The New CEO/Median Employee Compensation Ratio Disclosure Requirement by Michael E. Storck

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The New CEO/Median Employee Compensation Ratio Disclosure Requirement

September 18, 2013, by a vote of 3 to 2 the SEC proposed a rule requiring public companies to calculate and disclose the ratio of its CEO compensation to its median employee's compensation.

Section 953(b) of the 2010 Dodd-Frank Wall Street Reform and Consumer Protection Act (the Dodd-Frank Act), directed the SEC to amend Regulation S-K Item 402 (S-K 402) to require public companies to disclose (a) the median of the annual total compensation of all employees of the Company (excluding the CEO), (b) the annual total compensation of the CEO, and (c) the ratio of these two amounts. The SEC issued this proposed rule pursuant to the mandate of Section 953(b). Some questions and answers to common questions about the proposed rule follow.

Who is the Median Employee?

The proposed rule allows flexibility in determining the median employee. The methodology used to determine the median employee may differ company to company. The selection of a methodology would be based on a company's circumstances, including the size and structure of the company and the way it compensates employees.

For example, a company could identify the median employee based on total compensation using either its full population or a statistical sample of that population. Additionally, a company could identify the median of its population using either annual total compensation as determined under the SEC's existing executive compensation rules, or any consistently applied compensation measure (e.g., based on compensation amounts reported in payroll or tax records).

What is Total Compensation?

Once the median employee has been identified, that median employee's annual total compensation should be calculated under the acceptable methodology the company adopts. This could be the existing executive compensation rules (i.e., S-K 402(c)(2)(x)), and reflect compensation for the last completed fiscal year. The Rule would allow companies to use reasonable estimates in their determination of the annual total compensation of the median employee.

Which Employees are Covered by the Proposed Rule?

Under the Rule, companies should include all employees of a company, including full-time, part-time, temporary, seasonal, and non-US employees of the company or any of its subsidiaries as of the last day of the last completed fiscal year. Independent contractors and other temporary workers who are employed legally by a third party should not be included in the calculation.

Companies may, but are not required to, annualize the total compensation for permanent employees who were employed at the end of the fiscal year but who did not work a full year, such as new hires. However, companies may not include certain other adjustments including full-time equivalent adjustments for part-time workers, annualizing adjustments for seasonal or temporary employees, or cost of living adjustments for non-US employees.

What Else Must be Disclosed?

Under the proposed rule, companies must disclose the methodology used to determine the median employee and total compensation, including any material assumptions, adjustments or estimates used. If a company elects to identify the median employee based on a consistently applied compensation measure other than the SEC of total compensation definition, the proposed rule would require disclosure of the measure used. Companies may, but are not required to, supplement the required disclosure with a narrative discussion and/or additional ratios.

Who Must Comply?

The proposed pay ratio disclosure requirements do not apply to emerging growth companies, smaller reporting companies or foreign private issuers. They would apply to all other issuers filing any registration statement, annual report, proxy or information statement under either the Securities Act of 1933 or the Securities Exchange Act of 1934 that requires executive compensation disclosures pursuant to Regulation S-K 402.

When is Compliance Required?

A company must provide the new pay ratio disclosures with respect to compensation for its first fiscal year commencing on or after the effective date of the final rule. Companies may voluntarily begin complying with the new rule earlier than the required compliance date. Companies entering the Exchange Act reporting system after effective date of this rule must comply with these compensation disclosure requirements for the first fiscal year commencing on or after the date the company becomes subject to the reporting requirements.

When Will the Rule Become Effective?

The SEC has requested public comment on the proposed rule within 60 days after its publication in the Federal Register. Depending on the comments received, the SEC may request additional comment or proceed to promulgate a final rule.

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