SIDLEY AUSTIN LLP
SIDLEY

August 12, 2015

CORPORATE GOVERNANCE UPDATE

SEC Adopts CEO Pay Ratio Disclosure Rule Required by Dodd-Frank

On August 5, 2015, the Securities and Exchange Commission (SEC), by a 3-2 vote, adopted rule amendments[1] to implement Section 953(b) of the Dodd-Frank Act, which requires public companies to disclose the "pay ratio" between its CEO's annual total compensation and the median annual total compensation of all other employees of the company. [2]

The pay ratio disclosures that will result from this much-anticipated new rule will further heighten scrutiny on corporate executive compensation practices – with specific focus on how CEO compensation compares to the "median" employee. Companies should be aware that, depending on the magnitude of pay ratios, these new disclosures may exacerbate existing concerns among investors, labor groups and others around executive compensation practices.

Highlights of the Final Rule – New Item 402(u) of Regulation S-K	
Applicability	Applies to all companies required to provide summary compensation table disclosure pursuant to Item 402(c) of Regulation S-K. Smaller reporting companies, emerging growth companies, foreign private issuers, MJDS filers and registered investment companies are exempt.
Required Disclosures	Must disclose (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 (a) to (b) (the "pay ratio"). Must disclose the methodology and material assumptions, estimates, adjustments and exclusions (including relating to cost-of-living, non-U.S. employees, business combinations and acquisitions) used in the identification of the median employee and the calculation of that employee's annual total compensation.
Filings Where Disclosures are Required	Must include disclosure in any annual report on Form 10-K, proxy or information statement or registration statement that requires executive compensation disclosure pursuant to Item 402 of Regulation S-K.
	May identify the "median" employee: • using the company's entire employee population or by means of statistical

Identifying the Median Employee	sampling and/or other reasonable methods • once every three years, assuming no significant changes in either (a) the median employee's circumstances or (b) the company's compensation levels or employee composition • using any date within the last three months of the last completed fiscal year • using annual total compensation or any consistently applied compensation measure • by making cost-of-living adjustments for employees in jurisdictions other than the jurisdiction in which the CEO resides Once identified, the median employee's annual total compensation must be calculated in accordance with Item 402(c)(2)(x) of Regulation S-K.
Employees Included in the Identification of the Median	Must include all full-time, part-time, seasonal, temporary and non-U.S. employees of the company and its consolidated subsidiaries. Independent contractors and "leased" workers providing services to the company are excluded from the definition as long as they are employed by an unaffiliated third party and their compensation is determined by such party. May exclude: • employees employed in a foreign jurisdiction in which the laws or regulations governing data privacy are such that, despite reasonable efforts to obtain or process the necessary information, the company is unable to do so without violating such data privacy laws or regulations • a *de minimis* number of non-U.S. employees (up to five percent of the company's global workforce, including any employees excluded under the foreign data privacy law exemption)
Compliance Dates	First reporting period is the first full fiscal year commencing on or after January 1, 2017. For calendar-year companies, first disclosure will typically be in the proxy statement for the 2018 annual meeting of shareholders.

Background

Section 953(b) of the Dodd-Frank Act directed the SEC to amend Item 402 of Regulation S-K to require companies to disclose:

- the median of the annual total compensation of all employees of the company (except the CEO);
- the annual total compensation of the CEO; and
- the ratio of the median annual total compensation of all employees of the company (except the CEO) to the annual total compensation of the CEO (this measure is commonly referred to as the "pay ratio").

In response to Congress' mandate, the SEC proposed a pay ratio disclosure rule in September 2013[3] and received approximately 287,000 comment letters, including over 1,500 unique letters, in response to that proposal. (The proposed rules were discussed in our Sidley Update dated September 19, 2013, available here.) The primary concern raised in those letters was the potential cost of compliance, particularly for large and multi-national corporations. The SEC noted that the significant cost estimates submitted by some commenters supported its view that certain accommodations were appropriate. Accordingly, the final rule maintains the flexibility and accommodations of the proposed rule (such as permitting the use of statistical sampling) and provides additional flexibility as follows:

- the ability to exclude non-U.S. employees under certain circumstances;
- the ability to use cost-of-living adjustments;
- the ability to identify the median employee once every three years; and
- the ability to choose as an identification date any date within the last three months of the last completed fiscal year.

The Final Rule

Applicability

New Item 402(u) of Regulation S-K applies only to companies required to prepare a summary compensation table pursuant to Item 402(c) of Regulation S-K. Smaller reporting companies, emerging growth companies, foreign private issuers, MJDS filers and registered investment companies are exempt from having to comply with Item 402(u).

