Among several provisions affecting executive compensation, the CEO pay ratio disclosure rule was included in the Dodd-Frank Wall Street Reform and Consumer Protection Act of 2010. Section 953(b) amended Item 402 of Regulation S-K and directed the U.S. Securities and Exchange Commission (SEC) to issue regulations that would require public companies to disclose the pay ratio between the company’s median employee and the company’s chief executive officer or other principal executive officer. Emerging growth companies, smaller reporting companies and foreign private issuers are exempt from the rule.

The pay ratio disclosures will be “filed,” not “furnished,” and will therefore be subject to Sarbanes-Oxley Act certifications by the CEO and CFO and subject to potential securities laws liabilities.

The SEC finalized the regulations on August 5, 2015, with an effective date of October 19, 2015, and they require compliance for the first fiscal year beginning on or after January 1, 2017. Under the final rule, a public company must begin including pay ratio disclosure in its annual proxy statements for the
2018 season, or in its Form 10-K if it does not file a proxy statement.

A recent survey by TheCorporateCounsel.Net reported that less than 40 percent of responding public companies had started preparations for their pay ratio disclosures.

**Summary of the Rule**

The CEO pay ratio disclosure rule requires each public company to disclose:

- the median of the annual total compensation of all its employees except the CEO;
- the annual total compensation of its CEO;
- the ratio of the two amounts.

The final rule is generally consistent with the proposed rule, with a number of revisions that were intended to preserve the disclosure of information reflecting the pay ratio while minimizing the expected costs and unintended consequences of the required disclosure.

For example, employees in certain countries may be excluded from the calculation upon a showing of prohibitive data privacy laws, and the final rule includes a *de minimis* exemption, which permits a public company to exempt non-U.S. employees where these employees account for five percent or less of the company’s total U.S. and non-U.S. employees, with certain limitations. The final rule permits public companies to make certain cost-of-living adjustments for the compensation of employees in foreign jurisdictions to identify the median employee and calculate the annual total compensation.

Several other items were addressed in the final rule including:

- limiting the employees who must be included in the ratio to only the employees of the public company’s consolidated subsidiaries;
- permitting a public company to use any date within three months prior to the last day of its last completed fiscal year to identify the median employee;
- allowing a public company to identify its median employee every three years; and
- extending the initial compliance date.

One of the key concepts introduced by the SEC in this rule is a Consistently Applied Compensation Measure (CACM). Although not exhaustive, the SEC offered some examples that qualify as a CACM for purposes of the calculation. (See the Regulatory Interpretation and Guidance discussion below.)

**Potential Repeal**

_The Financial CHOICE Act._ In June 2017, the U.S. House of Representatives passed the Financial CHOICE Act (H.R. 10), by a 283-186 vote, largely along party lines. One of the provisions of the legislation, co-sponsored by House Financial Services Committee Chairman Jeb Hensarling (R-TX),
would repeal Section 953(b) of the Dodd-Frank Act, which directed the SEC to amend its rules to require the pay ratio disclosure. However, the lack of bipartisan support will make it extremely difficult to pass through the Senate on a filibuster-proof vote. Most observers believe it is unlikely that the Senate will approve the Financial CHOICE Act in its current form, if at all, before the 2018 proxy season.

**SECUReconsIDeration.** In February 2017, then-Acting SEC Chair Michael Piwowar launched a 45-day request for comment on the pay ratio rule, seeking input from companies about “any unexpected challenges” that they may have experienced in preparing to comply with the rule. He also directed the SEC staff to “reconsider the implementation of the rule based on any comments submitted and to determine as promptly as possible whether additional guidance or relief may be appropriate.” To date, the SEC has received approximately 14,000 “form” letters in support of the rule and over 200 comment letters from various interested parties, including individuals, professors, corporations, pension funds, asset managers, law firms and trade associations.

It is uncertain whether the SEC, under the new SEC Chair Jay Clayton, will repeal the rule, delay the compliance date, or otherwise limit compliance with the rule. The SEC’s unilateral ability to repeal the rule is questionable.

**Regulatory Interpretation and Guidance**

Despite opposition, public companies should prepare to comply with the rule. In October 2016, the SEC’s Division of Corporation Finance issued guidance in five compliance and disclosure interpretations (C&DI’s) to assist companies in preparing for compliance with the rule.

- **Consistently Applied Compensation Measure (CACM).** While the Division did not provide an exhaustive list of what it would consider a reasonable reflection of annual compensation, it did provide some parameters regarding what it believes may constitute a CACM. Total cash compensation could be a CACM so long as the registrant did not also distribute annual equity awards widely among its employee base. On the other hand, calculating annual compensation of employees on the basis of withheld social security taxes would likely not be a CACM, unless all employees earned less than the Social Security wage base.

