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SEC Adopts Pay Ratio Disclosure Rules

On August 5, 2015, the SEC adopted a final pay ratio disclosure rule that requires a public company to disclose (1) the median of the annual total compensation of all employees (excluding the CEO), (2) the annual total compensation of its CEO, and (3) the ratio of those two amounts.

Companies must comply with the pay ratio disclosure rule for the first fiscal year beginning on or after January 1, 2017. In practice, companies do not need to disclose this pay ratio until early 2018 in the later of its annual report on Form 10-K for the 2017 fiscal year or the related definitive proxy or information statement that incorporates executive pay disclosure into the Form 10-K.

While simple to describe, the initial costs of implementation, both in terms of resources needed and personnel hours devoted, could be significant, with the SEC estimating an initial compliance cost of $1.3 billion for all companies affected by this rule. Most of these costs will focus on the disclosure relating to the "median employee", and how that employee is identified. For companies with significant global operations in multiple jurisdictions, the calculation to determine the median employee will include determinations about methodology (including the use of statistical sampling), assumptions, adjustments, and estimates. So though the implementation deadline is a couple of years away, and though we expect legal and legislative challenges to this rule (see *Points to Note* below), companies should start understanding the scope of these calculations and disclosures now. This will help them to determine what systems to put in place to track and/or sample employee compensation across a consolidated company and to start discussions on any assumptions, estimates or adjustments that will be included in the disclosure.

Company Exemptions from Pay Ratio Disclosure

Emerging growth companies, foreign private issuers, registered investment companies, and smaller reporting companies are exempt from the pay ratio disclosure rules. When the status of a company changes so it is no longer an emerging growth company or smaller reporting company, it must comply with the pay ratio disclosure for the first fiscal year commencing on or after the date the registrant ceases to be an emerging growth company or smaller reporting company (but not earlier than the implementation timeline above). As an example, if the fifth anniversary of an emerging growth company's IPO occurs during 2017, it will cease to be an emerging growth company on the last date of that fiscal year (which for this purpose of this example will be December 31, 2017). Such a company would need to comply with the pay ratio disclosure rules for the 2018 fiscal year in the Form 10-K or proxy statement it will file in early 2019.

The "Median" Employee

In a company of one thousand employees, including the CEO, the rules require a company to exclude the CEO and then calculate the compensation for the median employee – in this example, the one employee in the middle so that 499 employees would receive equal or more compensation and 499 employees receive equal or less compensation.

Calculating the total annual compensation for each and every employee to determine who the "median" employee will be a cumbersome and costly exercise for many companies. The first step is to determine who should be included as an "employee."

Including "All Employees"

Companies must generally make its determination from all of its U.S. and non-U.S. employees that work for the company and any of its consolidated subsidiaries, including any part-time, seasonal and temporary employees under the final rule.

Anyone employed by the company or its consolidated subsidiaries as an independent contractor or "leased" workers who are employed and whose compensation are determined by an unaffiliated third party are not to be included when calculating the median of the compensation of all employees.

In a change from the proposal, companies can determine the employee population as of any date they select in the last three months of the fiscal year, and are not required to use the last day of the fiscal year. This provides a certain level of flexibility and may provide more time to prepare for the disclosure. To prevent potential manipulation, however, the rule requires companies to disclose the reasons if the selected date changes from the previous year.

The SEC has provided two exemptions from the general "all employee" determinations so that a company can exclude:

1. employees in a foreign country where it is not possible to obtain or process necessary information due to the data privacy laws or regulations of that country, and
2. a total of up to 5% of a company's total employees that are located outside the U.S. as part of a *de minimis* exemption for non-US employees.

To maintain an exemption for foreign employees under the foreign privacy laws, companies must exercise reasonable efforts to obtain or process the information necessary for compliance with the final rule, including seeking relief under the relevant jurisdiction's laws and regulations. After making these reasonable efforts, the company must provide a legal opinion that states that the company cannot comply with the final pay ratio disclosure rule without violating the jurisdiction's data privacy laws or regulations.

The *de minimis* exemption would include any non-U.S. employees subject to data privacy restrictions and other employees in foreign jurisdictions up to the 5% limit. A company using the *de minimis* exemption must exclude all employees in a particular jurisdiction so they cannot pick and choose which employees to exclude. Therefore, a company cannot exclude any non-U.S. employees in a jurisdiction that employs over 5% of the total employees of a company and cannot exclude any employees in a foreign jurisdiction that would put the company over the 5% limit if all employees in that jurisdiction were excluded together with the employees subject to the data privacy laws exemption.

Finding the "Median"

Under the final rule, how a company identifies the median employee may be highly specific to each company due to flexibility to use different methodologies, estimates and adjustments that can vary greatly between companies, even in a specific peer group. The adopting release acknowledged that that precise conformity or comparability of the pay ratio across companies is not necessarily achievable given the variety of factors that could cause this determination, and thus the ratio, to differ. The SEC notes that they believe the primary benefit of the pay ratio disclosure is to provide shareholders with a company-specific metric that they can use to evaluate a CEO's compensation within the context of their company.

