The SEC's Pay Ratio Disclosure Rule And Its Implications

by Laura D. Richman and Michael L. Hermsen

After years of debate, the SEC has finally approved rules requiring public companies to disclose the pay ratio between their top executives (particularly the CEO) and their employee median. How will your compensation committee need to respond? What unanswered compliance questions remain?

In August, the U.S. Securities and Exchange Commission, by a three to two vote, 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. The SEC has provided a transition period so that the initial pay ratio disclosure will be required 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. However, there is a lot that companies should begin doing in the meantime to prepare.

☐ ***Summary of the final rule.*** The SEC's pay ratio rulemaking was mandated by the Dodd-Frank Act. The SEC originally proposed pay ratio disclosure in 2013, and the proposal generated a great deal of interest and debate. The SEC received more than 287,000 comment letters.

The 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 pay of the chief executive officer.
- The ratio of these amounts.

For the purposes of the 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.

Workers such as independent contractors or leased workers are not considered employees for purposes of the rule. Also, for people who become employees as a result of a business combination or acquisition, the SEC has created a transition period before those employees must be included in determining the median of the annual total compensation of all employees.

If a company is going to rely on the disclosure exemption for employees covered by foreign data privacy rules, it must first use an exemption under the foreign rules or seek relief from the foreign government, and also gain a supporting opinion from company counsel.

In a change from the proposed rule, the SEC has provided two limited exemptions from the definition of employee. These exemptions permit companies to exclude certain employees located in non-U.S. jurisdictions (non-U.S. employees) 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 the company is unable to do so without violating those rules. The company, *at a minimum,* must use or seek an exemption or other relief under the applicable foreign law or regulation.

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The company would also need to obtain an opinion of counsel opining that the company cannot obtain or process the necessary information without violating the applicable privacy laws or regulations. If a company relies on this privacy exemption for any foreign jurisdiction, it must exclude all employees from that jurisdiction from its pay ratio calculation.

Second, the SEC also provided a *de minimis* exemption for non-U.S. employees. If non-U.S. employees account for five percent or less of a company's total employees, the company may choose to exclude all (but not less than all) of its non-U.S. employees when identifying its median employee.

Where 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 (including employees subject to the privacy exemption) from this determination. However, if the company excludes any employees in a particular non-U.S. jurisdiction it must exclude all employees in that jurisdiction.

The pay ratio disclosure will only be required for companies that provide a summary compensation table pursuant to Item 402(c) of Regulation S-K. Smaller reporting companies, emerging growth companies, foreign private issuers, MJDS filers (i.e., registrants filing under the U.S. Canadian Multijurisdictional Disclosure System) and registered investment companies will not be subject to the 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 pay programs.

Companies may identify the median employee based on any consistently used compensation measure, such as amounts reported in its tax and/or payroll records. When using a consistently applied measure to determine annual median employee pay, companies may use the same annual period that is used in these records.

Factors that a company can take into account when determining their median employee may include:

- The size and nature of the workforce.
- The complexity of the organization.
- Stratification of pay levels across the workforce.
- The types of compensation the employees receive.
- The extent that different currencies are involved.
- The number of tax and accounting regimes involved.
- The number of payroll systems the company has and the difficulty involved in integrating them.

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.

While the median employee must be an actual, individual employee, companies are not required to, and should not, identify this person by name or other identifiable information.

The SEC provided some guidance on statistical sampling. The SEC stated that a relatively small sample size may be appropriate in certain situations. It also indicated that a reasonable determination of sample size ultimately depends on the underlying distribution of pay data. The SEC advised that "all statistical sampling approaches should draw observations from each business or geographical unit with a reasonable assumption on each unit's compensation distribution and infer the registrant's overall median based on the observations drawn."

The median employee must be an actual, individual employee. However, companies are not required to, and should not, identify the median employee by name or other identifiable information. Companies may choose to generally identify the median employee's position to place the pay in context, but the instructions to the rule specify that they should not do so if providing the information could identify any specific individual.

