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SEC's Proposed CEO Pay Ratio Rules: Unduly Complicated Rules Produce Meaningless Results

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Excessive executive compensation was often cited as a major driver of behavior that resulted in the financial industry crisis. Therefore, it was no surprise that the Dodd-Frank Wall Street Reform and Consumer Protection Act (the Dodd-Frank Act)[1] imposed additional substantive and disclosure requirements on public companies and financial institutions with respect to executive compensation. Almost four years after the passage of the Dodd-Frank Act, the Securities and Exchange Commission is struggling with the pay for performance and pay ratio disclosure rules mandated by Section 953 of the Dodd-Frank Act, exposing a deep divide between proponents and opponents of the rule and the lack of legislative history regarding the intent of the disclosure provisions.

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Background

Section 953(a) of the Dodd-Frank Act mandates the SEC to adopt a rule requiring an issuer to disclose in its annual meeting proxy material a clear description of the relationship between executive compensation actually paid and the financial performance of the issuer. Such disclosure may include a graphic representation of the information, such as bar graphs, line graphs, etc. (i.e., "pay v. performance" disclosure).

This statutory requirement is particularly puzzling, because it seems to have ignored the executive compensation disclosure reforms implemented by the SEC over the past decade, as well as the private sector disclosure developments driven by the proxy advisory service firms.

For example, since 2006 issuers (other than smaller reporting companies) have been required to include a Compensation Discussion and Analysis (CD&A) in their annual proxy statement.[2]

With respect to the compensation paid to executive officers, the CD&A requires a company to disclose the objectives of its compensation programs, what the programs are designed to reward, specific items of corporate performance taken into account in setting compensation policies and how specific forms of compensation are structured and implemented to reflect these items.

Furthermore, the annual report (on Form 10-K) is required to include a five-year stock performance graph

[1] Pub. L. No. 111-203, Section 953, 124 Stat. 136, 1904 (2010).

[2] 17 C.F.R. § 229.402(b).

comparing company stock price to peer and industry indexes.[3]

The annual proxy statement also currently includes a three-year, seven column summary compensation table (the SCT), five additional supplementary compensation tables and a narrative that is intended to put into perspective for investors the numbers and tabular data.[4] In addition, the voting standards adopted by the proxy advisory services are focused on aligning executive pay with performance, which has lead to increased proxy disclosure of the linkage between executive pay and performance. [5]

Consequently, there already is sufficient information provided to shareholders to enable them to match executive pay with the issuer's financial performance. Therefore, it is questionable whether there is a need for more disclosure that shows the relationship between executive compensation and the financial performance of the issuer. Since there is no statutory deadline as to when the SEC must publish rules under Section 953(a) of the Dodd-Frank Act, it is no surprise that this rulemaking has not been high on the SEC's priority list. We don't expect SEC rulemaking as to Section 953(a) to commence until the storm surrounding the Section 953(b) disclosure proposal is settled.

Section 953(b) of the Dodd-Frank Act mandates the SEC to adopt a rule requiring that any filing that is subject to Regulation S-K[6] must disclose (i) the median of the annual total compensation of all employees of the issuer, except the chief executive officer (CEO); (ii) the annual total compensation of the CEO; and (ii) the ratio of those two amounts (pay ratio disclosure). Section 953(b) provides that ''total compensation'' for both the median employee and the CEO must be determined in accordance with the methodology set forth for disclosure of named executive officer compensation in the SCT pursuant to Item 402 of Regulation S-K.[7]

Although Section 953(b) of the Dodd-Frank Act directs the SEC to promulgate a rule requiring issuers to make these new pay ratio disclosures, there is no statutory deadline for when the SEC must issue such rules.

