

Client Alert

SEC Issues Final CEO Pay Ratio Rule

EXEQUITY

Independent Board and
Management Advisors

On August 5, 2015, the Securities and Exchange Commission (SEC) issued the final rule to implement the mandate contained in Section 953(b) of the Dodd-Frank Wall Street Reform and Consumer Protection Act (Dodd-Frank Act) for the disclosure of a CEO Pay Ratio. Largely similar to the rule proposed in late 2013, the final rule does introduce a few new concepts that likely will benefit companies that must comply with it.

This rule received more comments than just about any other measure in the SEC's history. According to the SEC release,¹ the SEC received 287,400 comment letters with about 1,500 unique comment letters and over 285,900 form comment letters of which there were 12 types of form letters.²

The final rule continues to provide leeway in the way companies approach identifying the median employee for purposes of the pay ratio disclosure and also provides some additional flexibility not offered in the Proposing Release.³ Depending on your point of view, this may be either a positive or negative. The SEC decided to give companies the **flexibility** to figure out their own method of determining the median annual total compensation of all employees, including identifying a median employee using a statistical sample and/or an alternative compensation measure. Simply put, but not simply implemented, Item 402(u) (the "Pay Ratio Disclosure Rule") will require companies to disclose:

- A. The median of the annual total compensation of all employees of the registrant, except the Principal Executive Officer (PEO⁴);
- B. The annual total compensation of the PEO; and
- C. The ratio of A to B by either (1) treating "A" as equal to "1," or (2) expressing narratively as the multiple that "B" bears to "A."

Collectively, A, B, and C are referred to as the Pay Ratio Disclosures.

Companies generally will not have to provide these Pay Ratio Disclosures until their **2018** proxy.

¹ *Pay Ratio Disclosure*, SEC Release 33-9877; 34-75610 (File No. S7-07-13) (Pay Ratio Disclosure Release).

² Pay Ratio Disclosure Release, footnotes 18 and 31.

³ Pay Ratio Disclosure, SEC Release 33-9452; 34-70443 (File No. S7-07-13) (Proposing Release).

⁴ While Section 953(b) of the Dodd-Frank Act requires the ratio with respect to "the chief executive officer (or any equivalent position)," the term PEO replaced CEO in the proxy disclosure rules related to executive compensation in the 2006 update and the SEC decided it was appropriate to make the Pay Ratio Disclosure Rule also use PEO.

Exequity Comment: *In order to make these calculations, companies must first determine the employee population. There are three choices: use the entire employee population, a statistical sample, or other reasonable methods. Once the employee population is determined, the median employee must be identified and such employee's annual total compensation can then be calculated in accordance with the Summary Compensation Table disclosure requirements.*

To identify the median employee, companies have two choices: they can use annual total compensation as defined for purposes of the Summary Compensation Table disclosure, with the flexibility to utilize estimates, or another compensation measure (e.g., salaries, salaries plus bonus, W-2 earnings). Companies can apply a cost-of-living adjustment (new in final rule) to the compensation measure used to identify the median employee. But a company using such a cost-of-living adjustment must use it in calculating the median employee's annual total compensation. If a cost-of-living adjustment is used, then a company must also present the median employee's annual total compensation and the pay ratio without the cost-of-living adjustment. We anticipate few companies will use the Summary Compensation Table definition of annual total compensation to determine the median employee. Rather, we expect most companies will use an alternative compensation measure, such as W-2 earnings (or its non-U.S. equivalent), to determine the median employee. If an alternative compensation method is used, this only identifies the median employee; however, for purposes of the Pay Ratio Disclosures, annual total compensation using the Summary Compensation Table method must be calculated for that one employee.

