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Securities Exchange Comission Adopts Pay Ratio Disclosure Rule

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The Securities and Exchange Commission (SEC), pursuant to a 3-to-2 party-line vote, recently adopted new Item 402(u) to Regulation S-K (Rule) to implement the pay ratio disclosure requirements of Section 953(b) (Section 953(b)) of the Dodd-Frank Wall Street Reform and Consumer Protection Act (Dodd-Frank).[1] The Rule differs from the SEC's original proposal in several ways that could make an issuer's compliance burden and expense less than they would have been had the original proposal been adopted without change.

The Rule requires certain public companies to disclose in specified filings:

- the median[2] of the annual total compensation of all employees of the issuer, except the issuer's principal executive officer (*i.e.*, the issuer's chief executive officer or the individual acting in a similar capacity) (PEO);
- the annual total compensation of the issuer's PEO; and
- the ratio of the foregoing compensation amounts.

A subject issuer must make its first pay ratio disclosure with respect to compensation for its first full fiscal year beginning on or after January 1, 2017.[3] Thus, an issuer with a December 31 fiscal year must first make pay ratio disclosure under the Rule based on the compensation deemed paid by it in fiscal 2017. That disclosure would be made in its annual report on Form 10-K (10-K) for fiscal 2017 or, if filed later than such 10-K and on or before April 30, 2018, its proxy or information statement for its 2018 annual shareholders' meeting.

Despite legislation being introduced in Congress to repeal Section 953(b)[4] and speculation that, like other SEC rules adopted pursuant to Dodd-Frank, the Rule may be challenged through a legal action, subject issuers should start preparing to comply with the Rule.

Issuers Subject to the Rule

Most issuers required to provide compensation disclosure pursuant to Item 402 of Regulation S-K (Item 402) in filings with the SEC must make pay ratio disclosure under the Rule. However, the Rule does not apply to emerging growth companies (EGCs), smaller reporting companies (SRCs), registered investment companies, foreign private issuers and issuers filing under the U.S.-Canadian multijurisdictional disclosure system. An issuer ceasing to be an SRC or an EGC must provide pay ratio disclosure with respect to compensation deemed paid in its first full fiscal year commencing when or after it ceases to qualify for such status and on or after January 1, 2017.

Identifying the Employee with the Median Annual Total Compensation

The Rule imposes a new burden on subject issuers—identifying the issuer's employee (Median Employee) whose annual total compensation is the median annual total compensation of all individuals who are treated as the issuer's employees under the Rule other than the issuer's PEO (Median Compensation).

Determine who are "employees." An issuer's first step toward compliance with the Rule will be to determine those individuals who constitute its "employees" under the Rule (Employee Population). The Rule defines an "employee" of an issuer as an individual employed by the issuer or one of its consolidated subsidiaries, whether as a full-time, part-time, temporary or seasonal worker, as of a particular date chosen by the issuer as discussed below. Named executive officers and other officers of an issuer, other than its PEO, are included in the issuer's Employee Population.

The SEC intends for the term "employee" to be construed to be broadly inclusive of all types of workers.[5] However, the term "employee" does not include any worker who is employed by, and whose compensation is determined by, an *unaffiliated* third party but who provides services to the issuer or one of its consolidated subsidiaries as an independent contractor or "leased" worker.[6] The status of independent contractors engaged directly by the issuer as an "employee" is unclear.[7]

The SEC's brief discussion in the Release of the exclusion of workers employed by third parties from an issuer's Employee Population fails to clarify whether employees of the general partner or another affiliate of an MLP conducting the management, administrative and operating functions of the MLP will be deemed to be "employees" of the MLP. However, the express limitation of the exclusion to workers employed by *unaffiliated* third parties and the absence of any discussion of the classification of workers performing work for an issuer, but who are employed by affiliated third parties, suggests that the SEC intends for employees of a sponsor, general partner or another affiliate of an MLP performing the management, administrative and operating functions of the MLP or its consolidated subsidiaries to be treated as "employees" of the MLP. This suggestion is given further credence by Commissioner Piwowar's dissenting statements.[8] As a result, when MLPs that are not SRCs or EGCs include Item 402 executive compensation information for the executive officers of their sponsors, general partners or other affiliates in such MLPs' 10-Ks or, when an MLP is required to make such filings, in proxy or information statements required to include Item 402 compensation disclosure, the SEC will likely expect those filings to include pay ratio disclosure comparing the PEO's compensation against the Median Compensation of the employees of the MLP's sponsor, general partner or other affiliates that perform work on behalf of the MLP pursuant to a shared services agreement or otherwise.

