SEC adopts rule to implement Dodd-Frank CEO pay ratio disclosure requirement

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Abstract

Purpose – *This article examines the rule issued by the Securities and Exchange Commission in August 2015 that requires most SEC-reporting companies to disclose annually the ratio of the annual total compensation of their chief executive officer to the median of the annual total compensation of their employees other than the CEO.*

Design/methodology/approach – *This article provides an in-depth analysis of the operation of the controversial pay ratio disclosure rule against the backdrop of concerns expressed by many commenters on the rule proposal, as well as by the two Commissioners who dissented from adoption of the rule, that the disclosure will not provide meaningful information to investors and will be excessively costly and burdensome for companies to produce.*

Findings – *The SEC fashioned the final pay ratio disclosure rule with a vaguely defined statutory purpose to guide it and a heavy volume of comments on its rule proposal that urged widely disparate approaches to implementation. In overhauling the proposed rule, the SEC sought to satisfy its mandate under the Dodd-Frank Act while providing companies with flexibility in implementing the new rule that it believes will reduce compliance costs and burdens.*

Originality/value – *This article provides expert guidance on a major new SEC disclosure requirement from experienced securities lawyers.*

Keywords *United States of America, Dodd-Frank Act, Securities regulation, Executive compensation disclosure, Pay ratio disclosure rule*

Paper type *Technical paper*

On August 5, 2015, nearly two years after the Securities and Exchange Commission (SEC or Commission) issued its rule proposal, a divided Commission amended Item 402 of the SEC's Regulation S-K to require most companies subject to public reporting obligations to disclose annually the ratio of the annual total compensation of their chief executive officer (CEO) to the median of the annual total compensation of their employees other than the CEO. The new rule is mandated by Section 953(b) of the Dodd-Frank Wall Street Reform and Consumer Protection Act (Dodd-Frank Act), which became law in July 2010. In its proposed form, the rule attracted thousands of comment letters that expressed widely divergent views on the purpose, scope and operation of this controversial disclosure requirement.

Companies will have to include the new disclosure in their proxy statements for annual shareholder meetings or in their annual reports on Form 10-K. The new rule does not apply to emerging growth companies, smaller reporting companies, foreign private issuers or companies filing under the US-Canadian Multijurisdictional Disclosure System. Companies subject to the rule will first be required to disclose the CEO pay ratio for the first full fiscal year beginning on or after January 1, 2017. Accordingly, companies with a calendar year-end generally will be required to include the new disclosure in annual proxy statements or Form 10-K reports they will file in 2018.

The new rule is described in the SEC's adopting release of nearly 300 pages (Nos. 33-9877 and 34-75610), which can be viewed on the Regulation page of the SEC's website at www.sec.gov. The rule became effective on October 19, 2015.

Background

In shaping the final rule, the SEC said it was guided by its view that Congress intended Section 953(b) of the Dodd Frank Act to provide a public company's shareholders with a "company-specific metric" that can assist them in evaluating the company's executive compensation practices and in casting their "say-on-pay" votes on whether they approve the compensation paid to the company's named executive officers. The SEC justified a number of changes to the rule proposal as part of its effort to avoid "unnecessary costs" while satisfying the mandate of Section 953(b). For some of the changes, the SEC exercised its exemptive authority under the Securities Exchange Act of 1934 (Exchange Act) to provide companies with flexibility in implementing the new rule in a manner it believes will reduce compliance costs and burdens.

New Item 402(u)

The rule adds a new paragraph (u) to Item 402 of Regulation S-K, which prescribes the disclosure requirements for executive compensation in a public company's annual proxy statements, annual reports and registration statements. Item 402(u) requires companies to disclose three values that constitute the components of the pay ratio disclosure:

1. Median of the annual total compensation of all employees of the company other than the CEO;
2. Annual total compensation of the CEO; and
3. Ratio of the median of the annual total compensation of all employees other than the CEO to the CEO's annual total compensation.

Once a company has assembled the records and other information needed to produce these values, the process outlined by the SEC generally would require the company to:

- First, use a reasonable method to identify the "median employee," an actual employee of the company whose compensation will represent the median of the annual total compensation of all of the company's employees other than the CEO.
- Second, calculate the total compensation of the median employee for the company's last completed fiscal year in the same manner in which the company calculates the CEO's annual total compensation for presentation in the summary compensation table for its named executive officers required under Item 402(c) of Regulation S-K.
- Third, after calculating the annual total compensation of the median employee and the CEO, formulate the pay ratio in one of the two ways permitted under the rule.
- Fourth, disclose the three values together with any supplemental pay ratios or narrative discussion which the company considers appropriate to provide context for the required disclosure.

