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EXECUTIVE COMPENSATION

Important Considerations in Light of the SEC's Proposed 'Pay Ratio' Rules Amending Item 402 of Regulation S-K



Bloomberg BNA recently conducted an e-mail interview with Alston & Bird LLP employee benefits and executive compensation attorney Kerry Wenzel about key chief executive officer pay disclosure issues.

Bloomberg BNA: As a reminder, what will the SEC's September 18, 2013 proposed "pay ratio" rules require public companies to disclose (11 CARE 948, 9/20/13)?

Kerry Wenzel: The proposed "pay ratio" rules would amend Item 402 of Regulation S-K to implement Section 953(b) of the Dodd-Frank Wall Street Reform and Consumer Protection Act. Specifically, the pay ratio rules would require a covered registrant to disclose annually:

- the median of the annual total compensation of all employees of the registrant, except the chief executive officer;

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- the annual total compensation of the chief executive officer; and
- the ratio of these two amounts, which may be expressed as a ratio in which the median of the annual total compensation of all employees is equal to one, or, alternatively, expressed narratively in terms of the multiple that the CEO total compensation amount bears to the median of the annual total compensation amount.

The proposed rule would not apply to emerging growth companies, smaller reporting companies or foreign private issuers.

BBNA: Can you highlight some of the flexibility offered by the proposed rule?

Wenzel: Other than specifying that "total compensation" of the median employee and the chief executive officer must be calculated in accordance with Item 402(c)(2)(x) of Regulation S-K, Section 953(b) is silent as to the mechanics of calculating and providing this disclosure. As such, the proposed rule offers registrants some flexibility, including permission to:

- identify the median using their full employee population or by using statistical sampling or another reasonable method;
- calculate the annual total compensation for each employee included in the calculation (whether the entire population or a statistical sample) and the chief executive officer using "total compensation" as defined in Item 402 and to identify the median using this method, or as an alternative, registrants may identify the median employee based on any consistently applied compensation measure, such as compensation amounts reported in its payroll or tax records (and then calculating the annual total compensation for that median employee in accordance with Item 402); and
- use reasonable estimates in calculating the annual total compensation for employees other than the

chief executive officer, including when disclosing the annual total compensation of the median employee identified using a consistently applied compensation measure.

BBNA: What actions should compensation committees and companies generally be taking in light of this proposed rule? Does more coordination and communication with the human resources department need to take place now?

Wenzel: The pay ratio rule will require registrants to disclose specific information about non-executive employees that it is not currently required to disclose. This will be a new exercise for everyone. As a result, it is likely that most companies will need to enlist additional resources from within the company to assist in the preparation of this disclosure. So, while we are still in the very early stages—assuming the final rule is effective in 2014, a calendar year registrant would be first required to include the pay ratio disclosure relating to compensation for fiscal year 2015 in its proxy statement for its 2016 annual meeting of stockholders—this is the time to prepare.

- Companies should begin compiling their data collection teams now, identifying any challenges associated with the data collection and deciding how it will prepare the calculations. Will the company calculate the median by using the compensation data of its full employee population or, alternatively, will it base the calculation on a statistical sampling of employees? If the company chooses to base the calculation on a statistical sampling of employees, does it have the resources to conduct the calculation in-house or, more likely, will it need to outsource the project to a statistician, actuary or the like? If outsourcing looks like the right approach for the company, as I expect it will be for many, what will it cost and how long will it take? These are all questions that need to be addressed before a company can even begin to prepare the disclosure.
- Consider doing a test run. Preparing the disclosure in advance will benefit the company in a number of ways. First, the exercise will highlight any challenges in obtaining the requisite information. Second, it will allow companies time to make informed decisions as to the selection of methodologies and assumptions. On this point, companies should keep in mind the requirement in the proposed rule to use a “consistently applied compensation measure” if it chooses to identify the median employee based on something other than Item 402 total compensation. The proposed rule specifically acknowledges that allowing registrants to select a methodology for identifying the median, rather than prescribing a methodology or set of methodologies, could permit a registrant to alter the reported ratio to achieve a particular objective with the ratio disclosure. Requiring the use of a consistently applied compensation measure is intended to lessen this concern—which is all the more reason for companies to prepare the disclosure now and make sure they are comfortable with the methodologies selected. Lastly, advance preparation will afford companies adequate time to digest the results.