More than three years passed from the Dodd-Frank Act's enactment on July 22, 2010, until the SEC published the proposed pay ratio disclosure rules on Oct. 1, 2013.[8]

Public Comments

The SEC sought comment from the public before issuing the proposed pay disclosure rules. As of Sept. 15, 2013, the SEC had received approximately 22,860 comment letters and a petition with approximately 84,700 signatures.[9] Even before the proposed pay ratio disclosures were published, commenters were divided in their views regarding such disclosures.

Industry groups, issuers, law firms and executive compensation professionals commented on the complexity and cost of the requirements, as well as the potential liability related to verification of the accuracy of the disclosures. Individuals, institutional investors and public policy organizations commented in favor of the expected benefits of the pay ratio disclosures.

Lack of Purpose

In proposing the pay ratio disclosure rules, the SEC noted that ''neither the statute nor the related legislative history directly states the objectives or intended benefits of the provision.''[10]

In fact, the legislative record includes only a few brief references to the pay disclosure requirements, each opposing the provision. The pay ratio disclosure requirements weren't discussed during the conference committee's deliberations on the legislation and the Joint Explanatory Statement of the Committee of Conference doesn't mention the pay ratio requirements. Nevertheless, the SEC is obligated to carry out the statutory mandate of issuing pay ratio disclosure rules.

Complexity of Determining Median Employee

Section 953(b) of the Dodd-Frank Act doesn't specify how the ''median'' employee should be determined for purposes of the pay ratio disclosure.

Likewise, the SEC's proposed rules don't specify any required calculation methodologies for identifying the median. Instead, the proposed rules allow issuers to choose from several alternative methods to identify the median employee.

In determining the population from which the median employee is identified, the proposed rules would allow the issuer to use either its total employee population, or a statistical sampling of the total employee population, or any other reasonable method or estimates and would also permit the use of any consistently applied compensation measures.

Once the ''median'' employee has been identified, the ''total compensation'' of the median employee must be calculated using SCT methodology. Thus, the issuer would only be required to determine that one employee's compensation in accordance with the SCT rules, along with the CEO's total compensation (which the issuer will prepare for the SCT anyhow).

Nevertheless, Section 953(b) expressly requires disclosure of the median of the annual total compensation of ''*all employees*,'' which the SEC interprets as including full-time, part-time, seasonal and temporary employees who are employed by the registrant or any of its subsidiaries, and regardless of whether such employees were employed in the U.S. or in a foreign country. ''Leased'' employees are excluded.

Although the proposed rules allow issuers to use reasonable estimates to determine total annual compensa-

[3] 17 C.F.R. § 229.201(e).

[4] 17 C.F.R. § 229.402(c) (general rule) and § 229.402(r) (for smaller reporting companies).

[5] For example, Institutional Shareholder Services Inc. (ISS) utilizes ''Total Shareholder Return'' (TSR) and ''Shareholder Value Transfer'' (SVT) analysis of executive compensation when advising its clients whether to vote for or against proxy proposals. Accordingly, many issuers proactively disclose in their proxy statements how their executive compensation practices include TSR and SVT considerations, which are links between executive pay and performance.

[6] 17 C.F.R. § 229.10(a).

[7] 17 C.F.R. § 229.402(c)(2)(x).

[8] SEC Release No. 33-9452, 78 Fed. Reg. 60,560 (Oct. 1, 2013) 190 PBD, 10/1/13; 40 BPR 2358, 10/8/13; 182 PBD, 9/19/13; 40 BPR 2239, 9/24/13.

[9] *Id.* at 60,561.

[10] *Id.* at 60,562.

tion, the proposed rules generally wouldn't permit any compensation conversions.

For example, compensation of part-time employees couldn't be converted into the equivalent of full-time employees and compensation of employees paid on a foreign pay scale couldn't be converted into the equivalent compensation of employees who are paid on a U.S. pay scale.

Failing to allow for the conversion of foreign employees' compensation into equivalent U.S. based compensation structures is particularly troublesome because of currency fluctuations, cost-of-living standards, and the fact that some items of compensation are recorded in payroll in the U.S. but not in foreign countries and vice versa, due to tax and accounting rules applicable to the respective jurisdictions.

