

THE PAY RATIO RULE

Preparing for Compliance

The SEC's recently adopted pay ratio rule is complex and offers companies flexibility in determining their pay ratios. Companies should start the compliance process in the near term to evaluate the options the pay ratio rule provides and address any issues that arise in applying those options.



AVROHOM J. KESS

PARTNER
SIMPSON THACHER & BARTLETT LLP

A.J. is the Head of the firm's Public Company Advisory Practice and assists clients on their public and private offerings of securities, as well as on a full range of corporate and securities law matters. He also advises public companies and their boards on governance-related matters, shareholder activism and internal investigations.



YAFIT COHN

ASSOCIATE
SIMPSON THACHER & BARTLETT LLP

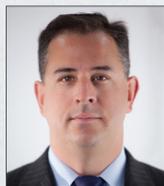
Yafit is a member of the firm's Public Company Advisory Practice. Her practice focuses on advising public companies and their boards on matters pertaining to securities law and corporate governance.



BINDU M. CULAS

PRINCIPAL
FREDERIC W. COOK & CO., INC.

Bindu is a Principal of Frederic W. Cook & Co., Inc., specializing in consulting on executive compensation and corporate governance matters. She previously practiced law, most recently as a partner at Linklaters LLP.



MICHAEL R. MARINO

PRINCIPAL
FREDERIC W. COOK & CO., INC.

Michael is a Principal of Frederic W. Cook & Co., Inc., specializing in consulting on executive compensation and corporate governance matters. He previously served as a senior executive compensation consultant and director of performance metrics at another leading consulting firm.



© iStockphoto.com/ChuckPlace

The Securities and Exchange Commission (SEC) adopted on August 5, 2015 its much-anticipated final rule implementing the pay ratio disclosure requirement of the Dodd-Frank Wall Street Reform and Consumer Protection Act of 2010 (Dodd-Frank Act) (*SEC Release No. 34-75610* (final release)).

Section 953(b) of the Dodd-Frank Act instructed the SEC to adopt rules requiring reporting companies to disclose the median of the annual total compensation of all company employees other than the company's chief executive officer (CEO), the CEO's annual total compensation and the ratio between these two numbers.

The SEC has provided companies with a generous phase-in period for the pay ratio disclosure requirement. The first disclosure is due in 2018, covering a company's fiscal year beginning on or after January 1, 2017. However, companies should not be lulled by this. The pay ratio disclosure requirement is complex and gives companies a great deal of flexibility. There are steps companies should take in the near future to ensure timely and seamless compliance with the pay ratio rule.

By starting the process early, companies can ensure they have sufficient time to evaluate the various options the pay ratio rule provides and address any issues that arise in applying those options. Preparing early will also enable management to consider how to draft pay ratio disclosure that provides useful information to the company's shareholders and puts the company's pay ratio in the proper context for shareholders, employees and other stakeholders. Against this background, this article:

- Provides an overview of the pay ratio disclosure requirement.
- Explains methodologies companies can use to carry out key tasks that are essential for determining elements of the pay ratio, including:
 - identifying the median employee; and
 - calculating annual total compensation.
- Offers guidance on how to present pay ratio disclosure.
- Suggests initial steps companies should take to prepare for compliance.

PAY RATIO DISCLOSURE OVERVIEW

The pay ratio rule, Item 402(u) of Regulation S-K, requires covered companies to disclose:

- The median of the annual total compensation of all company employees excluding the principal executive officer (PEO).
- The annual total compensation of the PEO.
- The ratio of these two amounts.

Covered companies must also provide other explanatory disclosure and may include additional narrative disclosure and ratios.

COVERED COMPANIES, LOCATION OF DISCLOSURE AND TIMING

All reporting companies must make pay ratio disclosure, except for:

- Smaller reporting companies (SRCs).
- Emerging growth companies (EGCs).
- Foreign private issuers (including multijurisdictional disclosure system filers).
- Registered investment companies.

Companies must include pay ratio disclosure in filings that are required to include executive compensation information under Item 402 of Regulation S-K. This includes proxy and information statements, annual reports on Form 10-K and registration statements under the Securities Act of 1933 and the Securities Exchange Act of 1934.