- **Hourly or Annual Rates of Pay.** The Division does not believe that the use of an hourly or annual pay rate alone is an appropriate CACM to identify the median employee. The rule does not permit making a full-time equivalent adjustment for part-time employees, and using an hourly rate without taking into account the number of hours actually worked would be an attempt to do just that, according to the Division.

- **Employee Population versus Median Employee.** The rule requires a registrant to select a date within three months following the end of its fiscal year to determine the population of its employees from which to identify the median. Once the employee population is determined, the registrant identifies the

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Early Results

In August 2016, Mercer conducted a survey of over 100 companies in 12 industries and found that the CEO-to-median-employee pay ratio is less than 200:1 for the majority of respondents that have estimated a ratio. These estimates are significantly lower than the AFL-CIO’s 335:1 average ratio for 2015 that is frequently cited.

In addition, three-quarters of respondents have already determined a method to identify the median employee or are considering one of more methods. Sixty percent of respondents have estimated their ratio with more than half reporting ratios under 200:1 and only 20 percent reporting ratios of more than 400:1.

Lastly, ratios vary by industry. Those with low ratios tend to have more professional staff, and those with high ratios tend to have more part-time, temporary and less-skilled employees. Sectors with the lowest ratios are in banking/financial services, technology and non-financial services. The highest ratios are in retail, wholesale and consumer goods.

Practical Considerations

Depending on the circumstances, the process to identify a public company’s median employee, calculate that employee’s annual total compensation, calculate the pay ratio, and prepare any accompanying narrative disclosure can be a significant and time-intensive undertaking. Several factors can influence the result, including whether a company has a large, global workforce or different payroll systems across multiple divisions or subsidiaries. Since a repeal or delay of the pay ratio rule currently appears unlikely, public companies should continue to prepare or—for those that have not yet started—begin to prepare the methodology they will use to calculate their CEO pay ratio disclosure well in advance of drafting their 2018 proxy statements. In addition, companies may want to consider the impact on its workforce of disclosing the compensation of the company’s median employee.

- **Furloughed Employees.** Because “furlough” could have different meanings for different employers, registrants should first determine whether the furloughed worker is, in fact, an employee. If the furloughed worker is determined to be an employee of the registrant on the date that the employee population is determined, then the registrant must determine the furloughed worker’s compensation using the same method as for a non-furloughed employee.

- **Independent Contractors and Leased Workers.** A registrant should include a worker as an “employee” for the purposes of the rule if the worker compensation is determined by the registrant or one of its consolidated subsidiaries. This is true regardless of whether such worker would be considered an “employee” for tax or employment law purposes. When a registrant obtains services of workers by contracting with an unaffiliated third party that employs the workers, the Division does not believe that the registrant is determining the workers’ compensation for purposes of the rule if the registrant specifies only that those workers receive a minimum level of compensation.

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Public companies should consider the following steps:

- Develop a process for collection of information, and consider a reasonable, documented approach to the calculation that is defensible to the SEC, investors and employees. Some companies will benefit from early collaboration with their Human Resources partners to assist in collection and analysis of payroll information. Gathering information from certain countries in a compliant manner may require additional data security measures.

- Update the compensation committee regarding the company’s progress to date and/or project plan for the initial calculation of the CEO pay ratio and timing of subsequent calculations.

- Conduct a simulated exercise (“dry run”) of the pay ratio calculation and disclosure using 2017 compensation data as a baseline. Doing so will allow companies to identify procedural pitfalls or data set gaps in advance. It will also prepare companies to craft the disclosure in a way that minimizes risk, but complies with the law.

- In drafting disclosures, consider how to frame the methodology, including assumptions, adjustments and any exemptions relied upon. Some companies plan to present alternative pay ratios using only U.S. employees, only foreign employees or another grouping.

- Provide the compensation committee with a draft of the CEO pay ratio disclosure as early as possible so the committee has an understanding of the likely magnitude of the pay ratio to be disclosed in the 2018 proxy statement. This will allow more time to consider the key messaging to investors given the results of the company’s pay ratio calculation, and the potential benefit of voluntary disclosure of supplemental pay ratio calculations to enhance investors’ understanding of how various aspects of the company’s employee demographics impact the pay ratio results.

- Consider an internal communication strategy. Some companies plan to issue a proactive communication to employees before the ratio is disclosed in a proxy, whereas others intend to react, arming HR partners with talking points for any employee inquiries.

We will continue to monitor the implementation of the rule and provide an update as it becomes available. For further information about the rule, please see our prior Client Advisory dated August 26, 2015.

The authors would like to thank summer associate Matthew H. Lewis for his contribution to this alert.