Note, however, that the proposed rules permit (but don't require) annualization of permanent, full-time employees' compensation if such employee was hired midyear (i.e., if a calendar year issuer hires a full-time employee on Aug. 1, 2015, that employee could nevertheless be deemed to have earned compensation from the issuer starting on Jan. 1, 2015).

Aside from such prohibitions on using equivalencies, the proposed rules state that issuers are permitted to use reasonable estimates of compensation to identify the ''median'' employee in the issuer's workforce. It is uncertain what ''reasonable estimates'' would be acceptable to the SEC, since the SEC appears to have taken an inconsistent view of allowing full-time employees to be treated as having been employed during the entire calendar year, while at the same time not allowing adjustments to be made for part-time employees, seasonal employees or foreign employees.

The proposed rules suggest that issuers could determine the median employee by using a statistical sampling of employees. The proposed rules further suggest that the issuer could exclude employees in the sample that have extremely low or extremely high pay, because they would fall on either end of the spectrum of pay and therefore wouldn't be the median employee.

But as a preliminary matter, the issuer must determine what items of compensation should be included in ''compensation'' before segregating those at the very high end or very low end of the designated population.

For purposes of calculating the median employee, the proposed rule allows the issuer to use ''total direct compensation'' (i.e., annual salary, hourly wages and any other performance-based pay) or any other less complex, readily available figure as opposed to total compensation determined under the SCT methodology.

But selecting such ''readily available'' criteria (for example, cash compensation) poses other problems. For example, cash compensation might be less in certain countries that mandate pension and health benefits or housing benefits for employees. So looking only at cash compensation would necessarily place all employees in that country at the low end of the workforce, even though the employer is providing ''in kind'' benefits that could cause ''total compensation'' for employees in those countries to be in the middle or even at the higher end of the workforce.

Section 953(b) of the Dodd-Frank Act didn't require any particular calculation date for determining who is an employee for purposes of determining the pay ratio. Yet, the proposed rule provides that ''employee'' means any individual employed as of the last day of the registrant's last completed fiscal year, which is consistent with determining which individuals qualify as named executive officers for the proxy statement.[11] This approach doesn't capture seasonal or temporary workers who aren't employed at year end.

Therefore, although the rules count seasonal or temporary workers as employees in the first instance, they may be excluded on the basis of not being employed on the last day of the issuer's fiscal year. Calendar year issuers who increase their workforce with seasonal or temporary employees during the Christmas season are likely to have an unfair outcome if they are required to count such seasonal workers who are employed by the issuer on Dec. 31, compared to calendar year issuers who operate a summer business (such as a beach resort, where seasonal hires peak during the summer months).

Because the proposed rules allow the issuers to determine for themselves a reasonable methodology to determine the median employee, it is likely that issuers will retain statistical experts to devise an appropriate methodology.

Experts disagree on the most appropriate methodology to undertake for an accurate analysis. Are issuers expected to retain two experts, and then have a third expert decide which of the other experts has the most appropriate methodology? Determining which expert's advice to follow would be costly for shareholders.

The SEC described several different statistical sampling techniques in the preamble to the proposed rules, which seems to have created even greater uncertainty and complexity for issuers, especially in light of the liability exposure if the pay ratio disclosure is considered ''filed'' and not ''furnished'' to the SEC.

The proposed rules did set forth a list of variables to be considered by issuers in crafting their methodology to identify the elusive ''median employee.'' These variables are: (i) size and nature of the workforce, (ii) complexity of the organization, (iii) types of compensation the employees receive (including cash and noncash), (iv) the extent that different currencies are involved, (v) the number of tax and accounting regimes involved, and (vi) the number of payroll systems involved and the degree of integrating such systems.

In addition, the proposed rules require the issuer to disclose the methodology and material assumptions, adjustments and estimates used in the calculation of the median employee and/or in the calculation of total annual compensation of the median employee and the CEO.

