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On August 5, 2015, the SEC adopted a final rule to implement Section 953(b) of the Dodd-Frank Wall Street Reform and Consumer Protection Act, often referred to as the pay-ratio provision.

The pay-ratio provision mandates that the SEC require most public companies to disclose, in a wide range of their SEC filings:

- the median of the annual total compensation of all employees of the company, except the CEO (that is, the point at which half the employees earn more and half earn less);
- the annual total compensation of the CEO; and
- the ratio of the two amounts above.

As Commissioner Luis Aguilar explained, "while the CEO-to-worker pay ratio is a seemingly simple requirement—after all, the primary output of today's rule is just a ratio, like 296:1—getting to the ratio may require some effort." Fortunately, companies will have some time to sort it all out—under the final rule, the first disclosure for calendar-year companies will be in the 2018 proxy statement with respect to compensation for 2017.

Highlights of the final rule

- **(Almost) all employees must be considered:** When determining the median employee, except as described below, a company must consider all employees of the company and its consolidated subsidiaries, including non-US, part-time, temporary and seasonal workers employed on any date within the last three months of the last fiscal year (a change from the proposal, which looked only at the last day of the fiscal year). In addition, the final rule adds two new "tailored" exemptions from the definition of "employee":
  - An exclusion for non-US employees if compliance would cause a violation of foreign data privacy laws, notwithstanding reasonable efforts by the company to seek an exemption or relief from the laws, provided the company files with the SEC a legal opinion supporting that position; and
  - A *de minimis* exclusion for non-US employees that account for 5% or less of the company's employees, including any non-US employees that are being excluded under the data privacy exemption.
- **Flexible approach to identifying the median employee:** To identify the median employee, a company is not required to calculate annual "total compensation" (as calculated under Item 402(c) of Regulation S-K) for each employee in the population or sample, although that approach is certainly permitted. Instead, the final rule retained the flexibility of the original proposal, allowing companies to determine the median employee from among the entire employee population, a statistical sample or other reasonable method. In addition, the company may then identify the median employee in the population or sample using annual total compensation or any other consistently applied compensation measure, such as compensation amounts reported in its payroll or tax records (*e.g.*, W-2 wages). Reasonable estimates may also be used in calculating the annual total compensation or any elements of compensation for employees other than the CEO.
- **Median employee required to be identified only once every three years:** In a change from the proposal, a company will be permitted to identify the median employee only once every three years, instead of every year, so long as there have not been changes in employee compensation or in the employee population that the company reasonably believes would significantly affect the pay ratio. In the event the median employee departs from the company or his or her position changes, the company may use another employee with compensation that is substantially similar to that of the median employee.
- **Cost-of-living adjustment permitted:** To make the information more internally comparable, a company may apply a cost-of-living adjustment to reflect the cost of living applicable in the jurisdiction where the CEO resides. The same adjustment must be made to both the compensation measure used to identify the median employee and the calculation of the total compensation paid to the median employee. In addition to the adjusted compensation and adjusted ratio, the company will need to disclose the unadjusted median compensation and unadjusted ratio, which means it will also need to identify the median employee without using any cost-of-living adjustments.
- **Identification and consistent application of methodology and assumptions:** In its disclosure, a company will need to

describe the methodology used to identify the median, as well as any material assumptions, adjustments and estimates. To reduce potential for manipulation to affect the outcome, the final rule requires that methodologies and material assumptions, adjustments and estimates be consistently applied. As in the proposal, a company may supplement with additional narrative or additional ratios.

- **Exempt companies:** Consistent with the proposal, emerging growth companies are exempt, as are smaller reporting companies, foreign issuers and US-Canada Multijurisdictional Disclosure System filers.
- **Compliance date:** Each company will be required to report pay-ratio information for its first fiscal year beginning on or after January 1, 2017, disclosing that information as part of its reporting for the 2018 proxy season. Transition rules apply in connection with IPOs, business combinations and companies that cease to be EGCs or SRCs.

Background of the final rule

Like the Dodd-Frank clawback rules proposed by the SEC a month earlier, implementation of the pay-ratio provision was not a simple task, taking more than five years from the date of enactment of Dodd-Frank in 2010. In part, the delays can be ascribed to the interest-group politics surrounding the provision. Throughout the long process, business, organized labor and consumer advocacy groups lobbied intensively both for and against the rule. Republicans in Congress sought numerous times to repeal the provision and pressured the SEC to delay adoption of final rules, while Democrats have pressured the SEC to accelerate its implementation.

