August 10, 2015

SEC Adopts Final CEO Pay-Ratio Disclosure Rules

Almost two years after the original proposal, the Securities and Exchange Commission has approved final rules to require U.S. public companies to disclose the ratio of their CEO's compensation to the median compensation of their other employees. Facing intense pressure from lawmakers and other constituencies both supporting and criticizing the requirement and vocal dissents from Commissioners Gallagher and Piwowar, the SEC has implemented rules that in the words of Chair White "provid[e] companies with substantial flexibility in determining the pay ratio, while remaining true to the statutory mandate." In the adopting release, the SEC explains at great length that the Congressional intent behind requiring pay-ratio disclosure was to provide investors with additional information on compensation in respect of the say-on-pay votes, rather than to facilitate a comparison among companies. In light of this purpose, the SEC asserts that many of the criticisms regarding the lack of conformity or comparability of the pay ratio across companies are misplaced, and that instead company-specific metrics are more relevant.

After reviewing the over 287,000 comment letters (including some 1,500 unique comment letters), the SEC has adopted final rules that include the following noteworthy changes from the proposed rules. All of these provisions are subject to conditions and requirements that are discussed in more detail below.

- *Triennial identification of the median employee.* While the proposed rules would have required companies annually to identify the median employee for purposes of calculating the pay ratio, the final rules allow companies to make that determination every three years as long as there are no changes in employee population or compensation arrangements that would significantly affect pay-ratio disclosure. Further, if the original identified median employee experiences changed circumstances, such as promotion or termination, companies may use a similarly compensated employee.

- *Additional flexibility in timing of pay-ratio determination.* While the proposed rules would have required all companies to make the pay-ratio determination as of the last day of the last completed fiscal year, the final rules allow companies to choose any date within the last three months of their last completed fiscal year to make such determination.

- *Non-U.S. employee exemptions.* The proposed rules would have required companies to include all non-U.S-based employees on the same basis as would have been required for U.S.-based employees; however, the final rules add the following two exemptions for non-U.S. employees (defined as employees located in a jurisdiction outside the United States):

- Companies may exclude non-U.S. employees employed in a jurisdiction where, despite reasonable efforts (including seeking an exemption or other relief), compliance with the pay-ratio requirements would violate local data privacy laws. There is no cap on the number of employees excludable under this exemption.

- Companies may exclude non-U.S. employees accounting for up to 5% of their total employees; however, any employees excluded pursuant to the foregoing data privacy exemption count towards this 5% *de minimis* exemption.

If a company excludes any non-U.S. employee in a particular jurisdiction under these exemptions, it must exclude all employees in that jurisdiction, subject to the 5% cap if applicable.

- *Cost-of-living adjustments.* In identifying the median employee and calculating the pay ratio, companies may apply a cost-of-living adjustment to employees in jurisdictions other than that in which the CEO resides; however, non-adjusted figures must still be disclosed. The proposed rules did not include the option of a cost-of-living adjustment.

- *Consolidated subsidiaries only.* While the proposed rules would have required companies to include the employees of all of their subsidiaries in the pay-ratio calculation, the final rules require only that the employees of consolidated subsidiaries be included.

- *Lengthier compliance timeline.* Companies must calculate the pay ratio with respect to compensation for their first full fiscal year beginning on or after January 1, 2017, and include such disclosure starting with their annual reports on Form 10-K for that fiscal year, or, if later, proxy or information statements filed after fiscal-year end, but no later than 120 days after the fiscal-year end. This means that for calendar-year end companies, pay-ratio disclosure will first be required with respect to compensation paid in fiscal year 2017, for inclusion in annual reports on Form 10-K for that fiscal year or, if later, proxy statements filed in 2018, but not later than 120 days after fiscal-year end. Transition rules for companies that cease to be smaller reporting or emerging growth companies and companies that engage in business combinations were also added in the final rules.

