Client Update
Minding the Gap: SEC Hands Down Final CEO Pay Ratio Rule

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The U.S. Securities and Exchange Commission (the "SEC") released the controversial final "CEO pay ratio" disclosure rule last week. While many believe the primary purpose of the rule is to embarrass CEOs, the SEC indicated that the rule is designed to inform shareholders exercising their say-on-pay voting rights. Beginning in 2018, the final rule will require all registrants (other than smaller reporting companies, foreign private issuers, emerging growth companies and newly public companies) to disclose the ratio of CEO pay to median employee pay in their annual report on Form 10-K or, if filed later, in their definitive proxy or information statement relating to the registrant's next annual meeting of shareholders. While the final rule is in most respects identical to the proposed rule of September 2013, the SEC introduced a small number of important changes designed to address concerns that the compliance costs of the proposed rule were too high. Most significantly, and as discussed more fully below, the final rule permits registrants (1) to exclude certain non-U.S. based employees from the pool from which the median employee is selected, (2) to use the same median employee for up to three years, and (3) to select the median employee as of any date within the three month period ending on the last day of the registrant's fiscal year.

IDENTIFYING THE "MEDIAN EMPLOYEE"

With two exceptions, the rule requires registrants to determine the median employee based on all employees of the issuer and its consolidated subsidiaries (as determined for purposes of its financial statements), including U.S. and non-U.S. employees, as well as part-time, seasonal and temporary employees.[1] In contrast to the proposed rule, which would have required registrants to identify the median employee as of the last day of the last completed fiscal year, the final

[1] The SEC specifically excluded those workers who are employed, and whose compensation is determined, by an unaffiliated third party but who provide services to the registrant as independent contractors or "leased" workers.

rule provides registrants with the flexibility of identifying the median employee on any date within the last three months of the registrant's last completed fiscal year. Once the determination date has been selected, however, the registrant must disclose the chosen date and provide an explanation for any change in the determination date in subsequent years.

Exclusions. Recognizing that the inclusion of non-U.S. employees in the determination of the median employee raises compliance costs for multinational companies, the final rule provides two limited exclusions under which registrants can exclude certain non-U.S. employees from the employee population for purposes of identifying the median employee.

- *Foreign Data Privacy Law Exclusion*. Registrants may exclude non-U.S. employees from the median employee determination when a jurisdiction's data privacy laws or regulations preclude a registrant from gathering the necessary information to comply with the final rule. There is no limit to the number of non-U.S. employees that may be excluded from the median employee determination under the data privacy exclusion, but once a registrant excludes any employee in a particular jurisdiction, it must exclude all employees in that jurisdiction.

  There are a number of conditions to this exclusion that will make its use both limited and costly. Before a registrant can avail itself of the exclusion, it must exercise reasonable efforts to obtain or process the information necessary for compliance with the rule, including by seeking an exemption or other relief under the applicable jurisdiction's data privacy laws and using the exemption if granted. In addition, the registrant must obtain a legal opinion, which must be filed as an exhibit to the filing that contains the pay ratio disclosure, explaining the registrant's inability to obtain the necessary information without violating the applicable jurisdiction's law, including the registrant's inability to obtain an exemption or other relief. The registrant also will need to disclose (i) any jurisdictions excluded under the data privacy exclusion, (ii) the specific data privacy laws or regulations impeding compliance with the final rule (and a description of how complying with the final rule would violate such laws or regulations) and (iii) the approximate number of employees excluded from each jurisdiction based on the data privacy exclusion.