The SEC clearly tried to further address registrants' concerns regarding the feasibility and cost of determining the median annual total compensation of all employees and gave registrants the ability to use the median employee identified for up to three years unless there has been a change in its employee population or employee compensation arrangements that the company reasonably believes would result in a significant change to its pay ratio disclosure. Additionally, if it is no longer appropriate for a company to use the median employee identified in year one as the median employee in years two or three because of a change in the original median employee's circumstances that the company reasonably believes would result in a significant change to its Pay Ratio Disclosures, the company may use another employee with substantially similar compensation as its original median employee. Nevertheless, for many companies, particularly larger, complex, or global organizations, the calculations will be time-consuming and costly. In the Proposing Release, the SEC estimated that of 4,000 registrants that will be subject to the rule, approximately 50% have an organizational structure which would allow the registrant to use a simple random sampling method. Of these companies, the majority would still have a sample size of 500 or more. The remaining 50% have multiple business and/or geographical segments. For these companies, statistical sampling will be much more difficult.

The table below presents key questions and answers with respect to the proposed Pay Ratio Disclosure Rule:

How do we have to disclose the pay ratio?

The proposed rule indicates the pay ratio can be disclosed either as a number (e.g., 1 to 100) or in narrative form (e.g., the PEO's annual total compensation is 100 times that of the median of the annual total compensation of all employees) if expressed as a multiple that the PEO's annual total compensation bears to the median of the annual total compensation of all the employees except the PEO.

Who is an employee for purposes of the final Pay Ratio Disclosures?

Change from Proposing Release

- An employee is **anyone employed by the registrant or any of its subsidiaries**, including any U.S. or foreign, full-time, part-time, seasonal, or temporary worker employed by the registrant or any of its subsidiaries.
- However, **non-U.S. employees** can be **excluded** in two situations:
 - Employees employed in a foreign jurisdiction in which the **data privacy laws make the company unable to comply with the rule without violating those laws** can be excluded provided the company obtains a legal opinion on the inability of the company to obtain or process the information necessary for compliance with the rule without violating the jurisdiction's laws or regulations governing data privacy; and
 - **Up to 5% of non-U.S. employees**, including any non-U.S. employees excluded using the data privacy exemption detailed above (if a company excludes any non-U.S. employee in a particular jurisdiction, it must exclude all non-U.S. employees in that jurisdiction).
- Independent contractors, "leased" workers, and other temporary workers who are employed by a third party are not covered.
- If a company acquires employees through a business combination or acquisition that is effective in that last fiscal year, such employees can be omitted from calculating the Pay Ratio Disclosures. However, if such employees are omitted, the company must identify the acquired business and disclose the approximate number of employees being omitted.

As of what date do we determine who is an employee for purposes of the Pay Ratio Disclosures?

Change from Proposing Release

Companies may select a **date within the last three months of its last completed fiscal year** on which to determine the employee population for purposes of identifying the median employee, rather than the last day of the registrant's last completed fiscal year as was proposed in the Proposing Release.

Exequity Comment: *Thus, seasonal or temporary workers not employed as of the selected day within the last three months of the last completed fiscal year would not be included.*

Using a date within the last three months of the last fiscal year deviates from the date used for the determination of who are the three most highly compensated executive officers under Item 402(a)(3)(iii) for the Summary Compensation Table (unless a company decides to use the last day of the fiscal year), but will likely give companies some added flexibility and time in which to identify their median employee.

How is annual total compensation determined?

Annual total compensation is determined in the exact same manner in which it is calculated for purposes of disclosure in the Summary Compensation Table.

What methods can be used to determine the median annual compensation of all employees?

- The final Pay Ratio Disclosure Rule **does not require** a particular method for determining the median. Instead, the instructions indicate companies can use a methodology that uses reasonable estimates to identify the median.
- Furthermore, in determining which employees will be used to identify the median, a company may use (1) its **employee population** or (2) **statistical sampling** or **other reasonable methods**.
- In identifying the **median employee**, a company may use (1) annual total compensation (compensation determined in accordance with the Summary Compensation Table rules) or (2) any other compensation measure consistently applied to all employees included in the calculation, such as amounts derived from a company's payroll or tax records. Once the median employee is identified, annual total compensation must be calculated, but only for that one employee.

