Final SEC Rules on CEO Pay Ratio Disclosure

Updated from October 2015 Issue Summary

May 2017

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Provisions

Pay Ratio Disclosure Requirement
As required by the Dodd-Frank Wall Street Reform and Consumer Protection Act of 2010, the final rule would amend existing executive compensation disclosure rules to require companies 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 those two amounts.

Definition of “Employee”
The final rule defines “employee” to include a registrant’s U.S. and non-U.S. employees, as well as its part-time, seasonal, and temporary employees. Workers not employed by a registrant (or its subsidiaries), however, such as independent contractors, “leased” workers, or other workers who are employed by a third party, were not covered by the SEC’s proposed definition of “employee.”

A registrant can supplement its pay ratio disclosure or provide additional pay ratios for its shareholders to consider if it wants to explain the effect of including part-time, seasonal and temporary employees on its pay ratio disclosure.

Methodology for Identifying the Median Employee
To identify the median employee, the final rule allows companies to select a methodology based on their own facts and circumstances. A company could use its total employee population or a statistical sampling of that population and/or other reasonable

April 2017 Update:

To help companies comply with the rule, the SEC issued further guidance on Oct. 18, 2016 for companies on the CEO pay ratio rule via five new Compliance & Disclosure Interpretations (C&DIs). The questions addressed by the SEC guidance focus on:

- How to select a different consistently applied compensation measure (CACM) if annual total compensation isn’t used to identify the median employee
- Whether registrants can exclusively use hourly or annual rates of pay as its CACM
- What time period a registrant may choose if they use a CACM to identify the median employee rather than annual total compensation
- Whether registrants must include furloughed employees in the employee population that’s used to identify the median employee
- How to determine whether a worker is considered an “employee” of a registrant rather than an independent contractor or leased worker

On Feb. 6, 2017, Securities & Exchange Commission (SEC) Acting Chairman Michael Piwowar asked for additional comments on the agency’s CEO pay ratio rule reflecting the continuing controversy over its elevated compliance costs and few benefits. The new acting chairman also asked SEC staff to reconsider the rule’s implementation and discover if additional guidance or relief is needed for companies.

WorldatWork submitted our additional comments and concerns on Mar. 21. The U.S. Treasury Dept. is also scheduled to deliver a report by June 2017 outlining what they believe is and what is not working with the regulation.
methods. A company could, for example, identify the median of its population or sample using:

- Annual total compensation as determined under existing executive compensation rules
- Any consistently-applied compensation measure from compensation amounts reported in its payroll or tax records.

A company could apply a cost-of-living adjustment to the compensation measure used to identify the median employee. If a company applies this adjustment, it would need to use the same cost-of-living adjustment in calculating the median employee's annual total compensation. To provide context for this adjustment, a company electing to present the pay ratio in this manner must also disclose the median employee's annual total compensation and the pay ratio without the cost-of-living adjustment.

Identifying the Median Employee Once Every Three Years

The final rule allows registrants to identify the median employee every three years unless there has been a change in its employee population or employee compensation arrangements that the registrant reasonably believes would result in a significant change in the pay ratio disclosure. However, the registrant must still calculate the identified median employee's annual total compensation and use that figure in calculating its pay ratio every year.

If there have been no changes that the registrant reasonably believes would significantly affect its pay ratio disclosure, the registrant must disclose that it is using the same median employee in its pay ratio calculation and describe briefly the basis for its reasonable belief. For example, the registrant could disclose that there has been no change in its employee population or employee compensation arrangements that it believes would significantly impact the pay ratio disclosure. If there has been such a change, the registrant must re-identify the median employee for that fiscal year. Also, within those three years, if the median employee's compensation changes, the company may use another employee with substantially similar compensation as its median employee.

Under the final rule's approach, the registrant will identify its median employee for year one and then be permitted to use that employee or one who is similarly compensated (if, for example, the median employee is no longer in the same position or is no longer employed by the registrant) in the following two years for calculating the median employee's annual total compensation and the registrant's pay ratio. The registrant must calculate the median employee's annual total compensation in year one and then re-calculate the annual total compensation for that employee in year two and again in year three.

If the median employee identified in year one is no longer in the same position or no longer employed by the registrant on the median employee determination date in year two or three, the final rule permits the registrant to replace its median employee with an employee in a similarly compensated position.

Determination of Total Compensation

A company would be required to calculate the annual total compensation for its median employee using the same rules that apply to the CEO's compensation. “Annual total compensation” means total compensation for the last completed fiscal year, calculated using the definition of “total compensation” in existing executive compensation rules, namely Item 402(c)(2)(x) of Regulation S-K. The rule would allow companies to use reasonable estimates when calculating any elements of the annual total compensation.

The pay ratio disclosure will provide shareholders with additional company-specific information that they can use when considering a company's executive compensation practices, an important area of corporate governance on which shareholders now have an advisory vote. A number of commenters noted that the pay ratio disclosure will be important to them as they exercise their say-on-pay votes.

