

Dodd-Frank CEO Pay Ratio Disclosure Rules Approved

Article By:

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On August 5, 2015, the SEC approved the final rules on the so-called “CEO pay ratio disclosure” under the Dodd-Frank Act. The CEO pay ratio disclosure will require most publicly traded companies (referred to below as a “registrant”) to disclose the ratio of CEO pay to the median income of all other employees of the registrant.

Companies must first begin providing the pay ratio disclosure for the first full fiscal year that begins on or after January 1, 2017. Accordingly, for most companies with a December 31 year-end, disclosure will first be required in the registrant’s 10-K filed in 2018 for the 2017 fiscal year or in the 2018 proxy statement for the 2018 shareholder meeting (so long as the proxy is filed within 120 days of the 10-K).

Here is a general summary of the CEO pay ratio disclosure requirements as well as an explanation of the more significant changes adopted as part of the final rule.

Note: The CEO Pay Ratio Rule uses the term PEO (Principal Executive Officer) in lieu of CEO. We refer to the CEO below for simplicity.

General Overview of the CEO Pay Ratio Disclosure Rule

- *Who does the rule apply to?* Registrants who are required to provide executive compensation disclosure pursuant to Item 402 of Regulation S-K must comply with the CEO pay ratio disclosure. ***Emerging growth companies, smaller reporting companies and foreign private issuers are not subject to the rule.*** Special transition rules apply to companies that become publicly traded or become subject to the rule as a result of a merger or acquisition.
- *Where must the CEO pay ratio be disclosed?* Generally, wherever executive compensation disclosure is otherwise required under Item 402 of Regulation S-K. Accordingly, disclosure will be required on Form 10-K, proxy statements and registration statements that require executive compensation disclosure (but not in current reports or quarterly reports). The pay ratio disclosure is considered “filed” with the SEC instead of “furnished.” Accordingly, the disclosure is subject to the applicable liability provisions under Section 18 of the Exchange Act and Section 11 of the Securities Act.

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- *How does the CEO Pay Ratio Rule work?* The focus of the rule is to identify the employee with the median income of the registrant and its affiliates (excluding the income of the CEO) and compare the median income employee's total annual compensation to the CEO's total annual compensation. This means the registrant must establish a compensation list of all employees (other than the CEO) and their compensation levels and then determine which employee has the same number of employee compensation levels above and below him or her on that list. Once the median income employee is identified, that employee's total annual compensation must be described in a ratio to the CEO's annual total compensation for the same year using the proxy statement summary compensation table rules in Item 402(c) of Regulation S-K ("SCT Compensation").
 - *May a registrant use a simplified method to identify the median income employee?* Yes. A registrant may use W-2 wages or other types of consistent compensation records to identify the median income employee. In addition, a registrant may use statistical sampling of its employees or other reasonable methods in identifying the employee with median income. Accordingly, a registrant could use a statistical sample of the W-2 wages of its employees to identify the median income employee. However, once the median income employee is identified, that median income employee's compensation must be calculated using SCT Compensation (defined above) in order to actually report the CEO pay ratio disclosure in the proxy or Form 10-K.
 - *Which employees must be considered in determining the median income employee?* All full-time, part-time, and seasonal workers worldwide of a registrant (and its affiliates) must be considered in identifying the median income employee. However, as explained below, the final rule does allow a registrant to exclude a limited number of non-U.S. employees and provides the registrant some flexibility in determining the date used to determine the list of employees considered in identifying the median income employee.
 - *How may the CEO pay ratio be described?* The ratio may be described numerically (e.g., "the ratio of the median of the total annual compensation of all employees (other than the CEO) to that of the CEO is 1 to 268") or narratively (e.g., "the CEO's annual total compensation is 268 times that of the median annual total compensation of all employees"). Registrants must also describe the methodology, assumptions and estimates used in creating the ratio. The pay ratio disclosure may be supplemented with additional information at the discretion of the registrant so long as such additional information does not detract from the required pay ratio disclosure and is not otherwise misleading.

Significant Changes to the Final CEO Pay Ratio Disclosure Rule

The final CEO pay ratio disclosure rules include a number of changes from the proposed rules that will provide some flexibility in determining the median income employee.

- A company may rely on the same median income employee determination to calculate the CEO pay ratio for as many as three years, so long as the registrant can reasonably determine that there has been no circumstance, such as a significant change in the number of

employees of the registrant, that would require a new determination of the median income employee. If the median income employee identified in year one of the three-year reliance period changes positions, or is no longer employed by the registrant in years two or three of the reliance period, the registrant may identify a replacement median income employee with similar compensation.

- A company may select any date within three months of the end of the registrant's fiscal year to determine the registrant's employees to be included in the median income employee determination. This date must be used consistently from year-to-year and the registrant must explain any change to the date selected in subsequent disclosure years.
- A company may exclude from the median income employee calculation the non-U.S. employees whose compensation information is protected from disclosure by foreign data privacy rules. Non-U.S. employees may be excluded if they are located in a jurisdiction in which foreign data privacy laws would preclude disclosure of such employees' compensation. To rely on this exclusion, the registrant must take reasonable steps to obtain a waiver from the foreign jurisdiction's data privacy requirements, explain in the actual CEO pay ratio disclosure that the foreign data privacy exclusion was used, and obtain a legal opinion certifying that it is unable to comply with the foreign jurisdiction's data privacy rules and that it was unable to obtain a waiver from the foreign jurisdiction's data privacy rules.
- A company may also exclude up to 5% of its employees who are non-U.S. employees so long as all employees of that same jurisdiction are excluded under the rule. Employees excluded from the median employee calculation under the foreign data privacy exclusion (described above) count against the number of employees that may be excluded under the general 5% exclusion. For example, if a registrant has excluded 4% of its employees of a jurisdiction in reliance on the data privacy exclusion, it may not exclude the employees in another foreign jurisdiction if the number of employees in that foreign jurisdiction exceed 1% of all employees of that registrant.
- A company may use a cost of living adjustment to adjust the compensation of employees outside of the jurisdiction in which the CEO lives to determine the median income employee. If a cost of living adjustment is used to identify the median income employee, then such same cost of living adjustment must be used in calculating SCT Compensation as part of the actual CEO pay ratio disclosure. The cost of living adjustment method, the jurisdiction in which the median income employee resides, and a separate pay ratio comparison without the use of a cost of living adjustment must be included in the CEO pay ratio disclosure.
- Only employees of a registrant and its consolidated subsidiaries, generally based on a 50% ownership threshold, will be included in the median income employee calculation.

Action Items

Although the CEO pay ratio disclosure is not required for more than two years, companies subject to

the disclosure requirement should begin now to evaluate the best method of identifying the median income employee. Accordingly, registrants should consider the following:

- Provide a summary of the final rule to the Board and/or compensation committee of the Board.
- Identify any foreign jurisdictions in which data privacy laws may preclude the registrant from including employees of that jurisdiction in the CEO pay ratio disclosure calculations.
- Determine whether non-U.S. employees may be excluded under the general 5% exclusion rule and determine which of those non-U.S. employees should be excluded.
- Evaluate how the median income employee will be determined (i.e., based on SCT compensation, W-2, statistical sampling, etc.) and identify any limits or restrictions in collecting that information that may arise.
- Begin to evaluate whether other disclosures may be appropriate to include with the CEO pay ratio disclosure to provide context and meaning to the CEO pay ratio disclosure.

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