

Corporate Governance Alert

September 2013

SEC Has Issued Proposed CEO Pay Ratio Disclosure Rules

The Securities and Exchange Commission has proposed rules requiring companies to disclose the pay ratio between their CEO and median compensated employee.

Overview of Proposed Rules for Disclosure of CEO Pay Ratio

On September 18, 2013, the SEC proposed rules amending Item 402 of Regulation S-K to require companies to disclose:

- (i) The median annual total compensation for all employees
- (ii) The annual total compensation of the chief executive officer (CEO), referred to in the proposed rules as the principal executive officer
- (iii) The ratio of the two

These rules are designed to implement and comply with Section 953(b) of the Dodd-Frank Wall Street Reform and Consumer Protection Act while also attempting to address the costs and burdens to companies of implementing the rules. As discussed below, the SEC's proposed rules permit some flexibility in determining median employee compensation.

The SEC has provided for a 60-day comment period before the proposed rules are finalized. The proposed pay ratio is determined as of the last date of the fiscal year and would be required in companies' annual reports on Form 10-K, proxy and information statements, and any registration statement that requires executive compensation disclosure pursuant to Item 402 of Regulation S-K. These disclosure requirements would not apply to emerging growth companies, smaller reporting companies or foreign private issuers. These disclosure requirements would also not be required in a Form S-1 or Form S-11 filed in connection with a company's initial public offering, but would apply to new registrants that do not qualify as emerging growth companies with respect to compensation for the first fiscal year to begin after the company becomes public.

Key Determinations

Currently, US public companies are required to discuss any internal pay equity policies they may have in the Compensation Discussion & Analysis section of their proxy statements. The SEC's proposed rules would require companies to quantify the disparity between the CEO's and the other employees' compensation. The proposed rules' key features are as follows:

- Determining "all employees" for the ratio. All employees employed as of the last day of the company's last completed fiscal year are taken into account, including any full-time, part-time, seasonal or temporary US or non-US worker employed by the company or any of its subsidiaries (which includes affiliates controlled by the company directly or indirectly through one or more intermediaries, as set forth in the definition of "subsidiary" under both Securities Act Rule 405 and Exchange Act Rule 12b-2). Independent contractors, "leased" workers or other temporary workers who are employed by a third party are not included. Companies may (but are not required to) annualize the compensation for all permanent employees (other than those in part-time or seasonal positions) who were not employed for the entire fiscal year, such as a new hire or an employee who took an unpaid leave of absence during the period. The proposed rules do not permit full-time equivalent adjustments for part-time employees, annualizing adjustments for temporary or seasonal employees or cost-of-living adjustments for non-US workers which will have the effect of skewing the ratio.

Many commenters have raised concerns that including non-US based employees could render the ratio of median employee compensation to that of a US-based CEO less meaningful due to international variations in compensation arrangements and benefits, cost-of-living differences and currency fluctuations. Others have raised concerns that including non-US based employees could lead to significant compliance costs and could implicate data privacy laws in various jurisdictions. Despite these concerns, the proposed rules include all worldwide employees of the company and its subsidiaries without any specific carve-out for any employee group.

- Finding the “median employee:” then determines that employee’s total compensation per S-K 402. The SEC’s proposed rules do not mandate any specific method for determining median employee compensation. Instead the rules permit companies to choose a consistent methodology appropriate to the company’s needs to identify the employee whose compensation is at the median of all employees, including statistical sampling or reasonable estimates. In addition, companies may use any consistently applied compensation measure (such as salary, wages and tips as reported to the US Internal Revenue Service on Form W-2 and the equivalent for non-US employees) to identify the median employee. The methodology and any material assumptions, adjustments or estimates used to identify the median must be disclosed, although companies need not disclose formulas or technical statistical analysis.

Once the median employee is identified, the company then needs to calculate that one median employee’s annual “total compensation” in accordance with S-K 402 to determine the pay ratio. By allowing companies to use a sampling of employees and to choose the statistical methodology to select the median employee, and requiring the calculation of total compensation with respect to a single median employee, the SEC is attempting to reduce the administrative burden to companies as compared to alternative approaches such as determining total compensation for all employees. It should be noted, however, that the financial and administrative burdens of the proposed rule are still likely to be significant for many companies.

