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SEC Adopts Final Rule for CEO Pay-Ratio Disclosures under Dodd-Frank

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The U.S. Securities and Exchange Commission (the "SEC") recently adopted a final rule (the "Final Rule") to implement Section 953(b) of the Dodd-Frank Wall Street Reform and Consumer Protection Act ("Dodd-Frank") with respect to chief executive officer pay-ratio disclosures. Under the Final Rule, a public company must disclose the ratio of the annual total compensation of its chief executive officer to the median of the annual total compensation for all of that company's other employees.

The Final Rule is contained in Release No. 33-9877 available here.

Pay Ratio Disclosure Required

The Final Rule amends Item 402 – "*Executive Compensation*" of Regulation S-K by adding a new paragraph (u) to Item 402, which, consistent with Section 953(b) of Dodd-Frank, requires registrants to calculate and disclose on an annual basis:

- The median of the annual total compensation of all employees of the registrant (excluding the principal executive officer, or "PEO");
- The annual total compensation of the registrant's PEO; and
- The ratio between these two amounts.

This pay ratio disclosure requirement applies to publicly-traded companies ("registrants") that are required to provide executive compensation disclosure under Item 402 of Regulation S-K. Thus, pay ratio disclosures must be included in any proxy statement that contains Item 402 executive compensation disclosures (such as for an annual meeting of shareholders), or in the registrant's annual report (*e.g.*, Form 10-K) filed under the Securities Exchange Act of 1934 (the "Exchange Act"). In any case, pay ratio disclosure will have to be filed with the SEC, subject to certain exceptions, not later than 120 days after the end of the registrant's fiscal year. Pay ratio disclosure will also be required for new registrants that file an initial public offering under the Securities Act of 1933 (the "1933 Act"), as further discussed below.

However, the pay-ratio disclosure requirements will not apply to the following entities:

- Smaller reporting companies, as defined in Item 10(f) of Regulation S-K;
- Foreign private issuers, as defined in Exchange Act Section 3(b)-4(c);
- Multijurisdictional Disclosure System registrants;
- Emerging growth companies, as defined in Section 3(a)(80) of the Exchange Act; and
- Registered investment companies under the Investment Company Act of 1940.

Effective Date and Transition Periods

The Final Rule provides that the first reporting period for current registrants will be their first full fiscal year beginning on or after January 1, 2017. This means that for most current calendar year registrants, pay ratio disclosures will not have to be provided until their proxy statements are filed with respect to their 2018 annual meeting of shareholders.

For registrants filing an initial public offering on a registration statement under the 1933 Act on Form S-1 or Form S-11 or a registration statement under the Exchange Act on Form 10, the Final Rule provides that the first pay ratio disclosure reporting period for these "new" registrants will be their first fiscal year commencing on or after January 1, 2017 that is after the date they first become subject to the periodic reporting requirements of Sections 13(a) or 15(d) of the Exchange Act.

Identifying Total Employee Count and the "Median Employee"

A key issue is how the median annual total compensation of all employees should be determined for the purpose of identifying the "median employee."

***"Employees" and Independent Contractors*.** Under the Final Rule, a registrant must collect compensation data for all of its U.S. and non-U.S. employees for purposes of calculating its median total annual compensation. The terms "employee" and "employee of the registrant" are defined to mean all full-time, part-time, seasonal or temporary U.S. and non-U.S. workers employed by the registrant (which by definition includes any of its consolidated subsidiaries) as of a date chosen by the registrant within the last three months of the fiscal year. Thus, employees of joint ventures or other entities in which the registrant owns equity interests, but whose results of operations are not consolidated with those of the registrant for financial accounting purposes, are not included when determining workforce totals.

The definition of "employee" under Regulation S-K Item 402(u)(3) also does not include "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."