In a change from the proposed rule, the final rule permits a company to choose any date during the last three months of the fiscal year for the purpose

Pay Ratio Q&A

Getting Ready For Disclosure

Key Questions	Brief Answer
What has to be disclosed?	◆ The median of the annual total compensation of all employees, except the CEO; ◆ The annual total compensation of the CEO; ◆ The ratio of those two amounts; and ◆ Methodology, assumptions and estimates. Supplemental narrative discussion and additional ratios are permitted.
How is the median employee determined?	Generally, the median employee is determiend once every three years, based on: ◆ Total employee population; or ◆ Statistical sampling of that population; and/or ◆ Other reasonable methods.
How is total compensation determined?	Annual total compensation for median employee is calculated using the same rules that apply to CEO compensation under Item 402 of Regulation S-K.
Who is included in the employee population?	All employees of the company and its consolidated subsidiaries, whether full-time, part-time, temporary, seasonal, U.S. or non-U.S. Two exceptions for non-U.S. employees: foreign data privacy law exemption and *de minimis* exemption.

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 employee population or employee pay plans that would significantly change the pay ratio disclosure.

Once the median employee has been identified, 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 pay for the same fiscal year.

The pay ratio rule permits companies to use reasonable estimates to calculate annual pay for employees other than the chief executive officer. Reasonable estimates will also be permitted in identifying the median employee.

The new rule permits a company to annualize the pay 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 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 calculating the annual total pay of the median employee, companies are permitted, but are not required, to include personal benefits that aggregate less than $10,000, as well as compensation under non-discriminatory benefit plans. To be consistent, however, the CEO's total used would have to reflect

Key Questions	Brief Answer
What compensation adjustments are permitted?	Compensation may be annualized for permanent employees, but not for temporary or seasonal employees. Full-time equivalent adjustments are not permitted. A cost-of-living adjustment is permitted, but if used the median employee's annual total compensation and the pay ratio must be disclosed with and without this adjustment.
What filings require pay ratio disclosure?	Proxy and information statements, registration statements and annual reports that must contain executive compensation information.
What companies must disclose pay ratio?	Pay ratio rule applies to companies that are required to provide executive compensation disclosre under Item 402(c)(2)(x) of Regulation S-K. (Smaller reporting companies, foreign private issuers, MJDS filers, emerging growth companies, and registered investment companies do not have to disclose pay ration.)
When is the first pay ratio disclosure required?	The first reporting period for a company's pay ratio disclosure is its first full fiscal year beginning on or after January 1, 2017.

the same approach. The company must also explain any difference between the CEO total used in the pay ratio disclosure and the amounts reflected in the summary compensation table, if material.

If a company has had more than one non-concurrent chief executive officer during its fiscal year, it may calculate the annual total CEO pay by using either of the following methods. First, combining the compensation provided to each such person during the year for the time that person served as chief executive officer. Or, the company may annualize the compensation of the chief executive officer serving in that position on the date selected to identify the median employee.

The pay ratio disclosure rule contains a number of disclosure requirements on the calculation and presentation of the pay ratio. For example, if a company chooses to express the ratio numerically, it needs to do so in relation to 1 (as in "50 to 1" or "50:1"). Alternatively, a company may express the pay ratio narratively (as in "the total annual compensation of the chief executive officer is 50 times that of the median of annual total compensation of all other employees.")

In addition, the rule requires a brief, non-technical overview of the methodology used to identify the median employee. Such disclosure should provide sufficient information to enable readers to evaluate the appropriateness of the estimates, but there is no need to disclose detailed formulas. If a company uses a consistently applied measure to identify 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. The disclosure should identify the sampling methods used and how the method deals with separate payroll systems. If a company changes methodology from a prior pay ratio disclosure, and the effects of the change are material, the change and the reasons for the change must be described, together with an estimate of the impact.

Companies can offer additional pay ratio calculations, but they must be clearly identified, not misleading, and not presented with greater prominence than the required ratio.

Companies will be permitted, but not required, to include additional disclosures. If companies choose to include any additional ratios, they must be clearly identified and not misleading. Additional ratios should not be presented with greater prominence than the required pay ratio.

The company will need to disclose the date as of which it identified its median employee. If a company uses a previously identified median employee, it must disclose that there have been no changes in its employee population or pay arrangements that would significantly impact the disclosure. If the company uses a substituted median employee due to changed circumstances, it will need to disclose that fact.

