Client Alert | Capital Markets / Employment, Compensation & Benefits

SEC Adopts Final Rules on CEO Pay Ratio Disclosure

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Companies are required to disclose the ratio of median employee annual total compensation to CEO annual total compensation starting in the 2018 proxy season; foreign private issuers, emerging growth companies and smaller reporting companies are exempt.

Background

On August 5, 2015, the Securities and Exchange Commission (the "SEC") adopted final rules (the "Final Rules") by a vote of three to two to require disclosure of (i) the median of the annual total compensation of all of a company's employees (excluding the chief executive officer (the "CEO") or equivalent position); (ii) the annual total compensation of the CEO or equivalent position; and (iii) the ratio of the two amounts.[1]

The Final Rules are substantially similar to the proposed rules released in September 2013.[2] The Final Rules incorporate certain modifications based on comments to the proposed rules largely aimed at reducing the costs of compliance. First, the Final Rules create exemptions for certain non-US employees. Specifically, the Final Rules permit companies to exclude non-US employees where foreign data privacy laws make it unlawful to obtain the information required to calculate annual total compensation and include a *de minimis* exemption that allows companies to exclude up to five percent of their workers who are located outside of the United States from the pay ratio disclosure irrespective of foreign data privacy concerns. Second, the Final Rules define "employee" to only include the employees of the company and its consolidated subsidiaries, excluding minority-owned subsidiaries and joint ventures. Third, the Final Rules permit companies to select a date within the last three months of its last completed fiscal year to determine their employee population for purposes of identifying the median employee, as opposed to requiring the determination as of the last day of the fiscal year. Fourth, the Final Rules permit companies to calculate the annual total compensation for the median employee only once every three years, instead of every year as provided under the proposed rules, provided certain conditions are met.

The new pay ratio disclosure will be required in annual reports or proxy statements beginning in the spring of 2018, covering compensation for the fiscal year on or after January 1, 2017, with transition periods for newly public companies.

Foreign private issuers, emerging growth companies and smaller reporting companies are exempt from the pay ratio disclosure requirements.

This Client Alert summarizes the material features of the Final Rules and the key issues that companies should begin to consider in preparation for compliance.

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1 The full text of the Final Rules can be found here.

2 The White & Case LLP Client Alert on the proposed rules can be found here. The full text of the proposed rules can be found here.

Summary of the Final Rules

Section 953(b) of the Dodd-Frank Wall Street Reform and Consumer Protection Act (the "Dodd-Frank Act") instructed the SEC to amend Item 402 of Regulation S-K to require the disclosure of (i) the median of the annual total compensation of all of the company's employees, excluding the CEO or equivalent position; (ii) the annual total compensation of the CEO or equivalent position; and (iii) the ratio of the two amounts. Under the Final Rules, each company subject to this disclosure requirement must evaluate the annual total compensation of its entire employee base and identify a "median employee" by applying any compensation measure that is appropriate to the size and structure of the company's business.[3] Under the Final Rules, the company is required to disclose the ratio of that median employee's annual total compensation as calculated under Item 402(c)(2)(x) of Regulation S-K to the CEO's annual total compensation. Companies must provide the new pay ratio in any registration statements, proxy and information statements and annual reports that are required to include executive compensation information pursuant to Item 402 of Regulation S-K.

The pay ratio disclosure is considered "filed" not "furnished" for purposes of the Securities Act of 1933, as amended, and the Securities Exchange Act of 1934, as amended (the "Exchange Act"), and companies are thus subject to the related higher standard of potential liability in connection with this disclosure.

Under the Final Rules, companies may disclose the pay ratio numerically presented where the median employee ratio is expressed as "1" or in a narrative format as a multiple showing the ratio that the CEO's annual total compensation bears to the annual total compensation of the median employee. For example, if the annual total compensation of a company's median employee is $50,000 and the CEO's annual total compensation is $5 million, the company could disclose the ratio as 100:1 or state that the annual total compensation of the CEO is 100 times that of the median employee compensation. The ratio is not to be expressed as a percentage. Although the Final Rules do not mandate where the pay ratio disclosure should appear, it is likely that companies will include the disclosure as a subsection of the Compensation Discussion and Analysis (the "CD&A") or as part of the narrative disclosure to the Summary Compensation Table. The pay ratio information does not need to be provided in XBRL (eXtensible Business Reporting Language) format as an exhibit to the company's annual report.

