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Davis Polk

Davis Polk & Wardwell LLP
450 Lexington Avenue
New York, NY 10017
212 450 4000 tel
212 701 5800 fax

Re: Comments on Proposed New Item 402(u) of Regulation S-K (Pay Ratio Disclosure); File Number S7-07-13

December 4, 2013

VIA E-MAIL: rule-comments@sec.gov

Ms. Elizabeth M. Murphy
Secretary
Securities and Exchange Commission
100 F Street, NE
Washington, DC 20549-1090

Dear Ms. Murphy:

We are submitting this letter in response to the solicitation by the Securities and Exchange Commission (the "**Commission**") for comments on the Commission's proposed new Item 402(u) of Regulation S-K (the "**Proposed Rule**"). Section 953(b) of the Dodd-Frank Wall Street Reform and Consumer Protection Act of 2010 (the "**Dodd-Frank Act**") directs the Commission to amend Item 402 to require each registrant to disclose: (i) the median of the annual total compensation of all employees of the registrant, except the chief executive officer, determined in accordance with Item 402(c); (ii) the annual total compensation of the chief executive officer of the registrant; and (iii) the ratio of these two amounts. On September 18, 2013, the Commission released the Proposed Rule implementing Section 953(b) of the Dodd-Frank Act, which was published in the Federal Register on October 1, 2013.[1]

We appreciate the Commission's desire to reduce the burden of compliance and provide flexibility to registrants in the calculation and disclosure of the pay ratio. In particular, we are supportive of:

- Providing flexibility to registrants in determining the median employee, including the flexibility to determine the compensation metric to be used to identify the median, and the ability to use statistical sampling and reasonable estimates;
- Exempting emerging growth companies, smaller reporting companies and foreign private issuers from the Proposed Rule; and
- Limiting the pay ratio disclosure to those filings requiring Item 402 disclosure.

While we support the Commission's approach with respect to the provisions noted above, we respectfully request that the Commission consider the following recommendations for several changes and clarifications to the Proposed Rule.

[1] Pay Ratio Disclosure, 78 Fed. Reg. 60560 (proposed Oct. 1, 2013) (to be codified at 17 C.F.R. pts. 229, 249) (the "**Release**").

■ *Timing of Determining Median Employee.*

Instruction 1 of the Proposed Rule provides that the pay ratio disclosure for any given fiscal year must be presented in the registrant's annual report on Form 10-K for that fiscal year, or in a proxy or information statement filed within 120 days after the end of the fiscal year. Because the median employee is required under the Proposed Rule to be based on the employee population on the last day of the registrant's fiscal year, registrants would have only 120 days to determine the median employee and calculate annual compensation of the median employee.[2] We believe that this 120-day period may not be sufficient for registrants to compile the data necessary to determine the median employee and calculate the pay ratio.

We recommend providing registrants with the option to select a date prior to the registrant's fiscal year end as the calculation date for purposes of determining the median employee. For instance, the rule could provide that registrants must determine the median employee based on the registrant's employee population on a date within a designated time period, such as a date occurring during the 90-day period preceding the fiscal year end. Under this method, a registrant could begin the task of identifying its median employee in advance of its fiscal year end, which is the most costly and time-consuming part of the pay ratio calculation. Calculation of the annual total compensation for the median employee could still be based on compensation earned during the applicable fiscal year.[3]

Similar approaches have been used by other federal rulemaking authorities to address calculation methodologies. For example, to determine which employees will be classified as "specified employees" under the nonqualified deferred compensation tax rules of Section 409A of the Internal Revenue Code of 1986, as amended (the "**Code**"), the Internal Revenue Service permits companies to select their own "specified employee" identification date so long as the company uses the same identification date for all nonqualified deferred compensation plans and any change to the identification date is not effective for 12 months.[4] In addition, the proposed regulations implementing the employer mandate of the Patient Protection and Affordable Care Act allow large employers to use an optional look-back measurement period, selected by the employer, of between three months and 12 months to determine whether employees are considered "full-time" employees who must be provided with health coverage.[5] To assess whether investment funds qualify as "venture capital operating companies" or "real estate operating companies" for purposes of the Department of Labor's "plan asset regulations" under the Employee Retirement Income Security Act of 1974, as amended, the Department of Labor permits funds to calculate their compliance with the applicable investment thresholds on any day chosen by the fund during a pre-established 90-day annual valuation period.[6]

Some have expressed the concern that allowing registrants to select a median employee calculation date creates the potential for manipulation of the pay ratio calculation. We believe this concern is unwarranted, particularly if the choice is restricted to a limited time period (such as the last fiscal quarter), since in general the employee population of a registrant would not vary significantly over such a period.

