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SEC Adopts New CEO Pay Ratio Disclosure Rules

Introduction

The U.S. Securities and Exchange Commission (SEC) recently adopted final rules to implement the CEO pay ratio disclosure requirements under Section 953 of the Dodd-Frank Act. The rules compel public companies to disclose how the compensation of the Chief Executive Officer compares with the median compensation of all other employees.

The Basics

Following receipt of more than 280,000 comment letters, including more than 1,500 individual letters, the SEC approved the CEO pay ratio disclosure requirements by a 3-2 party line vote. Covered companies will be required to disclose the following:

- Annual total compensation of a specific employee (who shall not be personally identified) whose compensation falls at the statistical “median” of the range of compensation for all company employees excluding the principal executive officer or CEO
- Annual total compensation of the CEO
- The ratio of these two total compensation numbers

The ratio may be expressed as a multiple of one – for example, a ratio of 50:1 would indicate that the CEO’s annual total compensation is 50 times that of the median employee. Alternatively, a company may disclose the pay ratio narratively – for example, the CEO’s annual compensation is 50 times that of the median employee.

The information must appear in any annual report, proxy, information statement or registration statement requiring executive compensation disclosure under Item 402 of Regulation S-K. The final rule does not apply to companies that are not required to provide Summary Compensation Table disclosure under Item 402(c). As such, foreign private issuers, smaller reporting companies and U.S.-Canadian Multijurisdictional Disclosure System (MJDS) filers are excluded. In addition, emerging growth companies (EGCs) were exempted from the pay ratio disclosure requirement under the JOBS Act.

Definition of Employee

The new rules define the employees from which the statistical “median employee” must be identified to include all full-time, part-time, seasonal or temporary workers employed by the company or any of its consolidated subsidiaries as of a specific date selected by the company (as discussed below). A company may annualize the salary for a full-time employee who was not employed the entire year; however, adjustments for part-time employees, or for temporary or seasonal workers, are prohibited. Independent contractors are excluded from the definition as long as they are employed, and their compensation is determined, by an unaffiliated third party. Companies may exclude individuals who became employees through a business combination or acquisition for the fiscal year in which the transaction occurs.

The definition of “employees” also includes all U.S. and non-U.S. employees of a company, except in two limited circumstances where the SEC has provided exemptions (discussed further below):

- Foreign data privacy law violations
- Five percent of non-U.S. employees (the *de minimis* exemption)

Foreign Data Privacy Laws

Non-U.S. employees are exempt from the definition of “employees” if they are employed in a jurisdiction where foreign data privacy laws preclude a company from obtaining or processing information necessary to comply with the rule. A company must make reasonable efforts to comply, including seeking an exemption or other relief. If relief is not available or granted, a company may exclude employees in such jurisdiction. In this case, the narrative portion of the company’s pay ratio disclosure must explain how complying with the rule violates the law or regulation, the efforts taken to seek relief and the approximate number of employees excluded from each jurisdiction based on this exemption. Further, the company must obtain a legal opinion concerning its inability to comply without violating such laws (or to obtain the necessary exemption), which must be filed as an exhibit with the filing in which the pay ratio disclosure is included. A company may exclude any non-U.S. employee exempted under the data privacy exemption, even if the number of excluded employees exceeds 5 percent of the company’s total employees.

De Minimis Exemption

Non-U.S. employees are also exempted if they account for 5 percent or less of the company's total U.S. and non-U.S. employees. If a company chooses to exclude any non-U.S. employees in a particular jurisdiction under this exemption, it must exclude all non-U.S. employees in that jurisdiction. A company with more than 5 percent non-U.S. employees may exclude up to the 5 percent threshold, provided that all non-U.S. employees in a particular foreign jurisdiction are excluded. The company may not pick and choose which employees to exclude in any one jurisdiction. The company's disclosure must include a list of the jurisdiction(s) from which employees are excluded under this exemption, the approximate number of employees excluded from each jurisdiction, the total number of its U.S. and non-U.S. employees irrespective of any exemption, and the total number of its U.S. and non-U.S. employees used for the *de minimis* calculation. In calculating the 5 percent threshold, a company must count any non-U.S. employees exempted under the data privacy exemption against the availability. In other words, if the number of employees excluded under the foreign data privacy exemption described above equals or exceeds 5 percent of the company's total employees, the *de minimis* exemption will not be available for any other jurisdiction.

Determination of 'Median Employee'

The rules do not mandate a specific method by which companies must identify the employee whose compensation makes him the "median employee." Rather, it permits each company to select a method based on its particular facts and circumstances, so long as it is consistently applied. Companies may identify the "median employee" in terms of compensation by using either the "total compensation" metric that must ultimately be disclosed or some other consistently applied measure (as discussed below). The determination may use the entire employee population as the sample where sufficient data are available; otherwise, statistical sampling or other reasonable methods, based on reasonable criteria consistently applied, may be utilized. Such methodology must be briefly described in the disclosure.