Select the determination date for the Employee Population. The Rule permits an issuer to

choose any date within the last three months of its last completed fiscal year as the date to determine its Employee Population. Only persons who are "employees" on the selected date will be included in the Employee Population. An issuer that typically employs a sizeable number of temporary or seasonal workers at its fiscal year end, but not at some earlier date during the last three months of its fiscal year, and that wants to have a lower disclosed pay ratio should consider determining its Employee Population at a date during that three month period when such issuer has fewer or no temporary or seasonal workers on its payroll.

Consider if the limited exemptions of individuals as "employees" apply. An issuer, at its option but subject to the satisfaction of certain conditions, may exclude the following employees from its Employee Population:

- all non-U.S. employees employed in a foreign jurisdiction whose data privacy laws or regulations make the issuer unable to comply with the Rule without violating those privacy laws or regulations (Privacy Law Exemption);
- up to 5% of the issuer's non-U.S. employees employed in foreign jurisdictions (De Minimis Exemption); and
- any individuals becoming employees of the issuer or one of its consolidated subsidiaries as the result of a business combination or acquisition of any entity by the issuer or one of its consolidated subsidiaries during the applicable fiscal year (Acquisition Exemption).

Privacy Law Exemption. An issuer may elect to exclude non-U.S. employees working in a foreign jurisdiction under the Privacy Law Exemption only if:

- it first undertakes reasonable efforts to obtain or process the non-U.S. employee information necessary for compliance with the Rule, which efforts must, at a minimum, include using or seeking an exemption from or other relief under the applicable data privacy laws or regulations; and
- it obtains a legal opinion confirming its inability to obtain or process the information necessary to comply with the Rule without violating the applicable data privacy laws or regulations, including its inability to obtain an exemption or other relief under the applicable data privacy laws or regulations, and files such opinion as an exhibit to the SEC filing including the pay ratio disclosure.

The SEC states that commenters on the proposed rule noted that European Union law prohibits the transfer of personal data to a third country that does not ensure adequate protection of the data and that the United States is not considered to provide such protection.[9] This provision of the Rule puts issuers with non-U.S. employees located in a country with strict data privacy laws and regulations in something of a box. If, for any reason, an issuer cannot comply with the conditions to rely on the Privacy Law Exemption and, as a result of applicable data privacy laws and regulations, the issuer cannot retrieve information necessary to comply with the Rule, the issuer's pay ratio disclosures could not comply with the Rule. The Rule offers no relief for issuers caught in this box.

De Minimis Exemption. The Rule imposes certain limits on the exclusion of non-U.S. employees pursuant to the De Minimis Exemption:

- non-U.S. employees excluded from an issuer's Employee Population under the Privacy Law Exemption will count against the 5% limit of the De Minimis Exemption and, therefore, an issuer cannot use the De Minimis Exemption if 5% or more of an issuer's employees are excluded under the Privacy Law Exemption;[10]

- if an issuer's non-U.S. employees constitute 5% or less of its total employees, the issuer cannot exclude any of those non-U.S. employees under the De Minimis Exemption unless it excludes all of those non-U.S. employees; and

- if an issuer excludes any non-U.S. employee in a particular jurisdiction from its Employee Population under this exemption, it must exclude all of its non-U.S. employees in that jurisdiction, meaning that no non-U.S. employees in a jurisdiction having more than 5% of the issuer's total employees can be excluded under the De Minimis Exemption.

Acquisition Exemption. Employees "acquired" by an issuer in an acquisition may be excluded from an issuer's Employee Population for the fiscal year in which the transaction took effect, but not for future fiscal years.