As had been proposed, these requirements would not apply to foreign private issuers, Canadian MJDS filers, smaller reporting companies, emerging growth companies and registered investment companies.

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The Final Rule

Pay-Ratio Disclosure.

General. New Item 402(u) of Regulation S-K requires companies to disclose, for their last completed fiscal year, (A) the median of the annual total compensation of all employees of the company and its consolidated subsidiaries, except the principal executive officer ("PEO")[1]; (B) the annual total compensation of the PEO of the company; and (C) the ratio of the amount in (A) to the amount in (B). This ratio must be expressed as a ratio in which the median employee compensation[2] (the amount in (A)) is equal to one, or, alternatively, expressed narratively where PEO total compensation is a multiple of the median employee compensation. For example, if the median employee compensation is $50,000 and the annual total compensation of the PEO is $2,500,000, then the pay ratio disclosed would be 50 to 1 or 50:1 or stated as "the PEO's annual total compensation is 50 times that of the median of the annual total compensation of all employees." Companies may not present the median employee compensation as a percentage of the PEO's total compensation.

Total compensation calculations. While the rules allow flexibility in the methodology used to identify the median employee (as described in more detail below), once identified, the total compensation of the median employee and that of the PEO must be calculated as currently prescribed for Summary Compensation Table purposes pursuant to Item 402(c)(2)(x) of Regulation S-K, except that companies may include personal benefits that aggregate less than $10,000 and compensation under non-discriminatory benefit plans in calculating total compensation for the median employee as long as those amounts are also included in the PEO's total compensation. The rules clarify that references to "named executive officer" in Item 402(c) may be deemed to refer instead to "employee," and, for non-salaried employees, references to "base salary" and "salary" may be deemed to refer instead to "wages plus overtime," as appropriate. Companies must explain any material differences between the PEO's total compensation used in the pay-ratio disclosure and that disclosed in the Summary Compensation Table.

Companies may annualize the total compensation for all permanent employees (full-time or part-time) that were employed for less than the full fiscal year (such as newly hired employees or permanent employees on unpaid leave), but may not annualize the total compensation of temporary or seasonal employees. No full-time equivalent adjustments may be made for any employee.

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[1] The rules use the term "PEO" instead of "CEO" for consistency with existing Regulation S-K, Item 402 requirements. "PEO" is defined in 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."

[2] For ease of use, we refer to the median of the total annual compensation of all employees of the company and its consolidated subsidiaries (other than the PEO) as the "median employee compensation."

If a company has more than one non-concurrent PEO serving during its fiscal year, it may calculate the annual total compensation for its PEO in either of the following ways and must disclose the option chosen and how the calculation was made:

- the company may calculate the compensation provided to each PEO serving during the year for the time he or she served as PEO and combine those figures; or
- the company may look to the PEO serving in that position on the date it selects to identify the median employee and annualize that PEO's compensation.

If total compensation for the PEO is unavailable at the time disclosure is otherwise required and a company omits disclosure of salary and bonus to the extent not calculable as of the latest practicable date (as permitted under Item 402 of Regulation S-K), the company must disclose that the pay ratio is not calculable until the PEO salary or bonus is determined and the date that the PEO's total compensation is expected to be determined and provide its pay-ratio disclosure in the same filing under Item 5.02(f) of Form 8-K in which the PEO's salary or bonus is disclosed.

Supplemental disclosures. Companies may supplement the required pay-ratio disclosure with additional information, including additional ratios, so long as that information is clearly identified, not misleading and not presented with greater prominence than the required ratio. As noted in the adopting release, among other things, companies may wish to supplement their pay-ratio disclosures to explain the effect of including part-time, seasonal and temporary employees in their calculations.

Required filings. Subject to the compliance deadlines and transition rules discussed below, companies must provide the pay-ratio disclosure in any SEC filing that requires Item 402 compensation disclosure, including annual reports on Form 10-K, registration statements under the Securities Act and the Exchange Act and proxy and information statements. However, the pay-ratio disclosure would only need to be updated once a year in the Form 10-K or proxy or information statement. Finally, the pay-ratio disclosure, as with other Item 402 information, would be treated as "filed" for purposes of the Securities Act and the Exchange Act.