- Consider what, if any, additional disclosures you will include in addition to the required pay ratio. The proposed rule states that, as with other mandated disclosure, registrants may, at their discretion, present additional ratios to supplement the required ratio (provided that they are clearly identified and not misleading, and not presented with greater prominence than the required ratio). We expect that many registrants will, in fact, include supplemental information—and perhaps additional ratio(s)—that is more relevant to the company’s circumstances. For example, a large retail company might include pay ratio disclosure that includes annualized compensation for part-time or seasonal employees.
- Your company’s pay ratio disclosure will no doubt generate attention from both stockholders and employees alike. Educate your investor relations and human resources departments. Make sure that they are well-equipped to address questions and concerns from stockholders and employees, respectively.

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For further analysis of compensation committee duties, see, *Compensation Committees*, Portfolio 73 in the *Corporate Practice Series*, available at Bloomberg BBNA. Go to <http://www.bna.com/compensation-committees-p6957/> for more information. For further analysis of executive compensation disclosure, see, *Periodic Reporting Under the Federal Securities Laws*, Portfolio 89 in the *Corporate Practice Series*, also available at Bloomberg BBNA. Go to <http://www.bna.com/periodic-reporting-federal-p12884910287/> for more information.

BBNA: In light of the fact the proposed rule doesn’t allow companies to exclude employees based in foreign countries from the calculation, are there important preparatory steps that U.S. companies with foreign presences should begin to take, or at least some issues they should begin to examine in your recommendation?

Wenzel: Yes, absolutely. As you noted, per the proposed rule, the pay ratio calculation would include all employees of the registrant, which is defined rather broadly to include any individual employed by the registrant or any of its subsidiaries (including full-time, part-time, seasonal or temporary workers) on the last day of the registrant’s last fiscal year. This would include employees outside the United States, without adjustments based on differences in cost-of-living or currency fluctuations.

As noted earlier, while gathering the required information for non-executive employees will be a new exercise for all companies, those with a global workforce may face additional challenges. For example, companies with a foreign presence should consider whether there are any applicable data privacy laws that might limit (or prohibit in some cases) access to, or transmission of, employees’ individual compensation-related information and whether employee consent might be required. Coordination among multiple payroll systems might also be necessary. Identifying now whether or

not these issues apply to your company will allow you to create a timeline for preparation that adequately addresses any additional steps.

I would also note that the proposed rule addresses some of these concerns directly, but does not offer any additional accommodation to companies who might find themselves faced with these obstacles. However, this very point was one on which the SEC specifically solicited public comment—whether any additional flexibility will be offered in the final rule remains to be seen.

BBNA: If the SEC’s proposed rule is implemented in its current form, can you lay out a few of the positive and negative impacts that you foresee it will have on investors, companies, CEOs?

Wenzel: One of the most-often cited statements from the proposed rule is that neither the statute nor the related legislative history directly states the objectives or intended benefits of the rule. That being said, there are both proponents and critics of the proposed rule, as evidenced by the more than 20,000 public comment letters received by the SEC.

Many proponents note that the pay ratio disclosure will encourage dialogue at companies regarding com-

pensation and morale. In addition, proponents advocate that the pay ratio disclosure will provide boards with an additional metric on which to evaluate its chief executive officer’s compensation, rather than focusing, perhaps singularly, on peer group comparisons. On the other hand, critics question the usefulness of the information and worry that the disclosure will lead to inaccurate comparisons and misleading results.

It is also worth noting that there has been a consistent emphasis on providing clear and concise disclosure, and even more frequent discussion regarding whether, as it relates to executive compensation, “the more information the better” is, in fact, true. The topic of information overload was just recently addressed by SEC Chair Mary Jo White in a speech to the National Association of Corporate Directors in October 2013 (11 CARE 1059, 10/18/13).

It is not likely that the pay ratio disclosure will do much in the way of reducing disclosure. As we discussed earlier, we anticipate companies not only including the required ratios, but also supplemental information. Balancing the usefulness of supplemental information and the desire for concise disclosure will be challenging.