Covered companies must begin providing pay ratio disclosure for their first full fiscal year beginning on or after January 1, 2017. For example, a calendar year-end company must first provide pay ratio disclosure for fiscal year 2017 in its Form 10-K for 2017 due in 2018, or the proxy statement for its 2018 annual meeting. Covered companies are required to provide their pay ratio disclosure no later than 120 days after the end of the previous fiscal year.

TRANSITION PERIODS

New reporting companies are not required to include pay ratio disclosure in their initial registration statement, whether on Form S-1, Form S-11 or Form 10. Instead, a new reporting company must begin making pay ratio disclosure for its first full fiscal year after it has been a reporting company for a period of at least 12 calendar months beginning on or after January 1, 2017 and has filed at least one annual report that does not contain the pay ratio disclosure (see *final release at Section II.B.6.d.iii and Instruction 7.1 to Item 402(u)*).

A company that loses SRC or EGC status must begin making pay ratio disclosure for its first full fiscal year after losing this status, but not for any fiscal year starting before January 1, 2017 (*Instructions 7-8, Item 402(u), Regulation S-K*).

IDENTIFYING THE MEDIAN EMPLOYEE

The first required element of pay ratio disclosure is the median of the annual total compensation of all company employees excluding the PEO. Essentially, this is the annual total compensation of the company's "median employee."

Under the pay ratio rule, companies must identify an actual employee as the median employee and use that individual's annual total compensation for the pay ratio disclosure. If, after identifying the median employee, a company reasonably determines that there are unusual characteristics of that individual's compensation that would have a significant impact on the pay ratio, the company may substitute another employee who has substantially similar compensation to the originally identified median employee. In this case, the company must disclose the substitution.

A company is not required to (and should not) disclose any personally identifiable information about the median employee other than that individual's annual total compensation. A company may disclose the median employee's position, but should not do so if it could identify the individual (*Instruction 11, Item 402(u), Regulation S-K*).

SELECTING A MEASUREMENT DATE

Under the pay ratio rule, a company has the flexibility to select any date within the last three months of its last completed fiscal year to identify its median employee. A company must disclose the date it chooses. If a company changes the date used to



Regardless of whether the company uses the same median employee identified during a previous year or identifies a new median employee, it must calculate the median employee's annual total compensation each year and use that figure to calculate its pay ratio.

identify its median employee from the date used for the previous year, it must disclose the change and provide a brief explanation of the reason or reasons for the change.

In preparation for complying with the pay ratio rule and as part of completing a "dry run" calculation using 2015 fiscal year data (see below *Initial Steps Toward Compliance*), a company should consider the impact of the particular date selected on the result of its pay ratio calculation. Together with its outside advisors, a company may wish to identify the median employee on several different dates within the permitted three-month range. The company can then assess the impact of the various dates selected on the company's pay ratio. Engaging in this iterative process is particularly important for companies that hire seasonal or temporary workers toward the end of the year, such as retailers.

The pay ratio rule permits a company to identify its median employee once every three years, unless there has been a change in its employee population or employee compensation arrangements that the company reasonably believes would result in a significant change in its pay ratio disclosure (*Instruction 2, Item 402(u), Regulation S-K*). If there has been no change of this kind and the company decides to take advantage of this option, it must disclose:

- That it is basing its pay ratio calculation on the same median employee as the previous year.
- The basis for its reasonable belief that there have been no changes that would significantly impact its disclosure.

Regardless of whether the company uses the same median employee identified during a previous year or identifies a new median employee, it must calculate the median employee's annual total compensation each year and use that figure to calculate its pay ratio.

In some circumstances, there may not have been a change in a company's employee population or compensation arrangements, but there may have been a change in the individual circumstances of the median employee previously identified. For example, that individual may no longer be employed by the company or the individual's compensation may have significantly changed from the earlier year.

In this case, the company may use as the median employee another employee whose compensation is substantially similar to the original median employee, based on the compensation measure used to select the original median employee (*Instruction 2, Item 402(u), Regulation S-K*). However, if there are no similarly situated employees, the company must go through the process of identifying a new median employee.

