

SEC Adopts Pay Ratio Disclosure Rule

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Introduction

On August 5, 2015, the SEC, by a 3 to 2 vote, adopted the controversial “pay ratio rule,” which requires public companies to disclose the ratio of the annual total compensation of the chief executive officer (CEO) to the median of the annual total compensation of the company’s employees. The SEC says that the rule, which is mandated by the Dodd-Frank Act, is intended to provide investors with additional information to consider when assessing CEO compensation.

As adopted in a 294-page release, the rule amends existing executive compensation disclosure rules to require companies to disclose:

- The median of the annual total compensation of all its employees except the CEO;
- The annual total compensation of its CEO; and
- The ratio of those two amounts (CEO compensation divided by median compensation, with median compensation equal to 1).

Companies Subject to the Rule

The pay ratio disclosure requirement applies to all companies required to provide executive compensation disclosure under Item 402(c) (2)(x) of Regulation S-K, which is essentially “Summary Compensation Table” level disclosure. Smaller reporting companies, foreign private issuers, emerging growth companies, and registered investment companies are *not* subject to the requirement.

Effective Time for New Reporting Requirements

Companies must report pay ratio disclosure for their first fiscal year beginning on or after January 1, 2017.

A company that has not previously been a reporting company is required to report the pay ratio disclosure for the first fiscal year following the year in which it becomes subject to the Commission’s reporting requirements, but not for any fiscal year commencing before January 1, 2017.

Determination of Median Employee

To identify the median employee, the rule allows companies to select a methodology based on their own facts and circumstances. A company may use its total employee population, a statistical sampling of that population, and/or other reasonable methods. A company may, for example, identify the median of its population or sample using:

- Annual total compensation as determined under existing executive compensation rules; or
- Any consistently-applied compensation measure from compensation amounts reported in its payroll or tax records.

A company may apply a cost-of-living adjustment to the compensation measure used to identify the median employee.

A company is also permitted to identify its median employee once every three years unless there has been a change in its employee population or employee compensation arrangements that it reasonably believes would result in a significant change to its pay ratio disclosure. Also, within those three years, if the median employee’s compensation changes, the company may use another employee with

substantially similar compensation as its median employee.

A company must calculate the annual total compensation for its median employee using the same rules that apply to the CEO's compensation. "Annual total compensation" means total compensation for the last completed fiscal year, calculated using the definition of "total compensation" in existing executive compensation rules, namely Item 402(c)(2)(x) of Regulation S-K. The rule allows companies to use reasonable estimates when calculating any elements of the annual total compensation.

A company is permitted to select a 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.

Employees Included In, and Excludable From, the Calculation

Subject to certain exceptions, the company is required to include all employees – U.S. and non-U.S., full-time, part-time, temporary and seasonal – employed by the company or any of its consolidated subsidiaries in performing its pay ratio calculation. Individuals employed by unaffiliated third parties or independent contractors would not be considered to be employees of the company.

A company *may exclude* non-U.S. employees from the determination of its median employee in two circumstances:

- Non-U.S. employees that are employed in a jurisdiction with data privacy laws that make the company unable to comply with the rule without violating those laws. The company would be required to obtain a legal opinion from counsel on the inability of the company to obtain or process the information necessary for compliance with the rule without violating the jurisdiction's laws or regulations governing data privacy.
- Up to 5% of its total employees who are non-U.S. employees, including any non U.S. employees excluded using the data privacy exemption. If a company excludes any non-U.S. employee in a particular jurisdiction, it must exclude all non-U.S. employees in that jurisdiction.

Companies are permitted, but not required, to annualize the total compensation for a permanent employee who did not work for the entire year, such as a new hire. In contrast, full time equivalent adjustments for part-time workers, and annualizing adjustments for temporary and seasonal workers, are not permitted.

A company subject to the pay ratio requirement may omit from its calculation any employees obtained in a business combination or acquisition for the fiscal year in which the transaction becomes effective. The company must identify the acquired business and disclose the approximate number of employees it is omitting.

Required Description of Methodology

Companies must briefly describe the methodology used to identify the median employee, and any material assumptions, adjustments (including cost-of-living adjustments), or estimates used to identify the median employee or to determine annual total compensation. If a company identifies a median employee based on a consistently applied compensation measure, it must disclose the measure it used.

Companies may, but not required to, supplement the required disclosure with a narrative discussion or additional ratios. Any additional discussion and/or ratios would need to be clearly identified, not misleading, and not presented with greater prominence than the required pay ratio.

Filings That Must Include Pay Ratio Information

Companies must provide pay ratio information in registration statements, proxy and information statements, and annual reports (Form 10-K) that include executive compensation information as set forth under Item 402 of Regulation S-K.

Companies are not required to:

- Disclose the pay ratio information in reports that do not require executive compensation information, such as current reports (Form 8-K) and quarterly reports (Form 10-Q).
- Update their disclosure for the most recently completed fiscal year until the company files its proxy or information statement for its annual meeting of shareholders (or annual report for companies that do not file proxy or information statements for annual meetings), but not later than 120 days after the end of the fiscal year.

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