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SEC ADOPTS PAY RATIO DISCLOSURE RULE

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OVERVIEW OF THE PAY RATIO RULE

The Basic Rule

Reporting companies subject to the rule (Subject Companies) must disclose the ratio (pay ratio) for the most recent fiscal year of (a) the median of total compensation of all employees of the Subject Company other than the principal executive officer (PEO) to (b) the compensation of the PEO.

- For purposes of this requirement, either (i) the ratio must present the amount in (a) as equal to one, or (ii) the ratio may be expressed narratively as the multiple that the amount in (b) bears to the amount in (a).
- Under the rule, Subject Companies must identify a “median employee” whose compensation will represent “the median of total compensation of all employees” for purposes of the rule.

Identification of the Median Employee

The median employee generally need be identified only once every three years; however, the total compensation of the median employee for purposes of the pay ratio disclosure must be recomputed annually.

- If the Subject Company reasonably believes a change in its employee population would significantly impact the pay ratio discount, the median employee must be re-identified for the fiscal year in which the change occurred.

The rule provides some flexibility for a Subject Company in identifying the median employee:

- The median employee may be determined as of any date that is within the last three months of the fiscal year.
- The company can identify the median employee using annual total compensation or any other measure (e.g., salary and incentive bonuses) consistently applied among all employees.
    - The company may apply cost-of-living adjustments to compensation for jurisdictions other than the jurisdiction where the PEO resides.
- The company need not compute the compensation of every employee; it may use statistical sampling and/or other reasonable methods to determine the median employee.
- The company may use reasonable estimates in the methodology used to identify the median employee and in the calculation of compensation used to determine the median employee.
- The company may annualize total compensation for permanent employees first employed during the subject fiscal year; however, it may not annualize compensation for temporary or seasonal employees and may not make full-time equivalent adjustments.

The rule provides for the exclusion of certain non-U.S. employees in determining the median employee:

- <u>Data Privacy Exception</u>—allows for the exclusion of foreign employees where the laws of the foreign jurisdiction governing data privacy render the company unable to obtain necessary information for compliance with the pay ratio rule without violating the laws, subject to specified conditions.
- <u>*De Minimis* Exception</u>—
    - Allows for exclusion of all non-U.S. employees if such employees constitute less than 5% of all U.S. employees.
    - Otherwise, Subject Companies are permitted to exclude up to 5% of all employees (minus the percentage of employees subject to the data privacy exclusion), provided that all employees in any particular jurisdiction must be excluded. If more than 5%

(or the net percentage after giving effect to the data privacy exception) of all employees are in a particular jurisdiction, none may be excluded under the *de minimis* exclusion.

Computing Total Compensation

Once the median employee is identified, total annual compensation for the PEO and the median employee generally must be based on the same methodology as is used to determine total compensation in the Summary Compensation Table typically included in a company's annual meeting proxy statement.

- However, personal benefits aggregating less than $10,000 and compensation under non-discriminatory benefit plans (which generally are excluded from the Summary Compensation Table) may be included in calculating the median employee's compensation (in which case, they also must be included in PEO compensation for this purpose).

Disclosures, Excluded Entities, Effective Date, Transition Provisions

- Extensive disclosure requirements apply, particularly where the Subject Company opts to take advantage of accommodations under the rule (e.g., use of data-sampling or other methodologies in lieu of calculating the compensation of each employee, cost-of-living adjustments, and data privacy or *de minimis* exceptions).
- The pay ratio rule does not apply to foreign private issuers, emerging growth companies, smaller reporting companies, Canadian issuers reporting under the U.S. Securities and Exchange Commission's (SEC's) Multijurisdictional Disclosure System, or registered investment companies.
- The rule applies to any fiscal year beginning on or after January 1, 2017.
  - For calendar year companies, the first pay ratio disclosure generally will cover 2017 and be included in the proxy statement for the 2018 annual meeting.
- Transition provisions apply with respect to newly public companies and companies that lose smaller reporting company or emerging growth company status.
- Other transition provisions apply in the context of mergers and acquisitions.

BACKGROUND

The pay ratio rule, which was adopted on August 5, 2015,[1] closely tracks the initial 2013 rule proposal,[2] subject to limited exceptions. The rule, which is discussed in further detail below, is the culmination of a somewhat contentious rulemaking process.

