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Long-Awaited Final CEO Pay Ratio Rule Issued

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SEC Offers Modifications from Proposed Rule

The Securities and Exchange Commission (SEC) has approved final implementation rules (Final Rules) nearly two years after issuing proposed rules (Proposed Rules) for disclosure of CEO pay ratios under the Dodd-Frank Act of 2010 (DFA). The vote was three to two for the Final Rule, with SEC Commissioners Piwowar and Gallagher again strongly opposed to the legislation and implementing regulations.

It is not a surprise the Final Rules were released so long after the Proposed Rules were issued in September 2013 – the SEC received over 187,000 comment letters responding to the most controversial compensation-related provision under the DFA. Moreover, cost of compliance may be staggering, with aggregate initial costs estimated to be $1.3 billion and ongoing annual costs of $526 million. Despite the voluminous comments and high cost estimates, the Final Rules offer limited relief from the Proposed Rules.

Delayed Implementation Date: For calendar year companies, the Final Rules first require disclosure in 2018 proxy filings based on 2017 fiscal year compensation, which is a year later than previously assumed.

Median Employee Determined Once Every Three Years: Companies no longer need to conduct an annual analysis to determine the median employee – the analysis generally only needs to be done once every three years.

Employee Population Determined at Any Time During Last Fiscal Quarter: Companies may now select a date anytime in the last three months of their last completed fiscal year to determine their employee population for purposes of identifying the median employee.

Limited Exclusions for Non-U.S. Employees: Exclusion of non-U.S. employees from determination of the median employee is permitted in two circumstances:

- Companies may exclude non-U.S. employees if obtaining their compensation data would cause the company to violate data privacy laws; and

- Companies may generally exclude non-U.S. employees up to 5% of their worldwide workforce.

Definition of “Employee” Clarified: For purposes of the ratio, leased workers and independent contractors are excluded, as are employees of subsidiaries which are not “consolidated subsidiaries”, which generally excludes employees of companies in which the reporting company does not own more than 50% of outstanding voting shares.

COLA Permitted: To identify the median employee, companies may make cost-of-living adjustments (COLA) to the compensation of employees in jurisdictions other than the one in which the CEO resides.

Treatment of Multiple CEOs Clarified: In the case of multiple CEOs in one year, a company may combine CEO compensation for purposes of calculating the ratio or alternatively annualize the compensation of the CEO actually in the role as of the median employee determination date.

Relief for Certain Transitioning Companies: Companies transitioning out of Smaller Reporting Company (SRC) and Emerging Growth Company (EGC) status do not need to provide pay ratio disclosure until after the first full fiscal year after exiting such status. In addition, employees of newly acquired companies do not need to be included in pay ratio calculations for the fiscal year in which the acquisition becomes effective.

The remainder of this Client Alert provides details on the Final Rules and updates our previously issued Alert from October, 2013 on the Proposed Rules. *Modifications contained in the Final Rules are shown in text in bold italics*.

Background

The DFA required the SEC to promulgate rules for implementing a new requirement that public companies provide disclosure that would illustrate the pay difference between the CEO and the median paid employee. The disclosure was to include:

- The median annual total compensation of all employees (except the CEO) of the issuer;
- The annual total compensation of the CEO; and
- The ratio between the two.

A literal reading of the statute mandates that "total compensation" be disclosed in accordance with Summary Compensation Table (SCT) rules - an enormous undertaking requiring companies to calculate – for every employee – the value of: salary, incentives, grant date fair value of equity, changes in pension value, nonqualified deferred compensation earnings, and any additional compensation.

For the past five years, the extensive lobbying efforts, legislative challenges within the House of Representatives, and flood of comment letters to the SEC has prolonged the

issuance of both the Proposed and Final Rules.

Among the key objections:

- *Cost and Complexity*: Calculating the ratio as literally drafted would be overly complicated and expensive.
- *Low Value*: The disclosed information would be of little to no value to investors, especially for global companies whose workforces include international and part-time workers.
- *No Impact on Governance*: Unlike current benchmarking disclosures, the pay ratio would not likely provide an incentive to keep executive compensation in check, nor would it raise pay levels for lower-level employees.

On the other hand, those in favor of the pay ratio rule (largely unions and pension funds) argued the rule would be beneficial on two fronts:

- *Governance*: The calculation of the pay ratio would enable investors to judge if executive pay is excessive.
- *Employee Morale:* If the ratio shows a large gap in pay between the CEO and the rest of a company's employees, it is likely to hurt productivity and increase turnover, ultimately affecting profitability and investor returns.