Identify the Median Employee. Once an issuer has determined its Employee Population, it then must identify the member of that Employee Population who is the issuer's Median Employee. An issuer is required to perform that identification only once every three years unless a change has occurred in the issuer's Employee Population or employee compensation arrangements in the last completed fiscal year that the issuer reasonably believes would result in a significant change to its pay ratio disclosure for such fiscal year from that of the prior fiscal year.[11] If such a change has occurred, the issuer must re-identify its Median Employee for that fiscal year. If a change in the circumstances of the Median Employee previously identified for a three-year period has occurred in the last completed fiscal year (for example, the employee received a promotion) that would result in a significant change in the pay ratio disclosure for that fiscal year, the issuer can use as its Median Employee for that last fiscal year another employee whose compensation, based on the same compensation measure used to identify the original Median Employee, is substantially similar to that of the original Median Employee when the original Median Employee was identified.

Select a methodology to determine its Median Employee and the Median Compensation. To lessen the Rule's compliance burden and expense, an issuer may select a methodology it will use to identify its Median Employee that is appropriate for the issuer's size, structure and compensation practices. An issuer may identify its Median Employee by using:

- a methodology that uses reasonable estimates to identify the issuer's Median Employee, and reasonable estimates to calculate, in accordance with Item 402(c)(2)(x) of Regulation S-K (Item 402(c)(2)(x)), the annual total compensation or any elements of total compensation of employees other than the PEO;

- its total Employee Population, a statistical sampling of its Employee Population[12] or another reasonable method to determine a group of its employees from which the issuer will identify its Median Employee; and

- annual total compensation or any other compensation measure that is consistently applied to all employees included in the calculation of its employees' annual total compensation, such as amounts derived from payroll or tax records.

The methodology selected need not involve the calculation of each employee's total compensation in accordance with Item 402(c)(2)(x).[13] In addition, a single measure could be used to identify an issuer's Median Employee, for example salary and wages (including overtime) as reported on Form W-2 for U.S. employees and equivalent reports for non-U.S. employees.[14]

The SEC intends for the Rule to allow issuers to choose a method of identifying the Median Employee that works best for, and is appropriate to, the issuer's particular facts and circumstances[15] so long as the methodology used is "reasonable." However, the SEC has provided no standard by which to measure the reasonableness of an issuer's methodology. The methodology used by an issuer must be applied consistently in a particular fiscal year's identification of the Median Employee.

The Rule's latitude allows an issuer to use reasonable estimates to determine the annual total compensation or any elements of the annual total compensation of its employees other than the PEO in connection with its identification of its Median Employee and determination of its Median Compensation. The price of this flexibility is that an issuer using estimates must disclose in its pay ratio disclosure that it used estimates to identify its Median Employee, and, if true, to calculate the annual total compensation of employees.

As a result of the flexibility that will be afforded in these respects, comparisons of issuers' pay ratios will likely be in many, if not most, instances of questionable value. The SEC recognizes that is the case, but, fortunately, views that result as not outweighing the overall benefit of the flexibility granted to issuers.

Limited compensation adjustments. Issuers may make limited adjustments to employee compensation when determining the Median Employee.

Cost-of-living adjustments. An issuer may make cost-of-living adjustments to the compensation of the employees in its Employee Population who are in jurisdictions other than that in which its PEO resides to adjust that employee's compensation for, and to bring it to a level reflecting, the cost of living in the PEO's jurisdiction of residence. That adjustment must be made for the compensation of all employees in a particular jurisdiction if the compensation of any employee in that jurisdiction is to undergo a cost-of-living adjustment. If an issuer uses a cost-of-living adjustment to identify its Median Employee and the Median Employee is located in a jurisdiction other than that in which the PEO resides, the issuer must also calculate the Median Employee's annual total compensation using the same cost-of-living adjustment and disclose the country in which the Median Employee is located. An issuer must also briefly describe the cost-of-living adjustment it uses to identify its Median Employee and to calculate its Median Employee's annual total compensation, including the measure it used as a basis for the cost-of-living adjustment.

Working a twist on the old saw maintaining that "no good deed goes unpunished," the Rule requires any issuer electing to present the pay ratio in this manner to also calculate and disclose the Median Compensation and pay ratio without making any cost-of-living adjustments.