Numerous publications have reported the dramatic growth of chief executive officer (CEO)[3] pay over the past several decades, highlighting studies that show an increasing range in CEO-to-worker pay, with some studies and reports asserting that CEOs are paid 300, 500, or even 1,000 times more than average worker pay.[4] There have been ongoing debates about the meaning and significance of CEO-to-worker pay ratio information.

[1] *See* Securities Act Release No. 9877, "Pay Ratio Disclosure," August 5, 2015, available at sec.gov/rules/final/2015/33-9877.pdf (Adopting Release).

[2] Securities Act Release No. 9452, "Pay Ratio Disclosure," available at sec.gov/rules/proposed/2013/33-9452.pdf.

[3] Because the pay ratio rule refers to the "principal executive officer" (PEO) rather than the chief executive officer, our discussion of the provisions of the rule uses the term "PEO."

[4] *See*, e.g., "Despite Federal Regulation, C.E.O.-Worker Pay Gap Data Remains Hidden," New York Times, (April 10, 2015), available at nytimes.com/2015/04/12/business/despite-federal-regulation-ceo-worker-pay-gap-data-remains-hidden.html.

The Dodd-Frank Wall Street Reform and Consumer Protection Act (Dodd-Frank Act),[5] enacted in July 2010, provided a point of focus on the debate. Section 953(b) of the Dodd-Frank Act directs the SEC to amend Item 402 of Regulation S-K to require "each issuer" to disclose the following:

- the median of the annual total compensation of all [emphasis added] employees of the issuer, except the chief executive officer (or any equivalent position) of the issuer;
- the annual total compensation of the chief executive officer (or any equivalent position) of the issuer; and
- the ratio of the median of the total compensation of all employees of the issuer to the annual total compensation of the chief executive officer of the issuer.

Section 953(b) also requires that the total compensation of an employee of an issuer "shall be" determined using the highly prescriptive definition of "total compensation" in Item 402(c)(2)(x) of Regulation S-K.[6]

In September 2013, the SEC proposed amendments to Item 402 of Regulation S-K to implement Section 953(b) of the Dodd-Frank Act. More than 287,000 comments were submitted regarding the rule proposal. Many commenters contended that the rule, as proposed, would impose substantial costs and burdens on companies without any corresponding benefit to investors. In particular, these commenters argued that requiring the ratio to be based on "all" employees would be overly burdensome and unfairly skew the resulting ratio.[7] At the open meeting of the SEC on August 5, 2015 held for the Commissioners to consider and vote on finalizing the pay ratio rules, Chair White stated that "[t]o say that the views on the pay ratio disclosure requirement are divided is an obvious understatement."[8] The disparity of views on the pay ratio rule was underscored by the dissents of two of the five Commissioners on the vote to approve the rule.[9] Nevertheless, on August 5, 2015, the SEC adopted its pay ratio rule as required by the Dodd-Frank Act.

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[5] Public Law No. 111-203, sec. 953(b), 124 Stat. 1376, 1904 (2010), as amended by Public Law No. 112-106,126 Stat. 306 (2012).

[6] Although Section 953(b) refers to Item 402(c)(2)(x) as in effect on the day before the date of enactment of the Dodd-Frank Act, the SEC explained that it did not include the reference in the rule because no changes had been made to Item 402(c)(2)(x) since the enactment of the Dodd-Frank Act and it will address the "as in effect" requirement in Section 953(b) if it amends Item 402(c)(2)(x) in the future.

[7] A number of these commenters suggested that the SEC should consider allowing companies to exclude from the proposed pay ratio calculations certain categories of employees, such as non-U.S. workers and part-time, temporary, and seasonal workers that would, in their view, distort the calculation. In contrast, many other commenters contended that the pay ratio information was needed to provide important transparency on executive compensation and enable investors to make more informed decisions when voting on the election of directors responsible for CEO compensation and on say-on-pay.

On June 4, 2015, to assist the SEC in developing final rules regarding pay ratio disclosure, the SEC's Division of Economic and Risk Analysis (DERA) issued a memorandum providing a technical analysis on the potential effects on the proposed pay ratio calculation of the exclusion of different percentages of employees. DERA concluded that, depending on the percentage of employees excluded from the calculation, whether the excluded employees were paid above or below the median pay and other technical factors, the pay ratio figure could vary considerably, with the variance increasing with the percentage of employees excluded. Specifically, DERA's analysis stated that the exclusion of 5% of employees could cause the pay ratio estimate to decrease by up to 3.4% or increase by up to 3.5%, resulting in a deviation range of 6.9%, whereas the exclusion of 20% of employees could cause the pay ratio estimate to decrease by up to 13% or increase by up to 15%, resulting in a deviation range of 28%. The SEC made the analysis available for public comment and extended the comment period for the proposed rules until July 6, 2015. On June 30, 2015, DERA extended its technical analysis in another memorandum, noting that its extended analysis was in line with the original analysis.

