Securities Alert: SEC Adopts Final Pay Ratio Disclosure Requirements

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On August 5, 2015, the SEC voted 3-2 to adopt the final pay ratio disclosure rules implementing Section 953(b) of the Dodd-Frank Wall Street Reform and Consumer Protection Act (the Dodd-Frank Act). The final rules add new Item 402(u) of Regulation S-K, which will require SEC reporting companies (also referred to in the adopting release as registrants) to disclose annually: (i) the median of the annual total compensation of all of their employees, excluding the chief executive officer (CEO); (ii) the annual total compensation of the CEO; and (iii) the ratio of the annual total compensation of the median employee to the CEO's annual total compensation.

In the adopting release, the SEC notes that it sought to tailor the final rules to meet what it believed to be the purpose of Section 953(b) of the Dodd-Frank Act -- providing shareholders with a company-specific metric that can assist in their evaluation of a registrant's executive compensation practices, including when exercising their "say-on-pay" voting rights -- while avoiding unnecessary costs.

COVERED FILINGS AND REGISTRANTS

With limited exceptions, registrants are required to include their pay ratio disclosure in annual reports on Form 10-K, registration statements under the Securities Act of 1933 and the Securities Exchange Act of 1934, and proxy and information statements, whenever those forms require compliance with other executive compensation disclosures under Item 402 of Regulation S-K. The SEC expressed its view that the most meaningful way to present pay ratio disclosure is in context with other executive compensation disclosure, such as the annual proxy statement's Summary Compensation Table and Compensation Discussion and Analysis, rather than on a stand-alone basis.

Smaller reporting companies, foreign private issuers, U.S.- Canadian Multijurisdictional Disclosure system filers and emerging growth companies are not subject to the pay ratio disclosure rules.

EMPLOYEES COVERED UNDER THE FINAL RULES

For purposes of calculating the pay ratio, the final rules define "employee" to include all U.S. and non-U.S. employees, including part-time, seasonal and temporary employees, of the registrant and its consolidated subsidiaries. The term expressly excludes workers who provide services to the registrant or its consolidated subsidiaries as independent contractors or "leased" workers as long as they are employed, and their compensation is determined by, an unaffiliated third party. The final rules provide flexibility in choosing the median employee determination date, allowing a registrant to choose any determination date which falls within the window of the last three months of the registrant's last completed fiscal year (instead of the proposed last day of the registrant's last completed fiscal year), with the determination date chosen to be included within the disclosure provided with the pay ratio.

In response to concerns that the inclusion of non-U.S. employees could raise compliance costs for multinational companies, introduce cross-border compliance issues and have an adverse impact on competition, the SEC exercised its exemptive authority to provide two tailored exemptions it believed would alleviate some of these concerns:

- ***Foreign Data Privacy Law Exemption*****:** Registrants may exclude non-U.S. employees from the median employee determination when a jurisdiction's data privacy laws or regulations are such that, despite a registrant's reasonable efforts to obtain or process information necessary to comply with the pay ratio disclosure rules, the registrant is unable to do so without violating those data privacy laws or regulations. As part of its reasonable efforts, the registrant must seek an exemption or other relief under the applicable jurisdiction's governing data privacy laws or regulations and use the exemption if granted. A registrant cannot cherry-pick which non-U.S. employees it excludes in a particular jurisdiction under the data privacy exemption -- it must exclude all or none. There are additional disclosures required if this exemption is relied upon, including a legal opinion that must be filed as an exhibit with the filing in which the pay ratio disclosure is included.
- ***De Minimus Exception*****:** A registrant may exclude non-U.S. employees from the median employee determination if those employees represent 5% or less of the total U.S. and non-U.S. employees. The rules include limitations which are designed to prevent a registrant from picking and choosing which non-U.S. employees to exclude both as a whole and in any particular jurisdiction. Although non-U.S. employees excluded under the foreign data privacy law exemption are not subject to the general 5% limitation, those excluded employees would be considered when determining whether the 5% threshold has been exceeded (*e.g.*, if more than 5% of the employees of a registrant and its consolidated subsidiaries are excluded under the foreign data privacy law exemption, no additional employees may be excluded under the de minimus exemption; if 3% of such employees are excluded under the foreign data privacy law exemption, up to 2% could be excluded under the de minimus exemption). There are additional disclosures required if the de minimus exemption is relied upon.