SCOPE OF ALL EMPLOYEES

To identify its median employee, a company must first define the universe of individuals that comprise all employees of the company. Under the pay ratio rule, "all employees" includes all full-time, part-time, seasonal and temporary employees of the company or any of its consolidated subsidiaries, whether located in the US or abroad and without regard to whether they are salaried (*Item 402(u)(3), Regulation S-K*). However, as discussed in further detail below, a number of exemptions and accommodations may apply.

Identifying all employees of a company and its consolidated subsidiaries may be a difficult and time-consuming task. Large companies that do not have a uniform human resources information system platform, such as companies that have grown by acquisitions, may have more difficulty gathering this data. Companies with consolidated subsidiaries or business units that operate autonomously should consider whether there are any structural impediments to collecting this data from these subsidiaries and how long this process may take.

Independent Contractors and Leased Workers

Individuals who provide services to the company or any of its consolidated subsidiaries as independent contractors or leased workers are not considered employees for purposes of the pay ratio rule if they are employed, and their compensation is determined, by an unaffiliated third party (*Item 402(u)(3), Regulation S-K*).

Companies should determine whether all of their contractors or leased workers meet this definition and would, therefore, be excluded from the pay ratio calculation.

Exemptions for Certain Non-US Employees

As a general matter, non-US employees fall within the scope of all employees under the pay ratio rule. However, the pay ratio rule provides two tailored exemptions permitting companies to exclude non-US employees from their selection pool of all employees in circumstances where either:

- Gathering data relating to employees in a non-US jurisdiction would violate the data privacy laws of that jurisdiction (foreign data privacy exemption).
- The non-US employees excluded represent a *de minimis* number of the company's employees (*de minimis* exemption).

The SEC recognized that some countries' data privacy laws or regulations may prohibit the transfer of compensation data outside a country's borders, making it impossible to compile the information necessary to calculate a company's pay ratio without violating those laws or regulations. As a result, the pay ratio rule permits a company to exclude employees located in such a jurisdiction if the company:

- Makes reasonable efforts to obtain the necessary information, including seeking an exemption from or relief under the relevant country's data privacy laws or regulations.
- Failing an exemption or relief, obtains a legal opinion regarding its inability to obtain or process the information necessary to comply with the pay ratio rule without violating the applicable country's data privacy laws or regulations, including its inability to obtain an exemption or other relief, which must be filed as an exhibit to the filing containing the pay ratio disclosure.
- Excludes all employees from that jurisdiction.
- Provides specified additional disclosure.

Once a company has gathered and centralized the data it needs to comply with the pay ratio rule, it should be able to determine the foreign countries in which its employees and employees of its consolidated subsidiaries are located (see below *Initial Steps Toward Compliance*). A company should work with its legal advisors to determine whether any of these countries have data privacy laws or regulations that make it impossible to lawfully compile the compensation information of the employees located there. If so, the company's legal advisors should:

- Analyze whether it is possible for the company to obtain an exemption under the applicable country's laws and regulations.
- Identify the process for applying for an exemption.
- Determine how long it is likely to take to receive the exemption.

The company should also consider the potential costs of applying for an exemption and the appropriate legal advisors to spearhead the process.

A company taking advantage of the foreign data privacy exemption to exclude employees located in a non-US jurisdiction must:

- Disclose the excluded jurisdiction or jurisdictions and the applicable data privacy law or regulation.
- Explain how compliance with the pay ratio rule would violate that law or regulation and what efforts the company made to seek an exemption or other relief.

- Disclose the approximate number of employees in each jurisdiction excluded based on this exemption.

Separate from the foreign data privacy exemption, companies whose non-US employees constitute 5% or less of their total workforce may exclude all of their non-US employees when identifying their median employee. If a company with 5% or fewer non-US employees decides to exclude any non-US employees under the *de minimis* exemption, it must exclude them all.

A company whose non-US employees constitute more than 5% of its total workforce may exclude non-US employees up to the 5% threshold, but if it excludes any non-US employees in a particular non-US jurisdiction, it must exclude all the employees in that jurisdiction.

There is an important interplay between the foreign data privacy exemption and the *de minimis* exemption. When a company calculates the number of non-US employees that it may exclude under the *de minimis* exemption, it must count any non-US employee exempted under the foreign data privacy exemption against the availability of the *de minimis* exemption. This means that a company that excludes more than 5% of its total employees under the foreign data privacy exemption may not take advantage of the *de minimis* exemption at all.

