INSIGHTS

THE CORPORATE & SECURITIES LAW ADVISOR

Volume 29 Number 9, September 2015

INSIDE THE SEC

SEC Adopts Pay Ratio Rule

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The Securities and Exchange Commission has adopted a pay ratio disclosure rule, requiring public companies to compare the compensation of their chief executive officer to the median compensation of their other employees.[1] The new pay ratio disclosure rule is contained in new paragraph (u) of Item 402 of Regulation S-K. It requires public companies to disclose:

- The median of the annual total compensation of all employees other than the chief executive officer;
- The annual total compensation of the chief executive officer; and
- The ratio of these amounts.

The SEC has provided a transition period so that the initial pay ratio disclosure will be required with respect to compensation for a company's first full fiscal year that begins on or after January 1, 2017. Therefore, calendar year-end companies will first be required to include pay ratio disclosure in 2018.

The Pay Ratio Disclosure Rule

For the purposes of the pay ratio rule, the term "employee" means an individual employed by the company or its consolidated subsidiaries as of any date (determined by the company) within the last three months of the company's last completed fiscal year. In addition to full-time employees and employees based in the United States, the term includes:

- Employees based outside of the United States;
- Part-time employees;
- Temporary employees; and
- Seasonal employees.

Independent contractors and leased workers are not considered employees for the purposes of the pay ratio disclosure rule if they are employed by, and have their compensation determined by, an unaffiliated third party. Individuals who become employees as a result of a business combination or acquisition can be omitted from the company's identification of the median employee for the fiscal year in which the transaction became effective, provided that certain information is otherwise disclosed.

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The SEC has provided two limited exemptions that permit companies to exclude certain employees located in non-US jurisdictions from the pay ratio calculation. First, the final rule provides an exemption for employees in a foreign jurisdiction in which data privacy laws or regulations are such that, despite the company's reasonable efforts to obtain and process the information necessary to comply with the pay ratio disclosure rule, the company is unable to do so without violating those data privacy laws or regulations. However, this exemption requires that, at a minimum, the company must use or seek an exemption or relief from such laws or regulations. Second, the rule provides a *de minimis* exemption for non-US employees representing 5 percent or less of a company's total employees. Any employees excluded under the privacy law exemption will count towards the 5 percent limit. If any employees in a foreign jurisdiction are excluded from the pay ratio calculation, all employees in that jurisdiction (other than the chief executive officer) must be excluded from the calculation.

Generally, the pay ratio disclosure will be provided in filings that require executive compensation disclosure pursuant to Item 402 of Regulation S-K, such as proxy and information statements, annual reports on Form 10-K and registration statements under the Securities Act of 1933 and the Securities Exchange Act of 1934. Smaller reporting companies, emerging growth companies, foreign private issuers, MJDS filers (i.e., registrants filing under the US Canadian Multijurisdictional Disclosure System) and registered investment companies will not be subject to the pay ratio disclosure requirement.

The pay ratio disclosure rule gives companies flexibility to select a method for identifying a median that is appropriate to the size and structure of their businesses and compensation programs. Companies may identify the median employee based on any consistently used compensation measure, such as compensation amounts reported in its tax and/or payroll records. Companies will be permitted to identify the median based on total compensation regarding their full employee population. Alternatively, they may do so by using a statistical sample or another reasonable method.

Once the median employee has been identified pursuant to one of the methods described above, the total compensation for the median employee will have to be calculated for the last completed fiscal year, consistent with the requirements for calculating the chief executive officer's total compensation for the same fiscal year for purposes of the summary compensation table.

The final rule permits a company to choose any date during the last three months of the fiscal year for the purpose of identifying the median employee. In addition, the final rule permits companies to identify the median employee only once every three years, as long as there has been no change in the employee population or employee compensation arrangements that would significantly change the pay ratio disclosure. If, during those three years, the median employee's compensation changes, or the median employee has left the company, the company may substitute another employee with substantially similar compensation as its median employee.

The new rule permits a company to annualize the compensation for all permanent employees, whether full-time or part-time, who were employed on the calculation date, but who did not work for the company for the full fiscal year. The rule does not permit annualization for temporary or seasonal employees. In addition, the pay ratio disclosure rule does not permit the use of full-time-equivalent adjustments for the required pay ratio disclosure. However, a company is permitted to derive and disclose an additional ratio using full-time equivalent adjustments.