Identifying Covered Employees

The employees considered must include any full-time, part-time, seasonal or temporary worker employed by the company or any of its consolidated subsidiaries in both the United States and abroad, subject to certain exemptions, using any date within the last three months of its last completed fiscal year. Independent contractors or "leased" workers who are employed by a third party are excluded. In his August 7, 2015 Additional Dissenting Comments on Pay Ratio Disclosure, Commissioner Michael S. Piwowar criticized the Final Rules for creating a distinction between the treatment of contract workers depending on whether they are employed by a third party and whether that third party is affiliated or not affiliated with the reporting company.[4] Under the Final Rules, to exclude contract workers from the definition of "employee," a company must satisfy at least three requirements: (i) the contract worker is employed by a third party; (ii) the contract worker's compensation is determined by a third party; and (iii) the third party is unaffiliated with the company. Absent compliance with these three requirements, a contract worker would be deemed an "employee." Therefore, as noted by Commissioner Piwowar, the Final Rules' application would result, for example, in any self-employed contract worker being counted as an "employee" because no third party is involved. Furthermore, as recognized in the adopting release, whether an entity is controlled by another is based on the facts and circumstances of each situation, so affiliate status for purposes of determining whether a contractor is employed by an affiliate third party is not always clear.

Companies must disclose the date used to identify the median employee and, if in subsequent years the date changes, to briefly explain the rationale for the change.

Non-US Employee Exemptions

The Final Rules include non-US employees in the definition of "employee." Commissioner Daniel M. Gallagher, in his dissenting statement, advocated limiting the scope of the Final Rules to full-time, US employees, noting that the SEC has "ample definitional authority, interpretive authority, and exemptive

3 As further discussed elsewhere in this Client Alert, the Final Rules allow companies to rely on statistical sampling when evaluating their employees in order to identify a "median employee."

4 Commissioner Piwowar's additional dissenting comments can be found here.

authority to do so."[5] However, the Final Rules only allow companies to exclude non-US employees from the determination of its median employee in two circumstances:

- **Data privacy exemption.** Because some foreign data privacy laws are expected to hinder the ability of companies to gather necessary data to identify the median employee, the Final Rules permit companies to exclude non-US employees in jurisdictions where data privacy laws would make the company unable to comply with the rule without violating those laws. Companies must first use reasonable efforts to obtain or process the information necessary for compliance. If a company is not able to comply without violating such law, the company must exclude all non-US employees in that jurisdiction from the median employee determination and would be required to obtain a legal opinion from counsel on the inability of the company to obtain or process the information necessary for compliance with the rule without violating the jurisdiction's laws or regulations governing data. The legal opinion must be filed as an exhibit with the filing in which the pay ratio disclosure is included. The company also must disclose all excluded jurisdictions and approximate number of employees in each impacted jurisdiction. Furthermore, the company must identify the specific data privacy law and explain how complying with the Final Rules would violate such law.

- ***De minimis* exemption.** The Final Rules permit companies with non-US workers comprising of five percent or less of their total workforce to exclude all non-US employees from the pay ratio calculation, provided that a company choosing to exclude any non-US employees under this scenario must exclude all of them. If the non-US workers exceed five percent of the company's total workforce, the company may exclude up to five percent of their total workforce from the pay ratio calculation, provided that a company must exclude all employees from any excluded jurisdiction. In calculating the number of non-US employees for the *de minimis* exemption, non-US employees subject to the data privacy exemption are included. Companies relying on the *de minimis* exemption must disclose the jurisdiction and approximate number of employees excluded under each excluded jurisdiction.

Compensation Adjustments

In identifying the median employee, consistent with the proposed rules, companies are permitted, but not required, to annualize total compensation for all permanent employees employed for only a portion of the covered year, but are not permitted to make full-time equivalent adjustments for part-time workers or annualizing adjustments for temporary or seasonal employees.

The Final Rules permit, but do not require, companies to apply a cost-of-living adjustment to the compensation measure used to identify the median employee for employees in different jurisdictions than the CEO. If a company applies such a cost-of-living adjustment, it would need to use the same cost-of-living adjustment in calculating the median employee's annual total compensation. To provide context for this adjustment, a company electing to present the pay ratio in this manner must also disclose the median employee's annual total compensation and the pay ratio without the cost-of-living adjustment. However, as noted in Commissioner Piwowar's dissenting statement, the Final Rules do not address adjustments within the United States and therefore "unfairly target[] publicly-traded companies that employ a large number of individuals in states with relatively lower costs of living."[6]

Voluntary Presentation of Supplemental Ratios

In addition, the Final Rules permit, but do not require, companies to supplement the disclosure with a narrative discussion or additional ratios for context, provided that such ratios are clearly identified, are not misleading and are not presented with greater prominence than the required pay ratio. For example, if the median employee by annual total compensation for a global company is a person who is located in a jurisdiction outside of the United States, the company may choose to also include a ratio of the CEO compensation to the compensation of the median US-based employee as part of the pay ratio disclosure to provide additional context. As part of this supplemental disclosure, companies may also find it helpful to briefly describe who the median employee is (e.g., an engineer or a sales consultant). However, the instructions clarify that companies are not required to disclose any information other than compensation, and should not provide an employee's position if doing so would make an individual identifiable.