***Exequity Comment:** We expect many companies, particularly large and/or global employers, will use W-2 wages (or its non-U.S. equivalent) and a statistical sample to determine the median employee. This ability to simply identify a **median employee** and then calculate that median employee's annual total compensation should somewhat lighten the burden in complying with the Pay Ratio Disclosure Rule.*

What additional disclosure, beyond the ratio, is required?

Change from Proposing Release

- The date selected within the last three months of the last fiscal year to identify the median employee must be disclosed.
- If the company changes the date it uses to identify the median employee from the prior year, the company must disclose this change and provide a brief explanation of the reason(s) for it.
- If there are no changes the company reasonably believes would significantly impact the Pay Ratio Disclosure from using the employee identified as the median employee for each of the years within the permissible three-year period, a company shall disclose it is using the same median employee in its pay ratio calculation and briefly describe the basis for its reasonable belief.
- Registrants must **briefly disclose** and consistently apply any **methodology** used to identify the median and any **material assumptions, adjustments, or estimates** used to identify the median or to determine total compensation or any elements of total compensation—and registrants must identify any estimated amount as such.

Where a compensation measure other than annual total compensation is used (e.g., salary, wages, and overtime for the fiscal year, W-2 Box 1 or similar amounts, etc.), the company must (1) disclose the **compensation measure used** and (2) calculate and disclose the **annual total compensation** for that **median employee**. The SEC has indicated this disclosure as well as any disclosure about the method used to determine the **median employee** should be brief. The final Pay Ratio Disclosure Rule provides that in disclosing the methodology and material assumptions, adjustments, and estimates used, a company should provide sufficient information for a reader to be able to evaluate the appropriateness of the estimates.

- If statistical sampling is used, the disclosure might need to include the size of both the sample and the estimated whole population, any material assumptions used in determining the sample size, which sampling method (or methods) was used, and, if applicable, how the sampling method deals with separate payrolls such as geographically separated employee populations or other issues arising from multiple business or geographic segments.
- If a company uses the data privacy exemption, it must file the legal opinion(s) as an exhibit to the filing in which the Pay Ratio Disclosure is included and also disclose the approximate number of employees being excluded from each jurisdiction as a result of the data privacy exemption.
- If a company excludes up to 5% of non-U.S. employees under the “*de minimis*” exemption, it must disclose the jurisdiction(s) from which those employees are being excluded, the approximate number of employees excluded from each jurisdiction, the total number of its U.S. and non-U.S. employees irrespective of any exemption, and the total number of its U.S. and non-U.S. employees used for its *de minimis* calculation.

Example of Brief Disclosure of Compensation Measure

Used: “We determined the median using salary, wages, and tips as reported to the U.S. Internal Revenue Service on Form W-2 and the equivalent for our non-U.S. employees.”⁵

Exequity Comment: *Based on the brief disclosure request for describing methods employed in complying with the Pay Ratio Disclosure Rule, if a company does utilize statistical sampling, it may have a harder time briefly describing its methodology. Additionally, we expect the SEC may focus on those companies indicating they used statistical sampling and make some follow-up requests, especially given the SEC’s lack of information disclosed in the Pay Ratio Disclosure Release as to how these methods could actually be employed.*

⁵ Proposing Release, Section II.C.3., Identifying the Median, pp. 45–46.

