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The SEC's Final Pay Ratio Rules: What You Need to Know

If you wish to receive more information on the topics covered in this publication, you may contact your regular Shearman & Sterling contact person or any of the following:

John J. Cannon III
New York
+1.212.848.8159
jcannon@shearman.com

Kenneth J. Laverriere
New York
+1.212.848.8172
klaverriere@shearman.com

Doreen E. Lilienfeld
New York
+1.212.848.7171
dlilienfeld@shearman.com

Linda E. Rappaport
New York
+1.212.848.7004
lrappaport@shearman.com

George T. Spera, Jr.
New York
+1.212.848.7636
gspera@shearman.com

On August 5, 2015, the Securities and Exchange Commission (the "SEC") released final rules[1] implementing the pay ratio disclosure requirements of Section 953(b) of the Dodd-Frank Wall Street Reform and Consumer Protection Act ("Dodd-Frank"). The final rules are largely consistent with the proposed rules issued by the SEC in September 2013 and will be codified as paragraph (u) to Item 402 of Regulation S-K.

The following Q&A summarizes the key requirements of the final rules.

Background and Basics

What disclosure is required by Section 953(b) of Dodd-Frank and the final rules?

The final rules establish a prescribed format for comparing the total compensation of the registrant's principal executive officer ("PEO") to the median compensation paid to the registrant's covered employees. New Item 402(u) of Regulation S-K requires issuers to disclose:

- the median of the annual total compensation of all employees of the registrant (except the registrant's PEO) (the "Median Compensation");
- the annual total compensation of the registrant's PEO (the "PEO Compensation"); and
- the ratio of the Median Compensation to the PEO Compensation (the "Ratio").

The SEC refers to the disclosure of the above three items as the "pay ratio" disclosure.

What does the SEC believe is the purpose of the pay ratio disclosure?

The SEC believes that Dodd-Frank's pay ratio disclosure is intended to assist shareholders in evaluating a registrant's executive compensation practices. The final rule, in the SEC's view, fulfills Congress's apparent goal of providing shareholders with additional data points that they will find relevant and useful when exercising their say on pay voting rights.

[1] Release Nos. 33-9877; 34-75610; File No. S7-07-13. The final rules can be found at http://www.sec.gov/rules/final/2015/33-9877.pdf.

Does the SEC believe that the new rules will be useful as a tool to compare the compensation practices of different registrants?

No. Due to the variety of factors that could cause the ratio to differ, the SEC does not believe that precise conformity or comparability of the pay ratio across companies is necessarily achievable. The primary benefit of the pay ratio disclosure, according to the SEC, is to provide shareholders with a registrant-specific metric that they can use to evaluate the PEO's compensation from the registrant.

Disclosure of the Pay Ratio

How is the ratio presented?

The Ratio must be presented as either:

- a ratio in which the Median Compensation equals one; or
- a narrative in terms of the multiple that the PEO Compensation bears to the Median Compensation.

For example, if the Median Compensation is $100 and the PEO Compensation is $1,000, the Ratio can be presented as: (1) 10 to 1, (2) 10:1 or (3) "The PEO Compensation is ten times the Median Compensation."[2]

Can a registrant present the Median Compensation as a percentage of the PEO compensation?

No. The registrant cannot present the Ratio by stating that, using the example above, the Median Compensation is 10% of the PEO Compensation.

When is the first reporting period?

The first reporting period is the first full fiscal year beginning on or after January 1, 2017.

Where will this information be disclosed?

The final rules require the pay ratio disclosure in any SEC filing that calls for executive compensation disclosure under Item 402 of Regulation S-K. Therefore, for calendar year registrants, the first pay ratio disclosure will be made in early 2018, as part of the proxy statement or information statement for the 2018 annual meeting. For some fiscal year companies, the disclosure may not be made until 2019. For example, if a registrant's fiscal year starts on November 1, 2017 and ends on October 31, 2018, the first pay ratio disclosure will be made in next the proxy statement or information statement, which may not be distributed until January 2019.

