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Skadden

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SEC Adopts CEO Pay Ratio Disclosure Requirements

On August 5, 2015, in a 3-2 vote, the U.S. Securities and Exchange Commission (SEC) adopted final rules implementing the controversial "CEO pay ratio" disclosure requirements that were proposed in 2013 and mandated by Congress pursuant to Section 953(b) of the Dodd-Frank Act. Despite much public debate and significant negative feedback on the proposed rules, the SEC adopted final requirements that are generally consistent with its initial proposal and largely without compromise on what were perceived as the most controversial issues. Some of the more notable changes to the proposed rules are:

- Companies are required to provide the new pay ratio disclosures for the first fiscal year commencing on or after January 1, 2017. As a result, companies with a fiscal year ending December 31, 2017, will need to disclose the pay ratio information (based on 2017 compensation) in their proxy or information statements for their 2018 shareholder meetings.
- Pay ratio disclosure is required annually, but the median employee calculation only needs to be performed once every three years, unless there is a change in employee population or employee compensation arrangements that could significantly skew the pay ratio. Companies also may select any date within the last three months of their last completed fiscal year to determine their employee population for purposes of identifying the median employee.
- Certain non-U.S. employees may be excluded pursuant to a foreign data privacy law exemption and/or a 5 percent *de minimis* exemption; reliance on either exemption requires additional disclosure.
- Compensation of employees may be adjusted to the cost of living in the jurisdiction where the CEO resides.

Other key terms of the new rules are outlined below.

Pay Ratio Disclosure Requirement. The SEC amended its existing executive compensation disclosure rules to require companies to disclose:

- the median annual total compensation of all employees of the company, except the CEO;
- the annual total compensation of the CEO; and
- the ratio of those two amounts.

The final rules require the pay ratio to be disclosed either as a ratio (*e.g.*, 50:1 or 50 to 1) or narratively in terms of the multiple (*e.g.*, "the CEO's total compensation amount is 50 times that of the median of the annual total compensation of all employees"). These disclosures must be included in any filing that requires executive compensation disclosure, including annual reports, proxy and information statements, and registration statements that otherwise require such disclosure.

In addition to disclosing the pay ratio, companies will be required to briefly describe the methodology used to identify the median employee, as well as any material assumptions, adjustments (including cost-of-living adjustments) or estimates used to determine the median employee or annual total compensation. A company that chooses to use a consistently applied compensation measure must briefly describe the measure chosen. Companies also may supplement the required disclosure with additional discussion or ratios, as long as they are clearly identified, not misleading and not presented with greater prominence than the required pay ratio.

Exempted Companies. Emerging growth companies, smaller reporting companies and foreign private issuers are exempt from the pay ratio disclosure requirements. The final rules also provide transition periods for private companies that go public and companies engaging in business combinations or acquisitions.

Employees Included in the Identification of the Median. The final rules require the pay ratio to be determined based on the annual total compensation of "all employees" other than the CEO. "Employee" is defined as an individual employed by the company or any of its consolidated subsidiaries as of a specified date, including U.S. and non-U.S. full-time, part-time, temporary and seasonal workers and officers (other than the CEO). Companies may calculate the ratio using the median employee based on any date within the last three months of its last completed fiscal year.

Unlike the proposed rules, the final rules permit companies to exclude certain "non-U.S. employees" from the employee population under limited circumstances. Employees that may be excluded include:

- non-U.S. employees in jurisdictions with data privacy laws that would make it illegal to comply with the pay ratio rule. However, companies that exclude such employees are required to obtain a legal opinion and disclose the circumstances of the reliance on the exemption; and
- non-U.S. employees up to 5 percent of all company employees (including those excluded under the data privacy law exemption). If a company excludes any non-U.S. employee in a specific jurisdiction, it must exclude all non-U.S. employees in that jurisdiction.

Identifying the Median Employee. Consistent with the proposed rules, the final rules permit companies to use a methodology to identify the median based on their own facts and circumstances. For instance, a company could use its total employee population or a statistical sampling of that population and/or other reasonable methods. The final rules also provide additional flexibility through the following:

- Companies may apply cost-of-living adjustments to the compensation measure used to identify the median employee. If applied, the company would need to use the same cost-of-living adjustment in calculating the median employee's annual total compensation, as well as disclose the median employee's annual total compensation and the pay ratio without the cost-of-living adjustment. Such adjustments are for cost of living in the jurisdiction where the CEO resides.
- A company is permitted to perform the median employee calculation once every three years, unless it reasonably believes that a change in its employee population or compensation arrangements would result in a significant change to its pay ratio disclosure. Also, if the median employee's compensation changes within those three years, the company may use another employee with substantially similar compensation as its median employee.

Determining Annual "Total Compensation." Once a company identifies the employee with the median compensation, the company will be required to calculate that employee's total compensation in accordance with the SEC's executive compensation disclosure rules (Item 402 of Regulation S-K) and disclose that amount as part of the pay ratio disclosure. The SEC provided the following guidelines on the determination of annual total compensation:

- Reasonable estimates may be used in determining any elements of the employee's total compensation.
- "Annual" total compensation means total compensation for the company's last completed fiscal year (consistent with the time period used for the company's other executive compensation disclosure requirements).
- Companies may annualize total compensation for a permanent employee who did not work for the entire fiscal year. However, the final rules prohibit full-time equivalent adjustments for part-time workers and annualizing adjustments for temporary and seasonal workers in calculating the required pay ratio.
- Amounts relating to a government-mandated pension plan generally would not be included in the employee's total compensation.
- Although not required as a component in executive compensation disclosure, companies are permitted to include in the employee's annual total compensation perquisites that aggregate less than $10,000 and/or compensation under nondiscriminatory benefit plans. Including those amounts may lower the ratio. Companies that adopt this approach would be required to

use the same approach in determining the CEO's total compensation for pay ratio purposes and also explain any difference between the CEO's total compensation for pay ratio purposes and the total compensation amount reflected in the summary compensation table. The standard executive compensation rules will apply in valuing any perquisites, such that the perquisite value will be based on the aggregate incremental cost to the company.

We expect that many companies will find compliance with the final rules cumbersome, difficult and time-consuming. While disclosure will not be required for more than two years, we strongly urge companies to focus on the requirements of these new rules now and to consult us on steps they might take to mitigate the burden of compliance.

A copy of the adopting release, including the final rules, is available here. For additional information on the final rules, see the SEC's press release.

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