

Memorandum

SEC Issues Rule on Pay Ratio Disclosure

August 25, 2015

On August 5, 2015, the Securities and Exchange Commission (“SEC”) issued a final rule to implement the Dodd-Frank Act requirement that issuers disclose:

- (A) the median of the annual total compensation of all employees of the issuer, except the issuer’s chief executive officer (or any equivalent position);
- (B) the annual total compensation of the issuer’s chief executive officer (or any equivalent position);
- and
- (C) the ratio of the amount described in subparagraph (A) to the amount described in subparagraph (B) (together, the “pay ratio disclosure”).¹

The pay ratio rule is codified in Item 402(u) of Regulation S-K.

Changes From the Proposed Rule

The final pay ratio rule contains several notable changes from the proposed rule issued in September 2013. As discussed in further detail below, unlike the proposed rule, the final rule:

- provides tailored exemptions from the definition of “employee” for non-U.S. employees (1) where foreign data privacy laws or regulations prevent the issuer from compiling information necessary to prepare its pay ratio disclosure, or (2) that constitute less than five percent of the issuer’s workforce;
- permits registrants to make cost-of-living adjustments for compensation of employees in jurisdictions other than that of the principal executive officer (“PEO”), both in identifying the median employee and in calculating the median employee’s annual total compensation;

¹ See *Pay Ratio Disclosure*, Release Nos. 33-9877; 34-75610; File No. S7-07-13 (Aug. 5, 2015), at 8; Dodd-Frank Wall Street Reform and Consumer Protection Act § 953(b)(1). Commissioners Daniel Gallagher and Michael Piowar voted against the rule.

- expressly states that registrants may provide supplemental pay ratios or other relevant information, “as long as any additional pay ratios are not misleading and are not presented with greater prominence than the required ratio”;
- defines “employee” as an employee of the registrant or any of its consolidated subsidiaries, rather than any other subsidiaries;
- allows registrants to select any date within the last three months of their last completed fiscal year on which to identify the median employee;
- permits issuers to identify the median employee only once every three years, “unless there has been a change in [the issuer’s] employee population or employee compensation arrangements that the registrant reasonably believes would result in a significant change in the pay ratio disclosure”;
- postpones the initial date for compliance with the pay ratio rule until the registrant’s first reporting period for its first full fiscal year beginning on or after January 1, 2017;
- amends the transition period for new registrants; and
- provides transition periods for registrants ceasing to be smaller reporting companies or emerging growth companies, as well as those engaging in business combinations or acquisitions.

Summary of the Pay Ratio Rule

Registrants Not Subject to the Disclosure

The pay ratio rule does not apply to:

- smaller reporting companies;
- emerging growth companies;
- foreign private issuers; or
- U.S.-Canadian Multijurisdictional Disclosure System filers.

Location of the Disclosure

Registrants must include their pay ratio disclosure “in any filing described in Item 10(a) that calls for executive compensation disclosure under Item 402,” including annual reports on Form 10-K, registration statements under the Securities Act of 1933 (the “Securities Act”) and the Securities Exchange Act of 1934 (the “Exchange Act”), and proxy and information statements “to the same extent that these forms require compliance with Item 402.”

Content and Format of the Pay Ratio Disclosure

- **Presentation of the Ratio.** In expressing the pay ratio, registrants are permitted to either:
 - present the ratio numerically, with the median employee's annual total compensation equal to one and the PEO's compensation presented "as the number compared to one" (*e.g.*, 50 to 1 or 50:1); or
 - "disclose the pay ratio narratively by stating how many times higher (or lower) the PEO's annual total compensation is than that of the median employee" (*e.g.*, "the PEO's annual total compensation is 50 times that of the median of the annual total compensation of all employees").

Registrants are not permitted to present the median employee's compensation as a percentage of the PEO's compensation.

- **Additional Information.** The rule permits (but does not require) registrants to supplement the required disclosure with additional ratios or other information that they believe will help shareholders understand their pay ratio disclosure, provided that any additional ratios are "clearly identified, not misleading, and not presented with greater prominence than the required ratio."