	<ul style="list-style-type: none"> The final rule makes clear that companies should not disclose any personally identifiable information about the median employee other than such employee's compensation. Companies may choose to generally identify the median employee's position, but are not required to do so and should not do so if providing such information could identify any specific individual.
<p>Will supplemental disclosures be permitted?</p>	<p>Companies will be permitted to supplement the required disclosure with a narrative discussion if they choose. Companies are also permitted to present additional ratios to supplement the required ratio. As with other disclosure requirements, however, any additional ratio must be clearly identified and not be misleading, and should not be presented with greater prominence than the required ratio.</p> <p><i>Exequity Comment: We expect many companies to take advantage of this "permission" and anticipate they will provide ratios that provide greater context for their business, e.g., excluding foreign, seasonal, or temporary workers, and/or explaining why a supplemental metric is more comparable than the one required (or why the required metric is not comparable).</i></p>
<p>What period of time is covered by "annual total compensation"?</p>	<p>The company's last completed fiscal year.</p> <p><i>Exequity Comment: This is intended to ensure that the determination of annual total compensation for all employees other than the PEO is done using the same time frame as that used in the Summary Compensation Table for the PEO's total compensation.</i></p>
<p>Can pay be annualized?</p>	<ul style="list-style-type: none"> Total compensation for all permanent employees (full-time or part-time) that were employed less than the full fiscal year can be annualized. Examples cited by the proposed rule where annualization would be appropriate include employees hired during the last fiscal year or employees that miss work as a result of medical leave. Total compensation of temporary or seasonal workers cannot be annualized and the pay of part-time workers cannot be annualized to a full-time equivalent.
<p>Are there any special considerations in determining annual total compensation for the <i>median employee</i> or all employees other than the PEO?</p> <p><i>Change from Proposing Release</i></p>	<ul style="list-style-type: none"> Cost-of-living adjustments for employees outside of the jurisdiction in which the PEO resides are permitted under the final rule, so that compensation is adjusted to the cost of living in the jurisdiction in which the PEO resides. If the company uses a cost-of-living adjustment to identify the median employee, and the median employee is in a jurisdiction other than the jurisdiction in which the PEO resides, the company must use the cost-of-living adjustment in calculating the median employee's annual total compensation and disclose the median employee's jurisdiction. In such cases, the company must also briefly describe the cost-of-living adjustments used as well as the median employee's annual total compensation and pay ratio without the cost-of-living adjustment.

- If an employee is a **union member** and entitled to benefits under a **multi-employer defined benefit pension plan**, a company should use reasonable estimates to determine the amount that reasonably approximates the aggregate change in the actuarial present value of such an employee's defined pension benefit.
- In most cases, **amounts relating to a government-mandated pension plan** would **not** be included in an **employee's total compensation** because the arrangement likely will not qualify as a company "retirement plan," i.e., a plan in which the company pays a specified amount at retirement that is not tied to the investment performance of the contributions funding the plan.
- The method for determining total compensation **might understate the overall compensation paid to employees** who are not executive officers because the rules were designed to capture the differences between regular employees and executive officers, e.g., non-discriminatory and certain *de minimis* benefits are excluded from the Summary Compensation Table. However, the SEC staff indicated that these exclusions are permissive rather than mandatory. Therefore, companies would be permitted to include personal benefits and perquisites that aggregate less than \$10,000 and compensation under non-discriminatory benefit plans in calculating the annual total compensation of employees. But, if a company does so, it must be consistent with its approach in calculating the PEO's total compensation and must then explain any difference between the PEO's total compensation used in the Pay Ratio Disclosures and the total compensation amounts reflected in the Summary Compensation Table.

How should we handle compensation paid in a foreign currency?

The instructions to the proposed Pay Ratio Disclosure Rule do not directly address the foreign currency issue. We expect foreign currency conversions to be one of the assumptions that must be made in coming up with the Pay Ratio Disclosures. As such, it may need to be described in the accompanying narrative disclosure if it is a material assumption. The easiest thing may be to use a method consistent with the company's current financial reporting, i.e., how it currently handles salary, bonus, and other amounts paid in foreign currencies.

Can we change our method for determining the median employee from year to year?

Change from Proposing Release

Companies would be permitted to change their methodology, material assumptions, adjustments, or estimates from year to year. However, if such a change is made, and it has a material effect, the company must briefly describe the change and the reasons for it as well as provide an estimate of the impact of the change on the median and the ratio.

But note that the final rule provides the median employee only has to be identified once every three years unless changes occur which cause the company to believe the Pay Ratio Disclosure would be significantly impacted.