A company that excludes fewer than 5% of its total employees under the foreign data privacy exemption may use the *de minimis* exemption to exclude an additional number of non-US employees up to an aggregate maximum of 5% of the company's total employees. However, if the number of employees in a particular jurisdiction exceeds the percentage of total employees that the company would be able to exclude under the *de minimis* exemption (after taking into account the company's use of the foreign data privacy exemption), the company may not exclude any of the employees in that jurisdiction.

As a practical matter, therefore, a company can only determine the availability of the *de minimis* exemption after calculating the percentage of non-US employees that are likely to be excludable from its pay ratio calculation under the foreign data privacy exemption.

In its initial steps toward compliance, a company should determine whether it is likely that less than 5% of the company's employees will be excluded under the foreign data privacy exemption. In such a case, the company should identify any other foreign country containing less than 5% of its workforce (or the percentage remaining after accounting for employees likely to be excluded under the foreign data privacy exemption). The company should then consider whether it is worth taking advantage of the *de minimis* exemption available to it given the compensation of employees in that country. For example, excluding employees located in India or the Philippines from the pay ratio calculation will likely have a different effect on the company's pay ratio than excluding employees located in Germany.

If a company chooses to take advantage of the *de minimis* exemption to exclude employees located in a non-US jurisdiction, it must disclose:

- The jurisdiction or jurisdictions where the employees are located.

- The approximate number of employees excluded from each jurisdiction under the exemption.
- The total number of its US and non-US employees irrespective of any exemption, as well as the total number of its US and non-US employees used for its *de minimis* exemption calculation.

Employees of Acquired Businesses

A company that completed a business combination or acquisition may exclude the employees of the acquired entity from its pay ratio calculation for the fiscal year in which the transaction becomes effective. A company relying on this exemption must identify the acquired business and disclose the approximate number of employees excluded from its calculation (*Instruction 7, Item 402(u), Regulation S-K*).

A company must include employees of an acquired business in its pay ratio calculation starting in the first fiscal year beginning after the transaction is effective. At that time, the company must determine whether the inclusion of those employees results in a significant change to the company's pay ratio disclosure. If so, the company would need to identify a new median employee.

COMPENSATION MEASURE FOR IDENTIFYING THE MEDIAN EMPLOYEE

To identify the median employee, companies can use:

- Annual total compensation, as that term is defined in Item 402(c)(2)(x) of Regulation S-K. This is the measure of compensation that reporting companies must use to report their named executive officers' compensation in the Summary Compensation Table required by Item 402(c) of Regulation S-K. Generally, this includes salary and a number of other elements, such as benefits, perquisites and other allowances.
- Any other compensation measure that is consistently applied to all employees in the selection pool.

 Search [Proxy Statements](#) for more on executive compensation tables and related narrative disclosure.

The latter option can include information derived from tax or payroll records, as long as a company discloses the measure of

compensation it is using. Companies may use a measure that is defined differently across jurisdictions or includes different annual periods across jurisdictions if, within each jurisdiction, the measure is consistently applied. However, companies may not use different compensation measures altogether across jurisdictions.

Most companies do not routinely compute annual total compensation as defined in Item 402(c)(2)(x) for employees other than named executive officers. Calculating this information for large groups of employees is likely to be cumbersome and costly. As a result, many companies are likely to use a more readily available measure for purposes of median employee selection.

For many companies, determining the appropriate compensation measure will be an experimental process. The selected measure will likely represent a balancing of the administrative ease or difficulty in collecting the data against the positive or negative impact on the company's pay ratio calculation. In many cases, annual cash compensation (base and bonus) is likely to be the easiest measure to collect and the most straightforward to use.

While a company has flexibility in determining the compensation measure used to identify the median employee, once the median employee is identified, the company must calculate that individual's annual total compensation as defined in Item 402(c)(2)(x) for purposes of calculating the company's pay ratio (see below *Calculating the Median Employee's Annual Total Compensation*).

Cost-of-living Adjustments

The SEC recognized that different economic conditions in various countries where a company operates affect employee pay, and that this could contribute to pay ratios that may not accurately reflect the value of compensation paid to non-US employees. As a result, in identifying the median employee, companies are permitted (but not required) to make cost-of-living adjustments (COLAs) to the compensation of employees located in jurisdictions other than the jurisdiction in which the PEO resides (*Instruction 4, Item 402(u), Regulation S-K*).

