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SEC Finalizes "Flexible" Pay Ratio Disclosure Rules Under the Dodd-Frank Act: Companies Have Choices to Make

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Introduction

On August 5, 2015, the Securities and Exchange Commission (the "SEC") adopted Item 402(u) of Regulation S-K—the pay ratio disclosure rules (the "Final Rules")[1], which require U.S.-based public companies to disclose the relative gap in pay between their chief executive officers and the median for all other employees. The Final Rules implement Section 953(b) of the Dodd-Frank Wall Street Reform and Consumer Protection Act (2010) and arrived nearly two years after the proposed rules were released and five years after the adoption of Dodd-Frank, in what may be one of its most contentious provisions. Some commentators claim that this disclosure "is designed to 'shame' American businesses in order to placate certain special interest constituencies"[2] and imposes a significant administrative and financial burden on public companies without providing meaningful information to stockholders as they make their say-on-pay voting decisions.

In the announcing release of the Final Rules, SEC Chair Mary Jo White observed generally that, "The rule provides companies with substantial flexibility in determining the pay ratio." Such "flexibility" is achieved by the methodologies a company can utilize in calculating the pay ratio, the exemptions provided with respect to non-U.S. employees, the cost-of-living adjustments permitted, the frequency with which companies are required to identify the median employee, and the transition periods available for certain companies. The SEC believes that Section 953(b) of Dodd-Frank was "intended to provide shareholders with a company-specific metric that can assist in their evaluation of a registrant's executive compensation policies" and that the flexibility of the Final Rules should reduce costs and burdens for companies, while maintaining the intended benefit of Section 953(b).

Despite the "flexibility" of the Final Rules, industry groups are likely to launch challenges and given that pay ratio disclosure is not required until 2018, they will have plenty of time to do so. This long lead-time also gives employers the opportunity to weigh a variety of alternatives that promise to significantly impact both the ratios they disclose and the costs for calculating them.

Our Advice for Issuers – Start the Process Now

Although many still hope for Congressional or legislative relief from Dodd-Frank's pay ratio disclosure requirement and the first pay ratio disclosures will not be required until 2018, the train is leaving the station and companies need to get started on the right track toward disclosure compliance by laying the foundation now for an informed process.

Companies will need to develop a consistent methodology for determining the median employee, which will undoubtedly take considerable time and resources to integrate data systems to come up with a workable methodology. Preparing rudimentary pay ratio calculations in the next 1-2 years would be a good test period to see what works best for the company while also allowing room for refinement based on practices that emerge by any early adopters of pay ratio disclosure.[3]

A thoughtful approach to the collection and analysis of the necessary information at the outset can result in realized disclosure efficiencies from the first year forward. Some of the key initial considerations will involve:

- Identifying the core team of employees, consultants, and legal counsel who will have primary responsibility for pay ratio calculations;
- Analyzing non-U.S. employee population and the availability of exemptions to exclude such employees from pay ratio calculations and whether cost of living adjustments are appropriate for such purposes;
- Selecting the median employee determination date by analyzing the fluctuations in employee populations and compensation in the last three months of the fiscal year;
- Assuring that compensation committees and senior executives understand the key choices that will drive the methodology, costs, and outcomes of their pay ratio; and
- Considering the costs and benefits of either becoming an early implementer of the Final Rules or learning from the experiences of those who start early.

Highlights from the Final Rules

The following chart provides a summary of certain key aspects of the Final Rules, which are discussed in more detail below:

Companies Subject to the Final Rules	All public companies, except: ▪ emerging growth companies; ▪ smaller reporting companies; and ▪ foreign private issuers.
Pay Ratio Disclosure	Companies are required to disclose: ▪ the median of the annual total compensation of all employees, except the principal executive officer (the "PEO"); ▪ the annual total compensation of its PEO;[4] and ▪ the ratio of the median of the annual total compensation of all employees to the compensation of the PEO.