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5 Commissioner Gallagher's dissenting statement can be found here.

6 Commissioner Piwowar's dissenting statement can be found here.

Companies presenting supplemental information should be mindful of the length of such additional disclosure. As a company's CD&A becomes more and more detailed, shareholders may find it increasingly difficult to parse out information critical to their investment decisions. Commissioner Gallagher expressed concern that the pay ratio "obscures material information" otherwise disclosed regarding CEO compensation. Another risk of supplemental disclosure is that, while such supplemental disclosure that is favorable to a company in one year, it may be less favorable in subsequent years. Although supplemental disclosure may change from year to year, companies should be mindful not to significantly change the narrative surrounding the pay ratio disclosure from year to year without explaining the underlying rationale for such changes.

Identifying the Median Employee

To identify the median employee, companies have the flexibility to select a consistently applied compensation measure for employees that is appropriate to the size and structure of their business and results in a reasonable estimate of the median employee. While the SEC declined to prescribe a specific methodology, it suggested that a company with only a few employees might rely on Item 402(c)(2)(x) to determine total compensation for each employee and identify the median employee, while larger companies might instead rely on statistical sampling or another reasonable method, such as centralized payroll figures or company tax records. In this context, the size of the sample group and complexity of sampling used would depend on the wage variance across a particular company's workforce. For example, a company with higher wage variance among employees requires a larger sample than a company with lower wage variance. The SEC stated that permitting companies to identify the median employee using compensation information in the form that is maintained in their own books and records would reduce compliance costs, yet still result in a reasonable estimate of the median employee.

Finally, companies are required to briefly disclose the methodology used to identify the median employee, any material assumptions, adjustments or estimates used to identify the median employee, and any estimates used to determine elements of the median employee's total compensation for the purposes of calculating the required ratio. However, although the required descriptions must provide sufficient information for readers to evaluate the appropriateness of the methodologies used, companies are not required to provide any technical analyses or formulas used to arrive at such figures.

Determining Total Compensation

Once the company has identified the median employee through the use of a consistently applied compensation measure, it is required to determine the total compensation for such median employee in a manner consistent with the current disclosure obligations for named executive officers under Item 402(c)(2)(x) of Regulation S-K. Item 402(c)(2)(x) requires disclosure of the total compensation, including base salary, bonuses, stock and option grants, compensation from non-equity incentive plans, changes in pension value, nonqualified deferred compensation earnings and certain other forms of compensation, with extensive instructions accompanying each element of compensation included in the calculation. Therefore, under the Final Rules, companies using the flexible approach to identify the median employee are required to calculate the Item 402(c)(2)(x) total compensation for that median employee for the last completed fiscal year, in order to maintain consistency with other Item 402 information. Because the total compensation calculation using Item 402(c)(2)(x) is only required for one additional employee (the median employee), the SEC declined to simplify the total compensation definition that is required to be used to disclose the median employee compensation and the ratio; however, companies are permitted to use reasonable estimates when determining the elements of the Item 402(c)(2)(x) total compensation of the median employee (but not the CEO's total compensation).

In adopting the Final Rules, the SEC explained that, by calculating annual total compensation for the median employee consistent with Item 402, shareholders will be better equipped to assess the compensation and accountability of a company's executives and potentially provide more meaningful context to inform shareholders' say-on-pay votes. As a result, the Final Rules do not permit companies to use alternative annual periods or the year prior to the last completed fiscal year to calculate median employee compensation.

Multiple CEOs during the Fiscal Year

The Final Rules provide companies two alternatives for calculating the annual total compensation for the CEO in situations where the company has replaced its CEO during the covered fiscal year. The first option permits companies to aggregate the total compensation provided to each person who served as the CEO during the fiscal year as calculated pursuant to Item 402(c)(2)(x). The second option permits companies to disclose the compensation of the person serving in the CEO capacity on the date selected to identify the median employee and annualize that CEO's compensation. In either case, the company must disclose the methodology chosen.