In identifying the median employee, companies are permitted (but not required) to make cost-of-living adjustments (COLAs) to the compensation of employees located in jurisdictions other than the jurisdiction in which the PEO resides.



Statistical Sampling and Other Identification Methodologies

In determining the pool of employees from which the median employee will be identified, companies may, but are not required to, use their entire employee population. Companies may instead use statistical sampling or another reasonable selection method as part of identifying their median employee (*Instruction 4, Item 402(u), Regulation S-K*).

STATISTICAL SAMPLING

Statistical sampling is a process for selecting a subset of individuals from a larger group in a way that provides a reasonable degree of confidence that the subset selected is representative of the entire population.

A company can use statistical sampling to select a subset of its entire employee population with a reasonable degree of confidence that the subset selected is representative of the entire population in terms of compensation. The company can then identify its median employee from that subset. As the SEC indicates in the final release, identifying the median employee through statistical sampling may be less costly than other methods.

For example, using statistical theory concepts of standard deviation, confidence level and z-score, along with random sampling techniques, a company can create a sample pool of employees and identify the median employee from that sample. This sample naturally will be far smaller than the entire employee population, making this approach more manageable. At the same time, the use of these statistical sampling techniques provides the company with a reasonable degree of confidence that the employee pool used to identify the median employee is representative of the entire population in terms of compensation.

The pay ratio rule does not provide specific parameters for statistical sampling and does not mandate an appropriate sample size or other requirements. However, it does offer some guidance on statistical sampling, including that a reasonable estimate of the median employee for companies with multiple business lines or geographical units may be determined using more than one statistical sample. Companies considering using statistical sampling to identify their median employee should review the information in the final release.

A company using COLAs must apply the COLAs to all non-US employees included in the calculation and adjust their compensation to the cost of living in the PEO's jurisdiction.

A company using COLAs must also:

- Disclose the median employee's jurisdiction.
- Briefly describe the COLAs applied, including the measure used as the basis for the COLAs.
- Disclose the median employee's annual total compensation and pay ratio without applying any COLA.

If a company uses a COLA in identifying the median employee and the median employee is located in a jurisdiction other than the jurisdiction where the PEO resides, the company must use the same COLA in determining the median employee's annual total compensation (see below *Calculating the Median Employee's Annual Total Compensation*).

In preparing to comply with the pay ratio rule, a company should evaluate the likely impact on its pay ratio of COLAs to the compensation of all employees located in jurisdictions other than the PEO's jurisdiction. A company should also assess whether applying COLAs is worthwhile given the potential cost involved and the fact that the company must also disclose the unadjusted pay ratio.

Annualization and Full-time Equivalent Adjustments

The pay ratio rule permits a company to annualize the compensation of permanent full-time and part-time employees who were employed for less than the company's full fiscal year (for example, new hires or employees who were on unpaid leave for part of the year). However, a company is not permitted to annualize the compensation of seasonal or temporary employees, nor is it permitted to make full-time equivalent adjustments for its part-time employees (projecting what a part-time employee would make if that employee worked full time) (*Instruction 5, Item 402(u), Regulation S-K*).

IDENTIFICATION METHODOLOGY

In determining the pool of employees from which the median employee will be identified, companies may, but are not required to, use their entire employee population. Companies may also use statistical sampling and other reasonable methods not specified in the pay ratio rule to identify a subset of its entire employee population, and then identify the median employee from that subset (see *Instruction 4, Item 402(u), Regulation S-K*).

The pay ratio rule grants companies the latitude to determine the appropriate sample size based on their individual facts and circumstances. Also, companies do not have to calculate the exact pay of every employee in the sample. For example, under

OTHER REASONABLE APPROACHES TO DETERMINING SAMPLE SIZE

Companies may use reasonable approaches other than statistical sampling to estimate a sample size. One commonly used short-hand approach to estimate a sample size is to employ the “square root of $n + 1$ ” rule, where “ n ” represents the total employee population.