- *De Minimis Exclusion*. The final rule introduces a new provision under which a registrant may exclude its non-U.S. employees, up to 5% of its total employees, when identifying the median employee. If a registrant chooses to exclude any non-U.S. employees under the *de minimis* exclusion, it must exclude all non-U.S. employees so long as the total number of excluded

employees does not exceed 5% of the registrant's total employee population. If more than 5% of a registrant's employees are located outside of the U.S., it can exclude employees in some, but not all, of its non-U.S. jurisdictions instead, so long as no more than 5% of the registrant's total employee population is excluded. However, the registrant may not exclude any employees in a jurisdiction under the *de minimis* exclusion unless all employees in that jurisdiction are excluded.[2] The percentage of a registrant's employees that may be excluded under the *de minimis* exclusion is reduced by the employees excluded under the data privacy exclusion. If the *de minimis* exclusion is used, the registrant will need to disclose (i) the jurisdiction(s) from which employees are being excluded, (ii) the approximate number of employees excluded from each jurisdiction under the *de minimis* exclusion, (iii) the total number of its U.S. and non-U.S. employee irrespective of any exclusion (data privacy or *de minimis*) and (iv) the total number of its U.S. and non-U.S. employees used for its *de minimis* calculation.

Methodology. The final rule does not specify a required methodology for identifying the median employee and no safe harbor methodologies (other than total annual compensation) are provided. Instead, registrants may identify the median employee using any reasonable method given the registrant's individual facts and circumstances. Accordingly, as described below, a registrant need not calculate the total annual compensation for each employee in the way the CEO's total annual compensation is calculated, and may rely instead on any compensation measure that is consistently applied to all employees included in the calculation (*e.g.*, information derived from tax and/or payroll records). In addition, a registrant need not analyze the compensation of its entire employee population, and may rely on statistical sampling or any other reasonable methods to narrow the employee pool from which the median employee is identified. However a registrant chooses to identify the median employee, it must disclose its methodology and the compensation measures used, as well as any changes in the methodology used in the previous year.

Cost-of-Living Adjustment. When identifying the median employee, the final rule permits registrants to make a cost-of-living adjustment to the compensation of employees in jurisdictions other than where the CEO resides. Registrants that choose to make this adjustment must (i) apply it to all employees included in the

[2] For example, if 50% of a registrant's employees are located in China and 50% are located in the U.S., none of the Chinese employees may be excluded under the *de minimis* exclusion. If, however, 48% of such registrant's employees are located in China, 2% are located in Spain and 50% are located in the U.S., the registrant may use the *de minimis* exclusion to exclude all the Spanish employees, but none of the Chinese employees, even though less than 5% of non-U.S. employees are excluded.

calculation, (ii) make the same adjustment when determining the median employee's total annual compensation, as discussed below, (iii) describe the adjustment used to identify the median employee, including the measure used as the basis for the adjustment, and (iv) disclose what the ratio would have been in the absence of the cost-of-living adjustment.

Annualizing Permanent Employee Compensation. Under the final rule, compensation of permanent full-time and part-time employees who were not employed throughout the entirety of the last fiscal year (for example, due to maternity leave, unpaid leave of absence, or recent hiring) may be annualized for purposes of identifying the median employee. Conversely, salaries or wages of temporary or seasonal employees may not be annualized and compensation of part-time employees may not be adjusted to their full time equivalent.

Selection of Median Employee Once Every Three Years. In a marked deviation from the proposed rule, and for the primary purpose of reducing compliance costs, the final rule allows registrants to identify the median employee once every three years (rather than every year), except in cases where there has been a change in the employee population (for example, as a result of M&A activity) or employee compensation arrangements that the registrant reasonably believes would result in a significant change in the pay ratio disclosure. This does not mean that the pay ratio may be presented only once every three years, but rather that the same employee may be used to represent the median compensation for three years before the registrant must conduct the process of selecting the median employee anew.[3] Registrants that choose to use the same median employee must disclose the decision and describe briefly their basis for believing that foregoing a new identification process will not cause a significant change in the pay ratio disclosure.