Median employee determination

Item 402(u) requires a company to disclose the median of the annual total compensation of all of its employees other than the CEO. The SEC acknowledged the potentially significant costs that companies in general, and large and international companies in particular, might incur to identify their median employee. Concluding that a "one-size-fits-all approach" to the median employee determination would not be appropriate in light of the "wide range of affected registrants and the disparate burdens" the new rule imposes on them, the SEC approved a number of accommodations intended to afford companies flexibility in choosing how to satisfy this part of the rule.

A company is not required to use a particular calculation methodology in determining the employees from which it will identify the median employee. The rule states that the company "may use its employee population or statistical sampling and/or other reasonable methods" to make this determination. In addition, the rule does not prescribe the use of "total compensation" as computed under Item 402(c)(2)(x) of Regulation S-K or any other specific compensation measure. Instead, it permits the company to identify the median employee using any appropriate compensation measure that is consistently applied.

Statistical sampling. The rule does not contain specific requirements for any statistical sampling method a company might employ to identify its median employee. The SEC sought to fill this gap by providing some guidance in the rule's adopting release on the use of statistical sampling. The SEC said that companies must determine based on their own facts and circumstances what they consider to be an appropriate statistical sampling method. It noted that companies may use more than one statistical sampling approach to derive reasonable estimates of the median compensation where there are multiple business lines or geographical units and infer the overall median based on observations drawn from each business or geographical unit. The SEC also observed that the company may not need to determine the exact compensation for every employee in the sample, since it might be able to identify and exclude employees that fall on the high or low end of the compensation spectrum without precise compensation data for those employees.

Consistently applied compensation measure. The rule permits a company to identify the median employee using annual total compensation or any other compensation measure that is consistently applied to all employees included in the calculation, such as a compensation measure derived from tax and/or payroll records, so long as the company briefly discloses the compensation measure it used. This approach allows companies to use a compensation measure other than annual total compensation, such as "taxable wages," "cash compensation" or another measure that is more readily ascertainable than annual total compensation. If the company uses a compensation measure other than annual total compensation, it must disclose the compensation measure it used. The SEC clarified in the rule's adopting release that the company may use a compensation measure that is defined differently in various jurisdictions and may include different annual periods so long as it applies the measure consistently within each jurisdiction. The company would not satisfy the rule if it were to use entirely different types of measures across jurisdictions.

In contrast to the proposed rule, the final rule permits a company to apply a cost-of-living adjustment to the compensation measure used to identify the median employee in a jurisdiction other than the jurisdiction in which the CEO resides, thereby adjusting the median employee's compensation to the cost of living in the CEO's jurisdiction. If a company applies this adjustment, it must use the same cost-of-living adjustment in calculating the median employee's annual total compensation, so that the pay ratio incorporating the adjustment would be the required ratio. In addition to other required information, the company would have to disclose the median employee's jurisdiction, the nature of the cost-of-living adjustment, and the median employee's annual total compensation and the pay ratio without the cost-of-living adjustment.

Disclosures concerning methodology. The rule permits companies to use "reasonable estimates" in the methodology they apply to identify the median employee and to calculate the annual total compensation or any elements of total compensation for employees other than the CEO. Regardless of the methodology they use, companies must briefly describe the methodology and any material assumptions, adjustments (including cost-of-living adjustments) or estimates they employed to find the median employee, and clearly identify as estimates any estimated amounts. Companies need a reasonable basis to conclude that any estimates approximate the actual amounts, but are not required to provide all technical details so long as they disclose enough information to enable investors to evaluate the appropriateness of the estimates.

Frequency of identifying median employee. In a departure from the proposed rule, which would have required companies to identify the median employee every year, the final rule allows a company to identify the median employee only once every three years unless there has been a change in its employee population or employee compensation arrangements that the company reasonably believes would result in a significant change in the pay ratio disclosure. It is unclear whether this accommodation will significantly reduce the annual compliance burden, because the company will still have to analyze each year whether changes require identification of a new median employee. If there has been such a change, the company must re-identify the median employee for the new year. Even if there is no such change, the company still must calculate the identified median employee's total compensation for each year in the three-year period and use that figure in calculating the pay ratio for the year. If the median employee identified in the first year is no longer in the same position or is no longer employed by the company on the median employee determination date in the second or third year, the final rule permits the company to replace its median employee with an employee whose compensation is substantially similar to that of the original median employee based on the compensation measure used to identify the original median employee.