For example, Company B has 100,000 employees, multiple payroll systems, US and non-US employees and many part-time, temporary and seasonal workers. Company B decides to draw a sample from the population that approximates the entire population. Company B calculates the square root of its employee population plus 1 to be approximately 317 employees (the square root of 100,000 plus 1 equals 317.23). This is not a statistical sample, but rather a sample based on an estimation technique. Company B then identifies the median employee from that group, using annual total compensation or any other compensation measure that is consistently applied to all employees.

Using a different approach, a company could exclude the highest and lowest paid workers in its workforce to

estimate sample size. By definition, the median employee in the population is not affected by groups of highly paid or lower-paid workers because the median employee is the middle employee in the pool.

Using the example of Company B, Company B 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 could then be identified in the remaining employee population of 96,000, including by first selecting a random sample from the remaining employees or estimating a sample from the remaining employees.

certain circumstances a company may identify and eliminate from the selection pool employees with extremely low pay and employees with extremely high pay (see *final release at Section II.B.2.a.ii(c)(ii)*).

For a discussion of selection methodologies companies may consider using as part of identifying their median employee, see *Box, Statistical Sampling and Other Identification Methodologies*.

CALCULATING ANNUAL TOTAL COMPENSATION

Once a company has identified its median employee it must calculate that individual's annual total compensation and the annual total compensation of the company's PEO.

Under the pay ratio rule, annual total compensation for both individuals is defined under Item 402(c)(2)(x) of Regulation S-K. This is the same definition that companies must use to report their named executive officers' total compensation in the Summary Compensation Table required by Item 402(c) of Regulation S-K.

CALCULATING THE MEDIAN EMPLOYEE'S ANNUAL TOTAL COMPENSATION

The median employee's annual total compensation must be calculated for the company's last completed fiscal year. This

applies even if the company used tax or payroll records from a different annual period to identify its median employee.

Companies can use reasonable estimates in calculating the median employee's annual total compensation or any element of it (*Instruction 4, Item 402(u), Regulation S-K*). Companies must have a reasonable basis to believe that the estimates used approximate the actual compensation amounts paid to the employee under Item 402(c)(2)(x). Companies must clearly identify any estimates used.

In the final release, the SEC offered guidance on calculating certain elements of compensation, including:

- **Salary.** In calculating annual total compensation for a non-salaried employee, the terms “base salary” and “salary” used in Item 402(c)(2)(x) should be read to mean wages plus overtime (*Item 402(u)(2)(i), Regulation S-K*).
- **Defined pension plans and change in pension value.** Companies may use reasonable estimates to determine the approximate aggregate change in actuarial present value of the median employee's defined pension plan. Government-mandated defined pension plans, which are provided by the government rather than the company, are not considered compensation under Item 402(c)(2)(x) of Regulation S-K.

- **Perquisites and other personal benefits.** Item 402(c)(2)(x) allows a company to exclude perquisites and certain benefits not exceeding \$10,000 in the aggregate from a named executive officer's compensation for purposes of disclosure in the Summary Compensation Table. The pay ratio rule permits (but does not require) a company to include in its calculation of the median employee's annual total compensation personal benefits valued at less than \$10,000 in the aggregate, so long as it also includes these types of benefits in the PEO's annual total compensation for the pay ratio calculation. Companies that choose to do this must explain any material difference between the PEO's total compensation used in the pay ratio calculation versus as reflected in the Summary Compensation Table.

Generally, companies should consider including personal benefits of less than \$10,000 in the calculation of the median employee's annual total compensation, even though this means the company must also include such personal benefits when calculating the PEO's annual total compensation. This could impact the company's pay ratio because of the relative size of these benefits to the respective salaries of a typical median employee and PEO.

For example, Company A identifies its median employee and calculates annual total compensation for that individual and the company's PEO without including in its calculation personal benefits valued at \$9,000 for each of the individuals. The annual total compensation of Company A's PEO is \$400,000 and that of its median employee is \$50,000. Using these numbers, the company's pay ratio would be 8 to 1. If, however, Company A includes the \$9,000 of personal benefits in the compensation of each of the PEO and the median employee, the company's pay ratio would be reduced to 6.9 to 1.

COLAs in Calculating Annual Total Compensation

If a company uses COLAs in identifying the median employee and the median employee is located outside the PEO's jurisdiction, the company must use the same COLA in determining the median employee's annual total compensation.

