October 2015

SEC Adopts Final CEO Pay Ratio Disclosure Rules

The Securities and Exchange Commission (SEC) recently adopted final disclosure rules under the controversial "CEO pay ratio" provision of the Dodd-Frank Act. The rules largely track the format the SEC previously proposed, with some modifications we describe below. The first disclosures for affected public companies will generally be required to be made in 2018.

Overview of the Final Rules

Section 953(b) of the Dodd-Frank Act requires the SEC to amend Item 402 of Regulation S-K to provide for the disclosure of (A) the median of the annual total compensation of all employees of an issuer, except the issuer's CEO; (B) the annual total compensation of the issuer's CEO; and (C) the ratio between (A) and (B). The SEC's final rules[1] require this disclosure for all public companies other than emerging growth companies, smaller reporting companies, foreign private issuers, US-Canadian multijurisdictional filers and registered investment companies. To find the median employee, affected public companies are required to calculate the annual total compensation of "all employees" other than the CEO, which includes all worldwide full-time, part-time, temporary and seasonal workers employed by the company and its consolidated subsidiaries. Independent contractors and leased workers are generally excluded from the calculation.

The SEC first proposed rules to implement pay ratio disclosure in 2013. Our alert describing the proposal is here. The final rules follow the overall direction of the proposed rules, with a few notable revisions:

- A company may make a cost-of-living adjustment to the compensation of employees who reside in a jurisdiction different from that of the CEO, but in doing so must make a host of explanatory disclosures.
- A company may use the same median employee for three consecutive 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.
- A company is permitted to select a measurement date within the last three months of its last completed fiscal year in order to determine the employee population for purposes of identifying the median employee.
- A company may exclude non-US employees from the determination of its median employee when those non-US employees are employed in a jurisdiction with data privacy laws that make the company unable to comply with the final rule without violating those laws. To do so, the company would be required to obtain an opinion of legal 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.

[1] The full text of the SEC's adopting release is available at http://www.sec.gov/rules/final/2015/33-9877.pdf.

- As a kind of de minimis exemption, a company may also exclude up to five percent of its total employees who are non-US employees, including any non-US employees excluded using the data privacy exemption. If a company excludes any non-US employee in a particular jurisdiction, it must exclude all non-US employees in that jurisdiction.

The pay-ratio disclosure will be required to be made in registration statements, proxy and information statements, and annual reports that are required to include executive compensation information under Item 402 of Regulation S-K. Conversely, companies would not be required to disclose the pay ratio in reports that do not require executive compensation information, such as Form 8-K and Form 10-Q. The first reporting period under the final rule is a public company's first full fiscal year beginning on or after January 1, 2017. For most affected companies, the first disclosure will therefore be made in proxy statements and annual reports filed in 2018.

Under the final rules, public companies may present additional ratios or other information to supplement the required ratio. The final rules state, however, that registrants choosing to provide such additional information must do so in a way that it is "clearly identified, not misleading, and not presented with greater prominence than the required ratio."

What You Should Do Now

It remains to be seen how mainstream investors will use the new disclosures in making investment decisions. For companies with multiple payroll systems or that operate in jurisdictions outside the United States, one of the main compliance challenges is developing a unified system to compile the data necessary to make the pay-ratio calculations. Thus, affected companies should use the next two years to begin putting in place appropriate systems and controls to collect worker compensation data across all consolidated subsidiaries and geographies. If a company intends to rely on the data privacy exemption for non-US employees, the company should begin analyzing local law in those countries that may prohibit cross-border sharing of personal information and then begin taking steps to secure necessary legal opinions from local counsel. Companies, particularly those that make use of large numbers of seasonal or temporary workers, should also begin to consider which measurement date in the three-month window should be selected. Finally, companies should begin to consider how the disclosure will be presented and what explanatory narrative will accompany it.

Contact

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