What pay ratio disclosure is required if a registrant files a registration statement prior to filing its proxy statement?

The final rules provide that a registrant does not need to update its pay ratio disclosure until it files its annual report on Form 10-K or, if later, its proxy statement or information statement for its next annual meeting of shareholders.[3]

[2] The example follows the illustration in the preamble to the final rules. The text of the rules could be read to suggest that the Ratio might be expressed as 1 to 10 or 1:10.

[3] As Form 10-K allows executive compensation disclosures to be incorporated by reference from a proxy statement filed within 120 days of the close of the fiscal year, an earlier filed Form 10-K need not include updated pay ratio disclosures. If the proxy statement is not filed within the 120-day period, the Form 10-K (or an amendment to the Form 10-K that is filed within the 120-day period) must include the updated pay ratio disclosure.

Therefore, a registration statement that incorporates by reference a Form 10-K (or amended Form 10-K) containing all Part III information other than updated pay ratio information could be declared effective before the proxy statement with the updated information is filed.

Will the pay ratio disclosure ever have to be reported on a Form 8-K?

If a registrant cannot calculate the salary or bonus of the PEO until the last practicable date, it is permitted under current SEC rules to omit the disclosure from the summary compensation table and include it on a later filed Form 8-K. In this case, the registrant can omit the pay ratio data until the filing of the Form 8-K that includes the omitted salary and bonus information.

When does a new registrant make its first pay ratio disclosure?

The first pay ratio disclosure for a new registrant will follow the first full fiscal year beginning after the registrant has (1) been subject to the requirements of Sections 13(a) or 15(d) of the Securities Exchange Act of 1934 (the "Exchange Act") for a period of at least 12 months beginning on or after January 1, 2017 and (2) filed at least one annual report pursuant to those same sections of the Exchange Act that does not contain the pay ratio disclosure.

By way of example, if a calendar year company completes its initial public offering on March 1, 2017, its pay ratio disclosure must be included in its proxy or information statement for its 2019 annual meeting of shareholders (but no later than 120 days following the end of the 2018 fiscal year).

No pay ratio disclosure is required on a registration statement on Form S-1 or Form S-11 for an initial public offering, or a registration statement on Form 10.

Are any registrants exempt from the disclosure requirements?

Yes. Smaller reporting companies, foreign private issuers, US-Canadian Multijurisdictional Disclosure System filers and emerging growth companies are all exempt. A registrant that ceases to be a smaller reporting company or an emerging growth company will not be required to provide the 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).

Identifying the Median Employee

How often must a registrant identify its median employee?

The final rules allow a registrant to identify its median employee once every three years, unless there has been a change in its employee population or compensation arrangements that it reasonably believes would result in a significant change in the pay ratio disclosure.

If there has been no change to a registrant's employee population or compensation arrangements, but the median employee is no longer employed with the registrant (or has had a change in circumstances), the registrant may use another employee whose compensation is substantially similar to the original median employee based on the compensation measure used to identify the original median employee.

What flexibility do the final rules provide registrants in determining the date for identifying its median employee?

Registrants may choose any date within the last three months of the relevant fiscal year to determine its median employee. Only employees that are employed on the chosen date will be taken into account for purposes of determining the median employee.

Is there a required methodology for identifying the median employee?

No. Each registrant is provided flexibility to choose a method to identify the median employee based on the registrant's facts and circumstances. The chosen methodology may use reasonable estimates.

May a registrant use statistical sampling to determine its median employee?

Yes. A registrant may use its employee population or a statistical sampling or another reasonable method to determine the median employee. Registrants have the ability to make their own determinations of an appropriate sample size dependent upon the underlying distribution of compensation data. Further, since identifying the median employee means finding the employee in the middle of the compensation range, as opposed to calculating the average compensation, then, to the extent a registrant is able to identify its extremely low or extremely highly paid employees, it need not determine the exact compensation for every employee paid more or less than the employee in the middle.

For purposes of identifying the median employee, must a registrant calculate each employee's total compensation using the methodology for determining total compensation for purposes of the summary compensation table (the "Item 402(c)(2)(c) calculation")?

