SEC Adopts Pay Ratio Disclosure Rule

August 10, 2015

Securities

On August 5, 2015, the Securities and Exchange Commission ("SEC") adopted, by a three-to-two vote, a rule[1] that will require most public companies[2] to disclose, annually, the ratio of the median of the annual total compensation of the company's employees to the annual total compensation of the company's principal executive officer (the "PEO"). The SEC noted that although Congress did not expressly state the specific objectives or intended benefits of requiring pay ratio disclosure, it believes the primary benefit of its rule requiring such disclosure is to provide shareholders with a company-specific metric that they can use to evaluate the PEO's compensation within the context of their company.[3]

Companies must comply with the pay ratio rule for the first fiscal year beginning on or after January 1, 2017. As a result, companies with December 31 fiscal years will first be required to provide pay ratio disclosure, for the 2017 fiscal year, in their proxy statements for their 2018 annual meeting of shareholders. Companies that cease to be smaller reporting companies or emerging growth companies are not required to provide pay ratio disclosure until they file a report for the first fiscal year commencing on or after they cease to be a smaller reporting company or emerging growth company.[4]

The Final Rule

The pay ratio rule requires annual disclosure of (i) the median annual total compensation of employees other than the PEO, (ii) the annual total compensation of the PEO and (iii) the ratio of the two amounts.[5] Consistent with Section 953(b) of the Dodd-Frank Act, "total

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[1] *Pay Ratio Disclosure*, Rel. No. 33-9877 (August 5, 2015), which can be found at http://www.sec.gov/rules/final/2015/33-9877.pdf.

[2] Companies that qualify as emerging growth companies, smaller reporting companies, foreign private issuers or are U.S. Canadian Multijurisdictional Disclosure System filers are exempt from the pay ratio disclosure requirement.

[3] This rule was adopted pursuant to the mandate of Section 953(b) of the Dodd-Frank Wall Street Reform and Consumer Protection Act (the "Dodd-Frank Act"). The SEC originally proposed this rule on September 18, 2013 (*Pay Ratio Disclosure*, Rel. No. 33-9452 (Sep. 18, 2013), which can be found at http://www.sec.gov/rules/proposed/2013/33-9452.pdf) .

[4] IPO issuers that do not qualify as emerging growth companies will be permitted to omit pay ratio disclosure from a registration statement on Form S-1 or S-11. Thereafter, such issuers will be required to disclose pay ratio information for the first fiscal year commencing on or after January 1, 2017 that is after the date the issuer becomes subject to the requirements of Section 13(a) or 15(d) of the Securities Exchange Act of 1934 (the "Exchange Act").

[5] The new requirement is set forth in new Item 402(u) of Regulation S-K.

compensation" would be calculated in accordance with Item 402(c)(2)(x) of Regulation S-K.[6] When reporting the ratio of these two figures, the amount in clause (i) would be expressed as "1," and the amount in clause (ii) would be expressed as a multiple of the amount in clause (i). Alternatively, the ratio could be expressed narratively as the multiple that the amount in clause (ii) bears to the amount in clause (i). For example, if the median annual total compensation of employees is $40,000 and the annual total compensation of the PEO is $6 million, the ratio would be expressed as "1 to 150" or, alternatively, "the PEO's annual total compensation is 150 times the median annual total compensation of other employees."

This new disclosure is required to be included in a company's annual report on Form 10-K, registration statements under the Securities Act of 1933 (the "Securities Act") and the Exchange Act, and proxy and information statements, to the extent such forms require executive compensation disclosure pursuant to Item 402 of Regulation S-K. As discussed below, the pay ratio disclosure will need to be accompanied by a brief description of the methodology, including any material estimates and assumptions, used by the company to calculate the median annual total compensation of employees.

The required pay ratio must be disclosed every year but not until the filing of the company's annual report on Form 10-K for that year or, if later, the filing of a definitive proxy statement relating to the company's next annual meeting of shareholders after such year-end. As with the other compensation information required by Item 402 of Regulation S-K, pay ratio disclosure must be disclosed within 120 days after the end of the company's fiscal year.[7] Notwithstanding the foregoing, if a company is unable to calculate the PEO's salary or bonus within this period, the company may defer providing pay ratio disclosure until the time it discloses the PEO's updated compensation pursuant to Item 5.02(f) of Form 8-K.

Determining the Median Annual Total Compensation of Employees

The pay ratio rule does not mandate a specific methodology for calculating the median annual total compensation of employees; rather, each company will have discretion to use a reasonable method of calculation based on the size and structure of its business and the way it compensates employees. Whichever methodology is used, the calculation must cover all persons (other than the PEO) employed by the company or any of its consolidated subsidiaries[8] as of a date within the last three months of the most recently completed fiscal year, wherever

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[6] Item 402(c)(2)(x) of Regulation S-K generally provides that "total compensation" is the sum of an individual's salary, bonus, stock awards, option awards, non-equity incentive plan compensation, change in pension value, nonqualified deferred compensation earnings, and all other compensation, including perquisites.