If we have multiple PEOs (CEOs) during a year, how do we calculate the PEO annual total compensation for purposes of the Pay Ratio Disclosure?

Change from Proposing Release

The final rule provides two methods to calculate the PEO annual total compensation when a company has had more than one PEO during its last fiscal year:

- Combine the compensation to each individual who served as PEO during the year for the time served as PEO, or
- Look to the individual serving as PEO on the date the company selects to identify the median employee and annualize that PEO's compensation.

Regardless of the alternative selected, companies must disclose which alternative it used and how they calculated their PEO's annual total compensation.

What filings have to include the Pay Ratio Disclosures?

Any filing described in Item 10(a) of Regulation S-K requiring executive compensation disclosure under Item 402 of Regulation S-K must include the Pay Ratio Disclosures. Therefore, the Pay Ratio Disclosures would be required in **annual reports on Form 10-K, registration statements** under the Securities Exchange Act, and **proxy and information statements**, to the extent the requirements of these forms require compliance with Item 402. Therefore, for companies that incorporate their Item 402 disclosures into their Form 10-K annual reports by reference to their proxy statements, the Pay Ratio Disclosures would be included in their proxy statements.

When do the Pay Ratio Disclosures need to be updated?

Companies will not have to update the Pay Ratio Disclosures until they file their next annual report (but can include the disclosure in the next proxy statement if the compensation disclosures are incorporated by reference into the annual report and the proxy is filed in a timely manner). So, the Pay Ratio Disclosures are intended to be updated annually. Thus, filings made after year-end that are required to include Item 402 disclosures, e.g., registration statements, are not required to update the disclosure until the 10-K or proxy filing. The prior year Pay Ratio Disclosures would be disclosed in those filings.

What if we do not know our PEO's salary or bonus when we file our proxy? Do we still have to provide the Pay Ratio Disclosures?

If a company does not know the PEO's salary or bonus at the time it files a form with a Summary Compensation Table, a company can delay including the Pay Ratio Disclosures until it files the Form 8-K providing the missing PEO salary and/or bonus amount. The subsequent Form 8-K then would contain the missing PEO salary and/or bonus amount as well as the disclosures required by the Pay Ratio Disclosure Rule.

<p>Which companies have to comply with this Pay Ratio Disclosure Rule?</p>	<ul style="list-style-type: none">• Only companies subject to Item 402(c) requirements will be required to comply with the Pay Ratio Disclosure Rule.• As a result, the following companies will not have to comply with the Pay Ratio Disclosure Rule: emerging growth companies under JOBS Act Section 102(a)(3), smaller reporting companies,⁶ foreign private issuers that file annual reports and registration statements on Form 20-F, and companies that file reports and registration statements in accordance with the requirements of the U.S.-Canadian Multijurisdictional Disclosure System.
<p>Will the Pay Ratio Disclosures be “filed” or “furnished?”</p>	<p>The proposed rule makes clear the Pay Ratio Disclosures will be filed for purposes of the Securities and Exchange Act, and therefore would be subject to potential liabilities thereunder.</p>
<p>When will the Pay Ratio Disclosure Rule become effective?</p> <p><i>Change from Proposing Release</i></p>	<p>In the final rule, the SEC has delayed implementation of the CEO Pay Ratio Disclosure Rule until the first fiscal year beginning on or after January 1, 2017, and companies would be permitted to exclude the initial Pay Ratio Disclosures from filings until the filing of their annual reports on Form 10-K for that fiscal year.</p> <p>Timing Example: Calendar-year companies would include the Pay Ratio Disclosures in their Form 10-K filed with respect to 2017 in early 2018 or in their proxy statements or information statements for their 2018 annual meeting of shareholders.</p>

⁶ As defined in Item 10(f)(1) of Regulation S-K, e.g., had a public float of less than \$75 million or public float of \$0 and annual revenues of less than \$50 million, etc.



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