Client Alert

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SEC Adopts CEO Pay Ratio Disclosure Rules

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The SEC recently adopted rules implementing Section 953(b) of the Dodd-Frank Wall Street Reform and Consumer Protection Act (the “Act”). Section 953(b) directs the SEC to expand current disclosure requirements to require disclosure of the ratio of the median of the annual total compensation of all employees to the annual total compensation of the CEO of the company. The implementing rules were proposed in September 2013, and the SEC received more than 287,400 comment letters on the proposal. The comment letters addressed the proposed rule as a whole (including commenters that supported or opposed the rule in its entirety), as well as comments directed toward particular requirements of the rule, such as its application to foreign, part-time, temporary, and seasonal employees. As adopted, the rule closely follows the approach set forth in the proposing release; however, the Commission made some revisions in the final rule that should allow more flexibility when implementing the requirements. Companies that are subject to the rule will be required to provide the disclosure starting with the first fiscal year beginning on or after January 1, 2017.

THE NEW CEO PAY RATIO DISCLOSURE REQUIREMENTS

The final rule adds new paragraph (u) to Item 402 of Regulation S-K, which requires disclosure of the following:

A. The median of the annual total compensation of all employees of the company, except the CEO of the company;

B. The annual total compensation of the CEO of the company; and

C. The ratio of the amount in (B) to the amount in (A), presented as a ratio in which the amount in (A) equals one, or, alternatively, expressed narratively in terms of the multiple that the amount in (B) bears to the amount in (A).

The final rule also requires disclosure of the ratio such that the CEO’s annual total compensation is always compared to the median employee’s annual total compensation—the ratio must always show how much larger or smaller the CEO’s annual total compensation is as compared to the median employee’s annual total compensation.

Companies may choose one of two options to express the ratio. First, a company could disclose the pay ratio with the median of the annual total compensation of all employees equal to one and the CEO’s compensation as the number compared to one. For example, if a company’s median annual total compensation for employees is $50,000 and the annual total compensation of the CEO is $2,500,000, the CEO’s compensation is 50 times larger than the median employee’s compensation. The company may describe the pay ratio as 50 to 1 or 50:1.

Alternatively, a company could disclose the pay ratio narratively by stating how many times higher or lower the CEO’s annual total compensation is than that of the median employee. For example, the company may state that “the CEO’s annual total compensation is 50 times that of the median of the annual total compensation of all employees.”

SUBJECT COMPANIES

The final rule applies to reporting companies that are required to provide disclosure under Item 402(c) of Regulation S-K. The final rule does not require pay ratio disclosure by smaller reporting companies ("SRCs"), emerging growth companies ("EGCs"), foreign private issuers, or Canadian filers filing reports and registration statements in accordance with the requirements of the U.S.-Canadian Multijurisdictional Disclosure System. Registered investment companies are also not subject to the requirement.

LOCATION OF THE NEW PAY RATIO DISCLOSURE

The pay ratio disclosure as set forth in the final rule is required in any filing that calls for executive compensation disclosure pursuant to Item 402 of Regulation S-K, including annual reports on Form 10-K and registration statements under the Securities Act of 1933, as amended (the "Securities Act") and the Securities Exchange Act of 1934, as amended (the "Exchange Act"), as well as proxy materials to the same extent that these forms require compliance with Item 402 of Regulation S-K. The pay ratio disclosure, as with other Item 402 information, will be treated as "filed" for purposes of the Securities Act and Exchange Act and, as such, will be subject to potential liabilities under those statutes, including Section 18 liability under the Exchange Act.

***Updating the Pay Ratio*.** Companies are not required to update their pay ratio disclosure for their most recently completed fiscal year until they file their annual report on Form 10-K, or, if later, their proxy or information statement for their next annual meeting of shareholders (or written consents in lieu of such a meeting), but, in any event, not later than 120 days after the end of such fiscal year.

"ALL EMPLOYEES" COVERED BY THE RULE

Who Is an Employee? The final rule defines "employee" to include a company's U.S. and non-U.S. employees, as well as its part-time, seasonal, and temporary employees employed by the company or any of its consolidated subsidiaries. Also included in this definition are all of a company's officers, other than the CEO. The definition of "employee" does not include independent contractors, "leased" workers, or other similar workers employed by a third party. A company can supplement its pay ratio disclosure or provide additional pay ratios for its shareholders to consider if it wants to explain the effect of including part-time, seasonal, and temporary employees on its CEO pay ratio disclosure.

The final rule includes only employees of consolidated subsidiaries, as determined by reference to applicable accounting standards, rather than employees of all subsidiaries, as was originally proposed.