[8] Chair Mary Jo White, Statement at Open Meeting on Security-based Swap Rules Under Title VII and on Pay Ratio Disclosure Rule, August 5, 2015, available at sec.gov/news/statement/statement-at-open-meeting-on-sbs-and-pay-ratio-disclosure.html.

[9] *See* Commissioner Michael S. Piwowar's Statement at Open Meeting Regarding Municipal Advisors and Pay Ratio Disclosure (Sept. 18, 2013), available at sec.gov/News/PublicStmt/Detail/PublicStmt/1370542565153. *See also* Dissenting Statement of Commissioner Daniel M. Gallagher Concerning the Proposal of Rules to Implement the Section 953(b) Pay Ratio Disclosure Provision of the Dodd-Frank Act (Sept. 18, 2013), available at sec.gov/News/PublicStmt/Detail/PublicStmt/1370542558873.

The pay ratio rule reflects the SEC's effort to address the Congressional mandate of Section 953(b) of the Dodd-Frank Act while providing flexibility "in a manner that we expect will reduce costs and burdens for registrants."[10] However, the rule is complex, and it remains to be seen if the objectives articulated by the SEC are, in fact, realized.

Framework of the Rule

The pay ratio rule is set forth in new paragraph (u) to Regulation S-K Item 402, which is accompanied by 11 substantive instructions. The rule tracks Section 953(b) of the Dodd-Frank Act, although it provides several accommodations not addressed in Section 953(b), particularly with respect to the gathering of information regarding "all" employees, and requires several significant disclosures that supplement the disclosed pay ratio and are not required by Section 953(b). The disclosure provisions of the rule are largely consistent with the rule as proposed.

Subject Companies and Initial Compliance Date

The rule does not apply to foreign private issuers, smaller reporting companies, emerging growth companies, registered investment companies, or Canadian issuers that file reports under the SEC's Multijurisdictional Disclosure System.

All other companies (Subject Companies) will be required to comply with the rule and provide disclosure of their pay ratios for their first full fiscal year beginning on or after January 1, 2017. This means that a calendar-year-end Subject Company will be required to make its first pay ratio disclosures in 2018. A newly public Subject Company will be required to provide pay ratio disclosure for the first fiscal year following the year in which it becomes an Exchange Act reporting company, but not for any fiscal year commencing before January 1, 2017. Once an emerging growth company or a smaller reporting company ceases to qualify as such, the company will be required to provide pay ratio disclosure for the first fiscal year, commencing on or after January 1, 2017, following the year in which the company ceased to be an emerging growth company or smaller reporting company, as applicable.

The pay ratio disclosures are required in any SEC filing that mandates the inclusion of executive compensation disclosure under Regulation S-K Item 402, that is, proxy statements, annual reports, and registration statements under the Securities Act and the Exchange Act. However, a registration statement need not include the pay ratio disclosure for the most recent fiscal year if it is filed prior to the filing of the Subject Company's Form 10-K or, if later, its annual meeting proxy statement, unless more than 120 days have elapsed since the end of the most recent fiscal year, in which case the pay ratio disclosure for such fiscal year must be provided.

Covered Employees

The rule requires a Subject Company to determine the median of the annual total compensation of all of its employees and the employees of its "consolidated subsidiaries." The Adopting Release explains that the requirement to consider all "employees" of "consolidated subsidiaries" "generally will result in a smaller pool of employees" than would be the case if, as proposed, the rule had covered employees of every "subsidiary," as that term is defined under Securities Act Rule 405. Interestingly, the SEC bases this conclusion on its understanding that the term "subsidiary" could include a company in which a Subject Company owns "as little as a 10% stake" due to the view held by "many practitioners" in the Section 16 context that a person can be an affiliate or a control person of an entity in which it owns a 10% voting interest.[11]

The SEC stated that defining "employees" with reference to "consolidated subsidiaries" would be less burdensome for Subject Companies "because most registrants consolidate based on their ownership of

[10] Adopting Release, page 13.

