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SEC proposes rules to disclose pay ratios

By Stephen M. Honig

"And the king said, 'Divide the living child in two, and give half to the one, and half to the other.'"
— 1 Kings 3:24-3:25

On Sept. 18, the SEC at long last proposed an "amendment" to Regulation SK to institute pay ratio disclosures mandated in Section 953(b) of the Dodd-Frank Act. A 60-day public comment period expires in November.

As King Solomon tried to do justice between two harlots claiming the baby, the SEC took its statutory requirement and cut its impact in half. No constituency will be happy — perhaps because the SEC started with a particularly ugly baby.

Amendment

The statute requires '34 Act registrants to disclose median annual compensation of all employees and the CEO, and the compensation ratio between the two.

Before promulgating the amendment, the SEC received 22,860 comment letters and a petition signed by 84,700 people. Many criticized the statute as requiring useless information. Others, such as the AFL-CIO, saw public policy benefits.

Dodd-Frank mandated the amendment to depress CEO compensation. That is a social goal, but is inconsistent with the SEC's mission of disclosure and regulating capital markets. The SEC, in this undertaking, is a tool for social management.

The SEC staff is hard-pressed to identify specific benefits from the disclosure, noting in its release that "[t]here is limited legislative history to inform our understanding of the legislative intent … or the specific benefits the provision is intended to secure."

SEC action

The commissioners expressed political stances at the Sept. 18 meeting. Commissioner Luis A. Aguilar, member of the three-person "liberal" majority, maintained that "shareholders have the right to know how their company's internal pay comparisons may impact employee morale, productivity, hiring, labor relations, succession planning, growth and incentives for risk-taking."

The two minority commissioners were scathing in dissent:

- Daniel M. Gallagher: "There are no — count them, zero — benefits that our staff had been able to discern." (That is hyperbole; the staff could not quantify economic benefits, but did identify other possible benefits.)
- Michael S. Piwowar: Quoting Dickens, he observed that this was "the worst of times" and that the reason for ratio disclosure "is to shame CEOs." He foresaw competitive disadvantage to U.S. companies with large workforces and global operations, a move toward temporary and seasonal workers (sometimes excluded from the calculation), and outsourcing of low-paid jobs. He objected "to the commission even considering" the ratio disclosure, ignoring that federal law requires it.

It's complicated

The statute is clear: state the ratio of median employee earnings to CEO earnings. Why did the SEC end up with a 162-page release?

First, we compare earnings of a "median" worker to a CEO. But we must use the formulation the SEC applies to CEOs. Companies don't maintain records for workers in the same way. Accounting standards to track employee compensation do not match SEC formulations for CEO compensation.

Item 402 of Regulation SK permits the exclusion of personal benefits in CEO compensation as long as the total value for the employee is less than $10,000, a fine exclusion for a CEO earning a million dollars but not for an employee earning $30,000.

Larger companies maintain complex payroll, benefit and pension systems, including systems maintained by third-party administrators. They have employees world-wide. Records are kept in different formats. How should a registrant calculate employee compensation?

The SEC states it will not tell a registrant how to calculate median compensation, opting instead for flexibility. Companies may consider workforce size, organizational stratification of pay levels, types of compensation, differences in currency, number of tax and accounting regimes, number of payroll systems and indeed anything else, and make reasonable estimates for all matters, as well as using statistical sampling.

There is discussion of sample size: Select a small number of employees from different employee cohorts, calculate compensation, and then find the median within that group. You thus might calculate compensation of only 100 or 1,000 employees, even if you had thousands.

The SEC fudges where disclosure should be made. The statute refers to "filings," but the SEC interprets that as only certain filings — 10K, registration statements and proxy statements. It then asks whether it has correctly cut the disclosure baby in half.

The SEC also cuts the number of covered companies. It must exempt "emerging growth companies," because the 2012 Jobs Act exempts for five years any newly public company with less than $1 billion gross and less than $700 million market cap.

The SEC on its own volition also exempts "smaller reporting companies" (public float under $75 million) and foreign private issuers. (By placing the onus only on American companies, U.S. companies are put at a competitive disadvantage by requiring additional disclosures and added cost.)

You might think that expressing the ratio would be simple: For example, the CEO earns 200 times as much as the median employee. But because the statute expresses the disclosure in different order, the SEC requires that median employee compensation be expressed first: The ratio would be "1 to 200."

Further complications: The statute says "all employees." The senator who drafted the statute wrote to the SEC saying, in effect, "What part of 'all' do you not understand?"

Undaunted, the SEC cuts out certain "employees." Part-time, seasonal and temporary workers are included only if they are employed on the last day of the year. Will that lead to companies manipulating employment dates? Independent contractors and "leased workers" are not included.

"Employees" means not only employees of the registrant, but also of its subsidiaries. It is unclear how affiliated companies would be handled. This provision makes sense; a company could manipulate its ratio by dropping lower-paid employees into a subsidiary. The SEC asks for comment on whether employees of subsidiaries should be included only if the subsidiary's financials are consolidated with the registrant's statements.

"Employees" includes offshore employees, who may be paid at a very low rate. It would be permissible, however, to have additional disclosure comparing CEO compensation separately for the U.S. and offshore median employees.

Assume a U.S. employee earns $100 and a loaf of bread costs $1. An offshore employee earns $10 but a loaf of bread cost a penny. To inflate the CEO ratio because one pays an offshore employee only $10 is to miss the point that such offshore employee may well be better compensated.

Should a company be permitted to annualize earnings of employees not employed during the entire fiscal year, to "more accurately reflect the employment relationship" and also, incidentally, drive down the ratio? The amendment permits but does not require annualization of compensation of permanent employees if employed less than one year.

The European Union and certain foreign countries have privacy regulations preventing the transmission of employee data. Companies must undertake some statistical analysis, which end-runs that issue.

What about the usefulness of the ratio in comparing one company to another? The SEC went out of its way to provide granular comparability in adopting XBRL financial reporting. In the proposing release, the SEC abandons that goal: "We do not believe that improving the comparability of the disclosure across companies by mandating a specific method for identifying the median would be justified in light of the cost that would be imposed."

One quirk: The statute requires compensation be calculated pursuant to SK Item 402 as in force on July 20, 2010. What happens when there is a subsequent amendment? That might mean greater cost for companies, as they may possess data conforming with newer requirements (particularly for CEOs) and yet be compelled to calculate pay ratio based on an historical formula.

The amendment requires "a brief overview" of assumptions and estimates used in calculating the median. What registrant, or its counsel, will have the nerve to resist detailed discussion of shortcuts taken that are not specifically permitted under an SEC safe harbor?

C-level management will not be pleased to learn that pay ratio disclosure will be treated by the commission as “filed” and not “furnished,” based on the use of the word “filing” in the statute. That means that the CEO and CFO, pursuant to SOX, must certify the accuracy of the disclosures, against which the CEO’s own compensation is measured.

Well-advised CEOs will press for broad disclosure of methodology, to support CEO certification affecting the CEO’s own compensation.

There is a phase-in for compliance; registrants must comply at the end of the first fiscal year commencing after the effective date of the amendment. If effective in 2014, a Dec. 31 registrant need not comply until filings required during 2016.

Conclusion

Comments to the SEC will address both policy (“it’s a bad/good idea”) and implementation (“you should change this particular requirement because …”).

Ultimately, there will be a final amendment; Dodd-Frank is a law, not a suggestion. The final amendment will continue to split the 953(b) baby by requiring some form of truncated disclosure.

Whatever eventuates, it will cost registrants lots of money and not affect CEO compensation one iota.

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