"All Employees"

- **Employees Included in the Pay Ratio Calculation.** When identifying the median employee, the rule requires registrants to include all full-time, part-time, seasonal, and temporary employees of the company or any of its consolidated subsidiaries, whether located in the U.S. or abroad and without regard to whether they are salaried.
 - Registrants may add narrative disclosure or provide additional pay ratios to explain the effect of including part-time, seasonal and/or temporary employees on their pay ratio disclosure.
- **Employees Excluded From the Pay Ratio Calculation.** Individuals who provide services to the registrant or any of its consolidated subsidiaries as independent contractors or "leased" workers are not considered "employees" for purposes of the pay ratio rule, so long as those workers "are employed, and their compensation is determined, by an unaffiliated third party."
 - Registrants may not voluntarily include independent contractors or "leased" workers in their pay ratio disclosure "if such persons make up a significant portion of the workforce." Registrants may, however, provide narrative disclosure to discuss their reliance on such workers and/or "additional ratios that factor in those workers, as long as any additional ratios are not misleading and are not more prominently displayed than the required ratio."
- **Date Used to Identify the Median Employee.** The rule provides registrants the flexibility to select any date within the last three months of their last completed fiscal year to determine their median employee. Registrants must disclose the date they chose. In the event that a registrant changes the date it uses to identify its median employee from the date it used the previous year, "the registrant must disclose

the change and provide a brief explanation about the reason or reasons for the change.”

- **Tailored Exemptions for Certain Foreign Employees.** Although non-U.S. employees are included in the rule’s definition of “employee,” the rule provides two tailored exemptions for foreign employees in certain circumstances.
 - **Foreign Data Privacy Law Exemption.** The rule recognizes that some countries’ data privacy laws or regulations prohibit the transference of payroll data outside that country’s borders, rendering the compilation of information necessary to calculate the company’s pay ratio impossible without violating the law in those countries. Accordingly, an issuer is permitted to exclude employees located in such jurisdictions if:
 - the issuer first exercises “reasonable efforts” to obtain the necessary information, including seeking “an exemption or other relief under the applicable jurisdiction’s governing data privacy laws or regulations and us[ing] the exemption if granted”;
 - the issuer excludes all employees from that jurisdiction to the extent it excluded any employees from that jurisdiction;
 - the issuer lists the excluded jurisdictions, identifies the specific data privacy law or regulation at issue, explains how compliance with the pay ratio rule would violate such law or regulation and what efforts it made to seek an exemption or other relief to obtain the necessary information, and discloses the approximate number of employees in each jurisdiction excluded based on this exemption; and
 - the issuer obtains a legal opinion regarding its inability to obtain or process the information necessary for compliance with the pay ratio rule without violating the jurisdiction’s data privacy laws or regulations, including the issuer’s inability to obtain an exemption or other relief. The legal opinion must be filed as an exhibit (under Exhibit 99) to the filing containing the pay ratio disclosure.
 - **De Minimis Exemption.**
 - **Registrants With Five Percent or Fewer Non-U.S. Employees.** Registrants whose foreign employees constitute five percent or less of their total workforce may exclude all of their foreign employees when identifying their median employee. If an issuer with five percent or fewer non-U.S. employees decides to exclude any non-U.S. employees under the de minimis exemption, it must exclude all of them.
 - **Registrants With More Than Five Percent Non-U.S. Employees.** A registrant whose foreign employees constitute over five percent of its total workforce may exclude non-U.S. employees up to the five percent threshold, “provided that, if such a registrant excludes any non-U.S. employees in a particular foreign jurisdiction, it must exclude all the employees in that jurisdiction.”

The pay ratio rule provides that “[i]n calculating the number of non-U.S. employees that may be excluded under the *de minimis* exemption, a registrant must count any non-U.S. employee exempted under the data privacy exemption against the availability.” This means that:

- if a registrant excluded over five percent of its total employees pursuant to the data privacy law exemption, it may not avail itself of the *de minimis* exemption; and
- if a registrant excluded less than five percent of its total employees under the data privacy law exemption, it may use the *de minimis* exemption “to exclude no more than the number of non-U.S. employees that, combined with the data privacy exemption, equals 5% of the registrant’s total employees.” If, however, the number of employees in a particular jurisdiction exceeds the percentage of total employees that the registrant would be permitted to exclude after using the data privacy exemption, the registrant may not exclude any employees in that jurisdiction.

