THE REVIEW OF
SECURITIES & COMMODITIES REGULATION
AN ANALYSIS OF CURRENT LAWS AND REGULATIONS AFFECTING THE SECURITIES AND FUTURES INDUSTRIES

Vol. 49 No. 7 April 6, 2016

SEC PAY RATIO RULES — A RECIPE FOR COMPLIANCE AND MODEL DISCLOSURE

The SEC has issued its final pay ratio disclosure rules that require public companies to disclose the ratio of CEO pay to that of their median employee. The authors discuss the general principles of the required disclosure and then proceed step-by-step through the calculation, noting the advantages and disadvantages of various options allowed by the rules. They close with a suggested model base disclosure for the initial year and summaries of some additional required and optional disclosures.

By Jason M. Halper and Jeremy D. Erickson *

In August 2015, the SEC adopted its final pay ratio disclosure rules, implementing the pay ratio disclosure requirement in the Dodd-Frank Wall Street Reform and Consumer Protection Act (the "Rules"), SEC Release No. 34-75610. Commencing in early 2018, public companies, other than companies not subject to the Rules (*i.e.*, emerging growth companies, smaller reporting companies, foreign private issuers, MJDS (or multijurisdictional disclosure system) filers, and registered investment companies), will have to disclose, at a minimum, (i) their CEO's total annual compensation, (ii) the median total annual compensation of all of their employees (other than the CEO), and (iii) a ratio comparing the two compensation amounts.[1] More likely, certain additional disclosure will be required under the Rules or desirable at the issuer's discretion in connection with various aspects of the pay ratio calculation.

The provision has generated its share of controversy. In commenting on this provision, Senator Robert Menendez wrote to then SEC Chair Mary Schapiro that: "I wrote this provision so that investors and the general public know whether companies' pay practices are fair to their average employees, especially compared to their highly compensated CEOs. . . . Such information is

[1] Dodd-Frank Section 953, titled "Executive Compensation Disclosures," provides in Section 953(b)(1) that the "Commission shall . . . require each issuer to disclose in any [of certain prescribed] filing[s] of the issuer…(A) the median of the annual total compensation of all employees of the issuer, except

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the chief executive officer (or any equivalent position) of the issuer; (B) the annual total compensation of the chief executive officer (or any equivalent position) of the issuer; and (C) the ratio of the amount described in subparagraph (A) to the amount described in subparagraph (B)."

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IN THIS ISSUE

RSCR Publications LLC Published 22 times a year by RSCR Publications LLC. Executive and Editorial Offices, 2628 Broadway, Suite 29A, New York, NY 10025-5055. Subscription rates: $1,197 per year in U.S., Canada, and Mexico; $1,262 elsewhere (air mail delivered). A 15% discount is available for qualified academic libraries and full-time teachers. For subscription information and customer service call (937) 387-0473 or visit our website at www.rscrpubs.com. General Editor: Michael O. Finkelstein; tel. 212-876-1715; e-mail mofinkelstein@gmail.com. Associate Editor: Sarah Strauss Himmelfarb; tel. 301-294-6233; e-mail shimmelfarb@comcast.net. To submit a manuscript for publication contact Ms. Himmelfarb. ISSN: 0884-2426.

highly material to investors who have the right to know about companies' policies and practices on compensation before they invest." Certain state government agencies, unions, and pension funds likewise weighed in supporting the proposed rules, including the New York State Comptroller at the time, Thomas DeNapoli, the AFL-CIO, and the Washington State Investment Board.

On the other hand, there was ample criticism of the usefulness and costs associated with the proposed rules. Former SEC Commissioner Michael Piwowar commented that: "The pay ratio rule will harm investors. . . . [A]ny investor that uses pay ratio disclosures to compare companies will be at best distracted from material information and at worst misled about the investment itself." The U.S. Chamber of Commerce's Center for Capital Markets Competitiveness submitted a comment letter on the proposed rules in which it stated that the "SEC likely underestimated costs [to comply] by more than 870 percent and underestimated compliance time by 560%," with annual costs to the private sector of over $700 million versus $72.7 million estimated by the SEC. The Chamber's view was echoed by others, including organizations like the American Benefits Council and corporations such as ExxonMobil. These comments were merely representative of the dialogue surrounding the proposed rules.