Employees Covered	In calculating the median of employee compensation for a company and its consolidated subsidiaries, companies should include employees in the following categories that are ***employed as of a selected date within the last three months of the last completed fiscal year:*** ▪ full-time and part-time; ▪ seasonal or temporary; and ▪ non-U.S. based (subject to the exemptions and adjustments described below).
Flexible Methodology for Identifying the Median Employee	A company may use reasonable estimates in the methodology to identify the median employee and to calculate the annual total compensation for employees other than the PEO, including by statistical sampling or other consistently applied measures. Identification of the median employee is only required once every three years.
Filings Covered	Disclosure is required in the following filings that require executive compensation disclosure under Item 402 of Regulation S-K:[5] ▪ registration statements; ▪ proxy and information statements; and ▪ annual reports on Form 10-K.
Compliance Date and Transition Periods	A company's first reporting period for pay ratio disclosure is its first full fiscal year beginning on or after January 1, 2017. There are additional transition periods for new public companies and companies engaging in business combinations or acquisitions.

Employees Covered by the Final Rules

All Employees as of a Selected Date within the Last Three Months of the Company's Last Completed Fiscal Year

The Final Rules require disclosure of the median of the annual total compensation of "***all employees***" (as set forth in the list above, including all officers, other than the PEO) employed by the company ***on a selected date within the last three months of the company's last completed fiscal year***, subject to certain exemptions described below for non-U.S. employees and excluding those persons who are independent contractors or "leased," or other temporary workers employed by an unaffiliated third party.

Employees are not just those at the parent company level but also include employees at "consolidated" subsidiaries. The SEC limited the required disclosure to "consolidated" subsidiaries instead of subsidiaries generally (as contemplated by the proposed rules) because under the more general definition of subsidiaries, companies would have potentially been required to include employees from companies that they did not control (e.g., where only a nominal interest is held), in which case obtaining the required information for such employees would be costly and in some cases impossible.

The date that a company uses to determine the median employee (within the three month window allowed by the rules) will need to be disclosed and companies will want to consider establishing a particular date to provide consistent disclosure from year to year. If a company changes its determination date from the prior year, it is required to disclose the change and provide a brief explanation about the reason for such change.

Non-U.S. Employee Exemptions and Cost of Living Adjustments

Exemptions

In response to concerns about the burden of compliance with respect to non-U.S. employees, the Final Rules provide two exemptions under which companies may disregard non-U.S. employees from their pay ratio determinations:

- *Data Privacy Exemption*: Companies may disregard non-U.S. employees from their pay ratio calculations if, despite reasonable efforts to obtain or process the necessary information to comply with the disclosure rules, it is unable to do so without violating a foreign jurisdiction's data privacy laws. Note, that "reasonable efforts"—at a minimum—requires using or seeking an exemption or other relief under the applicable jurisdiction's governing data privacy laws or regulations and using the exemption if granted.

- *De Minimis Exemption*: Companies may disregard non-U.S. employees from their pay ratio calculations when the number of non-U.S. employees represents 5% or less of the company's total employees (U.S. and non-U.S.). In addition, even if a company has more than 5% non-U.S. employees, it may exclude non-U.S. employees up to the 5% threshold, but can only do so on an all-or-nothing basis for employees within a particular foreign jurisdiction and is prohibited from picking and choosing which employees to exclude in a given jurisdiction.

If a company relies on the *Data Privacy Exemption* it must: (i) exclude all employees in such jurisdiction, (ii) disclose the specific data privacy law, (iii) explain how compliance with the Final Rules violates such law, and (iv) obtain a legal opinion supporting any data privacy exclusions, a copy of which must be filed as an exhibit to the applicable filing. If a company relies on the *De Minimis Exemption* with respect to a particular jurisdiction, it must disclose: (i) the total number of U.S. and non-U.S. employees, without giving effect to any exemption (including the data privacy exemption), and (ii) the total number of U.S. and non-U.S. employees used for the *de minimis* calculation. In addition, regardless of the exemption being relied upon, companies must also: (i) disclose the excluded jurisdiction, and (ii) state the approximate number of employees excluded from such jurisdiction(s).

To the extent there is any overlap in the availability of the foregoing exemptions, the Final Rules provide further guidance restricting a company's ability to "double-dip" on the exemptions.

Cost of Living Adjustments

The Final Rules also permit companies to make cost-of-living adjustments for the compensation of employees in jurisdictions other than the jurisdiction in which the PEO resides for the purpose of both identifying the median employee and calculating such employee's annual total compensation. Companies may (but are not required to) make such an adjustment so that the compensation is adjusted to the cost of living in the jurisdiction in which the PEO resides. Companies must briefly describe any such adjustments, including the measure used as the basis for such adjustment and the median employee's annual total compensation and pay ratio *without* the adjustment.

