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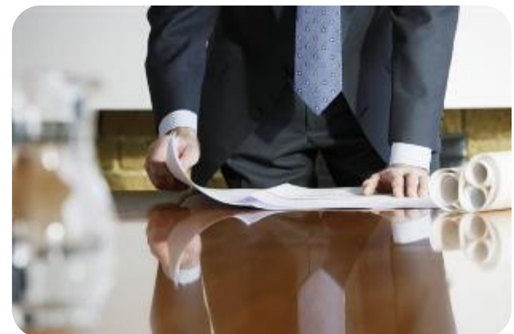
SEC Expands Executive Pay Disclosures

On August 5, a divided SEC adopted a final "CEO pay ratio" rule, mandated by the Dodd-Frank Act. The rule will require public companies to disclose the ratio of CEO pay to the median employee pay in registration statements, proxy and information statements, and annual reports that call for executive compensation disclosure. Because disclosure will be required for the first fiscal year beginning on or after January 1, 2017, the rule will affect companies beginning with the 2018 proxy season. Like the "pay versus performance" rule recently proposed by the SEC, the pay ratio rule is intended to increase transparency and assist shareholders in evaluating executive pay practices at major US companies.

Background

Item 402 of Regulation S-K lays out executive compensation disclosure requirements for various SEC filings by public companies under the Securities Act and the Exchange Act. Section 953(b) of the Dodd-Frank Wall Street Reform and Consumer Protection Act (Dodd-Frank) directs the SEC to amend Item 402 to require public companies to disclose: (1) the median of the annual total compensation of all company employees (excluding the CEO); (2) the annual total compensation of the company's CEO; and (3) the ratio of the median of the annual total compensation of all employees to the annual total compensation of the CEO. On September 18, 2013, the SEC proposed a new rule to implement that mandate.



The CEO Pay-Ratio Disclosure Requirement

Nearly two years and more than 287,000 comment letters later, the SEC adopted the final rule by a 3−2 vote on August 5. The rule, which becomes effective October 19, 2015, will require public companies to disclose the ratio of CEO pay to the median employee pay for their first fiscal year beginning on or after January 1, 2017 in registration statements, proxy and information statements, and annual reports that are required to include executive compensation information under Item 402. Companies will not be required to provide pay ratio information in reports that do not include Item 402 executive compensation information, such as current and quarterly reports.

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Who Must Disclose?

The pay ratio disclosure requirement will apply to all companies currently required to provide executive compensation disclosure under Item 402. Smaller reporting companies, foreign private issuers, emerging growth companies, MJDS filers (filers under the US-Canadian Multijurisdictional Disclosure System) and registered investment companies are exempt.

The final rule provides transition periods for newly public companies as well as for companies that no longer qualify for either the smaller reporting or emerging growth company exemption. For those companies, the disclosure rules will apply to compensation for the first fiscal year (commencing on or after January 1, 2017) following the year in which the company became subject to SEC reporting requirements or lost their exempt status.

Which Employees Are Included?

In determining the employee population for purposes of identifying the median employee, companies will have to include all full-time, part-time, temporary, seasonal and non-US employees of the company and its subsidiaries, as of the last day of the company's prior fiscal year. Independent contractors, leased employees or other temporary workers who are employed by an unaffiliated third party would not be included.

Companies may exclude non-US employees from the determination of its median employee in two circumstances:

- **Foreign Data Privacy Law Exemption.** Non-US employees are employed in a jurisdiction with data privacy laws that make the company unable to comply with the rule without violating those laws. Before relying on this exemption, the company must obtain a supporting legal opinion that must be filed as an exhibit to the filing that includes the pay ratio disclosure.
- ***De Minimis* Exemption.** Up to 5% of the company's non-US employees, including those excluded under the data privacy exemption, may be excluded if certain criteria are met. The *de minimis* exemption is not available to any company that excludes 5% or more of its employee population under the foreign data privacy law exemption.

Companies may also exclude employees that became employees through a merger or acquisition for the fiscal year in which the transaction became effective. However, the company must disclose the approximate number of employees omitted and identify the business acquired. In addition, the employees must be included in the total count in the fiscal year following the transaction to evaluate whether a significant change in the employee population occurred that would require recalculation of the pay ratio.

Foreign Worker Exclusion

Companies had pushed to exclude a larger percentage of foreign workers, which would likely have resulted in a narrower pay gap for some multinational firms.

Companies may select a date within the last three months of the last completed fiscal year to determine the employee population for purposes of identifying the median employee. The company must disclose the date used, and must explain any change in the date used to identify the median employee from the prior fiscal year.