As Chair White observed in her opening statement, to "say that the views on the pay ratio disclosure requirement are divided is an obvious understatement." Proponents of the provision, focusing on reports of the mounting disparity between executive and worker pay (and income inequality in general), have argued that pay-ratio information is essential to allow investors to determine if executive pay is excessive and needs to be reined in. According to a recent study from the Economic Policy Institute, for the largest US public companies, CEO pay in 2014 was 303 times an average worker's pay, compared to just 20 times in 1965. In addition, the study revealed, from 1978 to 2014, inflation-adjusted CEO compensation increased 997%, almost double the growth of the stock market and dwarfing the 10.9% growth experienced by typical workers over the same period. Providing pay-ratio data, they contended, may encourage boards, in setting executive compensation, to consider internal pay equity, not just external peer-to-peer comparisons, which, some argue, tend to inflate executive pay.

Opponents of the provision have argued that, for almost all companies, calculating the ratio would be of little value to investors, but tremendously complicated, expensive and potentially inaccurate. In its 2013 proposal, the SEC sought to address these cost and complexity issues by offering a relatively flexible approach that would allow each company to choose from several options for identifying the median in the way that would best suit the size, structure and compensation practices of that company. In particular, the proposal did not require any particular methodology for identifying the median employee. Instead, it allowed companies to choose from several alternative methods, including statistical sampling, reasonable estimates and use of any consistently applied compensation measure, such as W-2 wages, to identify the median in the employee population in a manner that would work best for their own facts and circumstances.

While that flexibility was welcomed, criticism did not abate. Most of the angst, however, was reserved for the proposal's requirement to include in the calculation of median compensation both foreign and part-time employees. Companies with a global workforce, critics contended, could face a variety of different complex payroll and pension systems, different compensation practices and different income tax reporting regimes in each country, and may not have a centralized network for capturing and analyzing all these types of data. The complications arising out of these variables could be compounded by foreign currency fluctuations and foreign data privacy rules. Moreover, with regard to part-time, seasonal and temporary employees as well as employees located in less developed countries where per-capita income and cost of living are substantially lower, companies and business organizations raised the concern that including these employees in the median calculation would substantially (and inappropriately) skew the results to widen the gap.

In its efforts to respond effectively to these objections, the majority of the SEC Commissioners clearly felt constrained by the provision's mandate to include "all employees" in the calculation. Nevertheless, the SEC attempted to thread the needle to provide some additional relief to companies on this issue, while still hewing closely—or closely enough—to the text of Dodd-Frank. While these new modifications will ameliorate some of the cost and complexity, whether they go far enough to substantially alleviate the burden on most companies remains to be seen.

Key provisions of the final rule

The pay-ratio calculation

What exactly will we be required to calculate?

Under new Item 402(u) of Regulation S-K, each company is required to calculate and 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 two amounts above.

Companies may express the pay ratio either numerically or in narrative form, but, in either case, the median of the annual total compensation of all employees must be presented as equal to one (*e.g.,* "1 to 200" or "CEO total compensation is 200 times that of the median of the annual total compensation of all employees").

Employees to be considered in the calculation

Which employees are covered by the term "employees"? What about part-time employees, non-US employees or employees of subsidiaries?

Dodd-Frank expressly requires disclosure of the median of the annual total compensation of "all employees," and the final rule defines "employees" to include, except as described below, all full-time, part-time, seasonal and temporary employees, including, subject to the exemptions discussed below, foreign employees, as of a date chosen by the company within the last three months of the company's last completed fiscal year. The ability to pick a date within that last quarter, a change from the proposal, could allow some companies with high proportions of seasonal workers in the last quarter of the year to exclude those employees from the pool. The company is required to disclose the date selected and, if the date is changed from year to year, the company must disclose the change and explain the reason for it. The rule covers employees of any consolidated subsidiary of the company, a change from the proposal, which would have covered employees of subsidiaries that were affiliates the company controlled directly or indirectly through one or more intermediaries. Independent contractors, "leased" workers or other temporary workers who are employed by a third party (*e.g.*, if the company pays a fee to a management company or employee-leasing agency that supplies workers) are not included in the definition of "employees."

Observations and commentary

- The broad definition of "employees" will likely present the greatest challenge for most companies, the SEC's efforts to ease the associated costs and burdens notwithstanding. The majority of the SEC Commissioners viewed the inclusion of non-US employees to be consistent with Dodd-Frank, undoubtedly bolstered in that view by comments submitted by the Senator responsible for inserting the pay-ratio provision into Dodd-Frank: he wrote that by "all employees of the issuer," he "intended that to mean both full-time and part-time employees, not just full-time employees. [He] also intended that to mean all foreign employees of the company, not just US employees." Organized labor and consumer advocacy groups contended that the Dodd-Frank mandate is "unambiguous" and that the SEC simply did not have "regulatory flexibility" under the statute to permit the exclusion of any employees from pay-ratio calculations.
- At the SEC open meeting to consider adoption of the final rule, Commissioner Gallagher nevertheless took issue with the definition of "employee" to be used in calculating the ratio, contending that the SEC "has ample definitional authority, interpretive authority, and exemptive authority" to exclude broad categories of employees. He reasoned that the term "employee" was ambiguous and, in the absence of any definition of "employee" in the statute, the SEC was free to define the term however it chose to make sense of the legislation, including a definition that excluded part-time and foreign employees. In his view, the "statutory language 'all employees' simply specifies that *all* members of the class of 'employees' must be included; it does not tell us *anything* about *how that class is defined*. Thus, the Commission has broad latitude to define or interpret 'employee' to mean 'persons who are employed by the issuer on a full-time basis within the United States.' The pay ratio would then need to be the ratio of the pay of the median of *all* of such persons to the pay of the [CEO]." Alternatively, he suggested, the SEC could "have simply exempted non-US, non-full time employees from the scope of the rule…." Had the majority supported

