SEC Adopts Pay Ratio Disclosure Rule

The Securities and Exchange Commission ("SEC") recently adopted, by a 3-2 vote, a final rule (the "Final Rule") amending Item 402 of Regulation S-K ("Item 402") to require public companies to disclose (A) the median of the annual total compensation of all their employees (excluding the principal executive officer ("PEO")), (B) the annual total compensation of the PEO and (C) the "pay ratio" of (A) to (B).[1] The Final Rule will require this disclosure in any annual report, proxy or information statement or registration statement that requires executive compensation disclosure pursuant to Item 402 for fiscal years beginning on or after January 1, 2017.

The key provisions of the Final Rule are as follows:

- *Methodology for Identifying the Median Employee*. Under the Final Rule, the median annual total compensation of all employees (other than the PEO) is determined using the total annual compensation of the median employee. The Final Rule does not require any particular methodology to identify the median employee. Companies may select a methodology that they deem appropriate to the size and structure of their business and the manner in which they compensate employees, including using statistical sampling and other reasonable estimates. Furthermore, the median employee may be identified using any compensation measure that is consistently applied to all employees included in the calculation, such as information derived from tax and/or payroll records. Unless there is a change in a company's employee population or compensation arrangements that it reasonably believes would result in a significant change to its disclosure, companies are required to identify the median employee only once every three years. If there is a change in the median employee's circumstances that the company reasonably believes would result in a significant change in its disclosure, the company will be permitted to substitute another employee with substantially similar compensation. Finally, companies are permitted to identify the median employee after adjusting the compensation of its employees to the cost of living in the jurisdiction in which the PEO resides.

- *Determining Total Compensation*. Once the median employee has been identified, a company must calculate the median employee's annual total compensation for the last completed fiscal year in accordance with Item 402(c)(2)(x), which is the same rule applicable to the PEO for purposes of reporting compensation in the Summary Compensation Table. Companies are permitted, however, to use reasonable estimates in calculating this amount. Furthermore, companies are permitted to include personal benefits that aggregate less than $10,000 and compensation under non-discriminatory benefit plans in calculating the annual total compensation of the median employee, so long as the items are also included in calculating the PEO's annual total compensation for purposes of the pay ratio disclosure. The company must explain any differences, if material, from the total compensation shown in the Summary Compensation Table. If a company uses a cost-of-living adjustment in identifying the median employee, it must use the same adjustment (if applicable) in calculating the total annual compensation for the median employee.

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[1] Securities and Exchange Commission, Release Nos. 33-9877; 34-75610; File No. S7-07-13, *Pay Ratio Disclosure* (August 5, 2015), *available at* http://www.sec.gov/rules/final/2015/33-9877.pdf. The amendments are reflected as new Item 402(u) of Regulation S-K and Item 25 to Schedule 14A and Item 5.02(f)(2) of Form 8-K. The Final Rule implements Section 953(b) of the Dodd-Frank Wall Street Reform and Consumer Protection Act (the "Dodd-Frank Act").

- *Employees to Include in Identifying the Median*. When calculating the median of the annual total compensation of "all employees" (other than the PEO), companies are generally required to include all full-time, part-time, seasonal, temporary and non-U.S. employees (including named executive officers other than the PEO) that were employed by the company or any of its consolidated subsidiaries, as of a date selected by the company within the last three months of its last completed fiscal year. The Final Rule, however, permits companies to exclude employees located in non-U.S. jurisdictions where data privacy laws prohibit them from obtaining or processing information necessary to otherwise comply with the rule. Furthermore, under a *de minimis* rule, companies may elect to exclude their employees located outside the U.S. if the number of non-U.S. employees is 5% or less of the total number of U.S. and non-U.S. employees, or to exclude the employees located in one or more non-U.S. jurisdictions if the total number of employees in the excluded jurisdictions (together with any employees excluded under the data privacy exemption) is 5% or less of the total number of U.S. and non-U.S. employees. In general, independent contractors, "leased" workers or other temporary workers employed by a third party are not included in the employees used to identify the median employee.[2] Subject to certain requirements, under the Final Rule, companies may exclude employees who became employees as a result of a business combination or acquisition that became effective during the last completed fiscal year.

