



## SEC Adopts Pay Ratio Disclosure Rules

Posted by Michael J. Segal, Wachtell, Lipton, Rosen & Katz, on Thursday, August 6, 2015

**Editor's Note:** [Michael J. Segal](#) is partner in the Executive Compensation and Benefits Department of Wachtell, Lipton, Rosen & Katz. This post is based on a Wachtell Lipton memorandum by Mr. Segal and [Michael J. Schobel](#). Related research from the Program on Corporate Governance about CEO pay includes [Paying for Long-Term Performance](#) (discussed on the Forum [here](#)) and the book [Pay without Performance: The Unfulfilled Promise of Executive Compensation](#), both by Lucian Bebchuk and Jesse Fried.

The SEC yesterday [August 5, 2015] voted 3-2 to adopt the long-awaited final [pay ratio disclosure rules](#) under the Dodd-Frank Act. The rules add new Item 402(u) of Regulation S-K, which will require SEC reporting companies to disclose annually (1) the median of the annual total compensation of all of their employees, excluding the CEO, (2) the annual total compensation of the CEO and (3) the ratio of the annual total compensation of the median employee to the CEO's annual total compensation. Below is a brief summary of the final rules.

**Covered Filings and Issuers:** Subject to limited exceptions, SEC reporting companies will be required to include the pay ratio disclosure in annual reports on Form 10-K, registration statements and proxy and information statements, whenever these forms require other executive compensation disclosures under Item 402 of Regulation S-K. Emerging growth companies, smaller reporting companies, foreign private issuers, U.S.-Canadian Multijurisdictional Disclosure System filers and registered investment companies are not subject to the rules.

**Compliance Date:** Issuers will be required to comply with the rules for the first fiscal year beginning on or after January 1, 2017. Accordingly, an issuer with a calendar year fiscal year must first include the disclosure in its Form 10-K or annual meeting proxy statement filed in 2018.

**Measuring the Employee Population:** For purposes of calculating the pay ratio, issuers are required to consider the annual total compensation of "all employees" (other than the CEO), which term includes all worldwide full-time, part-time, temporary and seasonal workers employed by the issuer and its consolidated subsidiaries. The term expressly excludes workers who are employed, and whose compensation is determined by, an unaffiliated third party, such as independent contractors and leased workers. In a change from the proposed rules, the employee population may be measured as of a date selected by the issuer within the last three months of its most recently completed fiscal year (as opposed to the last day of the issuer's most recently completed fiscal year). In addition, the final rules include a handful of exclusions that issuers may find useful:

- *Non-U.S. Employees.* Issuers may exclude up to 5% of their non-U.S. employees generally (subject to certain limitations designed to prevent cherry-picking within and

across jurisdictions), as well as any non-U.S. employees to the extent necessary to comply with data privacy laws. Although non-U.S. employees excluded under the data privacy exemption are not subject to the general 5% limitation, such excluded employees would be considered for purposes of determining whether the 5% limit has been hit (e.g., if more than 5% of an issuer's employees are excluded under the data privacy exemption, no additional employees may be excluded).

- **Business Combinations.** Issuers may exclude any persons that became their employees as a result of a business combination or acquisition for the fiscal year in which the transaction occurs. Such persons would need to be taken into consideration for subsequent years.

**Identifying the Median Employee:** The final rules provide issuers with flexibility when identifying the median employee. First, issuers may narrow the employees to be included in the determination of the median by using statistical sampling or other reasonable methods. Second, to identify the median of the employees included in the calculation, the rules permit the issuer to use either (a) annual total compensation (as described further below) or (b) any other compensation measure that is consistently applied to all employees included in the calculation, such as information derived from the issuer's payroll or tax records (e.g., W-2 reportable wages). Third, the final rules permit the issuer to make certain cost-of-living and annualizing adjustments in identifying the median employee and annual total compensation. Finally, and in a significant deviation from the proposed rules, the final rules permit the use of the same median employee for three consecutive years, unless there has been a change in the employee population or employee compensation arrangements that the issuer reasonably believes would result in a significant change in the pay ratio disclosure.

**Determination of Total Compensation:** Once identified, the median employee's and the CEO's annual total compensation is to be determined in accordance with Item 402(c)(2)(x) of Regulation S-K, which prescribes the calculation of total compensation for the named executive officers for purposes of the annual proxy Summary Compensation Table. In recognition of the potential for valuation difficulties in respect of certain types of benefits, the rules permit an issuer to use reasonable estimates to calculate annual total compensation or any elements of total compensation for the median employee. In addition, whether an issuer exercises the discretion allowed under the executive compensation disclosure rules to include or exclude from the calculation of the CEO's annual total compensation personal benefits that aggregate to less than \$10,000 and compensation under nondiscriminatory benefit plans, the issuer must take the same approach for the median employee; because such amounts are likely to constitute a relatively larger portion of the median employee's annual total compensation, excluding such amounts could increase the ratio. If an issuer replaces its CEO mid-year, the final rules permit the issuer to either (1) combine the total compensation of each CEO as reported in the Summary Compensation Table or (2) annualize the compensation of the person serving as CEO as of the date that the employee population is measured.

**Pay Ratio Disclosure:** The final rules require that the pay ratio be expressed either (1) as a ratio in which the annual total compensation of the median employee is equal to one (e.g., 1 to 268), or (2) narratively in terms of the multiple that the CEO's total compensation amount bears to the annual total compensation of the median employee (e.g., the CEO's annual total compensation is 268 times that of the annual total compensation of the median employee). In addition, the final rules require an issuer to briefly describe its methodology for identifying the median employee,

including any material assumptions, adjustments or estimates used to identify the median employee or to determine total compensation or any elements of total compensation. Further, to promote comparability from year to year, if an issuer changes the methodology or material assumptions, adjustments or estimates from those used in the previous period, and if the effects of any such change are significant, the issuer must briefly describe the change and the reasons for the change.

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The final rules, which were adopted nearly two years and 287,400 comment letters after they were first proposed, reflect the SEC's efforts to satisfy the requirements of the Dodd-Frank Act while mitigating the compliance costs imposed on issuers. These efforts notwithstanding, SEC Commissioner Daniel M. Gallagher properly characterized the final rules in his dissenting statement by saying, "the pay ratio being adopted today will produce so few (if any) benefits for regular shareholders that the information seems likely to be useless for anything *but* naming-and-shaming. Thus, the rule is not intended to, and does not, produce information in furtherance of a legitimate government purpose." It is speculated that corporate advocates may challenge the final rules in litigation, possibly on the grounds of inadequate cost-benefit analysis by the SEC, and Republicans in Congress have introduced legislation to repeal the pay ratio requirement of the Dodd-Frank Act. Nonetheless, with a date for implementation set, issuers should begin preparing to satisfy the pay ratio disclosure rules.