this type of broad exclusion, he maintained, companies could have saved an estimated aggregate of $788 million and he could have supported adoption of the rule.

- Companies with significant employee populations located outside the US or significant numbers of part-time or seasonal employees may want to look hard at providing one or more additional ratios that present these workforces separately, along with additional narrative explaining the implications. Although the final rule requires disclosure of a single ratio covering both foreign and domestic employees, it expressly permits companies, in their discretion, to present additional ratios to supplement the required ratio, so long as the supplemental ratios are clearly identified, not misleading and not presented with greater prominence than the required ratio. Presentation of additional ratios and narrative could go a long way toward mitigating concerns that inclusion of part-time employees or a non-US workforce in the pay-ratio calculation distorts the data.
- The final rule excludes from the definition of employee "workers who are employed, and whose compensation is determined, by an unaffiliated third party but who provide services to the registrant or its consolidated subsidiaries as independent contractors or 'leased' workers." The application of this exception in today's "gig" economy, in which many workers who provide services directly to or for companies are identified as "independent contractors," is not yet clear.

Were any accommodations made in the final rule to address concerns regarding non-US employees?

Yes, in addition to the provision for cost-of-living adjustments (discussed below), the SEC created two exceptions from the definition of "employee" to address cross-border compliance issues for multi-national companies.

- *Exemption related to foreign data privacy laws.* Non-US employees may be exempt if the company is unable, notwithstanding its reasonable efforts, to obtain or process the information necessary for compliance with the pay-ratio requirements because of the data privacy laws of the foreign jurisdiction where the employees are employed. At a minimum, "reasonable efforts" must include using or seeking an exemption or other relief under the data privacy laws. If any employees in a foreign jurisdiction are excluded under this exemption, all employees in that jurisdiction must be excluded. A company taking advantage of this exemption is required to disclose details such as the excluded jurisdictions, the number of employees excluded, the specific data privacy law and how it would have been violated, as well as the company's efforts to seek relief. In addition, the company will need to file as an exhibit to the relevant SEC filing a legal opinion supporting its position.
- *De minimis exemption for foreign employees.* If a company's non-US employees account for 5% or less of its total employees, the company may exclude all, but not less than all, of those employees. If the company's non-US employees exceed 5% of the total employees, the company may exclude up to 5% of its total employees who are non-US employees. However, if the company excludes any non-US employees in a particular foreign jurisdiction, it must exclude all non-US employees in that jurisdiction. Under this exemption, if the number of employees in a particular foreign jurisdiction exceeds 5% of the total, none may be excluded from that jurisdiction. Companies relying on this exemption must disclose the number of employees excluded and the jurisdictions where they were employed, total employees and the total used for the *de minimis* calculation.

How do these two exemptions interact?

Any employees excluded under the data privacy exemption will count against the 5% that may be excluded under the *de minimis* exemption. As a result, if the number of employees excluded under the data privacy exemption exceeds 5% of total employees, the *de minimis* exemption will not be available. Similarly, if less than 5% are excluded under the data privacy exemption, the *de minimis* exemption is available only to exclude the difference.

What about cost-of-living adjustments?

Recognizing that differences in the underlying economic conditions of various foreign countries in which a company may operate may affect the compensation paid to employees in those countries, the SEC added to the final rule an option allowing the company to make cost-of-living adjustments to the compensation of its employees to reflect the cost of living in the jurisdiction where the CEO resides. If any adjustment is made, it must be made for all employees and must be used both to identify the median employee and to calculate the median employee's annual total compensation. The company must also describe the adjustments and disclose the pay ratio and the median employee's compensation without the adjustments, which means that it will also need to identify the median employee without using any cost-of-living adjustments. Although the SEC acknowledged that a cost-of-living adjustment could involve some subjectivity, it was ultimately persuaded that a ratio comparing the value of the CEO's compensation to the value of the median employee's compensation (as opposed to just the dollar amount) by filtering out the difference attributable to the cost of living might prove to be more useful to shareholders.