Flexible Methodologies for Identifying the Median Employee

The Final Rules do not expressly set forth a methodology that must be used to determine the employees from which the median employee is identified and companies may choose a method based on their own facts and circumstances, including by utilizing reasonable estimates, statistical sampling, annual total compensation, or other consistently applied measures.

Companies may consider a number of factors when determining the specific methodology for identifying the median employee, including the number of employees, complexity of the organization, stratification of pay levels among employees, type of compensation received, currency in which compensation is paid, tax and accounting issues, and payroll systems.

Statistical Sampling

Consistent with the "flexibility" approach, companies may use statistical sampling to identify their median employee. For large organizations, this approach could make data collection more efficient and less costly while at the same time providing a reliable way in which to identify the median employee. The Final Rules do not specify any particular parameters for statistical sampling (e.g., sample size) and companies may make their own determinations based on their particular situation.

Consistently Applied Measures

Another method by which companies may determine the median employee is through the use of a consistently applied compensation measure, such as information derived from tax and/or payroll records (e.g., taxable wages or cash compensation), which measure must be disclosed. For companies operating in multiple jurisdictions where the compensation measure has different meanings in each jurisdiction (e.g., different annual periods for determining taxable wages), companies may still utilize such measures as long as the applicable measure is consistently applied within each such jurisdiction.

Every Three Years, Median Employee Only – No Averaging and No Ranges

As a means to address the cost concerns associated with identifying the median employee on an annual basis (as contemplated by the proposed rules), companies are only required to identify the median employee once every three years, unless there has been a change in the employee population or employee compensation arrangements that the company "reasonably believes would result in a significant change in the pay ratio disclosure." Since it is expected that most of the cost related to the implementation of the Final Rules will arise from the process of identifying the median employee, the SEC believes that the three year rule will help reduce the related cost and burden to companies. Note however that companies are still required to calculate the total compensation for that particular median employee each year. Even if the company does not reasonably believe there have been any changes that would significantly affect its pay ratio disclosure, it must affirmatively disclose that it is using the same median employee in its calculations and must also briefly describe the basis for its belief. If the median employee terminates employment or changes position after being identified in year one, the Final Rules permit a company to substitute an employee who is "similarly compensated" for the following two years.

A company must identify an actual "median" employee and determine his or her annual total compensation for purposes of the pay ratio disclosure and may not rely on the use of average compensation or the compensation of a range of employees (as argued for by several commenters). The SEC takes the position that the express language of Section 953(b), which requires disclosure of "the median of the annual total compensation . . ." is more useful than averaging because the median reduces the impact of outlying compensation information. Although companies are not required to disclose the name of the median employee, they may (but are not required to) identify the employee's position to put the compensation in context (but only to the extent that doing so would not otherwise identify any specific employee).

Calculating Annual Total Compensation

Once a company has identified its median employee, it must determine and disclose the median employee's annual "total compensation" in accordance with Item 402(c)(2)(x) of Regulation S-K. The rationale for this approach is that it creates a more consistent result for the pay ratio given that the PEO's annual "total compensation" is determined under Item 402(c)(2)(x). In addition, given that it is not necessary for companies to calculate the total compensation for each employee (just the median employee once that person has been identified) it does not impose a significant burden. The Final Rules address certain differences in the application of Item 402(c)(2)(x), by substituting certain defined terms as appropriate. For example, references to "named executive officer" are deemed to refer to the "employee" and terms such as "base salary" and "salary" are deemed to refer to "wages plus overtime" (as applicable).

As Item 402(c)(2)(x) requires disclosure of numerous elements of compensation accompanied by extensive instructions, the SEC will permit the use of reasonable estimates to determine the value of the various elements of total compensation for employees under Item 402(u), other than the PEO. For example, valuation of certain pension benefits can be difficult as employers may not have access to the information from pension plan administrators that would be needed to calculate the value of such benefits. In this instance, the SEC believes it to be appropriate for a company to use reasonable estimates in determining the value of such pension plan. Similarly, and relying on "consistent application" of measures, although Item 402(c)(2)(x) permits companies to exclude personal benefits that aggregate less than $10,000, if a company determines to include such benefits in calculating the annual total compensation of the median employee, it must also do so in the calculation of the PEO's total compensation (and alternatively, if such benefits are excluded from the PEO's calculation they must be excluded for the median employee).