A registrant relying on the *de minimis* exemption must disclose the jurisdiction(s) from which the employees were excluded, “the approximate number of employees excluded from each jurisdiction under the *de minimis* exemption, 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.”

- **Cost-of-Living Adjustment.** In recognition that “differences in underlying economic conditions” in the various countries in which a registrant operates is likely to affect the pay of employees in those jurisdictions and result in a statistic that may not accurately reflect the value of the compensation paid to foreign workers, the final rule allows (but does not require) registrants to “make cost-of-living adjustments to the compensation of their employees in jurisdictions other than the jurisdiction in which the PEO resides when identifying the median employee.” Registrants applying cost-of-living adjustments must:
 - apply the adjustments “to all such employees included in the calculation”;
 - adjust the compensation of these employees to the cost of living in the PEO’s jurisdiction;
 - briefly describe any cost-of-living adjustments they applied, including the measure they used as the basis for the cost-of-living adjustment;
 - disclose the median employee’s annual total compensation and pay ratio without the cost-of-living adjustments; and
 - if the median employee identified through the use of a cost-of-living adjustment is an employee in a jurisdiction other than that of the PEO, “use the same cost-of-living adjustment in calculating the median employee’s annual total compensation” and disclose the median employee’s jurisdiction.

A registrant that does not use cost-of-living adjustments when identifying its median employee may not make such adjustments to the median employee's annual total compensation if the median employee is located in a jurisdiction other than that of the PEO.

- **Employees of Consolidated Subsidiaries.** The rule defines “employee” to include “only the employees of the registrant and its consolidated subsidiaries,” rather than employees of other “subsidiaries,” which, under the definitions provided in both the Securities Act and the Exchange Act, are affiliates that the registrant controls directly or indirectly through one or more intermediaries.
- **Annualization and Full-Time Equivalent Adjustments.** The rule permits annualization for permanent full-time and part-time employees who, for whatever reason, did not work for the issuer's full fiscal year. Annualization is not permitted for seasonal or temporary employees. Full-time equivalent adjustments, which involve projecting what a part-time employee would make if that employee worked full time, “are prohibited under the final rule under all circumstances.” Registrants are permitted to provide supplemental disclosure to explain the effect of part-time, seasonal or temporary employees on their pay ratio.

Identifying the Median Employee

- **Frequency.** Under the final rule, a registrant is permitted to identify its 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 there have been no such change, the registrant is required to disclose that it is basing its pay ratio calculation on the same median employee and “briefly describe the basis for its reasonable belief” that there have been no changes that would significantly impact its disclosure. Regardless of whether the registrant uses the median employee identified during a prior year, it must calculate that employee's annual total compensation every year and use the updated figure to calculate its pay ratio.
 - Where there has been no change in the issuer's employee population or employee compensation arrangements but there has been a change in the circumstances of the median employee previously identified (e.g., that individual is no longer employed by the registrant or the individual's compensation changed significantly), “the registrant may use another employee whose compensation is substantially similar to the original median employee based on the compensation measure used to select the median employee in year one.” If there are no other similarly situated employees, the registrant must identify its median employee anew.
- **Methodology.** The rule provides registrants with the flexibility to determine a methodology for identifying the median employee based on their particular facts and circumstances.
 - **Reasonable Estimates.** The rule permits registrants to apply “a methodology that uses reasonable estimates in identifying the median employee and calculating the annual total compensation or any elements of compensation for employees other than the PEO.”

