RADFORD ALERT

SEC Publishes Proposed Rules for the Implementation of CEO to Worker Pay Ratio

Overview

Among the many executive compensation related items included in the Dodd-Frank Wall Street Reform Act of 2010, one of the most heavily debated and anticipated was the CEO to worker pay ratio. This ratio, designed to illuminate the relationship between total reported compensation for a CEO and his or her median employee, sounds simple in concept, but generates a number of complex challenges. These challenges explain much of the two year delay in moving forward with the rule.

However, on September 18th, following a tight 3 to 2 vote, the SEC issued a set of proposed rules to the public for comments. The SEC press release, along with the complete rule proposal is available online here:

- **http://www.sec.gov/News/PressRelease/Detail/PressRelease/1370539817895#.Ujt9wtLktvA**

While the proposed rules are not final, and there are some unanswered questions as to the potential timing of their implementation, this proposal provides solid insights into the direction of the SEC's thinking. Absent persuasive public commentary, it is certainly possible the rules could be finalized in this format.

Key Considerations

Based on our review of the rule proposal, we believe there are a number of significant issues companies should immediately consider, especially if they intend to participate in the comment period provided by the SEC. Key issues include:

- **Global Companies** – When originally passed by Congress, there was serious discussion as to whether the SEC would provide any exclusion for non-US workers. The argument being that differences in mandated benefit structures and compensation laws around the globe made considering pay ratios across boarders a significant challenge. However, the SEC release makes it clear that all workers are to be covered, regardless of location.

  The Commission acknowledged that this could cause data privacy issues, especially in the European Union (EU), and asked for specific comments on the burden this might create. For our part, we believe the inclusion of non-US workers could potentially reduce the usefulness of these pay ratios for comparing multi-national companies. If for example, you have two companies of similar size, and with similar CEO pay, but one company has employees concentrated in high-wage nations, and the other in low-wage nations, what information is actually conveyed by the ratio?

- **Defining Employees** – The proposed rule states that all employees, whether full-time, part-time, permanent or seasonal must be included in the pay ratio calculation. Further, the proposed rule uses an end-of-fiscal-year employment identification date for determining who needs to be included in the mix. This wrinkle is not specified in the Dodd-Frank Act itself, and may cause an issue for some employers, especially those with large seasonal workforces (e.g., retail firms) employed near the end of the year.

- **Determining the "Median Employee"** – The proposed rules create some significant leeway for companies to determine who is the median employee. It was originally assumed that companies would have to effectively calculate "proxy pay" for all employees and then determine the median employee from that calculation. However, the proposed regulations allow companies to apply some shortcuts, referring in the proposed regulations to "statistical sampling or other reasonable methods", although the Commission refused to provide either approved specific methodologies or safe harbor sampling techniques in determining who constitutes a median employee.

  Unanswered at this time is what requirements will need to be met for a company to be considered as using a valid statistical sampling. This lack of safe harbor provisions is especially troubling given that the SEC affirmed the fact that the information contained in the pay ratio would be considered as "filed" rather than "furnished", thereby attaching significantly greater legal liability to the number.

  Ironically, by introducing significant (and still undefined) flexibility into the pay ratio calculation, the SEC also opens the door for criticism of the effectiveness of pay ratios. If companies use widely different methodologies for sampling and calculating pay, then there is little value in comparing pay ratios across companies.

- **Rule Timing** – The proposed rules contain a very long implementation timeline. As proposed, they would not become applicable until the first fiscal year following approval of final rules, and the report would not need to be completed until the later of the filing of the 10-K or proxy for that year. In other words, if the rules were approved on January 15, 2014, they would become applicable for the first fiscal year commencing after that date. For a calendar year company, that would mean that they would apply to calendar/fiscal year 2015, and would not need to be reported until either the 10-K or proxy was filed in 2016.

Next Steps

While the publication of proposed rules for the implementation of the CEO to worker pay ratio is a major step forward for the SEC, it appears unlikely that the new rule will become final on an expedited basis. The SEC's 60-plus requests for additional comments show the door is wide open for considerable updates to the proposal. This fact, coupled with the 3 to 2 nature of the vote among SEC commissions, suggests we may not see further progress on these regulations until well into 2014.

To connect with a member of our compensation consulting team to discuss CEO to worker pay ratios, please write to **consulting@radford.com**.

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