have any questions.

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