

INSIGHTS

What You Need to Know About the SEC's New Pay Ratio Disclosure Rules

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On August 5, 2015, the Securities and Exchange Commission voted to approve final rules to implement pay ratio disclosure pursuant to Section 953(b) of the Dodd-Frank Wall Street Reform and Consumer Protection Act. As required by Dodd-Frank, the new rules amend Item 402 of Regulation S-K to require public companies to disclose:

- The annual total compensation of the chief executive officer;
- The median annual total compensation of all employees excluding the chief executive officer; and
- The ratio of these two amounts.

The SEC voted 3-2 to approve the final rules following a comment period during which it received over 287,000 comment letters. In adopting the final rules, the SEC stated that the rules provide issuers with substantial flexibility in determining the median employee for purposes of calculating the pay ratio, while implementing the statutory requirements of Dodd Frank. The new rules will become effective for most issuers in proxy statements or Annual Reports on Form 10-K filed in 2018 for fiscal years beginning on or after January 1, 2017.

Highlights of the New Rules

Determining the Median Employee

- Subject to limited exceptions for non-U.S. employees described below, an issuer must include all employees when determining its median employee, including full-time, part-time, seasonal and temporary employees employed by the issuer and any of its consolidated subsidiaries.
- Non-U.S. employees may be excluded from the determination of the median employee in the following circumstances:

- An issuer may exclude non-U.S. employees who are employed in jurisdictions with data privacy laws that make the issuer unable, despite its reasonable efforts, to comply with the pay ratio disclosure requirement without violating those laws. An issuer relying on the data privacy exclusion must obtain and file a legal opinion regarding the issuer's inability to comply.
- An issuer may exclude all of its non-U.S. employees if they account for five percent or less of its total employee population. If the issuer relies on this exception, it must exclude all of its non-U.S. employees. If more than five percent of the issuer's employees are non-U.S. employees, the issuer may exclude up to five percent of its total employees who are non-U.S. employees. If the issuer relies on this exception, it must exclude all of its employees in each jurisdiction in which employees are excluded.
- An issuer that engages in a business combination or acquisition may omit the employees of the acquired company from the pay ratio calculation for the fiscal year in which the transaction occurred.
- An issuer may choose any date within the last three months of its fiscal year to identify its median employee.
- The same median employee may be used for three years unless there has been a change in the issuer's employee population or employee compensation arrangements that the issuer reasonably believes would result in a significant change to the pay ratio.
- An issuer may select its methodology for identifying the median employee based on its own facts and circumstances. An issuer may make its median employee identification based on statistical sampling, by analyzing its entire employee population, or by using other reasonable methods. The median employee may be identified using annual total compensation measures or any other compensation measure that is consistently applied to all employees included in the calculation, such as information from tax or payroll records.
- Although issuers may annualize compensation for newly hired full-time or part-time permanent employees, issuers may not make such adjustments for seasonal or temporary employees and may not make full-time equivalent adjustments for any employee.
- An issuer may apply a cost-of-living adjustment for employees residing in jurisdictions other than the jurisdiction in which the chief executive officer resides; however the issuer must disclose the median employee's annual compensation and the pay ratio without the cost-of-living adjustment.

Determining Median Employee Compensation

- To determine total compensation for its median employee, an issuer is required to use the same rules that apply to the calculation of chief executive officer compensation under Item 402 of Regulation S-K.

Required and Permitted Disclosures

- In addition to disclosure of the annual total compensation for the chief executive officer and the median employee and the ratio of those two amounts, an issuer must briefly describe its methodology and any material assumptions, adjustments or reasonable estimates used to identify the median employee.
- Issuers are permitted to provide additional information, including additional supplemental ratios, which must be clearly identified, not misleading, and not presented with greater prominence than the required ratio.

Compliance Dates

- The first period for which pay ratio disclosure will be required is an issuer's first full fiscal year beginning on or after January 1, 2017. For an issuer with a fiscal year ending December 31, the disclosure will be required as part of its executive compensation disclosures in its proxy statement for its 2018 annual meeting of shareholders or its Form 10-K for the year ended December 31, 2017.
- A newly public issuer must comply with the disclosure requirements for its first full fiscal year beginning after the issuer has (1) been subject to Exchange Act reporting requirements for at least twelve calendar months beginning on or after January 1, 2017 and (2) filed at least one annual report that did not include the pay ratio disclosure.
- An issuer that ceases to be a smaller reporting company or an emerging growth company will not be required to provide pay ratio disclosure until after the first full fiscal year after exiting such status and not for any fiscal year commencing before January 1, 2017.

Companies Subject to the Rules

- In general, the rules apply to issuers that are required to provide executive compensation disclosures pursuant to Item 402 of Regulation S-K.
- The rules do not apply to emerging growth companies, smaller reporting companies, registered investment companies and foreign private issuers. As noted above, the rules provide for a transition period for issuers exiting emerging growth company or smaller reporting company status.

Reports Requiring Pay Ratio Disclosure

- The pay ratio disclosures are required in any annual report, proxy or information statement or registration statement that requires executive compensation disclosure pursuant to Item 402.
- Contrary to the suggestion of many commenters, the information will be “filed” and not “furnished” for purposes of the Securities Act and the Exchange Act and, accordingly, will be subject to potential liability under those laws.

What Companies Should Do Now

Although the new rules will not require disclosure for fiscal years beginning before January 1, 2017, issuers should begin to assess the impact of the disclosure rules well in advance. Initial preparation steps may include:

- Informing your Board, Compensation Committee and HR department of the new rules, and discussing the potential compliance and disclosure implications.
- Evaluating your employee population. How many employees are outside of the U.S.? Of these, which are employed in jurisdictions with data privacy laws, and how will those laws affect compliance with the rules? How many employees are temporary, seasonal or part-time, and does this have a significant effect on the median employee?
- Ensuring that payroll systems and other related disclosure controls and procedures are in place to facilitate the determination of the median employee.
- Reviewing the disclosures of any voluntary “early adopters.”
- Considering pay ratio disclosure discussions when planning your next shareholder outreach program.
- Staying tuned. Because of the controversial nature of the new rules and the strong dissents by Commissioners Piwowar and Gallagher, litigation challenging the new rules is possible. However, companies should move forward with their evaluation of an implementation strategy.

The full text of the final rules may be found [here](#).