[11] Adopting Release, page 85.

over 50% of the outstanding voting shares of their subsidiaries and more guidance is readily available on when consolidating subsidiaries is appropriate than when an entity should be considered a 'subsidiary' based on the concept of control."[12] The Adopting Release notes, however, that consolidation may be required when "[t]he power to control [thus triggering a consolidation requirement] exist[s] with a lesser [than 50%] percentage of ownership, for example, by contract, lease, agreement with other stockholders, or by court decree."[13] For some Subject Companies, we believe that consolidation determinations can be very complex precisely because of contractual arrangements and other factors unrelated to voting control. In addition, the Financial Accounting Standards Board's most recent standard on consolidation requirements, Financial Accounting Standards Update No. 2015-02 (Feb. 2015), will require companies to reassess their consolidation decisions relating to partnership interests and variable interest entities.

The rule requires that all employees of a Subject Company and its consolidated subsidiaries—including full-time, part-time, temporary, seasonal, and non-U.S. employees—be treated as covered employees.[14]

Date of Determination of Employee Pool

The rule allows a Subject Company to define its "employee" pool using any date within the last three months of the Subject Company's last completed fiscal year. A Subject Company must disclose the date used and, if the date changes year to year, the reasons for the change.[15]

Exceptions Related to Non-U.S. Employees

The rule also provides exceptions for non-U.S. employees from the definition of "employee" in two instances, as follows.

Data Privacy Exception

The data privacy exception contemplates the exclusion from the definition of "employee" of all (but not less than all) non-U.S. employees employed in a jurisdiction where data privacy laws would prevent the Subject Company's access to the information needed to comply with the pay ratio rule, provided that:

- The Subject Company makes "reasonable efforts" to obtain the non-U.S. employees' compensation information, with "reasonable efforts" including, "at a minimum, using or seeking an exemption or other relief under any governing data privacy laws or regulations."[16]
- The Subject Company obtains an opinion of legal counsel "opining on the inability of the [Subject Company] to obtain or process the information necessary" for compliance with the pay ratio rule, including the company's "inability to obtain an exemption or other relief under any governing laws or regulations."[17]

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[12] Adopting Release, page 86.

[13] Adopting Release, footnote 222, citing FASB Accounting Standards Codification, Paragraph 810-10-15-8.

[14] Regulation S-K Item 402(u)(3). The rule further states that covered employees do not include "workers who are employed, and whose compensation is determined, by an unaffiliated party but who provides services to the registrant or its consolidated subsidiaries as independent contractors or 'leased' workers." Commissioner Piwowar, in his additional dissenting comments on the rule, stated that this exclusion's focus on an unaffiliated party would have the following effect:

"Employees of unconsolidated subsidiaries would be swept back into the definition of employee to the extent that they provide services to the company or its consolidated subsidiaries because they are not employed by an unaffiliated third party."

Commissioner Michael S. Piwowar, Additional Dissenting Comments on Pay Ratio, August 7, 2015, available at sec.gov/news/statement/additional-dissenting-statement-on-pay-ratio-disclosure.html. We are hopeful the SEC staff will clarify the scope of the exclusion in an interpretive statement.

[15] Regulation S-K Item 402(u), Instruction 1. This represents a change from the rule as proposed, which would have defined the term "employee" as those employees employed as of the last day of the issuer's fiscal year.

[16] Regulation S-K Item 402(u)(4)(i).

[17] *Id.*

- The Subject Company files the legal opinion as an exhibit to the SEC filing that includes the pay ratio disclosure and provides disclosure about its use of the data privacy exception.

There is no limit on the number of non-U.S. employees who can be excluded from the pay ratio definition of “employee” under the data privacy exception.

Some data privacy laws outside the United States are rigorous. As a practical matter, the conditions for excluding non-U.S. employees in these countries from the pay ratio definition of “employee” are formidable and likely will impose significant additional costs on Subject Companies that intend to use this exception. We believe that these conditions to the exception will raise significant issues for Subject Companies with non-U.S. employees in countries that have meaningful data privacy laws, and that such companies should begin a process to address these issues well in advance of the time that pay ratio disclosures are first required to be made.