Determination of "Employees" of the Company; Non-U.S. Employee Exemptions.

General. "Employees" include full-time, part-time, seasonal and temporary, U.S. and non-U.S. individuals employed by the company or its consolidated subsidiaries as of any date within the last three months of the company's last completed fiscal year. Allowing companies to choose the date to make this determination is intended not only to give companies additional time to comply with these requirements, but also to alleviate any burdens on companies that employ a significant number of employees at year-end by allowing them to choose a date that excludes those employees. The date used to determine the employees of the company and its consolidated subsidiaries (which is also the date to be used to identify the median employee) must be disclosed by the company along with any changes to the date and a brief explanation of the reasons for the change.

Workers, such as independent contractors or "leased" workers, who are employed, and whose compensation is determined, by unaffiliated third parties may not be included, even if they provide services to the company or its consolidated subsidiaries. The SEC expressed concern that allowing companies the option to include such individuals would allow manipulation of the pay-ratio disclosure, but noted that companies may provide additional ratios that factor in these workers so long as such information is not misleading or more prominently displayed than the required ratio.

Non-U.S. employee exemptions. Two exemptions for non-U.S. employees (defined as employees located in a jurisdiction outside of the United States) apply:

- Companies may exclude non-U.S. employees employed in non-U.S. jurisdictions where, despite reasonable efforts (including at a minimum seeking an exemption or other relief), compliance with the pay-ratio disclosure requirements would violate local data privacy laws or regulations. There is no cap on the number of employees excludable under this provision, but if any employee is so excluded in a particular jurisdiction, all employees must be excluded in that jurisdiction. In addition, if a company excludes any employees under this provision, it must:
    - list the excluded jurisdictions;
    - identify the specific data privacy law or regulation;
    - explain how complying with the pay-ratio disclosure rules violates that law or regulation (including the company's efforts to use or seek an exemption or other relief thereunder);
    - provide the approximate number of employees excluded from each jurisdiction; and
    - obtain and file as an exhibit a legal opinion that opines on the inability of the company to process the information needed to comply with the pay-ratio disclosure requirements without violating the data privacy law or regulation, including the company's inability to obtain exemptive or other relief.
- In addition, under the so-called *de minimis* exemption, companies may exclude non-U.S. employees accounting for up to 5% of its total employees, subject to the following conditions:
    - if a company chooses to exclude any non-U.S. employee under this exemption and its total non-U.S. employees account for less than 5% of total employees, it must exclude all non-U.S. employees;

- if a company's non-U.S. employees exceed 5% of its total employees, it may exclude non-U.S. employees up to the 5% cap, but if it excludes any employee in a particular jurisdiction, it must exclude all employees in that particular jurisdiction;

- if more than 5% of a company's employees are included in any non-U.S. jurisdiction, it may not exclude any employees in that jurisdiction;

- any non-U.S. employees excluded as a result of the data-privacy exemption count towards this 5% cap. In other words, if the number of non-U.S. employees excluded pursuant to the data-privacy exemption exceeds 5% of total employees, this *de minimis* exemption would not be available; and

- the company must disclose:

    - the jurisdictions from which the employees are being excluded;

    - the approximate number of employees excluded from each jurisdiction;

    - the total number of its U.S. and non-U.S. employees irrespective of any exemption (data privacy or *de minimis*); and

    - the total number of its U.S. and non-U.S. employees used for its *de minimis* calculation.

Accommodations for companies engaged in business combinations. Companies may omit employees that became its employees as the result of a business combination or acquisition for the fiscal year in which the transaction becomes effective, but must disclose the approximate number of excluded employees and the identity of the excluded business. As an example, a calendar year-end company that engages in a business combination or acquisition in 2017 must include the newly-acquired employees in the pay-ratio calculations for fiscal year 2018, with the disclosure included in its Form 10-K for 2018 or a proxy or information statement for their next annual meeting of shareholders following the end of the 2018 fiscal year, but not later than 120 days after the end of such fiscal year.