No. Because of the complexity of applying the Item 402(c)(2)(x) calculation to all employees of a registrant, the final rules permit registrants to use any other consistently applied compensation measure, such as information derived from tax and/or payroll records. If the measure used is recorded on a basis other than the registrant's fiscal year, such as might be the case with tax and/or payroll records, the registrant may use the same annual period used in those records.

Regardless of the measure used to determine the median employee, the total compensation for the identified median employee will need to be calculated using the Item 402(c)(2)(x) calculation for the completed fiscal year.

May a registrant make cost-of-living adjustments to its employees' compensation when determining the median employee?

Yes. A registrant may adjust the compensation of its employees in countries other than that in which the PEO is based to the cost-of-living in the PEO's jurisdiction, so long as the adjustment applies to all employees in the country. If a registrant chooses to make a cost-of-living adjustment, the registrant must use the same cost-of-living adjustment in calculating the median employee's annual total compensation and disclose the median employee's jurisdiction. No cost-of-living adjustment is permitted to the compensation of the PEO or any employee in his or her jurisdiction.

May a registrant annualize any compensation for an employee who worked only part of the registrant's fiscal year?

Yes, but only for permanent employees, not seasonal or temporary employees. Annualization is allowed for any full-time employee and any part-time employee who did not work the full year because, for example, the employee was newly hired or had taken an unpaid leave of absence.

A registrant, however, may not make full-time equivalent adjustments for any employee.

Once the median employee is identified, are there any requirements for calculating his or her total compensation?

Yes. As discussed below, once identified, the median employee's total compensation must be calculated using the Item 402(c)(2)(x) calculation. Unlike the total compensation of the PEO, however, a registrant is permitted to make certain reasonable estimates to determine the total compensation of the median employee.

For further information on calculating "total compensation," see "Total Compensation," below.

Do the rules require disclosure of any of the median employee's personally identifiable information?

No. The final rules state that the registrant should not disclose any personally identifiable information about the median employee other than his or her compensation. A registrant may choose to identify the individual's position to put the compensation in context, but should not do so if providing this information could identify the specific individual.

Covered Employees

What employees must a registrant take into account in determining its median employee?

The final rules define "employee" as the US and non-US employees of the registrant and any of its consolidated subsidiaries. This definition includes part-time, seasonal and temporary employees. Only employees that are employed on the date chosen for the determination of the median employee are taken into account. A consolidated subsidiary of a registrant is a subsidiary with financial statements that are consolidated with those of the registrant. Although this will result in a smaller pool of employees than would be the case under the proposed rules (which required inclusion of all employees of the registrant's subsidiaries as such term is defined under Rules 405 of the Securities Act of 1933 and 12b-2 of the Exchange Act), the SEC does not believe it will undermine the usefulness of the pay ratio disclosure.

For information on annualization of compensation and full-time equivalent adjustments, see "Identifying the Median Employee," above.

Do registrants need to include employees acquired in a business combination or acquisition?

Registrants may omit the employees of a newly-acquired business from their pay ratio calculations for the fiscal year in which the business combination or acquisition becomes effective. Further, the acquired employees will not cause a change in employee population requiring a redetermination of the median employee in the fiscal year that they join the registrant. The new employees will, however, be included in the total employee count beginning in the first full fiscal year following the transaction and, if the additional employees would result in a significant change in the pay ratio disclosure, the registrant will need to identify a new median employee (even if it has been less than three years since it last chose a median employee).

Is there a tailored exemption to avoid violating a Non-US jurisdiction's data privacy laws?

Yes. Registrants are not required to include non-US employees in the pay ratio disclosure if obtaining the information required to comply with the rules would cause a violation of a non-US jurisdiction's data privacy laws. Before taking advantage of this exception, the registrant must make reasonable efforts to obtain the information, such as seeking an exemption or other relief. In addition, the registrant must obtain an opinion from legal counsel opining on the registrant's inability to comply with the pay ratio disclosure rules without violating the non-US jurisdiction's data privacy laws.

