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Understanding the SEC's Pay Ratio Disclosure Rule and its Implications

The US Securities and Exchange Commission (SEC), by a 3 to 2 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.[1]

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. However, there is a lot that companies should begin doing in the meantime to prepare.

Summary of the Final Rule

Background. The SEC's pay ratio rulemaking was mandated by the Dodd-Frank Wall Street Reform and Consumer Protection 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. Of these, more than 1,500 were distinct individual letters and the remainder represented form letters submitted by interested persons.

Disclosure Requirement. 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.

Filings Requiring Pay Ratio Disclosure. Generally, the pay ratio disclosure will be needed 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.

Employees Covered. 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.

However, a worker employed by, and whose compensation is determined by, an unaffiliated

third party, such as independent contractors or leased workers, are not considered employees for purposes of the pay ratio disclosure rule.

For individuals 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. For more information, see "Compliance Date and Transition Rules" below.

Limited Exemption for Foreign Employees. 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-US jurisdictions (non-US 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, 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. The rule makes clear that in order to satisfy the reasonable efforts requirement of this privacy exemption, the company, *at a minimum*, must use or seek an exemption or other relief under the applicable foreign law or regulation. In addition, the proxy statement (or other disclosure document) would need to list the excluded jurisdictions, provide the approximate number of employees from each such jurisdiction so excluded and explain how compliance with the pay ratio rule would violate the foreign data privacy law or regulation, describing the company's efforts to obtain an exemption or other relief. 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 and file that opinion as an exhibit to the filing containing the pay ratio disclosure. 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-US employees. If non-US employees account for 5% or less of a company's total employees, the company may choose to exclude all, but not less than all, of its non-US employees when identifying its median employee. Where a company's non-US employees exceed 5% of the company's total US and non-US employees, it may exclude up to 5% of its total employees who are non-US employees from this determination. However, if the company excludes any employees in a particular non-US jurisdiction it must exclude all employees in that jurisdiction. Therefore, a company cannot use the *de minimis* exemption to exclude any employees from a non-US jurisdiction in which more than 5% of its total employees are located. In addition, employees excluded pursuant to the privacy exemption discussed above will count toward the 5% limit for the *de minimis* exemption. Use of the *de minimis* exemption also requires an accompanying explanation of the details of how the company applied the exemption.

Companies Covered by Pay Ratio Disclosure Requirement. 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 US Canadian Multijurisdictional Disclosure System) and registered investment companies will not be subject to the pay ratio disclosure requirement.

Identifying the Median Employee. 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. When using a consistently applied measure to determine annual compensation in order to identify the median employee, companies may use the same annual period that is used in the records from which such compensation is derived.

According to the adopting release, factors that a company can take into account when determining their methodology for identifying the median employee may include the following variables:

- The size and nature of the workforce;
- The complexity of the organization;
- The 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; and
- The number of payroll systems the company has and the difficulty involved in integrating those payroll systems to compile total compensation information for all employees.

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.

In the adopting release, 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 compensation data. The SEC believes that reasonable estimates of the median for companies with multiple business lines or geographical units may be determined using more than one statistical sampling approach. 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."

According to the SEC, a company "could identify the employees in its sample that have extremely low or extremely high pay that would, therefore, fall on either end of the compensation spectrum. Since identifying the median involves finding the employee in the middle, it may not be necessary to determine the exact compensation amounts for every employee paid more or less than that employee in the middle. Instead, just noting that the employees are above or below the median may be sufficient for finding the employee in the middle of the compensation spectrum."

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 compensation in context, but the instructions to the rule specify that they should not do so if providing the information could indentify 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 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 compensation arrangements that would significantly change the pay ratio disclosure. If, during those three years, the median employee's compensation changes, or the previously identified median employee has left the company, the company may substitute another

employee with substantially similar compensation as its median employee.

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.

