



Corporate and Association Counsel Division

by Rachel V. Rose, J.D., M.B.A.

What You Need To Know: Dodd-Frank Pay-Ratio Disclosure Rules

Compensation is at the forefront of everyone's mind.

Both in-house and external counsel may be called upon to provide advice in relation to executive compensation. If the company is a publicly traded company, additional Securities and Exchange Commission (SEC) reporting obligations exist pursuant to the Dodd-Frank Wall Street Reform and Consumer Protection Act (Dodd-Frank)¹ and related securities laws and regulations.

Before diving into the specifics, it is important to appreciate the nuances of some basic terms that are referenced in the proposed rule: mean, median, and mode. “The ‘mean’ is the ‘average’ you’re used to, where you add up all the numbers and then divide by the number of numbers. The ‘median’ is the ‘middle’ value in the list of numbers. To find the median, your numbers have to be listed in numerical order, so you may have to rewrite your list first. The ‘mode’ is the value that occurs most often. If no number is repeated, then there is no mode for the list.”² Because of the September 2013 SEC proposed rule implementing Section 953(b) of Dodd-Frank requiring companies to disclose the median of the annual total compensation of its employees and the ratio of the median to the annual pay of its chief executive officer (CEO),³ appreciating the aforementioned terms is imperative. Presently, no final rule exists, but counsel should remain vigilant.

Dodd-Frank Section 953(b)

In general, Section 953 addresses executive compensation disclosures. The first part of this section of the law amended Section 14 of the Securities Exchange Act of 1934 (15 U.S.C. 78n) by adding the provision of pay versus performance.⁴ Basically, the SEC requires each “issuer to disclose in any proxy or consent solicitation material for an annual meeting of the shareholders of the issuer a clear description of any compensation required to be disclosed under section 22 of title 17, Code of Federal Regulations (or any success thereto), including information that shows the relationship between the executive com-

pensation actually paid and the financial performance of the issuer, taking into account any change in the value of the shares of stock and dividends of the issuer and any distributions.”⁵ This is accomplished by adhering to the guidelines in the rules, which are discussed below.

Like most areas of law, there is discretion by the government agency, as well as exceptions to the general rule described above. First, Congress gave the SEC discretion to permit various exchanges to “prohibit the listing of any security of an issuer that is not in compliance with the requirement.”⁶ The opportunity to cure defects within a timely manner was also provided, as well as the controlled company exemption.⁷ So, what is a controlled company for purposes of this provision?

[A] “controlled company” means an issuer—

- (A) that is listed on a national securities exchange or by a national securities association; and
- (B) that holds an election for the board of directors of the issuer in which more than 50 percent of the voting power is held by an individual, a group, or another issuer.⁸

These items lay the foundation for the SEC’s proposed rule for pay ratio disclosure, which was released in September 2013.⁹

Proposed Rules

The SEC voted 3-2 to set forth new rules in accordance with Section 953 of Dodd-Frank, “requir[ing] public companies to disclose the ratio of the compensation of its chief executive officer (CEO) to the median compensation of its employees.”¹⁰ The proposed rules were effectuated in September 2013.¹¹ Looking on the bright side, no particular methodology was prescribed for determining the pay ratio, hence giving different types of companies discretion over how that is determined.

Rachel V. Rose, J.D., M.B.A., is a principal with Rachel V. Rose—Attorney at Law PLLC, located in Houston. She is currently the chair of the FBA Corporate and Association Counsel Division. Rose is the co-editor of the American Health Lawyers Association’s Enterprise Risk Management Handbook for Healthcare Entities (Second Edition), vice chair of the Distance Learning Committee for the Health Law Section of the American Bar Association, and a co-author of the book The ABCs of ACOs. Disclaimer: This article contains general information only, and Deloitte is not, by means of this article, rendering accounting, business, financial, investment, legal, tax, or other professional advice or services. This article is not a substitute for such professional advice or services, nor should it be used as a basis for any decision or action that may affect your business. Before making any decision or taking any action that may affect your business, you should consult a qualified professional adviser. Deloitte shall not be responsible for any loss sustained by any person who relies on this article. © 2015 Rachel V. Rose. All rights reserved.

