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SEC Finalizes CEO Pay Ratio Disclosure Rule

Two years since issuing the proposed rule, after considering more than 285,000 comment letters, and in a contentious three to two vote, the Securities and Exchange Commission (SEC) approved the final rule implementing the CEO pay ratio disclosure mandated by the Dodd-Frank Act. The rule requires disclosure of the ratio of (i) median annual total compensation of all employees other than the CEO to (ii) the reported annual total compensation for the CEO.

Noteworthy differences between the proposed and final rule include:

- Disclosure of the pay ratio will be required for a registrant's first full fiscal year beginning on or after January 1, 2017 (i.e., not required until 2018 proxy season).
- Consistent with the proposed rule, when identifying the median employee, companies must include "all employees," including non-U.S., part-time, seasonal and temporary employees. However, the final rule:
  - includes only employees of consolidated subsidiaries;
  - appears to only allow exclusion of independent contractors and "leased" employees if they are employed by and their compensation is determined by an unaffiliated third party (which would mean that directly employed independent contractors must be treated as employees);
  - allows registrants to determine their employee population as of any date in the last three months of the fiscal year for purposes of identifying the median employee; and
  - allows exclusion of certain non-U.S. employees pursuant to a foreign data privacy law exemption and/or a 5 percent *de minimis* exemption; reliance on either exemption requires additional disclosure.
- Companies may apply "cost-of-living adjustments" to the compensation of employees in jurisdictions different from that of the CEO.
- The pay ratio must be calculated and disclosed annually, but the median employee only needs to be identified once every three years, unless there is a change in employee population or employee compensation arrangements that could significantly alter the pay ratio.

Introduction

On August 5, 2015, the SEC approved the final rule for implementing Section 953(b) of the Wall Street Reform and Consumer Protection Act (the "Dodd-Frank Act"). Under new paragraph 402(u) of Regulation S-K, disclosure is required in any annual report, proxy, information or registration statement that requires executive compensation disclosure. Emerging growth companies, smaller reporting companies, foreign private issuers, MJDS filers, and registered investment companies are not subject to the rule.

The new rule requires disclosure of:

- the median annual total compensation of all employees of the registrant, except the CEO;
- the annual total compensation of the CEO; and
- the ratio of those two amounts.

Compliance Date

Registrants are required to comply with respect to compensation for the first full fiscal year beginning on or after January 1, 2017. For example, disclosure will first be required in the Form 10-K or proxy statement filed in 2018 for calendar-year companies.

A newly public registrant's first pay ratio disclosure is required in its first full fiscal year beginning after the registrant has (i) been subject to the requirements of Section 13(a) or 15(d) of the Exchange Act for a period of at least 12 calendar months beginning on or after January 1, 2017 and (ii) filed at least one annual report that does not contain the pay ratio disclosure. The SEC's release states that if a newly public registrant completes its IPO on March 1, 2017, it will first provide the pay ratio disclosure in the proxy or information statement for its 2019 annual meeting of shareholders, where the disclosure would relate to its 2018 fiscal year. As such, new registrants will not become subject to the final rule sooner than existing registrants.

Transition periods are provided for newly public companies, companies engaged in business combinations during the year, and companies who cease to be smaller reporting or emerging growth companies.

Employee Definition

"All employees" are covered under the rule, including non-U.S., full-time, part-time, temporary and seasonal workers employed by the registrant and any of its consolidated subsidiaries.

Independent Contractors. In what appears to be a surprising change from the proposed rule, it seems that under the final rule independent contractors or "leased" workers need to be treated as employees, unless they are employed by and their compensation is determined by an unaffiliated third party. At a minimum this would appear to require inclusion of directly employed independent contractors where no third party is involved. Although the SEC release accompanying the final rule states "Individuals employed by unaffiliated third parties or independent contractors would not be considered to be employees," the actual text of the rule reads differently:

> "The definition of employee or employee of the registrant does not include those 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 accompanying SEC explanation further provides:

> "Workers who provide services to the registrant or its consolidated subsidiaries as independent contractors or 'leased employees' are excluded from the definition ***as long as*** they are employed and their compensation is determined by an unaffiliated third party." (Emphasis added.)

While the text and explanation of the final rule indicates there has been a major shift in the definition of employee, the inconsistent press release and the SEC's failure to give any indication that it was planning such a change makes it difficult to be certain what has occurred. We have been told, however, that staff on the SEC Division of Corporate Finance have informally confirmed that the expansive interpretation is intended. It is noteworthy that one of the dissenting SEC Commissioners has clearly stated his view that the final rule marks a major expansion in the definition of employee. Dissenting Commissioner Michael S. Piwowar noted on August 7, 2015 (as part of his additional dissenting comments), that

> "The requirements for excluding contract workers from the definition of employee fundamentally changed the nature of the pay ratio disclosure rule. As adopted, any self-employed contract worker would be counted as an 'employee,' because no third party is involved." In addition, "Employees of unconsolidated subsidiaries would be swept back into the definition of employee to the extent that they provide services to the company or its consolidated subsidiaries because they are not employed by an unaffiliated third party."

