

SEC Adopts Final Rules on CEO Pay Ratio Disclosure

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On August 5, 2015, the Securities and Exchange Commission (“SEC”) adopted long-awaited final rules on CEO pay ratio disclosure (the “Rules”), which require that almost every SEC registrant disclose the ratio of the annual total compensation of its principal executive officer to the annual total compensation of its median employee. The Rules implement Section 953(b) of the Dodd-Frank Wall Street Reform and Consumer Protection Act (“Dodd-Frank”), passed by Congress in 2010, a very controversial section strongly supported by many union groups and equally strongly opposed by several industry groups and the U.S. Chamber of Commerce.

The SEC originally proposed the Rules on September 18, 2013, by a 3-2 vote of the five commissioners. Since 2013, the SEC has proposed several rules to implement increased executive compensation disclosure, regulating clawback policies, pay-for-performance initiatives, and hedging policies. The pay ratio disclosure seems to be the most contentious.

Pay Ratio Disclosure

Under the rules, new Item 402(u) of Regulation S-K enacted under the Securities Act of 1933, as amended, will require registrants to disclose:

- The annual total compensation of the chief executive officer, referred to as the “principal executive officer,” or the “PEO”;
- The annual total compensation of the median employee of all employees of the registrant; and
- The ratio of these two annual total compensation amounts.

The ratio can be expressed in one of two approved manners - as a ratio in which the annual total compensation of the median employee of all of the employees is equal to one and the PEO’s annual total compensation is represented as a number compared to one (e.g., “100 to 1”), or, alternatively, expressed narratively in terms of the multiple that the principal executive officer’s total compensation amount bears to the median employee’s total compensation amount (e.g., “the principal executive officer’s annual total compensation is 100 times that of the annual total compensation of the median employee of all of the employees”).

Included Employees

Median compensation calculations must include all full-time, part-time, seasonal, and temporary individuals (other than the PEO) employed by the company and its consolidated subsidiaries, as of a date chosen by the registrant within the last three months of its last completed fiscal year. Subject to certain specified exemptions, this includes U.S. and non-U.S. employees, but does not include independent contractors or “leased” or other temporary workers employed by a third party.

Registrants may, but are not required to, annualize the total compensation for full-time employees who were employed for less than the full fiscal year. However, the Rules do not permit full-time equivalent adjustments for part-time workers or annualizing adjustments for temporary or seasonal employees.

Permitted Exemptions

Although non-U.S. employees are included in the definition of employees under the Rules, registrants can exclude in their calculations: (1) non-U.S. employees employed in a foreign jurisdiction with data privacy laws precluding compliance with Item 402(u); and (2) up to 5% of the company's total non-U.S. employees. Registrants relying on the data privacy exemption must use reasonable efforts to obtain information for the pay ratio calculation, and they must obtain a legal opinion from counsel with respect to their inability to obtain or process the information necessary for compliance with the Rules without violating one or more country's data privacy laws or regulations.

The Rules also provided an exemption for employees joining the registrant as a result of a business combination or acquisition for the fiscal year in which any such transaction was completed. However, a registrant relying on this exemption must disclose the number of employees it is omitting from its calculation and identify the acquired business that is excluded for the fiscal year in which any such transaction was completed.

Companies Subject to the Rules

The Rules apply to registrants required to provide summary compensation disclosure (in filed documents like proxy statements, registration statements and the like) but the following types of registrants are exempt:

- Emerging growth companies;
- Smaller reporting companies;
- Foreign private issuers and multijurisdictional disclosure system filers; and
- Registered investment companies.

Method of Calculating the Median Employee

Reacting to extensive feedback received in response to the initial proposed rules in 2013, the SEC attempted to provide some flexibility in the mechanism with which registrants are allowed to calculate median employees.

Although registrants must disclose total compensation for their median employee in connection with the required pay ratio every year, they may identify their "median employee" used to calculate such ratio once every three years, so long as no changes in employee population or compensation arrangements from the prior fiscal year would cause the registrant to reasonably believe a significant change in the pay ratio would occur. This three year option was not included in the proposed rules of September 18, 2013.

