SEC Adopts Dodd-Frank Mandated Pay Ratio Disclosure Rules

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On August 5 the SEC adopted final rules that require disclosure of the ratio between CEO compensation and the median employee compensation, as called for by the Dodd-Frank Act. In response to comment letters pointing out the significant costs of compliance with the rule as proposed in 2013, the final rule includes a few additional areas of flexibility in calculating the ratio, but for the most part retains the provisions of the rule as proposed.

The new disclosure requirement is codified as Item 402(u) of Regulation S-K and applies to Forms 10-K, proxy statements, and registration statements that require the executive compensation disclosures called for by Item 402 of Regulation S-K (other than registration statements for an initial public offering). Emerging growth companies, smaller reporting companies, and foreign private issuers are exempt from the new disclosure requirement.

Companies are required to determine the pay ratio using compensation for their first fiscal year beginning on or after January 1, 2017 and to disclose this information in their Form 10-K and proxy statement containing compensation information for that fiscal year. Thus for calendar year companies, the first pay ratio disclosure will be based on 2017 compensation and included in proxy statements for annual meetings to be held in 2018.

Calculation of the Pay Ratio

New Item 402(u) requires disclosure of:

- the median of the "annual total compensation" of all employees other than the CEO;
- the "annual total compensation" of the CEO; and
- the ratio of these amounts.

The rules permit a company to express the ratio in either of the following ways:

- as a ratio where the median employee compensation is equal to one (*e.g.*, "50 to 1"); or
- in narrative form as the multiple that the CEO's compensation bears to the median employee compensation (*e.g.*, "the CEO's compensation is 50 times that of the median compensation of all employees").

As is the case with other Item 402 disclosures, a company is permitted to provide additional ratios and supplemental disclosures regarding its employment practices and the composition of its workforce in order to provide perspective with respect to the required disclosure, so long as the supplemental disclosure is not misleading and is not given greater prominence than the required disclosure.

The pay ratio information is required to be "filed" rather than "furnished" and is subject to the certification requirements established under the Sarbanes-Oxley Act.

Defining Annual Total Compensation

As required by the Dodd-Frank Act, the "annual total compensation" for purposes of the pay ratio disclosure is the total compensation as determined for purposes of the Summary Compensation Table. In order to adapt the rules for that table to rank and file employees, the rules provide that references to "named executive officers" are to be read as referring to "employees" and, for non-salaried employees, references to "base salary" and "salary" are to be read as including wages and overtime. The compensation of the median employee must be determined for the company's fiscal year, even though compensation records for that employee are otherwise maintained on a different 12-month period.

The rules permit the company to use "reasonable estimates" to determine the values of the various elements of compensation for the median employee. The adopting release indicates that such estimates may be necessary, for example, to determine changes in the actuarial value of pension benefits where the employee is a participant in a multi-employer plan.

If an estimate is used, the disclosure would need to clearly identify the disclosed amount as an estimate and briefly describe the estimation methods used. In addition, the company would need to have "a reasonable basis" for concluding that the estimate approximates the actual amount of the compensation called for by the Summary Compensation Table. The adopting release does not define "reasonable basis" and states that it would depend on the company's particular facts and circumstances.

The adopting release repeats the position taken in the proposing release that "government-mandated pension benefits" under which the employee receives pension payments from the government funded by payments made by the employer to the government (typically as a tax) would not be included in the Summary Compensation Table, and thus are not included in calculating the annual total compensation of the median employee. The release also provides that benefits under non-discriminatory plans (such as health care benefits) and perquisites and personal benefits that aggregate less than $10,000 – which are typically excluded from the Summary Compensation Table – may be included in determining the median employee compensation so long as the same elements of compensation are included in the CEO's compensation for purposes of the pay ratio disclosure. In that case, the company would need to explain any differences between the CEO's pay as reflected in the pay ratio and as shown in the actual Summary Compensation Table, if material.

Employees included in the Median

In implementing the Dodd-Frank Act mandate that the median employee compensation reflect the compensation of "all employees," the rules provide that the relevant employee population includes full-time, part-time, seasonal, and temporary workers employed by the registrant or any of its consolidated subsidiaries, including employees located outside the United States. This is a change from the proposed rules, which would have applied to employees of "all subsidiaries" (defined as affiliates directly or indirectly controlled by the registrant), whether or not consolidated in the company's financial statements. Independent contractors and "leased" workers supplied by a third party are excluded from the definition of "employee" as long as they are employed, and their compensation is determined, by an unaffiliated third party.

Population Determination Date. The employee population for a given year is determined as a snapshot of the population on a given date. Under the proposed rules, the date required to be used was the last day of the registrant's last completed fiscal year. However, in response to comments, the final

rules allow a registrant to use any date within the last three months of the last completed fiscal year. Using an earlier date to determine the employee population would give companies more time to collect the required data. A registrant must disclose the date used to determine the median employee and, if it changes the determination date from the date used in the prior year, must disclose the change and the reasons for the change.