Important here is the term "independent contractor" in determining the median employee under the Final Rule. Questions have arisen since the Final Rule's adoption as to whether *self-employed* consultants or similar individuals fitting the more traditional definition of independent contractors are excluded from the population of "total employees" for purposes of Item 402(u), since their compensation is most likely not determined by unaffiliated third parties. Hopefully, an SEC clarification on this point will be forthcoming, particularly given the varying definitions of "independent contractor" applied in recent years by state and federal tax and employment law regulators in terms of their jurisdictional ambits.

Non-U.S. Employees. The Final Rule includes two potential exceptions for registrants from the requirement to include all non-U.S. employees in the total employee population for purposes of determining the median:

1. A registrant will be permitted to exclude workers in any jurisdiction having data privacy regulations under certain circumstances.
    - This exception requires the registrant to make reasonable efforts to obtain or process the requisite information, and to demonstrate its inability to do so without violating those regulations. "Reasonable efforts" must include, at a minimum, relying upon or seeking an exemption or other relief under the applicable data privacy regulations of the subject jurisdiction.
    - Another condition for this exemption is that the registrant must list in its filing all excluded jurisdictions, identify the specific data privacy regulation, explain how complying with the Final Rule would violate the data privacy regulations (including any efforts made by the registrant to use or seek an exemption or other relief) and disclose the approximate number of employees not included.

- In addition, the registrant must obtain an opinion of legal counsel as to the registrant's inability to obtain or process the requisite information required by the Final Rule without violating the subject jurisdiction's data privacy regulations, and file the legal opinion as an exhibit to its filing.

2. A registrant may also exclude all non-U.S. employees if the number of non-U.S. employees does not exceed 5 percent of the number of its total global employees. If the number of the registrant's non-U.S. employees exceeds 5 percent of the registrant's total U.S. and non-U.S. employees, then it may exclude up to 5 percent of its total employees who are non-U.S. employees. However, if any non-U.S. employees in a particular jurisdiction are excluded, the registrant must then exclude all employees in that jurisdiction.

Employees acquired in a business combination. Employees joining a registrant's workforce during a fiscal year as a result of a business combination or acquisition may be excluded with respect to the fiscal year in which the transaction is effective, although the registrant must then identify the acquired business and disclose the approximate number of employees it is omitting.

Frequency of median employee determination. The Final Rule permits registrants to make the determination of its median employee once every three years.

Thus, once a registrant determines its median employee, it can continue to use that person as the median employee for two more years, unless there is a change in the registrant's employee population or employee compensation arrangements that would result in a significant change in the pay ratio disclosure. If there has been such a change in any fiscal year during the three-year period, the registrant must re-identify the median employee with respect to that fiscal year. If the median employee identified in year one is, as of the determination date in year two or three, no longer in the same position or no longer employed by the registrant, the Final Rule permits the registrant to replace its median employee with an employee having a compensated position similar to that of the departing employee.

Use of reasonable methods in determining the median employee. In determining the employees from which the median employee is to be identified, a registrant "may use its employee population or statistical sampling and/or other reasonable methods."

Determining Annual Total Compensation

Consistently applied compensation measures in determining the median employee. When identifying the median employee for pay-ratio disclosure purposes, registrants are not required to calculate total compensation for every employee in the same manner as required for the PEO or named executive officers in the Summary Compensation Table pursuant to Item 402(c)(2)(x) of Regulation S-K. Instead, a registrant may choose a method suited to its own circumstances. The median employee may be identified using annual total compensation or any other compensation measure that is consistently applied to all employees included in the calculation, including information derived from a registrant's payroll or tax records, so long as the registrant discloses the compensation measure used. It is likely that registrants will also describe why a particular compensation measure was chosen.

In addition, registrants are permitted to use the same annual period used for purposes of their payroll or tax records in identifying the median employee.

"Reasonable estimates" may be employed by the registrant, both in the methodology it applies to determine the median employee and in calculating the annual total compensation or any elements thereof for its employees other than the PEO.

Methodology employed to identify the median. Registrants are required to describe in a brief overview any methodology used to identify the median employee, and any material assumptions, adjustments or estimates used to identify the median employee or to determine annual total compensation or any elements thereof.