Filings Where Disclosures are Required

A company must include the pay ratio and related disclosures in any filing, including an annual report on Form 10-K, proxy or information statement or registration statement, that requires executive compensation disclosure pursuant to Item 402 of Regulation S-K.

Identifying the Median Employee

The rule requires a company to identify its median employee (that is, the individual employee whose annual total compensation is in the middle of all of the company's employees except the CEO) once every three years and calculate the total compensation for that employee once each year, provided that there have been no significant changes in any of the following that the company reasonably believes would result in a significant change to its pay ratio disclosure:

- the circumstances of the median employee;
- the company's employee population; or
- the company's compensation arrangements.

A company must re-identify its median employee for any year in which it believes a significant change has occurred. If a company concludes that there was no significant change, then the company must disclose that it is using the same median employee and briefly describe the basis for its belief that there was no significant change.

Under the new rule, a company may select any date within the last three months of its last completed fiscal year to identify its median employee. "Employees" are defined to include full-time, part-time, seasonal, temporary and non-U.S. employees of a company and its consolidated subsidiaries, but do not include independent contractors or "leased" workers providing services to the company if such individuals are employed by an unaffiliated third party and their compensation is determined by such party. A company may annualize compensation for its permanent (part-time and full-time) employees who were not employed during the entire fiscal year, but may not annualize the compensation of its seasonal or temporary employees or make any full-time equivalent adjustments. In addition, any employees that became employed by a company as the result of a business combination or acquisition may be omitted from that company's median employee identification for the fiscal year in which the transaction became effective.

A company may exclude employees employed in a foreign jurisdiction in which the laws or regulations governing data privacy are such that, despite reasonable efforts to obtain or process the necessary information (including at a minimum, using or seeking an exemption or other relief under governing data privacy laws or regulations), the company is unable to do so without violating such data privacy laws or regulations. If the company excludes such employees, it must obtain a legal opinion from counsel in that jurisdiction that opines on the inability of the company to obtain or process the information necessary for compliance with the new rule, including the company's inability to obtain an exemption or other relief.

In addition, the rule contains a *de minimis* exemption that allows a company to exclude from its median employee identification:

- if non-U.S. employees account for five percent or less of the company's total employees – all non-U.S. employees; or
- if the company's non-U.S. employees exceed five percent of total employees – up to five percent of total employees who are non-U.S. employees, provided that if non-U.S. employees in a particular jurisdiction are excluded, all non-U.S. employees in that jurisdiction must be excluded.

This *de minimis* exemption is limited by the fact that any employees excluded using the data privacy exemption count toward the number of non-U.S. employees that may be excluded.

The rule allows a company, based on its own facts and circumstances, to select an appropriate methodology for identifying its median employee and use reasonable estimates. Rather than analyzing its entire employee population, a company may make its median employee identification based on statistical sampling and/or by using other reasonable methods.

In response to concerns that the rule may effectively require a company to conduct the complicated Item 402(c)(2)(x) calculations for all of its employees, as is required for named executive officers, the final rule does not require a company to use a specific compensation measure in identifying its median employee. Instead, a company may identify its median employee based on any compensation measure that is consistently applied to all employees (e.g., compensation amounts reported in payroll or tax records). In making its median employee identification, a company may make cost-of-living adjustments to the compensation of employees in jurisdictions (i.e., countries) other than the jurisdiction in which the CEO resides so that the compensation in those jurisdictions is adjusted to the cost of living in the jurisdiction in which the CEO resides. The SEC notes in the adopting release that cost-of-living adjustments could be based on, for example, purchasing power parity.

Calculating Annual Total Compensation of the Median Employee and CEO

Once a company identifies its median employee, the company will be required to calculate that employee's annual total compensation. "Annual total compensation" is defined to mean total compensation for the company's last completed fiscal year and must be calculated in accordance with Item 402(c)(2)(x) of Regulation S-K; note that companies can, at their discretion, include personal benefits that aggregate less than $10,000 and compensation under non-discriminatory benefit plans in calculating the annual total compensation of the median employee as long as these items are also included in the CEO's calculation (these items are typically excluded from the CEO's total compensation in the summary compensation table). The company will then use this amount to calculate the required pay ratio.