Since each issuer is permitted to design its own methodology, it is likely that it will take some time for issuers to settle on the best methodology for them. Changing from one methodology to another will necessitate lengthy proxy disclosure describing the old method, new method and reason for the change. Attempting to describe such complex analytics and methodologies in ''plain English'' poses further challenges for issuers.

Absurd Results

For issuers subject to the pay disclosure rules, the proposed rules are likely to produce a nonsensical result that is of little relevance to investors, yet preparing

[11] 17 C.F.R. § 229.402(a)(3)(iii).

the disclosure will cost issuers significant time and effort, as well as exposure to potential liability.

For example, one hotly debated aspect of the current SCT disclosure rules involves the SEC's decision to require inclusion of full grant date fair market value with respect to equity awards as current compensation, even if the grants are subject to a vesting schedule.[12] Including all of the equity grant as current compensation in the year that the award was granted skews that year's total annual compensation significantly, because the named executive officer hasn't (during that first year) acceded to the wealth that is disclosed in the proxy, because most of the equity grant is unvested.

The award may never vest, yet many people view the named executive officer's total compensation number as if such deemed compensation was the same as cash compensation.[13]

The proposed pay disclosure rules will exacerbate this problem because the proposed rules require use of the SCT rules for determining ''total annual compensation.'' Thus, it follows that the pay ratio will necessarily be grossly skewed in years where an issuer makes an equity grant to the CEO that is subject to a vesting schedule because the full fair market value of the grant will be treated as current compensation in the year of grant.

Often, equity grants are only given to senior executive officers, so it is unlikely that the median employee would have an equity grant that is deemed to be fully vested in the year of grant included in the employee's ''total annual compensation.'' Therefore, the pay ratio disclosure is inherently conflicted.

In addition, for issuers that have defined benefit pension plans (either tax-qualified or nonqualified plans), the SCT rules for reporting changes in pension values as current compensation [14] are likely to produce great variances because of factors such as interest rates, discount rates and mortality assumptions, which have nothing to do with actual take-home pay from the issuer for either the CEO or the median employee whose compensation is being compared under the pay ratio disclosure rules.

Often CEOs have supplemental pension plans that aren't available to rank-and-file employees under ERISA's ''top hat'' plan rules, so if the CEO participates in both a tax-qualified defined benefit plan and a nonqualified supplemental executive retirement plan with a defined benefit formula, the CEO's compensation will be doubly affected by the outside, extraneous factors that have nothing to do with the CEO's individual performance in any particular fiscal year or the issuer's overall financial performance during that fiscal year.

Global issuers face even greater challenges, due to distortions relating to currency conversion, cost-of-living adjustments and standards, foreign government requirements for wages, pensions and benefits, and foreign privacy rules for collecting and transmitting employee compensation data in order to obtain the median employee's total annual compensation.

In the past, the SEC has limited its rulemaking to employees located in the U.S.

For example, SEC Regulation BTR,[15] which governs certain actions that must be taken by issuers and officers and directors of issuers when the issuer's tax-qualified retirement plan is in a ''blackout'' period, only requires the issuer to count employees located in the U.S.[16] Furthermore, the proposed rules require issuers to include data from all subsidiaries, foreign or domestic, so it reasonable to conclude that conglomerates (particularly multinational conglomerates) will have a very difficult time obtaining such data. Currently, most entities don't have one central source of data. Collecting such data is likely to be impracticable at best and perhaps even impossible. Such a centralized data source isn't likely to ever exist (but may need to be created, at great expense, solely to fulfill this SEC disclosure requirement for issuers who are subject to U.S. securities regulation).

CEO Pay Ratio v. Pay for Performance

Because CEO total annual compensation is much more volatile than rank-and-file employee pay, significant fluctuations in the pay ratio disclosure are likely year-over-year. Issuers would need to explain this difference to shareholders, which is likely to be confusing and would increase the already expanding length of the compensation portions of the proxy statement.