Technical analyses or formulas are not required to be provided. This brief description should describe the methodology employed as well as any such material assumptions, adjustments or reasonable estimates utilized, which must be consistently applied. Permitted adjustments for these purposes include a cost-of-living adjustment (COLA).

Registrants must also disclose any change in methodology or in any significant assumptions, adjustments or estimates from the prior year's methodology, assumptions, adjustments or estimates used, if the effects of any such change are significant. The reasons for this change must be disclosed as well.

Cost-of-living adjustments. A COLA may be applied when identifying the median employee and calculating the median employee's compensation. All compensation for the sample used to determine the median employee will have to be adjusted, country by country, in order that it is made equivalent to that for the jurisdiction where the PEO resides.

However, in this event, the registrant must also disclose the median employee's annual total compensation and the pay ratio without the COLA applied. Therefore, registrants applying a COLA must perform two separate calculations for the median employee – a COLA-adjusted pay ratio and an unadjusted pay ratio.

Registrants having a significant number of non-U.S. employees in their workforce are the most likely candidates to use a cost-of-living adjustment to identify their median employee. Additionally, a registrant must disclose whether it changed from using the COLA applied in the prior year to not using that COLA for the subject year, as well as if it changed from not using a COLA adjustment in the prior year to using one for the current year.

Estimates. The Final Rule requires a registrant to clearly identify any estimates it uses and provides an example of this type of identification: In the case of registrants using statistical sampling, "registrants must describe the size of both the sample and the estimated whole population, any material assumptions used in determining the sample size and the sampling method (or methods) … used." While the descriptions required must provide sufficient information for readers to evaluate the appropriateness of the methodologies used, registrants are not required to include any technical analyses, formulas, confidence levels or steps used in data analysis.

Annualizing information. In their calculations, registrants will be permitted to annualize the total compensation for a permanent employee who did not work for the entire year, such as a new hire. However, full-time equivalent adjustments for part-time workers and annualizing adjustments for temporary and seasonal workers are not permitted.

Determining Annual Total Compensation of Median Employee and Pay Ratio Disclosure

Once the median employee is identified – no personal identifiable information about the median employee need be disclosed – the next step is to determine the median employee's annual total compensation. The Final Rule defines "annual total compensation" to mean total compensation for the last completed fiscal year calculated for the median employee (after he or she is determined) in accordance with Item 402(c)(2)(x) of Regulation S-K in the same manner as it is calculated for the PEO. The resulting amount should then be disclosed as part of the pay-ratio disclosure.

Filing Requirements

Controversially, the Final Rule provides that the information will be treated as "filed" rather than "furnished" for purposes of the Exchange Act and the 1933 Act, and, accordingly, will be subject to potential liabilities thereunder, including under Section 18 of the Exchange Act.

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What You Should Do Now

While 2017 is more than a year away:

- It may be helpful for many multinational companies to begin assessing their workforces and determining ways of formulating pay-ratio disclosures – particularly, in determining their annual total compensation of all employees – that meet the requirements of the Final Rule. For companies without the internal resources to do so, it might be wise to begin contacting executive compensation consulting firms about whether they are reviewing procedures to assess workforce and total compensation under the Final Rule. The flexibility afforded to registrants under Item 402(u) in selecting methodologies, using reasonable estimates, picking testing dates and applying COLAs, among other features, means that their pay-ratio disclosures can be tailored to their own facts and circumstances. Perhaps valuable insights can be gained even at this early stage from those familiar with the registrant's workforce in order to devise cost- and time-efficient formulations to determine the elements of proposed pay-ratio disclosures.
- As noted above, questions have been raised about whether certain independent contractors can be excluded from the total "employee" population. Resolving these questions may prove more complicated than it may first appear, since the black lines that previously distinguished "independent contractors" from "employees" are being erased in many areas – income tax and employment laws in particular. Hopefully, SEC guidance such as Compliance & Disclosure Interpretations will be provided soon to clarify some of these issues.

If you have any questions about this topic, please contact a member of our Capital Markets and Securities Practice Group.

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