[7] A company requesting that the SEC declare effective a registration statement after the end of its fiscal year but before it has filed its proxy statement for its annual meeting of shareholders will not be required to include updated pay ratio disclosure in order to have its registration statement declared effective. But, such companies must include or incorporate by reference in the registration statement their pay ratio disclosure (if it was required) for the fiscal year prior to the last completed fiscal year.

[8] While the proposed rule would have required coverage of employees at all subsidiaries, in response to concerns raised over the cost of compliance, the final pay ratio rule only requires including in the calculation employees of subsidiaries that the company treats as consolidated subsidiaries for financial reporting purposes.

located in the world, including full-time, part-time, seasonal and temporary employees.[9] Companies are required to disclose the date used to identify the median employee and, if the date is changed in subsequent years, to disclose the change and provide a brief explanation for the change.

One way for a company to determine the median annual total compensation of employees other than the PEO is to determine the total compensation of *each* employee in accordance with Item 402(c)(2)(x) of Regulation S-K, and then identify the median value (*i.e.*, the point where the compensation of half of the employee population is higher than the median value and half is lower). Recognizing that certain elements of total compensation under Item 402(c)(2)(x) require complicated calculations, the SEC will allow companies to use other methodologies that make use of reasonable estimates to identify the median, as well as reasonable estimates to calculate any of the elements of total compensation (other than for the PEO). Instructions to the pay ratio rule set forth two specific alternative methodologies that companies may use to identify the median employee — statistical sampling, and a consistently applied compensation measure other than "total compensation." Companies are required to identify once every three years the median employee whose compensation will be used for the total compensation calculation, provided that if the company's employee population or compensation changes such that the company reasonably believes its pay ratio disclosure would significantly change, it shall re-identify the median employee for that fiscal year.

Statistical Sampling

The pay ratio rule permits a company to identify the median employee by analyzing a statistical sampling of the total employee population, as long as the sampling method used is reasonable. The SEC noted that what constitutes a reasonable sampling methodology (including sample size) will depend on a variety of factors, such as the variance of underlying compensation distributions (*i.e.*, how widely employee compensation is spread out or distributed around the mean), and variation in the type of employees across business units and geographical regions. Within a chosen employee sample, the SEC noted that companies could, in lieu of calculating the total compensation of each employee, identify employees who have extremely high or extremely low pay that would fall on either side of the pay spectrum, since the search for the median focuses on identifying the employee in the middle of the range.

Consistently Applied Compensation Measures Other than Total Compensation

The pay ratio rule also permits companies to identify the median employee not by calculating "total compensation" for employees, but by using any other compensation measure that is consistently applied to all employees included in the calculation, such as salary and wages or comparable amounts derived from the company's payroll or tax records. The adopting release states that companies are in the best position to select the appropriate compensation measure to use for this purpose based on their own facts and circumstances. The pay ratio rule also provides that, where the annual period for payroll or tax recordkeeping is different from the

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[9] The pay ratio rule allows, but does not require, companies to annualize the compensation of permanent employees that were not employed for the entire fiscal year, such as new hires (but if the company annualizes the compensation of any such employees, it must annualize it for all such employees). However, the pay ratio rule does not permit full-time equivalent adjustments for part-time workers or annualizing adjustments for temporary or seasonal employees.

company's fiscal year, the company may nevertheless use its payroll and tax information to identify the median employee.

Calculating Total Compensation

After the median employee has been identified (whether through a review of compensation information for the entire employee pool or through an estimation process using statistical sampling or use of an alternative compensation measure), the company would then need to calculate the "total compensation" of the median employee in accordance with Item 402(c)(2)(x) of Regulation S-K.[10] Since this would likely be a hypothetical employee if sampling was used to identify the median, the pay ratio rule allows companies to use reasonable estimates to calculate any of the elements of total compensation for such employee. Such estimates might be especially useful when calculating items included in total compensation such as the grant date fair value of stock awards and option awards, changes in pension value and company contributions to defined contribution plans.

While the final pay ratio rule allows companies to identify the median employee once every three years, companies are still required to calculate the identified median employee's total compensation annually (*i.e.*, calculate the median employee's annual total compensation in year one and then re-calculate the annual total compensation for that employee in years two and three).

Cost-of-Living Adjustments

The proposed rule would not have permitted companies to make cost-of-living adjustments. The final pay ratio rule, however, allows companies identifying the median employee, whether using annual total compensation or another compensation measure consistently applied to all employees, to make cost-of-living adjustments for the compensation of employees in jurisdictions other than the jurisdiction in which the PEO resides in order to adjust the cost of living to the jurisdiction in which the PEO resides. Where a company uses a cost-of-living adjustment to identify the median employee, and the median employee does not reside in the same jurisdiction as the PEO, the pay ratio rule requires the company to use the same cost-of-living adjustment in calculating the median employee's annual total compensation. Companies choosing to factor in such cost-of-living adjustments will also be required to disclose the median employee's annual total compensation and pay ratio without the cost-of-living adjustments, which will therefore require these companies to conduct a second identification process in order to identify the median employee without using any cost-of-living adjustments.[11]

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[10] Companies that engage in business combinations and/or acquisitions are permitted 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. Companies that exclude employees as a result of a business combination must disclose the acquired business and the approximate number of employees that are excluded from the calculation.

