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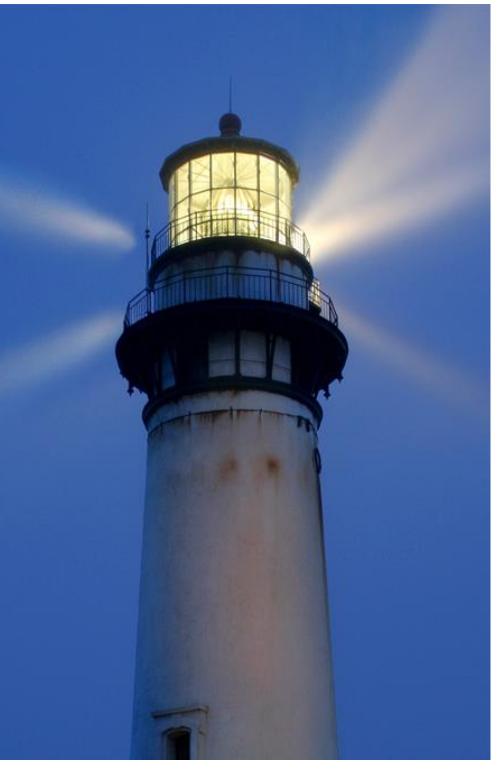

SEC Requires Pay Ratio Disclosure

The SEC recently adopted a final rule mandated by the Dodd-Frank Act that requires companies to disclose the ratio of the primary executive officer's (PEO) compensation to the median compensation of all employees.[1] The rule allows flexibility to determine the pay ratio.

Key Facts

- The pay ratio disclosure will appear in registration, proxy and information statements, and annual reports that require executive compensation disclosure.[2]
- Companies must disclose the methodology, assumptions, and estimates used in determining median employee annual total compensation. However, they are permitted, but not required, to disclose other information, such as other ratios or narrative explanations.
- The SEC believes the pay ratio disclosure should allow shareholders to better understand and assess a particular company's compensation practices rather than facilitating comparison with other companies.
- The pay ratio disclosure is required for fiscal years beginning on or after January 1, 2017. The rule does not apply to smaller reporting companies, emerging growth companies, foreign private issuers, Multijurisdictional Disclosure System (MJDS) filers, or registered investment companies.

Key Impacts

- Companies should plan how they will determine the median annual total compensation of all employees.
- While reasonable estimates and assumptions may be used, the determination may be challenging for companies with disparate payroll systems, high employee turnover, contractors or part-time workers, and foreign operations.

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[1] SEC Release Nos. 33-9877 and 34-75610, Pay Ratio Disclosure, August 5, 2015, available at www.sec.gov. The rule is required by the Dodd-Frank Wall Street Reform and Consumer Protection Act, which became law in July 2010. It only applies to SEC registrants; it does not apply to non-issuer subsidiaries and private companies.

[2] Item 402 of Regulation S-K.

Companies should evaluate what information is needed to determine the median employee's compensation. Whether using the full population of employees or a statistical sample, upfront planning may be required when compensation records are maintained on different systems or in multiple jurisdictions.

Definition of All Employees

All employees include domestic and international employees and those of consolidated subsidiaries, including full-time, part-time, seasonal, and temporary employees. There are two specific exemptions from this broad pool. First, employees in foreign jurisdictions where it is not possible to obtain information without violating data privacy laws are exempted. Second, companies can exempt non-U.S. employees if they account for five percent or less of the total U.S. and non-U.S. employees, with certain limitations. Independent contractors and employees of third-party contractors are not considered employees.

The rule includes employees of subsidiaries consolidated under U.S. GAAP rather than employees of all entities meeting the SEC's definition of subsidiary, which is broader. The SEC reasoned that using the U.S. GAAP definition would limit the costs and burdens because employee information about subsidiaries under its control may be more readily available than information from minority-owned subsidiaries and joint ventures.

Example 1: SEC Pay Ratio Disclosure Rule

$$\frac{\text{PEO Annual Total Compensation } \$2{,}500{,}000}{\text{Median Annual Total Compensation } \$50{,}000} =$$

Pay Ratio
50 to 1

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

Identifying the Median Employee

The final rule seeks to alleviate the cost of compliance by allowing flexibility in the methods and assumptions used to determine the median of the annual total compensation of all employees. Companies may make certain adjustments to employee annual total compensation to make the ratio's metrics more comparable. Companies can identify the median employee every three years, unless there is a significant change to the total employee population requiring remeasurement. However, they must calculate total compensation for that employee each year.

- Determining the median employee may be done on any date within the last three months of the fiscal year. The pool of employees from which the median is identified includes all employees as of that date.

- Companies may use a methodology for finding the median employee that is reasonable based on its specific facts and circumstances. For example, the median employee could be selected from the full population of all employees or a statistically representative sample. It is not appropriate to assume a median, use an average, or develop a theoretical median.
- No matter what method is used to identify the median employee, companies must identify an actual employee and determine that employee's total compensation. No personally identifiable information about that employee other than his or her compensation should be disclosed.
- To identify the median employee, companies may use total compensation as defined by SEC executive compensation rules or other consistently applied compensation measures such as payroll or tax records.
- Companies are permitted, but not required, to annualize total compensation of permanent full-time and part-time employees as of the testing date, adjusting for the portion of the year that the employee did not work. However, the rule prohibits adjustments to compensation of seasonal or temporary employees, or adjustments to treat part-time employees as full-time equivalents.
- Companies are permitted, but not required, to adjust employee compensation for cost-of-living differences between where the PEO lives and the median employee's residence. These adjustments must be consistently applied to all employees of a jurisdiction where any adjustment is made.

Calculating Annual Total Compensation

The period of annual total compensation is the last completed fiscal year, which is consistent with other executive compensation disclosure requirements. Annual total compensation has the same meaning for the median employee as it does for named executive officers under existing SEC executive compensation rules. Total compensation is defined as the sum of an employee's salary, bonus, stock and option awards, non-equity incentive plan compensation, change in the actuarial present value of the accumulated benefit under all defined benefit and actuarial pension plans, nonqualified deferred compensation earnings, and all other compensation.[3]

Reasonable estimates may be used in determining annual total compensation of the median employee. In particular, it would be appropriate to estimate the change in value of an employee's defined benefit pension plan if the actuarial information is not available on an individual basis.

In most cases, the PEO's annual total compensation used in the pay ratio disclosure will agree with executive compensation disclosures. In years when the PEO is replaced, the company may determine the PEO's total compensation using one of two options: (a) the sum of the predecessor and successor PEO annual total compensation during the fiscal year, or (b) the annualized total compensation of the PEO as of the date the median employee was determined.

[3] Regulation S-K, Item 402(c)(2)(x).

Disclosure

Companies must briefly describe any methodologies used to identify the median employee along with material assumptions, adjustments, and estimates used to calculate the annual total compensation of employees. The disclosures must provide sufficient information to evaluate the estimates' appropriateness.

For example, when companies use statistical sampling to determine the median employee, they should disclose the size of both the sample and the estimated whole population, which sampling method is used, and how the sampling method deals with geographically separate employee populations or other issues arising from multiple business or geographic segments. Companies must disclose when they make adjustments for cost-of-living differences or annualize employee compensation.

Transition

A one-year transition period is allowed for new companies and those that no longer fall into the exempt categories. Companies may omit employees of a newly acquired entity in the year a business combination occurs.

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