

SEC Adopts “Pay Ratio” Disclosure Rule

August 15, 2015

The SEC has adopted amendments to Item 402 of Regulation S-K to implement the pay ratio disclosure mandated by Section 953(b) of the Dodd-Frank Act. New paragraph (u) to Item 402 of Regulation S-K requires registrants to disclose:

- the median of the annual total compensation of all the company’s employees (excluding the chief executive officer);
- the annual total compensation of the company’s chief executive officer; and
- the ratio of the median of the annual total compensation of all employees to the annual total compensation of the chief executive officer.

The disclosure would be required in any annual report, proxy or information statement or registration statement that requires executive compensation disclosure pursuant to Item 402 but would not apply to smaller reporting companies, foreign private issuers, U.S.-Canadian multijurisdictional disclosure system filers and emerging growth companies. Registrants covered by the rule will be required to include the disclosure with respect to its first fiscal year commencing on or after January 1, 2017. As a practical matter this means that the pay ratio disclosure will be included in the 2018 proxy statement.¹

How must the pay ratio be expressed?

The pay ratio must be expressed as a ratio in which the median of the annual total compensation of all employees is equal to one, or, alternatively, expressed narratively in terms of the multiple that the chief executive officer’s total compensation bears to the median of the annual total compensation of all employees other than the chief executive officer.

For example, if the median of the annual total compensation of all employees is \$50,000 and the annual total compensation of the chief executive officer is \$11,000,000, the pay ratio would be “1 to 220” or, expressed narratively, “the chief executive officer’s annual total compensation is 220 times that of the median of the annual total compensation of all employees.”

¹ Registrants that cease to be smaller reporting companies or emerging growth companies must provide the required disclosure when they file a report for the first fiscal year commencing on or after they exit such status.

You may provide supplemental information, including additional ratios, provided that such information is clearly identified, not misleading, and not presented with greater prominence than the required ratio.

Which employees are covered by the rule?

You must select a date within the last three months of your last completed fiscal year. Subject to specific exclusions for employees located outside the United States and employees of recently acquired businesses (see below), all individuals who are employed by you or any of your consolidated subsidiaries on that date must be included in the calculation of the median compensation, whether full-time, part-time, seasonal, or temporary. You must disclose the date you use for the calculation and, if you change the date in a subsequent year, you must disclose the change and explain the reason for the change. Independent contractors and “leased” workers are excluded.

How do we identify the median employee?

The rule does not prescribe a specific methodology you must use in identifying the median employee but give you flexibility to choose a methodology based on your own facts and circumstances. In determining the employees from which the median employee is identified, you may use your employee population or statistical sampling and/or other reasonable methods. If you use statistical sampling, you must describe the size of the sample and the estimated whole population, any material assumptions you use in determining the sample size and the sampling method you used.

Once you have established the relevant group of employees, you may identify the median employee within the group by using annual total compensation or any other compensation measure that is consistently applied to all employees included in the calculation, such as information derived from tax and/or payroll records. However, if you use a compensation measure other than annual total compensation under Item 402(c)(2)(x) to identify the median employee, you must disclose the compensation measure used.

You must briefly describe the methodology you have used to identify the median employee and any material assumptions, adjustments, or estimates you used to identify the median employee or to determine total compensation or any elements of total compensation. You must clearly identify any estimates used. Estimates, assumptions and adjustments must be consistently applied.

Can we make cost-of-living adjustments when identifying the median employee?

You may make cost of living adjustments to the compensation of employees in jurisdictions other than the jurisdiction in which your CEO resides so that the compensation is adjusted to the cost of living in the jurisdiction in which your CEO resides. You must briefly describe the cost-of-living adjustments you used to identify the median employee and briefly describe the cost-of-living adjustments you used to calculate the median employee’s annual total compensation, including the measure used as the basis for the cost-of-living adjustment. If you present the pay ratio using a cost-of-living adjustment, you must disclose the median employee’s annual total compensation and pay ratio without the cost-of-living adjustment.

Can we annualize less than full-year compensation?

The total compensation of permanent employees (full-time or part-time) employed by you for less than the full fiscal year (e.g. newly hired employees or permanent employees on an unpaid leave of absence) may be annualized. However, you may not annualize the total compensation for employees in temporary or seasonal positions or make a full-time equivalent adjustment for any employee.

