

Client Alert

August 2015

SEC Adopts CEO Pay Ratio Rule

On August 5, 2015, the SEC adopted a final rule, commonly referred to as the “pay ratio rule,” requiring public companies to disclose the following items:

- The median of the annual total compensation of all employees of a company, other than its chief executive officer (“CEO”);
- The annual total compensation of the company’s CEO; and
- The ratio of the annual total compensation of the company’s “median employee” to the CEO’s annual total compensation.

This new rule, which was mandated by the Dodd-Frank Wall Street Reform and Consumer Protection Act, is intended to assist shareholders in evaluating companies’ executive compensation practices, including when voting on “say on pay.”

Employees Included in the Calculation

In performing the pay ratio calculation, a company is required to include all U.S. and non-U.S. employees of the company and its consolidated subsidiaries (including part-time, seasonal and temporary employees), determined as of a date chosen by the company within the last three months of its most recently completed fiscal year (which date must be disclosed). However, there are two notable exceptions:

- A company may exclude non-U.S. employees from jurisdictions where foreign data privacy laws prevent the company from being able to comply with the pay ratio rule. However, to take advantage of this exception, the company must exercise reasonable efforts to procure the information and must obtain (and include as an exhibit to the applicable filing) a legal opinion from counsel on the company’s inability to comply.

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- A company may omit up to 5% of its non-U.S. employees, which includes any non-U.S. employees excluded under the above data privacy exemption. If the company excludes *any* non-U.S. employee in a jurisdiction, it must exclude *all* non-U.S. employees in that jurisdiction, subject to compliance with the overall 5% limitation.

In addition, a company may exclude employees obtained in a business combination or acquisition transaction from the pay ratio calculation for the fiscal year in which the transaction occurs, provided that the company discloses the acquired business and the approximate number of employees being omitted.

Identifying the Median Employee

The pay ratio rule affords companies a certain amount of flexibility when identifying the median employee and determining the pay ratio. To identify its median employee, a company can use its total employee population, a statistical sampling of that population, and/or any other reasonable method, which may include using annual total compensation as determined under the SEC's executive compensation rules or another consistently applied compensation measure as reported in the company's payroll or tax records.

A company is permitted to identify its median employee once every three years, unless changes to its employee population or employee compensation arrangements would reasonably be expected to result in a significant change to the pay ratio disclosure. For example, the addition of employees of an acquired business, who must be included in the company's employee population commencing in the fiscal year following the transaction, may give rise to the need to re-identify the median employee. Also, if the median employee's compensation changes at any time during this three-year period (or he or she is no longer employed by the company), the company may substitute another employee with substantially similar compensation as the former median employee.

A company is allowed to make certain adjustments to determine its median employee:

- The company may adjust the compensation of its employees in countries other than where the CEO is located to account for the cost of living in the CEO's home jurisdiction. If the company elects to make this cost-of-living adjustment, then it must also (1) apply the same adjustment to determine the median employee's annual total compensation and (2) disclose the median employee's annual total compensation and the pay ratio without the cost-of-living adjustment.

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- The company may annualize the total compensation for permanent full-time and part-time employees who worked for only part of the fiscal year, such as new hires. However, it may not annualize compensation for temporary or seasonal workers or make full-time equivalent adjustments for part-time employees.

Calculating Annual Total Compensation

To determine the pay ratio, the annual total compensation for the median employee is calculated in the same manner as for CEOs, by using the definition of “total compensation” in Item 402(c)(2)(x) of Regulation S-K. Companies are allowed to use reasonable estimates in calculating the annual total compensation of their median employee (but not for the CEO). Although the median employee may remain the same for a three-year period, his or her annual total compensation must be recalculated in each fiscal year.

Disclosure Requirements

In addition to the required annual total compensation and pay ratio disclosures, the company must briefly describe the methodology/compensation measure it uses to determine its median employee and make certain disclosures regarding any assumptions, adjustments and estimates used to identify the median employee or to determine annual total compensation.

Companies are permitted, but not required, to supplement this disclosure with a narrative discussion or additional ratios, but these must be clearly identified, may not be misleading and may not be presented with greater prominence than the required disclosure.

Companies and Filings Subject to the Rule; Compliance Date

Companies must make the pay ratio disclosure in any registration statement, proxy or information statement, and annual report in which they are required to include the executive compensation disclosure under Item 402 of Regulation S-K. A company does not need to update its disclosure for its most recently completed fiscal year until it files its proxy or information statement for its next annual meeting of stockholders, but no later than 120 days after the end of the fiscal year.

Companies are required to include the pay ratio disclosure with respect to their first fiscal year beginning on or after January 1, 2017. Therefore, as a general rule, for calendar year registrants, the pay ratio disclosure initially would be made in connection with their 2018 annual meetings.

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Companies that become subject to the reporting requirements of the Securities Exchange Act of 1934 must comply with this rule with respect to the following fiscal year. Thus, a calendar year company that first becomes a reporting company in 2017 may omit the pay ratio disclosure until its proxy statement for its 2019 annual meeting.

Smaller reporting companies, emerging growth companies, foreign private issuers, MJDS filers, and registered investment companies are not subject to the rule.

Please contact the Olshan attorney with whom you regularly work or the attorneys listed below if you have any questions regarding the pay ratio rule.

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