Non-U.S. Employees. The SEC declined to exercise its interpretative authority to exempt all non-U.S. employees, but did provide two exemptions, each subject to certain limitations described below:

- <u>Foreign Data Privacy Law Exemption:</u> Non-U.S. employees may be excluded if inclusion would violate data privacy laws or regulations. To qualify for this exemption, a company must "exercise reasonable efforts" to seek relief from the applicable jurisdiction's privacy laws, as well as obtain and file a legal opinion of its inability to process the information without violating such laws or regulation.

- <u>De Minimis Exemption:</u> Non-U.S. employees may be excluded if they account for 5% or less of total employees. If non-U.S. employees account for more than 5% of total employees, registrants may exclude a number of non-U.S. employees up to 5% of total employees. Non-U.S. employees who are excluded due to the data privacy law exemption count against this 5% limit.

Under either exemption, if a registrant excludes any non-U.S. employee in a particular foreign jurisdiction, it must exclude all employees in that jurisdiction (i.e., no cherry-picking which non-U.S. employees to exclude in any one jurisdiction). This requirement could prevent certain registrants from excluding any non-U.S. employees. For example, if 10% of a company's total employees are non-U.S., but all non-U.S. employees are located in a single jurisdiction, none of them may be excluded under the *de minimis* exemption. However, if including data for these employees would violate data privacy laws, all may be excluded under the *Foreign Data Privacy Law* exemption.

If the registrant excludes any employees using the *Foreign Data Privacy Exemption*, it must list the excluded jurisdictions, identify the specific data privacy law or regulation, explain how complying with the final rule violates such data privacy law or regulation (including the efforts made by the registrant to use or seek an exemption or other relief under such law or regulation), and provide the approximate number of employees exempted from each jurisdiction.

If a registrant excludes non-U.S. employees under the *de minimis* exemption, it must list the excluded jurisdictions, the approximate number of employees exempted from each jurisdiction, the total number of its U.S. and non-U.S. employees irrespective of any exemption (data privacy or *de minimis*), and the total number of its U.S. and non-U.S. employees used for its *de minimis* calculation.

Acquired Employees. In the fiscal year of an acquisition, employees of acquired companies may be excluded, and the acquisition would not be considered a "change in the employee population" that requires re-determination of the median employee (see "Identifying the Median Employee" below). Registrants that exclude employees as a result of a business combination must disclose the relevant acquired business and the approximate number of employees that are excluded from the pay ratio calculation.

Determining the Employee Group

The final rule permits registrants to use any date within three months prior to the last day of their last completed fiscal year to determine the employee population for purposes of identifying the median employee. Moreover, in determining the employees from which the median is identified, the rule allows a registrant to use (i) the entire employee population, (ii) a statistical sampling of employees, or (iii) any other reasonable method. Some example approaches that we think would be considered reasonable are provided below.

- Statistical Sampling Approach: Allows registrants to draw a sample from the entire population from which to identify the median employee and calculate annual total compensation.

  For example, Company A has 100,000 employees, multiple payroll systems, non-U.S. employees and many part-time, temporary and seasonal workers. Company A decides to sample from the total population of employees to determine the group of employees from which to draw the median employee. First, Company A draws a random sample of employees to estimate the standard deviation of annual total compensation or any other compensation measure that is consistently applied to all employees; for example, $30,000. Next, Company A selects a confidence level (e.g., 95% which corresponds to a z-score of 1.96), and then determines a critical factor for precision (e.g., +/-$3,000). Based on this fact pattern, the sample size would be 384 employees[1]. With this sample, Company A will be 95% confident that the sample mean will be within $3,000 of the true population mean. Lastly, Company A randomly samples from the population a total of 384 employees and then identifies the median employee from that sample.

- Other Reasonable Approaches: In addition to relying on statistical sampling, registrants have the option to utilize other reasonable approaches to estimate a sample size.

  Estimation Technique. While the SEC is not prescriptive with respect to which approaches are deemed to be "reasonable," one commonly used short-hand approach to estimate a sample size is to employ the "square root of n +1" rule, where n is the total employee population.

  For example, Company A, same as above, decides to draw a sample from the population to approximate the population. Company A calculates the square root of the employee population plus 1 to be ~ 317 employees (square root of 100,000 plus 1 = 317). This is not a statistical sample, but rather a sample based on an estimation technique. Company A identifies the median employee from the 317 employees using annual total compensation or any other compensation measure that is consistently applied to all employees.

  Exclude High-paid and Low-paid Workers Approach. By definition, the median employee in the population is not affected by groups of highly paid or lower paid workers. The median employee is the middle employee in the distribution.

  For example, Company A, same as above, excludes 2,000 highly paid workers and 2,000 lower paid workers based on annual total compensation or any other compensation measure that is consistently applied to all employees. The median employee is identified in the remaining employee population and annual total compensation is calculated for that individual.