Observations and commentary

- The data privacy laws of foreign countries may either prohibit collection and transfer of personally identifiable compensation data or impede transfer of the data out of the home country or jurisdiction. Other data privacy laws may make the collection or transfer of the underlying data more burdensome, but do not actually prohibit transfer of compensation data. The adopting release notes that, in some European Union member countries, transmitting personally identifiable human resources data of EU employees onto global human resource information system networks in the US, sending personal data in hard copy to the US, or making personal data 'onward transfers' to third-party payroll, pension and benefits processors outside the EU may be prohibited or require employee consent. The release also notes that other jurisdictions, such as Peru, Argentina, Canada and Japan, also have data privacy laws that could be implicated by compliance with the rule. In some cases, there may be ways to comply with the rule, but still address these prohibitions, for example, by making the compensation data "truly anonymous" (so that the data may not attributed to any identifiable person), by using estimates or conducting the analysis in the EU In other instances, however, the issue may not be easily resolved and the company may need to take advantage of the data privacy exemption.
- Concern regarding an almost certain court challenge to the pay-ratio rule, together with the memory of 2011, when the SEC's ill-fated proxy access rule was vacated in the DC federal courts on the basis of an inadequate cost-benefit analysis, may have been the impetus for the SEC's Division of Economic and Risk Analysis to conduct two additional economic analyses demonstrating the potential effect on the pay ratio of excluding various percentages of employees. These analyses showed that exclusion of 5% of employees may cause the pay-ratio calculation to decrease by up to 3.4% or to increase by up to 3.5%, which the SEC viewed as *de minimis*. By comparison, one study showed that, with a 20% exclusion, the pay ratio could decrease by up to 13% or increase by up to 15%, depending on the scenario considered.
- The inclusion of non-US employees has the potential to skew the ratio up or down. Employees working in less developed countries may earn substantially less than their counterparts in the US. However, in some countries, commenters noted, employees also receive, as part of their compensation, the cost of "transportation, food, housing, wedding, birth, education and phone expenses, as well as profit-sharing arrangements" and other benefits. The provision under the final rule allowing for cost-of-living adjustments may address some, but not all, of these differences in pay practices.
- The release notes that companies may use cost-of-living adjustments based on national price level ratios (the ratio of a "purchasing power parity" conversion factor divided by the market exchange rate) available from the World Bank. These ratios make it possible to compare the cost of goods across countries by indicating how many dollars are needed to buy a dollar's worth of goods in the country as compared to the US.

Performing the calculation

Which CEO's compensation do we use if we have more than one CEO during the year?

Where more than one person has served as CEO during the year, the company may choose between two options in calculating CEO annual total compensation: combining the total compensation as reflected in the Summary Compensation Table for both CEOs or using the total compensation for the CEO serving in that position on the date the company selects for identification of the median employee and annualizing that CEO's compensation. In either case, the company must disclose which option it chose and how it calculated its CEO's annual total compensation.

What is included in "total compensation"?

"Total compensation" as applied to the median employee has the same meaning as in the compensation disclosure rules that apply to named executive officers under Item 402 of Regulation S-K. Accordingly, "total compensation" includes not just cash compensation, but also the grant date value of stock options and other equity awards, the aggregate change in pension value and nonqualified deferred compensation earnings and the value of certain other compensation, including personal benefits. For non-salaried employees, references in the existing rules to "base salary" and "salary" will refer instead to "wages plus overtime," as applicable. For non-US employees, any accrued pension benefits payable by the government under a government-mandated pension plan are not considered compensation for purposes of Item 402 or included in the calculation of total compensation (just as Social Security benefits are excluded).

What does "annual" mean in this context?
The final rule defines "annual" total compensation as the total compensation for the last completed fiscal year, consistent with the executive compensation disclosure rules. To more accurately reflect the employment relationship, companies may choose to annualize compensation paid to all full-time or part-time permanent employees who were not employed during the entire fiscal year, such as newly hired employees, employees called for active military duty or employees on unpaid leaves of absence during the period. The final rule does not permit full-time equivalent adjustments for part-time, seasonal or temporary employee compensation; the SEC was concerned that that type of adjustment would not reflect the company's actual workforce and compensation structure. Where comparing full-time compensation with part-time compensation may result in potential distortions of the ratio that cannot otherwise be salvaged, companies should consider adding an additional ratio and explanatory narrative.

To identify the median, do we need to consider the compensation paid to every employee?
Not necessarily. The final rule provides each company the flexibility to choose a methodology to identify the median employee based on its own facts and circumstances. The company can use its entire employee population, a statistical sample or a pool selected by another reasonable method to choose a smaller group of employees for purposes of identifying the median.