Annualizing adjustments. An issuer may, but is not required to, annualize the total compensation of all, but not less than all, of its permanent full-time and part-time employees (but not temporary or seasonal workers) who were employed for less than the full fiscal year (*e.g.* permanent employees hired after the beginning of the fiscal year or on an unpaid leave of absence during the fiscal year). An issuer may not adjust the compensation of any workers, including part-time, temporary or

seasonal employees, to reflect their compensation as if they were full-time equivalent employees. For an issuer with large populations of part-time, temporary or seasonal employees, the ability to determine its Employee Population as of any day during the last three months of its fiscal year may mitigate the harsh outcomes that may result from the prohibition on making full-time equivalent adjustments.

Calculate the Median Compensation. Once an issuer has determined its Median Employee for a fiscal year, it must calculate the Median Employee's annual total compensation for that fiscal year for inclusion in its pay ratio disclosure. The Median Employee's annual total compensation must be calculated separately for every fiscal year, even if the issuer identifies its Median Employee only once every three years as discussed above. The annual total compensation of employees, and thus that of the Median Employee, will be determined in accordance with Item 402(c)(2)(x), which provides for the calculation of the annual total compensation of an issuer's named executive officers and requires the disclosure of that amount in the "total" column of summary compensation tables. Item 402(c)(2)(x) would be applied by substituting the term "employee" wherever the term "named executive officer" appears in Item 402 and, for non-salaried employees, the term "wages plus overtime" for the terms "base salary" and "salary."

Issuers may, but need not, include personal benefits totaling less than $10,000 and compensation under non-discriminatory benefit plans in calculating the Median Employee's annual total compensation, but only if these items are also included in calculating the PEO's annual total compensation. The only other adjustments that may be made when calculating this compensation are the cost-of-living adjustment for non-U.S. employees and the annualizing adjustment discussed above.

As discussed above, issuers may use reasonable estimates to calculate the Median Employee's total compensation, but must clearly disclose any estimates used and must have a reasonable basis to conclude that their estimates approximate the actual amounts of the Median Employee's Item 402(c)(2)(x) compensation. The SEC did not prescribe a standard for determining if the issuer has a reasonable basis for such estimates, but that determination will likely depend on an issuer's particular facts and circumstances.

Calculating the PEO's Total Compensation

An issuer will typically disclose as the PEO's annual total compensation in the pay ratio disclosure for a fiscal year the total compensation of the PEO for that fiscal year as shown in the "total" column in the summary compensation table contained in the filing in which the pay ratio disclosure appears. That total compensation is calculated in accordance with Item 402(c)(2)(x). If an issuer has two or more PEOs that served non-concurrently during a fiscal year, the issuer may calculate the PEO's annual total compensation in one of the following manners if it discloses the manner chosen and how it calculated the PEO's annual total compensation:

- combine the compensation provided to each PEO for the time he or she served in that position; or
- annualize the compensation of the PEO serving in that position on the date the issuer identifies its Median Employee.

Disclosure Requirements

Required pay ratio disclosure. An issuer must disclose for its last completed fiscal year:

- the Median Compensation, *i.e.*, the annual total compensation paid to its Median Employee;
- the annual total compensation of its PEO; and
- the ratio of the foregoing compensation amounts.

Issuers have two choices for disclosing the pay ratio:

- using the ratio form of “X:Y” or “X to Y,” in which X would be “1” and represent the Median Compensation for the last completed fiscal year and Y would be the quotient of the PEO’s annual total compensation for the last completed fiscal year divided by such Median Compensation (*e.g.*, if the Median Compensation were $75,000 and the PEO’s annual total compensation were $7,500,000, the pay ratio to be disclosed would be 1:100 or 1 to 100); or
- stating the PEO’s annual total compensation as a multiple of the Median Compensation (*e.g.*, “the PEO’s annual total compensation is 100 times that of the Median Compensation”).

An issuer is not required to, and should not, identify its Median Employee or disclose any other personally identifiable information about that employee (other than the amount of his or her Median Compensation) in its pay ratio disclosure. An issuer may opt to disclose the Median Employee’s position with the issuer to put his or her compensation in context, but is not required to do so and should not do so if the disclosure of the position could result in the Median Employee being identified.