Timing and Related Considerations

Compliance Date and Transition Periods

The Final Rules will take effect for the first full fiscal year commencing on or after January 1, 2017. The pay ratio disclosure is required in any filing by a company for which disclosure under Item 402 of Regulation S-K is mandated. Typically a company would satisfy its disclosure obligations under the new Item 402(u) of Regulation S-K by including the disclosure in its Form 10-K or, if filed within 120 days following the end of the company's last fiscal year, its definitive proxy statement.

New Registrants

A new registrant's first pay ratio disclosure must follow its first full fiscal year beginning after such company has (i) been subject to the requirements of Sections 13(a) or 15(d) of the Exchange Act for a period of at least twelve calendar months beginning on or after January 1, 2017, and (ii) filed at least one annual report pursuant to Sections 13(a) or 15(d) of the Exchange Act that does not contain the pay ratio disclosure.[7] Additionally, as proposed, the Final Rules do not require the pay ratio to be disclosed in a registration statement on Form S-1 or Form S-11 for an initial public offering or an initial registration statement on Form 10.

Foreign Private Issuers, Smaller Reporting Companies and Emerging Growth Companies

Foreign private issuers, smaller reporting companies and emerging growth companies are exempt from the pay ratio disclosure requirements. A company that ceases to be a smaller reporting company or an emerging growth company may rely on a transition period permitted in the Final Rules that allows such companies to exclude pay ratio disclosure until after their first full year after existing such status and not for any fiscal year commencing before January 1, 2017.

Business Combination Transactions

Companies that engaged in business combinations and/or acquisitions may omit the employees of the newly acquired entity from their pay ratio calculation for the fiscal year in which the business combination or acquisition occurs. Companies choosing to exclude the newly acquired entity must identify the business and indicate the approximate number of employees that are excluded from the pay ratio.

Omission of Salary or Bonus Information and Corresponding Form 8-K Amendments

In situations where salary or bonus information for a named executive officer is not calculable as of the latest practicable date, instructions to Item 402 of Regulation S-K permit companies to omit the disclosure in the Summary Compensation Table, provided that the company includes a footnote disclosing that fact and providing the date when the amount will be determined. Once the final amounts are determined, such companies must disclose the required information under Item 5.02(f) of a Form 8-K and provide a new total compensation figure for that named executive officer. The Final Rules permit a company relying on the above instruction for its CEO to omit pay ratio disclosure until the final total compensation of its CEO can be determined, provided it discloses that fact and the expected date that the total compensation for the CEO will be determined. The company must provide the pay ratio disclosure in the same Form 8-K filing in which the final total compensation figure is disclosed.

On-Going Compliance – Identify Median Employee Every Three Years

The Final Rules permit companies to use the same median employee or one who is similarly compensated (if, for example, the median employee is no longer in the same position or is no longer employed with the company), for three years, unless there has been a change in the employee population or employee compensation arrangements that the company reasonably believes would result in a significant change in the

[7] For example, a company with a fiscal year ending on December 31 that completes its initial public offering on March 1, 2017 will first be required to include pay ratio disclosure in its Form 10-K for its 2018 fiscal year or its definitive proxy or information statement for its 2019 annual meeting of shareholders, but no later than 120 days following the end of its 2018 fiscal year.

pay ratio disclosure. However, companies must still calculate the identified median employee's annual total compensation and use that figure to calculate the pay ratio each year. Companies relying on the same or similarly situated median employee must provide a brief explanation for their reasonable belief that there have been no corporate events that would result in a significant change in the pay ratio.

Practical Considerations

The Final Rules create new disclosure obligations for companies that must already provide executive compensation disclosure under Item 402 of Regulation S-K. The proposed rules were highly controversial, receiving over 287,000 comment letters. Commenters were especially sensitive to the costs of compliance, and the Final Rules include fewer concessions than requested by commenters. Given the estimated $1.3 billion total, or $368,159 per company, initial compliance cost and arguably limited usefulness of the newly required disclosures, it is not surprising that the Final Rules have already become subject to sharp criticism. In his dissenting statement, Commissioner Piwowar indicated that the Final Rules implement a "highly partisan" provision of the Dodd-Frank Act "that pandered to politically-connected special interest groups." Commissioner Gallagher's dissenting statement notes that the statute "does not have a statutory deadline," and that the SEC has "other, more pressing matters" to consider. Possibly hinting at legal challenges in the future, Commissioner Gallagher further stated that as was the case with the Conflict Minerals rule, "naming-and-shaming rules can fall afoul of the First Amendment" and expressed his concerns regarding "whether pay ratio disclosures are constitutional."