[11] Companies that make cost-of-living adjustments are also required to disclose the country in which the median employee is located and briefly describe the cost-of-living adjustments used, including the measure used as the basis for the adjustment.

Limited Exemptions for Non-U.S. Employees

In response to concerns expressed by several commentators over cross-border compliance issues that may arise from the pay ratio disclosure requirement, the final pay ratio rule allows companies to exclude from the determination of the median employee all, but not less than all, employees who are employed in a foreign jurisdiction in which the laws or regulations governing data privacy would be violated by the company's compliance with the pay ratio rule (the "data privacy exemption").[12] As a result of the burdensome prerequisites described below, we expect that few companies will ultimately decide to rely on the data privacy exemption.

In order to rely on this exemption, companies are required to use reasonable efforts to obtain or process the information necessary for compliance with the pay ratio rule, which efforts must include seeking an exemption or other relief under any governing data privacy laws or regulations. In addition, such companies must obtain a legal opinion from counsel in that jurisdiction that opines on the inability of the company to obtain or process the information necessary for compliance with the pay ratio rule without violating that jurisdiction's data privacy laws or regulations, including the company's inability to obtain an exemption or other relief.[13] This legal opinion is required to be filed as an exhibit to any filing in which the pay ratio relying on this exemption appears (including as an exhibit to a proxy statement, under a newly added "Item 25. Exhibits" to Schedule 14A).

The final pay ratio rule also contains a *de minimis* exemption that allows companies to exclude non-U.S. employees. This exemption has two categories. The first applies to companies with non-U.S. employees that account for five percent or less of the company's total employees. Under this category of the exemption, the company is allowed to exclude all, but not less than all, non-U.S. employees when making pay ratio calculations.

The second category of the exemption is for companies with non-U.S. employees which exceed five percent of the total U.S. and non-U.S. employees. These companies may exclude up to five percent of total employees who are non-U.S. employees. However, to prevent "cherry-picking," if a company excludes any non-U.S. employees in a particular jurisdiction, it must exclude all employees in that jurisdiction, but the company may not exclude any employees from a particular jurisdiction where more than five percent of the company's employees are located.

In calculating the number of non-U.S. employees that may be excluded under the *de minimis* exemption, a company must count any non-U.S. employee exempted under the data privacy exemption against the availability. Companies relying on this *de minimis* exemption must disclose the jurisdictions from which its non-U.S. employees are being excluded, the approximate number of employees excluded from each jurisdiction, the total number of U.S. and non-U.S. employees (irrespective of any exemption) and the total number of U.S. and non-U.S. employees used for purposes of determining qualification for the *de minimis* exemption.

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[12] Companies relying on this exemption must disclose the excluded jurisdiction, identify the specific data privacy law or regulation, explain how complying with the final rule violates such data privacy law or regulation (including the efforts made by the company to use or seek an exemption or other relief under such law or regulation) and provide the approximate number of employees exempted from each jurisdiction based on this exemption.

[13] While it is not explicit in the adopting release, we expect that the required legal opinion will need to be delivered by an independent local counsel in the relevant jurisdiction.

Additional Disclosure Regarding Methodologies Used

The pay ratio rules require companies to “briefly” disclose (and consistently apply) any methodology used to identify the median, as well as any material assumptions, adjustments or estimates used to identify the median, or to determine total compensation or any element of total compensation. Further, any amounts that are estimates must be clearly identified.

More specifically, if statistical sampling is used, a company would be required to disclose:

- the size of both the sample and the estimated entire employee population;
- any material assumptions used in determining the sample size;
- which sampling method (or methods) is used; and
- if applicable, how the sampling method deals with separate payrolls such as geographically separated employee populations or other issues arising from multiple businesses or geographic segments.

Further, where a company uses a compensation measure other than annual total compensation to identify the median employee, the company would be required to disclose the compensation measure used and calculate and disclose the annual total compensation for that median employee. If a company changes methodologies or material assumptions, adjustments or estimates from those used in a previous period and if the effects of any such change are material, the company would be required to briefly describe the change, the reasons for the change and provide an estimate of the impact of the change on the median and the ratio.

Conclusion

The SEC received over 287,000 comment letters on the proposed pay ratio rule, including more than 1,500 unique letters. In an effort to address concerns raised over aspects of the proposed rule, the SEC added certain of the measures described above to the final pay ratio rule to minimize the expected costs and unintended consequences of the required disclosure. Nevertheless, it is likely that there remains strong opposition to the new rule, perhaps even fueled by the dissents of two Commissioners which cited, among other things, the high cost of compliance and a concern that the rule does little to advance the SEC’s core mission of investor protection. Depending on the strength of any continuing opposition to the adopted rule, pending legislation could move forward to remove or modify the required pay ratio disclosure. Litigation might also be possible. Since companies will not have to disclose the pay ratio before proxy statements for 2018 annual meetings, those opposing the adopted rule will have ample time to mount attempts to modify or eliminate pay ratio disclosure requirements.

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