SEC Adopts CEO Pay Ratio Disclosure Rules

The Securities and Exchange Commission has adopted rules to implement Section 953(b) of the Dodd-Frank Wall Street Reform and Consumer Protection Act, which requires public companies to disclose the relationship between the annual total compensation of their Chief Executive Officer and the median of the annual total compensation of all their employees.

On August 5, 2015, the SEC adopted a modified version of the rules that were initially proposed in September 2013. The final rule contains several notable changes from the original proposal, the most important of which is the extension of the compliance date by an additional year. Companies are first required to comply with the rule for their first fiscal year beginning on or after January 1, 2017 – *consequently, the initial CEO pay ratio disclosures will not appear until the 2018 proxy season*.

This Thoughtful Pay Alert summarizes the key aspects of the final rule and provides our initial observations about the likely impact of the rule on technology and life sciences companies.

Background

To enhance the mix of compensation information available to investors, Section 953(b) of the Dodd-Frank Act directed the SEC to amend Item 402 of Regulation S-K to require disclosure of the relationship between the annual total compensation of a company's CEO and the annual total compensation of its median employee.

Five Things Technology and Life Sciences Companies Should Know about the CEO Pay Ratio Disclosure Rule

- **Must Determine Median Compensation of All Employees.** The final rule requires companies to consider the compensation of "all" U.S. and non-U.S. employees to determine the median of their annual total compensation. This includes full-time, part-time, temporary, seasonal employees, as well as employees of consolidated subsidiaries.
- **Enhanced Flexibility in Identifying "Median Employee."** The final rule does not require the use of a specific methodology to determine the median of the annual total compensation of a company's employees. Companies are permitted to select a methodology that is appropriate to the size and structure of their own businesses and the way they compensate employees (including, where appropriate, statistical sampling) as long as it is applied on a consistent basis. *Additional enhancements that should ease the compliance burden are discussed elsewhere in this Thoughtful Pay Alert*.
- **"Total Compensation" Based on Summary Compensation Table Requirements.** While "total compensation" (which includes salary, bonuses, long-term incentive awards, and any other compensation items) is to be calculated using the SEC's executive compensation disclosure rules, when calculating the median of the annual total compensation of their employees, companies may use reasonable estimates of various compensation elements (where appropriate).
- **Disclosure Required in Filings That Include Executive Compensation Information.** The final rule requires that the CEO pay ratio be disclosed in any filing that includes executive compensation information, including registration statements (except in the case of an IPO), annual reports on Form 10-K, and proxy and information statements.
- **Initial Disclosures Will Not Appear Until 2018 Proxy Season.** The final rule contemplates a transition period that would allow companies to postpone compliance until the first fiscal year beginning on or after January 1, 2017. Thus, companies with calendar year fiscal year-ends would disclosure their first CEO pay ratio during the 2018 proxy season.

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Specifically, Section 953(b) requires public companies (with certain exceptions) to disclose:

- The median of the annual total compensation of all its employees except its Chief Executive Officer;
- The annual total compensation of its Chief Executive Officer; and
- The ratio of the two amounts.

Since the Dodd-Frank Act was signed into law, Section 953(b) has been a flashpoint for criticism from the corporate community, which contends that, for many companies, particularly those with international operations, the challenges and costs of compliance will be substantial and that the benefit to investors of the required pay ratio information is negligible at best. As a result, the proposed rules generated the most comments of any Dodd-Frank Act provision for which the SEC has rulemaking responsibility (nearly 290,000 comments letters, including over 1,500 individual comment letters). Largely as a result of its controversial nature, as well as the SEC's other rulemaking responsibilities under the Dodd-Frank Act and the Jumpstart Our Business Startups ("JOBS") Act, it took nearly two years for the SEC to consider the comments from the public and reach agreement on a final rule to implement the CEO pay ratio disclosure requirement.

The key aspects of the final rule are summarized below.

Identification of "Median Employee"

The crux of the CEO pay ratio disclosure requirement is the identification of the median employee, whose annual total compensation is to be compared against that of the company's CEO. One of the key criticisms of Section 953(b) has concerned the challenges and costs of compliance that companies, particularly those with global operations, will face in identifying their "median employee," particularly when compared to the benefits to investors of providing the pay ratio disclosure.