***Employed on Any Date Within Three Months of the Last Completed Fiscal Year*.** The final rule provides flexibility in choosing the median employee determination date, as opposed to the proposed rule, which proposed to define "employee" as an individual employed as of the last date of the company's last completed fiscal year. The final rule defines "employee" as an individual employed on any date of the company's choosing within the last three months of the company's last completed fiscal year. Companies must disclose the date used to identify the median employee.

***Employees Located Outside the United States*.** In response to particular issues and concerns raised during the comment process, the final rule provides two tailored exemptions from the general requirement to include all employees located outside of the United States.

- **Data Privacy Laws**

  The first exemption to the general requirement that non-U.S. employees be included in the pay ratio disclosure is when a jurisdiction's data privacy laws or regulations are such that, despite a company's reasonable efforts to obtain or process information necessary to comply with the rule, it is unable to do so without violating those laws or regulations. For example, the European Union prohibits the transfer of personal data to a third country that does not ensure an adequate level of privacy protection; China, Japan, Mexico, Canada, Peru, Australia, Russia, Switzerland, Argentina, and Singapore have adopted or are considering similar rules.

  To prevent any potential manipulation, companies are required to exercise reasonable efforts to obtain or process the information necessary for compliance with the final rule. As part of its reasonable efforts, the company must seek an exemption or other relief under the applicable jurisdiction's governing data privacy laws or regulations and use the exemption if granted.

  If a company excludes any non-U.S. employees in a particular jurisdiction under the data privacy exemption, it must exclude all non-U.S. employees in that jurisdiction. Additionally, the company must list the excluded jurisdictions, identify the specific data privacy law or regulation, explain how complying with the final rule violates the law or regulation (including the efforts made by the company to use or seek an exemption or other relief under such law or regulation), and provide the approximate number of employees exempted from each jurisdiction based on this exemption.

  The company must obtain a legal opinion that opines on the inability of the company to obtain or process the information necessary for compliance with the final rule without violating that jurisdiction's laws or regulations governing data privacy, including the company's inability to obtain an exemption or other relief under any governing laws or regulations. The legal opinion must be filed as an exhibit to any filing in which the pay ratio disclosure is included.

- ***De Minimis* Exemption**

  The second exemption from the general requirement to include non-U.S. employees in identifying the median employee is when a *de minimis* number of a company's employees work outside the United States.

  Under the final rule, if a company's non-U.S. employees account for five percent or less of its total employees, it may exclude all of those employees when making its pay ratio calculations. If the company chooses to exclude any non-U.S. employees, it must exclude all of them. If a company's non-U.S. employees exceed five percent of the company's total U.S. and non-U.S. employees, it may exclude up to five percent of its total employees who are non-U.S. employees. If a company excludes any non-U.S. employees in a particular jurisdiction, it must exclude all non-U.S. employees in that jurisdiction. The company must also disclose the jurisdictions from which its non-U.S. employees are being excluded, the approximate number of employees excluded from each jurisdiction under the *de minimis* exemption, the total number of its U.S. and non-U.S. employees irrespective of any exemption (*de minimis* or data privacy), and the total number of its U.S. and non-U.S. employees used for its *de minimis* calculation.

***Cost-of-Living Adjustment*.** The SEC recognized that differences between the underlying economic conditions of the countries in which companies operate likely have an effect on the compensation paid to employees in those jurisdictions, and therefore the final rule provides companies with the option of making cost-of-living adjustments to the compensation of their employees in jurisdictions other than the jurisdiction in which the CEO resides when identifying the median employee (whether using annual total compensation or any other consistently applied compensation measure).

The company is required to disclose the country in which the median employee is located, briefly describe the cost-of-living adjustments it used to identify the median employee, and briefly describe the cost-of-living adjustments it used to calculate the median employee's annual total compensation, including the measure used as the basis for the cost-of-living adjustment. To provide context for the Item 402(u)(1)(iii) disclosure, a company electing to present the pay ratio in this manner must also disclose the median employee's annual total compensation and pay ratio without the cost-of-living adjustments. To calculate this pay ratio, the company must identify the median employee without using any cost-of-living adjustments.

***Multiple CEOs in the Last Full Fiscal Year*.** When a company replaces its CEO with another CEO during its fiscal year, the final rule allow a choice of two options in calculating the annual total compensation for its CEO:

- First, a company may take the total compensation calculated pursuant to Item 402(c)(2)(x), and reflected in the Summary Compensation Table, provided to each person who served as CEO during the year and combine those figures. This figure would constitute the company's annual total CEO compensation.
- Alternatively, a company may look to the CEO serving in that position on the date it selects to identify the median employee and annualize that CEO's compensation.