De Minimis Exception

The rule also includes the following two-prong “*de minimis*” exception that allows a Subject Company to exclude up to 5% of its non-U.S. employee population:

- Where non-U.S. employees account for 5% or less of a Subject Company’s total employees, the Subject Company may exclude all, but not less than all, of those non-U.S. employees.
- Where non-U.S. employees exceed 5% of a Subject Company’s total employee population, the Subject Company may exclude up to 5% of its total employees who are non-U.S. employees.[18]

If a Subject Company excludes any non-U.S. employees in a particular jurisdiction, it must exclude all non-U.S. employees in that jurisdiction. Accordingly, if more than 5% of a Subject Company’s employees are located in any one non-U.S. jurisdiction, the Subject Company may not exclude any employees in that jurisdiction.

Moreover, any employees excluded from the definition of “employee” under the data privacy exception must be counted towards the 5% limit of the *de minimis* exception. Therefore, if more than 5% of a Subject Company’s total employees are excluded under the data privacy exception, the Subject Company may not rely on the *de minimis* exception.

If a Subject Company relies on the *de minimis* exception, it must provide detailed disclosure relating to its reliance on the exception, including the jurisdiction(s) from which employees are excluded and the approximate number of employees excluded.

Business Combinations

The rule permits a Subject Company to omit any employees who became its employees as a result of a business combination or acquisition of a business for the fiscal year in which the transaction becomes effective. If the Subject Company excludes such employees, it must identify the acquired business and disclose the approximate number of employees it is omitting.[19]

Determination of the “Median Employee”

After identifying its “employee” pool, a Subject Company must then identify from that pool the “median employee,” that is, “the employee in the middle of the compensation spectrum.”[20] In a helpful change from the rule as initially proposed, Subject Companies are required under the rule to identify their “median employee” only once every three years, provided that during the last completed fiscal year there was no change to the employee population or compensation arrangements that the Subject Company

[18] Regulation S-K Item 402(u)(4)(ii).

[19] Regulation S-K Item 402(u), Instruction 7, paragraph 2.

[20] Adopting Release, page 119

"reasonably believes" would result in a significant change to its pay ratio disclosure.[21] If there has been a change, the Subject Company would have to identify a new median employee for the affected fiscal year.[22] A Subject Company that retains the same median employee under the three-year provision must disclose that it is using the same median employee and that there has been no change in its employee population or employee compensation arrangements that it reasonably believes would result in a significant change to its pay ratio disclosure, and the <u>basis</u> for such reasonable belief. In this regard, the rule states: "For example, the registrant could disclose that there has been no change in the employee population or employee compensation arrangements that it believes would significantly impact the pay ratio disclosure."[23] This is a curious example, as it essentially parrots the "reasonable belief" requirement without articulating a basis for that belief.

It is important to note that the three-year provision regarding the frequency of median employee identification does not apply to the frequency of computing the compensation of the median employee for purposes of pay ratio disclosure. A Subject Company that uses the same median employee for two or three years would still be required to calculate that employee's total annual compensation and disclose the pay ratio each year.

The rule does not specify a required methodology for identifying a median employee. Instead, the rule "permits [Subject Companies] the flexibility to choose a method to identify the median employee based on their own facts and circumstances."[24] The SEC states that among the factors a Subject Company could consider in determining the methodology to use are the size and nature of its workforce, the complexity of its organization, the "stratification of pay levels across the workforce," the types of compensation its employees receive, the number of payroll systems it has (and any integration challenges between such systems), the number of tax and accounting regimes to which it is subject, and the extent to which different currencies are involved.[25] A Subject Company may use "reasonable estimates" in the methodology used to identify the median employee and in calculating the annual total compensation or any elements of total compensation for employees other than the PEO.[26]

In identifying its "median employee," the rule would allow a Subject Company to develop a methodology that does the following:

- Uses the entire employee population, a statistical sampling, or other "reasonable methods."[27] Regarding use of statistical sampling, the Adopting Release states that "a relatively small sample size may be appropriate in certain situations" and that Subject Companies may use more than one statistical sampling approach where, for example, a Subject Company has multiple business lines or geographical units.[28]
- Uses the annual "total compensation" paid to those employees or, instead, any consistently applied compensation measures, such as information derived from tax and/or payroll records.[29] The flexibility permitted in applying compensation measures is underscored by the SEC's favorable reference to a commenter's observation:

> As one commenter noted, while a consistently applied compensation measure may exclude benefits, perquisites, and other allowances, it will still capture

[21] Regulation S-K Item 402(u), Instruction 2.