Once the employee pool has been determined, how do we identify the median employee?
Under the final rule, a company may use one of two methodologies:

- calculate the annual total compensation in accordance with the existing executive compensation disclosure rules for each employee in the pool (whether the entire population or a statistical sample), and then identify the median; or
- identify the median employee in the pool based on any other compensation measure that is consistently applied to all employees included in the calculation, such as information derived from tax and/or payroll records (*e.g.*, total direct cash compensation or W-2 reported wages), and then compute the annual total compensation only for that median employee.

In applying either methodology, a company could choose not to calculate annual total compensation precisely for those employees in the pool with extremely high or extremely low pay—who are obviously not at the median—so long as it is noted that they are above or below the median. Companies may also use reasonable estimates in calculating the annual total compensation or any elements of compensation for employees other than the CEO.

What is a "compensation measure" under the rule?
A compensation measure would include, for example, measures such as compensation amounts reported in the company's payroll or tax records. The rule requires, however, that any measure selected be consistently applied to all employees. In selecting the compensation measure, companies should keep in mind that there can be significant variation in the components of pay, even for employees that are paid similar cash wages. Under the final rule, the same compensation measure may be defined differently across multiple jurisdictions and may include different annual periods, but could still be used as the compensation measure as long as, within each jurisdiction, the measure is consistently applied. For example, if the compensation measure selected is W-2 wages and there is not an equivalent to a Form W-2 in a particular foreign jurisdiction, the company may use other reasonable data sources to collect the comparable information, as long as those data sources are consistently applied within that foreign jurisdiction. Any compensation measure used to identify the median employee must be disclosed.

What if there is something unusual about the identified median employee's compensation that would skew the pay ratio?
If, after calculating total compensation for the median employee, the company "reasonably determines that there are anomalous characteristics of that employee's compensation that would have a significant higher or lower impact on the pay ratio," the company may substitute another employee with substantially similar compensation to the original median employee, based on the same compensation measure. Disclosure of the substitution is required.

Will we be allowed to use estimates?
Yes. Companies may use reasonable estimates in identifying the median and in calculating the annual total compensation for employees other than the CEO. For example, estimates could be employed where precise individual data may not be available in connection with multi-employer defined benefit pension plans. Companies

should have a reasonable basis to conclude that any estimates approximate the actual amounts of compensation, which will depend on the particular facts and circumstances. Companies must clearly identify any estimates used.

Do we need to go through this process to identify the median employee every year?
No. In a significant change from the proposal, the final rule allows a company to identify the 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 in the pay ratio disclosure." If the same median employee is used, the company must disclose that fact and describe briefly the basis for its reasonable belief (*e.g.*, by indicating the absence of changes that it believes would significantly affect the pay-ratio disclosure). Even though the company may identify the median employee only once every three years, it must still calculate that median employee's annual total compensation each year and use that figure to update its pay-ratio disclosure each year. If there has been a change in the selected median employee's circumstances in years two or three, such as a promotion or departure of the employee, that significantly affects the median employee's compensation, the company may select an alternative employee whose compensation is substantially similar to the original median employee (based on the same compensation measure). If no other employee has similar compensation, however, the company must go through the process of re-identifying the median employee.

Observations and commentary

- Because the existing executive compensation disclosure rules were crafted to apply to executive compensation, they capture components of compensation more likely to apply to executives and exclude components, such as benefits under non-discriminatory plans (*e.g.,* health insurance) available to all employees, and perquisites (*e.g.,* employee discounts) that aggregate less than $10,000. The SEC acknowledged that exclusion of these components could understate the real compensation of the broad workforce, making the pay-ratio disclosure less meaningful. However, the SEC noted, because those exclusions are permissive, rather than mandatory, companies have the discretion to include those components in calculating the annual total compensation of employees, so long as the same components are also included in calculating CEO compensation for purposes of the ratio and the company explains any difference between CEO total compensation used in the pay-ratio disclosure and the amounts reflected in the summary compensation table.
- Although the final rule does not provide any specific parameters for statistical sampling or sample size, the SEC did provide some limited guidance. While a relatively small sample size would be appropriate in certain situations, a reasonable determination of sample size depends in part on how widely compensation is distributed around the mean, as well as variations in the types of employees across business units and geographical locations. According to the SEC's economic analysis, for companies with a low variance, an appropriate sample population size might be less than 135; for companies with a high variance, the sample size may be more than 1,200. In the SEC's economic analysis, the appropriate sample size for companies with a single business or geographical unit varied between 81 and 1,065 across industries, with the average estimated sample size close to 560. Companies with multiple business lines or geographical units may use more than one statistical sampling methodology; however, data should be drawn from each unit.
- The SEC recognized that allowing companies the flexibility to use various estimates and to select a methodology for identifying the median would impair comparability across companies and was subject to the risk that companies could try to distort results to achieve a particular objective. However, the SEC believed that the need for flexibility outweighed the need for comparability and that the risk of manipulation would be mitigated by requiring that any compensation measure used be consistently applied. Notwithstanding the SEC's views regarding the limitations on comparability, it is almost certain that the media will highlight comparisons of ratios among companies, whether in the same industry or otherwise. That likelihood underscores the importance of providing persuasive explanations of any unusual results or aspects of the calculation, whether in narrative or by providing additional ratios (so long as they are not misleading or more prominently presented than the mandated ratio) or both. Moreover, the media will also undoubtedly examine year-to-year comparisons of the ratio at each company. Accordingly, companies will want to be sure that their methodologies are structured to maximize not only accuracy, but also consistency from year to year.
- To provide context, companies may also want to consider including a scrupulously anonymous description of the

