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SEC Adopts CEO Pay Ratio Disclosure Rules

The SEC has adopted rules requiring companies to disclose the pay ratio between their CEO and median compensated employee.

Last week, the Securities and Exchange Commission (the SEC) adopted final rules requiring companies to disclose the pay ratio between their CEO and median compensated employee (the CEO Pay Ratio). The rules are effective for fiscal years beginning on or after January 1, 2017, so the CEO Pay Ratio disclosure will not be required until 2018. The final rules make several changes to the proposed rules, including unexpected changes to the workers used for purposes of calculating the CEO Pay Ratio. Observers widely expect that these rules may be challenged in lawsuits and that Congress may amend the statute before the new rules become effective. However, companies subject to these rules should begin to evaluate their ability to comply and their disclosure strategies.

Overview

As expected, the SEC voted along party lines to largely adopt the CEO Pay Ratio rules it had initially proposed on September 18, 2013. Most of the changes to the proposed rules contained in the final rules are intended to provide issuers with some relief from the heavy administrative burdens associated with the rules. The rules add a new Item 402(u) of Regulation S-K which requires companies to disclose annually:

- The median of the annual total compensation for all employees of the company except the CEO.
- The annual total compensation of the chief executive officer (the CEO).
- The ratio of the two

These rules are designed to implement and comply with Section 953(b)(1) of the Dodd-Frank Wall Street Reform and Consumer Protection Act while also attempting to address the costs and burdens to companies of implementing the rules. As discussed below, the final rules permit some flexibility in determining the median employee and total compensation.

Companies must include the CEO Pay Ratio in their annual reports on Form 10-K, proxy and information statements, and any registration statement that requires executive compensation disclosure pursuant to Item 402 of Regulation S-K. Emerging growth companies, smaller reporting companies, foreign private issuers, registered investment companies or US-Canadian Multijurisdictional Disclosure System filers are exempted from this disclosure requirement. The CEO Pay Ratio is also not required in a Form S-1 or Form S-11 filed in connection with a company's initial public offering. However, the requirement would apply to new companies that do not qualify as emerging growth companies with respect to compensation for the first fiscal year to begin after the company becomes public but not for any fiscal year commencing before January 1, 2017.

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As has been widely reported since the enactment of the Dodd-Frank Act, the requirement that US public companies disclose the CEO Pay Ratio has been hotly debated and it is clear that the adoption of the final rules will not end the debate. It is also clear that much can happen to change the rules before they require disclosures to be made in 2018 proxies. The extension of the application and disclosure compliance dates by one year in the final rules has taken some of the pressure off companies subject to the rules. However, companies should now begin to consider what it would take for them to gather the necessary information to make the CEO Pay Ratio calculations for 2017. Companies should also start to consider whether in 2018 it may make sense to disclose more than the minimum required disclosure in order to provide additional context in view of their particular employee, public and investor relations issues.

Key Determinations

The CEO Pay Ratio rules' key features and action items are as follows.

Determine "all employees."

For purposes of calculating the pay ratio, companies are required to determine the annual total compensation of "all employees" (other than the CEO) of the registrant and its consolidated subsidiaries. Subject to the exceptions listed below, this captures all employees employed as of a date selected by the company within the last three months of the company's last completed fiscal year, including all worldwide full-time, part-time, seasonal or temporary workers.

Under the proposed rules, independent contractors and "leased" workers who are employed by a third party were excluded from the determination of "all employees" for purposes of the pay ratio calculation. Under the final rules, however, it is unclear whether or not independent contractors who are engaged directly and not through third parties are excluded. The SEC's press release implies that all independent contractors should be excluded, but Commissioner Piwowar in his Additional Dissenting Comments on Pay Ratio Disclosure indicates that independent contractors may only be excluded if they are employed by an unaffiliated third party.

Item 402(u)(3) of Regulation S-K provides in relevant part:

> "The definition of employee or employee of the registrant does not include those workers who are employed, and whose compensation is determined, by an unaffiliated third party but who provide services to the registrant or its consolidated subsidiaries as independent contractors or 'leased' workers."

This language — including the use of the word "workers" instead of limiting the definition to employees — could be interpreted to mean that only independent contractors whose compensation is determined by a third party, and not independent contractors who contract directly with the registrant, may be excluded. This interpretation would impose significant additional costs and administrative burdens on many companies that directly contract with consultants and other independent contractors. But it is not clear whether this reflects the SEC's interpretation. We and others have asked the SEC for additional guidance, but as of the date of this *Client Alert* the SEC has declined to provide additional clarity.

The final rules also exclude employees of joint ventures and unconsolidated subsidiaries.

Companies may also exclude:

A. Non-U.S. employees in a particular jurisdiction where foreign data privacy laws or regulations make the company unable to include the employees in such jurisdiction. If a 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. The company must also obtain a legal opinion from counsel as to the inability of the company to obtain or process the information necessary for including employees in such jurisdiction, including the company's inability to obtain an exemption or other relief under any governing laws or regulations. This legal opinion must be filed as an exhibit with the filing in which the CEO Pay Ratio is disclosed.