A company may use reasonable estimates when valuing the elements of its median employee's total compensation. While the SEC did not prescribe what a reasonable estimate would be, it noted in the adopting release that it may be appropriate for a company to use reasonable estimates in determining an amount that would approximate the change in actuarial present value of an employee's defined benefit plan. If a company uses a cost-of-living adjustment to identify its median employee, the company must use the same adjustment in calculating that employee's annual total compensation and, for comparison, disclose the median employee's jurisdiction and annual total compensation without the cost-of-living adjustment.

A company will be required to calculate the annual total compensation of its CEO in accordance with Item 402(c)(2)(x) of Regulation S-K. If a company had more than one non-concurrent CEO serve during its fiscal year, the company may calculate the annual total compensation of its CEO, for purposes of the pay ratio, in either of the following manners:

- calculate the compensation provided to each person who served as CEO during the year for the time that he or she served as CEO and combine those figures; or
- look to the CEO serving in that position on the date the company has selected to identify the company's median employee and annualize that CEO's compensation.

Disclosing the Pay Ratio

The ratio of the median annual compensation of all employees (except the CEO) to the annual total compensation of the CEO should be disclosed either: (a) as a ratio in which the median of the annual total compensation of all employees (except the CEO) is equal to one; or (b) narratively in terms of the multiple that the CEO total compensation amount bears to the median employee amount. For example, the disclosure may be formulated either as "1 to 200" or "the chief executive officer's annual total compensation is 200 times that of the median annual total compensation of all employees (excluding the CEO)."

If a company uses a cost-of-living adjustment to identify its median employee and calculate his or her annual total compensation, the company must use the same adjustment in calculating the pay ratio and, for comparison, provide the employee's annual total compensation and the pay ratio *without* making any cost-of-living adjustment.

Related Disclosures

A company must disclose and briefly describe the methodology and material assumptions, estimates, adjustments and exclusions (including relating to cost-of-living, non-U.S. employees, business combinations and acquisitions) used to identify its median employee and calculate that employee's annual total compensation. Technical analyses and formulas are not required to be disclosed. In addition, a company must disclose any methodology changes from the prior year where the changes have significant effects, as well as the reasons for such changes.

Any company with multiple CEOs during a year must disclose the methodology used to calculate CEO annual total compensation. In addition, any legal opinion relating to the data privacy law exemption must be included as an exhibit to the relevant filing.

A company is permitted, but not required, to supplement its required pay ratio disclosure with a narrative discussion (for example, a general description of the median employee's position to put his or her compensation into context) or additional ratios. Any additional discussion and/or ratio must be clearly identified, not misleading and not presented with greater prominence than the required pay ratio. The rule prohibits companies from disclosing personally identifiable information about the median employee, except for his or her compensation.

Compliance Dates

A company's first reporting period for the pay ratio and related disclosures is its first full fiscal year commencing on or after January 1, 2017. As a result, a calendar-year company would not be required to make this disclosure until 2018 (when it will report pay ratios based on fiscal 2017 compensation information).

Newly public companies subject to the rule may take advantage of a transition period whereby compliance is not required until the first fiscal year beginning on or after the date that the company becomes subject to the requirements of Section 13(a) or 15(d) of the Exchange Act.

Smaller reporting companies and emerging growth companies are exempt from the rule until the first fiscal year beginning on or after the date that such company ceases to be a smaller reporting company or emerging growth company.

Practical Implications

The new rule requires companies to disclose, for the first time, the median employee's annual total compensation. Once this is disclosed, 50 percent of each company's workforce will learn that they are in the bottom half of pay at their company. Employees will also have greater visibility into how their compensation stacks up against compensation at competitors and peers. All of this has the potential to create workforce morale issues – accordingly, Human Resources personnel should be actively engaged in the disclosure process, in addition to Investor Relations and Public Communications personnel.

Although the new rule provides companies with considerable latitude regarding how the median employee is identified, compliance has the potential to be burdensome, particularly for large or multi-national companies, and especially in the first year of compliance. For a calendar-year company, this disclosure will first be provided in early 2018. In the interim, a company should consider consulting with counsel regarding its compliance with the rule and taking the following actions:

In the short term:

- Discuss the new rule and its implications with the company's compensation committee and the full board, as well as with Human Resources.
- Begin the process of considering how the median employee will be identified, taking into consideration, in particular, the significant flexibility provided by the rule (compensation consultants or other advisors may be able to be of assistance).