Definition of "Issuer" (Companies Covered)

The SEC adopted a broad definition of "issuer" that covers not just employees of the SEC reporting company, but also those of any consolidated subsidiaries (as determined by accounting rules, but generally requiring ownership of at least 50% of the outstanding voting shares of the company). The Final Rules narrowed the scope of the Proposed Rules which would have required inclusion of employees of all subsidiaries, effectively making the pay ratio calculation applicable to all employees on an enterprise-wide basis.

Definition of Employees Covered

The SEC chose to apply the DFA's literal definition of "all employees", which means companies must incorporate in their calculations all domestic, non-U.S. *(with limited non-U.S. exemptions, discussed below)*, full-time, part-time, temporary and seasonal workers employed on any date of the company's choosing *within the last three months of its last competed fiscal year* (the Proposed Rules would have required this date to be the last day of the fiscal year, discussed below). *The Final Rules also allow for the exclusion of individuals whose compensation was determined by an unaffiliated third party (e.g., leased workers and independent contractors).*

Limited Exceptions for Non-U.S. Employees

The Final Rules provide two exceptions to the inclusion of non-U.S. employees in the calculation of the pay ratio, primarily in response to harsh criticisms.

Data Privacy Exemption: Companies may exclude from the pay ratio calculation all non-U.S. employees who are employed in jurisdictions with data privacy laws in which compliance with the mandated pay ratio disclosure would violate those laws. In order to use this exemption, the company must:

- Demonstrate reasonable efforts to seek an exemption or other relief under any governing data privacy laws and use it if granted;
- Exclude all non-U.S. employees in the particular jurisdiction (not just some);
- Disclose the excluded jurisdictions, the approximate number of employees excluded from such jurisdictions, the applicable data privacy laws, how compliance with the SEC rule would violate those laws, and the company's efforts to use or seek relief under them; and

Obtain an opinion from legal counsel on its inability to comply (including being unable to obtain an exemption or other relief), which must be filed as an exhibit to the proxy statement or annual report.

5% De Minimis Exception: In identifying the median employee, companies may exclude all of their non-U.S. employees if they total 5% or less of their total employee population (including those excluded under the data privacy exemption). If this exception is used, companies must exclude all of their non-U.S. employees.

If a company has more than 5% non-U.S. employees, then it may exclude up to 5% of its total employees who are non-U.S. employees. If this exception is used, companies must exclude all of the employees of any particular jurisdiction and cannot pick and choose which non-U.S. employees to exclude in any one jurisdiction. Thus, this exemption will not be available in any non-U.S. jurisdiction where more than 5% of the company's total employees are located.

If this exception is used, companies must disclose:

- The excluded jurisdictions and the approximate number of employees excluded from such jurisdictions; and
- The total number of its U.S. and non-U.S. employees (disregarding the de minimis and data private exemptions), and the total number of its U.S. and non-U.S. employees used for the de minimis calculation.

Identification of Median Employee and Calculation of Median Employee Compensation

Identification of Median Employee

Companies can choose a facts-and-circumstances-driven methodology they believe best fits their particular size, structure and compensation practices. Sample considerations suggested by the SEC include:

- The size and nature of the workforce;
- The complexity of the organization;
- The stratification of pay levels across the workforce;
- The different types of employee compensation;
- The extent to which different currencies are involved;
- The extent to which different tax and accounting regimes are involved; and
- The number of payroll systems and the difficulty of integrating those systems to readily compile total compensation information for all employees.

While no safe harbor methodology is provided, the SEC suggests several non-exhaustive approaches for arriving at an appropriate median employee for pay ratio purposes, including:

- *All employees or a statistical sampling of all employees*: No statistical technique or confidence level is required, but larger sample sizes would generally be needed for more complicated structures. If sampling is used, the methodology must be disclosed in the proxy statement.
- *A consistently applied compensation measure:* This could include SCT total compensation, wages, total annual cash compensation, total direct compensation, payroll, or tax records (e.g. Form W-2), as long as the selected measure is disclosed. The SEC's intention here was to enable companies to use data that they already track.
- *Reasonable estimates in calculating compensation measures*: Reasonable estimates are allowed if disclosed, but the SEC expressly prohibited the use of employee earnings estimates available through the U.S. Department of Labor's Bureau of Labor Statistics.