While compliance is not required for some time, the work required to make the calculation is likely to be time-consuming, expensive, and complex. To undertake this effort as efficiently as possible and achieve as favorable a ratio as permissible under the Rules, issuers need to engage in thorough advance planning taking into account the various options and considerations raised by the Rules. This article explains step-by-step how to prepare for compliance and then comply with the Rules, including identifying the median employee and computing total annual compensation; describes the advantages and disadvantages associated with the various options that need to be weighed along the way; summarizes the required and/or potential disclosures that need to be made; and includes model disclosure.

GENERAL PRINCIPLES

- Required Filings: The pay ratio disclosure is required in all filings in which executive compensation disclosure is required by Item 402 of Regulation S-K, including Form 10-Ks/annual reports, proxy statements, and registration statements. The disclosure is not required in Form 10-Qs.

- "Determination Date": The Rules provide some flexibility in selecting the date for purposes of identifying the median employee or the determination date. Issuers may choose any date within the last three months of their fiscal year, although the chosen date and any changes thereto must be disclosed. For example, choosing a date well before the holidays could avoid the inclusion of any seasonal employees.

- The median employee must be identified only once every three years unless there is a subsequent change in the company's employee population or employee compensation arrangements that the company reasonably believes would result in a significant change in its pay ratio disclosure. If there has been no such change, the company must disclose that it is using the same median employee as the previous year and its basis for doing so.

- If the identified median employee's compensation changes, the company may use another employee whose compensation is substantially similar to the original median employee, based on the compensation measure used to select the original median employee. A company must disclose if it uses a different median employee due to a material change in the compensation of the original median employee. If there is no comparable employee, the company must undertake again the process to identify a new median employee.

- A company should not disclose any personally identifying information about the median employee other than the employee's compensation. It is permissible but not required to disclose the median employee's position so long as doing so would not result in identifying the employee.

Transition Periods: New reporting companies are not required to include pay ratio disclosure in their initial registration statement. Instead, a new reporting company must make disclosure for its first full fiscal year after it has both (i) been a reporting company for at least 12 calendar months starting on or after January 1, 2017 and (ii) filed at least one annual report that does not include the disclosure. A company that loses exempt status (i.e., because it no longer qualifies as a smaller reporting or emerging growth company) must make disclosure for its first full fiscal year thereafter, for any fiscal year starting on or after January 1, 2017.

STEP 1: DETERMINE CEO TOTAL ANNUAL COMPENSATION

The first step is to calculate the CEO's total annual compensation for the applicable fiscal year. This is the simplest aspect of the Rules because the CEO's total compensation will, with relatively minor exceptions, be the same as reported in the Summary Compensation Table of a company's proxy statement determined in accordance with Item 402(c)(2)(x) of Regulation S-K.[2] There are, however, certain permitted deviations from the Item 402 calculation.

Importantly, a company must include as part of the CEO's total compensation, for purposes of the pay ratio calculation, personal benefits and other perquisites valued at less than $10,000 in the aggregate (which generally are excluded in the Summary Compensation Table calculation) to the extent it includes such personal benefits and other perquisites in its calculation of the median employee's total compensation. Because of the greater percentage increase resulting from including these benefits in the median employee's compensation versus on the CEO's compensation, it will usually make sense to include such perquisites in the compensation calculation.

If a company had more than one CEO during the fiscal year, it can determine the CEO's total compensation by either: (i) aggregating the total compensation that was paid to each individual who served as CEO during the year or (ii) annualizing the compensation paid to the individual serving as CEO on the determination date the company selects to identify the median employee. In this situation, the company must disclose which of the two methods it used to calculate the CEO's annual total compensation.

