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# SEC Adopts Final Rules on Pay Ratio Disclosure

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On August 5, 2015, the Securities and Exchange Commission ("SEC") adopted final rules to implement the pay ratio disclosure requirements (the "Final Rules") of Section 953(b) of the Dodd-Frank Wall Street Reform and Consumer Protection Act (the "Dodd-Frank Act"). Section 953(b) of the Dodd-Frank Act generally requires public companies to disclose the median of annual total compensation of all employees (excluding the chief executive officer), the annual total compensation of the chief executive officer, and the ratio of those two amounts. The rules regarding pay ratio disclosure take effect for filings for the first fiscal year of a registrant beginning on or after January 1, 2017.

Due to the complexities of calculating the median of the annual total compensation of all employees, these rules generated a significant number of comments. The Final Rules include some accommodations to registrants from the proposed rules, including the ability to generally exclude up to 5% of non-U.S. employees from the calculation and the ability to calculate the median employee once every three years rather than annually.

## Pay Ratio Disclosure

The pay ratio disclosure requirement has been implemented through a new paragraph (u) of Item 402 of Regulation S-K. Under this paragraph, a registrant must disclose:

- the median of the annual total compensation of all employees of the registrant, except the principal executive officer ("PEO");
- the annual total compensation of the PEO; and
- the ratio of such amounts.

The ratio may be expressed either as an amount in which the median for all employees is one (the pay ratio would be disclosed as "X to 1" or "X:1" where X is the PEO's annual total compensation) or narratively as "the PEO's annual total compensation is X times that of the median of the annual total compensation of all employees."

## Calculation of Median Employee Compensation

No area of the new rule generated more comment from a policy and implementation standpoint than the calculation of the median of the annual total compensation of all employees of the registrant. While public companies already calculate and disclose the annual total compensation of the PEO, calculation of the median of the annual total compensation for all employees raises a host of issues where companies may have many thousands of employees in various countries and with differing terms of employment. The Final Rules and the SEC Release addressed many of these issues.

- **All Employees**. For the most part, the Final Rules provide that "all employees" truly means all employees. It includes any full-time, part-time, seasonal or temporary workers employed by the registrant or any of its consolidated subsidiaries (including officers other than the PEO). Persons who are not employed, such as leased workers and independent contractors, are not included as long as they are employed by, and their compensation is determined by, an unaffiliated third party. Non-U.S. workers are generally included in the determination of the median, but may be excluded in two limited circumstances: Non-U.S. employees who are employed in a jurisdiction with data privacy laws that make the registrant unable to comply with the Final Rules without violating those laws may be excluded. However, there are a number of conditions to rely on this exclusion, including using reasonable efforts to obtain the information without violating data privacy laws (including, at a minimum, using or seeking an exemption or other applicable relief), providing disclosure regarding the exclusion and obtaining a legal opinion from counsel on the inability to obtain or possess the necessary information without violation such laws.
    - Up to 5% of non-U.S. employees (including any employees excluded using the data privacy exemption) may be excluded. If a registrant excludes any non-U.S. employees in a particular jurisdiction, it must exclude all non-U.S. employees in that jurisdiction. The registrant must also disclose that it is relying on the exclusion, including the relevant jurisdiction or jurisdictions, the number of employees excluded from each jurisdiction, and the total number of its U.S. and non-U.S. employees used for its calculation of the 5% limit. A registrant may also exclude anyone who became an employee as a result of an acquisition for the fiscal year in which the transaction became effective, although the registrant must disclose the approximate

number of employees it is excluding.

- **Calculation Date**. A registrant may select a date within the last three months of its last completed fiscal year as of which it will determine the employee population for purposes of identifying the median employee. If, in subsequent years, a registrant changes the date it uses to identify the median employee, it must disclose this change and provide a brief explanation of the reasons for the change.
- **Annualizing Adjustments**. The Final Rules allow registrants to annualize compensation for permanent employees who did not work for the entire year. For example, if an employee is hired permanently on September 30 and is still employed as of December 31 (the registrant's fiscal year end), the registrant would be allowed to annualize the three months of compensation for the entire year. Such adjustments apply only to permanent employees, and not to temporary or seasonal workers. A registrant also may not adjust its compensation for part-time workers for full-time equivalent amounts. The adjustments are optional, but if a registrant makes such adjustments, it must do so for all eligible employees.
- **Identifying the Median**. For purposes of the Final Rules, identifying the median means identifying the median employee and then calculating that employee's annual total compensation using Item 402(c)(2)(x) (the rule for calculating the PEO's compensation). The Final Rules do not mandate any particular calculation methodology for identifying the median employee. Recognizing the variability in the size and complexity of workforces, Item 402(u) allows a registrant to select a methodology that is appropriate to its facts and circumstances. Methods that may be selected include calculating total compensation for the registrant's entire employee population using Item 402(c)(2)(x), using reasonable estimates and using statistical sampling. The SEC emphasized that the method selected and its application should be tailored to a particular registrant's circumstances.

