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SEC Adopts Final CEO Pay Ratio Disclosure Rule

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Speed Read

The SEC has adopted a final rule requiring public companies to disclose the ratio of its CEO compensation to the median compensation of its employees, as mandated by the Dodd-Frank Act. Disclosure of the pay ratio will be required in registration statements, proxy and information statements, and annual reports that require executive compensation disclosure. Subject to certain transition provisions, the final rule will first apply to compensation paid for a company's first full fiscal year that begins on or after January 1, 2017 and, therefore, will not require new disclosure in SEC filings by calendar year-end companies until 2018.

On August 5, 2015, the Securities and Exchange Commission adopted the final CEO pay ratio disclosure rule by a 3-2 vote. The final rule amends Item 402 of Regulation S-K, as required by Section 953(b) of the Dodd-Frank Wall Street Reform and Consumer Protection Act of 2010. The rules require public companies to disclose:

- the median annual total compensation for all employees of the company other than the CEO (subject to limited exceptions for foreign employees) for the last completed fiscal year;
- the annual total compensation of the CEO (or equivalent position) for the last completed fiscal year; and
- the ratio of the two amounts.

The pay ratio disclosure may be expressed as a ratio with the median employee compensation equal to one (for example, "x to 1" or "x:1"), or may be expressed narratively (for example, "The CEO's annual total compensation is x times that of the median total annual compensation of employees").

As discussed in greater detail in a separate section below, the CEO pay ratio disclosure rule will first apply to compensation paid for a company's first full fiscal year that begins on or after January 1, 2017 and will therefore not require new disclosure in a company's SEC filings until 2018. Although the final rule is likely to face legal challenges in court and there are already bills in both the House of Representatives and the Senate that would repeal the section of the Dodd-Frank Act under which the SEC adopted the final rule, companies should begin to evaluate whether they have information and reporting systems that would produce the required data and how compliance would impact internal and external reporting and disclosure.

Companies Covered by the Final Rule

The CEO pay ratio disclosure rule applies to all companies that are required to provide Summary Compensation Table disclosure under Item 402(c) of Regulation S-K. The final rule therefore does not apply to smaller reporting companies, emerging growth companies, U.S.-Canadian multijurisdictional disclosure system filers, foreign private issuers or registered investment companies.

Identifying the Median Employee

Employee Population. In determining the employees from which the median employee is identified, a company may use its full employee population or a statistical sampling and/or other reasonable methods. A company's full employee population for purposes of identifying the median employee for a particular year includes all individuals other than the CEO who were employed by the company or any of its consolidated subsidiaries as of a date selected by the company that is within the last three months of its fiscal year. All full-time, part-time, seasonal and temporary workers who were employed on the date selected are included. Workers who provide services to the company as independent contractors or "leased" workers are excluded if they were employed by and their compensation was determined by an unaffiliated third party. In addition, companies may exclude persons who became employees as the result of a business combination or acquisition occurring during the year and, under limited exemptions described below, non-U.S. employees.

Employee Compensation. The final rule provides companies with significant flexibility in determining the compensation measure to be used to identify the median employee. Companies may use annual total compensation, calculated in the same way as total compensation is for the named executive officers in the Summary Compensation Table, or any other compensation measure that is consistently applied to all employees included in the calculation. For example, a company may use information from its tax or payroll records to identify the median employee. Companies also may use a measure that is defined differently across jurisdictions, such as "taxable wages," and may include different annual periods as long as the company applies the measure consistently within each jurisdiction. As described in more detail below, companies may also make cost-of-living adjustments to the compensation of employees in jurisdictions other than the jurisdiction in which the CEO resides.

Frequency of Determination. Companies must identify the median employee at least once every three years; provided that if there has been a change in employee population or compensation arrangements during a company's prior fiscal year that the company reasonably believes would result in a significant change to its pay ratio disclosure, the company must re-identify the median employee for that fiscal year.

Substitution of Median Employee. In cases where a company would otherwise not be required to re-identify the median employee for a particular year but it is no longer appropriate to use the median employee for the prior year because of a change in the employee's circumstances that the company reasonably believes would result in a significant change in its pay ratio disclosure, the final rule permits a company to use another employee whose compensation was substantially similar to the original median employee based on the compensation measure that the company used to select the original median employee. This could become necessary if the original median employee is no longer employed by the company in year two or year three, or if the employee's compensation significantly changes in year two or year three (for example, as a result of a promotion that significantly increases his or her compensation).