The final rule continues to allow companies to choose from several alternative methods to identify the "median employee" so that they may select an approach that is appropriate to the size, structure, and compensation practices of their own businesses. It also contains several new features that are intended to help contain compliance costs.

"All" Employees Covered

As proposed, the SEC ultimately construed Section 953(b) to cover employees on an enterprise-wide basis. Thus, under the final rule, all employees are to be considered in the identification of a company's "median employee" including its full-time, part-time, seasonal, and temporary workers, whether employed by the company or any of its consolidated subsidiaries. This includes both U.S. and non-U.S. employees. The compensation of permanent employees who did not work for the entire year may be annualized, but annualization is not permitted for seasonal or temporary workers.

Date for Identification of Median Employee. In a significant change from the initial proposal, companies may use any date within three months prior to the last day of the last completed fiscal year to identify their "median employee." This should make it easier, as well as allow additional time, to determine the median employee, calculate his or her annual total compensation, and prepare the required information before it must be disclosed. A company must disclose this determination date as part of its narrative disclosure accompanying the pay ratio, but need not explain why this date was selected.

Median Employee Identified May Be Used For Up to Three Years. Once identified, that median employee may be used for purposes of calculating the pay ratio for that fiscal year and each of the next two fiscal years (with his or her annual total compensation updated for each subsequent fiscal year). If there has been a change in the employee population or compensation arrangements in one of these subsequent fiscal years that the company reasonably believes would result in a significant change to its pay ratio disclosure, the company may either replace the identified individual with an employee with substantially similar compensation or re-identify the median employee for that fiscal year. A company must disclose whether it is using the same or a different median employee for the covered fiscal year as part of its narrative disclosure accompanying the pay ratio. If the same median employee is being used in a subsequent fiscal year, the company must briefly explain the basis for its reasonable belief that such use is appropriate.

Employees of Subsidiaries. The final rule limits the inclusion of employees of a subsidiary in a company's employee population to individuals employed by consolidated subsidiaries. Typically, this will include only subsidiaries

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where the company owns over 50% of the outstanding voting securities.

Treatment of Independent Contractors. *A company may exclude independent contractors and "leased" workers from its employee population, but only if these individuals are employed, and have their compensation determined, by an unaffiliated third party.* This position is likely to prove very controversial, as it suggests that a company would be required to treat an independent contractor who is retained directly by the company, rather than through a third party, as an "employee." Interestingly, this result was not readily apparent from the proposed rules and, therefore, qualifies as the biggest surprise of the final rule.

Employees of Acquired Company. In identifying the "median employee," companies may omit from their employee population any employees that become its employees as the result of a business combination or other acquisition for the fiscal year in which the transaction becomes effective (but not for future year calculations). Although these individuals may be omitted from the employee population, the company must disclose the identity of the acquired company and the approximate number of individuals being omitted from its employee population as part of its narrative disclosure accompanying the pay ratio.

Observations. Notwithstanding significant pressure from the corporate community, the SEC chose to retain its initial reading of the term "employee" to include all employees of the company, including non-U.S. employees. For global companies, as well as growth-oriented companies with expanding international operations, the need to consider non-U.S. employees in its employee population may lead to significant challenges – and potentially may lead them to rethink their workforce composition. With respect to the costs of compliance in this situation, the SEC has attempted to address this concern through its extended compliance period, which is intended to allow companies ample time to develop and test the systems needed to capture the necessary compensation data, and the introduction of two limited exemptions (as described below).

Limited Exemptions for Non-U.S. Employees

Data privacy exemption. Companies may exclude from their employee population non-U.S. employees who are employed in countries with data privacy laws that prohibit a company, despite its reasonable efforts, from complying with the pay ratio disclosure requirement without violating those laws. To take advantage of this exemption, however, a company must do the following:

- Disclose the excluded country or countries;
- Identify the specific governing data privacy law or regulations;
- Explain how complying with the pay ratio disclosure requirement violates such law or regulations;
- Describe the efforts the company made to comply with such law or regulations (including, at a minimum, using or seeking an exemption or other relief under such law or regulations);
- Disclose the approximate number of employees exempted from each country based on the data privacy exemption;
- Obtain a legal opinion from counsel that opines on the company's inability to obtain or process the information necessary to comply with the pay ratio disclosure requirement without violating such law or regulations, including its inability to obtain an exemption or other relief under such law or regulations; and
- File the legal opinion as an exhibit to the filing in which the pay ratio disclosure is included

If a company excludes any non-U.S. employees in a particular country using the data privacy exemption, it must exclude all non-U.S. employees in that country.