In a change from the proposed rules, the final rules allow companies to determine the "median employee" every three years (unless a change in employee population or employee compensation arrangements occurred that would significantly change a company's pay ratio disclosure). While a company must disclose the ratio every year – and, if applicable, its basis for concluding that it is appropriate to use the same "median employee" in consecutive years – the SEC modified the requirement to every three years in an attempt to minimize compliance costs. If the "median employee" used for determining the prior year's ratio is no longer in the same position, is no longer employed by the company or otherwise experienced a material change to compensation, the company would be permitted (if practicable) to select another employee who is in a similarly compensated position as the "median employee." If no other employee is similarly compensated, the company must re-identify the median employee. To allow companies sufficient time to make their calculations and identify their "median employee," they may select any date within three months prior to the last day of the company's most recent fiscal year. The date of determination must be disclosed, and the company must provide a brief explanation if it changes its determination date for subsequent years.

Total Compensation Calculation

The definition of "total compensation" tracks the requirements of Item 402(c)(2)(x) of Regulation S-K, which sets forth the current total compensation calculation for those executives whose compensation must be disclosed in the Summary Compensation Table (the Named Executive Officers or NEOs). However, the SEC recognizes that most companies do not track every element of the Item 402(c) definition of "total compensation" for non-executive employees. Accordingly, rather than force companies to calculate total compensation for their entire workforce, the rule permits identification of the median employee using some other consistently applied measure that is tracked on the same basis for all employees (such as total cash compensation or other W-2 based metrics). The company then needs to perform the full total compensation calculation only for the identified "median employee" to develop the final pay ratio disclosure.

As noted, the rule permits companies to use reasonable estimates in identifying the median employee and in valuing the median employee's total compensation, subject to appropriate disclosure. Companies also will be allowed to include *de minimis* perquisites and benefits such as health insurance – which are excludable from NEO compensation in the Summary Compensation Table – in the calculation of total compensation for the median employee, provided they also include such amounts in the calculation of the CEO's total compensation for purposes of the pay ratio disclosure (even if they are excluded from the CEO's total compensation in the Summary Compensation Table). Excluding these amounts could increase the ratio, because such amounts may comprise a greater percentage of the median employee's annual total compensation.

Regardless of the approach taken, all companies must include in their disclosure a brief description of the methodology used to identify the median and any material assumptions, adjustments or estimates used to identify the median compensation for all employees or to determine total compensation. If a company modifies its methodology from previous years and the effects are material, the company must describe the changes and the reason for them.

If a company replaces its CEO during its fiscal year, it may calculate the CEO's annual total compensation in one of two ways:

- Calculate the total compensation for each person who served as CEO during the year and combine those figures.
- Annualize the compensation of the CEO serving in that position on the date it selects to identify the median employee.

Companies may also apply an optional cost-of-living adjustment to the compensation of employees in jurisdictions other than that in which the CEO resides (non-U.S. employees in most cases) for purposes of identifying the median employee and calculating the median employee's annual total compensation and the CEO pay ratio. Companies must disclose and explain any such adjustments, and disclose the jurisdiction, compensation and pay ratio figures without the cost-of-living adjustments.

Alternative Ratios and Supplementary Disclosure

Companies may supplement the ratio disclosure with narrative discussion or additional ratios if they believe that doing so will enhance investor understanding, so long as any additional ratios are not given greater prominence than the required ratio and are not misleading.

Compliance Deadlines

The initial CEO pay ratio disclosure will be required for compensation paid in the company's first fiscal year beginning on or after January 1, 2017. Accordingly, a company with a calendar year-end will have to include pay ratio disclosure for the first time in its 2018 annual meeting proxy statement, using compensation numbers for the fiscal year ended December 31, 2017.

For newly public companies, initial compliance will be required for the first fiscal year beginning on or after the date the company became subject to the reporting requirements, and it will not be required for new registrants in an IPO registration statement on Form S-1 or Form S-11. In addition, the final rules include transition periods for companies that cease to be smaller reporting companies or EGCs. Those companies will not be required to provide pay ratio disclosure until they file a report for the first fiscal year beginning on or after they cease to be a smaller reporting company or EGC.

What This Means to You

While the deadline for compliance for public companies is extended from the original proposal, we recommend that companies subject to these new rules begin considering now the strategy and methodology they will use to identify their "median employee" and develop the required disclosure, particularly since the rules allow for some discretion in making the necessary determinations.

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