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DISCLOSURE

SEC Requires Registrants to Disclose Ratio of CEO Pay to Median Pay of Employees

By Jayne E. Juvan

Overview of Pay Ratio Disclosure Rule

On August 5, 2015, in a narrow 3–2 vote of its five commissioners, the Securities and Exchange Commission (SEC) settled a heated debate when it adopted a final rule that requires certain publicly traded companies to disclose the gap in pay between the company's chief executive officer (''CEO'') and its median worker (13 CARE 1756, 8/7/15). The SEC adopted the rule to comply with Section 953(b) of the Dodd-Frank Wall Street Reform and Consumer Protection Act (the ''Dodd-Frank Act''). Section 953(b) requires the SEC to mandate disclosure of (a) the median of the annual total compensation of all employees of the company, except the CEO, (b) the annual total compensation of the CEO, and (c) the ratio of these two amounts. The rule imposes an obligation on certain registrants to begin reporting pay ratios for their first fiscal year that occurs on or after January 1, 2017.

Jayne E. Juvan is a corporate partner at Roetzel & Andress LPA and is admitted to practice law in New York and Ohio. She serves as legal counsel to public and high-growth private companies, as well as venture capital and private equity firms, on corporate governance, risk management and compliance. She currently serves as the co-chair of the American Bar Association's Task Force on Director Misconduct and the Corporate Governance Publications Subcommittee, which produces CGC In Sight, a quarterly newsletter covering recent developments in corporate governance.

When adopting the rule, the SEC indicated that it considered concerns expressed on behalf of registrants subject to the rule. The SEC also weighed Congress's intent and other executive compensation provisions included in the Dodd-Frank Act that encourage shareholder engagement over executive compensation issues. Attempting to strike a balance, the SEC stated that the new rule ''provides companies with flexibility in calculating this pay ratio, and helps inform shareholders when voting on 'say on pay.' ''

The proposed rule was quite contentious, and the SEC reported that it received more than 287,400 comment letters addressing the likely ramifications. Proponents suggested that pay ratio disclosure is important for investors because it enhances transparency about executive compensation. They also expressed that material disparities in pay adversely impact the morale and productivity of employees and have a negative effect on corporate performance. These commenters indicated that the rule may discourage excessive pay practices that contributed to the 2008 financial crisis and lessen economic inequality.

On the other hand, critics of the rule expressed their belief that the rule would fail to provide material information to shareholders and would be expensive to comply with, particularly given the costs associated with developing a single database of all employees (including U.S. and non-U.S. employees). They also expressed that these disclosures could place those companies required to report at a competitive disadvantage. Though the

Summary

■ On August 5, 2015, the SEC adopted a final rule that requires certain publicly traded companies to disclose the gap in pay between the company's CEO and its median worker.

■ The rule attempts to provide some flexibility to registrants required to calculate pay ratio, while at the same time providing greater transparency about CEO compensation to shareholders.

■ The proposed rule was controversial, and the SEC received more than 287,400 comment letters discussing the potential ramifications. Given the heated debate, many in the governance community have indicated that the rule will likely be litigated.

■ Registrants subject to the rule should proactively prepare to deal with the fallout and be ready to address potentially damaging headlines that may follow their disclosures.

■ Registrants must begin reporting pay ratios for their first fiscal year that occurs on or after January 1, 2017.

SEC has voted in favor of the rule, given the controversy surrounding the adoption, the rule may be litigated.

Registrants subject to the rule should proactively prepare to deal with the fallout and be ready to address potentially damaging headlines that may follow their disclosures.

Because of the likelihood that many public companies subject to the rule will disclose a significant gap in pay between their CEO and median employees, some companies may receive negative press. As a result, registrants subject to the rule should proactively prepare to deal with the fallout and be ready to address potentially damaging headlines that may follow their disclosures.

Applicability and Exemptions

The rule applies to registrants required to disclose executive compensation data pursuant to Item 402(c)(2)(x) of Regulation S-K. However, the rule also provides an exemption for smaller reporting companies, foreign private issuers, MJDS filers, emerging growth companies and registered investment companies. In addition, a company is not required to include certain employees hired due to a corporate transaction during the year in which the transaction closes, though the company is required to disclose this omission.

Filings Subject to Reporting Requirements

A company must include its pay ratio disclosure in registration statements, proxy and information statements, and annual reports. However, the final rule does not require pay ratio information to be included in reports that omit executive compensation disclosures such as current and quarterly reports. In addition, a company is not required to update its disclosure until the company files its proxy or information statement for its annual meeting (as long as the filing occurs within 120 days of the end of the company's last fiscal year).

Determining the Employee Population

To make the disclosure required by the Dodd-Frank Act and the rule adopted by the SEC, registrants must identify their employee population.

A company may select a date for determining its employee population that falls within the last three months of its previously completed fiscal year. When determining its employee population, the company must include all individuals employed by the company and its consolidated subsidiaries, including U.S. and non-U.S., full-time, part-time, temporary and seasonal workers.

However, a company is not required to include individuals who are independent contractors, leased employees or individuals who are employed by unaffiliated third parties. In addition, a company may exclude non-U.S. employees in two specific instances. First, a company may exclude those workers in jurisdictions in which a company would violate data privacy laws if it were to comply with the disclosure rule. If a company attempts to exclude employees on these grounds, the company must have taken reasonable efforts to comply, including seeking an exemption from the applicable data privacy laws, and must file a legal opinion from counsel concluding that the company is unable to comply without violating data privacy laws. Second, a company may exclude non-U.S. employees if they account for five percent or less of the company's total employees. If a company excludes employees from a jurisdiction outside of the U.S., it must exclude all non-U.S. employees in that jurisdiction. When calculating its number of non-U.S. employees in a particular jurisdiction, the company must count the non-U.S. employees excluded under the data privacy exemption. A company relying on this exception must make disclosures about employees excluded.

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For permanent workers who did not work a full year (such as new hires), the rule allows companies to decide whether to annualize their total compensation. However, the rule does not allow companies to compute full-time equivalent adjustments for part-time, temporary and seasonal workers.

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Identifying the Registrant's Median Employee

In order to make the required disclosure, a registrant subject to the rule must identify its median employee. The final rule provides each registrant subject to the disclosure obligation with flexibility in selecting the methodology applied to make this determination. A company may, for example, take a statistical sampling of its employee population or prepare its calculation by adopting another reasonable method, though a registrant is required to provide a brief overview of the methodology it used to identify its median employee.

A company may identify its median employee once every three years, though it must calculate total compensation for the employee every year. However, if the company reasonably believes there has been a change in its population that would necessitate an update, the company must make a new median employee determination.

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When a registrant identifies a median employee, the registrant may apply a cost-of-living adjustment if the employee resides in a different jurisdiction than the CEO. The registrant is also required to describe the adjustment it used and disclose the employee's annual total compensation and pay ratio without the cost-of-living adjustment.

Calculating Total Compensation

Annual total compensation is calculated based upon the total compensation for the company's last completed fiscal year. ''Total compensation'' is determined in accordance with Item 402(c)(2)(x) of Regulation S-K, an existing rule that governs executive compensation.

Explaining the Data

The rule allows registrants to include a narrative discussion with the required disclosure along with additional ratios. However, these additional ratios reported by the registrant may not be misleading or presented more prominently than the pay ratio disclosure required pursuant to the rule.