> **Comment.** Individuals hired after the date selected may not be counted toward the employee population. By contrast, the total compensation for permanent full- and part-time employees who did not work for the entire year, such as new hires, may be annualized.

What Compensation is Included?

The annual total compensation for the median employee must be calculated using the same rules that apply to CEO compensation in the Summary Compensation Table in the annual proxy statement. Reasonable estimates may be used when calculating any elements of the annual total compensation for employees other than the CEO (with disclosure).

Companies are permitted, but not required, to annualize the total compensation for a permanent full-time or part-time employee who did not work a full year, such as a new hire or employee on a leave of absence. However, the rules prohibit companies from full-time equivalent adjustments for part-time workers — or annualizing adjustments for temporary and seasonal workers — when calculating pay ratios.

Compensation information is to be calculated and presented in accordance with US Generally Accepted Accounting Principles (GAAP), which differs from the tax and accounting standards that companies may use for the purposes of determining employee compensation. As a result, the rules call for a disclosure about employee compensation that is not currently required and in a manner that may not be currently used.

Companies do have, however, some leeway on determining their median employees' pay. Companies may use total employee headcount, a statistical sampling of workers or other methodology. That could include applying cost-of-living adjustment to the compensation measure used to identify the median. However, the firm would also be required to disclose the median employee’s annual total compensation and pay ratio without the cost-of-living adjustment.

Total compensation raises some issues for companies with regard to non-US employees in terms of how to value unique types of compensation (such as specialized allowances) given only in certain countries. The SEC left this determination with the company’s management, which must make a reasonable estimate using a consistent methodology.

Where is it Disclosed?

The information must be disclosed in the registration statement, proxy and information statement, and annual reports that must already include executive compensation information under Item 402. Companies are not required to disclose the pay ratio information in reports that do not require executive compensation information, such as current and quarterly reports.

The pay ratio must be disclosed either as a ratio (*e.g.*, X:1 or X to 1) or narratively in terms of the multiple (*e.g.*, “the CEO’s total compensation amount is X times that of the median of the annual total compensation of all employees”). In addition to disclosing the pay ratio, companies will be required to describe briefly the methodology used to identify the median employee and that employee’s compensation, as well as any material assumptions, adjustments (including cost-of-living adjustments) or estimates used. Companies are permitted to supplement the required disclosure with a narrative discussion or additional ratios (so long as they’re clearly identified, not misleading, nor presented with greater prominence than the required ratio).

When Must Disclosure Be Made?

The rule applies to a public company’s first fiscal year beginning on or after January 1, 2017. For a calendar year company, the initial pay ratio disclosure would encompass 2017 compensation and would be disclosed in the company’s 2018 proxy.

The ratio must be recalculated every three years unless there has been a change in the employee population or employee compensation arrangements that would result in a significant change to the pay ratio disclosure. If the median employee's compensation changes within those three years and the company reasonably believes that would significantly change the disclosure, the company may use another employee with substantially similar compensation as its median employee.

How Do We Do It? Next Steps

Although the new pay ratio rule will not be effective until the 2018 proxy season, companies should start gearing up now. In preparation for the new disclosures, companies will want to:

- Determine if current HRIS and payroll systems are adequate to gather the necessary data, including data for non-US employees
- Select a methodology to identify the median employee
- Review the laws of various foreign jurisdictions to determine which non-US employees to exclude
- Inventory demographic data on worker pay throughout the organization
- Consider which non-U.S. employees to exclude
- Consider whether to apply a cost-of-living adjustment, particularly if there are many non-US employees
- Select a methodology to identify the median employee
- Begin to evaluate possible testing dates
- If all signs point to a large CEO pay ratio, start developing an effective communications strategy

In Closing

When publicly traded companies are required to disclose how much their CEOs are paid relative to their median employees, companies with large pay gaps are likely to face public and investor pressure to narrow the gap. The SEC has always contended that the rule will help inform shareholders, especially as they decide how to vote on companies' pay practices. It is not clear how institutional investors or their advisers will use the pay ratio, if at all; though it is conceivable that labor pension funds may factor it into decisions whether to invest in a company. Large ratios may hurt a company's image and trigger increased debate over income inequality. Companies may face new challenges explaining large pay gaps to rank-and-file employees, and boards may think twice about giving their CEO a raise. And it may have an unexpected result, with chief executives who feel underpaid moving to privately held companies that don't face similar disclosure rules.

We don't know what the fallout will be from the new disclosure, but we do know one thing: it will be an expensive and time-consuming exercise.

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