For example, for years, shareholder advisory groups such as ISS, Glass, Lewis & Co. and others, have focused on ''pay for performance'' which encourages issuers to adopt executive incentive plans with performance matrices that are based on achieving stated goals. Typically, such matrices include a threshold, target and stretch level, where the value of the payout is higher if the higher performance goals are achieved. Therefore, in a year where the higher performance goals are reached, the pay ratio would be particularly high, which could have a perverse, negative impact—which is the exact opposite of the intended purpose of achieving the performance goals.

In addition, multiyear performance periods are encouraged in long-term incentive plans for CEOs but not generally for rank-and-file employees, so it is impossible to achieve ''year-to-year'' parity when comparing a CEO's total annual compensation to a rank-and-file employee's total annual compensation.

Longer, More Tedious Proxy Disclosure

Once the pay ratio is determined, it would be expressed, for example, as ''250:1'' where the CEO's total annual compensation is 250 times the total annual compensation of the issuer's median employee. Issuers are

[12] 17 C.F.R. § 229.402(c)(2)(v) and (vi).

[13] Some issuers attempt to clarify this discrepancy by including a chart or discussion comparing ''realizable pay'' (i.e., potential pay that may be received by the named executive officers if targets or vesting is achieved) versus ''realized pay'' (i.e., actually received by the named executive officers) in their proxies, but Regulation S-K doesn't mandate such disclosure.

[14] 17 C.F.R. § 229.402(c)(2)(viii).

[15] 17 C.F.R. §§ 245.100 through 245.104.

[16] In a comment letter to the SEC dated Nov. 29, 2013, Frederic W. Cook & Co. noted that Section 306 of the Sarbanes-Oxley Act of 2002 limited blackout trading restrictions to issuers where more than a majority of retirement plan participants located in the U.S. were affected by the blackout period. Therefore, SEC Regulation BTR implementing such blackout trading restrictions only applies to U.S.-based workforces.

required to provide a narrative explaining the material assumptions, adjustments or estimates used. Also, in future years, any changes to the methodology or assumptions used to calculate the pay ratio must be explained.

Issuers are permitted to provide a narrative further explaining the pay ratio (for example, explaining the difference between at least the prior year's pay ratio and the current year's pay ratio). It is likely that such narratives will necessarily be long in order to explain all of the permutations or special circumstances that were taken into account in arriving at the pay ratio.

Attempting to reduce statistical sampling techniques into ''plain English'' also poses a significant challenge, since mathematical statisticians often insist on precision when describing samples and related analytics, and it is likely that issuers will necessarily rely on such outside experts to conduct the necessary testing. Such narrative will increase the already expanding length of the executive compensation disclosures in the proxy, thereby making the totality of the disclosure daunting to the average shareholder.

Filed v. Furnished

The proposed rules call for the pay ratio disclosure to be ''filed'' with the SEC, not merely ''furnished'' to the SEC. ''Filing'' results in a greater degree of potential liability for issuers under Section 18 of the Securities Exchange Act of 1934[17] for false or misleading disclosure unless the issuer can establish that it acted in good faith or had no knowledge that the disclosure was false or misleading.

Section 18(a) expressly provides that any person who makes false or misleading statements in a document filed with the SEC will be liable to anyone who, in reliance on those statements, purchases or sells a security whose price was affected by the statements. Filing also results in greater potential for liability for the issuers' principal executive officers (PEOs) and principal financial officers (PFOs), who must sign certifications as to the material accuracy and completeness of the pay ratio disclosures under Section 302 of the Sarbanes-Oxley Act of 2002.[18]

Given the complexity of data collection and analysis, it seems unduly burdensome to place that level of liability exposure on issuers, PEOs and PFOs.