circumstances of the median employee, keeping in mind any applicable employee data privacy laws. The median employee's demographics may make a significant difference in the total compensation that is ultimately reported for that employee. For example, although the company may offer generous broad-based retirement benefits, the median employee may be a recent hire and may not have yet qualified for those benefits, may have chosen not to participate in an offered program or may be a younger employee with fewer accrued benefits. Similarly, the median employee could be employed in a foreign country with government-provided health and welfare benefits that the company provides in other countries.

Additional disclosure

Do we need to disclose our methodology and assumptions?

Yes. Companies will need to disclose the methodology used to identify the median, as well as any material assumptions, adjustments (including any cost-of-living adjustments) or estimates used to identify the median employee or to calculate total compensation. Although the disclosure must be sufficiently detailed to allow readers to evaluate appropriateness, the SEC emphasizes that companies should avoid "dense" technical analyses or formulas, such as statistical formulas, confidence levels or the steps used in data analysis. Companies that conduct statistical sampling would, however, need to disclose the size of the sample and the estimated whole population, any material assumptions used in determining the sample size and the sampling methods used. To reduce potential for manipulation to affect the outcome, the final rule requires that methodologies and material assumptions, adjustments and estimates be consistently applied. If a company changes methodology or material assumptions, adjustments or estimates from those used in its pay-ratio disclosure for the prior fiscal year and the effects of the change are significant, the company must also briefly describe the change and the reasons for the change, and provide an estimate of the impact of the change on the median and ratio. For example, the company must disclose if it elects not to use a cost-of-living adjustment after using the adjustment the prior year.

Observations and commentary

Companies that elect to conduct sampling may want to formulate their methodologies keeping in mind they will need to explain—and, in effect, justify the use of—that methodology in their annual filings in a way that is accurate but simple enough for investors who are not statisticians to understand—or at least understand enough to deter any suspicion of manipulation or distortion. To that end, companies considering use of complex methodologies may want to prepare and review descriptions of those methodologies as part of the selection process to assess how comprehensible they are.

Location of disclosure

Where do we need to disclose the pay-ratio information?

The disclosure is required in annual reports on Form 10-K and in proxy and information statements and registration statements requiring executive compensation disclosure, although pay-ratio disclosure will not be required in IPO registration statements. The final rule does not add any requirements to include pay-ratio disclosure in any filings that do not already require executive compensation disclosure.

The pay-ratio information needs to be updated only annually in the proxy statement or Form 10-K. If a company is required to disclose pay-ratio information prior to the time when an annual update is due, the company must include or incorporate by reference its pay-ratio disclosure for the most recently completed fiscal year. For example, if a company with a calendar-year fiscal year is required to file a proxy statement requiring executive compensation disclosure in October 2018, the company would not be required to update its pay-ratio disclosure as of that date. Rather, the company would include or incorporate by reference the pay-ratio disclosure in the company's annual proxy statement or annual report filed earlier in 2018.

Will pay-ratio information be deemed "filed" rather than "furnished"?

Yes. As result, the information will be subject to potential liabilities under the Securities Act and Exchange Act (in particular, Exchange Act Section 18 and Rule 10b-5).

Observations and commentary

Because companies do not need to update their pay-ratio disclosures for the most recently completed fiscal year until filing their annual meeting proxy statements, a company could request effectiveness of a registration statement (and make other filings that include executive compensation disclosure), even after the end of its fiscal year and prior to filing its annual meeting proxy statement, without the obstacle of needing to calculate new pay ratios.

Companies subject to the rule

Are any categories of companies exempt from the rule?

Yes. The following types of companies, which are subject to limited executive compensation disclosure requirements, are exempt from the pay-ratio disclosure:

- EGCs;
- SRCs; and
- foreign private issuers filing on Form 20-F and companies that file reports and registration statements with the SEC in accordance with the requirements of the US-Canada Multijurisdictional Disclosure System.

Timing

When do we need to comply? Will we need to provide this information in our next proxy statement?

