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## SEC Adopts Final Pay Ratio Disclosure Rules

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*The Securities and Exchange Commission (SEC) has adopted final rules under the Dodd-Frank Wall Street and Consumer Protection Act (the Dodd-Frank Act) to require U.S. public companies to disclose the ratio of the annual total compensation of their principal executive officer (PEO) to the median annual total compensation of all employees (Final Rules).*

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Although the Final Rules are generally consistent with the proposed rules,<sup>1</sup> they do permit issuers to rely on the same median employee for three years to calculate the ratio, absent a material change in the issuer's employee population or compensation arrangements. In addition, partial relief has been extended to issuers that have significant operations outside the United States.

### Background and Final Rules

On August 5, 2015, the SEC adopted the Final Rules implementing Section 953(b) of the Dodd-Frank Act that amends Item 402 of Regulation S-K to add a new paragraph (u) to require issuers to disclose:

- the median of the annual total compensation of all employees of the issuer, excluding the PEO (the median compensation);
- the annual total compensation of the PEO (the PEO compensation); and
- the ratio of the median compensation to the PEO compensation.

The disclosure must be reported in all filings that require disclosure of executive compensation matters under Item 402 of Regulation S-K, including annual reports, proxy and information statements and certain registration statements.

Emerging growth companies (EGCs), smaller reporting companies, registered investment companies and foreign private issuers are exempt from this rule. The Final Rules also provide transition periods for private companies undergoing IPOs, companies engaging in business combinations or acquisitions and companies that cease to be EGCs or smaller reporting companies.



<sup>1</sup> See "SEC Proposes Pay Ratio Disclosures" (Pillsbury client alert, dated October 9, 2012) [\[link\]](#).

The disclosure will be required for filings with respect to the first full fiscal year on or after January 1, 2017. This means, for calendar year issuers, the first pay ratio disclosure will be reported in the issuer's proxy statement or Form 10-K filed starting in 2018 and, for fiscal year issuers, the first pay ratio disclosure will be reported in the issuer's proxy statement or Form 10-K filed starting in fiscal 2019 (but not later than 120 days after fiscal year-end).

The following memorandum summarizes some of the more notable changes to the proposed rules.

### Disclosure of the Pay Ratio

The pay ratio must be presented as either:

- a ratio in which the median employee's compensation is one (e.g., 100 to 1); or
- narratively, as a multiple that the PEO compensation bears to the median compensation (e.g., the PEO compensation is 100 times the median compensation).

The pay ratio may not be presented by expressing the median compensation as a percentage of the PEO compensation (e.g., the median compensation is 1 percent of the PEO compensation).

In addition to the pay ratio disclosure, an issuer is required to disclose, among other items, the measurement date for identifying the median employee, the methodology for determining the median employee, any material assumptions, and adjustments or estimates used to identify the median employee or determine annual total compensation.

### Covered Employees

For purposes of calculating the pay ratio, issuers are required to consider all full-time, part-time, seasonal and temporary workers employed by the issuer and its consolidated subsidiaries (other than the PEO) on any date within the last three months of its last completed fiscal year, irrespective of whether such employees are located in the United States or abroad (subject to the exceptions discussed below). Independent contractors and other persons employed (and whose compensation is determined) by unaffiliated third parties, such as leased employees, are excluded from the calculation.

In determining the covered employees, unlike the proposed rules, issuers may exclude non-U.S. employees if:

- obtaining the information required to comply with the Final Rules would violate a non-U.S. jurisdiction's data privacy laws, so long as the issuer makes reasonable efforts to obtain the information and obtains a legal opinion as to the issuer's inability to comply with the rules; or
- the issuer's non-U.S. employees account for 5 percent or less of its total employee population (including those employees excluded on the basis of the data privacy exemption).

If an issuer's non-U.S. employees account for more than 5 percent of its total employee population, the issuer may exclude up to 5 percent of its total non-U.S. employees, but it must exclude all non-U.S. employees of a particular jurisdiction (i.e., an issuer cannot choose which employees to exclude in any one non-U.S. jurisdiction). An issuer must disclose its reliance on these exemptions.

### Identifying the Median Employee

Although the pay ratio is required to be disclosed annually, the Final Rules allow an issuer to identify its median employee once every three years, unless there has been a change in the issuer's employee population or

compensation arrangements that it reasonably believes would result in a significant change to its pay ratio disclosure. An issuer may choose any date within the last three months of the relevant fiscal year to identify its median employee.

As with the proposed rules, the SEC did not set a bright-line methodology for identifying the median employee. Instead, the Final Rules allow issuers to select a methodology that best fits their size, structure and compensation practices, and any such methodology may use reasonable estimates. For example, if appropriate, an issuer could determine its median employee based on statistical sampling or tax and/or payroll records.

The Final Rules also provide flexibility in determining the median employee by permitting an issuer to:

- adjust the compensation of its employees to the cost of living in the PEO's jurisdiction, provided the adjustment applies to all employees in that jurisdiction who are included in the calculation; and
- annualize any compensation for permanent part- or full-time employees (but not temporary or seasonal employees) employed for less than the entire fiscal year.

The Final Rules prohibit issuers from making full-time equivalent adjustments for part-time employees.

### Median Employee Total Compensation

Once the median employee is identified, an issuer must calculate the employee's total annual compensation for the last fiscal year. The median compensation must be recalculated each year, and, if the median employee's compensation changes significantly during the three years, an issuer may use another employee with compensation that is substantially similar to the compensation of its original median employee.

While there is no required methodology for identifying an issuer's median employee, an issuer is required to calculate the total compensation of its median employee using Item 402(c)(2)(x) of Regulation S-K, which is the rule used to calculate the PEO's compensation in the Summary Compensation Table.

### Defining Total Compensation

In some cases, strict application of the Item 402(c)(2)(x) methodology to an employee who is not an executive officer might produce results that seem distorted. As such, the SEC has identified the following key exceptions in calculating the median compensation:

- for non-salaried employees, the term "base salary" refers to wages plus overtime;
- an issuer may use reasonable estimates for the median compensation, provided the issuer has a reasonable basis to conclude that the estimates approximate the actual amount of Item 402(c)(2)(x) compensation; and
- if an issuer includes in the median compensation personal benefits that would otherwise be excluded under Item 402(c)(2)(x) (because the amounts of such benefits are less than \$10,000) or nondiscriminatory benefits, then the PEO's compensation must be recalculated to include any such benefits.

### Identifying the PEO

The term "principal executive officer" has the same meaning under Item 402(a)(3)(i) of Regulation S-K (i.e., all individuals serving as the issuer's PEO or acting in a similar capacity during the last completed fiscal year). As such, an issuer may have more than one PEO in any given fiscal year, in which case the issuer may:

- combine the total compensation provided to each person who served as the PEO during the year to constitute the issuer's total annual PEO compensation; or
- use the PEO serving in that role on the date that the issuer selects to identify its median employee and annualize the PEO's compensation.

### Practical Considerations

Although the pay ratio disclosures will not be required to be reported until 2018, all U.S. public reporting companies should begin making preparations to review their employment structures, plan for data collection and begin considering what methodologies they would use to make the determinations required under the Final Rules. Companies should also review their proxy statement disclosure controls and procedures to determine whether they should be updated to reflect the new disclosures. Since the Final Rules allow issuers to make supplemental disclosures, including additional ratios if desired, issuers should also consider what supplemental disclosures might provide helpful context for investors. Finally, issuers may want to prepare a rough pay ratio calculation in advance of the required disclosure to assess whether advance Compensation Discussion & Analysis disclosure, shareholder outreach or compensation restructuring would be advantageous.

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