Non-U.S. Employees. Despite numerous comments to the effect that including non-U.S. employees in the workforce population would significantly increase the costs of compliance with the pay ratio rules, the final rules continue to require their inclusion. However, the rules include several accommodations that are intended to address some of the concerns raised by these comments.

> **Data Privacy Law Exemption.** First, for purposes of identifying the median employee, the rules permit a registrant to exclude non-U.S. employees working in a foreign jurisdiction if it is not able to comply with the pay ratio rule without violating the data privacy laws of that jurisdiction. In order to use this limited exemption, the registrant must first use reasonable efforts to obtain the information needed to comply with the rule, including seeking an exemption or other relief from the applicable jurisdiction's data privacy laws. The company must also obtain (and file) a legal opinion that it is unable to comply with the pay ratio rule without violating the laws of the foreign jurisdiction. If the company excludes any non-U.S. employees in a particular jurisdiction under this exemption, it must exclude all non-U.S. employees in that jurisdiction and must disclose each excluded jurisdiction, the approximate number of employees exempted from that jurisdiction, the specific data privacy law that would be violated, an explanation of how compliance with the pay ratio rule would violate that law, and the company's efforts to obtain an exemption or other relief under that law.

***De Minimis* Exemption.** A second accommodation is a *de minimis* exemption, which permits a company to exclude a number of non-U.S. employees up to 5% of its total (U.S. and non-U.S.) workforce. If the company's non-U.S. employees make up less than 5% of its total workforce, the company may choose to exclude all of its non-U.S. employees; but if such a company excludes any of its non-U.S. employees, it must exclude all of them. A company whose non-U.S. employees constitute more than 5% of its workforce may exclude non-U.S. employees up to the 5% threshold, subject to two caveats – (1) if the company excludes any non-U.S. employees in a particular jurisdiction, it must exclude all the employees in that jurisdiction, and (2) employees excluded under the data privacy exemption must count against the 5% threshold under the *de minimis* exemption. This second caveat does not limit the number of employees who may be excluded under the data privacy exemption; but if the number excluded under that exemption exceeds the 5% threshold, no additional employees may be excluded under the *de minimis* exemption. The adopting release clarifies that if excluding all of the employees in a particular jurisdiction would cause the registrant to exceed the 5% threshold, the registrant cannot exclude any of the employees in that jurisdiction (even if the aggregate number of employees excluded as a result was below the 5% threshold). A company using the *de minimis* exemption must disclose each jurisdiction from which employees have been excluded, the approximate number of employees excluded from each jurisdiction under this exemption, the company's total workforce before any exemption, and the total number of U.S. and non-U.S. employees used in making the 5% calculation.

Cost-of-Living Adjustment. The final rules also permit a registrant to make cost-of-living adjustments to the compensation of its employees living in countries other than the country in which the CEO resides, both to determine the median employee and to calculate the pay ratio. If this option is chosen, the cost-of-living adjustment must be made to the compensation of all employees living in a country other than the CEO's country of residence (to determine the median employee) and must also be made to the compensation of the median employee. The company must describe the cost-of-living adjustments used (including the measure used as a basis for determining the adjustment) and disclose the country in which the median employee resides. The company must also determine the median employee without using any cost-of-living adjustments, and calculate and disclose the (unadjusted) compensation and pay

ratio information of this employee as well.

Annualizing of Compensation. Companies are permitted, but not required, to annualize pay of all permanent workers (full-time or part-time) who were hired mid-year or who were on an unpaid leave of absence for part of the year. The rules do not permit adjustments for part-time, seasonal, or temporary employees in order to generate "full-time equivalent" compensation data. The adopting release states that these types of adjustments "would reflect a different workforce composition and compensation structure than used by the registrant."

> **Mid-Year Hire of CEO.** The final rules allow a company to choose one of two alternatives if it had more than one CEO during the fiscal year. Under the first alternative, all compensation reported in the Summary Compensation Table for all CEOs who served during the fiscal year would be aggregated and treated as total CEO compensation. Under the second alternative, the CEO serving on the date used to determine the median employee would be the applicable CEO and that person's compensation would be annualized.

Identifying the Median Employee

Frequency of Determination. In a significant change from the proposed rules, the final rules allow a registrant to determine the median employee once every three years (rather than annually) unless there has been a change in the employee population or employee compensation arrangements which would result in a significant change in the pay ratio. The registrant is required to disclose that it is using the same median employee as in a prior year, as well as the basis for its belief that there have been no significant changes from the prior year. The annual compensation of the median employee and the resulting pay ratio must be calculated for the applicable year.