[22] *Id.* In accordance with the rule, the three-year period prior to another identification of the median employee will recommence with the fiscal year in which the new identification is made.

[23] Adopting Release, page 113.

[24] *Id.*

[25] Adopting Release, page 115.

[26] Regulation S-K Item 402(u), Instruction 4, paragraph 1.

[27] Regulation S-K Item 402(u), Instruction 4, paragraph 2.

[28] Adopting Release, page 118.

[29] Regulation S-K Item 402(u), Instruction 4, paragraph 3; Adopting Release, page 121.

> salary, incentive cash earned, and stock awards, which will encompass "the substantial majority of compensation and [should] not lead to distortion of the median."[30]

The Adopting Release also states that "[f]or purposes of calculating the annual total compensation amounts when using a consistently applied compensation measure," a Subject Company may use a measure "that is defined differently across jurisdictions and may include different annual periods as long as within each jurisdiction, the measure is consistently applied." In this regard, the SEC cited an example of a compensation measure suggested by a commenter ("taxable wages") and noted that the measure may be defined differently across jurisdictions and may include different annual periods.[31] However, the SEC noted that a Subject Company "would not be permitted to use an entirely different type of measure across jurisdictions that would not be consistently applied."[32]

- Uses a cost-of-living adjustment, as discussed below.

In addition, the rule permits Subject Companies to annualize the total compensation for full-time and part-time employees employed by the Subject Company for less than the full fiscal year. However, annualizing adjustments may not be made for temporary or seasonal positions, and full-time equivalent adjustments also are not permitted.[33] The impact of the prohibition on annualizing adjustments may be mitigated by the Subject Company's ability to define its employee pool as of any date within the last three months of its fiscal year.

Whatever methodology a Subject Company determines to use to identify its median employee, the Subject Company must briefly describe the methodology. In addition, it must briefly describe any material assumptions, adjustments (including any cost-of-living adjustments) or estimates used to identify the median employee or determine total compensation or any elements of total compensation.[34]

Cost-of-Living Adjustments

In response to several comments, the Adopting Release acknowledged that "requiring registrants to determine their median employees and calculate the pay ratio without permitting them to adjust for different underlying economic conditions [in the countries in which the Subject Company operates] could result in what some would consider a statistic that does not appropriately reflect the value of the compensation paid to individuals in those countries."[35] Therefore, the rule permits a Subject Company, when identifying its median employee—whether using "total compensation" or another consistently applied compensation measure—to make cost-of-living adjustments to the compensation of employees employed in jurisdictions other than the one where the Subject Company's PEO resides (which, the SEC notes, typically will be the United States).[36]

A Subject Company seeking to make cost-of-living adjustments may only do so if the adjustments are made as prescribed by Paragraph 4 of Instruction 4 to Regulation S-K Item 402(u). However, the instruction is not entirely clear as to whether the cost-of-living adjustment provisions of the rule allow Subject Companies with employees in multiple non-U.S. jurisdictions (assuming their PEOs reside in the United States) to use cost-of-living adjustments in only certain of those non-U.S. jurisdictions, or would require that cost-of-living adjustments, if made in any non-U.S. jurisdiction, must be made in all non-U.S. jurisdictions. In the Adopting Release, the SEC acknowledged that Subject Companies

[30] Adopting Release, page 120.

[31] Adopting Release, pages 120-121.

[32] Adopting Release, page 121.

[33] Regulation S-K Item 402(u), Instruction 5.

[34] Regulation S-K Item 402(u), Instruction 4, paragraph 5.

[35] Adopting Release, page 79.

[36] Adopting Release, page 80.

> could alter the reported ratio to achieve a particular objective with the ratio disclosure. [Footnote omitted.] Registrants with a significant number of employees in countries with a higher cost of living than the jurisdiction in which the PEO resides may be unlikely to adjust those compensation figures downward, while registrants with a sizeable work force in countries with a lower cost of living may be likely to adjust the compensation figures upward.[37]

The SEC did not state, however, that a Subject Company with employees in both higher and lower cost-of-living jurisdictions could choose among the jurisdictions to select, which might be read to imply that if a Subject Company chooses to apply a cost-of-living adjustment, it must do so with respect to all jurisdictions other than the jurisdiction in which the PEO resides. However, absent more definitive guidance from the SEC staff, the scope of a Subject Company's discretion in the application of cost-of-living adjustments is uncertain.