For example, a company would be permitted to identify the median employee based on total compensation using either its full employee population or a statistical sample of that population.

A company could, for example, identify the median of its population or sample:

- Using annual total compensation as determined under existing executive compensation rules.
- Using any consistently used compensation measure such as compensation amounts reported in its payroll or tax records. A company would then calculate the annual total compensation for that median employee in accordance with the definition of total compensation set forth in the SEC's executive compensation rules.¹²

When a population is utilized, all full-time, part-time, seasonal, and temporary employees who were employed at the end of the fiscal year by the company and its U.S. and foreign subsidiaries need to be included. One way to reduce the ratio is to include health benefits in the compensation amount. This benefit reduces the gap between the CEO and the employees.

What it Means For General Counsel

Despite receiving more than 127,000 comments, the SEC still has not provided additional guidance or issued a final rule. A good place to start is reviewing the SEC's website for guidance and updates. Also, find a good statistician to conduct the mean, median, and mode valuations. "As required by the Dodd-Frank Act, median employee total compensation would be calculated using the definition of 'total compensation' in existing executive compensation rules, namely Item 402(c)(2)(x) of Regulation S-K. Item 402(c)(2)(x) requires companies to provide extensive compensation information about the CEO and other named executive officers, which is not ordinarily calculated for all employees."¹³ Finally, review all relevant and referenced laws and regulations.

As I learned at a recent continuing legal education (CLE) presentation, there are a couple of key items companies should be cognizant of disclosing in their compensation discussion and analysis, according to Michael Kesner:

- [T]he ratio of the CEO's annual total compensation for the fiscal year to the median employee's annual total compensation for year;
- [T]he methodology used to determine the median employee; and
- [O]ther assumptions and estimates used to identify the median employee or total compensation (or elements of total compensation).¹⁴

Because the final rules have not been approved to date, it is unlikely that the first year of compensation subject to the pay ratio test would be 2015, with disclosure requirements in 2016. Instead, it looks like 2016 would be the first year of the test, with commencement of disclosure occurring in 2017.



Conclusion

The pay-ratio disclosure rule is significant in many ways. By appreciating what the fundamental terms are, what resources are needed, and what disclosures are required, counsel can be proactive. Doing so will help prevent a commission from potentially prohibiting the listing of the issuer. ☉

Endnotes

¹Dodd-Frank Wall Street Reform and Consumer Protection Act (Pub. L. 111-203 (Jul. 21, 2010).

²See www.purplemath.com/modules/meanmode.htm (last accessed Dec. 6, 2014).

³*Id.* at Section 953—Executive Compensation Disclosures, available at www.gpo.gov/fdsys/pkg/PLAW-111publ203/pdf/PLAW-111publ203.pdf.

⁴*Id.* at Section 953(a)(i).

⁵*Id.*

⁶*Id.* at Section 953(f)(1).

⁷*Id.* at Section 953(f)(2),(3).

⁸*Id.* at Section 953(g)(1), (2)(A), (B).

⁹Securities and Exchange Commission, *SEC Proposes Rules for Pay Ratio Disclosure*, available at www.sec.gov/News/PressRelease/Detail/PressRelease/1370539817895#.VIOJ-r6aHKA.

¹⁰*Ibid.*

¹¹See www.sec.gov/rules/proposed/2013/33-9452.pdf (last accessed, Dec. 6, 2014).

¹²*Supra*, n. 10.

¹³*Ibid.*

¹⁴Michael Kesner, *Presentation—SEC's CEO Pay-Ratio Disclosure Rules: Do Tell*, Joint Committee on Employee Benefits, 2014 Executive Compensation National Institute (Nov. 13, 2014).