— SEC Chair Mary Jo White

during the Aug. 5, 2015, vote approving the final rulemaking

April 2017 Update (continued):

While it is possible the CEO pay ratio rule will either be repealed, amended or delayed by the Trump Administration, companies should still be spending some time preparing for the rule. Any significant changes to the pay ratio rule or the Dodd-Frank Act itself will require an act of Congress, which typically takes some time to enact.
Disclosure Reporting Requirements
The final rule requires registrants to disclose the ratio such that the CEO’s annual total compensation is always compared to the median employee’s annual total compensation. The final ratio must always show how much larger or smaller the CEO’s annual total compensation is as compared to the median employee’s annual total compensation.

The final rule permits registrants to choose one of two options to express the ratio. Registrants may disclose the pay ratio with the median of the annual total compensation of all employees equal to one and the CEO’s compensation as the number compared to one. For example, if a registrant’s median annual total compensation for employees is $50,000 and the annual total compensation of the CEO is $2,500,000, the CEO’s compensation is 50 times larger than the median employee’s compensation. The registrant may describe the pay ratio as 50 to 1 or 50:1.

Alternatively, registrants may disclose the pay ratio narratively by stating how many times higher (or lower) the CEO’s annual total compensation is than that of the median employee. For example, the registrant may state that “the CEO’s annual total compensation is 50 times that of the median of the annual total compensation of all employees.”

The proposed rule would define “employee” as an individual employed as of the last day of the registrant’s last completed fiscal year because this calculation date would be consistent with the one used for the determination of the three most highly compensated executive officers under existing Item 402(a)(3)(iii).

Companies would not be required to:
- Disclose the pay ratio information in reports that do not require executive compensation information, such as current and quarterly reports.
- Update their disclosure for the most recently completed fiscal year until the company files its proxy or information statement for its annual meeting of shareholders (or annual report for companies that do not file proxy or information statements for annual meetings), but not later than 120 days after the end of the fiscal year.

Excluded Registrants
The final rule does not require pay ratio disclosure by smaller reporting companies, foreign private issuers, MJDS filers, and emerging growth companies. Congress explicitly excluded emerging growth companies from the pay ratio disclosure requirement. Regarding smaller reporting companies, Section 953(b)(2) requires total compensation to be calculated in accordance with Item 402(c)(2)(x).

Employees Employed on Any Date within 3 Months of the Last Completed Fiscal Year
The proposed rule would define “employee” as an individual employed as of the last day of the registrant’s last completed fiscal year because this calculation date would be consistent with the one used for the determination of the three most highly compensated executive officers under existing Item 402(a)(3)(iii).

The final rule permits registrants to use any date within three months prior to the last day of their last completed fiscal year to identify the median employee. If in subsequent years the registrant changes the date it uses to identify the median employee, it must disclose this change and provide a brief explanation about the reason or reasons for the change. This provision provides consistency for individual registrants from year to year while also providing registrants with flexibility to choose the determination date.

To provide additional transparency about how the pay ratio disclosure has been calculated, the final rule requires registrants to disclose the date used to identify the median employee.

Non-U.S. Employee Exemptions and Additional Permitted Disclosure
The final rule defines “employee” to include a registrant’s U.S. and non-U.S. employees, as well as its part-time, seasonal, and temporary employees. To help address concerns about compliance costs, the final rule provides two exemptions from the definition of “employee”:

1. The final rule provides an exemption for circumstances in which foreign data privacy laws or regulations make registrants unable to comply with the final rule.

2. The final rule permits registrants to exempt non-U.S. employees where these employees account for 5 percent or less of the registrant’s total U.S. and non-U.S. employees, with certain limitations.

Data Privacy Exemption
The final rule permits registrants to exclude from their determination of the median employee an employee who is employed in a foreign jurisdiction in which the laws or regulations governing data privacy are such that, despite its reasonable efforts to obtain or process the information necessary for compliance with
the final rule, the registrant is unable to do so without violating such data privacy laws or regulations.

If a registrant excludes any non-U.S. employees in a particular jurisdiction under this exemption, it must exclude all non-U.S. employees in that jurisdiction, list the excluded jurisdictions, identify the specific data privacy law or regulation, explain how complying with the final rule violates such data privacy law or regulation (including the efforts made by the registrant to use or seek an exemption or other relief under such law or regulation), and provide the approximate number of employees exempted from each jurisdiction based on this exemption. In addition, the registrant must obtain a legal opinion from counsel that opines on the inability of the registrant to obtain or process the information necessary for compliance with the final rule without violating that jurisdiction's data privacy laws or regulations, including the registrant's inability to obtain an exemption or other relief under any governing laws or provisions.

