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SEC ADOPTS FINAL CEO PAY RATIO DISCLOSURE RULES

To Our Clients and Friends:

On August 5, 2015, the SEC voted, 3-2, to adopt final rules to implement the pay ratio disclosure provision of Section 953(b) of the Dodd-Frank Wall Street Reform and Consumer Protection Act (the "Dodd-Frank Act"). Consistent with their positions on the proposed rules, SEC Chair Mary Jo White and Commissioners Luis Aguilar and Kara Stein voted to adopt the rules and Commissioners Daniel Gallagher and Michael Piwowar dissented, making this Commissioner Gallagher's 16th dissent (which Gallagher indicated is a Commission record).

As discussed in our September 18, 2013 blog post, Section 953(b) of the Dodd-Frank Act mandates that the SEC promulgate rules requiring companies to disclose in certain of their SEC filings (i) the median of annual total compensation of all employees other than the CEO (or any equivalent position), (ii) the annual total compensation of the CEO (or any equivalent position) and (iii) the ratio of those two amounts.

The adopting release containing the final rules is available here, the press release and a fact sheet are available here, and statements made by the Commissioners are on the SEC website and available here. This client alert notes and summarizes the following significant points that are reflected in the final pay ratio disclosure rules:

Summary of the Final Rules

- ***Identifying the median employee***. The final rules provide that companies must determine the median employee from among all of the U.S. and non-U.S. full-time, part-time, temporary and seasonal employees of the company or any of its consolidated subsidiaries[1] (other than the company's CEO or any equivalent position). The final rules permit companies to annualize the compensation of a permanent employee who did not work for the entire year, but they do not allow annualizing adjustments for temporary or seasonal employees or full-time equivalent adjustments for any employees. As proposed, companies are permitted to select a methodology used to identify the median employee based on their own facts and circumstances (for example, companies may employ any consistently used compensation measure, such as payroll or tax records, to identify their median employee, and may base the determination on their entire employee population or a statistical sampling).[2] Individuals who provide services to a company or its consolidated subsidiaries as independent contractors or "leased" workers are excluded from the definition of "employee" as long as they are employed, and their compensation is determined, by an unaffiliated third party.

The final rules contain a few important provisions that were not included in the proposed rules and that are designed to provide some flexibility with respect to identifying the median employee. Specifically:

- *Frequency of identification.* A company is permitted to make the determination of its median employee once every three years (instead of every year) unless there has been a change in the company's employee population or employee compensation arrangements that it reasonably believes would result in a significant change to its pay ratio disclosure. Also, within those three years, if it is no longer appropriate for the company to use the median employee identified in year one as the median employee in years two or three because of a change in the original median employee's circumstances that the company reasonably believes would result in a significant change in its pay ratio disclosure, the company may use another employee with substantially similar compensation as its median employee. Either using the same median employee for three years or a different median employee has to be disclosed as provided in the final rules.

- *Timing of identification.* A company is permitted to select the date as of which it determines the employee population for purposes of identifying the median employee (as opposed to having to do so as of the last day of the company's fiscal year), except that it must select a date occurring within the last three months of its last completed fiscal year. This date (or a change in the date from a prior year) has to be disclosed as provided in the final rules. According to the adopting release, this approach "provides consistency for individual registrants from year to year while also providing registrants with flexibility to choose the determination date."

- *Non-U.S. employees.* A company is permitted to exclude non-U.S. employees from the determination of its median employee in two very limited circumstances:

  - Privacy data exemption. A company may exclude non-U.S. employees that are employed in a non-U.S. jurisdiction where data privacy laws make the company unable to comply with the rule without violating such data privacy laws or regulations. The company would be required to obtain and file as an exhibit a legal opinion from counsel on the inability of the company to obtain or process the information necessary for compliance with the rule without violating the jurisdiction's laws or regulations governing data privacy, including the company's inability to obtain an exemption or other relief under any governing rules or regulations.

  - *De minimis* exemption. Up to five percent of a company's total employees who are non-U.S. employees may be excluded for any reason.[3] Any employees excluded on the basis of the privacy data exemption would count against this five percent limit meaning that if the number of employees excluded under the data privacy exemption equals or exceeds five percent of the company's total

employees, the company may not use the *de minimis* exemption to exclude additional non-U.S. employees.