Most companies will not be required to disclose their pay-ratio information until the 2018 proxy season. Under the final rule, each company will be required to calculate its pay ratio for compensation for its first fiscal year that *begins* on or after January 1, 2017, and disclose that information in the following year's proxy statement. This means that a calendar-year company will calculate pay-ratio information for 2017 compensation, disclosing that information as part of its reporting for the 2018 proxy season. Similar to the requirements for executive compensation in proxy statements, the pay-ratio disclosure must be filed no later than 120 days after the end of the fiscal year. Accordingly, if a company with a fiscal year ending on December 31 does not file its annual proxy statement by April 30, 2018, the company would need to amend its Form 10-K to include pay-ratio information for 2017.

Are there any transition rules for newly public companies?

Yes. For a company that has just completed an IPO, the first pay-ratio disclosure will be required for its first full fiscal year beginning after it has:

- been subject to the Exchange Act reporting requirements for a period of at least 12 calendar months beginning on or after January 1, 2017 and
- filed at least one 10-K that does not contain the pay-ratio disclosure.

What about transitions out of EGC and SRC status?

A company that ceases to be an EGC or SRC will not be required to disclose pay-ratio information until after the first full fiscal year after exiting such status or for any fiscal year commencing before January 1, 2017.

How do we treat employees of companies newly acquired as a result of business combinations?

A company that engages in a business combination may, but need not, omit from its pay-ratio calculation the employees of a newly acquired entity for the fiscal year in which the business combination becomes effective. For example, employees of a business acquired in 2017 may be omitted from the 2017 fiscal year compensation calculation, but will be included for the 2018 fiscal year calculation and reported during the 2019 proxy season.

What do we do if we don't have all of the necessary bonus information by the due date?

In certain circumstances, companies may omit disclosure in the summary compensation table of the salary or bonus of a named executive officer where the amount is not yet calculable. In that situation, the final rule allows the company to delay filing its pay-ratio disclosure and instead allows the company to report the omitted pay-ratio disclosure when it is fully available in the same Form 8-K as the omitted salary or bonus information.

We know that disclosure won't be required until 2018, but is there anything we can do in advance to prepare?

Each company will probably want to explore the various methodologies available to find the median employee to see which is most efficient and effective, keeping in mind the need to maintain consistency and avoid distortion of the data. Companies should consider the following as initial preparation steps:

- Companies will want to assess the complexity of their workforces and payroll systems. Each company's choice of the appropriate methodology will depend on the particular facts and circumstances, including the following variables identified by the SEC:

  - the size and nature of the workforce;
  - the complexity of the organization;
  - the stratification of pay levels across the workforce;
  - the types of compensation the employees receive;
  - the extent that different currencies are involved;
  - the number of tax and accounting regimes involved; and
  - the number of payroll systems the company has and the degree of difficulty involved in integrating payroll systems to readily compile total compensation information for all employees.

- Companies that have few overseas employees and a single payroll system may well be candidates for determining the median based on a single compensation measure, such as W-2 wages, for the entire employee population.
- Companies with more than one payroll system may want to examine the possibility of linking and harmonizing those systems in a way that enables communication and collection of the necessary information.
- Companies that have multiple payroll systems and more complex workforces, especially those that comprise significant overseas or part-time components, will want to explore the impact of the data privacy and *de minimis* exemptions, if available.
- Those companies should also examine the impact of statistical sampling using different methodologies to determine the pool and compensation measures to determine the median employee. Companies that do not have statistics expertise in-house may need to look to outside compensation or other consultants for that purpose.
- Conducting test samplings of the data could prove to be a useful exercise in helping to determine the appropriate sampling methodology and compensation measure.
- Insights gleaned from test data may also provide a head start in determining the kind of supplemental ratios and narrative that will likely be necessary down the road. Comparative industry pay-ratio data might be especially useful in that regard. Compensation consultants may be able to provide estimated pay-ratio data for comparable or other companies within the industry, which may assist companies in assessing the results of their own pay-ratio analyses.

What is the expected impact of pay-ratio disclosure?

The adopting release acknowledges that Congress did not expressly state the specific objectives or intended benefits of the pay-ratio provision, but the SEC majority believes that the ratio will provide shareholders with a company-specific metric that can assist in their evaluation of a company's executive compensation practices, particularly in connection with say-on-pay votes. Commissioner Aguilar also cited as potential benefits of the new disclosures that they would better equip shareholders to promote accountability for compensation policies and practices and improve shareholder engagement on executive compensation issues. Commissioner Gallagher, on the other hand, contended that the real purpose of the rule was to "name and shame" companies into lowering CEO pay.