5% De Minimus Exemption
Under the final rule, if a registrant’s non-U.S. employees account for 5 percent or less of its total employees, it may exclude all of those employees when making its pay ratio calculations. In this circumstance, however, if the registrant chooses to exclude any non-U.S. employees, it must exclude all of them. If a registrant's non-U.S. employees exceed 5 percent of the registrant's total U.S. and non-U.S. employees, it may exclude up to 5 percent of its total employees who are non-U.S. employees. If a registrant excludes any non-U.S. employees in a particular jurisdiction, it must exclude all non-U.S. employees in that jurisdiction. The registrant must also disclose the jurisdictions from which its non-U.S. employees are being excluded, the approximate number of employees excluded from each jurisdiction under the de minimis exemption, the total number of its U.S. and non-U.S. employees irrespective of any exemption (de minimis or data privacy), and the total number of its U.S. and non-U.S. employees used for its de minimis calculation.

Cost of Living Adjustment
The final rule permits registrants to make cost-of-living adjustments for the compensation of employees in jurisdictions other than the jurisdiction in which the CEO resides to identify the median and calculate annual total compensation.

If the registrant uses a cost-of-living adjustment to identify the median employee, and the median employee identified is an employee who does not reside in the same jurisdiction as the CEO, the registrant must use the same cost-of-living adjustment in calculating the median employee’s annual total compensation and disclose the country in which the median employee is located. The registrant is also required to briefly describe the cost-of-living adjustments it used to identify the median employee and briefly describe the cost-of-living adjustments it used to calculate the median employee’s annual total compensation, including the measure used as the basis for the cost-of-living adjustment.

To provide context for the Item 402(u)(1)(iii) disclosure, a registrant electing to present the pay ratio in this manner must also disclose the median employee’s annual total compensation and pay ratio without the cost-of-living adjustments.

Employees of Consolidate Subsidiaries
The final rule requires a registrant’s pay ratio disclosure to include the employees of any of its subsidiaries (including officers other than the CEO), in addition to its direct employees, in its pay ratio disclosure.

Initial Compliance Date
Registrants must comply with the final rule for the first fiscal year beginning on or after Jan. 1, 2017.
Under the final rule, the registrant's initial pay ratio disclosure would be included in its first annual report on Form 10-K or proxy or information statement for its annual meeting of shareholders following the end of the first fiscal year on or after Jan. 1, 2017.

Transition Period for New Registrants
The proposed rule would not have required pay ratio disclosure by new registrants subject to the rule in a registration statement on Form S-1 or Form S-11 for an initial public offering or registration statement on Form 10. Consistent with the revised transition period for existing registrants, the final rule provides that the first pay ratio reporting period begins for new registrants with their first fiscal year commencing on or after Jan. 1, 2017 that is after the date they first become subject to the requirements of Section 13(a) or 15(d) of the Exchange Act. In this way, new registrants will not become subject to the final rule sooner than existing registrants.

Such registrants are also permitted to omit their initial pay ratio disclosure from their registration statements (or any other filing) made before their first annual report or proxy or information statement following the end of that reporting period, but not later than 120 days after the end of the fiscal year.

Additional Transition Periods
The final rule provides that registrants that cease to be smaller reporting companies or emerging growth companies are not required to provide pay ratio disclosure until they file a report for the first fiscal year commencing on or after they cease to be a smaller reporting company or emerging growth company. The final rule also permits registrants that engage in business combinations and/or acquisitions to omit the employees of a newly-acquired entity from their pay ratio calculation for the fiscal year in which the business combination or acquisition occurs.

In these cases, a registrant does not have to include these individual employees in its median employee calculation until the first full fiscal year following the acquisition. Registrants that exclude employees as a result of a business combination must disclose the relevant acquired business and the approximate number of employees that are excluded from the pay ratio calculation.

Practitioner Impact
The SEC’s final CEO pay ratio rule gives companies more flexibility than the original 2013 proposed rule did, potentially lessening the compliance burden and expense. And for most companies the pay ratio won’t appear until the 2018 proxy statement (for the fiscal year ending in 2017).

However, compliance may take significant time, be expensive and be quite complex. Practitioners should consider these early action steps necessary to comply with the rule, which may include the following:

1 | Become familiar with the rules. Stay informed on discussions about the regulations and approaches being taken by others regarding identifying the median employee.
2 | Brief your board of directors and/or compensation committee.
3 | Assemble a team (e.g., HR, compensation, legal, finance, payroll, IT, etc.) and put together a compliance plan.
4 | Review HRIS, payroll and accounting systems to ascertain how you can collect data. Companies with employees outside the U.S. need to identify and consider non-U.S. data privacy laws.
5 | Collect data and analyze employee populations so you can determine the appropriate method to identify the median employee and calculate the ratio.
6 | Identify and test possible methodologies.
7 | Evaluate possible testing dates and determine which one you will use.
8 | Prepare a preliminary estimate and draft a mock-up disclosure.
9 | Develop a communications strategy that includes various stakeholders (e.g., investors, board/compensation committee, employees, unions, proxy advisors, public, media, activists, etc.).

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