Disclosure Requirements. The final rule includes a number of disclosure requirements relating to the identification of the median employee. In particular, a company must disclose:

- the date selected by the company to determine the full employee population, and if such date was changed from the prior year, disclosure of the change and a brief explanation of the reason for the change;
- the compensation measure used to identify the median employee if the company uses a compensation measure other than annual total compensation;
- if true, that the company is using the same median employee as it did in the prior year and a brief description of the basis for its reasonable belief that there have been no changes in employee population or compensation arrangements during its prior fiscal year that it reasonably believes would significantly affect its pay ratio disclosure;
- the approximate number of employees that have been omitted because they became employees as the result of a business combination or acquisition during the year, if any, and the identity of the acquired business that is excluded; and
- if cost-of-living adjustments are made, the additional disclosures described in that section.

Companies also must briefly describe the methodology and any material assumptions, adjustments or estimates they use to identify the median employee. In addition, if a company changes its methodology or its material assumptions, adjustments or estimates from those used in its pay ratio disclosure for the prior fiscal year, and the effects of any such change are significant, the company must briefly describe the change and the reason for the change. The final rule also separately requires companies to clearly identify any estimates used. As an example, the adopting release stated that when a company uses statistical sampling, it must describe the size of both the sample and the estimated full employee population, any material assumptions used in determining the sample size and the sampling methods used.

Determination of Annual Total Compensation

Median Employee. The annual total compensation of the median employee that is required to be disclosed and used to determine the CEO pay ratio is to be calculated in the same way total compensation is calculated for the named executive officers in the Summary Compensation Table pursuant to Item 402(c)(2)(x) of Regulation S-K, except as noted below. Companies are required to recalculate the annual total compensation of the median employee each year, even in situations where they were not required to re-identify the median employee for the particular year.

Salary. For non-salaried employees, references to "salary" refer instead to "wages plus overtime."

Annualizing Adjustments. Companies may annualize total compensation for all permanent employees that were employed for less than the full year, such as newly hired employees or those on unpaid leave. Companies may not annualize total compensation for temporary or seasonal positions, and may not make a full-time equivalent adjustment for any employee.

Personal Benefits. Companies may include (1) personal benefits that are less than $10,000 in the aggregate and (2) non-discriminatory benefit plan compensation in calculating annual total compensation of their median employee if they include the same items in the annual total compensation of their CEOs used for purposes of calculating the CEO pay ratio. If a company does so, it must explain the difference between the CEO's annual total compensation used for the pay ratio disclosure and the total compensation shown in the Summary Compensation Table if the difference is material.

Reasonable Estimates. Companies are permitted to use reasonable estimates to calculate annual total compensation or any element of annual total compensation for the median employee. As interpreted by the SEC in the adopting release, this means that companies must have a reasonable basis to conclude that their estimates approximate the actual amounts of compensation, or a particular element of compensation, calculated in accordance with Item 402(c)(2)(x) of Regulation S-K. The SEC did state that companies may use reasonable estimates in determining an amount that reasonably approximates the aggregate change in the actuarial present value of the median employee's defined pension benefit. In this situation, the SEC recognized that companies may not have access to the information needed to calculate the precise amount.

Companies must clearly identify any estimates they use in calculating the annual total compensation or any element of annual total compensation for the median employee. Companies must also briefly describe any material assumptions, adjustments, or estimates they use to determine total compensation. If a company changes its assumptions, adjustments or estimates from the prior fiscal year and the effects of the change are significant, the company must describe the change and the reason for the change. These disclosure requirements are the same as the disclosure requirements relating to assumptions, adjustments and estimates used to identify the median employee.

Cost-of-Living Adjustments. As described in more detail below, the final rule permits companies to make cost-of-living adjustments to the compensation of employees in jurisdictions other than the jurisdiction where the CEO resides if they use such an adjustment to identify the median employee.

Multiple CEOs During a Single Year. The final rule permits a company that has more than one non-concurrent CEO serving during a single fiscal year to calculate the annual total compensation for its CEO in either of two manners:

- the company may calculate and combine the compensation provided to each person who served as CEO during the year for the period during which he or she served as CEO; or
- the company may calculate and annualize compensation for the individual who was serving as CEO on the date the company selected for identification of the median employee.