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[1] Mathematical Formula = [(STDev * Z-score) / critical value) ^2)], or [($30,000 * 1.96) / $3,000))^2].

Identifying the Median Employee

To identify the median employee, registrants may use a methodology that uses reasonable estimates. For example, registrants may identify the median employee using annual total compensation or any other compensation measure that is consistently applied to all employees included in the calculation, such as amounts derived from the registrant's payroll or tax records (e.g., base salary, total cash compensation, W-2 earnings).

Companies will need to consider the trade-off between selecting a compensation measure that is limited in focus (i.e., base salary) versus a measure that is broader in focus (i.e., W-2 earnings which include annual incentives and equity vesting/option exercises). Identifying the median employee on W-2 amounts may be better for the ratio but more burdensome to collect. Companies may find that they want to perform the calculation in a variety of ways before deciding which approach is most appropriate for their business, as the choice of compensation measure will likely change the identification of the median employee.

The final rule provides that a registrant must identify its median employee for year one, but then is permitted to use that employee in the following two years for calculating the median employee's annual total compensation and the registrant's pay ratio, unless there has been a change in the employee population or compensation arrangements that would significantly impact the pay ratio. The compensation of this median employee must be recalculated annually when calculating the CEO pay ratio. Additional guidance includes:

- If the median employee identified in year one is no longer in the same position or no longer employed by the registrant on the median employee determination date in year two or three, the median employee may be replaced with an employee in a similarly compensated position.
- No full-time adjustments are allowed for part-time employees.
- No annualization is allowed for temporary and seasonal employees. However, registrants are allowed to annualize compensation for full-time and part-time permanent employees who did not work the full year.
- Registrants may also make cost-of-living adjustments to compensation for employees in countries outside the CEO's jurisdiction in determining the median employee and in calculating annual total compensation. However, use of such adjustments requires further work. If the registrant uses a cost-of-living adjustment to identify the median employee, and the median employee does not reside in the same jurisdiction as the CEO, the registrant must use the same cost-of-living adjustment in calculating the median employee's annual total compensation and disclose the country in which the median employee is located. A registrant electing to present the pay ratio in this manner must also disclose the median employee's annual total compensation and pay ratio without the cost-of-living adjustments. To calculate this pay ratio, the registrant will need to identify the median employee without using any cost-of-living adjustments.

Determining Annual Total Compensation

Once the median employee is determined, annual total compensation of such employee would be determined in accordance with Item 402(c)(2)(x) of Regulation S-K, which prescribes the calculation of total compensation for a named executive officer for purposes of the Summary Compensation Table. Annual total compensation of the CEO will be calculated in the same manner. However, reasonable estimates may be used in determining any elements of annual total compensation for the median employee. In addition:

- Amounts relating to a government-mandated pension plan generally would not be included in the employee's annual total compensation.
- Registrants, at their discretion, may 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; to be consistent, however, the CEO's annual total compensation used in the related pay ratio disclosure must also reflect the same approach to these items used for the median employee.
- A registrant has two choices in calculating the annual total compensation for its CEO when its CEO has been replaced during the year. First, a registrant may take the annual total compensation calculated pursuant to Item 402(c)(2)(x) and provided to each person who served as CEO during the year and combine those figures. Alternatively, a registrant may look to the CEO serving in that position on the date it selects to identify the median employee and annualize that CEO's compensation. The registrant must disclose which option it chose and how it calculated its CEO's annual total compensation.

<u>Disclosure</u>

Registrants may disclose the pay ratio with the median of the annual total compensation of all employees equal to one and the CEO's compensation as the number compared to one. The SEC provides the following example: If a registrant's median annual total compensation for employees is $50,000 and the annual total compensation of the CEO is $2,500,000, the CEO's compensation is 50 times larger than the median employee's compensation. *The registrant may describe the pay ratio as 50 to 1 or 50:1. Alternatively, the registrant may disclose the pay ratio narratively: "the CEO's annual total compensation is 50 times that of the median of the annual total compensation of all employees."*

The rule requires a registrant to briefly describe its methodology for making all determinations, including material assumptions, adjustments, estimates, and any changes in methodology from one year to the next. Additional ratios or other information to supplement the required ratio is permitted, as long as such information is not misleading, and not presented with greater prominence than the required ratio.

<u>Next Steps</u>

We expect that calculating the pay ratio may be time-consuming and complex for many companies. Although the rules will not take effect for more than two years (i.e., after the national elections in 2016), we recommend that companies begin to think about the new rule and the early steps that may be taken to prepare for compliance.

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General questions about this letter can be addressed to

- Michael Marino at 212-299-3598 or mrmarino@fwcook.com
- Samantha Nussbaum at 310-734-0145 or snussbaum@fwcook.com
- Cimi Silverberg at 312-894-0073 or cbsilverberg@fwcook.com

Specific questions should be referred to company counsel. Copies of this letter and other related materials are available on our website at www.fwcook.com.