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[2] We note that many calendar year companies file their proxy statements as early as March, in some cases to fulfill bylaw provisions requiring specific annual meeting dates, which would provide for fewer than 90 days after fiscal year end to calculate the pay ratio.

[3] We acknowledge that it is possible that a median employee identified prior to fiscal year end may not be employed at the fiscal year end. Registrants could, however, make reasonable estimates to determine the annualized total compensation for the median employee if he or she has terminated service prior to fiscal year end.

[4] See 26 C.F.R. § 1.409A-1(i)(3). Under Section 409A of the Code, public companies must delay for six months payments of nonqualified deferred compensation to certain "specified employees" that become due upon their termination of employment. Specified employees generally include the company's highest paid 50 employees (or, if fewer, the highest paid 10% of employees). Accordingly, public companies must determine their "specified employee" population each year, as employee compensation is subject to change from year to year.

[5] See Shared Responsibility for Employers Regarding Health Coverage, 78 Fed. Reg. 217 (proposed Jan. 2, 2013) (to be codified at 26 C.F.R. pts. 1, 54, 301).

[6] See 29 C.F.R. §§ 2510.3-101(d), (e).

Allowing registrants to perform the median employee analysis before fiscal year end will simply permit them to complete this task outside of the crush of the busy fiscal year end.

■ *Treatment of Part-Time, Seasonal and Temporary Employees.*

The Proposed Rule states that "employee" or "employee of the registrant" includes all full-time, part-time, seasonal or temporary employees employed by the registrant or its subsidiaries on the last day of the registrant's fiscal year.

We recommend that the determination of the median employee include only full-time employees of registrants. We believe that the inclusion of part-time, seasonal and temporary employees distorts the calculation. The calculation of the annual total compensation of the chief executive officer of the registrant values the compensation of the chief executive officer as a full-time employee. A ratio of this full-time employee's compensation to the median compensation of all employees that includes part-time, seasonal and temporary employees is not an apples-to-apples comparison and may be misleading. In addition, including part-time, seasonal and temporary employees could be burdensome to registrants, because non-full-time employees are often paid under different compensation and benefit regimes than full-time employees. For example, certain temporary employees or interns might receive a lump-sum stipend rather than a regular salary or wage. As a result, identifying an appropriate, consistently applied compensation measure to determine the median employee could be more difficult.

We acknowledge that the Dodd-Frank Act directs registrants to find the median of the annual total compensation of "all employees" in calculating the pay ratio. However, in light of the fact that the rules would otherwise require comparability between two unequal and very different measurements and the Commission's desire to implement the statute in a way that reduces compliance costs for registrants, we believe that it would be consistent with the statutory mandate to permit registrants to exclude part-time, seasonal and temporary employees from their pay ratio disclosure.

If the Commission believes that the exclusion of part-time, seasonal and temporary employees would produce inadequate disclosure, we alternatively recommend that registrants be permitted to exclude these employees, but supplement the pay ratio disclosure by describing how the pay ratio might differ if the excluded employees had been included in the calculation. For example, a registrant that excludes its part-time, seasonal and temporary employees from its pay ratio calculations could state that had it included part-time, seasonal and temporary employees in its pay ratio calculation, its pay ratio would likely have been higher.

■ *Definition of "chief executive officer".*

The Proposed Rule defines "chief executive officer" in the same manner as "principal executive officer", as defined in Item 402(a)(3). Under Item 402, a registrant can have more than one principal executive officer if more than one person served in that capacity during the most recently completed fiscal year. Accordingly, under the Proposed Rule, a registrant could theoretically be required to disclose more than one pay ratio (*i.e.*, one for each principal executive officer serving during the applicable fiscal year). For purposes of the pay ratio disclosure, we recommend that the Commission require the disclosure of the pay ratio for only the individual serving as principal executive officer on the last day of the registrant's most recently completed fiscal year, which we believe is the most relevant ratio.[7]

[7] We acknowledge that if a new chief executive officer is hired during the later part of a registrant's fiscal year, his or her annual total compensation could represent less than a full year's compensation. We note that this would have been an issue regardless of whether the ratio was given with respect to multiple chief executive officers serving during the fiscal year. This issue could be addressed by requiring registrants to annualize the annual total compensation for the chief executive officer serving at fiscal year end.