Additional narrative disclosures. In addition to the narrative disclosures discussed elsewhere in this alert, issuers must also make disclosures about a number of other subjects to explain how they identified their Median Employees, including:

- the methodology used to identify the Median Employee;
- any material assumptions, adjustments (such as any cost-of-living adjustments), or estimates used to identify the Median Employee or to determine total compensation or any elements of total compensation for members of their Employee Population;
- if annual total compensation is not used to identify the Median Employee, the compensation measure used to make that identification;
- whether the use or non-use of the cost-of-living adjustment changed from the prior fiscal year; and
- the date within the last three months of their last completed fiscal year selected to determine their Employee Population and identify their Median Employee, and if that date is different from the date used to determine the Employee Population for the prior fiscal year, a brief explanation of the reasons for such change.

The narrative disclosures for the first two bullets above are to be “brief overviews” and need not

include technical analyses or formulas. If an issuer changes its methodology or its material assumptions, adjustments or estimates from those used in its pay ratio disclosure for its prior fiscal year and the effect of any such changes is significant, the issuer must briefly describe the change and the reasons for making the change.

In addition, issuers must make specific disclosures regarding their reliance on one or both of the Privacy Law Exemption and De Minimis Exemption. An issuer relying on the Acquisition Exemption must identify the acquired business that is excluded for a fiscal year and disclose the approximate number of employees being excluded from its Employee Population in reliance on the Acquisition Exemption.

Supplemental Pay Ratio Disclosure

Issuers may, but are not required to, present additional pay ratios to supplement the required pay ratio disclosure. Any additional ratios disclosed will have to be clearly identified, may not be misleading, and may not be presented with greater prominence than the required pay ratio. An issuer with a significant number of part-time, temporary or seasonal employees working for a short time during a fiscal year may want to provide such supplemental disclosure. By adjusting its part-time, temporary or seasonal employees' compensation to full-time equivalents, identifying its employee with the median annual total compensation of its Employee Population based on the adjusted compensation and disclosing a supplemental pay ratio based on such information, an issuer could correct any misimpression given by its required pay ratio disclosure.

Filings to Include Pay Ratio Disclosure

Subject issuers must include the pay ratio disclosure, except as noted below under "Timing of Pay Ratio Disclosures," in each SEC filing in which executive compensation disclosure pursuant to Item 402 of Regulation S-K is required, including registration statements under the Securities Act of 1933 (Securities Act) and the Securities Exchange Act of 1934 (Exchange Act), and 10-Ks and proxy and information statements. Pay ratio disclosure is not required in registration statements on Form S-1 or S-11 relating to an issuer's initial public offering or an initial Form 10 registration statement filed under the Exchange Act if, in the case of such a Form 10, the issuer has not been subject to the filing requirements under the Exchange Act and previously filed a 10-K or a proxy statement for a fiscal year beginning on or after January 1, 2017.

Pay ratio disclosure will be "filed," not "furnished," and, as a result, the disclosure will be subject to liability under the Securities Act for pay ratio disclosure included in Securities Act registration statements and under the Exchange Act, including under Section 18 of the Exchange Act.

Timing of Pay Ratio Disclosure

An issuer will be required to first make pay ratio disclosure relating to compensation for a completed fiscal year beginning on or after January 1, 2017 (1) in such issuer's 10-K for such fiscal year or (2) if filed after such 10-K but on or before the 120th calendar day following the end of such fiscal year, the issuer's definitive proxy or information statement relating to its annual shareholders' meeting next following the end of such fiscal year.[16] An issuer intending to include its pay ratio disclosure in its annual shareholders' meeting proxy or information statement that does not file its definitive proxy or information statement with the SEC by the 120-day deadline must amend its 10-K to include the pay ratio disclosure by no later than that deadline. An SEC filing including executive compensation

disclosure under Item 402 made after an issuer's most recently completed fiscal year and before the 10-K for that fiscal year or definitive proxy or information statement for the issuer's next annual shareholders' meeting is required to be filed would only need to include pay ratio disclosure relating to the fiscal year immediately prior to the most recently completed fiscal year (if that prior fiscal year is one as to which the pay ratio disclosure must be made).

A newly public issuer that does not qualify as an EGC or SRC must make pay ratio disclosure with respect to compensation paid or deemed to be paid in the first fiscal year commencing on or after January 1, 2017 that follows the fiscal year in which the issuer became subject to the reporting requirements of Section 13(a) or 15(d) of the Exchange Act. Such an issuer may exclude pay ratio disclosure from any filing made with the SEC prior to the filing of its 10-K for the fiscal year as to which they must first make pay ratio disclosure or, if filed later but before 120th calendar day after such fiscal year ends, the proxy or information statement for its next annual shareholders' meeting following that fiscal year.