The rule specifically provides that if a Subject Company "uses a cost-of-living adjustment to identify the median employee, and the median employee identified is in a jurisdiction other than where the PEO resides, the [Subject Company] must use the same cost-of-living adjustment in calculating the median employee's annual total compensation and disclose the median employee's jurisdiction."[38]

The rule also provides that where a Subject Company calculates its median employee using a cost-of-living adjustment, the company must also disclose the median employee's annual total compensation without the cost-of-living adjustment.[39] The final sentence of the instruction states that "[a Subject Company] electing to present the pay ratio in this manner [with a cost-of-living adjustment] also shall disclose the median employee's annual total compensation and pay ratio without the cost-of-living adjustment. To calculate this pay ratio, the [Subject Company] will need to identify the median employee without using any cost-of-living adjustments." It appears that the rule could be calling for a Subject Company to identify its median employee without using any cost-of-living adjustments, and the re-identified median employee could be different from the median employee identified through use of the cost-of-living adjustment. We anticipate that the SEC staff will provide an interpretive clarification on this point.

Finally, if a Subject Company identifies its median employee without using any cost-of-living adjustment and finds that the median employee resides in a jurisdiction other than the one where the PEO lives, the Subject Company may not then make a cost-of-living adjustment to the median employee's compensation for purposes of the pay ratio disclosure.

Determination of Total Compensation for Purposes of the Pay Ratio Disclosure

The rule requires a Subject Company to calculate the "total compensation" for both its PEO and median employee using the requirements in Regulation S-K Item 402(c)(2)(x), which governs the calculation of "total compensation" of a public company's "named executive officers" for purposes of the Summary Compensation Table typically included in an annual meeting proxy statement. However, because the item relates to "named executive officers," as defined in Item 402(a) of Regulation S-K, the rule provides the following guidance regarding the application of certain terminology in Item 402(c)(2)(x) to non-executive employees under the pay ratio rule:

- All references to "named executive officer" in Item 402 may be deemed to refer instead, as applicable, to "employee."

[37] Adopting Release, page 81.

[38] Regulation S-K Item 402(u), Instruction 4, paragraph 4.

[39] *Id.*

- For non-salaried employees, references to “base salary” and “salary” in item 402 may be deemed to refer instead, as applicable, to “wages plus overtime.”[40]

As a result of the SEC’s acknowledgment that “the application of the definition of total compensation under Item 402(c)(2)(x) to employees who are not executive officers could understate the overall compensation paid to such employee,[41] the rule permits the Subject Company to include the following items (which otherwise would be excluded under Item 402) in calculating the median employee’s total compensation, provided that the items also are included in the PEO’s compensation:

- Personal benefits that aggregate less than $10,000.
- Compensation under non-discriminatory benefit plans.[42]

LOOKING AHEAD

The SEC adopted the rule in a split vote, with Chair White and Commissioners Aguilar and Stein voting in favor and Commissioners Gallagher and Piwowar voting against. The split vote is consistent with the votes of the Chair and Commissioners on issuing the rule proposal and representative of intense interest and conflicting views of commenters that were expressed during the rulemaking process.

SEC Commissioners Gallagher and Piwowar each made strong dissenting statements against the rule. Commissioner Gallagher stated that the rule would result in “low quality data,” and that due to the SEC’s failure to opt for a “less expensive rule” and his assertion that the benefits of the rule, as adjusted, “do not justify the costs,” he concluded that “there is no reasoned basis for the Commission’s action.”[43] He also suggested that the rule may not be constitutional.

Commissioner Piwowar’s dissenting remarks were similarly critical as to the costs and benefits of the rule, and asserted that the pay ratio rules were politically driven. Moreover, on August 7, 2015, Commissioner Piwowar released additional dissenting comments on the rule,[44] including several legal arguments that certain of the procedures followed (or not followed) by the SEC in proposing and adopting the pay ratio rules violated the Administrative Procedures Act. The specificity of the criticism levied by the dissenting Commissioners—and particularly the content and form of Commissioner Piwowar’s second dissent—signal the possibility that the pay ratio rules may be challenged in court using arguments similar to prior challenges of SEC rules.[45] Of course, whether any legal challenge will result or succeed cannot be predicted, and Subject Companies should assume that the rule will take effect as scheduled.