The Final Rules permit flexibility for companies to select the methodology and enhance their disclosure surrounding the pay ratio. Companies should carefully consider factors that may affect their pay ratio compared to their peer companies of the same size or industry. While Commissioner Gallagher asserted that the pay ratio provides "low-quality, non-comparable data," a company's initial pay ratio disclosure will likely be used as an additional tool for establishing benchmarking peer groups or as an additional metric for companies to compare against their existing peer group in subsequent years. Commissioner Piwowar's August 7, 2015 Additional Dissenting Comments on Pay Ratio Disclosure specifically raised the benchmarking concerns, indicating that the SEC's "economic analysis was deficient because it failed to consider fully whether pay ratio disclosure might increase CEO compensation." Commissioner Piwowar's comments proceeded to cite academic studies illustrating that "pay ratio disclosure could exacerbate any upward bias in executive pay by providing another benchmark that could be used in certain situations to increase CEO compensation (i.e., for a CEO whose company's pay ratio is lower than its peers' pay ratios)." Companies should also be aware of difficulties relating to capturing non-US employees in the ratio, including the potential costs associated with cross-border compliance issues, potential legal obstacles in obtaining and using personal compensation data from other countries, the value of comparing companies with substantial non-US compensation regimes to companies without offshore operations and the possibility that some companies could attempt to structure employment arrangements to reduce the number of employees at the end of their fiscal year in order to achieve a more favorable pay ratio.

Although compliance is several years away, companies may begin to prepare by taking the following steps:

- **Assessing workforce composition.** Companies should consider how the composition of their workforce will have an impact on their pay ratio compared to their peers. For example, a company with a large portion of seasonal or part-time employees may have a less favorable ratio compared to its peers. On the other hand, a company that outsources many low paid positions may have a more favorable ratio compared to its peers. Other factors to consider are whether the company has any consolidated subsidiaries with different pay structures or whether the company has recently undergone a significant corporate transaction resulting in a bifurcated pay structure between the company and the recently acquired business.

- **Global company considerations.** Companies with significant numbers of non-US employees must address additional considerations arising from their diverse employee base and variable labor costs across jurisdictions. Such pay disparities may result in a less favorable pay ratio compared to their peers. Additionally, in certain jurisdictions, non-wage benefits may be more prevalent, making calculations of their annual total compensation more complex. Companies should consider whether data privacy rules in certain jurisdictions prevent the calculation of annual compensation for covered employees and require exclusion. Companies should also consider the effects of using the *de minimis* exemption on their pay ratio compared to their peers. Furthermore, companies with high variation in compensation as a result of differing cost-of-living across jurisdictions should consider presenting cost-of-living adjusted pay ratios.

- **Selecting a methodology.** Based on the review of the company's segments and workforce composition, companies should identify the most cost-effective methodology to determine the median employee and calculate total compensation. Relying on centralized payroll figures or company tax records may be feasible for some companies, while it may be more appropriate to determine the median employee based on the total employee population or a statistical sampling of their population for others.

- **Implementing procedures.** Consider developing protocols and procedures to centralize databases that aggregate and consistently measure company-wide employee compensation data across segments, including payroll, pension and tax data. Companies with centralized record-keeping systems in place could significantly reduce the costs of compliance.

- **Enhancing disclosure.** Consider what, if any, additional information could enhance the pay ratio disclosure and whether supplemental narrative disclosure or other metrics could assist investors by providing context for the required ratio. Companies should consider including explanations as to the reasons why their ratios may not be directly comparable to their industry peers. Companies are also permitted to supplement the required pay ratio disclosure with additional pay ratios, which could exclude employees that skew the company's ratio, such as part-time or seasonal workers. While additional voluntary disclosures are permitted, companies should be mindful of increasing already lengthy CD&As and related compensation disclosures, balancing that consideration against the desire to include further clarifying explanations.

- **Distinguishing components of CEO compensation.** A substantial portion of CEO compensation frequently includes long-term compensation that is subject to vesting conditions. Median employee compensation, on the other hand, may not include material long-term compensation components. Companies may wish to take the opportunity to highlight the differences in CEO versus median employee compensation components in the context of the broader CD&A disclosure.

- **Say-on-pay impact.** The pay ratio disclosure is intended to provide shareholders with an additional metric to assess a company's executive compensation practices. Companies should consider the impact of the pay ratio disclosure on the say-on-pay vote.[8] Although the required votes are nonbinding, say-on-pay has a significant impact on the relationship between management and shareholders. Companies with substantially out of line pay ratios compared to their peers face an increased risk of unfavorable say-on-pay vote outcomes.

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[8] The White & Case LLP Client Alert on the say-on-pay rules can be found here. The full text of the say-on-pay rules can be found here.