If a component of a CEO's compensation (i.e., salary or bonus) is not calculable at the time a company makes a filing required to contain the disclosure, the company may omit such compensation component and the pay ratio disclosure in the filing until the component is determinable, as long as the company also discloses when the supplemental filing is expected to occur. Once the information is available, the company would then disclose the omitted component and the pay ratio in a filing under Item 5.02(f) of Form 8-K. Although a supplemental Item 5.02(f) filing with respect to an omitted compensation component would be triggered when the component becomes calculable in whole or in part, the pay ratio disclosure is not required until the omitted compensation component becomes calculable in whole.

STEP 2: DETERMINE THE MEDIAN EMPLOYEE'S COMPENSATION

Identifying the median employee, who must be an actual employee of the issuer, is the most burdensome and complex aspect of the Rules, implicating numerous potential choices in methodologies and disclosure requirements or options. Fortunately, the Rules afford some flexibility with respect to identifying the median employee as set forth below.

Identifying the Universe of Employees

The Rules define "employee" to include all worldwide full-time, part-time, seasonal, and temporary employees employed by the company or any of its consolidated subsidiaries.[3] This does not include independent contractors or "leased" employees as long as an *unaffiliated* third party (i) employs them and (ii) determines their compensation. Given a lack of clarity in the Rules with respect to independent contractors, companies should consult counsel regarding whether an independent contractor who is self-employed and determines his or her own compensation may be excluded from the group of employees used to determine the median employee.[4]

[2] Rel. No. 34-75610 at 283 (2015).

[3] *Id.*

[4] The Rules exclude from the definition of employee "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." The application of this

Excluding Certain Non-U.S. Employees

Although the Rules generally require inclusion of worldwide employees, a company may exclude non-U.S. employees from its determination of the median employee in the two limited instances described below.

Foreign Law Exemption

This exemption provides that if compliance with the Rules would cause a company to violate foreign data privacy laws or regulations, the employees of that foreign jurisdiction may be excluded. While helpful in concept, it remains to be seen whether this exemption has much utility in practice. As a threshold matter, it often may be possible to collect employee compensation data without running afoul of foreign privacy protection laws. Even were that not the case, in order to take advantage of the exemption, companies must satisfy a number of fairly stringent criteria, consisting of: (i) undertaking reasonable efforts to seek an exemption or other relief under the foreign data privacy laws before relying on this exemption; (ii) obtaining a legal opinion from counsel on the inability to comply with the Rules without violating foreign laws; and (iii) filing such opinion as an exhibit to the filing in which the pay ratio disclosure is included.[5]

If a company is able to utilize the foreign data privacy law exemption to exclude employees located in a particular non-U.S. jurisdiction, it must:

1. disclose the excluded jurisdiction and the applicable data privacy law or regulation;

2. explain how compliance with the Rules would violate such law or regulation, and the efforts the company made to seek an exemption or other relief; and

3. disclose the approximate number of employees in the jurisdiction excluded based on this exemption.

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exception in today's economy, in which many workers who provide services directly to or for companies are identified as independent contractors, is not yet clear.

[5] *Id* at 284.

de Minimis Exemption

If a company's non-U.S. employees account for 5% or less of its global workforce, all of the non-U.S. employees may be excluded. If the non-U.S. employees exceed the 5% threshold, the company may exclude up to 5% of its global workforce who are non-U.S. employees. However, non-U.S. employees excluded under the foreign law privacy exemption will count against this 5% cap. If any non-U.S. employees in a particular jurisdiction are excluded pursuant to this exemption, all non-U.S. employees in that jurisdiction must be excluded. Cherry-picking within jurisdictions is prohibited. Companies should consider the likely effect on the pay ratio of excluding employees in a given jurisdiction (e.g., the impact will be different if employees in relatively higher-wage nations are excluded as opposed to excluding employees in lower-wage countries) in assessing whether to employ the *de minimis* exemption.