Practical Considerations

Issuers with large, complex Employee Populations may face significant compliance challenges. Issuers with a large number of employees, most of whom are hourly wage workers, face disclosing pay ratios that could appear to some to show extraordinary differences between the compensation of the issuers' PEO and their Median Employee. Multinational issuers with large numbers of low-wage, non-U.S. employees working in low-wage economies may be able to lessen such difference to some meaningful degree by making all available cost-of-living adjustments. However, the Rule's prohibition of full-time equivalent adjustments for part-time, temporary or seasonal employees when identifying an issuer's Median Employee will unfairly exaggerate the difference between the PEO's total compensation and the Median Compensation disclosed in the pay ratio disclosure of an issuer with large numbers of part-time, temporary or seasonal employees on its payroll on the date it determines its Employee Population.

Issuers with tens or hundreds of thousands of workers, complex payroll situations and payroll services provided by multiple vendors should give serious consideration to taking advantage of the flexibility the Rule offers as to methods for identifying their Median Employee and should avoid calculating every employee's annual total compensation every year to identify their Median Employee. An issuer not taking advantage of the Rule's flexibility may encounter the logistical problems that the Rule can present and that are best avoided.

Where there are a number of issuers with large Employee Populations within the same industry, those issuers should consider working with their trade associations to develop a reasonable methodology for identifying Median Employees, such as a model for statistical sampling, that could be broadly adopted by such issuers. Issuers or their trade association should attempt to vet any such methodology with the staff of the SEC's Division of Corporation Finance (Staff) to avoid the Staff questioning the reasonableness of that methodology and to allow the issuers using that methodology to disclose that they are using a methodology that is an industry standard methodology.

Issuers should start considering compliance logistics. The lead time needed to design, test and implement the methodology to be used to comply with the Rule and the systems for capturing the information needed to comply with the Rule could be long. Consequently, the compliance effort should not be deferred to the 2018 annual disclosure season. Although that season may now seem far off, a subject issuer, its counsel and human resources department should begin considering whether any problems exist in identifying the Median Employee or determining Median

Compensation. For example:

- issuers with international operations must determine how data privacy laws and regulations in the international jurisdictions in which they have operations could affect or restrict the gathering, transfer, verification and use of the data necessary to comply with the Rule and consider how and when to seek relief or an exemption from such laws and regulations;

- issuers should consider whether they may properly exclude any employees from the Employee Population under the Rule and, if so, decide whether they intend to rely on any such exemptions and the impact such reliance will have on their pay ratio disclosure;

- issuers with large Employee Populations should review their accounting, payroll and other information systems to determine whether those systems allow them to (1) capture the necessary data to produce the required disclosure without modifying those systems or changing their payroll systems or payroll service providers, (2) produce the information necessary to perform any statistical sampling to identify the Median Employee, (3) make reasonable estimates or (4) take other reasonable measures to identify the Median Employee or to determine the Median Compensation;

- issuers wanting to use statistical sampling to identify the Median Employee may want to engage in the near future a professional statistician to help design the statistical sampling methodology and to gain an understanding of the type of information and other resources that will be needed to conduct such statistical sampling; and

- issuers wanting to use an alternative measure to identify the Median Employee, such as employees' income as reported on Form W-2, should consider testing whether the use of that measure would produce a materially accurate result in the context of the anti-fraud rules of the federal securities laws.

Compensation committees should consider the nature of the required pay ratio disclosure and whether to disclose supplemental pay ratios. Compensation committees of subject issuers should become acquainted with the Rule, the work that must be done to comply with the Rule and the disclosure required by the Rule. While the pay ratio disclosure requirement should not drive compensation decisions, compensation committees should keep the Rule's requirements, particularly the Rule's disclosure requirements, in mind, especially in connection with their review and consideration of the issuer's executive compensation disclosure and say-on-pay vote.

