

SEC Adopts CEO Pay Ratio Disclosure Rules

On August 5, 2015, the Securities and Exchange Commission adopted rules implementing 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.

While the final rules contain several notable changes from the original proposal, the most important development is that the SEC extended the compliance date by an additional year. Companies are first required to comply with the rules for their first fiscal year beginning on or after January 1, 2017 – consequently, the disclosure of the CEO pay ratio will not be required until the 2018 proxy season.

This Thoughtful Pay Alert summarizes the key aspects of the final rules.

Required Disclosure

Section 953(b), and the final rules, require public companies (other than smaller reporting companies, foreign private issuers, and emerging growth companies) 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.

Identification of “Median Employee”

The key criticism of the proposed rules concerned the challenges and costs of compliance that companies, particularly

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

- **Must Determine Median of All Employees.** The final rules require 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, and seasonal employees, as well as employees of consolidated subsidiaries.
- **Enhanced Flexibility in Identifying “Median Employee.”** The final rules do not require the use of a specific methodology to determine the median of the annual total compensation of their 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 listed on page two of this Thoughtful Pay Alert.
- **“Total Compensation” Based on SCT 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 rules require that the CEO pay ratio be disclosed in any filing that includes executive compensation information, including registration statements, annual reports on Form 10-K, and proxy statements.
- **Compliance Not Required Until 2018 Proxy Season.** See the discussion on page two of this Thoughtful Pay Alert.

SEC Adopts CEO Pay Ratio Disclosure Rules (continued)

those with international operations, would face in identifying their “median employee” relative to the benefits to investors of providing the pay ratio disclosure. While the final rules continue 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, to further help manage compliance costs the final rules contain the following additional enhancements:

- Companies need only identify their “median employee” once every three years. Once identified, the same median employee can be used for purposes of the ratio for three consecutive years (unless there have been significant changes in the employee population or employee compensation arrangements).
- 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 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.
- Companies may exclude employees in countries where obtaining their compensation information would result in a violation of data privacy laws from the “median employee” determination.
- Companies with non-U.S. employees that comprise 5% or less of their workforce may exclude them from the “median employee” determination. Where non-U.S. employees comprise more than 5% of the workforce, companies may exclude non-U.S. employees up to the 5% threshold. (Employees excluded pursuant to the data privacy law exception must be taken into account for purposes of this exception. Also, this de minimis exception must be applied on an “all or nothing” basis from country to country.)
- Companies may apply a cost-of-living adjustment when determining their “median employee” and in calculating that employee’s annual total compensation.
- Companies may omit 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).

Disclosure Not Required Until 2018

The SEC has provided that companies will not need to comply with the final rules until the first fiscal year on or after January 1, 2017. Thus, companies with calendar year fiscal year-ends will first provide the disclosure during the 2018 proxy season with respect to 2017 compensation information.

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. ■

SEC Adopts CEO Pay Ratio Disclosure Rules (continued)

About Compensia

Compensia, Inc. is a management consulting firm that provides executive compensation advisory services to Compensation Committees and senior management.

Silicon Valley

1731 Technology Drive
Suite 810
San Jose, CA 95110
408.876.4025

Timothy J. Sparks, President
tsparks@compensia.com
408.876.4024

Thomas G. Brown
tbrown@compensia.com
408.876.4023

Susan Gellen
sgellen@compensia.com
408.907.4302

Tom LaWer
tlawer@compensia.com
408.907.4309

San Francisco

1550 Bryant Street
Suite 740
San Francisco, California 94103
415.462.2990

Mark H. Edwards, Chairman
medwards@compensia.com
415.462.2985

Mark A. Borges
mborges@compensia.com
415.462.2995

Southern California

Ralph Barry
rbarry@compensia.com
858.603.2288

Mathew T. Quarles
mquarles@compensia.com
323.919.7338