Dodd-Frank Executive Compensation Update: SEC Adopts CEO Pay Ratio Disclosure Rules

The Securities and Exchange Commission (SEC) recently adopted final rules implementing one of the last four remaining executive compensation requirements under the Dodd-Frank Wall Street Reform and Consumer Protection Act. These CEO pay ratio rules generally require U.S. public companies to disclose the following information:

- The median of the annual total compensation of all employees, excluding the chief executive officer (CEO);
- The annual total compensation of the CEO; and
- The ratio of these two totals.

These rules, which were adopted in a 3-2 vote by the SEC, implement Section 953(b) of the Dodd-Frank Act by adding a new Item 402(u) to Regulation S-K.

The timing for the SEC’s adoption of final rules implementing the three remaining Dodd-Frank executive compensation requirements is uncertain, but it is unlikely that final rules will be effective for the 2016 proxy season. For more information about the proposed rules to implement these remaining three requirements, see recent Perkins Coie updates on executive compensation clawback proposed rules, executive pay-for-performance disclosure proposed rules and the hedging disclosure proposed rules.

Although these rules become effective October 19, 2015, the SEC has provided a transition period, so that public companies will generally first disclose their CEO pay ratio based on compensation paid for a company’s first full fiscal year that begins on or after January 1, 2017. As a result, calendar year-end companies will generally first be required to include the new disclosure in filings made in 2018.

This update highlights key provisions of the final disclosure rules and offers practical advice.

Where and How to Make Pay Ratio Disclosures

Companies will be required to include pay ratio disclosures in annual reports on Form 10-K, registration statements and proxy and information statements, in each case so long as these filings require disclosure of executive compensation under Item 402 of Regulation S-K. As is common with other Item 402 disclosures, companies may provide the pay ratio disclosures in their annual proxy statements and incorporate the information by reference into their annual reports on Form 10-K. Also consistent with treatment of other Item 402 disclosures, the pay ratio disclosure will be treated as “filed” rather than “furnished” for purposes of the Securities Act of 1933 and the Exchange Act of 1934, subject to potential liabilities under those statutes.

Companies must disclose the pay ratio either numerically—where the median employee’s annual total compensation is equal to 1 and the CEO’s is expressed as a multiple of 1 (for example, 50 to 1)—or narratively—where companies describe by how many times the CEO’s annual total compensation exceeds (or is less than) that of the median employee (for example, “the CEO’s annual total compensation is 50 times that of the median of the annual total compensation of all employees”). Companies may not disclose the ratio in the form of a percentage or fraction of the CEO’s compensation.

The Median Employee

Identifying the Median Employee. The final rules do not specify a required methodology that companies must use to identify the median employee and instead allow companies the flexibility to apply a methodology that uses reasonable estimates based on the company’s facts and circumstances. A company may consider, among other factors:

- size and nature of its workforce;
- complexity of the organization;
- variation in pay levels and types of compensation across the workforce;
- use of different currencies, tax and accounting regimes; and
- number of payroll systems used by the organization.
For example, companies may identify the median employee using a compensation measure (such as total direct compensation or cash compensation) derived from tax or payroll records that is consistently applied to all included employees and may refer to its entire employee population or a statistical sample in its analysis. Other key considerations include the following:

- **Must Include All Employees.** The median employee must be determined from all "employees," which include all U.S. and non-U.S. full-time, part-time, seasonal and temporary employees of the company and its consolidated subsidiaries (other than the company's CEO). Independent contractors or "leased" workers are excluded from this analysis but only if they are employed and their compensation is determined by an unaffiliated third party.

- **May Select a Date for Determining Median Employee Within Last Three Months of Fiscal Year.** The rules provide companies with flexibility to select the median employee from a pool of covered employees on any date within the last three months of a company's last completed fiscal year. Companies are required to disclose the date selected. Although disclosure of the reason a specific date was selected is not generally required, if a company changes the determination date from the prior year, disclosure of the change and a brief explanation about the reason for the change will be required.

- **May Use Different Measures and Annual Periods in Different Jurisdictions.** In applying a consistent compensation measure, companies may use a measure that is defined differently across jurisdictions and may include different annual periods, so long as the measure is consistently applied within each jurisdiction.

- **Should Not Disclose Identify of Median Employee.** Companies should not disclose any personally identifiable information about the median employee other than his or her compensation, although they may disclose the individual's position within the company so long as doing so would not identify the specific individual.

