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Cost Benefit Analysis of Pay Disparity Disclosure

As we previously discussed in our memorandum of August 2, the Dodd-Frank Act directs the SEC to amend the proxy rules to require disclosure of the ratio of the median annual total compensation of a company's employees (excluding its chief executive officer) to the total annual compensation of its chief executive officer. For the sake of clarity, the median is the number exactly between the top and the bottom -- not the average. This means that, on its face, the rule would require each of the nation's 12,000 public companies to determine the value under the proxy disclosure rules of each element of compensation provided to each employee of the issuer on an annual basis and then to calculate the median amount of such compensation.

Based on the statute, it appears that this disclosure is required for all companies covered by the Securities Act of 1933 and the Securities Exchange Act of 1934, which includes, in addition to companies listed on a public exchange, companies with public debt and those that are otherwise obligated to file periodic reports with the SEC (but does not include foreign private issuers). Unlike other compensation-related provisions of the Act, such as say on pay, the Act does not appear to provide the SEC with express exemption authority from the pay ratio disclosure.

Prior to adoption of the enhanced executive compensation rules in 2006, commentators gave significant consideration to the burdens that would be associated with compilation of new compensation data for executive officers under the proposed revisions to Item 402 of Regulation S-K, as it was widely recognized that compliance was a substantial endeavor. In addition, the so-called "Katie Couric" rule that would have required compensation disclosure for up to three additional highly compensated employees (whether or not they were executive officers) was ultimately not implemented at least in part due to concerns about the burdens of compliance. Now, in the name of addressing the causes of the financial crisis, the Federal government has required public companies to undertake the same task for all employees, which at the largest public companies number in excess of 2,000,000 worldwide, with little warning, no obvious relation to the financial crisis and no obvious relevance to investors' decisions about whether to purchase shares in any given publicly traded company.

For most companies, this will be a significant undertaking, as it requires the gathering and compilation of compensation data on an annual basis, including salaries paid or earned, bonuses and commissions earned, equity compensation awards granted, pension accruals recognized, deferred compensation gains achieved and perquisites including certain training, relocation benefits and expatriate allowances provided on an individual-by-individual basis throughout the entire company. Tracking and calculating the necessary information will require for most companies an entirely new set of internal and disclosure controls and related infrastructure, systems and dedicated employees. The value of this disclosure to shareholders is unclear, as they generally understand that the chief executive officer is highly paid and, in most industries, earns multiples of the compensation earned by other employees. Moreover, even the political motive of the rule is dubious, given the fact that the pay of high earners (other than public company executive officers) has increased at a far greater rate in recent years than that of public company executive officers.

Compliance with the new rule presents a host of interpretive challenges of the Item 402 disclosure rules, since these rules are focused on executive compensation and do not necessarily translate to the compensation schemes applicable to the employee population at large. We are hopeful that the SEC will provide relief for some of the most administratively burdensome challenges of the new rule and, consistent with prior statements by SEC officials that it will likely not be applicable this proxy season, select an effective date that provides sufficient lead time for companies to comply with the new disclosure requirement. Areas of concern that merit SEC guidance include: (1) whether "all employees of the issuer" includes non-U.S employees, employees of non-wholly-owned subsidiaries, employees of joint ventures, part-time employees, union and/or leased employees, (2) whether compensation for this purpose includes pension accruals for union employees under multi-employer plans, pension accruals for employees under government and statutory pension schemes, which are the norm for employees outside of U.S. jurisdictions, (3) the treatment of terminated employees and newly-hired employees, and (4) the treatment of so-called "Cadillac health" and similar welfare plans that are provided to certain union employees but not other employees of an issuer generally. As a practical matter, due to the varied structures of corporations and the disparate characterization of employees among corporations, as well as the complexity of the executive compensation disclosure rules, the pay ratio disclosure, at least as a comparative tool among companies, will be unreliable. Moreover, to the extent that this disclosure has any effect on corporate behavior, it may simply lead more companies to hire individuals as consultants and not employees, to outsource more functions to third party service providers including those outside the U.S. and to freeze or eliminate their broad-based pension plans.

It is not clear that the cost, both in terms of dollars and corporate resources, of compliance with the pay disparity disclosure requirement bears any relationship to the benefits to be derived by investors. Companies are advised to keep abreast of regulatory developments and to begin to coordinate with payroll providers and systems specialists to understand the realm of the possible in terms of data compilation.

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