In determining the median employee, a company is permitted to use a cost-of-living adjustment for employees living in jurisdictions other than the jurisdiction in which the chief executive officer

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resides. If a company uses a cost-of-living adjustment, and the median employee resides in a different jurisdiction than the chief executive officer, the company must use the same cost-of-living adjustment in calculating the median employee's annual total compensation. In that event, the pay ratio disclosure must be provided two ways—including the cost-of-living adjustment and excluding the cost-of-living adjustment.

The rule requires a brief, non-technical overview of the methodology used to identify the median employee and any material assumptions, adjustments or estimates used to identify the median employee or to determine total compensation or elements of total compensation. If a company uses a consistently applied compensation measure to determine the median employee, it will have to disclose the measure used. If statistical sampling is used, the size of the sample and the estimated whole population should be disclosed, as well as material assumptions used in determining sample size.

Practical Considerations

Timing

Public companies will not be required to include pay ratio disclosures in their proxy statements for the next two proxy seasons—pay ratio disclosure will not be required until the 2018 proxy season at the earliest. Meanwhile, there may be litigation or legislative responses challenging the SEC's pay ratio rule. These responses may echo points raised by the two dissenting SEC commissioners at, and subsequent to, the meeting at which the final pay ratio disclosure rule was approved. However, public companies should assume that they will have to comply with this final rule and begin preparations in the near future to be able to provide the pay ratio disclosure on a timely basis.

Preparation

Companies should recognize that it may take a significant amount of time to determine the methodology they will use to calculate and report their pay ratio disclosure, to coordinate their reporting systems in various jurisdictions and to determine the ability to obtain and time involved to gather necessary information. Companies should evaluate their payroll and other compensation recordkeeping systems for planning purposes, develop strategies for compliance and consider how they will update their disclosure controls and procedures for pay ratio disclosure. Employees who have the responsibility to assemble the information to make the disclosure should be sure they understand what compensation programs the company has, including on a worldwide basis if the company has employees outside of the United States. This also should include an understanding of how the company contracts with and makes payments to independent contractors in different jurisdictions if those workers are to be included for purposes of determining the median employee. In addition, it should be determined whether the gathered information needs to be adjusted to reflect differences in internal compensation reporting systems in various jurisdictions.

Filed, Not Furnished

Pay ratio disclosure will be "filed" as opposed to "furnished." As a result, it will be subject to securities law liabilities and the certifications required of the chief executive officer and the chief financial officer. Therefore, companies affected by the rule should use this period before the compliance date to make sure that they are in a position to provide pay ratio disclosure with confidence that the information they include in their SEC filings will be accurate and in compliance with the rule.

Independent Contractors

In order to not be considered an employee for purposes of the pay ratio disclosure rules, an independent contractor must be employed by, and have his or her compensation determined

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by, unaffiliated third parties. Companies with a significant number of independent contractors will need to determine whether each individual is an employee for purposes of the new rules. Sooner rather than later companies should begin determining whether an independent contractor is employed by an unaffiliated party and whether more information is needed to make this determination.

Statistical Sampling or All-Employee Data

A company also should determine whether it would prefer to disclose its pay ratio using statistical sampling or by gathering complete pay data for all employees, if it has existing systems in place that make it more convenient. To the extent a company plans to use statistical sampling, it may find it useful to try various sampling methods to determine which is the most appropriate, given the company's specific facts and circumstances. It is important to use a sampling measure that can be justified and supported with a methodology that can be repeated.

Non-U.S. Privacy Law Exemption

If a company with employees outside the United States determines that there is a foreign data privacy law that would be violated by complying with the SEC's pay ratio disclosure rule, it will need to take the steps necessary to use, or seek an exemption to or other relief from such foreign law. If the company is unable to qualify for an exemption, or receive a waiver, it will need to obtain an opinion of counsel from the foreign jurisdiction in order to rely on the exemption for pay ratio disclosure provided by the final rule. Because these measures are likely to be time-consuming, companies with an employee population outside of the United States should begin reviewing the applicable data privacy laws and regulations to ascertain whether there are any conflicts with the SEC rule and, if so, to determine the process they will need to follow to satisfy the SEC's foreign data privacy law exemption.

De Minimis Foreign Employee Exemption

Companies with employees in multiple jurisdictions outside of the United States should identify the jurisdictions in which 5 percent or less of their total employee population is located to determine which jurisdictions, if any, they plan to exclude using the *de minimis* foreign employee exemption. Because all employees in a foreign jurisdiction must be excluded if any are excluded, and because employees excluded due to the privacy exemption count toward the 5 percent threshold for the *de minimis* exemption, companies in this situation may want to balance the relative difficulties of gathering the information with respect to employees in such jurisdictions to determine how best to apply the exemption, if at all.