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[40] Regulation S-K Item 402(u)(2)(i).

[41] Adopting Release, pages 132-133.

[42] Regulation S-K Item 402(u), Instruction 4, paragraph 6. The following example illustrates the potential understatement that the instruction is designed to address. Assume that the PEO’s total annual compensation calculated in accordance with Item 402(c)(2)(x) was $3,000,000 and the median employee’s compensation was $50,000. The ratio of the median employee’s compensation to the PEO in this instance is 1:60. However, assume further that the median employee received $5,000 in personal benefits, while the PEO’s benefits already exceeded the $10,000 threshold for disclosure under Item 402(c)(2)(ix)(A) (i.e., the PEO’s total annual compensation would already have included all personal benefits). Moreover, both the PEO and the median employee received $15,000 in medical coverage for their families under a non-discriminatory health plan. Finally, under the Subject Company’s tax-qualified Section 423(b) plan, the median employee purchased $10,000 in company stock at a 15% discount from the market price, realizing a $1,500 benefit; the PEO, having meaningful equity benefits under other plans, did not participate. In calculating total annual compensation including these items, the median employee’s total annual compensation is $71,500 while the PEO’s compensation is $3,015,000, resulting in a ratio of approximately 1:40.

[43] Commissioner Daniel M. Gallagher, Dissenting Statement at an Open Meeting to Adopt the “Pay Ratio” Rule, August 5, 2015, available at sec.gov/news/statement/dissenting-statement-at-open-meeting-to-adopt-the-pay-ratio-rule.html.

[44] Commissioner Michael S. Piwowar, Additional Dissenting Comments on Pay Ratio, August 7, 2015, available at sec.gov/news/statements/additional-dissenting-statement-on-pay-ratio-disclosure.html.

[45] Indeed, one commenter addressed the form and content of Commissioner Piwowar’s second dissenting comments as follows:

While the initial pay ratio disclosures will not be required until 2018, the complexity involved in the rule's requirements, particularly for multinational Subject Companies, underscores the need for Subject Companies to begin analyzing how they can comply with the rule and begin to establish reasonable and efficient methodologies and systems to enable timely compliance when required. Specifically:

- A Subject Company should consider whether its payroll and related systems accommodate a cost-efficient method of computing total compensation (or key elements of total compensation) in identifying a median employee. If this is not feasible, a Subject Company should determine whether new systems should be established and provide for appropriate testing mechanisms. In this regard, the Subject Company should consider whether existing or new systems could or should accommodate statistical sampling or some other reasonable methodology.
- A multinational Subject Company should additionally consider the following:
    - A determination of the scope of applicable data privacy laws is essential. If permitted under the applicable statute, the company should consider a strategy for seeking an exemption from the data privacy provisions (to establish that it took reasonable efforts to obtain or process the necessary information for compliance with the rule).
    - If the *de minimis* exemption is available (based on the employee population and extent of reliance on the data privacy exclusion), identify any jurisdictions in which pay practices are such that they may unduly distort the pay ratio and make the employee population of that jurisdiction an appropriate candidate for exclusion.
    - Consider the practicality and effect of applying cost-of-living adjustments to employees in jurisdictions other than the PEO's jurisdiction.
- If feasible, annualize compensation for all permanent full-time and part-time employees that were employed for less than the full fiscal year for which pay ratio disclosure will be provided.
- If the Subject Company hires employees in seasonal positions, consider using a date, within the last three months of the fiscal year, when seasonal employees (or a significant number of seasonal employees) are not engaged.
- Finally, the Subject Company should take steps to develop appropriate disclosure controls and procedures to enable the effective gathering and review of information regarding identification of the median employee and computation and disclosure of the pay ratio, in accordance with the rule.

> The second dissent could be a blueprint for how a complaint would look if this rulemaking is challenged in court. It claims the SEC violated the Administrative Procedure Act in adopting the rule and similar legal mumbo jumbo (e.g., the SEC acted in an "arbitrary & capricious" manner, a phrase that describes a standard of review used when a government agency's actions are challenged under administrative law). This is interesting because Piwowar is not a lawyer, he's an economist.

Broc Romanek, Pay Ratio: SEC Commissioner Piwowar Doubles Down (On His "No"), August 10, 2015, available at compensationstandards.com/member/Blogs/consultant/2015/08/pay-ratio-sec-commissioner-piwowar-doubles-down-on-his-no.html.

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