A company must disclose which option it chooses, and how it calculates its CEO's annual total compensation.

***Additional Information Is Permissible*.** The final rule includes an instruction stating that companies may present additional ratios or other information to supplement the required ratio, but are not required to do so. Additional pay ratios are not limited to any particular information, such as pay ratios covering U.S. and non-U.S. employees. If a company includes any additional ratios, the ratios must be clearly identified, not misleading, and not presented with greater prominence than the required ratio.

IDENTIFYING THE "MEDIAN EMPLOYEE"

In order to comply with the final rule, a company must identify the "median employee"—whose compensation will be used for the annual total compensation calculation—once every three years, unless there has been a change in its employee population or employee compensation arrangements such that the company reasonably believes the change would result in a significant change in the pay ratio.

If there has been such a change, the company must disclose this change, re-identify the median employee, and provide a brief explanation about the reason or reasons for the change. Alternatively, if there has been no such change, the company must disclose that it is using the same median employee in its pay ratio calculation and describe briefly the basis for its reasonable belief. For example, the company could disclose that there has been no change in its employee population or employee compensation arrangements that it believes would significantly affect the pay ratio.

If the median employee identified in “year one” is no longer in the same position or no longer employed by the company on the median employee determination date in “year two” or “year three,” the final rule permits the company to replace its median employee with an employee in a similar compensation position.

To provide additional transparency about how the pay ratio disclosure has been calculated, the final rule requires that companies disclose the date used to identify the median employee.

CALCULATING “MEDIAN” WHEN IDENTIFYING THE MEDIAN EMPLOYEE

Although Section 953(b) of the Act requires that companies choose the “median” employee as the point of comparison, rather than the average or some other measure, the provision did not prescribe a methodology that must be used to identify the median. Consistent with the proposal, the final rule provides companies with the flexibility to choose a method to identify the median employee based on their own facts and circumstances.

Companies may use a methodology that uses reasonable estimates. The median employee may be identified using annual total compensation, or any other compensation measure that is consistently applied to all employees included in the calculation, such as information derived from tax and/or payroll records.

In addition, in determining the employees from which the median is derived, a company is permitted to use its employee population or statistical sampling, and/or other reasonable methods. If statistical sampling is used, the SEC believes that a relatively small sample size may be appropriate in certain situations, and that reasonable estimates of the median may be determined using more than one statistical sampling approach by companies with multiple business lines or geographical units.

Regardless of the calculation method chosen, the final rule requires that the company briefly describe the methodology it used to identify the median employee and any material assumptions, adjustments (including any cost-of-living adjustments), or estimates it used to identify the median employee or to determine total compensation or any elements of total compensation, which shall be consistently applied.

CALCULATING “ANNUAL TOTAL COMPENSATION” FOR THE MEDIAN EMPLOYEE AND CEO

The final rule requires that “annual total compensation” for both the median employee and CEO be calculated using the requirements of Item 402(c)(2)(x) of Regulation S-K. This is the case even if the company has identified the median employee using reasonable estimates of compensation based on payroll or tax records. Accordingly, a company must go through the process of replicating the Summary Compensation Table compensation for the median employee, including, for example, the grant date fair value of equity awards, the incremental change in pension value, and “all other compensation” items such as 401(k) contributions and other benefits. The SEC notes in the final rule that any compensation that is permitted to be excluded from annual total compensation under Item 402 of Regulation S-K, such as benefits under plans available to all employees, may be added back into the calculation if necessary to reflect benefits that are significant for non-management employees of the company.

Companies are permitted to use reasonable estimates in calculating the annual total compensation of their median employee, including any elements of the total compensation, but must clearly identify any estimates used and have a reasonable basis to conclude that their estimates approximate the actual amounts of Item 402(c)(2)(x) compensation, or a particular element of compensation that is awarded to, earned by, or paid to the median employee.

Although the final rule allows companies to identify the median employee every three years, it requires total compensation for that employee to be calculated each year. Accordingly, following the company's calculation of the median employee's annual total compensation in "year one," it must recalculate the annual total compensation for that employee in "year two" and again in "year three."

DISCLOSURE OF METHODOLOGY, ASSUMPTIONS, AND ESTIMATES

The final rule requires companies to briefly describe and consistently apply any methodology used to identify the median and any material assumptions, adjustments (including cost-of-living adjustments), or estimates used to identify the median or to determine total compensation or any elements of total compensation.

The final rule also requires a company to clearly identify any estimates used. For example, when statistical sampling is used, a company must describe the size of both the sample and the estimated whole population, any material assumptions used in determining the sample size, and the sampling method (or methods) used. However, companies are not required to include any technical analyses, formulas, confidence levels, or the steps used in data analysis.