Frequency of Determining Median Employee

Under the Proposed Rules, companies would need to identify the median employee on an annual basis. *The Final Rules permit companies to identify the median employee only once every three years, unless there has been a change in its employee population or employee compensation arrangements the company reasonably believes would result in a significant change to its pay ratio disclosure. If there have been no changes the company reasonably believes would significantly affect its pay ratio disclosure, the company must disclose it is using the same median employee in its pay ratio calculation and describe briefly the basis for its reasonable belief. However, even if a company uses the same median employee, it must re-calculate the median employee's annual total compensation*

each year and use the new figure to update its pay ratio disclosure each year.

If during the three-year period the median employee's compensation significantly changes or the employee is no longer working at the company, the company may either: (i) identify a new median employee, or (ii) use a replacement median employee whose compensation is substantially similar.

Median Employee Determination Date

Under the Proposed Rules, companies would need to identify the median employee on the last day of the last completed fiscal year. *The Final Rules permit companies to choose any day within the last three months of the completed fiscal year to determine the median employee. Companies must disclose their determination date, but not the reason for the decision. If the date changes in subsequent years, disclosure must include a brief explanation of the reasons for the change.*

Calculating Median Employee Compensation

While the rules permit companies to choose the methodology used to identify the median employee, the actual compensation would have to be re-calculated based on the median employee's annual total compensation as if reported in the SCT. The latter includes the combined value of: (i) base salary; (ii) bonus/incentive or other non-equity incentive pay; (iii) grant date fair values of equity awards for the year; (iv) changes in pension value or certain non-qualified deferred compensation earnings; and (v) all other compensation.

The SEC, however, would permit the use of "reasonable estimates" of both the annual total compensation for the median employee, as well as any of the specific elements described above that contribute to annual total compensation. The regulators noted those estimates would be particularly helpful for some pension plan benefits, as well as for computing pay for non-U.S. employees. The use of any estimated value must be disclosed in the proxy statement.

Perquisites with an aggregate value of less than $10,000, which are typically excluded from the SCT tables, may be counted towards median employee compensation. In such cases, however, the value of these perquisites must also be counted toward CEO pay. Other than that exception, total annual compensation for the CEO would be calculated pursuant to SCT proxy rules.

Calculating CEO Compensation

For purposes of the pay ratio, CEO compensation is simply the amount reported in the SCT. *However, the Final Rules provide more guidance as to how to report in years when there were multiple CEOs. In this case, the rules permit companies to either: (i) aggregate CEO compensation, or (ii) use the annualized compensation of the CEO in the position on the date the median employee is determined. Companies must then disclose in the proxy statement which approach was selected and how they calculated the CEO's annual total*

compensation.

Adjustments

The Final Rules permit, but do not require, companies to annualize total compensation for full- or part-time permanent employees who have been employed less than a full fiscal year. If annualization is used for part-time employees, it must reflect a full year of part-time work; it cannot be annualized to reflect full-time compensation. Annualization for temporary or seasonal workers is not permitted, and *the Final Rules clarify that companies may not make a full-time equivalent adjustment for any part-time employees.* If companies choose to annualize for permanent employees, they must do so for the entire population.

Unlike the Proposed Rules, the Final Rules permit COLA adjustments in identifying the median employee who lives in a different jurisdiction from the CEO. If the company uses COLA to identify its median employee, it must also:

- Apply the COLA to all employees in the jurisdiction who are included in the calculation;
- Use the same COLA adjustment in determining the median employee's annual total compensation and disclose the median employee's jurisdiction (but if the company did not make the COLA adjustment in identifying the median employee, it may not make the adjustment in calculating the median employee's compensation);
- Disclose the country in which the median employee is located and briefly describe the COLA it used, including the measure used as the basis for the adjustment; and
- Disclose the median employee's annual total compensation and the pay ratio without the COLA adjustment.

Exclusions

The following companies were specifically exempted from reporting pay ratios:

- *Emerging Growth Companies (EGCs):* As defined in the JOBS Act, these are generally companies that have completed their IPO after December 8, 2011 and have less than $1 billion in total annual gross revenues, with companies potentially retaining this status for up a maximum of five years post-IPO
- *Smaller Reporting Companies:* Generally, companies with less than a $75 million float
- *Foreign Private Issuers:* Generally, foreign companies in which 50% or less of outstanding voting securities are held by U.S. residents

Disclosure

Pay ratios must be reported only in public filings that require Item 402 disclosure (i.e., annual reports on Form 10-K, and proxy and information statements). The SEC emphasized the pay ratio disclosures should be *brief* and include:

- Annual total compensation of the median employee and the CEO;
- The ratio of the two amounts; and
- Methodology, material assumptions, adjustments and estimates used in the calculations *(including any COLA applied)*.