Reasonable Estimates. The pay ratio rule permits companies to use reasonable estimates to calculate annual total compensation or any element thereof for employees other than the chief executive officer. Reasonable estimates will also be permitted in the methodology used to identify the median employee. The final rule does not prescribe what constitutes a reasonable estimate. However, the adopting release states that in "using an estimate for annual total compensation (or for a particular element of total compensation), a registrant would be required to have a reasonable basis to conclude that the estimate approximates the actual amount of compensation under Item 402(c)(2)(x) (or for a particular element of compensation under Item 402(c)(2)(iv)-(ix)) awarded to, earned by, or paid to the employee."

Adjustments. 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 resides. If a company uses a cost-of-living adjustment, and the median employee so identified 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 addition, the company must disclose the median employee's jurisdiction. It must also describe the cost-of-living adjustments it used to identify the median employee, as well as the cost-of-living adjustments it used to calculate the median employee's annual total compensation, including the measure used as the basis for the cost-of-living adjustment. The company will also have to present the median employee's total compensation and pay ratio without the cost-of-living adjustment.

In calculating the annual total compensation 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 chief executive officer's total compensation used in the related pay ratio disclosure would have to reflect the same approach. The company must also explain any difference between the chief executive officer total compensation used in the pay ratio disclosure and the total compensation amounts reflected in the summary compensation table, if material.

Multiple Chief Executive Officers. If a company has had more than one non-concurrent chief executive officer during its fiscal year, it may calculate the annual total chief executive officer compensation by using either of the following methods:

- Combining the compensation provided to each such person during the year for the time that person served as chief executive officer or
- Annualizing the compensation of the chief executive officer serving in that position on

the date selected to identify the median employee.

Disclosure Elements. The pay ratio disclosure rule contains a number of disclosure requirements relating to 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 and any material assumptions, adjustments or estimates used to identify the median employee or to determine total compensation or elements of total compensation. 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 compensation 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, to the extent applicable, how the method deals with separate payroll systems, such as from different geographic areas or business segments. If a company changes methodology, material assumptions, adjustments or estimates from those used in 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 on the change on the median employee and the pay 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 compensation arrangements that would significantly impact the pay ratio 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. And, if a company makes use of either or both foreign employee exemptions, the details of how the exemption applied would need to be disclosed.

Compliance Date and Transition Rules. 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.

Individuals who become employees as a result of a business combination or the acquisition of a business can be omitted from the company's identification of the median employee for the fiscal year in which the transaction became effective. However, the company must disclose

the approximate number of employees it is omitting. Similarly, a company would not have to assess whether a business combination or acquisition resulted in a substantial change to its pay ratio disclosure such that it would have to re-identify its median employee rather than rely on a triennial determination until the fiscal year following the acquisition or business combination.

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.

Other Technical Requirements. The pay ratio disclosures will be "filed," not "furnished." Therefore, they will be subject to certifications by the chief executive officer and the chief financial officer and subject to potential securities law liabilities.

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 of shareholders. Accordingly, registration statements may be filed and declared effective under the Securities Act prior to this time without updating the pay ratio previously disclosed.

If chief executive officer salary and bonus is to be disclosed in a Form 8-K because it is not calculable at the time the proxy statement is filed, the pay ratio disclosure may also be disclosed in the Form 8-K. The final rule also includes a conforming amendment to Item 5.02(f) of Form 8-K to reflect the addition of this pay ratio disclosure requirement.

Practical Considerations

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.

Companies should recognize that it may take significant 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 gather necessary information. Because 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 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.

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 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.

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 should also 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 information gathered needs to be adjusted to reflect differences in internal compensation reporting systems in various jurisdictions.

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, 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.

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.

Companies with employees in multiple jurisdictions outside of the United States should identify the jurisdictions in which 5% 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% 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.

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 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, in order to use a cost-of-living adjustment for the pay ratio, 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 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 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 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.

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.

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 there is a specific timing that 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 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.

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. While employees as a group may share 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.

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Endnotes

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

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