- *Disclosure and Application of Methodology, Assumptions and Estimates*. The Final Rule requires companies to briefly disclose the methodology and any material assumptions, adjustments or estimates used to identify the median employee, and any material assumptions, adjustments or estimates used to determine total compensation or any elements of total compensation (which shall be consistently applied). Companies are also required to clearly identify any estimates used.[3] In addition, if a company changes methodology or material assumptions, adjustments or estimates from those used in the previous year, and if the effects of any such change are significant, the company is required to briefly describe the change and the reasons for the change. The Final Rule also allows, but does not require, companies to supplement the required disclosure with a narrative discussion or additional ratios. Additional information must be clearly identified, not misleading, and not presented with greater prominence than the required ratio. Certain other disclosures also may be required depending on the particular exclusions or special rules that are applied under the Final Rule. For example, the following may be required:

    - If companies exclude non-U.S. employees due to data privacy requirements, they must disclose the jurisdictions in which employees were excluded with the approximate number of employees, identifying the specific data privacy laws and explaining how complying with the Final Rule would violate the requirements of the laws. The disclosure must also explain the efforts made to use or seek an exemption or other relief under the laws and the company must attach as an exhibit to the filing that includes the disclosure a legal opinion as to the inability of the company to obtain or to process information necessary for compliance with the Final Rule or to obtain exemptive relief. If companies exclude non-U.S. employees under the *de minimis* exclusion, they must disclose the jurisdictions in which the employees were

[2] Companies are permitted, but not required, to annualize the total compensation for permanent employees who did not work for the entire year (*e.g.*, new hires). Companies are not, however, permitted to include full-time equivalent adjustments for part-time workers or annualizing adjustments for temporary and seasonal employees.

[3] While the Final Rules do not mandate the specific placement for this disclosure in companies' proxy statements and other filings, companies' pay ratio disclosure, like other executive compensation disclosure under Item 402 of Regulation S-K, is subject to the shareholder advisory (i.e., "say on pay") vote under Section 951 of the Dodd-Frank Act.

excluded with the approximate number of employees, together with specified information about the total numbers of U.S. and non-U.S. employees.

▪ If companies determine their median annual total compensation based on compensation of the median employee identified for the year preceding, or next preceding, the last fiscal year (*i.e.,* rather than reidentifying the median employee for the last completed fiscal year), they must disclose that the median employee used for the disclosure was identified for a prior year and must describe briefly the basis for the companies' reasonable belief that there has been no change in their employee population or compensation in the last fiscal year that they believe would significantly affect their disclosure.

▪ If companies use a cost-of-living adjustment in identifying their median employee, and if the adjustment was actually applied to the compensation for the median employee (*i.e.*, because the median employee identified resides in a different jurisdiction than the PEO), the companies must disclose the median employee's jurisdiction, must briefly describe the cost-of-living adjustments used to identify the median employee and calculate its total annual compensation (including the measure used as the basis for the adjustment), and must disclose the median annual total compensation and the pay ratio determined without any adjustment based on the annual total compensation for the median employee that would have been identified with no adjustment applied.

- *Companies Subject to the Rule*. The Final Rule applies only to companies that are required to provide Summary Compensation Table disclosure pursuant to Item 402(c). The Final Rule does not apply to emerging growth companies, smaller reporting companies, foreign private issuers and MJDS filers.[4]

- *Compliance Dates*. Companies that are subject to the Final Rule must provide the relevant disclosures for their first fiscal year commencing on or after January 1, 2017. For example, calendar year registrants will first be required to include the new disclosures in their annual report or proxy or information statement filed in 2018 with respect to the 2017 fiscal year.[5]

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If you have any questions about the issues addressed in this memorandum or if you would like a copy of any of the materials mentioned, please do not hesitate to call or email Charles A. Gilman at 212.701.3403 or cgilman@cahill.com Jon Mark at 212.701.3100 or jmark@cahill.com; John Schuster at 212.701.3323 or jschuster@cahill.com; Glenn Waldrip at 212.701.3110 or gwaldrip@cahill.com; or Mark Gelman at 212.701.3061 or mgelman@cahill.com.

[4] The term "MJDS filers" refers to registrants that file reports and registration statements with the SEC in accordance with the requirements of the U.S.-Canadian Multijurisdictional Disclosure System.

[5] In the case of a newly public company, initial compliance may be delayed, if later, until the filings made with respect to the first fiscal year following the year that the company becomes subject to the reporting requirements of Section 13(a) or Section 15(d) of the Securities Exchange Act of 1934. In the case of companies that cease to be smaller reporting companies or emerging growth companies, they must include the disclosure in filings with respect to the first fiscal year commencing on or after the date they cease to be smaller reporting or emerging growth companies, but not prior to the 2017 fiscal year.

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