

September 2015

## TOP TAKEAWAYS FROM THE SEC'S NEW PAY RATIO DISCLOSURE RULES

On August 5, the Securities and Exchange Commission ("SEC") adopted final rules requiring most public companies to make pay ratio disclosures pursuant to the Dodd-Frank Wall Street Reform and Consumer Protection Act. The rules require registered securities issuers to disclose:

- The median of the annual total compensation of all employees other than the principal executive officer ("PEO").
- The annual total compensation of the PEO, as defined in Item 402 of Regulation S-K.
- The ratio of these two amounts.

The final rules are effective on Oct. 19, 2015. They implement rules proposed by the SEC almost two years ago on Sept. 18, 2013, described in detail in a previous [Securities Law Update](#). The final rules were published in [SEC Release No. 33-9877](#); [34-75610](#). Here is what you need to know.

### AFFECTED COMPANIES

The new rules affect all issuers that must provide executive compensation summary tables, but expressly do not apply to emerging growth companies, smaller reporting companies, foreign private issuers and registered investment companies.

### COMPLIANCE DATE

The first reporting period for each affected issuer will be its first fiscal year commencing on or after Jan. 1, 2017. Subject to transition rules noted below, a company with a Dec. 31 year-end would not need to make pay ratio disclosures until 2018 for its fiscal year ended Dec. 31, 2017.

### FILINGS

Issuers must make pay ratio disclosures in any filing that requires Item 402 executive compensation disclosure, including proxy and information statements, annual reports and registration statements.

### IDENTIFYING THE MEDIAN EMPLOYEE

The issuer can select any date within the last three months of their last fiscal year to determine the median employee and relevant total employee population. Any

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reasonable method can be used to identify the employee receiving the median level of compensation in its workforce.

Methods include statistical sampling or complete analysis of payroll records using total compensation or any consistently-applied compensation measures. If an issuer believes that an identified median employee's total compensation elements are not characteristic of similar employees, then another median employee may be chosen so long as the methodology and reasons for selection are fully disclosed.

### **CALCULATING ANNUAL TOTAL COMPENSATION**

To determine the median employee's annual total compensation, an issuer must consider all of the elements of compensation outlined in Item 402(c)(2)(x) of Regulation S-K pertinent to the PEO's compensation, including retirement or pension benefits, stock rights, and other perquisites.

Issuers may use reasonable estimates for some elements of compensation that are difficult to quantify, such as partly vested future rights. They must provide a brief disclosure of the basis for any estimates used to calculate total compensation.

### **COVERED EMPLOYEES**

The final rules require each issuer to determine the median employee among all of its U.S. and non-U.S. full-time, part-time, temporary and seasonal employees, including employees of any consolidated subsidiaries. Independent contractors and workers employed by third parties (e.g., temporary workers employed by an outside company) would not be included.

### **EXCLUDED EMPLOYEES**

Under a data privacy exemption, issuers may exclude from their compensation analysis all employees outside of the United States who are employed in jurisdictions with data privacy laws that could make the required analysis and disclosure illegal, despite reasonable efforts by the company to comply.

There is also a *de minimis* exemption allowing an issuer to exclude for any reason up to five percent of its foreign workers, including any non-U.S. employees excluded under the data privacy exemption.

Specifically, if an issuer's non-U.S. employees account for five percent or less of its total employees, it may exclude all (but not less than all) of those employees. If their non-U.S. employees exceed five percent of their total U.S. and non-U.S.

employees, they may exclude up to five percent of their total employees who are non-U.S. employees.

The SEC reasoned that the potential cost savings to issuers was significant in relation to the relatively minor effect it would have on pay ratio disclosure. If the number of employees excluded by the data privacy exemption is equal to or greater than five percent, the *de minimis* exemption would not apply. To validate use of the data privacy exemption, an opinion of company counsel would have to be filed as an exhibit to the company's SEC filing in which the pay ratio disclosure is made.

### **FREQUENCY OF MEDIAN COMPENSATION ANALYSIS**

The median employee must be identified once every three years, unless there has been a change in employee population or employee compensation arrangements that would result in a significant change to pay ratio disclosures. The pay ratio analysis must still be disclosed during the two "off-years" incorporating changes to the PEO's compensation, but the detailed median employee analysis need not be completed.

An issuer must disclose the basis for its conclusions that no significant change has occurred. If the median employee's compensation significantly changes within a three-year period, or if that employee leaves, then that employee may be replaced with another appropriately selected median employee, provided that the reasonable basis for such replacement is fully disclosed.

### **COST-OF-LIVING ADJUSTMENTS**

In a change from the proposed rules, the final rules permit issuers to apply cost-of-living adjustments to the compensation of all employees in jurisdictions other than the one in which the PEO is located so that the effective pay ratio is put into context.

If an issuer makes such adjustments, they must be disclosed with the jurisdiction of the median employee, and both the actual and adjusted compensation of the median employee. If an issuer did not make adjustments for all employees to identify the median employee, then the issuer is prohibited from adjusting the median employee's compensation.

### **ANNUALIZATION OF COMPENSATION**

An issuer may annualize the compensation of permanent employees who worked for less than the full fiscal year. But in issuer cannot adjust a permanent part-time employee's compensation as if it were based on a full-time schedule.

## ADDITIONAL DISCLOSURES

Relevant narrative discussion or additional ratios that are not misleading may be used but are not required to supplement the required disclosures. For example, an issuer could present additional ratios to illustrate the effect of part-time, seasonal and temporary employee inclusion. An issuer could also break out the calculations of separate pay ratios for U.S. and foreign employees.

## THE CASE OF SUCCESSIVE PEO'S

The final rules permit an issuer to aggregate the total compensation provided to each person serving as PEO during the course of a reporting period, or to annualize the compensation of the PEO serving on the date selected for median employee identification. Full disclosure of the option chosen and the methods of calculation is required.

## TRANSITIONAL RULES

Employees of an acquired entity do not have to be included in pay ratio calculations until the first full fiscal year after the acquisition is complete. Similarly, expanding issuers that no longer qualify for exempt status as emerging growth or smaller reporting companies do not need to provide pay ratio disclosures until after they complete a full fiscal year with non-exempt status.

A new public issuer must make its initial required disclosures in its first full fiscal year after the issuer has been subject to relevant Securities Exchange Act requirements for at least 12 months, and has filed at least one annual report without pay ratio disclosures.

The SEC's goal with these transition rules is that new issuers will not become subject to the new rules sooner than existing issuers.

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### EXPLANATORY NOTES:

This update is intended to call your attention to various statements by the SEC of possible interest and relevance to you, but it is not intended to constitute a legal opinion or definitive summary of all interpretations and legal information that could be material to you. Please contact a member of the Securities Law Group at Burns & Levinson if you have any questions about these interpretive statements or if you want to learn more about our expertise in this area.

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