If a company is able to take advantage of the *de minimis* exemption to exclude employees located in a particular non-U.S. jurisdiction, it must disclose:

1. the excluded jurisdiction;

2. the approximate number of employees excluded from such jurisdiction; and

3. the total number of its U.S. and non-U.S. employees before the application of any exemption, and the total number of its U.S. and non-U.S. employees used for its de minimis exemption calculation.[6]

Excluding Employees of an Acquired Company

A company that completed a business combination or acquisition may exclude the employees of the acquired entity from its pay ratio calculation during the covered fiscal year, but not future years. The company would have to disclose the identity of the acquired company and the approximate number of employees excluded. Further, upon inclusion of such employees for the first complete fiscal year after the acquisition, the company would have to determine if the inclusion of such employees would result in a significant change to the employee population and underlying pay ratio disclosure requiring the identification of a new median employee.

[6] *Id.* at 285.

Reasonable Estimates

To identify the median employee, a company may compute the annual total compensation of each employee in a manner similar to calculating the annual total compensation of the CEO and other executive officers in the proxy statement. However, the difficulty and cost of calculating such amounts for large groups of employees could be prohibitive. Therefore, reasonable estimates are permitted and there is no prescribed methodology for making such estimates. Permissible methods include statistical sampling (i.e., the use of a subset of employees from the entire employee population in a way that provides a reasonable degree of confidence that the subset selected is representative of the entire employee population) or any other compensation measure that is consistently applied to all employees in the selection pool (*e.g.*, the use of tax or payroll records). A company must disclose any material assumptions, adjustments, or estimates used to identify the median employee.[7]

Annualizing Adjustments

A company may annualize the compensation of all permanent employees (full-time or part-time) who did not work for the entire year (e.g., newly hired employees or permanent employees on an unpaid leave of absence during the period), but may not annualize the compensation of employees hired for temporary or seasonal purposes. A company is further prohibited from making full-time equivalent adjustments for part-time employees.[8] For example, the compensation of an employee who is not a seasonal or temporary employee, works half-time (or 20 hours per week), and is hired at the mid-point of the company's fiscal year, could be annualized by doubling the employee's compensation since he was hired at mid-point. However, the company could not again double the employee's compensation to arrive at a full-time equivalent of such part-time employee's annualized compensation under the Rules.

Cost-of-Living Adjustments

A company may make cost-of-living adjustments to the compensation for employees that reside in a jurisdiction different from that of the CEO provided that these adjustments are applied to all such employees included in the calculation. If the company uses a cost-of-living adjustment to identify the median employee and the median employee does not reside in the same jurisdiction as the CEO, the company must use the same cost-of-living adjustment in calculating the median employee's annual total compensation and disclose the country in which the median employee is located. A company electing to present its pay ratio in this manner must *also* disclose the median employee's annual total compensation and pay ratio without the cost-of-living adjustments. In order to make this additional pay ratio disclosure, a company will need to identify the median employee without using any cost-of-living adjustments. Companies will need to assess the value of disclosing this additional measure given the costs to make the cost-of-living adjustments and the requirement to present an unadjusted pay ratio.

Determine the Annual Compensation of the Median Employee

Once a company has identified the median employee (and whether or not it uses a prior year's median employee as permissible under the Rules), each year the company must calculate the total annual compensation of the median employee in the same manner as it calculates total annual compensation for the CEO. A company may use reasonable estimates in calculating the median employee's total annual compensation or any element of it so long as the company has a reasonable basis to believe the estimates used approximate the actual compensation amounts paid to the median employee and the estimates are clearly identified. As described in more detail above, if a company uses cost-of-living adjustments to identify the median employee and such employee does not reside in the same jurisdiction as the CEO, the company must use the same cost-of-living adjustment in calculating the median employee's annual total compensation.

STEP 3: FORMULATE THE PAY RATIO

The pay ratio must be expressed either (i) as a ratio in which the annual total compensation of the median employee is equal to one and the CEO's compensation presented as the number compared to one (e.g., 100 to 1 or 100:1) or (ii) narratively in terms of the multiple that the CEO's total annual compensation bears to the annual total compensation of the median employee.[9]

STEP 4: PREPARE THE DISCLOSURE

The pay ratio disclosure must be provided in all filings in which executive compensation disclosure is required by Item 402 of Regulation S-K (e.g., Form 10-

[7] *Id.* at 288.