As described in the DFA, the numerator in the pay ratio would be the median employee compensation and the denominator would be the CEO's compensation. That would have resulted in an odd fraction, however. As an example, comparing CEO compensation of $10M and median employee compensation of $50,000 would produce a ratio of .005. The SEC accordingly nuanced the provision to require the calculation be disclosed as either (i) a ratio, in which the median of the annual total compensation of all employees is equal to one or (ii) a narrative, describing the multiple of the CEO's annual total compensation relative to the median annual total compensation. Such a formula could express the preceding pay example as either "200 to 1" or, narratively, as "the CEO's annual total compensation is 200 times that of the median of the annual total compensation of all employees."

The SEC emphasized it does not want highly technical or detailed descriptions of pay ratios. Rather, relevant information might include the statistical sampling and size, how the company arrived at data in regard to separate businesses or segments, currency translations, and/or the annualization of permanent employees not employed for the full year. The company must also disclose any changes in the methodology or assumptions used in the prior year which would result in a materially different ratio, as well as the reason for the change, along with its estimated impact on the median compensation and overall pay ratio.

The rules would permit, but not require, companies to supplement the required pay ratio disclosure with a narrative description or additional ratios, providing it is clear such disclosures are not intended to replace the SEC-required calculation.

The Final Rules do not specify where this new disclosure (Item 402(u)) should be located, but most likely it would be within the CD&A.

Effective Date

The pay ratio disclosure will first apply with respect to a company's first full year commencing on or after January 1, 2017. For companies with a fiscal year ending on December 31, the pay ratio will be required as part of its executive compensation disclosure in proxy statements starting in 2018. The Final Rules effectively delayed implementation for a full year, as the Proposed Rules would have become effective for proxy statements filed in 2017 with respect to 2016 compensation.

Transition Rules for IPO, Acquisitions, SRC and ECG

Newly public companies that are not EGCs do not need to disclose a pay ratio until the first fiscal year beginning on or after the date the company becomes a public filer. For example, a calendar year company that completes its IPO in June 2020 would provide its first required ratio disclosure in the proxy filed for its 2022 annual meeting, reflecting compensation in 2021.

The Final Rules provide new transition relief for companies that have recently undertaken a merger or acquisition. Companies may omit the employees of a newly acquired company from their pay ratio calculation (but must disclose the company acquired and the approximate number of employees) for the fiscal year in which the acquisition becomes effective. They must be included in their median employee calculation beginning in the first full fiscal year following the acquisition.

The Final Rules also provide new transition relief for companies coming out of SRC and EGC status, as companies that cease to be SRCs or EGCs do not need to provide pay ratio disclosure until after the first full fiscal year after exiting such status, and not for any fiscal year commencing before January 1, 2017.

Conclusion

While the effective date of the pay ratio rules is far from imminent, companies should begin (or continue) to consider steps towards implementation. Preliminary action items may include:

- Select a methodology to identify the median employee best suited to the company's business, and mock up disclosure intended to explain the methodology;
- Assess whether compensation data is available for the median employee, and whether reasonable estimates will be needed, and mock up disclosure explaining how the reasonable estimate was calculated;
- Analyze which "determination date" should be used in the three month window; and Determine whether there are any employees in non-U.S. jurisdictions that may be excluded either by means of foreign data privacy laws or the 5% exception, and mock up disclosures for use of any such exceptions.

Finally, one of the overlooked unintended consequences of the new rule is not the impact of disclosure on investors, but the impact on each company's general employee population. For the first time, all employees of public companies will now be able to

compare their own compensation to a statistically derived “median employee.” While most individuals generally know they earn far less compensation than the CEO, a comparison to the median employee could have a profound impact on the workforce. A communication plan for the employee population regarding the new disclosures is critical in this regard.

About the Author

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About Pearl Meyer

Pearl Meyer is the leading advisor to boards and senior management helping organizations build, develop, and reward great leadership teams that drive long-term success. Our strategy-driven compensation and leadership consulting services act as powerful catalysts for value creation and competitive advantage by addressing the critical links between people and outcomes. Our clients stand at the forefront of their industries and range from emerging high-growth, not-for-profit, and private organizations to the Fortune 500.