Over the long term:

- Ensure that payroll and HR systems and disclosure controls and procedures are adjusted as necessary to support the methodology chosen to identify the median employee, calculate his or her annual compensation and ensure that the company can make the other disclosures required by the rule.
  - For companies with more than five percent of employees outside the U.S., be cognizant that any reliance on the data privacy exemption will require prior efforts to obtain an exemption or relief from the relevant law or regulation, as well as a legal opinion from counsel in that jurisdiction, both of which could require significant lead time.
- Monitor the policies and preferences of key shareholders as they relate to pay ratios and prepare to engage with shareholders as appropriate.
- Follow future proxy advisory firm policy developments and recommendations with respect to pay ratios, including whether pay ratios of a particular magnitude are deemed to constitute a "problematic pay practice" or other governance failure that could warrant negative vote recommendations against say-on-pay and/or directors.
- Review pay ratio disclosures that any peer or other relevant companies make on a voluntary basis and gauge investor and public reactions.

Although it is possible that the new rule may be challenged in litigation (similar to several other recent SEC rulemakings required by Dodd-Frank), companies should not defer consideration of the significant steps that will be necessary to ensure compliance by the effective date.

If you have any questions regarding this Sidley Update, please contact the Sidley lawyer with whom you usually work, or

Holly J. Gregory	John P. Kelsh	Thomas J. Kim	Corey Perry	Rebecca Grapsas
Partner	*Partner*	*Partner*	*Partner*	*Counsel*
holly.gregory@sidley.com	jkelsh@sidley.com	thomas.kim@sidley.com	cperry@sidley.com	rebecca.grapsas@sidley.com
+1.212.839.5853	+1.312.853.7097	+1.202.736.8615	+1.312.853.7797	+1.212.839.8541

Sidley Corporate Governance and Executive Compensation Practice

Lawyers in Sidley's Corporate Governance and Executive Compensation practice regularly advise corporate management, boards of directors and board committees on a wide variety of corporate governance matters, including shareholder activism and engagement, fiduciary duties, board oversight responsibilities, board investigations and special committees, SEC disclosure, legal compliance, corporate responsibility, board evaluation, board and committee structures and issues arising under Sarbanes-Oxley and Dodd-Frank. Our advice relates to the procedural aspects as well as the legal consequences of corporate and securities transactions and other corporate actions, including takeover defenses, proxy contests, SEC filings and disclosure issues, stock option issues and general corporate law matters. Our broad client base allows us to provide advice regarding best practices and trends in such matters as directors' and officers' responsibilities, board and committee practices, disclosure controls and procedures, internal controls, executive compensation and other matters.

---

[1] SEC Release No. 33-9877, *Pay Ratio Disclosure* (Aug. 5, 2015), available here.

[2] Chair Mary Jo White and Commissioners Luis A. Aguilar and Kara M. Stein voted to approve the final rule, and Commissioners Daniel M. Gallagher and Michael S. Piwowar dissented. In his dissenting statement, Commissioner Gallagher described his concerns around the definition of "employee" encompassing a broader group than U.S. full-time employees and that the rule "improperly compels corporate speech." In his dissenting statement, Commissioner Piwowar described his concerns around the lack of specific or convincing justification for the rulemaking. Moreover, in an unusual development, two days after the SEC's open meeting, Commissioner Piwowar issued *additional* dissenting comments setting forth the following "defects" in the pay ratio disclosure rulemaking: (a) the proposing release did not provide sufficient notice under the Administrative Procedure Act, in particular, in relation to what objective, goal or benefit the SEC believed the rulemaking was intended to accomplish; (b) once the SEC decided what objectives Section 953(b) of the Dodd-Frank Act was intended to accomplish, it failed to publicly disclose such understanding prior to adopting the final rule; (c) the SEC failed to consider what the quantitative effects of providing flexibility would be on the accuracy of the pay ratio and thereby acted in an "arbitrary and capricious" manner when it limited the *de minimis* exclusion of non-U.S. employees to 5%; (d) the SEC acted "arbitrarily and capriciously" when it defined "employee" to exclude contract workers only if they are employed by an unaffiliated third party; (e) the SEC's economic analysis failed to consider academic studies as to whether the pay ratio might create pressure to increase CEO compensation; and (f) use of the pay ratio for comparative purposes among companies may violate an investment advisor's fiduciary duty under the Investment Advisers Act of 1940, given the significant limitations to using pay ratio information for such purposes. *See* Commissioner Piwowar, Additional Dissenting Comments on Pay Ratio Disclosure (Aug. 7, 2015), available here. Statements made at the open meeting on August 5, 2015 are available on the SEC website here.

[3] SEC Release No. 33-9452, Pay Ratio Disclosure (Sept. 18, 2013), available here.