The pay ratio disclosure requirement may prompt consideration of making supplemental pay ratio disclosure as permitted by the Rule. A compensation committee may want to include supplemental pay ratio disclosure that discloses pay ratios and other comparisons of the compensation of its PEO and that of other officers and employees of the issuer computed on a basis that avoids certain of the troublesome aspects of the Rule and may tell a very different story from the Rule's pay ratio disclosure.

Issuers are exposed to liability for materially inaccurate pay ratio disclosure. Any pay ratio disclosure of an issuer that is discovered to have been materially inaccurate or incomplete when made could result in liability for the issuer. Consequently, issuers using an alternative means to identify the Median Employee or determine the Median Compensation should confirm that their methodology will produce an identification of a Median Employee or determination of a Median

Compensation that is not materially inaccurate or misleading and that is demonstrably "reasonable" under their particular facts and circumstances.

Dealing with the adverse effects of the pay ratio disclosure. Pay ratio disclosure may prove to be a cudgel in the hands of the activists and labor unions who pushed for the enactment of Section 953(b) and other of the Dodd-Frank "name and shame" laws. Pay ratio disclosures promise to lead to attacks on PEOs, boards and compensation committees by the same activists and labor unions. In the Release, the SEC discusses receiving comments noting that high pay disparities in issuers could harm employee morale and that pay ratio disclosure would highlight employee morale issues within issuers. Unfortunately, by putting a spotlight on the PEO's compensation and the differences between the PEO's pay and other employees' pay, the pay ratio disclosure has the potential to create or exacerbate animosity that lower-paid employees have for the PEO and to harm worker morale.

It is likely that various factions within the investment community, particularly activist investors, will make comparisons of the pay ratios of various issuers, especially where they can use an industry's or peer group's outliers that have significantly lower pay ratios to serve as an "example" to the other issuers in the industry or peer group. Despite a probable lack of comparability among the pay ratios disclosed by issuers, activists can be expected to use such comparisons against the issuers who are the targets of their agendas. Even if well-crafted, an issuer's pay ratio disclosure may create rancor among an issuer's shareholders, as well as tensions between its PEO and rank-and-file employees, especially when the disparity shown in the ratio changes in favor of a PEO from one year to the next.

Issuers may also find the pay ratio disclosure is a potential lightning rod for shareholder activists and proxy advisors in connection with the issuers' say-on-pay votes and is one more factor that heightens issuers' risk that proxy advisors will recommend "against" votes with respect to compensation committee members standing for re-election at the annual meeting, in particular when the activists and proxy advisors interpret the pay ratio disclosure to reflect "pay inequity" that is not effectively addressed or explained by the issuer.

It is not just the pay ratio disclosure that may serve as a lightning rod for activists and other investors. As median employee compensation will be disclosed for the first time, some activists focusing on cost control may attack issuers with high median employee compensation relative to their peers.

As the time of its first pay ratio disclosure nears, an issuer should consider engaging its investor relations and human resources groups to prepare for and address how to combat the possible adverse publicity regarding, and the reactions of employees, shareholders, activists and others to, the issuer's pay ratio disclosure. Although the optics of the pay ratio disclosure will be very important, an issuer's messaging to address potential concerns with the pay ratio disclosure, as well as supplemental pay ratio disclosure, could mitigate any potential negative reactions.

1. *See* Pay Ratio Disclosure, Securities Act Release No. 33-9877; Exchange Act Release No. 34-75610 (Aug. 5, 2015), 80 Fed. Reg. 50104 (Aug. 18, 2015)*, available at* http://www.gpo.gov/fdsys/pkg/FR-2015-08-18/pdf/2015-19600.pdf (Release). As has been typical of late in connection with the

proposal or adoption of rules mandated by Dodd-Frank, the adoption of the Rule was accompanied by statements of a number of SEC Commissioners.

Commissioners Daniel M. Gallagher and Michael S. Piwowar issued stinging dissenting statements regarding the adoption of the Rule, which are

available here and here. Commissioner Piwowar issued additional dissenting comments that read like a brief for the plaintiffs in a court proceeding seeking to invalidate the Rule, which are available here (Additional Piwowar Dissent).

2. If Congress and the SEC have used the term "median" with its usual meaning, the median annual total compensation of all employees (other than the principal executive officer) is the compensation of that employee or employees as to which half of the other employees (other than the principal executive officer) have annual total compensation less than and the other half of the other employees (other than the principal executive officer) have annual total compensation greater than the annual total compensation of the employee or employees at the median.