A registrant may also exclude any persons 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, but the registrant must disclose the approximate number of employees being omitted. Those employees would be included in calculations of the median employee for subsequent years.

DETERMINING THE MEDIAN EMPLOYEE

The final rules provide registrants with flexibility when determining the median employee. First, registrants may use statistical sampling or other reasonable measures to narrow the number of employees to be included in determining the median employee. Second, registrants may determine the median employee (i) by calculating the annual total compensation for each employee included in the calculation in accordance with Item 402(c)(2)(x) of Regulation S-K or (ii) based on any consistently applied compensation measure (such as information derived from payroll or tax records). The methodology and any material assumptions, adjustments or estimates used to identify the median employee must be included as part of the disclosure.

Third, the final rules permit registrants to make cost-of-living adjustments for the compensation of employees in jurisdictions other than the jurisdiction in which the CEO resides so that the compensation is adjusted to the cost of living in the jurisdiction in which the CEO resides. Fourth, the final rules allow annualization adjustments for full-time and part-time employees who did not work for the registrant's full fiscal year for some reason, such as employees who were newly hired, on leave under the Family and Medical Leave Act of 1993, called for active military duty or took an unpaid leave of absence during the period. Annualization is not, however, allowed for seasonal or temporary employees.

Finally, the final rules allow a registrant to 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 the registrant's employee population or employee compensation arrangements that the registrant reasonably believes would result in a significant change in the pay ratio disclosure. Disclosure as to the basis for using the same median employee must also be included. If the registrant is using the same employee as its median employee for more than one year, it must calculate that median employee's total compensation each year and use that figure to update the registrant's pay ratio disclosure each year.

CALCULATION OF TOTAL COMPENSATION

Once the median employee is identified, the median employee's and the CEO's annual total compensation is to be calculated using the requirements of Item 402(c)(2)(x) of Regulation S-K, which prescribes the elements to be included in the total compensation reported for named executive officers in the annual proxy statement's Summary Compensation Table. Recognizing the potential for valuation difficulties with respect to certain types of benefits, the rules permit a registrant to use reasonable estimates to calculate annual total compensation or any elements of total compensation for the median employee (but not for the CEO). Generally, a registrant may exercise the same discretion allowed under the executive compensation disclosure rules to include or exclude from the calculation of the CEO's annual total compensation perquisites that aggregate to less than $10,000 and compensation under nondiscriminatory benefit plans, in the calculation of the median employee's annual total compensation. However, in determining annual total compensation for purposes of the pay ratio disclosure -- which requires the same approach be used for both the CEO and the median employee -- a registrant may determine to include those amounts as they are likely to represent a relatively larger portion of the median employee's total compensation than the CEO's and may decrease the pay ratio.

If a registrant replaces its CEO during the fiscal year, the final rules provide two alternatives for calculating the "CEO" total compensation to be used in the pay ratio calculation: (i) combine the total compensation of each CEO as reported in the Summary Compensation Table; or (ii) annualize the compensation of the person serving as CEO as of the date the employee population is measured for purposes of determining the median employee.

DISCLOSURE OF PAY RATIO

The final rules require that the pay ratio be expressed either (i) as a ratio in which the annual total compensation of the median employee is equal to one (*e.g.*, 1 to 50), or (ii) narratively in terms of the multiple that the CEO's annual total compensation amount bears to the annual total compensation of the median employee (*e.g.*, the CEO's annual total compensation is 50 times that of the median employee).

The final rules also require that a registrant briefly describe its methodology for identifying the median employee, including any material assumptions, adjustments or estimates used to identify the median employee, and for determining total compensation or any elements of total compensation. To allow for comparability in reviewing a registrant's pay ratio disclosure from year to year, if the registrant changes the methodology or material assumptions, adjustments or estimates from those used in the previous period, and if the effects of any such changes are significant, the registrant must briefly describe the change(s) and the reasons for the change(s).

COMPLIANCE DATE

Registrants must comply with the final rules for the first fiscal year beginning on or after January 1, 2017. This means that a registrant with a calendar year fiscal year must first include the pay ratio disclosure in its Form 10-K or annual meeting proxy statement filed in 2018.

Given the magnitude of compensation information to be compiled and complexity of the calculations to be made in order to satisfy the pay ratio disclosure requirements, registrants should not delay in determining their methodology and considering the assumptions, adjustments and estimates to be used in calculating their pay ratios as well as developing the narrative disclosure that will accompany the pay ratio.