Companies that do not use COLAs in identifying the median employee may not use COLAs in calculating the median employee's annual total compensation. However, these companies may include narrative disclosure that describes the effect of the cost of living in the median employee's jurisdiction on the company's pay ratio (see below *Optional Narrative Disclosure and Additional Ratios*).

CALCULATING THE PEO'S ANNUAL TOTAL COMPENSATION

A company must calculate the PEO's annual total compensation in accordance with Item 402(c)(2)(x) of Regulation S-K. However, a company must include in PEO annual total compensation, solely for purposes of the pay ratio calculation, personal benefits valued at less than \$10,000 in the aggregate that are generally excluded for Summary Compensation Table disclosure purposes, if it includes these benefits in its calculation of the median employee's total compensation.

If a company replaces its PEO during a fiscal year, the company may calculate PEO annual total compensation by either:

- Calculating total compensation according to Item 402(c)(2)(x) for each PEO who served during the fiscal year and combining those figures.
- Annualizing the compensation of the individual that held the position of PEO on the date the company chose to identify the median employee.

(*Instruction 10, Item 402(u), Regulation S-K*).

In these circumstances, a company must disclose which method it used to calculate PEO annual total compensation.

PRESENTATION OF THE PAY RATIO

In expressing the pay ratio, companies can either:

- Present the pay ratio numerically, with the median employee's annual total compensation equal to 1 and the PEO's compensation presented as the number compared to 1 (for example, 50 to 1 or 50:1).
- Disclose the pay ratio in narrative form by stating how many times higher (or lower) the PEO's annual total compensation is than that of the median employee (for example, the PEO's annual total compensation is 50 times that of the median of the annual total compensation of all employees).

Companies may not present the median employee's compensation as a percentage of the PEO's compensation.

OPTIONAL NARRATIVE DISCLOSURE AND ADDITIONAL RATIOS

The pay ratio rule allows, but does not require, a company to supplement the required pay ratio disclosure with additional ratios or other information that it believes will help shareholders understand the company's pay ratio disclosure. However, any additional ratios must:

- Be clearly identified.
- Not be misleading.
- Not be presented with greater prominence than the required pay ratio.

(*Instruction 9, Item 402(u), Regulation S-K*.)

Companies satisfied with their pay ratio may choose to limit their narrative disclosure. However, there are many scenarios in which companies can use the narrative disclosure to their advantage. For example, a company can provide supplemental information to:

- Explain the impact of including a significant number of part-time, seasonal and temporary workers in the company's pay ratio calculation.
- Discuss the effect on the company's pay ratio of the fact that many of the company's employees are located in low-cost jurisdictions (whether or not the company applied COLAs).
- Discuss the company's reliance on independent contractors or leased workers excluded from the pay ratio calculation under the pay ratio rule or provide one or more additional ratios taking these workers into account.
- Preemptively diffuse potential criticisms of the company's pay ratio, particularly as compared to its competitors' expected pay ratios.



The pay ratio rule allows, but does not require, a company to supplement the required pay ratio disclosure with additional ratios or other information that it believes will help shareholders understand the company's pay ratio disclosure.

In considering whether to provide supplemental disclosure and the substance of this disclosure, companies should bear in mind that their disclosure will be read by multiple audiences, including:

- Shareholders.
- Employees, including works councils and unions.
- Corporate governance and other activists.
- The media.

DISCLOSURE OF METHODOLOGY, ASSUMPTIONS AND ESTIMATES

Companies must briefly describe:

- The methodology they used to identify the median employee.
- Any material assumptions, adjustments (including COLAs) or consistently applied estimates used to identify the median employee or to determine total compensation or any elements of compensation.

Companies must also clearly identify the estimates used (*Instruction 4, Item 402(u), Regulation S-K*). For example, if a company uses statistical sampling, it must describe:

- The size of both the sample and the estimated whole population.
- Any material assumptions used in determining the sample size.
- The sampling method or methods used.

If a company changes its methodology or a significant assumption, adjustment (including COLAs) or estimate from the previous year, it must describe the change if the change has a material impact.