De minimis exemption. Companies may exclude from their employee population non-U.S. employees who comprise up to 5% of their workforce. This exemption works as follows:

- A company may exclude all of its non-U.S. employees if they comprise 5% or less of its total employee population. In this situation, if the company elects to take advantage of the exemption it must exclude all of its non-U.S. employees.
- A company that has more than 5% non-U.S. employees may exclude up to 5% of its total employee population who are non-U.S. employees. In this situation, if the company elects to take advantage of the exemption it must exclude all of the employees of a specific country. In other words, it cannot pick and

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choose which non-U.S. employees to exclude in any particular country.

- If a company elects to take advantage of this exemption, it must disclose:
- The excluded country or countries;
  - The approximate number of employees excluded from such countries;
  - The total number of U.S. employees and non-U.S. employees irrespective of any exemption; and
  - The total number of U.S. employees and non-U.S. employees used for the de minimis exemption.

Any non-U.S. employees excluded pursuant to the data privacy exemption also must be taken into account for purposes of calculating compliance with the de minimis exemption. In addition, the de minimis exception must be applied on an "all or nothing" basis from country to country.

Observations. While companies should welcome the introduction of these two exemptions, taking advantage of them will not be easy. In the case of the data privacy exemption, companies must make reasonable efforts to overcome any law or regulations prohibiting access to or use of compensation information in each country with such a law and demonstrate such efforts as part of the narrative disclosure accompanying the pay ratio. In addition, it is not clear how easy or difficult it will be to obtain the necessary legal opinion to support this exemption.

In the case of the de minimis exemption, exclusion of non-U.S. employees will turn largely on the size of a company's non-U.S. workforce. The exemption is most suitable for companies with a nominal number of non-U.S. employees where all can be excluded without reaching the 5% limit. On the other hand, where a company's non-U.S. workforce is greater than 5% of its total employee population, it may be more difficult to take advantage of the exemption given its requirements. For example, if more than 5% of a company's employee population is located in a single foreign country, the exemption is simply not available given the need to exclude all of the employees in a country. Similarly, if the number of non-U.S. employees excluded under the data privacy exemption equals or exceeds 5% of the company's total employee population, the exemption would not be available.

Identification Methodology

To help manage compliance costs, the final rule does not specify any particular calculation methodology for identifying the median of the annual total compensation of a company's employees. Instead, companies may use an approach that works best for their own individual facts and circumstances and that is appropriate to the size, structure, and compensation practices of their own businesses. Specifically, in determining the employee population from which the "median employee" is to be identified, a company may use:

- its entire employee population:
- statistical sampling; and/or
- any other reasonable methods.

Further, companies may identify their median employee 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 the company's tax and/or payroll records. In using a compensation measure other than annual total compensation to identify the median employee, if that measure is recorded on a basis other than the company's fiscal year (such as information derived from tax and/or payroll records), a company may use the same annual period that is used to derive those amounts. Where a compensation measure other than annual total compensation is used to identify the median employee, the company must disclose the measure used as part of its narrative disclosure accompanying the pay ratio.

Observations. By allowing companies to choose the methodology that works best for their particular facts and circumstances in identifying the median employee, the SEC is seeking to enable them to comply with the CEO pay ratio disclosure requirement in a relatively cost-efficient manner. Consistent with this approach, the final rule does not prescribe specific estimation techniques or confidence levels for an estimated median and, instead, relies on each company to determine what is reasonable in light of its own employee population and access to compensation data.

Notably, companies must briefly describe the methodology that they use to identify their median employee and any material assumptions, adjustments, or estimates that they used for that purpose (as well as to determine total compensation or any individual compensation element).

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Annualizing compensation. Companies may annualize the total compensation for all permanent employees (full-time or part-time) who were employed for less than the full fiscal year (such as newly-hired employees or permanent employees on an unpaid leave of absence during the year). On the other hand, companies may not annualize the total compensation for employees in temporary or seasonal positions. Further, companies may not make a full-time equivalent adjustment for any employee.