The final rule requires the company disclose which option it chose and how it calculated the CEO's annual total compensation.

Cost-of-Living Adjustments

The final rule permits companies to make cost-of-living adjustments to the compensation of employees in jurisdictions other than the jurisdiction where the CEO resides. From the discussion in the adopting release, these references to "jurisdiction" appear to be limited to different countries rather than different U.S. states or local jurisdictions. If a company uses such an adjustment to identify the median employee, and the median employee is in a jurisdiction other than the jurisdiction where the CEO resides, the company must use the same adjustment to calculate the median employee's annual total compensation and disclose the median employee's jurisdiction. The company must also briefly describe the cost-of-living adjustment it used (1) to identify the median employee and (2) to calculate the median employee's annual total compensation, including the measure used as the basis for the cost-of-living adjustment. If the company makes a cost-of-living adjustment, it must also present the median employee annual total compensation and pay ratio determined *without* the cost-of-living adjustment. To calculate these amounts, the company will need to identify the median employee without using any cost-of-living adjustment. Companies must disclose if they change from using a cost-of-living adjustment to not using that adjustment (or vice versa).

Non-U.S. Employees

The CEO pay ratio rule provides two exemptions for employees located outside the United States.

Data Privacy Exemption. The final rule allows companies to exclude non-U.S. employees from the company's employee population if they are employed in a foreign jurisdiction in which the laws or regulations governing data privacy are such that, despite reasonable efforts to obtain or process the necessary information, the company is unable to do so without violating those laws or regulations. If a company excludes any non-U.S. employees under this exemption in a particular jurisdiction, it must exclude all non-U.S. employees in that jurisdiction. The data privacy exclusion is subject to the following additional requirements:

- A company's "reasonable efforts" to obtain the necessary information must include, at a minimum, using or seeking an exemption or other relief under the applicable data privacy laws or regulations.
- If a company excludes any employees under this exemption, it must identify the excluded jurisdiction(s) and identify the specific data privacy laws or regulations that prohibit the collection of information and explain how complying with the CEO pay ratio disclosure rule would violate those laws or regulations (including the efforts the company made to seek an exemption from the laws or regulations). Companies must also indicate the approximate number of employees excluded from each jurisdiction based on this exemption.
- A company that relies on this exemption must obtain a legal opinion from counsel that opines on the company's inability to obtain or process the required information without violating the jurisdiction's data privacy laws or regulations, including the company's inability to obtain an exemption or other relief. Companies must file this legal opinion as an exhibit to the filing that includes CEO pay ratio disclosure.

The data privacy exclusion is not subject to the 5% limitation of the *de minimis* exemption described below, but employees excluded under the data privacy exemption count against the 5% limitation of the *de minimis* exemption.

De Minimis Exemption. The adopted rule also provides a "*de minimis*" exemption for non-U.S. employees. To the extent available, this exemption permits companies to exclude up to 5% of their total employees. If a company's non-U.S. employees account for 5% or less of its total employees, the company may choose to exclude all (but not less than all) of its non-U.S. employees under this exemption. If a company's non-U.S. employees exceed 5% of its total employees, a company may exclude up to 5% of its total employees who are non-U.S. employees, subject to the following restrictions:

- If a company excludes any non-U.S. employees in a jurisdiction, it must exclude all employees in that jurisdiction. If more than 5% of the company's employees are in a single non-U.S. jurisdiction, companies may not exclude any employees in that jurisdiction under the *de minimis* exemption.
- Companies may not use the *de minimis* exemption if the number of employees excluded under the data privacy exemption equals or exceeds 5% of the company's total employees. Non-U.S. employees excluded under the data privacy law exemption count against the 5% total that may be excluded under the *de minimis* exemption.
- If employees excluded under the data privacy exemption are less than 5% of the company's total employees, the company may use the *de minimis* exemption to exclude up to the number of non-U.S. employees that would, combined with employees excluded under the data privacy exemption, not exceed 5% of the company's total employees.

If a company uses the *de minimis* exemption, it must disclose the jurisdiction or jurisdictions from which it is excluding employees, the approximate number of employees excluded from each jurisdiction under the *de minimis* exemption, the total number of its U.S. and non-U.S. employees calculated without regard to the data privacy and/or *de minimis* exemptions, and the total number of its U.S. and non-U.S. employees used for its *de minimis* calculation.