The SEC has stated that reasonable statistical sampling and sample size will be determined on a case-by-case basis and will depend on several variables at each company, including:

- Wage variances
- Size and nature of the workforce
- Complexity of the organization
- Types of compensation employees receive
- Extent that different currencies are involved

The SEC estimates approximately 50 percent of companies have a structure that would allow use of a simple random sampling. The SEC used data comparing companies with a single business or geographical unit suggesting that companies who may use simple random sampling may use anywhere from 81 to 1,065 employees depending on the variance of the pay levels. The other 50 percent of companies with different business units and geographical regions will need to undertake a more complex process to determine an appropriate reasonable statistical sampling. Alternative statistical sampling procedures would require drawing observations from each business or geographical segment and statistically inferring the overall median based on the observation drawn (e.g., using a stratified cluster sampling with a weighted sample median for different business or geographic units).

- Disclosing the CEO pay ratio. The proposed pay ratio under subsection (iii) above must be expressed as a ratio in which the median of the annual total compensation of all employees is equal to one (e.g., “1 to 200”) or, alternatively, expressed in narrative form in terms of the multiple that the CEO total compensation amount bears to the median of the annual total compensation amount of all employees (e.g., “the CEO’s annual total compensation is 200 times that of the median of the annual total compensation of all employees”). Although the order of the values in the ratio is contrary to the express language of the statute (which states

the ratio in the inverse order), the SEC nevertheless has mandated this approach, ostensibly to provide for consistent disclosure between companies.

- Compliance Date. These rules will be applicable with respect to compensation for a company's first fiscal year commencing on or after the effective date of the final rules. Companies should disclose the pay ratio information in the latter of: the Form 10-K for such fiscal year; or the filing of a proxy or information statement for its next annual meeting of shareholders following the end of such year.

For example, if the final rules become effective in 2014 and a company's fiscal year ends on December 31st, then the company would generally first be required to include pay ratio information relating to compensation in its 2016 proxy statement and the ratio would be determined based on fiscal year 2015 compensation.

- Requests for Comment. Although the SEC received more than 20,000 comments on the pay ratio rules before issuing the proposed rules, the proposed rules contain 60 requests for comment on specific issues related to the proposals and individual SEC Commissioners have underscored the SEC's desire to receive additional input from affected companies and their representatives prior to finalizing these rules. Specific requests for comment include:
 - Requests for detailed analysis of the costs to comply with the proposed rules and the potential anti-competitive impact of such costs
 - Proposals for alternative determinations of covered employees (e.g., would it be appropriate to exclude non-U.S. employees? is it appropriate to include employees of subsidiaries?)
 - Identification of specific foreign data privacy laws that could impact the collection or transfer of data necessary to comply with the proposed rules.

If you have questions about this *Corporate Governance Alert*, please contact one of the authors listed below or the Latham lawyer with whom you normally consult:

James D. C. Barrall

jim.barrall@lw.com

+1.213.891.8342

Los Angeles

Bradd L. Williamson

bradd.williamson@lw.com

+1.212.906.1826

New York

Maj Vaseghi

maj.vaseghi@lw.com

+1.650.470.4852

Silicon Valley

Ashley E. Wagner

ashley.wagner@lw.com

+1.650.470.4873

Silicon Valley

Unsubscribe and Contact Information

Corporate Governance Alert is published by Latham & Watkins as a news reporting service to clients and other friends. The information contained in this publication should not be construed as legal advice. Should further analysis or explanation of the subject matter be required, please contact the attorneys listed above or the attorney whom you normally consult. A complete list of our publications can be found on our website at www.lw.com.

If you wish to update your contact details or customize the information you receive from Latham & Watkins, please visit <http://events.lw.com/reaction/subscriptionpage.html> to subscribe to our client mailings. To ensure delivery into your inbox, please add LathamMail@lw.com to your e-mail address book. If you wish to be removed from our distribution, please click this link, unsubscribe@lw.com, or reply to this message with "Unsubscribe" in the subject line.

Latham & Watkins operates worldwide as a limited liability partnership organized under the laws of the State of Delaware (USA) with affiliated limited liability partnerships conducting the practice in the United Kingdom, France, Italy and Singapore and as affiliated partnerships conducting the practice in Hong Kong and Japan. The Law Office of Salman M. Al-Sudairi is Latham & Watkins associated office in the Kingdom of Saudi Arabia. In Qatar, Latham & Watkins LLP is licensed by the Qatar Financial Centre Authority. Under New York's Code of Professional Responsibility, portions of this communication contain attorney advertising. Prior results do not guarantee a similar outcome. Results depend upon a variety of factors unique to each representation. Please direct all inquiries regarding our conduct under New York's Disciplinary Rules to Latham & Watkins LLP, 885 Third Avenue, New York, NY 10022-4834, Phone: +1.212.906.1200. © Copyright 2013 Latham & Watkins. All Rights Reserved.