**How Often Must Companies Identify the Median Employee?** The rules provide companies with the flexibility to identify the median employee only once every three years, instead of annually, unless there has been a change in employee population or compensation arrangements such that the company reasonably believes a significant change in its pay ratio disclosure would result. Where there has been a significant change in the individual circumstances of the employee identified as the median employee in year one, such that it is no longer appropriate for the company to use that median employee in years two or three (for example, if such employee is no longer employed by the company), the company may use another employee with substantially similar compensation for years two and three. If no other employee has similar compensation, the company must re-identify the median employee. Total compensation for the median employee must be calculated each year, regardless of whether the same median employee is used for three years.

**Limited Exceptions for Non-U.S. Employees**

- **Non-U.S. Privacy Law Exemption.** Companies may exclude non-U.S. employees to the extent that a jurisdiction's data privacy laws or regulations prevent compliance with the disclosure rules without violation of these laws or regulations. In such a case, a company must exclude from its analysis all of its non-U.S. employees in that jurisdiction and disclose the excluded jurisdictions and the approximate number of employees exempted from each jurisdiction. It must also disclose other details, such as how complying with the pay ratio rule violates the law or regulation. Companies must use reasonable efforts to obtain or process the information necessary to comply with the disclosure rules before relying on this exemption, including seeking an exemption or other relief under the governing data privacy laws or regulations. Finally, to rely on this exemption, a company must obtain a legal opinion regarding the inability to comply with the disclosure rules without violating these data privacy laws or regulations, which must be filed as an exhibit to the filing in which the pay ratio disclosure is included.

- **De Minimis Foreign Employee Exemption.** Under a de minimis exemption, companies may exclude all non-U.S. employees when 5% or less of their total U.S. and non-U.S. employees are non-U.S. employees. In addition, where non-U.S. employees exceed 5% of all employees, a company may exclude from its analysis up to 5% of its total non-U.S. employee headcount. If the company excludes any non-U.S. employees in a particular jurisdiction, it must exclude all employees in that jurisdiction. As a result, if a company has more than 5% of its employees in one jurisdiction, none of the employees in that jurisdiction may be excluded under the de minimis exemption.

Non-U.S. employees excluded under the data privacy exemption count toward the number of non-U.S. employees that may be excluded under the de minimis exemption. A company may exclude any non-U.S. employees that meet the data privacy exemption, even if the number of employees excluded exceeds 5% of all employees. However, if the number of employees excluded under the data privacy exemption equals or exceeds 5% of all employees, the company may not use the de minimis exemption to exclude additional non-U.S. employees.

- **Annualizing Permitted but Full-Time Equivalent Adjustments Prohibited.** Companies may annualize the compensation of a permanent full- or part-time employee who worked for a company for only part of the fiscal year as if the employee worked the full fiscal year on the same schedule the employee worked for the portion of the year that the employee actually worked. On the other hand, companies must not adjust for full-time equivalents, where the compensation the company paid to a part-time employee is adjusted based on a projection of what the employee would have made if employed on a full-time basis.

- **Cost-of-Living Adjustments.** When identifying the median employee, companies have the option of making a cost-of-living adjustment to the compensation of employees in jurisdictions other than the jurisdiction in which the CEO resides. The adjustment must reflect the cost of living of the jurisdiction in which the CEO resides. In addition, the adjustment must be applied to all
employees in that jurisdiction that the company includes in the analysis. If a company makes this adjustment to identify its median employee, and the median employee the company identifies is in a different jurisdiction than the CEO, the company must use the same adjustment used in determining the median employee’s annual total compensation and the company must also identify the median employee’s jurisdiction. Conversely, if a company does not rely on this adjustment in determining the median employee, the company may not make any cost-of-living adjustment to the median employee’s annual total compensation if the median employee identified is in a different jurisdiction than the CEO. A company that applies a cost-of-living adjustment must also disclose the median employee’s annual total compensation, as well as the pay ratio calculated, without applying the cost-of-living adjustment.

Calculating Annual Total Compensation

**Calculation Method.** Once a company identifies the median employee based on the compensation measure the company selected, the company must calculate total compensation for the median employee consistent with the requirements for calculating total compensation for a company’s CEO for purposes of the summary compensation table under Item 402 of Regulation S-K.

**Reasonable Estimates Permitted.** The final rules permit the company flexibility to use reasonable estimates when calculating any elements of the median employee’s total compensation. For example, for non-salaried employees, references to “base salary” and “salary” (in Item 402) are deemed to refer, as applicable, to “wages plus overtime.” In addition, companies may use reasonable estimates in determining an amount that reasonably approximates the aggregate change in actuarial present value of an employee’s defined pension benefit, if applicable.