Additional Disclosure Permitted

The final rule permits (but does not require) companies to present additional information, including additional ratios, such as additional pay ratios for U.S. employees or non-U.S. employees. Additional information and ratios must be clearly identified and must not be misleading or presented with greater prominence than the required ratio.

Personally Identifiable Employee Information

The final rule provides that companies are not required to, and should not, disclose any personally identifiable information about the median employee other than his or her compensation. The final rule permits companies to generally identify an employee's position to put the employee's compensation in context, but does not require companies to provide this information and provides that companies should not do so if providing that information could identify any specific individual.

CEO Compensation Not Available and New Form 8-K Disclosure

If a company's CEO's salary or bonus is not calculable through the latest practicable date for a filing that otherwise would require disclosure of the CEO pay ratio, the company must disclose that the pay ratio cannot be calculated until the CEO salary or bonus, as applicable, has been determined and the date on which it expects to determine the CEO's actual total compensation. The company must then include the CEO pay ratio disclosure required by the final rule in the current report under Item 5.02(f) of Form 8-K that discloses the CEO's salary or bonus.

Compliance Date, Affected Filings and Transition Periods

For companies that are subject to the CEO pay ratio disclosure rule, the final rule will first apply to compensation paid for their first fiscal year beginning on or after January 1, 2017. As a result, the final rule will not require CEO pay ratio disclosure until 2018 for calendar year-end companies.

Filings Affected. Companies are required to include CEO pay ratio disclosures in any registration statement, proxy or information statement and annual report that requires executive compensation disclosure pursuant to Item 402 of Regulation S-K.

Disclosure Timing. Generally, CEO pay ratio disclosure is subject to the same filing timetable as other compensation disclosure required by Item 402. This means that the final rule does not require a company to file CEO pay ratio disclosure for the last completed fiscal year until it files its annual report on Form 10-K or, if later, when the company files its definitive proxy or information statement relating to its next annual meeting of shareholders or written consent in lieu of such a meeting. As is the case with other Item 402 compensation disclosure, a company may incorporate the CEO pay ratio disclosure into its annual report on Form 10-K from its definitive proxy statement. If the company does not file its definitive proxy statement within 120 days after the end of its prior fiscal year, the company must file the CEO pay ratio disclosure and other disclosure that would have been incorporated by reference from its definitive proxy statement in an amendment to its annual report on Form 10-K. Unlike other disclosures required by Item 402, if the CEO pay ratio disclosure for the mostly recently completed fiscal year would be required in a registration statement or a proxy or information statement that is filed before such disclosure is included, or required to be included, in a company's Form 10-K, the company would not be required to include the updated CEO pay ratio disclosure in that filing. The adopting release suggests that, in that instance, the most recent CEO pay ratio disclosure that previously had been included in a Form 10-K (i.e., the prior year's CEO pay ratio disclosure) would be required to be included in the filing.

Filed, not Furnished. CEO pay ratio disclosure will be treated as "filed" rather than "furnished" for purposes of the federal securities laws, and will be subject to the CEO/CFO certifications required by Rule 13a-14 under the Securities Exchange Act of 1934 and Section 906 of the Sarbanes-Oxley Act.

Transitional Relief for New Reporting Companies. For a new reporting company that is not an emerging growth company or a smaller reporting company, the final rule will first apply to compensation paid for the first fiscal year following the year on which it first becomes subject to reporting requirements under Section 13(a) or Section 15(d) of the Securities Exchange Act, but not for any fiscal year that begins before January 1, 2017. For example, a company that completes its initial public offering in 2016 would first be required to provide CEO pay ratio disclosure with respect to 2017 compensation in its Form 10-K or definitive proxy statement filed in 2018. Similarly a company that completes its initial public offering in 2018 would first be required to provide CEO pay ratio disclosure with respect to 2019 compensation in its Form 10-K or definitive proxy statement filed in 2020.

Transitional Relief for Emerging Growth and Smaller Reporting Companies. For a company that qualifies as an emerging growth company or smaller reporting company, the final rule will first apply to compensation paid for the first fiscal year commencing on or after the date on which the company ceases to be an emerging growth company or smaller reporting company, as applicable, but not for any fiscal year that begins before January 1, 2017. For example, a company that ceases to be an emerging growth company during 2017 would first be required to provide CEO pay ratio disclosure with respect to 2018 compensation in its Form 10-K or definitive proxy statement filed in 2019.

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