If a registrant uses the same median employee for more than one completed fiscal year, as described above, the registrant must disclose that it is doing so and describe briefly the basis for its reasonable belief that no material change has occurred.

In determining the universe of employees to use in such calculation, registrants can rely on their total employee population, a statistical sampling of the employee population, or any other reasonable method. The final rules did not provide specific parameters for acceptable statistical sampling, but the SEC staff did indicate that reasonable estimates of median employee compensation values for registrants with multiple business lines or geographical units may be determined using one or more statistical sampling methodologies.

Method of Calculating Total Compensation

Pursuant to Item 402(c)(2)(x) of Regulation S-K, registrants must annually calculate total compensation for all employees, which includes wages and overtime for non-salaried employees. In doing so, registrants may annualize total compensation for permanent employees that did not work for the entire previous year (e.g., new hires or those on un-paid leaves of absence), but the same cannot be done for temporary, seasonal, or other part-time workers.

Each registrant is permitted to make cost of living adjustments to employee compensation in jurisdictions other than where the PEO resides. If a registrant does this, it must use the identical adjustment in determining the median employee's total compensation. However, if a registrant does not use a cost of living adjustment to identify its median employee, it cannot make such an adjustment for the median employee's total annual compensation.

Total annual PEO compensation used for the pay ratio must be identical to the amount disclosed in the registrant's Summary Compensation Table, unless the total annual PEO compensation is modified to conform to calculation methodologies used in determining the median employee's compensation.

Additional Disclosure Obligations

In the event that a registrant excludes employees from any calculation, changes the date of calculation for any statistical input to the compensation ratio, uses the same median employee for multiple fiscal years, or makes any change to assumptions, methodologies, or estimates relied on to accomplish required calculations under the Rules, the registrant must disclose relevant details of each along with its pay ratio.

Effective Date

The Rules will require registrants to make pay ratio disclosure for the first fiscal year beginning on or after January 1, 2017. For example, a company with a December 31 fiscal year end would have to make its first disclosure under the Rules in its 2017 Form 10-K (due in 2018) or the proxy or information statement for its 2018 annual meeting.

Implications and Insights

As has often been the case in recent SEC rulemaking efforts, the final rules passed by a narrow 3-2 vote, with the three votes coming from Chair Mary Jo White and her fellow Democrat commissioners. Compared to other recent compensation-related rule proposals, each of which

spurred rigorous debate in their own right, the pay ratio disclosure provision of Dodd-Frank has created by far the most controversy. This is evidenced by the over 287,000 comment letters (most of which were form letters from a few sources, duplicated by thousands) received by the SEC. There are also several pending House and Senate bills seeking to repeal Section 953(b) of Dodd-Frank, the section specifically mandating the SEC to implement complying pay ratio regulations.

Democrat commissioners expressed support for the final Rules' added flexibility in comparison to the proposed rules of 2013 and the SEC's core responsibility of implementing the mandates of Congress. Chair White said of the Rules, "these are good and reasonable changes that should reduce costs for many companies while adhering to the statutory requirements." Another Democrat commissioner commented that the new disclosure "will provide valuable information to investors about how a company manages human capital." On the other side, one of the Republican commissioners questioned the lack of valuable information that the Rules would realistically deliver to potential investors, emphasizing that "neither the statute nor the legislative history directly states the objectives or intended benefits of the provision or of a specific market failure, if any, that is intended to be remedied...[and] brushes aside the estimated \$1.3 billion in initial compliance costs." Another Republican commissioner more directly stated "...here we are, on the cusp of adopting a nakedly political rule that hijacks the SEC's disclosure regime to once again effect social change desired by ideologues and special interest groups."

A copy of the final rules can be found [here](#) and the SEC's press release is [here](#). For additional information on the proposed rules, please refer to our earlier advisory [here](#).

Please contact one of the attorneys listed below or any of the attorneys in the Corporate & Securities Practice Group at Benesch to discuss the implications and effective strategies for your company of this rule change.

Megan L. Mehalko | mmehalko@beneschlaw.com | 216.363.4487