Cost-of-Living Adjustment

Companies should explore whether they want to apply cost-of-living adjustments to identify their median employee and to determine such employee's annual compensation. Presumably, a company only will present a pay ratio with a cost-of-living adjustment if it shows a lower ratio, which may be helpful in supporting a company's say-on-pay proposal. However, in order to use a cost-of-living adjustment for the pay ratio, the company also must give non-adjusted numbers. It is likely that people who view pay ratio disclosure as a means to achieve pay equity, and journalists who seek a more dramatic story, will focus on the unadjusted number even when the adjusted ratio is presented. Therefore, part of the assessment may be whether it is worth the time and effort to calculate pay ratio on both a cost-of-living adjusted and a non-adjusted basis.

Privacy Issues

While gathering the necessary data for the pay ratio disclosure, companies should review all applicable privacy laws and regulations, even when the privacy exemption does not apply. For example, while the company must identify a specific employee as its median employee, it must

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be careful when preparing its narrative disclosure not to violate any privacy laws and provide information that will identify the individual whose compensation data is being presented.

A privacy quandary can arise where a company uses a cost-of-living adjustment that results in the median employee being from a jurisdiction where the company has a very small number of employees. When a company uses a cost-of-living adjustment, the pay ratio rule requires the company to disclose the median employee's jurisdiction if that employee resides in a jurisdiction other than the chief executive officer's jurisdiction. Yet, companies are not supposed to provide information that could identify the specific individual who is the median employee. If this situation arises, a company should consider carefully the pay ratio disclosure before it is made.

Early Adoption

To date, a small number of companies have provided some pay ratio disclosure in their proxy statements. Companies that are considering being early adopters of pay ratio disclosure or that would like to get a sense of how some companies have addressed this disclosure may want to review these examples. However, such disclosures are contained in proxy statements that were prepared before the final pay ratio disclosure rules were adopted. Therefore, they should be reviewed more for background and style and not as precedents for compliance with the new requirements.

Additional Narrative Explanations

Companies should consider whether, in addition to required disclosures, they want to provide additional narrative explanations. The narrative portion of the pay ratio disclosure may be sensitive. Therefore, it may be worthwhile to spend time drafting and reviewing possible disclosure even though pay ratio disclosure will not be required before the 2018 proxy season.

Selecting a Benchmark Date

The final rule gives companies the flexibility to select a date within the last three months of the fiscal year as of which the median employee will be determined. Companies might find it productive to assess fluctuations in the number and nature of their employee population during the last three months of 2015 and 2016 to determine if there is a specific timing that makes the most sense for their company.

Disclosure Controls and Procedures

Companies will need to update their disclosure controls and procedures to take into account the pay ratio disclosure rule. For example, the final rule permits companies to identify the median employee only once every three years, but only if there has not been a change in employee population or employee compensation arrangements that would significantly change the pay ratio disclosure. To retain the flexibility of relying on the identification of the median employee in a previous year, companies should develop a procedure to assess whether or not any such change has occurred. Similarly, it would be useful to have a procedure to provide prompt notice to the disclosure team if the median employee's compensation has changed to reflect a promotion or if that individual is no longer employed by the company.

Alerting the Compensation Committee

Even though the SEC has provided a relatively long lead time for compliance with pay ratio disclosure, it is important to update compensation committees on the final rule so that committee members can reflect on what impact, if any, the rule might have on their companies.

Employee Morale Implications

Companies also should consider the practical impact of pay ratio disclosure on its employee population. While employees as a group may share

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a general interest in the ratio of the chief executive officer's pay to the median employee, many employees may react to the pay ratio disclosure more personally, wanting to know why their compensation is in the bottom half or why their compensation is only in the middle of the compensation spectrum. Therefore, in addition to planning for public pay ratio disclosure, companies may want to begin planning on how they will handle internal employee communications on this subject.

Conclusion

The SEC has complied with its Dodd-Frank mandate by adopting a final pay ratio disclosure rule. Although there may be challenges to the rule, public companies should be operating under the assumption that pay ratio disclosure is becoming part of the SEC reporting landscape. The SEC has provided a relatively long transition period before pay ratio disclosure will be required. However, there is a lot that companies should begin doing in the meantime to prepare. Public companies should be using this time wisely so that they will be in a position to comply with this new rule by the time they are required to do so.

Note

1. Available at *http://www.sec.gov/rules/final/2015/33-9877.pdf*.

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