TRANSITION PERIODS

The transition period for compliance with the final rule for new companies and companies with particular circumstances are as follows:

***Newly Public Companies*.** The pay ratio disclosure is not required to be included in a registration statement on Form S-1 or Form S-11 for initial public offerings, and is not required in an Exchange Act registration statement on Form 10. The first pay ratio reporting period begins with a new company's first fiscal year commencing on or after January 1, 2017 that is after the date it first becomes subject to the requirements of Section 13(a) or 15(d) of the Exchange Act. A company in this situation is permitted to omit its initial pay ratio disclosure from registration statements (or any other filing) made before its first annual report or proxy or information statement following the end of that reporting period, but not later than 120 days after the end of the fiscal year.

***SRCs and EGCs*.** Companies that cease to be SRCs or EGCs are not required to provide pay ratio disclosure until they file a report for the first fiscal year commencing on or after they cease to be a smaller reporting company or emerging growth company.

***Business Combinations/Acquisitions*.** Companies that engage in business combinations and/or acquisitions may omit the employees of a newly-acquired entity from their pay ratio calculation for the fiscal year in which the business combination or acquisition occurs; these employees need not be included in the company's median employee calculation until the first full fiscal year following the acquisition. Companies that exclude employees as a result of a business combination must disclose the relevant acquired business and the approximate number of employees that are excluded from the pay ratio calculation.

PREPARING FOR CEO PAY RATIO DISCLOSURE

Although the CEO pay ratio and accompanying disclosure mandated by the final rule will not be included in disclosure materials for calendar year-end companies until 2018, companies may face significant costs and burdens preparing for the disclosure requirement. As a result, it is important to begin planning for the CEO pay ratio disclosure today.

***Form a Compliance Team*.** Compliance with the pay ratio disclosure requirement will be a multidisciplinary effort within an organization. In many companies, the development of the data necessary to calculate the pay ratio will involve personnel from, for example, SEC reporting, the general counsel's office, investor relations, information technology, human resources, accounting and finance, and payroll processing. The requirement will also need to be incorporated into a company's disclosure controls and procedures, and thus will need to involve a company's disclosure committee. In many cases, a company's compensation committee may also want to be briefed about the efforts toward compliance and the potential results. Given the complexity of the requirement and the large team effort that will typically be involved, it is important to identify a team leader who can manage the overall compliance process and ensure that appropriate resources are allocated to the effort.

Assess the Landscape. A company's approach to the CEO pay ratio disclosure requirement will depend on an assessment of the particular circumstances of its workforce, organizational structure, and internal systems, including: (i) the size and nature of the workforce; (ii) the complexity of the organization; (iii) the stratification of pay levels across the workforce; (iv) the types of compensation the employees receive; (v) the extent to which different currencies are involved; (vi) the number of tax and accounting regimes involved; and (vii) the number of payroll systems the company has and the degree of difficulty involved in integrating payroll systems to readily compile total compensation information for all employees. Companies will need to assess early on whether existing systems need to be modified or new systems developed in order to capture the necessary data to perform the analysis required under the final rule.

Consider Outside Advisors. Depending on the level of analysis necessary for a company to develop its CEO pay ratio, the use of outside consultants, such as statisticians and compensation consultants, may be necessary. An outside advisor could assist the company in designing, testing, and implementing a statistical sampling methodology. It may also be necessary to bring in information technology consultants to evaluate critical systems and to address integration issues that may arise when collecting data across a large organization. Outside legal advisors may be necessary to evaluate data privacy concerns in international jurisdictions in which the company operates, including whether such provisions would influence the approach that the company can take when implementing the final rule. Investor relations professionals, proxy solicitors, compensation consultants, and disclosure counsel may also be useful in the evaluation of the pay ratio and how to best position the information for communication to investors.

***Review the Calculation and Disclosure Options*. ** Companies can now assess whether they will use a statistical sampling methodology or some other methodology for calculating median employee pay, as well as whether they intend to rely on any exemptions contemplated by the final rule. Moreover, a company may want to consider now how it intends to ultimately disclose the pay ratio disclosure, including disclosure about associated assumptions and analysis. In addition to meeting the requirements contemplated by the final rule, the company may also need to consider the public relations, investor relations, and employee relations consequences of the CEO pay ratio disclosure. It may be appropriate for the compliance team to develop a mock-up of the disclosure in the near term so that everyone within the organization can understand how the information will be presented.

Address Any Necessary Compensation Changes. An estimate of the CEO pay ratio prior to the time when the disclosure is required could allow the compensation committee to consider whether changes should be made to the CEO's compensation.

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