- **Statistical Sampling and “Other Reasonable Methods”.** In determining the pool of employees from which the median employee will be identified, registrants may, but are not required to, use their entire employee population from which the median employee will be selected; registrants are also permitted to use statistical sampling and/or “other reasonable methods” unspecified in the rule. Registrants, such as those with several business lines or geographical units, can use more than one statistical sampling approach to determine their median employee. The rule provides registrants the latitude to determine the appropriate sample size based on their individual facts and circumstances. Additionally, registrants are not required to ascertain the exact pay of every employee in the sample; where appropriate, registrants can find the median employee by simply identifying those employees with pay significantly higher or lower pay than the median employee.
- **Consistently Applied Compensation Measures.** In identifying the median employee, registrants may use either annual total compensation or “any other compensation measure that is consistently applied to all employees included in the calculation,” such as information derived from tax or payroll records, provided that they disclose the measure of compensation used. Registrants are permitted “to use a measure that is defined differently across jurisdictions and may include different annual periods as long as within each jurisdiction, the measure is consistently applied.” Registrants may not, however, use different compensation measures for employees in different jurisdictions.
- **Actual Employee.** Registrants must identify an actual employee as its median employee – not a range of employees – and use that employee’s annual total compensation for its pay ratio disclosure. A registrant need not and should not disclose any personally identifiable information about the median employee other than that employee’s annual total compensation. While registrants are permitted (but are not required to) disclose the position of the median employee, registrants should not do so if such disclosure could identify the individual.
 - If, upon identifying the median employee, the registrant “reasonably determined that there are anomalous compensation characteristics of that employee’s compensation that would have a significant higher or lower impact on the pay ratio,” the registrant may substitute “another employee with substantially similar compensation to the original median employee based on the compensation measure used to select the median employee,” provided that the registrant discloses this fact.

Calculating Annual Total Compensation

For both the PEO and median employee, the rule defines “annual total compensation” as the Summary Compensation Table total as calculated under Item 402(c)(2)(x) of Regulation S-K. “Annual total compensation” must be calculated for the registrant’s last completed fiscal year (regardless of whether the registrant used tax and/or payroll records from a different annual period to determine its median employee).

- **Calculating Annual Total Compensation of the PEO.** In cases where the registrant replaced its PEO during its fiscal year, the registrant may either:
 - calculate the total compensation pursuant to Item 402(c)(2)(x) for each PEO that served during that fiscal year and combine those figures; or
 - annualize the compensation of the PEO serving in that position on the date it chose to determine the median employee.

A registrant in this situation must disclose how it calculated its PEO's annual total compensation.

- **Calculating Annual Total Compensation of the Median Employee.** As noted above, registrants are permitted to use reasonable estimates in calculating the median employee's annual total compensation, or any portion thereof, under Item 402(c)(2)(x). Registrants using reasonable estimates must have a "reasonable basis" to believe that their estimates approximate the actual compensation amounts paid to the employee under Item 402(c)(2)(x) and must "clearly identify any estimates used."
 - **Salary.** For non-salaried employees, registrants must use "wages plus overtime" in lieu of "base salary" or "salary" under Item 402.
 - **Defined Pension Plans and Change in Pension Value.** Registrants may use reasonable estimates to determine the approximate aggregate change in actuarial present value of the employee's defined pension plan. Government-mandated defined pension plans, which are provided by the government rather than the registrant, are not considered compensation under Item 402(c)(2)(x).
 - **Perquisites and Other Personal Benefits.** Item 402 permits "the exclusion of personal benefits as long as the total value for the employee is less than \$10,000, based on the basis of the aggregate incremental cost to the registrant." The pay ratio rule permits (but does not require) registrants to include in their calculation of the median employee's annual total compensation personal benefits valued at less than \$10,000, provided that they take the same approach when calculating the PEO's total compensation for purposes of the pay ratio disclosure. In addition, registrants taking this route must "explain any difference between the PEO total compensation used in the pay ratio disclosure and the total compensation reflected in the Summary Compensation Table, if material."

Disclosure of Methodology, Assumptions, and Estimates

Registrants are required to briefly describe the methodology they used to identify the median employee and any material assumptions, adjustments (including cost-of-living adjustments), or consistently-applied estimates used to identify the median employee or to determine total compensation or any elements thereof. Registrants must "clearly identify" the estimates used. "For example, when statistical sampling is used, registrants must describe the size of both the sample and the estimated whole population, any material assumptions used in determining the sample size and the sampling method (or methods) used." To the

extent a registrant changes its methodology or a significant assumption, adjustment (including cost-of-living adjustment), or estimate from the previous year, it must describe such change if the effects of the change are material.