B. Non-US employees, if these employees account for 5% or less of the company's total worldwide employees. If a company relies on this exemption to exclude any non-US employees, the company must exclude all of them.

C. In addition, if a company's non-US employees exceed 5% of the company's total worldwide employees (such that the exemption under (B) above is not available), the company may exclude up to 5% of its total employees who are non-US employees. If the company excludes any non-US employees in a particular jurisdiction, the company must exclude all non-US employees in that jurisdiction. In addition, in calculating the number of non-US employees that may be excluded under this de minimis exemption, the company must count any non-US employees exempted under the data privacy exemption (under (A) above) against the availability. Thus, if the number of employees excluded under the data privacy exemption equals or exceeds 5% of the company's total employees, this exemption will not be available.

D. Any persons that became a company's employees as a result of a business combination or acquisition for the fiscal year in which the transaction occurred. However, these individuals would need to be considered for subsequent years.

If a company omits any employee based on the above exclusions, it will need provide certain disclosures explaining that such employees have been omitted from the pay ratio calculations, including, among other information, the approximate number of employees omitted. To the extent that a company excludes non-US employees under these exceptions, then it must also disclose the jurisdictions where such employees are located. If employees are excluded under the de minimis exception, then the company must also disclose the total number of US and non-US employees (without regard to any exclusions) and the total number of US and non-US employees used for the de minimis calculation.

Find the "median employee."

To help mitigate compliance costs, the final rules allow companies to identify the median employee once every 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 in the pay ratio disclosure. Thus, absent one of these significant changes, the same median employee may be used for three consecutive years.

The rules do not mandate any specific method for identifying the median employee. The median employee may be identified using annual total compensation or any other compensation measure consistently applied to all employees included in the calculation, such as information derived from tax or payroll records (*e.g.*, W-2 reportable wages). Also, in determining the employees from which the median is identified, a company is permitted to use its employee population, statistical sampling or other reasonable methods.

Companies may (but are not required to) annualize the compensation for all permanent employees (other than those in temporary or seasonal positions) who were not employed for the entire fiscal year, such as a new hire or an employee who took an unpaid leave of absence during the period. The rules do not permit full-time equivalent adjustments for part-time employees, or annualizing adjustments for temporary or seasonal employees. The rules also permit cost-of-living adjustments for the compensation of employees in jurisdictions other than the jurisdiction in which the CEO resides, such that the compensation is adjusted to the cost of living in the jurisdiction in which the CEO resides. A company that uses cost-of-living adjustments to present the pay ratio must also disclose the median employee's annual total compensation and pay ratio without the cost-of-living adjustments.

The methodology and any material assumptions, adjustments or estimates used to identify the median employee must be disclosed, although companies need not disclose technical analyses or formulas. If a company changes its methodology or its material assumptions, adjustments, or estimates from those used in the prior fiscal year, and if the effects of any such change are significant, the company must briefly describe the change and the reasons for the change.

Determine the median employee's total compensation per Item 402 of Regulation S-K.

Once the median employee is identified, the company then needs to calculate that one median employee's annual "total compensation" in accordance with Item 402 of Regulation S-K to determine the pay ratio. Companies may use reasonable estimates when calculating any elements of the annual total compensation for the median employee. In addition, companies may, at their discretion, include personal benefits that aggregate less than $10,000 and compensation under non-discriminatory benefit plans in calculating the annual total compensation of the median employee — as long as these items are also included in calculating the CEO's annual total compensation.

Calculate the CEO's Total Compensation.

A company will normally use the total compensation figure of the CEO from the Summary Compensation Table as reported in the proxy. However, if a company has more than one CEO during the prior fiscal year, the final rules permit the company to either (i) combine the total compensation of each CEO or (ii) annualize the compensation of the person serving as CEO as of the date the company selected to determine the median employee.

Disclose the CEO Pay Ratio.

The CEO Pay Ratio must be expressed as a ratio in which the median of the annual total compensation of all employees is equal to one (*e.g.*, "1 to 200") or, alternatively, expressed in narrative form in terms of the multiple that the CEO total compensation amount bears to the median of the annual total compensation amount of all employees (*e.g.*, "the CEO's annual total compensation is 200 times that of the median of the annual total compensation of all employees"). Companies are permitted to supplement required disclosure with a narrative discussion or additional ratios. Any additional information has to be clearly identified, not misleading and not presented with greater prominence than the required ratio.

Other Considerations

Currently, US public companies are required to discuss any internal pay equity policies they may have in the Compensation Discussion & Analysis section of their proxy statements. Companies should review that disclosure in light of the CEO Patio Ratio disclosure and assess whether or not further detail should be provided or other revisions should be made.

If you have questions about this *Client Alert*, please contact one of the authors listed below or the Latham lawyer with whom you normally consult:

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