If a company excludes any non-U.S. employee in a particular jurisdiction, it must exclude all non-U.S. employees in that jurisdiction, which means that the *de minimis* exemption cannot be applied in any non-U.S. jurisdiction where more than five percent of a company's total employees are located.

- *Cost-of-living adjustments.* A company may apply a cost-of-living adjustment to the compensation of employees in jurisdictions other than the jurisdiction in which its CEO resides so that the compensation is adjusted to the cost of living in the jurisdiction in which the CEO resides. If a company applies this adjustment, it will be required to use the same cost-of-living adjustment in calculating the median employee's annual total compensation and will also be required to disclose (i) the median employee's jurisdiction, (ii) the median employee's annual total compensation and the pay ratio, both with and without the cost-of-living adjustment as well as (iii) a description of the cost-of-living adjustments utilized.

- *Business combinations/acquisitions.* A company may exclude any employees of an entity that was acquired by the company during the covered fiscal year (but not future years). A company relying on this provision would be required to identify the acquired business and disclose the approximate number of employees it is omitting.

- ***Determining total compensation***. As proposed, once a company has identified the median employee, the final rules require the employee's total compensation to be calculated, for purpose of computing the pay ratio, using the same rules that apply to the CEO's compensation (*i.e.*, in accordance with the SEC's executive compensation rules set forth in Item 402(c)(2)(x) of Regulation S-K). Use of reasonable estimates for this calculation (where appropriate) is permitted.

- ***Multiple CEOs during the year***. The proposed rules did not discuss the compensation information that would be required if one or more of the company's CEOs served only part of a fiscal year. The final rules allow a company a choice of two options (which choice would have to be disclosed) in calculating the annual total compensation for its CEO in situations in which the company has more than one non-concurrent CEO serving during its fiscal year:

  - *Combining compensation of both CEOs.* A company may take the total compensation calculated pursuant to Item 402(c)(2)(x), and reflected in the Summary Compensation Table, provided to each person who served as the company's CEO during the year and combine those figures.

  - *Annualizing compensation of one CEO.* A company 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.[4]

- ***Companies subject to the pay ratio rules***. As proposed, all companies that are required to provide Summary Compensation Table disclosure under Item 402(c) of Regulation S-K are subject to the final pay ratio rules. As a result, the pay ratio rules do not apply to emerging growth companies, smaller reporting companies, companies filing under the U.S.-Canadian Multijurisdictional Disclosure System and registered investment companies.

- ***Filings where disclosure is required***. As proposed, companies that are subject to the pay ratio rules will be required to include the pay ratio disclosures in registration statements, proxy and information statements and annual reports (including Forms 10-K) that include executive compensation information as set forth under Item 402 of Regulation S-K. As with other executive compensation information, the annual report on Form 10-K can incorporate the pay ratio disclosure from a proxy statement that is filed within 120 days after the end of the fiscal year covered by the Form 10-K.

- ***"Filed"; not "furnished*."** As proposed, the final rules treat the pay ratio disclosure, as with other Item 402 information, as "filed" for purposes of the Securities Act and the Exchange Act, and, therefore, subject to potential liabilities under those statutes, including liability under Section 18 of the Exchange Act.

- ***Compliance dates***. Companies will be required to report the pay ratio disclosure based on compensation paid in their first fiscal year beginning on or after January 1, 2017 (instead of on or after the effective date of the rules, as proposed). This means that, for a calendar-year company, the disclosure will be required in the company's 2018 proxy statement, reporting on 2017 compensation.

    - *Newly public companies*. Pay ratio disclosure does not need to be included in a registration statement on Form S-1 or Form S-11 for an initial public offering or registration statement on Form 10; and a newly public company's first pay ratio disclosure must follow its first full fiscal year beginning after the company has (i) been subject to the requirements of Sections 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 pursuant to Sections 13(a) or 15(d) of the Exchange Act that does not contain the pay ratio disclosure.[5]

    - *Smaller reporting companies and emerging growth companies.* The final rule provides that a company that ceases to be a smaller reporting company or an emerging growth company will not be required to provide pay ratio disclosure until after the first full fiscal year after exiting such status and not for any fiscal year commencing before January 1, 2017.