Cost-of-living adjustment. Companies may apply a cost-of-living adjustment when identifying their "median employee" and in calculating that employee's annual total compensation. Specifically, a company may make cost-of-living adjustments to the compensation of employees in countries other than the country in which its CEO resides so that the compensation is adjusted to the cost of living in the country in which the CEO resides.

If a company uses a cost-of-living adjustment to identify the "median employee," and the median employee identified is an individual in a country other than the country in which the CEO resides, the company must use the same cost-of-living adjustment in calculating his or her annual total compensation and disclose the median employee's country. The company also must briefly describe the cost-of-living adjustments it used to identify the median employee and briefly describe the cost-of-living adjustments it used to calculate his or her annual total compensation, including the measure used as the basis for the cost-of-living adjustment.

Perhaps most importantly, a company that elects to present the pay ratio in this manner also must disclose the median employee's annual total compensation and pay ratio ***without*** the cost-of-living adjustment. To calculate this pay ratio, the company will need to identify the median employee without using any cost-of-living adjustments.

Observations. The SEC's decision to permit flexibility in identifying the "median employee" represents a pragmatic decision to an intractable problem – formulating a single methodology that would work for the myriad of companies subject to Section 953(b). While it's clear that this decision is intended to address the overarching criticism about the CEO pay ratio disclosure requirement – the cost of compliance, it is likely that global companies, as well as companies with a growing international presence, will still incur a significant investment in time and expense in collecting and analyzing the required employee compensation information.

The ability to make cost-of-living adjustments represents a significant departure from the proposed rules, which would not have permitted such adjustment. Unfortunately, even with this flexibility it's unclear whether companies will take advantage of this technique, particularly given that they must still identify the median employee (and provide the related disclosure) without using the adjustment.

Definitions of "Total Compensation" and "Annual Total Compensation"

To ensure congruity in the presentation of the required information, the final rule requires companies to calculate the total compensation of their "median employee," as well as their CEO, using the same rules which apply to the calculation of the total compensation of their named executive officers for purposes of completing the Summary Compensation Table. To simplify this requirement in the case of the median employee's total compensation, the final rule permits companies to use reasonable estimates to calculate his or her total compensation – or any specific element of total compensation.

For purposes of the final rule, "annual total compensation" means total compensation for the company's last completed fiscal year. Thus, the required pay ratio for a given fiscal year will be based on the total compensation reported for the CEO for the last completed fiscal year in the Summary Compensation Table included in its definitive proxy statement (or annual report on Form 10-K) and the annual total compensation for the last completed fiscal year calculated for its "median employee" as of the end of the last completed fiscal year. This approach ensures that the disclosure will not need to be updated more than once a year.

Observations. While companies have become very comfortable complying with the SEC's executive compensation disclosure rules to determine the total compensation of their named executive officers, who consist of only a handful of senior executives, applying these rules to all, or a significant portion, of their entire employee population to identify the "median employee" will be impractical, particularly when it comes to retirement compensation and certain benefits offered in a foreign countries. For example, companies that offer pension benefits to their employees

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are likely to experience difficulty in determining the aggregate change in actuarial present value of the accumulated benefits of a particular employee. Further complexities may arise in connection with other types of compensation and benefits, such as personal benefits (for example, housing) offered or required only in certain countries, government-required pension plans, health and welfare benefits, employee discounts, and similar forms of pay.

Further, although the SEC has agreed to allow companies wide latitude to use reasonable estimates, where appropriate, to determine total compensation, this also may not be easy, particularly where such compensation or benefits represents a significant portion of an employee's overall pay. Calculating these amounts could be expensive and time-consuming with few realistic alternatives, particularly if estimating (or possibly omitting altogether) such amounts would make the pay ratio less meaningful.

Required Disclosure

Presentation of Pay Ratio

The final rule provides the required CEO pay ratio to be expressed in one of two ways:

- as a ratio in which the median of the annual total compensation of all employees (other than the CEO) is equal to one; or
- narratively in terms of the multiple that the CEO's annual total compensation bears to the median of the annual total compensation of all employees.