[8] *Id.* at 289.

[9] *Id.* at 282-283.

Ks, proxy and information statements, and registration statements). As with other executive compensation information, the Form 10-K can incorporate this disclosure from a proxy statement that is filed within 120 days after the end of the fiscal year covered by the Form 10-K. After the initial pay ratio disclosure, a company will be able to benchmark how its pay ratio compares to the pay ratio of its peer group members. We expect more commentary on how companies rank and explanations for ratios by the 2019 proxy season.

A company may supplement its pay ratio disclosure by providing additional pay ratios or a narrative discussion to address any unwarranted conclusions that may be drawn from its disclosure. However, any additional ratios must:

- be clearly identified,
- not be misleading, and
- not be presented with greater prominence than the required ratio.[10]

Model Base Disclosure in Year of Initial Pay Ratio Disclosure

We suggest the following form of pay ratio disclosure for the initial year:

Our Compensation Committee reviews the internal ratio between the CEO's annual total compensation and the median annual total compensation of all employees (excluding the CEO). We identified the "Median Employee" by taking a statistical sampling of the annual total compensation of all full-time, part-time, seasonal, and temporary employees employed by us on [*date*]. In making this determination, we used a random sample size of [x] from a population size of [y]. Our CEO had annual total compensation of $10,000,000, and our Median Employee had annual total compensation of $100,000. Therefore, our CEO's annual total compensation is 100 times that of the median of the annual total compensation of all of our employees.

Additional Required Disclosures

As explained above, additional disclosure often may be required under the Rule, including:

- changes to the Determination Date from the prior year and reasons for the change.
- In fiscal years after the initial pay ratio disclosure, whether the company is using the same median employee as the prior year and its basis for doing so (e.g., believing that no changes have occurred that would significantly impact the pay ratio disclosure). If a different employee is being used due to compensation changes to the previously identified employee, that must be disclosed.
- In years where the company had two CEOs, disclosure must include which of the two permissible methods is being used to calculate the CEO's total annual compensation.
- With respect to the use of the foreign law privacy exemption, companies need to disclose: (i) the excluded jurisdiction; (ii) an explanation of how compliance with the Rules would violate foreign law and the efforts made to seek an exemption; and (iii) the approximate number of employees in the jurisdiction excluded on this basis.
- With respect to the *de minimis* exemption, companies must disclose the information in points (i) and (iii) above, plus the number of U.S. and non-U.S. employees before application of the exemption, and the number of U.S. and non-U.S. employees used for its *de minimis* exemption calculation.
- If employees of an acquired business are excluded, the identity of the acquired company and the approximate number of employees excluded must be disclosed.
- In making reasonable estimates to identify the median employee, all material assumptions, adjustments, or estimates should be disclosed.
- Where a cost-of-living adjustment is used, disclosure is required of the median employee's total annual compensation and the pay ratio without the adjustment.

Additional Optional Disclosures

The Rules also permit companies to make additional disclosures, subject to the limitations described above. Companies may want to consider additional disclosure in the following areas, although the potential benefits and disadvantages of any particular optional disclosure necessarily will depend on that issuer's facts and circumstances. Companies should consult with their advisors concerning the merits of making additional non-compulsory disclosure.

[10] *Id.* at 291.

- The median employee's position so long as such disclosure would not reveal the employee's identity;

- Additional ratios so long as they are clearly identified, not misleading, and not given greater prominence than the required pay ratio;

- The impact on the ratio, or providing an alternative ratio, based on excluding part-time, temporary, and/or seasonal workers, or premised on excluding non-U.S. employees beyond the exemptions provided by the Rule; and

- A narrative discussion of the ratio in the context of the company's overall compensation arrangements and pay practices, and/or in comparison to the company's industry peers (particularly as benchmarking becomes more prevalent after 2018 disclosures). ■