Effective Dates and Transition Rules

Assuming that the proposed pay ratio disclosure rules are finalized during 2014, they would become effective one year thereafter, such that pay ratios for 2015 would need to be disclosed for proxy statements for the 2016 shareholder meeting. Some comments requested that the rules not take effect until two years (or longer) after they are finalized, in order for issuers to develop systems for collecting the necessary data and undertaking the necessary analysis.

Some comments requested that the SEC provide a good faith compliance period for two or more years where disclosure of the methodology and assumptions used to calculate the pay ratio isn't required, in order to allow some time for experimentation and experience with how to undertake the data collection and perform the analysis.

Some comments asked that the pay ratio not be disclosed in the proxy, but rather in Form 8-K filed before the end of the second quarter, to allow issuers' compensation committees, compensation consultants and management more time to prepare the burdensome calculations, rather than adding those requirements to the same disclosure cycle as the proxy statement.

Because the SEC included 69 specific requests for comments, it is likely that the SEC will need significant time to review all of the comments it received. Given the significant potential costs of the proposed rule and the deep divide between the proponents and opponents of the proposed rule, as it has done in the past with significant rule changes, the SEC may wish to consider reproposing the rule to include changes made based on comments it received, rather than proceeding directly to a final rule.

Exemptions

The proposed pay ratio disclosure rules won't apply to ''emerging growth companies'' under the Jumpstart Our Business Startups (JOBS) Act.[19] This exemption would be set forth in a new instruction to Item 402(u) of Regulation S-K.

Likewise, the proposed rules won't apply to smaller reporting companies, because they are permitted to follow the scaled disclosure requirements set forth in Items 402(m) to (r) of Regulation S-K, instead of complying with the disclosure requirements in Items 402(a) to (k) and (s) of Regulation S-K. Accordingly, because smaller reporting companies aren't required to follow Item 402(c)(2) of Regulation S-K (SCT disclosure), the SEC concluded that pay ratio rules wouldn't apply to smaller reporting companies.

In addition, foreign private issuers and U.S.-Canadian Multijurisdictional Disclosure System (MJDS) filers are exempt from the proposed pay ratio disclosure rules. Although these categorical carve outs are tremendously helpful in reducing the overall burden of compliance with the pay ratio disclosure requirement, significant burdens still remain for those issuers who are subject to the pay ratio disclosure rule, without the benefit of knowing what value, if any, investors will place on such disclosures.

Conclusion

The SEC estimates that approximately 3,830 issuers will be affected by the proposed pay ratio rules. The SEC received hundreds of comment letters from corporate representatives urging the commission to limit disclosures to full-time U.S. employees and for a longer transition period for implementing the new rules.

However, the SEC received more than 116,000 comment letters from labor groups, investor advocates and institutional and individual shareholders in support of the proposed rule, as well as a letter in support of the proposed rule signed by 30 Democratic House members. Proponents of the proposed rule claim that the pay ratio disclosure shines a light on the company pay

[17] 15 U.S.C. § 78r.
[18] Pub. L. No. 107-204, 116 Stat. 745.
[19] Pub. L. No. 112-106, 126 Stat. 306 (2012).

ladder and that employee productivity, morale and loyalty suffer if the pay ratio is too great.

Even with the flexibility given in the proposed rules for calculating the median employee (i.e., through statistical sampling using methodology set forth in the preamble to the proposed rules which focused on Bureau of Labor Statistics information), issuers face significant data collection challenges.

Although the potential benefits of the pay ratio disclosure are speculative, the costs of compliance are real. The proposed rule does little to balance the cost-benefit misalignment for those issuers who are subject to the rule. Such costs will inevitably translate into lower earnings per share, lower dividends or reductions in other performance metrics that shareholders expect from issuers.

So while the general public (including the media) who aren't shareholders may look forward to the juicy gossip involved in the CEO pay ratio disclosures, shareholders (and the economy as a whole) will suffer actual losses due to the increased cost of compliance.