If a cost-of-living adjustment is used, the company will also have to disclose the unadjusted compensation information. If a company makes use of either or both foreign employee exemptions, the details of how the exemption applied would need to be disclosed.

The pay ratio disclosure rules become effective on October 19, 2015. However, companies generally will first be required to report the pay ratio disclosure for their first fiscal year beginning on or after January 1, 2017.

A company that had not previously been a reporting company would be required to report pay ratio disclosure for its first fiscal year following the year in which it becomes a reporting company, but not for any fiscal year commencing before January 1, 2017. Accordingly, pay ratio disclosure is not needed in the prospectus for an initial public offering.

A company that ceases to be either a smaller reporting company or an emerging growth company will not have to provide pay ratio disclosure until after the first full fiscal year after it exits such status, but not for any fiscal year commencing before January 1, 2017.

The pay ratio disclosure will not need to be updated throughout the year. It will only have to be calculated once per year, as of fiscal year-end. Companies may wait to update their pay ratio disclosure until they file their Form 10-K or, if later, their definite proxy statement for their annual meeting.

Companies are not required to disclose a pay ratio for the next two proxy seasons—and there may be legal challenges before then.

☐ ***What practical considerations should your board bear in mind?*** First, public companies will not be required to include pay ratio disclosures 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. 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.

Recognize also that it may take significant time to determine the methodology used to calculate and report your pay ratio disclosure, to coordinate reporting systems in various jurisdictions and to gather necessary information.

Because the pay ratio will be "filed" as opposed to "furnished" disclosure, 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 to make sure that they are in a position to provide pay ratio disclosure with confidence that

the information will be accurate and in compliance with the rule.

To not be considered an employee for purposes of the rules, an independent contractor must be employed by, and have his or her pay set by, unaffiliated third parties. Companies with a significant number of independent contractors will need to determine whether each 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.

Companies should evaluate their payroll and other recordkeeping systems for planning purposes, develop strategies for compliance and consider how they will update their disclosure controls and procedures. Employees who have the responsibility to assemble information for the disclosure should be sure they understand all pay programs the company has, including on a worldwide basis if the company has employees outside of the United States.

This 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. In addition, determine whether information gathered needs to be adjusted to reflect differences in internal pay reporting systems in various jurisdictions.

It is important to use a sampling measure that can be justified, and supported with a methodology that can be repeated.

A company should also determine whether it would prefer to disclose its pay ratio using statistical sampling or by gathering complete pay data for all employees. 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.

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 seek an exemption from such foreign law. If the company is unable to qualify for an exemption, it will need to obtain an opinion of counsel from the foreign jurisdiction in order to rely on the exemption for pay ratio disclosure.

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 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 exemption.

Companies with employees in multiple jurisdictions outside of the United States should identify those in which five percent or less of their total employee population is located if they plan to exclude using the *de minimis* foreign employee exemption. Companies in this situation may want to balance the relative difficulties of gathering the information for employees in such jurisdictions to determine how best to apply the exemption, if at all.

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 a cost-of-living adjusted ratio is presented.

Companies should explore whether they want to apply cost-of-living adjustments. Presumably, a company will only 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, the company must also 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.

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 be careful not to violate any privacy laws and provide information that will identify the individual whose pay 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 other than the chief executive officer's. Yet, companies are not supposed to provide information that could identify the specific median employee. If this situation arises, a company should carefully consider the pay ratio disclosure before it is made.

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 rules were adopted. Therefore, they should be reviewed more for background and style and not as precedents for compliance with the new requirements.

Companies should consider whether 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 2018.

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 calculated. 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 a specific timing makes the most sense for their company.

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 compensation arrangements that would significantly change the pay ratio disclosure.

To retain flexibility on the identification of the median employee in a previous year, 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 pay has changed to reflect a promotion or if that person is no longer employed.

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.

Companies should also consider the practical impact of pay ratio disclosure on its employee population. Employees as a group may share a general interest in the ratio of the chief executive officer's pay to the median employee.

However, many employees may react to the pay ratio disclosure more personally, wanting to know why their pay is in the bottom half, or why they are only in the middle of the 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. ■

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