Annualizing adjustments. Companies may annualize the total compensation for full-time or part-time permanent employees who did not work for the entire year, such as newly hired employees, employees called for active military duty or employees who took an unpaid leave of absence during the period. The total compensation of any such permanent employee thus may be projected to the level the employee would have attained if the employee had worked for the full year at the schedule followed for the portion of the year worked. An annualizing adjustment would not be mandatory, but any annualizing adjustments that are made would have to be applied on the same basis to all similarly-situated employees. Companies may not annualize the total compensation for temporary or seasonal employees, or make a "full-time equivalent" adjustment for any employee. The SEC noted that a full-time equivalent adjustment prohibited by the rule would involve taking the compensation of a part-time employee and projecting what the employee would have earned if the employee had been employed on a full-time basis.

Calculation of median employee annual total compensation

Calculating the median employee's annual total compensation is a process separate from the process used to identify the median employee. Accordingly, regardless of the methodology it used in the median employee determination, once the company identifies its median employee, it must calculate the median employee's annual "total compensation," as well as the CEO's annual total compensation, in accordance with Item 402(c)(2)(x) of Regulation S-K. The results of these calculations are the values the company must disclose and use in computing the pay ratio.

In adopting this requirement, the SEC recognized some of the difficulties companies will face in calculating median employee compensation using requirements intended to apply solely to executive officers. Accordingly, the rule clarifies that, for any median employee that is non-salaried, references to "base salary" and "salary" in Item 402 are deemed to refer to "wages plus overtime." Further, to avoid understatement of the median employee's total compensation, the rule also permits companies to include personal benefits that total less than $10,000 and compensation under non-discriminatory benefit plans, items that are typically excluded from executive officer compensation, in calculating the median employee's compensation so long as these items also are included in calculating the CEO's annual total compensation. The SEC also noted, by way of additional clarification, that a company determining the median employee's total compensation may exclude government-related pension benefits payable to a non-US employee and use reasonable estimates in determining an amount that reasonably approximates the aggregate change in actuarial present value of the employee's defined pension benefit (for example, in estimating pension benefits provided to a union member under a multi-employer defined benefit pension plan).

Disclosure concerning median employee

The rule states that a company should not disclose any personally identifiable information about its median employee other than the employee's compensation and, if the company wishes to put the employee's compensation in context, the employee's position (unless disclosing the position could enable someone to identify the employee). As noted earlier, the company also would have to disclose the median employee's jurisdiction of employment if the company applied a cost-of-living adjustment to identify the employee.

Calculation and presentation of pay ratio

Section 953(b) of the Dodd-Frank Act does not specify how companies should calculate and present the CEO pay ratio. The new rule sets forth the following three requirements for the pay ratio disclosure:

1. The company must compare the median employee's annual total compensation to the CEO's annual total compensation.
2. The company must express the pay ratio as a "factor," showing how much larger the CEO's compensation is compared to the median employee's compensation (or how much smaller, if the CEO is paid only nominal compensation), rather than as a fraction, so that the company may not present the median employee's compensation as a fraction of the CEO's compensation.
3. The company may choose one of two options to express the pay ratio:
   - It may express the pay ratio as the median employee's compensation equal to 1 and the CEO's compensation as the number compared to 1 (*e.g.,* by disclosing that the pay ratio is 50 to 1 or 50:1); or
   - It may disclose the pay ratio narratively by stating how many times higher (or lower) the CEO's compensation is than the median employee's compensation (*e.g.,* by disclosing that the CEO's compensation is 50 times that of the median employee's compensation).

The SEC did not adopt the suggestion of some commenters on the rule proposal that a company be permitted simply to disclose that its pay ratio exceeds a particular ratio level, such as 300 to 1.

Companies may present additional pay ratios or narrative disclosure to supplement the disclosed pay ratio where they believe the required disclosure may be confusing or incomplete without further explanation, but are not required to do so. If a company includes any additional pay ratios, the ratios must be clearly identified, not misleading and not presented with greater prominence than the required pay ratio. Additional pay ratios are not limited to any particular information, such as separate pay ratios covering US and non-US employees.

Scope of "employee"

Much of the SEC's rulemaking process focused on the task of defining the terms "employee" and "employee of the registrant" for purposes of designating the employee population the company must use in finding the median employee.

Included employees. Under the new rule, a company's employees will encompass:

- Its US and "non-US employees," which the rule defines as employees located in a jurisdiction outside the United States;
- Its full-time, part-time, seasonal and temporary workers;

- Its salaried employees and its non-salaried employees who receive "wages plus overtime" rather than salary; and
- All of the foregoing types of employees working for any subsidiary which the company consolidates for financial reporting purposes (rather than, as under the rule proposal, any subsidiary of the company, whether or not consolidated).