CALCULATING ANNUAL TOTAL COMPENSATION

Median Employee. Once the median employee has been identified, the median employee's annual total compensation must be calculated in accordance with the same rules used to determine the CEO's total annual compensation for purposes of the Summary Compensation Table. In so doing, registrants are permitted to

[3] If, during the three-year period in which a registrant is permitted to use the same median employee, it no longer makes sense to use the previously selected median employee (for example, due to a promotion, termination or any other significant change in circumstances), registrants are permitted to select a new median employee that was receiving substantially similar compensation to the previous median employee in the year the previous median employee was selected (without having to conduct the costly and lengthy process of determining a new median employee until three years have elapsed since the previous process).

use reasonable estimates for any element of total compensation so long as (i) there is a reasonable basis to conclude that an estimate will approximate the actual compensation received and (ii) any estimates are clearly identified as such. For example, registrants are permitted to estimate the aggregate change in the actuarial present value of the median employee's defined pension benefit because the information needed to arrive at the actual figure may be temporarily or permanently unavailable to the registrant.

Chief Executive Officer. The CEO's total annual compensation is calculated in the same way it is calculated for purposes of the Summary Compensation Table. In situations where more than one individual served as CEO during the registrant's last fiscal year, the final rule provides two alternatives for calculating the CEO's total annual compensation for purposes of presenting the pay ratio. First, the registrant may use the total compensation (as reflected in the Summary Compensation Table) of each person who served as CEO during the last fiscal year and combine those figures. Alternatively, the registrant may use the annualized compensation of the individual who was serving as CEO on the date the median employee was identified.

EXPRESSING THE PAY RATIO

The final "pay ratio" disclosure rule permits registrants to express the pay ratio either as a numerical ratio (*e.g.*, 50 to 1), or in a narrative form (*e.g.*, "the CEO's annual total compensation is 50 times that of the annual total compensation of the median employee"). The SEC explicitly rejected expressing the median employee's total annual compensation as a percentage or fraction of the CEO's annual compensation in order to avoid potential confusion.

While registrants are not required to provide additional ratios, they are permitted to do so as long as any supplementary ratios are not misleading and are not displayed more prominently than the required pay ratio. However, registrants that present the pay ratio using a cost-of-living adjustment, as discussed above, must also disclose the median employee's total annual compensation and pay ratio without the cost-of-living adjustment.

LOCATION OF DISCLOSURE

The final rule requires registrants to include the pay ratio disclosure in any filing that calls for executive compensation disclosure under Item 402 of Regulation S-K, which includes annual reports on Form 10-K, registration statements, and proxy and information statements. For filings made shortly after the end of a registrant's fiscal year, the pay ratio data is not required to be updated until the annual report on Form 10-K or proxy statement for that fiscal

year is filed. The disclosure is not, however, required in IPO registration statements. In addition emerging growth companies, foreign private issuers and U.S.-Canadian Multijurisdictional Disclosure System filers (otherwise known as "MJDS") will not be subject to the rule. The SEC has indicated a preference that the "pay ratio" disclosure be presented in the context of other executive compensation disclosures as opposed to on a stand-alone basis. Accordingly, the disclosure should be made in such a way that it can be read and understood in conjunction with the Summary Compensation Table and the Compensation Discussion and Analysis (commonly referred to as the "CD&A").

TRANSITION

The final rule provides that registrants' first reporting period is for compensation earned during the first full fiscal year beginning on or after January 1, 2017, meaning that the first disclosure under the rule must be made in 2018. Accordingly, registrants are advised to begin making preparations for identifying and calculating the total annual compensation of their median employee starting in the 2016 fiscal year. For newly public companies, and for registrants that lose emerging growth company or foreign private issuer status, disclosure is not required until the report disclosing compensation for the first full fiscal year beginning after the later of January 1, 2017 and the date of an IPO (or loss of status), meaning that such filers have at least a one-year transition period.

While the transition period is at least a year, registrants should immediately begin considering and assessing which median employee identification method will work best within their compensation framework and determining the extent and applicability of foreign data privacy laws.

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Please do not hesitate to contact us with any questions.