If a registrant excludes any non-US employee in a particular jurisdiction under this exemption, it must exclude all non-US employees in that jurisdiction.

Is there a tailored exemption for de minimis non-US employees?

Yes.

- Registrants whose non-US employees make up 5% or less of their total employees. These registrants may exclude all of their non-US employees when identifying the median employee. If the registrant chooses to exclude any of these employees, it must exclude all of them.

- Registrants whose non-US employees make up more than 5% of their total employees. These registrants may exclude non-US employees up to the 5% threshold. However, if a registrant excludes any non-US employees in a particular jurisdiction, it must exclude all employees in that jurisdiction, subject to compliance with the overall 5% limitation. For example, if employees in a single non-US jurisdiction constitute 6% of the registrant's covered employees, none of the employees in that jurisdiction could be excluded, unless the data privacy exception applied.

Non-US employees that are excluded under the data privacy exemption will also be counted as excluded under the 5% *de minimis* exemption. As a practical matter, together, these exemptions allow registrants to exclude a number of non-US employees equal to the greater of 5% of total employees and the number of employees covered by the data privacy exemption.

Defining Total Compensation

For purposes of the ratio, how is "annual total compensation" calculated for the PEO and the median employee?

The final rules requires that "annual total compensation" for both the PEO and the median employee be determined using the Item 402(c)(2)(x) calculation. However, the final rules allow certain estimates and modifications to the Item 402 requirements when calculating the total compensation of the median employee. The key exceptions are noted below.

How often does the annual total compensation of the median employee need to be calculated?

The total compensation of the identified median employee must be recalculated each year.

How is the total compensation calculated for a median employee who is paid on an hourly, rather than salaried, basis?

Item 402 refers to "base salary." The final rules clarify that, for non-salaried employees, the term "base salary" means "wages plus overtime."

May the registrant use reasonable estimates in calculating the annual total compensation of the median employee?

Yes. As noted above, a registrant may use reasonable estimates for any of the elements of total compensation utilized in the Item 402(c)(2)(x) calculation with respect to its median employee, so long as the registrant has a reasonable basis to conclude that the estimates approximate the actual amount of compensation.

Reasonable estimates may not be used for purposes of calculating the PEO's total compensation.

What are some examples in which a registrant may use reasonable estimates?

Reasonable estimates can be used for:

- determining an amount that reasonably approximates the aggregate change in actuarial present value of an employee's defined pension benefit; and
- calculating the amount of personal benefits that may be excluded because the total value is less than $10,000.

Does a registrant need to include government-mandated pension plans in determining the actuarial present value of defined benefits?

No. Where a pension benefit is being provided to the employee from the government, a government-mandated defined benefit pension plan should not be considered a defined benefit plan, and any accrued benefit should not be considered compensation.

If the registrant decides to include personal benefits for its median employees that are permitted to be excluded from the Item 402(C)(2)(X) calculation, must it also apply this same approach to the PEO's total compensation?

Yes. The Item 402(c)(2)(x) calculation permits named executive officers listed in the summary compensation table to exclude perquisites and other personal benefits with an aggregate value of less than $10,000. If the registrant determines that it will include these amounts in calculating the total compensation of its median employee, then it must recalculate the compensation of the PEO that is provided in the summary compensation table so that, for purposes of the pay ratio disclosure, it includes any perquisites and other personal benefits provided to the PEO that had been excluded.

What if a registrant has more than one PEO in a given year?

The registrant will have two options:

- combine the total compensation of both PEOs; or
- annualize the compensation of the PEO serving on the date chosen for the determination of the median employee.

Supplemental Disclosure and Filing Status

May a registrant include additional ratios or other information to supplement the ratio?

Yes. If additional ratios are included, they must be clearly identified, not misleading and not presented with greater prominence than the Ratio.

Are any additional disclosures required by the final rules?