***Methodology for Identifying the Median Employee and Calculating Total Compensation Required*.**

Triennial identification of the median employee. Although median employee compensation must be calculated annually, companies are required to identify the median employee only once every three years, so long as they reasonably believe that there has been no change in their employee population or compensation arrangements that would result in a significant change to their pay-ratio disclosure.

Employees excluded as a result of the business combination exemption discussed above must be included in the total employee count for the triennial calculations of the median employee in the year following the transaction for purposes of evaluating whether a significant change has occurred.

If there have been no such changes, companies must disclose their use of the same median employee and briefly describe their basis for the reasonable belief that there has been no such change. If there has been a change in the original median employee's circumstances (such as promotion or termination), companies may use another employee whose compensation is substantially similar to the original median employee.

Flexible methodologies for identifying the median employee and calculating employee compensation. The final rules do not prescribe a specific methodology for identifying the median employee or calculating compensation for employees other than the PEO. Companies may choose their own reasonable methodology, including:

- Using reasonable estimates. Companies may use reasonable estimates to identify the median employee and calculate the employee compensation. If a company uses an estimate, it should have a reasonable basis to conclude that the estimate approximates the actual amount of total compensation (or a particular element of compensation) awarded to, earned by or paid to those employees.

- Using statistical sampling. Companies may use its full employee population, a statistical sampling or any other reasonable method to determine the pool from which the median employee is identified. While a relatively small sample size may be suitable in certain circumstances, the appropriate size of the statistical sample should be determined by the level of variance in the compensation of the employees, with higher variance requiring a larger sample size. Companies with multiple businesses or geographic locations may use multiple statistical sampling approaches when identifying a sample of the employee population. The SEC also noted that companies may not have to calculate exact compensation for every employee, but could instead identify the employees with extremely low or high pay that would fall completely on either end of the pay spectrum, since identifying the median employee involves finding the employee in the middle of spectrum.

- Using alternative compensation metrics. For purposes of determining the median employee, companies may use any compensation metric that is consistently applied to all of its employees, such as compensation amounts reported in its payroll and/or tax records (instead of the more onerous total compensation calculation under Item 402(c) of Regulation S-K), but must disclose the metric used. The SEC recognizes that a consistently applied compensation measure, such as "taxable wages" may nevertheless be defined differently in different jurisdictions. In using a compensation measure other than total compensation to identify the median employee, if that measure is recorded on a basis other than a company's fiscal year (such as payroll or tax information), the company may use the same annual period that is used to derive those amounts.

In determining the proper methodology for calculating the pay ratio, the SEC listed factors that companies may consider, which primarily address the complexity of the work force and compensation structure and the number of currencies, tax and accounting regimes and payroll systems involved.

Cost-of-living adjustments. In recognition that the "actual value" of the median employee compensation in comparison to that of the PEO's compensation may be more meaningful to certain investors, companies may apply cost-of-living adjustments to the compensation of employees in jurisdictions other than that in which the PEO resides so that the employee compensation is adjusted to the cost of living in the PEO's resident jurisdiction. If a company uses a cost-of-living adjustment and the median employee identified is an employee in a jurisdiction other than the PEO's resident jurisdiction, the company must use the same cost-of-living adjustment in calculating the median employee compensation.

In addition, the company must:

- disclose the median employee's jurisdiction;
- briefly describe the cost-of-living adjustments used, including the measure used as the basis for the cost-of-living adjustment; and
- disclose the median employee compensation and pay ratio without any cost-of-living adjustments.