Observations. To ensure uniformity in presentation and to promote comparability, the SEC is requiring that the CEO pay ratio disclosure be presented in one of two specific ways. Thus, for example, if the median of the annual total compensation of all employees is $45,790.39 and the annual total compensation of the CEO is $12,260,000.40, the pay ratio disclosure would be "1 to 268," which may also be expressed narratively as "the Chief Executive Officer's annual total compensation is 268 times that of the median of the annual total compensation of all employees."

Disclosure of Methodology, Assumptions, and Estimates

The final rule requires companies to briefly describe the specific methodology used to identify their "median employee," as well as any material assumptions, adjustments (including any cost-of-living adjustment), or estimates used to identify the median or to determine total compensation or any elements of total compensation. Further, if a compensation measure other than annual total compensation is used to identify the "median employee," a company is required to disclose the compensation measure used and calculate and disclose the annual total compensation for that median employee.

The SEC has emphasized that this description should be a brief overview. Further, it is not necessary for a company to provide technical analyses or formulas. If a company changes its methodology or its material assumptions, adjustments, or estimates from those used in its CEO pay ratio disclosure for the prior fiscal year, and if the effects of any such change are significant, the company must briefly describe the change and the reasons for the change. Companies must also disclose if they changed from using the cost-of-living adjustment to not using that adjustment and vice versa.

Observations. Given the anxiety over the potential misinterpretation of the CEO pay ratio disclosure, we expect that many companies will seek to put the ratio into context by providing additional information on how they believe the disclosure should be evaluated. Similar to what has occurred in the case of past disclosure requirements, there may be a great deal of experimentation as companies gauge investor reactions to the disclosure and try to understand and anticipate the market response. We also expect to see the disclosure placed in a variety of locations within a company's SEC filings, including, in some instances, the Compensation Discussion and Analysis.

In the adopting release, the SEC indicates that companies will be permitted to supplement the required disclosure with a narrative discussion or additional ratios if they choose to do so, as long as this information is clearly identified, not misleading, and not presented with greater prominence than the required CEO pay ratio disclosure. In light of the potential for misuse of the CEO pay ratio disclosure, we expect that many companies will take advantage of this opportunity. For example, some companies may view the disclosure as an additional way opportunity to present a robust analysis of their executive compensation program and make their case for their "Say-on-Pay" proposal. Still other companies, including those with diverse workforces

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(such as, for example, a large number of lower-paid or part-time workers, or a significant non-U.S. employee contingent), may choose to present a variety of pay ratios to better place the required CEO pay ratio disclosure in context.

Companies Subject to Disclosure Requirement

Generally, the final rule applies to companies subject to the reporting requirements of the Securities Exchange Act of 1934, but does not apply to:

- emerging growth companies (that is, (that is, newly-public companies with total annual gross revenues of less than $1 billion as of the end of their last completed fiscal year);
- smaller reporting companies (that is, companies with a public float of less than $75 million);
- foreign private issuers; and
- registered investment companies.

Observations. As stipulated in the JOBS Act, emerging growth companies are statutorily exempt from compliance with the CEO pay ratio disclosure requirement. In addition, the SEC construed Congressional intent with respect to the scope of Section 953(b) to contemplate exempting smaller reporting companies and foreign private issuers as well from the disclosure requirement.

Filings Subject to Disclosure Requirement

The final rule requires a company to include the CEO pay ratio disclosure in any filing for which the executive compensation disclosure specified in Item 402 of Regulation S-K is required, which includes:

- an annual report on Form 10-K as required by the Exchange Act;
- registration statements filed under the Securities Act of 1933 and the Exchange Act; and
- proxy or information statements filed under the Exchange Act.

One benefit of this approach is that a company that files its definitive proxy statement within 120 days of the end of its last completed fiscal year will be able to take advantage of the SEC's "forward incorporation by reference" technique; thereby receiving credit for including the information in its annual report on Form 10-K as long as it physically includes the disclosure in its definitive proxy statement for its next Annual Meeting of Shareholders following the end of such fiscal year.

