

SEC Finalizes the CEO Pay Ratio Rule - Additional Executive Compensation Disclosure for Public Companies Beginning in 2017

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On August 5, by a vote of 3-to-2 with the SEC Commissioners voting along party lines, the SEC approved the final rule to implement the requirements of Section 953(b) of the Dodd-Frank Act, which instructed the SEC to amend existing rules under Item 402 of Regulation S-K to require public companies to disclose the ratio of their CEO's annual total compensation to that of the median annual total compensation of all company employees. All public companies will be subject to this new disclosure requirement, with the exception of emerging growth companies, smaller reporting companies and foreign private issuers.

The rule requires companies to disclose:

- (a) The median of the annual total compensation of all company employees, excluding the CEO;
- (b) The annual total compensation of the company's CEO; and
- (c) The ratio of (a) to (b).

Companies will be required to provide disclosure of this ratio commencing with their first fiscal year beginning on or after January 1, 2017, which information will be disclosed in the Executive Compensation section of a company's Form 10-K (or proxy statement). Thus, disclosure will begin in the 2018 proxy season. In addition to the ratio itself, disclosure describing the methodology used to identify the median employee, determine total compensation and any material assumptions, adjustments (including allowable cost-of-living adjustments) or estimates used to identify the median employee or to determine annual total compensation will also be required. As described in the proposed rule, when identifying the median employee, the final rule requires companies to include all employees, including full-time, part-time, temporary, seasonal, and foreign employees employed by the company or any of its subsidiaries and to annualize the compensation of permanent employees who were not employed for the entire year, such as new hires. Companies may not, however, annualize the compensation of part-time, temporary, or seasonal employees. Consultants and other advisors who are not employees and individuals who are employed by unaffiliated third parties are not to be included in the calculation.

The SEC made changes from the proposed rule to address concerns in the cost of compliance with the rule and to make the rule a bit easier for companies to implement. For example, the SEC changed the timing of the date of the ratio calculation. Instead of the determination being made based solely on the number of employees employed as of the last day of the company's prior fiscal year, the final rule allows a company to choose a date within the last three months of its last completed fiscal year on which to determine the employee population. In addition, companies will be allowed to identify its median employee once every three years unless there has been a change in its employee population or compensation arrangements that the company reasonably believes would result in a significant change to its pay ratio and if within those three years, the median employee's compensation changes, the company may use another employee with substantially similar compensation as its median employee.

To address the criticism regarding the inclusion of foreign employees, the final rule allows companies to exclude foreign employees from the calculation under two circumstances:

- Foreign Data Privacy Law Exemption - If the foreign employees are employed in a jurisdiction with data privacy laws that make the company unable to comply with the rule without violating those laws, provided that the company obtains a legal opinion from counsel to that effect and files the legal opinion with the SEC with its disclosure filing.

- De Minimis Exemption - If a company's foreign employees account for 5% or less of its total employees, it may exclude all foreign employees when making its pay ratio calculation. However if it chooses to exclude foreign employees, it must exclude all of them. If more than 5% of a company's employees are foreign employees, it may also exclude up to 5% of its total employees who are foreign employees. However, if a company excludes any foreign employees in a particular jurisdiction, it must exclude all foreign employees in that jurisdiction. In calculating the number of foreign employees that may be excluded under this de minimis exemption, a registrant must count any foreign employee exempted under the data privacy exemption. Once the company identifies a median employee, the company must calculate such employee's annual total compensation for the last completed fiscal year using the definition of "total compensation" in Item 402(c)(2)(x) of Regulation S-K. As with the proposed rule, the final rule permits a company to include perquisites that aggregate less than \$10,000 and broad-based health coverage in the calculation of total compensation, provided that the company uses the same approach in calculating the CEO's total compensation.

As with the proposed rule, the final rule allows for flexibility in identifying a median employee and does not specify a required methodology for purposes of such analysis. In determining the employees from which the median is identified, companies may choose to use their entire employee population, statistical sampling or other reasonable methods. Under the final rule, the SEC will allow a company to apply a cost-of-living adjustment in the determination of its median employee, provided the same cost-of-living adjustment is used in calculating total compensation for that employee.

Authors