How often are we required to identify the median employee?

You must perform the calculation once every three years so long as there has been no change in your employee population or employee compensation arrangements that you reasonably believe would result in a significant change in the pay ratio disclosure. You must disclose that you are using the same median employee in your pay ratio calculation and describe briefly the basis for your belief.

If you are using the same median employee, you must calculate that median employee's annual total compensation each year and use that figure to update your pay ratio disclosure each year. If the median employee changes his or her position or is no longer employed during the three-year period, you may select another employee with substantially similar compensation to the original median employee to serve as the median employee.

Can we exclude employees of a newly acquired business from the pay ratio calculation?

If you have acquired a new business during the fiscal year you may omit the employees of the newly-acquired entity from your pay ratio calculation for the fiscal year in which the transaction occurs. You must include these individual employees in your median employee calculation in the first full fiscal year following the acquisition. If you exclude acquired employees you must disclose the relevant acquired business and the approximate number of employees that are excluded from the pay ratio calculation. You must include the excluded employees in your total employee count for the triennial calculations of the median employee in the year following the transaction for purposes of evaluating whether a significant change has occurred.

When can we exclude employees outside the United States from the pay ratio calculation?

There are two circumstances in which you can exclude employees located outside the United States: (i) when, despite using reasonable efforts to obtain or process information necessary to comply with the rule, provision of the information would violate a foreign jurisdiction's data privacy laws or regulations; and (ii) when a de minimis number of your employees work outside the United States.

When can we use the foreign data privacy law exemption?

First you must exercise reasonable efforts to obtain the information necessary for compliance and seek relief under the foreign jurisdiction's governing data privacy laws. If relief is granted, you cannot use the exemption. If you do use this exemption, however, you must list the affected jurisdiction(s), identify the specific data privacy law, explain how compliance would violate the law (including the efforts you made to seek relief, provide the approximate number of employees exempted and obtain a legal opinion regarding the inability to obtain or process the information necessary for compliance (which must be filed as an exhibit with the filing in which the pay ratio disclosure is included). If you exclude any employees in a particular jurisdiction, you must exclude all non-U.S. employees in that jurisdiction.

When can we use the de minimis exemption?

You can exclude all non-U.S. employees (but not less than all) when identifying the median employee if your non-U.S. employees constitute 5% or less of your total U.S. and non-U.S. employees. If your non-U.S. employees make up more than 5% of the total, you may exclude non-U.S. employees up to the 5% threshold, provided that if you exclude any non-U.S. employees in a particular jurisdiction, you must exclude all employees in that jurisdiction. If more than 5% of your employees are located in any one non-U.S. jurisdiction, you may not exclude any employees in that jurisdiction under this exemption.

If you use this exemption, you must disclose the affected jurisdiction(s), the approximate number of employees excluded from each jurisdiction under the de minimis exemption, the total number of your U.S. and non-U.S. employees irrespective of any exemption (data privacy or de minimis) and the total number of your U.S. and non-U.S. employees used for your de minimis calculation.

In calculating the number of non-U.S. employees that may be excluded under the de minimis exemption, you must count any non-U.S. employee exempted under the data privacy exemption against the availability. If the number of employees you exclude under the data privacy exemption equals or exceeds 5% of your total employees, you may not use the de minimis exemption to exclude additional non-U.S. employees.

How do we determine annual total compensation?

You must determine “total compensation” for both the median employee and CEO using the requirements of Item 402(c)(2)(x).² You may use reasonable estimates in calculating the annual total compensation of your median employee, including any elements of the total compensation, under Item 402(c)(2)(x) provided that you clearly identify any estimates used and you have a reasonable basis to conclude that your estimates approximate the actual amounts of Item 402(c)(2)(x) compensation, or a particular element of compensation under Item 402(c)(2)(iv)-(ix), that are awarded to, earned by, or paid to the median employee.

You may 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 provided that, to be consistent, your CEO’s total compensation used in the related pay ratio disclosure must be similarly adjusted and you must explain any difference between the CEO total compensation used in the pay ratio disclosure and the total compensation amounts reflected in the Summary Compensation Table, if material.

² All references to “named executive officer” refer instead to “employee” and, for non-salaried employees, references to “base salary” and “salary” refer instead to “wages plus overtime”.



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