In addition to requiring the disclosure of the total compensation of the PEO and the median employee and the applicable pay ratio, the final rules require disclosure of the following:

- Disclosure that the registrant is using the same median employee for more than one year, along with the basis for the registrant's reasonable belief that no change is required.
- Disclosure of the registrant's choice of the date used to determine its median employee and, if relevant, the reason for any change in the date from the prior year.
- Description of the methodology used to determine the median employee, including: any material assumptions, adjustments (including cost-of-living adjustments) or estimates used to identify the median employee, or determine total compensation, which shall be consistently applied. The estimates must be clearly identified. The information provided must be sufficient for readers to evaluate the appropriateness of the methodology but needs not include any technical analysis, formulas, confidence levels or the steps used in the data analysis.
- Description of both the size of any statistical sample and the estimated whole population, as well as any material assumptions used in determining the sample size and the sampling method (or methods) used.
- Disclosure of the compensation measure used to determine the median employee if other than the Item 402(c)(2)(x) calculation, clearly identifying any estimates used.
- Description of the cost-of-living adjustment used to determine the median employee and the median employee's annual total compensation, including the measure used as the basis for the cost-of-living adjustment. In addition, the registrant must disclose the median employee's annual total compensation and pay ratio without the cost-of-living adjustment in order to provide context. This will require identifying the median employee without any cost-of-living adjustment.

- Description of any change to a registrant's methodology or its material assumptions, adjustments or estimates from those used in a prior year, and the reasons for the change, if the effects are significant. In addition, a registrant must disclose if it ceases using, or commences using, a cost-of-living adjustment.
- Identification of an acquired business excluded for the fiscal year in which a business combination or acquisition became effective and the approximate number of employees excluded from the pay ratio calculation.
- Disclosure of any jurisdiction or jurisdictions excluded due to the foreign jurisdiction data privacy law exemption, including: identifying the specific data privacy law or regulation, explaining how the law or regulation would be violated (including the efforts made to use or seek an exemption) and the approximate number of employees exempted from each jurisdiction.
- Disclosure of any jurisdiction or jurisdictions from which employees are being excluded due to the *de minimis* non-US employee exemption, including: the approximate number of employees excluded from each jurisdiction, the total number of US and non-US employees irrespective of any exemption (*de minimis or* data privacy) and the total number of its US and non-US-employees used for its *de minimis* calculation.
- Identification of any estimates used in determining the annual compensation of the median employee.
- Explanation of any material difference between the PEO's pay in the summary compensation table and the pay ratio disclosure.
- Disclosure of the registrant's method of calculating the total annual compensation of multiple PEOs and how it calculated the PEO's total compensation.

Is the pay ratio disclosure "furnished" or "filed" with the SEC?

The pay ratio disclosure required by the new rules is "filed" with the SEC. As a result, false or misleading statements can lead to liability under Section 18 of the Exchange Act. Similarly, regardless of whether the pay ratio disclosure is "furnished" or "filed," potential liability exists under Exchange Act Sections 13(a) and 15(d) if the registrant fails to comply with the rule. Finally, misleading statements in the pay ratio disclosure can be interpreted as a manipulative or deceptive device in connection with the purchase or sale of a security leading to potential liability under Section 10(b) of the Exchange Act and Rule 10b-5 promulgated thereunder.

Conclusion

Although the majority of pay ratio disclosures will not appear until 2018, each registrant must begin the process of formulating a strategy that will enable it to gather the required information and present it in a manner that best suits its individual circumstances. Many registrants have already begun planning for this process, and a small number have made pay ratio disclosures in their proxy statements. Despite the flexibility incorporated into the final rule, the process will likely be both time consuming and costly for many registrants. The final rules were approved by a 3-2 vote of the SEC commissioners, and it is likely that the debate over the cost and benefit of the rules will continue unabated for some time as more registrants begin disclosing pay ratios and shareholder advisory groups begin incorporating the information into their voting recommendations.

This memorandum is intended only as a general discussion of these issues. It should not be regarded as legal advice. We would be pleased to provide additional details or advice about specific situations if desired.

599 LEXINGTON AVENUE | NEW YORK | NY | 10022-6069

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