Excluded workers. Workers who are employed by an unaffiliated third party and whose compensation is determined by such a third party do not fall within the scope of "employee." The rule therefore excludes independent contractors or "leased" workers from the employee population. The SEC indicated, however, that companies may discuss their reliance on "leased" workers in the pay ratio disclosure and may present additional pay ratios that reflect the inclusion of those workers in the calculation so long as any additional ratios are not misleading and are not disclosed more prominently than the required pay ratio.

Determination date. The proposed rule would have defined "employee" as an individual employed as of the last day of the company's last completed fiscal year. The final rule, however, permits a company to choose any date within the last three months of its last completed fiscal year on which to determine the employee population for purposes of identifying the median employee. Among other advantages, the change in approach will afford companies more time to take the steps necessary to complete the identification process. The company must disclose the date it used to identify the median employee and, if it changes the date in a future year, must disclose the change and the reasons for the change.

Exemptions for non-US employees. Citing Section 953(b)'s mandate to include "all employees of the issuer" in the pay ratio calculation and its own reading of the statute's purpose, the SEC rejected the recommendation of some commenters on the rule proposal that non-US employees be excluded from the ambit of the new rule. In an attempt to reduce compliance costs and burdens of including non-US employees, however, the SEC included two exemptions in Item 402(u) that permit a company to exclude non-US employees from the median employee determination:

- *Data privacy exemption*: The company may exclude from the determination its non-US employees who are employed in a jurisdiction with data privacy laws or regulations that render the company unable, despite its "reasonable efforts," to obtain or process the information necessary for the pay ratio disclosure without violating those laws or regulations. To meet the reasonable-efforts standard, the company will be required, at a minimum, to seek an exemption or other relief under the governing data privacy laws or regulations. To exclude any non-US employees in a particular jurisdiction under the data privacy exemption, the company must exclude all non-US employees in that jurisdiction, list the excluded jurisdictions, identify the specific data privacy law or regulation precluding compliance, explain how complying with the rule violates the data privacy law or regulation (and, as part of this disclosure, describe the efforts it made to use or seek an exemption or other relief under the law or regulation), and disclose the approximate number of employees excluded in each jurisdiction in reliance on the exemption. In addition, the company must obtain an opinion of counsel that addresses the company's inability to obtain or process the information necessary to comply with the rule without violating that jurisdiction's data privacy laws or regulations, including the company's inability to obtain an exemption or other relief under any governing laws or regulations. The company will have to file the legal opinion as an exhibit to the filing in which its pay ratio disclosure appears.
- *De minimis exemption*: The company may exclude up to five per cent of its non-US employees from the median employee determination for any reason. To prevent a company from using this exemption to manipulate its compensation data, the rule

requires a company excluding any non-US employee in a particular jurisdiction to exclude all its non-US employees in that jurisdiction. If the number of employees in a single non-US jurisdiction exceeds five per cent of the company's total employees, the company may not exclude any employees in that jurisdiction under this exemption. If a company relies on the *de minimis* exemption, it must disclose the jurisdictions from which its non-US employees are being excluded, the approximate number of employees excluded from each jurisdiction under the *de minimis* exemption, the total number of its US and non-US employees without application of the data privacy or *de minimis* exemption, and the total number of its US and non-US employees used for its *de minimis* calculation.

A company wishing to rely on the exemptions will have to be aware of the limits on the relief they offer. There is no limitation on the number of non-US employees that may be excluded under the data privacy exemption. Non-US employees excluded under the data privacy exemption, however, will count against the five per cent limit for the *de minimis* exemption. Therefore, if the number of employees excluded under the data privacy exemption equals or exceeds five per cent of the company's total employees, the *de minimis* exemption will not be available. In addition, if the number of employees excluded under the data privacy exemption is less than five per cent of the company's total employees, the company may use the *de minimis* exemption to exclude no more than the number of non-US employees that, combined with those excluded under the data privacy exemption, does not exceed five per cent of the company's total employees.

Aside from the data privacy and the *de minimis* exemptions, the SEC declined to provide relief under the rule to mitigate the complexities or legal impediments that may arise from the inclusion of non-US employees in the median employee determination. The SEC suggested, however, that there are ways to address any legal impediments and the significant compliance costs that could result from the rule's coverage of a global workforce. The SEC noted, as an example, that companies could use reasonable estimates of the compensation of affected employees that might be consistent with laws protecting employee privacy in the relevant jurisdictions. We expect that every company with international operations will have to take these complexities into account in determining which approach to use.