Timing Considerations

- **Initial Compliance Date.** Issuers must provide the pay ratio disclosure for their full fiscal year beginning on or after January 1, 2017.
- **Transition Periods.**
 - **New Registrants.** A new registrant must provide its first pay ratio disclosure after “its first full fiscal year beginning after the registrant has (i) 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 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.”
 - **Registrants Ceasing to be Smaller Reporting Companies or Emerging Growth Companies.** A registrant that no longer qualifies as a smaller reporting company or an emerging growth company must only provide its pay ratio disclosure “after the first full year after exiting such status and not for any fiscal year commencing before January 1, 2017.”
 - **Registrants Engaging in a Business Combination/Acquisition.** A registrant that engaged in a business combination and/or acquisition may exclude the employees of the acquired entity from its pay ratio calculation “for the fiscal year in which the business combination or acquisition becomes effective.” It is only in the fiscal year following the business combination/acquisition that the registrant must determine whether the transaction “would result in a substantial change to its pay ratio disclosure that would necessitate a re-identification of the median employee.” For the fiscal year during which the business combination/acquisition became effective, however, the registrant must identify the acquired business and disclose the approximate number of employees excluded from the calculation.
- **Updating the Pay Ratio Disclosure.** The rule requires registrants to provide pay ratio disclosure for their last completed fiscal year only upon filing its Form 10-K for that year or, if later, its definitive proxy or information statement relating to its next annual meeting of shareholders (or written consents in lieu of such meeting). In either case, registrants must provide their pay ratio disclosure no later than 120 days after the end of the last fiscal year.
- **Situations Where the PEO’s Salary or Bonus is Not Yet Calculable.** Where the registrant relies on Instruction 1 to Items 402(c)(2)(iii) and (iv) to omit the PEO’s salary or bonus that is not yet calculable, the registrant may also omit the pay ratio disclosure. In this situation, the registrant must “disclose that the pay ratio disclosure is not calculable until the PEO salary or bonus, as applicable, is determined and

disclose the date that the PEO's actual total compensation is expected to be determined." Only when the PEO's salary or bonus become "calculable in whole" must the registrant provide the pay ratio disclosure.

If you have any questions or would like additional information, please do not hesitate to contact **Yafit Cohn** at (212) 455-3815 or yafit.cohn@stblaw.com, any other member of the Firm's Public Company Advisory Practice, or any Partner, Senior Counsel or Counsel in the Firm's Executive Compensation and Employee Benefits Practice.

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UNITED STATES

New York
425 Lexington Avenue
New York, NY 10017
+1-212-455-2000

Houston
600 Travis Street, Suite 5400
Houston, TX 77002
+1-713-821-5650

Los Angeles
1999 Avenue of the Stars
Los Angeles, CA 90067
+1-310-407-7500

Palo Alto
2475 Hanover Street
Palo Alto, CA 94304
+1-650-251-5000

Washington, D.C.
900 G Street, NW
Washington, D.C. 20001
+1-202-636-5500

EUROPE

London
CityPoint
One Ropemaker Street
London EC2Y 9HU
England
+44-(0)20-7275-6500

ASIA

Beijing
3901 China World Tower
1 Jian Guo Men Wai Avenue
Beijing 100004
China
+86-10-5965-2999

Hong Kong
ICBC Tower
3 Garden Road, Central
Hong Kong
+852-2514-7600

Seoul
West Tower, Mirae Asset Center 1
26 Eulji-ro 5-gil, Jung-gu
Seoul 100-210
Korea
+82-2-6030-3800

Tokyo
Ark Hills Sengokuyama Mori
Tower
9-10, Roppongi 1-Chome
Minato-Ku, Tokyo 106-0032
Japan
+81-3-5562-6200

SOUTH AMERICA

São Paulo
Av. Presidente Juscelino
Kubitschek, 1455
São Paulo, SP 04543-011
Brazil
+55-11-3546-1000