Application and disclosure of methodology. Once a methodology is selected, companies must apply that methodology (including any assumptions, adjustments or estimates) on a consistent basis. Companies also must:

- briefly describe (without the need to provide technical analysis or formulas), the methodology used to identify the median employee and any material assumptions, adjustments or estimates (including any cost-of-living adjustments) used to identify the median employee or to determine total compensation or any compensation elements;
- clearly identify any estimates used;
- briefly describe any changes in methodology or material assumptions, adjustments or estimates that have a significant effect and the reasons for the change; and
- disclose if they changed from using the cost-of-living adjustment to not using that adjustment or if they changed from not using the cost-of-living adjustment to using it.

Compliance Dates and Transition Rules

Compliance Dates. Companies must calculate the pay ratio with respect to compensation paid in their first full fiscal year beginning on or after January 1, 2017, and include such disclosure starting with their annual reports on Form 10-K for that fiscal year, or, if later, proxy or information statements filed after fiscal-year end, but no later than 120 days after fiscal-year end. This means that calendar-year end companies will make their first pay-ratio disclosures with respect to compensation paid in fiscal year 2017, in annual reports on Form 10-K for that fiscal year or, if later, proxy or information statements filed in 2018, but no later than 120 days after fiscal-year end. Pay-ratio disclosure is not required for any registration statements or other filings until the filing of the initial annual report or proxy or information statement subject to this requirement, although companies may voluntarily comply earlier.

Transition for New Registrants. New registrants are required to first provide pay-ratio disclosure with respect to compensation paid in the first fiscal year after the year in which the company becomes subject to the requirements of Section 13(a) or Section 15(d) of the Exchange Act (but not for any fiscal year commencing before January 1, 2017). The pay ratio will be required in their Form 10-Ks for that fiscal year or, if later, the filing of a proxy or information statement after the end of such fiscal year, but in any event not later than 120 days after the end of such fiscal year. Put another way, the final rule provides that a new registrant's first pay-ratio disclosure must follow its first full fiscal year after the company has (i) been subject to the requirements of Sections 13(a) or 15(d) of the Exchange Act for at least 12 calendar months beginning on or after January 1, 2017 and (ii) filed at least one annual report pursuant to Section 13(a) or 15(d) of the Exchange Act that does not contain the pay-ratio disclosure.

Transition for Smaller Reporting Companies and Emerging Growth Companies. Emerging growth companies and smaller reporting companies must provide the pay-ratio disclosure with respect to compensation paid in their first fiscal year commencing after the date that they cease to qualify for such status (but not for any fiscal year commencing before January 1, 2017), in their Form 10-Ks for that fiscal year or, if later, the filing of a proxy or information statement after the end of such fiscal year, but in any event no later than 120 days after the end of such fiscal year. For example, if a calendar year-end smaller reporting company's public float exceeds $75 million as of the end of the second quarter in 2017, the company will cease to be a smaller reporting company as of the beginning of its fiscal year starting on January 1, 2018. The company, therefore, must include its pay-ratio disclosure in its Form 10-K for 2018 or a proxy or information statement for its 2019 annual meeting of shareholders (or written consents in lieu of a meeting) following the end of the 2018 fiscal year, but not later than 120 days after the end of the 2018 fiscal year.

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For a copy of the final rules, see http://www.sec.gov/rules/final/2015/33-9877.pdf For a copy of the SEC's press release and fact sheet on this development, see http://www.sec.gov/news/pressrelease/2015-160.html

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This memorandum is not intended to provide legal advice, and no legal or business decision should be based on its content. Questions concerning issues addressed in this memorandum should be directed to:

Mark Bergman
+44-20-7367-1601
mbergman@paulweiss.com

David Huntington
212-373-3124
dhuntington@paulweiss.com

John Kennedy
212-373-3025
jkennedy@paulweiss.com

Raphael Russo
212-373-3309
rrusso@paulweiss.com

Lawrence Witdorchic
212-373-3237
lwitdorchic@paulweiss.com

Frances Mi
212-373-3185
fmi@paulweiss.com

Hank Michael
212-373-3892
hmichael@paulweiss.com