- *Consistently Applied Compensation Measure.*

The Proposed Rule permits registrants to use any consistently applied compensation measure to identify the median employee. In light of the differences in compensation practices within a registrant across different jurisdictions, geographic locations and lines of business, we recommend that the Commission clarify that registrants may use one or more comparable compensation measures to identify the median employee. For example, a registrant using cash compensation as its consistently applied compensation measure for purposes of determining its median employee may intend to include only base salary and bonus amounts for its U.S. employees, but may find it appropriate to also include other benefits commonly considered to be part of base compensation for its non-U.S. employees, such as meal stipends or automobile allowances. We believe that it would be appropriate for registrants to use these reasonably comparable measures, even if not the exact same measure, across different employee populations in order to provide for more meaningful comparisons across the varying compensation structures in international jurisdictions and to reduce unnecessary burdens on registrants.

The Proposed Rule also recognizes that the annual period used by registrants in the ordinary course of business to track the compensation measure used to determine the median employee (such as payroll or tax records) can differ from the registrant's fiscal year. We recommend that the Commission confirm that registrants are permitted to use any annual period to calculate the compensation measure being used to determine the median employee as long as such annual period substantially relates to the fiscal year for which pay ratio disclosure is being provided, regardless of whether the last day of such annual period falls before or after the end of the registrant's fiscal year or calculation date for purposes of determining the median employee. For example, if the registrant has a fiscal year ending on November 30, the registrant would be permitted to determine the median employee based on a compensation measure calculated from January 1 through December 31 of that year, as long as such records substantially relate to the fiscal year for which pay ratio disclosure is being provided.

- *Employees of Unconsolidated Subsidiaries.*

The Proposed Rule states that "employee" or "employee of the registrant" includes all employees of any of a registrant's "subsidiaries", as defined under Rule 405 under the Securities Act of 1933, as amended, and Rule 12b-2 under the Securities Exchange Act of 1934, as amended (the "**Exchange Act**").[8] Rule 405 and Rule 12b-2 define a subsidiary as "an affiliate controlled by the registrant directly or indirectly through one or more intermediaries".[9] Because of the broad definition of "subsidiary", registrants could be required to include employees of unconsolidated subsidiaries who are not generally considered, and do not consider themselves to be, employees of their parent registrants.

We recommend that the final rules include only employees of consolidated subsidiaries in the pay ratio calculation. Unconsolidated subsidiaries are not included in the financial statements of the registrant and are rather accounted for as an investment of the registrant for financial reporting purposes. Registrants may have little impact or influence on the employment or compensation of employees at affiliates that are not consolidated subsidiaries, and such information regarding those employees may not be readily available or ever accessible to the registrant to the degree needed to accurately determine the pay ratio, which further suggests that these employees should be excluded from the final rules.

The Commission states that its approach is intended to be consistent with the requirement under Item 402 of Regulation S-K to include disclosure with respect to certain employees of, and compensation from, a registrant's subsidiaries.[10] In order for an employee of a registrant's subsidiary to be included as an executive officer of the registrant (and thus to be subject to Item 402 disclosure), however, such employee must meet the test set forth under Rule 3b-7 under the Exchange Act, which would require that the

[8] See Release at 60565.

[9] 17 C.F.R. § 230.405; 17 C.F.R. § 240.12b-2.

[10] Release at 60566.

employee perform a policy function for the registrant.[11] Employees of unconsolidated subsidiaries would generally not fall under this definition unless such employees had other functions at the registrant in addition to their roles as employees of the subsidiaries.