In calculating the median employee a company:

- May use reasonable estimates both in the methodology used to identify the median employee and in calculating the annual total compensation or any elements of total compensation for employees but must identify any estimates used.
- May use its employee population or statistical sampling and/or other reasonable methods.

- May identify the median employee 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 the registrant's tax and/or payroll records, but must disclose the measures used.
  - These methods may be defined differently across countries and include different annual periods, but they must be consistently applied
- May use the same annual period that is used to derive those measures recorded on a basis other than the company's fiscal year (such as information derived from tax and/or payroll records if used instead of annual total compensation).
- May make cost-of-living adjustments to 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 CEO's jurisdiction.
- May, at their discretion, include personal benefits that aggregate less than $10,000 and compensation under non-discriminatory benefit plans in calculating the annual total compensation of the median employee as long as these items are also included in calculating the CEO's annual total compensation.
- May annualize the total compensation for all permanent employees (full-time or part-time) that were employed for less than the full fiscal year, but *may not* annualize the total compensation for employees in temporary or seasonal positions and *may not* make a full-time equivalent adjustment for any part-time, seasonal or temporary employee.

The final rule allows companies to identify the median employee once every three years unless there is a significant change in the total employee population or compensation that might reasonably result in a significant change in the ultimate ratio. But the calculation of the median employee's total annual compensation must be done every year to provide the required disclosure.

The Pay Ratio Disclosure

A company must disclose the total annual compensation for the median employee for the applicable fiscal year in a manner similar to how the CEO's total annual compensation is calculated pursuant to the requirements of Item 402(c)(2)(x) of Regulation S-K. If a company uses cost-of-living adjustments to identify the median employee and compare the median employee's compensation in a jurisdiction to the CEO's compensation, the company must disclose the jurisdiction in which the median employee is located and describe the cost-of-living adjustments were that were made.

In addition, the company must make a second calculation to determine the median employee without any cost-of-living adjustments and provide a separate ratio of that second "median employee's" total compensation (without adjustments) to the total compensation of the CEO. The SEC requires two ratios in this case so that "shareholders would have pay ratio information both in terms of the value of compensation received by the employee and in terms of the compensation paid by the registrant."

The pay ratio disclosure can be made through a numerical ratio (x:1) or in a narrative sentence and companies are to consistently apply and disclose any methodology, assumptions, adjustments and estimates used in identifying the median employee and calculating the total compensation. To add context to this disclosure, companies are permitted, but not required, to provide additional pay ratios as long as any additional pay ratios are not misleading and are not presented with greater prominence than the required ratio or ratios.

Pay Ratio Disclosure is "Filed"

Like other disclosures under Item 402, the pay ratio disclosure will be treated as "filed." This means that the company disclosure may be subject to liabilities, including Section 18 liability so companies are advised to prepare in advance of the upcoming compliance date.

Points to Note

Challenges to the Final Rules – The final rules passed via a split vote of the SEC commissioners. We expect this rule to be challenged in the courts and there are already bills in Congress that would repeal the pay ratio provisions of the Dodd-Frank Act. It is too early to determine if any of these legal or legislative challenges will succeed in mooting the pay ratio disclosure rules as adopted but we will continue to provide updates to our clients as these challenges develop. However, compliance with these rules may require significant resources and personnel hours so we recommend companies begin understanding the scope of the required calculations and start discussing the systems needed to make these calculations and any assumptions, estimates or adjustments that will be included in the disclosure. Please contact any of the attorneys listed if you'd like more information.

Externally Managed Public Companies – Public companies that utilize an external manager to conduct their operations (including certain REITs) generally do not have any employees of their own even if certain employees of the manager are designated as officers of the company. Therefore, they will not need to comply with these pay ratio disclosure rules.

Unintended Consequences – Though the SEC believes that pay ratio disclosure will help shareholders understand executive pay in the specific context of a particular company, no one knows what investors will do with this information. Certain employee and labor pension funds and activist shareholders did tell the SEC through their comment letters that this information would help inform their voting in Say-on-Pay votes and, possibly, director elections. These pension funds and activists shareholders may directly pressure boards to reduce CEO compensation depending on the results of the pay ratio disclosure. However, it is also possible that other activist shareholders will use these ratios to pressure management to derive more value out of employees where they feel the ratio is too low. This may lead certain activist shareholders to call for layoffs and other forms of restructuring.

If the optics of these ratios are harmful to companies, they may also lead companies to utilize more "leased" employees and other independent contractors or outsourcing firms to fill the positions currently held by lower-paid, part-time or seasonal employees. And where outsized ratios may be due to returns from equity compensation that aligns the interests of the CEO with the interests of shareholders, companies may decide to replace some equity compensation with cash compensation that won't fully align the CEO's interests with a company's shareholders, even where such cash compensation is tied to performance.

A copy of the SEC final pay ratio rule (17 CFR Parts 229 and 249) is available at:
http://www.sec.gov/rules/final/2015/33-9877.pdf

This briefing provides general information and does not constitute legal advice for any specific person or situation. Questions concerning issues addressed in this memorandum should be addressed to:

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