If there have been no significant changes in the overall workforce but it is no longer appropriate to use the individual determined to be the median employee in a prior year (for example, because that individual has terminated employment or been promoted), the company may substitute another employee whose compensation in the prior year was substantially similar to that of the original median employee.

Methodology. Consistent with the proposed rules, the final rules do not prescribe a specific methodology for determining the median employee. In an effort to reduce compliance costs, the rules allow statistical sampling of the employee population and "other reasonable methods" in order to select the median employee, as well as "reasonable estimates" to identify the median and to calculate annual total compensation or any elements of compensation for any employee other than the CEO. In addition, the median employee can be determined by using any compensation measure that is consistently applied to all employees included in the calculation, such as cash compensation or amounts derived from payroll and/or tax records. If the median employee is determined using a compensation measure other than annual total compensation (as defined for the Summary Compensation Table), the company must disclose the compensation measure used as well as the median employee's annual total compensation.

While the final rules do not specify the "other reasonable methods" that could be used to identify the median employee, the adopting release describes various methods that had been suggested by commenters and notes that the rule provides flexibility for registrants to determine the method that best suits their particular facts and circumstances, which "may include" some of the suggestions made by commenters. For example, one commenter suggested that a company should be able to use salary grades or job levels to determine the job level containing the median employee and then use statistical sampling or other techniques to identify the median employee from within that job category.

In addition, the adopting release expressly states that a registrant may use a compensation measure such as "taxable wages" or "cash compensation" that may be defined differently in different jurisdictions, and may collect this information using different annual periods, as long as within each jurisdiction the measure is consistently applied.

Disclosure of Methodology and Assumptions

The rules require companies to briefly describe the methodology used to identify the median employee and any material assumptions, adjustments or estimates used in determining either the median employee or the median employee's total compensation. For example, the adopting release states that when statistical sampling is used, the company should disclose the size of the sample and of the estimated whole population, any material assumptions used in determining the sample size, and the sampling method(s) used. The disclosure should provide sufficient detail to enable readers to evaluate the appropriateness of the methodology and estimates, but need not include "any technical analyses, formulas, confidence levels, or the steps used in data analysis." However, if a company uses cost-of-living adjustments, it must include the measure used as the basis for such adjustments.

In order to provide comparability from year to year, any material changes from the prior year's methodology, assumptions, adjustments or estimates would need to be described, together with the reasons for the change.

Timing and Transition Matters

The pay ratio information for a fiscal year would generally be provided in a company's Form 10-K or, if later, its annual meeting proxy statement or information statement containing the Reg. S-K Item 402 executive compensation information for that fiscal year. As is the case with other compensation information, the Form 10-K for that fiscal year could incorporate the information from a subsequently filed proxy statement (or information statement), as long as the proxy statement (or information statement) was filed within 120 days of fiscal year-end. If the proxy statement (or information statement) was not filed within that time frame, or if the company was not required to file a proxy statement (or information statement), the pay ratio disclosures would be required to be included in the company's Form 10-K. Registration statements filed after fiscal year-end but before the pay ratio disclosure was otherwise due could provide the prior year's disclosure.

If the CEO's salary or bonus is not known in time to be included in the Summary Compensation Table, the pay ratio disclosure would also be omitted from the proxy statement or Form 10-K and would instead be provided in the Form 8-K in which the CEO's total compensation was disclosed.

The final rules provide that a new registrant (other than an emerging growth company, which is exempt from the pay ratio rules by the JOBS Act) need not provide pay ratio information until the first full fiscal year after it has been subject to Exchange Act reporting requirements for at least 12 calendar months and filed at least one Exchange Act annual report. For example, a calendar year company that completes its initial public offering on March 1, 2017 will first be required to include pay ratio information in its Form 10-K or proxy statement containing 2018 compensation information, filed in 2019.

A company that ceases to be an emerging growth company or a smaller reporting company will not be required to disclose pay ratio information until after the first full fiscal year after exiting such status. For example, if a calendar year company ceases to be a smaller reporting company on January 1, 2018 (based on its public float at the end of its second quarter of 2017), it will need to collect pay ratio information based on 2018 compensation and disclose it in the Form 10-K or proxy statement filed in 2019.

A registrant that engages in an acquisition or merger may omit the employees of a newly-acquired entity from the pay ratio calculation for the fiscal year in which the transaction becomes effective. For example, employees of an entity acquired by the registrant in 2017 need not be included in the pay ratio calculation until 2018, for disclosure in the Form 10-K or proxy statement filed in 2019. However, the company must identify the acquired business whose employees were excluded from the calculation and the approximate number of excluded employees as part of its pay ratio disclosure for the year in which the transaction occurred.

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