- *Transition Period.*
    - *Compliance Date.*

The Release provides that registrants will be required to include the new pay ratio disclosure with respect to compensation for the registrant's fiscal year beginning on or after the effective date of the Proposed Rule. We understand, based on the examples set forth in the Release, that the Commission's intent is that if the Proposed Rule becomes effective at any time in 2014, registrants would provide their first pay ratio disclosure with respect to their 2015 fiscal year in their proxy statements filed in 2016. As drafted, the Proposed Rule could be read to require registrants with non-calendar year fiscal years to provide the new pay ratio disclosure prior to the 2016 proxy statement. For example, if the Proposed Rule becomes effective in March 2014, a registrant with a fiscal year ending on June 30 (*i.e.*, whose fiscal year runs from June 30, 2014 to June 30, 2015) would appear to first need to provide the pay ratio disclosure in its proxy or information statement for the fiscal year ended June 30, 2015, which would be filed in 2015. We recommend that the Commission revise the rule to clarify that the first required disclosure is in the 2016 proxy statement for all registrants, regardless of when the rule becomes effective in 2014, if final rules are indeed implemented in 2014.

- *Treatment of Registrants Undergoing Business Combinations.*

We believe that registrants that have recently undergone a significant corporate transaction, such as a merger, acquisition, spinoff, business combination or other similar transaction (a "**Significant Corporate Transaction**"), should be provided with transition relief similar to that provided to newly public companies under Instruction 5 of the Proposed Rule.

A company undergoing a Significant Corporate Transaction that impacts the company's employee population will likely face significant challenges in calculating its pay ratio and may need additional time to modify and/or aggregate compensation data and compile the information necessary to compute the pay ratio with respect to its post-transaction employee population. For instance, a registrant that acquires another company in a transaction that closes immediately prior to the acquirer's fiscal year end, under the Proposed Rule, would be required to report its pay ratio based on the new post-transaction employee population in its Item 402 disclosure covering the year in which the transaction occurred, which disclosure would be required to be filed within at least 120 days after fiscal year end. Whether the target company was a public company that used a different calculation method to determine its median employee or a private company not subject to the pay ratio disclosure rules, the acquirer will likely need additional time to centralize compensation data relating to the target company's employees and to develop an appropriate methodology for calculating the pay ratio.

We recommend permitting registrants that undergo a Significant Corporate Transaction to elect to disregard changes in its employee population resulting from the Significant Corporate Transaction in calculating their pay ratio until the filing of their annual report on Form 10-K for the first fiscal year commencing on or after the closing date of the transaction, or, if later, the filing of their proxy or information statement relating to their next annual meeting of shareholders if filed within 120 days after fiscal year end.

- *Disclosure Requirements.*

Instruction 2(iv) of the Proposed Rule states that registrants must briefly disclose any methodology, material assumptions, adjustments or estimates used to identify the median employee, but that this overview should be brief and need not provide technical analyses or formulas. The Commission indicates that it does

[11] See 17 C.F.R. § 229.402(a)(3), Instruction 2.

not believe that a detailed technical discussion including statistical formulas, confidence levels or the steps used in the data analysis would enhance the usefulness of the disclosure.[12] However, the Commission also states that "when statistical sampling is used, registrants should disclose the size of both the sample and the estimated whole population, any material assumptions used in determining the sample size, which sampling method (or methods) is used, and, if applicable, how the sampling method deals with separate payrolls such as geographically separated employee populations or other issues arising from multiple business or geographic segments".[13] We agree with the Commission that registrants should only be required to provide a brief overview, which may be difficult if they are expected to provide this type of specification about sampling as part of the full information about the method, assumptions, adjustments and estimates. The Commission should confirm that detailed technical data, such as sample size or confidence levels, is not expected or encouraged.

The Proposed Rule would also require disclosure of any material change to the methodology or material assumptions, adjustments or estimates from the prior year, including a description of the change, the reasons for the change and an estimate of the impact of the change on the median and the pay ratio. While we agree that it is reasonable to require disclosure regarding material changes to a registrant's methodology, we would recommend removing the requirement that the registrant provide an estimate of the impact of the change on the median and the ratio. Any such estimate would be difficult to accurately ascertain without calculating two ratios—one using the prior methodology and one using the new methodology—which would be overly burdensome to registrants.

* * *

We appreciate the opportunity to participate in this process, and would be pleased to discuss our comments or any questions the Commission may have with respect to this letter. Any questions about this letter may be directed to Ning Chiu, William Kelly, Kyoko Takahashi Lin or Richard Sandler at 212-450-4000.

Very truly yours,

DAVIS POLK & WARDWELL LLP

[12] Release at 60576.

[13] Id.