Observations. While the SEC has taken a practical reading of Section 953(b) to require that the disclosure only be included in filings that require the presentation of executive compensation disclosure pursuant to Item 402 of Regulation S-K, it did not, as its critics have pointed out, explain how this disclosure contributes to the overall mix of information to be used to make informed investment and voting decisions. In the adopting release, the SEC indicates that this disclosure can assist in investors' evaluation of a company's executive compensation practices and provide additional data points that shareholders may be able to use when exercising their voting rights on a "Say-on-Pay" proposal. At least on this latter point, it remains to be seen whether the CEO pay ratio disclosure will serve as a meaningful tool. It's also unclear how this disclosure will be factored into the analyses of the proxy advisory firms, both for "Say-on-Pay" proposals and other compensation-related action items.

Compliance Date

In a significant development, companies must comply with the CEO pay ratio disclosure requirement with respect to the compensation for their first fiscal year commencing on or after January 1, 2017 – a full year later than contemplated in the proposed rules. *Consequently, the initial CEO pay ratio disclosures will not appear until the 2018 proxy season.*

In addition, a newly-public company's initial CEO pay ratio disclosure will not be required until its first full fiscal year beginning after the company has:

- been subject to the reporting requirements of the Exchange Act for a period of at least 12 calendar months beginning on or after January 1, 2017; and
- filed at least one annual report on Form 10-K that does not contain the CEO pay ratio disclosure.

In the case of a company that ceases to be an emerging growth company or a smaller reporting company, it does not need to provide the CEO pay ratio disclosure until after the

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first full fiscal year after relinquishing such status (and, in any case, not for any year beginning before January 1, 2017).

Observations. To give companies adequate time to implement and test any necessary systems changes to collect, process, and analyze the required employee compensation information, the SEC has provided a long transition period. As adopted, companies will be required to comply with the final rule with respect to the compensation for their first fiscal year commencing on or after January 1, 2017. Thus, for example, a company with a December 31 fiscal year-end will be first subject to the CEO pay ratio disclosure requirement with respect to the compensation of their CEO and employees for fiscal 2017. This company would then be required to include the CEO pay ratio disclosure in the definitive proxy statement (or annual report on Form 10-K, as applicable) for that year, which would be filed in the first half of 2018. A company with a November 30 fiscal year-end will not be subject to the CEO pay ratio disclosure requirement until 2019 (with respect to the compensation paid in its 2018 fiscal year).

Final Observations

Of the various executive compensation-related disclosure provisions of the Dodd-Frank Act, the CEO pay ratio disclosure requirement turned out to be the most controversial and continues to be so. The final rule was approved by a 3-2 vote and at least one of the dissenting Commissioners has continued to criticize the SEC's decision to adopt the rule on both substantive and procedural grounds. Given that the Dodd-Frank Act also included the mandatory shareholder advisory vote on executive compensation (the so-called "Say-on-Pay" vote), this is truly notable.

While the SEC has sought to mitigate the potential compliance burden of identifying the "median employee" by providing an array of alternatives and exemptions to the general requirement that companies start with their total employee population, each company is likely to discover over the next several months whether this additional flexibility will result in a meaningful reduction in the cost and other challenges of compliance. Companies with a global workforce are likely to need several months – and perhaps even an entire reporting cycle – to perfect the mechanics involved in identifying their "median employee." While the initial compliance date may appear to be a long way off, companies should not be lulled into inaction. Now that the SEC's rulemaking has been completed, it will be critical to develop a firm understanding of what will be involved in the "median employee" determination at your company to ensure that effective and efficient processes are developed and in place by 2017.

It's also worth noting that, although unlikely, some form of legislative intervention remains possible. Currently, there are two bills pending in Congress – H.R. 414, "The Burdensome Data Collection Relief Act," and S. 1722, "The Salary Collection Regulatory Relief Act" – each of which would repeal Section 953(b). While, in the current environment, the ultimate fate of these bills is uncertain, given its tumultuous history, the final chapter of the CEO pay ratio disclosure requirement may not yet have been written.

Need Assistance?

Compensia has extensive experience in helping companies understand how the corporate governance and executive compensation-related disclosure provisions of the Dodd-Frank Act will affect the design, operation, and disclosure of their executive compensation program. If you would like assistance in understanding how the final rules are likely to impact your executive compensation disclosure, or if you have any questions on the subjects addressed in this Thoughtful Pay Alert, please feel free to contact Mark A. Borges. ■

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