Conclusion

The pay ratio disclosure provision of the Dodd-Frank Act has been among the most controversial of the statute's provisions to be implemented by the SEC. According to Chair White, the final rules are "reasonable," "flexible" and "faithful" to the terms and objectives of the pay ratio provisions of the

Dodd-Frank Act. Nevertheless, in light of Commissioner Gallagher's and Commissioner Piwowar's dissents and the pending House[6] and Senate[7] bills that seek to repeal Section 953(b) of the Dodd-Frank Act, the controversy is likely far from over.

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[1] Unlike the proposed rules, the final rules define "employee" to include only the employees of the company and its consolidated subsidiaries rather than employees of subsidiaries that were affiliates it controlled directly or indirectly through one or more intermediaries, as set forth in the definition of "subsidiary" under both Rule 405 of the Securities Act of 1933, as amended (the "Securities Act") and Rule 12b-2 of the Securities Exchange Act of 1934, as amended (the "Exchange Act").

[2] Companies must also briefly describe the methodology they used to identify the median employee, including any material assumptions, adjustments (including any cost-of-living adjustments) or estimates they used to identify the median employee or to determine total compensation or any elements of total compensation. If a company changes its methodology or its material assumptions, adjustments or estimates from those used in its pay ratio disclosure for the prior fiscal year, and if the effects of any such changes are significant, the company must briefly describe the change and the reasons for the change. Companies would also have to disclose if they changed from using the cost-of-living adjustment (as discussed below) to not using it and vice versa.

[3] If the company's non-U.S. employees account for five percent or less of the company's total employees and the company decides to rely on the *de minimis* exemption to exclude its non-U.S. employees from the definition of "employee" under the final pay ratio rules, it must exclude all non-U.S. employees. If a company excludes non-U.S. employees under the *de minimis* exemption, it must disclose (i) the jurisdiction or jurisdictions from which those employees are being excluded, (ii) the approximate number of employees excluded from each jurisdiction under the *de minimis* exemption, (iii) the total number of its U.S. and non-U.S. employees irrespective of any exemption (data privacy or *de minimis*), and (iv) the total number of its U.S. and non-U.S. employees used for its *de minimis* calculation.

[4] The final rules provide the following example. If a company chooses October 15 as the date to determine its median employee, the company would calculate the compensation of the person serving as its CEO on that date and annualize that CEO's compensation. If the person was its CEO for six months and received $100,000 of total compensation, the company would use $200,000 as the annual total compensation of its CEO.

[5] The final rules provide the following example. A company with a fiscal year ending on December 31 that completes its initial public offering on March 1, 2017 will not be required to include any pay ratio information in its registration statement on Form S-1. This company will be first required to include pay ratio disclosure in its Form 10-K for its 2018 fiscal year or its definitive proxy or information statement for its 2019 annual meeting of shareholders, but no later than 120 days following the end of its 2018 fiscal year. The company's pay ratio disclosure will be required for its 2018 fiscal year because it (i) filed its registration statement after January 1, 2017 (March 1, 2017),

(ii) will have been subject to the requirements of Sections 13(a) or 15(d) of the Exchange Act for a period of at least twelve calendar months (March 1, 2017 to March 1, 2018), and (iii) will have filed at least one annual report pursuant to Sections 13(a) or 15(d) of the Exchange Act (for fiscal year 2017).

[6] H.R. 414, 114th Cong. (2015), *available at* https://www.congress.gov/bill/114th-congress/house-bill/414.

[7] S. 1722, 114th Cong. §1 (2015), *available at* https://www.congress.gov/bill/114th-congress/senate-bill/1722/text.

Gibson, Dunn & Crutcher's lawyers are available to assist in addressing any questions you may have about these developments. To learn more about these issues, please contact the Gibson Dunn lawyer with whom you usually work, or any of the following lawyers in the firm's Securities Regulation and Corporate Governance practice group:

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