For example, if a registrant uses statistical sampling, the variance of underlying compensation distribution can affect the sample size needed for reasonable statistical sampling. The data used by a registrant to determine the median employee does not necessarily need to be total compensation. For example, a registrant could use salary and wage data from payroll or tax records to identify the median employee and then calculate the median employee's annual total compensation in accordance with Item 402(c)(2)(x). A registrant can apply a cost-of-living adjustment to the compensation measure used to identify the median employee, and would then use the same adjustment in calculating the median employee's annual total compensation. A registrant electing to do so must also disclose the median employee's annual total compensation and the pay ratio without the cost-of-living adjustment. A registrant would be permitted to identify its median employee once every three years, unless there has been a change in its employee population or employee compensation that the registrant reasonably believes would result in a significant change to its pay ratio disclosure. During year two and year three, where the registrant continues to use the same median employee, it must disclose that it is using the same median employee and the basis for its reasonable belief that there have been no changes that would result in a significant change to the registrant's pay ratio disclosure.

Also, within those three years, if the median employee's compensation changes, the registrant may use another employee with substantially similar compensation as its median employee. The registrant still must determine the annual total compensation of the median employee every year and make the required disclosure; this provision only allows a registrant to go through the process of identifying its median employee every three years. A registrant will be required to briefly disclose the methodology to determine the median employee and any material assumptions, adjustments (including cost-of-living adjustments) and estimates used to identify the median employee or to calculate the median employee's annual total compensation. Any estimated amounts should be clearly identified as such.

- **Determination of Total Compensation**. Total compensation is defined by reference to Item 402(c)(2)(x) of Regulation S-K. As a result, the annual total compensation of the median employee must be calculated using the same rules and methods as for the PEO and other executive officers under Item 402. As discussed above, a registrant is permitted to use reasonable estimates, sampling or similar methods to identify the median employee, and then calculate that employee's total compensation based upon Item 402(c)(2)(x) of Regulation S-K. As part of calculating the median employee's total compensation, a registrant would be permitted to use reasonable estimates in determining any element of total compensation. Annual total compensation for the median employee is determined for the registrant's last completed fiscal year, as with the PEO, under Item 402(c)(2)(x).

## Filings Subject to the Disclosure Requirements

The pay ratio disclosure must be made in any filing that requires executive compensation disclosure under Item 402 of Regulation S-K. For most public companies, the disclosure will appear in the annual proxy or information statement, and be incorporated by reference into the annual report on Form 10-K. Disclosure will also be required in those registration statements under the Securities Act of 1933 that require executive compensation disclosure.

## Additional Disclosure

Registrants will be permitted, but not required, to supplement the required disclosure with a narrative discussion or additional notes. For example, a registrant could also disclose the annual total compensation of the median of U.S. full-time employees and the ratio of such compensation to the PEO's total compensation. Any additional discussion or ratios must be clearly identified, not misleading and not presented with greater prominence than the required pay ratio.

## Registrants Subject to Disclosure Requirements

The disclosure requirements will apply to those registrants that are required to provide summary compensation disclosure pursuant to Item 402(c) of Regulation S-K. This includes most public companies that file Form 10-K reports with the SEC. However, the requirements will not apply to emerging growth companies and smaller reporting companies. In addition, foreign private issuers will not be covered because they are not required to provide Item 402 disclosure.

## Compliance Date

A registrant must comply with the requirements of Item 402(u) with respect to compensation for the registrant's first fiscal year commencing on or after January 1, 2017. As a result, for a registrant with a December 31 fiscal year end, the rule would take effect for compensation for the year ending December 31, 2017. The disclosure would need to be included in the registrant's Form 10-K for that year or, if the registrant's proxy or information statement for its annual stockholders meeting is filed within 120 days of December 31, 2017, the disclosure can be included in the proxy or information statement and incorporated by reference into the Form 10-K.

For most public companies, the pay ratio disclosure will not be required until the 2018 proxy statement, which gives companies more than two years to prepare for compliance. However, the reason the SEC moved the compliance date back from its original proposal is the complexity of assembling the data to make the calculation for many companies. Public companies should start planning for implementation of the rule now, including determining the method by which to identify the median employee, considering the applicability of exclusions, running test calculations, and determining the processes and controls that will be used to support the calculation.

If you have questions on the topics discussed in this e-alert, please contact your Reinhart attorney or any member of the firm's Securities team.