Observations and commentary

What impact, if any, the disclosure of pay-ratio information will have on executive pay is an open question. Levels of executive pay have been public for years, and the shock value of outlying CEO compensation is likely to have largely dissipated. What will be new—along with the ratio itself—is the median employee compensation data. Some have speculated, especially in view of the recent focus on income equality and "living" wages, that, in some cases, the spotlight will possibly fall less on CEO compensation and more on low levels of employee compensation. (Indeed, in his additional dissenting statement, Commissioner Piwowar cited academic studies suggesting that "pay ratio disclosure could exacerbate any upward bias in executive pay by providing another benchmark that could be used in certain situations to increase CEO compensation.") If that were to occur, would companies begin to experience public pressure to increase employee wages? Or will persuasive narrative justifications deflect that spotlight?

Another variable that may affect the impact of the rule is whether proxy advisory firms, such as ISS and Glass Lewis, and institutional shareholders will profess an interest in the result. Historically, these firms have been primarily interested in the ratio of CEO pay to other named executive officers. Whether these firms will formulate policies to review and analyze pay-ratio disclosure as part of reviewing a company's executive pay practices in connection with its say-on-pay proposal and the election of compensation committee members, or otherwise express any concern regarding internal employee pay equity, is, for now, an open question. Further, while executive pay has long been under scrutiny from standard-issue corporate governance activists, commentators have recently suggested that some hedge fund activists have been using executive compensation issues as wedge issues. The possibility that pay-ratio data could pique their interest has the potential to introduce a more disquieting note to the compensation conversation.

Consumer behavior could also be affected. A recent study from the Harvard Business School demonstrated that the disclosure of a firm's pay ratio can influence consumer purchase intentions. In one of a series of experiments conducted to assess the effect of pay ratios on the relationship between companies and customers, the evidence showed that, to achieve as favorable a rate of purchase as a hypothetical company with a low pay ratio offering a product at full price, a hypothetical company with a high pay ratio had to offer a 50% price discount. As a result, companies in consumer-facing industries may feel additional pressure to justify their ratios in narrative discussions.

State legislatures may also begin to take advantage of pay-ratio disclosure to craft legislation, as attested by the introduction of recent bills in California and Rhode Island. The California bill, which was defeated, would have adjusted the state's corporate income tax rate depending on whether the pay ratio (as calculated in the bill) was above or below certain thresholds. The Rhode Island bill would give preferences in awarding state contracts to companies with very favorable pay ratios. Other states, likewise seeking to address income inequality, could follow suit.

On the horizon

Even though the pay-ratio rule is final, the debate will likely resurface in the likely event that opponents of the rule, such as the US Chamber of Commerce, employ the now familiar—and largely successful—tactic of challenging the rule in court. (Recent rulemakings by the SEC, including the proxy access and resource extraction rules, have been tossed out by courts on the basis of inadequate cost/ benefit analyses, and the conflict minerals rule, which survived a court challenge on the basis of an inadequate cost/benefit analysis, was recently struck down in part as compelled commercial speech in violation of the First Amendment.)

In this instance, the two dissenters, Commissioners Gallagher and Piwowar, did not hold back in their disdain for the rule and appeared to be methodically establishing a case for a court challenge to the pay-ratio rule on both these grounds. Commissioner Piwowar published lengthy additional dissenting comments claiming, among other things, that the adoption of the rule violated the procedural requirements of the Administrative Procedure Act—including a failure to timely identify an objective or benefit of the rulemaking—and lambasting the inadequacy of the SEC's quantitative analyses. In that regard, both dissenters characterized the majority's efforts to attribute "benefits" to the rule as "speculative" and pure "conjecture." In Commissioner Gallagher's view, the record did not show a "reasoned basis" for the rule or that the SEC had performed the work necessary to consider what, if any, the benefits of the rule are; to determine whether there were benefits to shareholders, Commissioner Piwowar argued, the SEC should have performed "investor testing." Moreover, Commissioner Gallagher contended, whatever the benefits may be, they do not justify the enormous costs: the initial costs of compliance were expected to be $1.3 billion, with ongoing costs of $526 million. And, he maintained, had the SEC followed his analysis for limiting the reach of the rule to full-time domestic employees, the cost estimates could have been reduced by $788 million.

In addition, Commissioner Gallagher asserted that, like the conflict minerals rules, the pay-ratio rules run afoul of the First Amendment as improperly compelled commercial speech. In his view, where the purpose of the rule is only to name and shame companies, then "the rule is not intended to, and does not, produce information in furtherance of a legitimate government purpose." Anticipating this line of attack, the adopting release recites the view of the majority, which does "not believe that the pay ratio disclosure that Congress has mandated is inconsistent with the First Amendment. We believe that, in passing Section 953(b), Congress determined that the disclosure advances an important government interest, and we have carefully tailored the disclosure through this rulemaking to further that interest…. Accordingly, we believe the disclosure fits comfortably within the class of securities law disclosures that have been deemed to be consistent with the First Amendment." Which view the courts will ultimately adopt remains to be seen.

If you have any questions about this alert, please contact one of your Cooley team members or one of the attorneys identified above.

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