**Benefits and Perquisites.** Where the government, and not the company, provides a pension benefit to the employee, the company should not consider such pension benefit a “defined benefit plan” for purposes of calculating the median employee’s compensation. Companies may include personal benefits that aggregate less than $10,000 and compensation under non-discriminatory benefit plans in calculating the total compensation of the median employee. However, companies must also include these items in calculating the CEO’s total compensation for the pay ratio disclosure, with an explanation of any material differences between the CEO’s total compensation used in the pay ratio disclosure and the total compensation amounts reflected in the summary compensation table.

**What if a Company Has More than One CEO During a Year?** Where a company has more than one CEO during its fiscal year, there are two alternatives for calculating the CEO’s annual total compensation for the pay ratio disclosure. A company may aggregate the total compensation for each individual who served as the company’s CEO during the year. This combined figure would then serve as the annual total compensation for the company’s CEO. Alternatively, a company may look to the individual serving in the CEO position on the date the company selects to identify the median employee and annualize that CEO’s compensation. Companies must disclose which alternative the company used to make its pay ratio calculation and how the CEO’s total compensation was calculated.

**Must Disclose Methodology, Assumptions and Estimates**

A company must briefly describe and consistently apply any methodology it used to identify the median employee and any material assumptions, adjustments (including cost-of-living adjustments) or estimates it used to identify the median employee or to determine total compensation or any elements of total compensation. Companies must also disclose any change in methodology, significant assumption, adjustment or estimate from the prior year if the effects are significant.

**Exempt Companies and Transition Periods**

**Exempt Companies.** The pay ratio rules do not apply to smaller reporting companies, foreign private issuers, U.S.-Canadian Multijurisdictional Disclosure System filers and emerging growth companies.

**Transition Period for Smaller Reporting Companies and Emerging Growth Companies.** Under the final rules, a company that no longer qualifies as a smaller reporting company or as an emerging growth company may delay compliance during a grace period and will first be required to provide the CEO pay ratio disclosure after the first full fiscal year after the company ceased to qualify for such status, and not for any fiscal year beginning before January 1, 2017.

**Transition Periods for New Public Companies and Business Combinations.** These rules also provide transition periods for newly registered companies and following a business combination or acquisition. A company that is newly registered must provide the required disclosures after its first full fiscal year beginning after the company has (1) been subject to Section 13(a) or 15(d) of the Exchange Act for at least 12 months beginning on or after January 1, 2017, and (2) filed at least one annual report that does not contain the pay ratio disclosure. In addition, a company that has engaged in a business combination or acquisition may omit employees of the acquired business from its pay ratio calculation for the fiscal year in which the transaction becomes effective. Similarly, a company must evaluate whether an acquisition or business combination would result in a substantial change to its pay ratio disclosure that would necessitate the re-identification of the median employee for the first time in the fiscal year following the transaction. A company that uses this approach must identify the business acquired and indicate the approximate number of employees the company excluded.
Practical Tips

Seven Ways Companies Can Prepare Now for New Disclosure Rules

Although companies will not need to comply with these disclosure rules until 2018 generally speaking, companies should begin now to plan for and strategize their data gathering and analysis processes and should consider taking the following actions:

1. Educate your compensation committee now on the final rules and the general approach the company intends to take for implementing them.

2. Determine whether using a specific date within the last three months of the company’s fiscal year end to identify the median employee alleviates concerns regarding timing and/or the composition of the employee pool, e.g., seasonal employees.

3. Assess whether and to what extent it would be desirable to rely on the rule’s non-U.S. employee exemptions to help limit data collection costs.

4. Discuss data collection and analysis processes with the various internal and external groups that will be involved in the process, including an assessment of whether statistical sampling might be appropriate to carry out the data collection activities.

5. Engage in relatively limited data accumulation activities using 2015 data to gain a sense of an estimate or range of annual total compensation and ratio figures that ultimately may be disclosed.

6. Prepare a mock-up of the pay ratio disclosure to help streamline later efforts.

7. Consider how shareholders, employees and shareholder groups may react to your pay ratio and whether providing additional disclosure or presentation of a separate pay ratio covering a different group of employees would provide a helpful supplement to your required disclosure.

Additional Information

A copy of the full text of the final rules is here. Additional information on these issues and discussions of recent speeches, cases, laws, regulations and rule proposals of interest to public companies is also available at Perkins Coie’s online library of news and insights.

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