Calculation of compensation for multiple CEOs

The new rule specifies how a company may calculate the CEO's annual total compensation for purposes of the pay ratio disclosure if one or more of the company's CEOs served for only part of a fiscal year. In these circumstances, the company may calculate CEO compensation in one of two ways:

1. The company may take the total compensation calculated under Item 402(c)(2)(x), and reflected in the summary compensation table, for each person who served as CEO during the year and combine those figures; or
2. It may look to the CEO serving in that position on the date within three months of the end of its last completed fiscal year used to identify the median employee and annualize that CEO's compensation.

Location and timing of pay ratio disclosure

The final rule requires companies to provide the pay ratio disclosure in any filing described in Item 10(a) of Regulation S-K that calls for executive compensation disclosure under Item 402, including annual reports on Form 10-K, registration statements under the Securities Act of 1933 (Securities Act) and the Exchange Act, and proxy and information statements, to the same extent that these filings require compliance with Item 402. Companies are not required to update their annual pay ratio disclosure until they file their next annual report on Form 10-K for their last completed fiscal year or, if later, until they file their next definitive proxy statement for their annual meeting of shareholders following that fiscal year, so long as they provide the disclosure not later than 120 days after the end of the fiscal year (which is the same filing deadline that applies generally to executive compensation disclosure). In the rule's adopting release, the SEC expressed the view that the most meaningful way to present the pay ratio disclosure is in the context of other executive compensation disclosure, such as the summary compensation table required under Item 402(c) and the compensation discussion and analysis required under Item 402(b), rather than on a stand-alone basis.

The rule permits new registrants to delay compliance with Item 402(u), so that the pay ratio disclosure is not required in a registration statement filed on Form S-1 or Form S-11 under the Securities Act for an initial public offering or in a registration statement filed on Form 10 under the Exchange Act. A new registrant will be required to provide its initial pay ratio disclosure following its first full fiscal year beginning after the registrant has been subject to the reporting requirements of Section 13(a) or 15(d) of the Exchange Act for a period of at least twelve calendar months beginning on or after January 1, 2017, and has filed at least one Form 10-K report pursuant to Section 13(a) or 15(d) that does not contain the pay ratio disclosure.

Transition periods

A company that ceases to be a smaller reporting company or an emerging growth company is not required to provide pay ratio disclosure until it files a Form 10-K report or an annual proxy statement for the first full fiscal year beginning on or after the date on which it ceases to be a smaller reporting company or emerging growth company (but not for any fiscal year commencing before January 1, 2017). The final rule also permits companies that complete acquisitions or other business combinations to omit the employees of a newly-acquired entity from their pay ratio calculation for the fiscal year in which the acquisition or business combination occurs. In this case, companies must identify the acquired business and the approximate number of employees they have omitted from the pay ratio calculation.

Looking ahead

The pay ratio disclosure mandated by the Dodd-Frank Act has been controversial from the time of the statute's enactment. The SEC received more than 22,000 advisory letters and a petition with more than 84,000 signatures even before it proposed Item 402(u). In many of those letters and comments, as well as in later comments on the proposed rule, a range of public companies and other commenters opposed the pay ratio disclosure on the grounds that it would be immaterial to investors and excessively costly and burdensome for companies to produce. In their statements dissenting from adoption of the final rule, two of the Commissioners concurred with the most severe critics of Section 953(b) and the rule that the pay ratio disclosure amounts to little more than a project to shame companies into lowering CEO pay. Many shareholders and investor groups, on the other hand, vigorously expressed a contrary view, arguing that the requirement would produce useful information for shareholders and the marketplace.

The SEC attempted to soften the financial impact of the pay ratio disclosure requirement, primarily by affording companies flexibility in calculating the median annual compensation of their employees, although, for the rule's critics, the SEC's efforts to address this and other objections to the proposed rule fell far short of satisfactorily accommodating legitimate concerns over expected compliance costs. Companies will have to determine the calculation method that will work best for them, and would be well served to begin the process of making that determination at an early date. Discussions with, and analyses by, human resources and finance personnel, as well as advice from counsel and outside consultants, should help identify potential impediments to the use of different methods.

The SEC's approach to the method of calculating median annual compensation of employees may help to limit the costs and other burdens of the new rule. This approach however, will reduce the comparability of a company's pay ratio information with that of other companies using different calculation methods. How useful the pay ratio information will be in light of differences in calculation methodology remains to be seen, and is likely to vary on the basis of the importance that individual investors ascribe to CEO compensation in making their investment and voting decisions.

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