Companies may also annualize total compensation for <u>permanent</u> full-time or part-time employees that were employed for less than the full fiscal year, but may not annualize total compensation for temporary or seasonal employees or make full-time equivalent adjustments for part-time, temporary, or seasonal employees. However, if a company believes that not making full-time equivalent adjustments for such employees may not provide its stockholders with a complete picture of its compensation practices, the company may provide additional disclosure to address that point.

Disclosure of Methodology, Assumptions, and Estimates

Companies are required to provide a brief disclosure of the methodology used to identify the median employee and any material assumptions, adjustments (including cost of living), and estimates used to determine the median sufficient for a reader to evaluate the appropriateness of such methodology, estimates, and assumptions used. In addition, if a company chooses to rely on statistical sampling, it must disclose the size of the sample and the estimated entire population, as well as the material assumptions used in determining such sample size and sample method.

If a company changes the methodology or significantly changes any significant assumptions, adjustments, or estimates from those used in the previous period, the company must briefly (i) describe the change, (ii) describe reasons for the change, and (iii) provide an estimate of the impact of the change on the median and the ratio. The SEC expects that a succinct description of the methodology and material assumptions, adjustments, and estimates used would not be overly burdensome and would make it easier for stockholders to understand and evaluate the pay ratio in connection with their say-on-pay voting decisions.

Disclosing the Pay Ratio

The Final Rules prohibit the disclosure of pay ratios as fractions or percentages. Instead, the SEC permits "one of two options" that the Final Rules illustrate through the following sample disclosures:

- The "PEO'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."
- "The PEO's annual total compensation is 50 times that of the median of the annual total compensation of all employees."

Compliance Dates and Transition Periods

The Final Rules provide that a company's first reporting period for pay ratio disclosure is their first full fiscal year beginning on or after January 1, 2017. For example, a company with a December 31 fiscal year end would not be required to make its pay ratio disclosure until 2018. The Final Rules do not apply to smaller reporting companies, emerging growth companies, foreign private issuers, U.S.-Canadian Multijurisdictional Disclosure System (MJDS) filers or registered investment companies. However, smaller reporting companies and emerging growth companies are required to comply with the Final Rules after the first full fiscal year in which such companies exit such status.

There are additional transition periods for new public companies and companies engaging in business combinations or acquisitions. Specifically, for new registrants, the first pay ratio reporting period begins with their first full fiscal year commencing on or after January 1, 2017 after they first become subject to the reporting requirements. For companies that engage in business combinations and/or acquisitions, they are allowed 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.

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[1] The Final Rules are described in the SEC's Release "Pay Ratio Disclosure," SEC Release 33-9877 (August 5, 2015), currently available at: http://www.sec.gov/rules/final/2015/33-9877.pdf.

[2] The Egregious Costs of the SEC's Pay-Ratio Disclosure Regulation, Center for Capital Markets (May 2014), currently available at: http://www.centerforcapitalmarkets.com/wp-content/uploads/2013/08/Egregious-Cost-of-Pay-Ratio-5.14.pdf.

[3] See, e.g., NorthWestern Corp. (2015 Proxy Statement, page 31), Noble Energy (2015 Proxy Statement, page 53), First Real Estate Investment Trust of NJ (2015 Proxy Statement, page 22).

[4] A principal executive officer is defined under Item 402(a)(3) as an "individual serving as the registrant's principal executive officer or acting in a similar capacity during the last completed fiscal year."

[5] The Final Rules include a conforming amendment to Item 5.02(f) of Form 8-K under the Exchange Act. If a company is excluding from the applicable filing certain salary or bonus information pursuant to Instruction 1 to Item 402(c)(iii) of Regulation S-K, it is required to disclose that the pay ratio is not calculable until such information is available and the date on which such information is expected to be available. At the time such information becomes available, the company is required to disclose the pay ratio information under Item 5.02(f) of Form 8-K.