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SEC Adopts Final CEO Pay Ratio Disclosure Rule

On August 5, 2015, the Securities and Exchange Commission (“SEC”) adopted the final rule implementing Section 953(b) of the Dodd-Frank Wall Street Reform and Consumer Protection Act (the “Dodd-Frank Act”), which requires public companies to disclose the median pay of their employees and the ratio of such amount to the pay of the CEO. Like the 2013 proposed rule, the final rule was adopted by a 3-2 vote, divided along party lines.

We previously discussed the proposed pay ratio disclosure rule in our September 24, 2013 client update, available at <http://www.groom.com/resources-811.html>. While closely resembling the proposed rule in most respects, the final rule includes some important changes intended to reduce the administrative burden for companies. The important changes from the proposed rule, and continuing aspects of the rule, are provided below.

Compliance Date

Perhaps one of the most welcome differences between the proposed rule and the final rule is the initial compliance date. Whereas the proposed rule would have required compliance starting with the first fiscal year commencing after the effective date of the rule, the final rule will require companies to comply during the first fiscal year commencing on or after January 1, 2017. This means the first required disclosures for calendar year companies will not occur until early 2018. Thus, this change will provide companies with considerably more time to prepare for this new administrative effort.

Identifying the Median Employee

The major administrative undertaking imposed by the pay ratio disclosure rule involves identifying the median employee. The final rule features a number of welcome changes to the proposed rule with respect to this task.

Who?

The final rule follows the proposed rule in that companies must consider “all” employees, including full-time, part-time, temporary and seasonal employees. Companies do not need to include independent contractors and “leased” workers employed by unaffiliated third parties.

The final rule also made some helpful changes, including:

- Employees of Subsidiaries - Only employees of those subsidiaries that are consolidated in the company’s financial statements need to be considered. Employees of non-consolidated subsidiaries do not need to be considered in the

analysis.

- Foreign Employees - Like the proposed rule, the final rule requires consideration of employees based outside of the U.S. However, the final rule contains two important exemptions for non-U.S. employees:
 - *Data privacy exemption*: Employees in a non-U.S. jurisdiction can be excluded if, despite the company's reasonable efforts, the jurisdiction's privacy laws prevent the company from obtaining or processing the information necessary for compliance with the rule. To take advantage of this exemption, the company must seek an exemption or other relief from the privacy law, and if such cannot be obtained, the company must also obtain and file a legal opinion from counsel supporting the company's position. Further, the company will need to describe the jurisdiction and the specific data privacy law involved, and the number of employees so excluded.
 - *De minimis exemption*: Up to 5% of a company's total employees who are non-U.S. employees may be excluded. If non-U.S. employees make up 5% or less of the company's total employees, all non-U.S. employees may be excluded. Employees excluded under the data privacy exemption must be counted when determining the *de minimis* exemption. As a result, if 5% or more of a company's total employees are excluded under the data privacy exemption, the company cannot exclude any employees using the *de minimis* exemption.

Under both of these exemptions, an employee may be excluded only if all of the employees in the same jurisdiction are excluded. Thus, the *de minimis* exemption may not be applied to employees in jurisdictions where more than 5% of the company's total employees are located.

- M&A - In another departure from the proposed rule, the final rule permits exclusion of employees that join the company through a merger or acquisition, but only for the fiscal year in which the transaction becomes effective. The company must disclose the approximate number of employees being excluded.

When?

The final rule permits companies to select a date other than the last day of the fiscal year to determine the median employee. Instead, the company can choose any date within the last three months of the company's fiscal year for identifying the median employee. This change provides additional flexibility to select a date to allow adequate time to make the necessary calculations. Companies can also change the determination date of the median employee in subsequent years; however, any change must be disclosed.

How Often?

Whereas the proposed rule would have required companies to identify the median employee each year, the final rule will generally require companies to determine the median employee only once every three years, unless there has been a change to the employee population or compensation arrangements that the company reasonably believes would result in a significant change to the pay ratio disclosure. The company may then use such employee as the median employee for the following two years, or if the employee's situation changes (e.g., a promotion), the company can use another employee whose compensation is substantially similar to the original median employee. Although the median employee's compensation must still be calculated each year, the removal of an annual

identification requirement should significantly reduce the administrative burden of the pay ratio rule.

What Compensation to Use?

Like the proposed rule, the final rule allows companies to choose either total annual compensation as determined under the SEC proxy rules (“Proxy Compensation”), or another uniformly applied compensation measure to identify the median employee. If a compensation measure other than Proxy Compensation is used to determine the median employee, the measure must be disclosed.

Unlike the proposed rule, the final rule permits companies to make cost-of-living adjustments to the compensation of employees in jurisdictions other than the jurisdiction in which the CEO resides, so long as the company includes a brief description of the adjustments. However, if the company uses cost-of-living adjustments to select the median employee, the company must also disclose the median employee’s Proxy Compensation and pay ratio without the cost-of-living adjustment.

The final rule also offers companies a choice to calculate the CEO compensation in a year where there is a CEO transition by either (a) adding the compensation provided to each person who served as CEO during the year for the period of time he or she served as CEO, or (b) annualizing the compensation of the individual in the role of the CEO on the date that the median employee is selected. The final rule did not provide for any exceptions or special rules addressing how to treat specific compensation provided to a CEO as a result of his or her departure, hiring or promotion when determining the CEO compensation for the year of the transition. As a result, a company’s choice of method may depend on separation compensation or promotion/sign-on compensation for each individual.

How?

The final rule continues to permit each company to identify the median employee using one of a number of different methods, including calculating the Proxy Compensation for each employee, using reasonable compensation estimates for employees, or using statistical sampling.

Other Aspects Remain Unchanged

The final rule also continues to apply several of the important aspects of the proposed rule including:

- the method to calculate Proxy Compensation for the median employee,
- the disclosures of the Proxy Compensation of the median employee and CEO and the pay ratio, and
- allowing, but not requiring, supplemental information or pay ratio disclosures that are clearly identified, not misleading, and not presented more prominently than the required pay ratio.

Conclusion

Although welcome modifications have been made to address concerns over administrative costs, the changes are unlikely to eliminate the controversy surrounding the pay ratio disclosure rule. Considering the partisan disagreement over the rule and the looming 2016 elections, more changes may be possible. Nevertheless, with the rule now in final form, companies should soon begin their compliance preparations.

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