INITIAL STEPS TOWARD COMPLIANCE

Before delving into the details of how it will comply with the pay ratio rule, a company should take several initial steps, including:

- Assembling a team.
- Drafting a work plan.
- Identifying and gathering data.
- Preparing the board or compensation committee.

ASSEMBLE A TEAM

As an initial matter, the company should form a multi-disciplinary working group to spearhead compliance with the pay ratio rule. This working group should consist of representatives from the company's human resources, compensation, payroll and legal departments.

The company should also consider whether personnel from the company's corporate communications and investor relations departments should be included in the working group. Involving these additional personnel can help ensure that all relevant perspectives are taken into account.

DRAFT A WORK PLAN

The working group should create a work plan with milestones and target dates for completing each of the steps involved in complying with the pay ratio rule. Management should set a goal to complete a dry run of calculating the company's estimated pay ratio for 2015, with the help of any necessary outside advisors. Part of this process should be to identify elements of the calculation that remain unknown or that must be further refined to prepare the first publicly filed pay ratio disclosure covering fiscal year 2017.

Most companies likely will not have the time to draft narrative disclosure for 2015 given the significant work involved in completing the dry run of the pay ratio calculation. However, if time permits, management should work with the company's legal advisors to draft a mock disclosure for 2015.

After completing a dry run calculation for the 2015 fiscal year, the working group should continue to refine:

- The process used to collect and analyze data and the methodology used to identify the median employee.
- Decisions made regarding the options presented or permitted by the pay ratio rule.
- Its calculations.

After completing its 2015 dry run, a company should also consider whether it makes sense to do an additional dry run with 2016 data, given the outcome of the 2015 dry run and available resources.

Following its 2015 dry run, the company should consider updating its timetable for the proxy statement and annual meeting to account for compliance with the pay ratio rule. Going forward, a company should keep in mind that its timetable may need further adjustment depending on whether the company is relying on a previously identified median employee or identifying a new median employee in a given year (see above *Selecting a Measurement Date*).

IDENTIFY AND GATHER DATA

The first step in a company's work plan should be determining what relevant data the company and its consolidated subsidiaries have and where that data resides. The working group should then begin to gather this data and consider how to centralize it.

For example, the working group may create a single database or platform to house all the data necessary to calculate the pay ratio and prepare related disclosure. The working group should also consider how to ensure that this platform is timely updated so that the company may rely on it when making its pay ratio calculations going forward.

In gathering data, a company should begin working with its legal advisors to determine whether it is likely to be able to take advantage of the foreign data privacy exemption (see above *Exemptions for Certain Non-US Employees*).

PREPARE THE BOARD

Given that covered companies do not need to provide their pay ratio disclosure until 2018, briefing the entire board on the forthcoming requirement at this point is premature. Unless a company has a very hands-on board, it is likely that only the compensation committee will be involved at this early stage. The compensation committee should be briefed on:

- The parameters of the pay ratio rule.
- Management's plan for complying with the pay ratio rule.

Members of management presenting to the compensation committee should be prepared to:

- Respond to questions on the company's estimated pay ratio, even if the answer is that the pay ratio cannot yet be ascertained or that the pay ratio will fall within a certain range, depending on still-unknown variables.
- Discuss how the company's pay ratio is likely to compare to competitors' pay ratios and to industry estimates prepared by the media and governance advisors.

Depending on the company, its full board may not yet be involved in the pay ratio compliance process a year from now either. However, by the end of 2016, management should:

- Speak with the compensation committee or the full board about the process and methodology management used to identify the median employee and calculate the pay ratio.
- Inform the compensation committee or the full board of the company's estimated pay ratio based on 2015 compensation data.
- Explain any remaining unknown variables and how management plans to determine them.

By the end of 2016, management may also have a better sense of how the company's estimated pay ratio compares to the expected pay ratios of peer companies, particularly since the company's advisors are likely to begin observing industry pay ratio trends. Understanding how the company's estimated pay ratio is likely to compare to that of its peers can assist the company in evaluating whether:

- Supplemental proxy disclosure may be necessary to provide context for the company's pay ratio.
- The company's calculation methodology should be modified.

An advantage of calculating a company's pay ratio sooner rather than later is that it gives the company extra time to resolve any administrative and technical issues. This, in turn, will enable the company to present its pay ratio in an accurate, fully vetted and thoughtful manner.