3. The Rule will become effective on October 19, 2015.

4. *See* H.R. 414, 114th Cong. (2015), *available at* https://www.congress.gov/bill/114th-congress/house-bill/414, and S. 1722, 114th Cong. (2015), *available at* https://www.congress.gov/bill/114th-congress/senate-bill/1722/text.

5. Release at 50116.

6. In the Release, the SEC also discusses "borrowed workers" employed by a third party in the same vein as it discusses "leased workers" employed by a third party. *Id.* at 50118.

7. Commissioner Piwowar noted in the Additional Piwowar Dissent that independent contractors may only be excluded from the Employee Population if they are employed, and their compensation is determined, by an unaffiliated third party. If this interpretation is correct, the inclusion of self-employed independent contractors (*e.g.*, cybersecurity or computer consultants, contract attorneys or contract accounting personnel) in an issuer's Employee Population would impose significant additional compliance burdens and expense.

8. *See* Additional Piwowar Dissent.

9. *See* Release at 50123. The SEC also notes there that China, Japan, Mexico, Canada, Peru, Australia, Russia, Switzerland, Argentina and Singapore have adopted or are considering data privacy rules similar to those of the European Union.

10. An issuer may exclude non-U.S. employees under the Privacy Law Exemption without regard to the number of non-U.S. employees excluded, even if the excluded employees exceed 5% of the issuer's total employees.

11. If there have been no such changes that the issuer reasonably believes would significantly affect its pay ratio disclosure, the issuer must disclose that it is using the same Median Employee in its pay ratio calculation and describe briefly the basis for its reasonable belief. For example, the issuer could disclose that there has been no change in its Employee Population or employee compensation arrangements that it believes would significantly affect the pay ratio disclosure.

12. The Rule does not require issuers to use a particular type of statistical sampling, suggest a methodology favored by the SEC or establish a safe harbor type of statistical sampling. The SEC does, however, indicate in the Release that a reasonable determination of sample size would depend on the "underlying distribution of compensation data." Release at 50136. The SEC also notes that reasonable estimates of the Median Employee for an issuer with multiple business lines or geographical units could be determined using more than one statistical sampling approach, but that all approaches should draw observations from each business or geographical unit with a reasonable assumption on each unit's compensation distribution and infer the

13. *See* Release at 50131 and 50136. If an issuer is identifying its Median Employee by statistical sampling, it would not have to determine the exact compensation of every single employee included in the sample, as the issuer could identify employees in the sample having extremely low or extremely high pay and not calculate their compensation exactly.

14. If a compensation measure other than annual total compensation is used to identify the Median Employee and that measure is recorded on a basis other than the issuer's fiscal year, such as the employees' tax year, the issuer may use that annual period to derive amounts used to identify the Median Employee. The SEC is allowing this methodology for identifying the Median Employee despite the annual total compensation of the Median Employee identified by this method being calculated for the fiscal year for which the pay ratio disclosure is made and not, for example, the tax year of the employee identified as the Median Employee by reference to the W-2 reported income of the issuer's employees.

15. The Release indicates that those facts and circumstances could include variables such as the size and nature of the issuer's workforce, the complexity of its organization, the stratification of pay levels across its workforce, the type of compensation its employees receive, the extent to which different currencies are used to pay its employees, the number of tax and accounting regimes involved, the number of payroll systems the issuer has and the degree of difficulty of integrating payroll systems to readily compile total compensation information for all of its employees. Release at 50135.

16. Issuers relying on Instruction 1 to Item 402(c)(2)(iii) and (iv) of Regulation S-K to exclude their PEO's salary or bonus for the last completed fiscal year from their summary compensation table disclosure because that salary or bonus is incalculable through the latest practicable date prior to the pertinent filing date must disclose in that filing that the pay ratio for that fiscal year is not calculable until the PEO's salary or bonus, as applicable, is determined and the date on which the issuer expects to determine the PEO's actual total compensation for that fiscal year. An issuer in this situation must provide the pay ratio disclosure for such fiscal year in a filing under Item 5.02(f) of Form 8-K that is required to be filed to disclose the PEO's

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