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SEC Adopts Pay Ratio Rule

On August 5, 2015, the SEC adopted the pay ratio disclosure rule,[1] as required by Section 953(b) of the Dodd-Frank Wall Street Reform and Consumer Protection Act. This new rule comes more than five years after Dodd-Frank was enacted and after thousands of comment letters from companies, trade groups, unions, and investors. The rule was adopted over strong dissent from two of the five Commissioners. Backed by special interest groups, the rule does little more than attempt to shame corporate America while providing no meaningful benefit to investors.

Under the rule, public companies will be required to disclose, in any proxy statement, registration statement, or other filing that requires executive compensation disclosure, the total compensation of its CEO, the median compensation of its employees, and the ratio between those two amounts.[2] [3] The rule applies to executive compensation disclosures for fiscal years that start on or after January 1, 2017. The rule does not apply to foreign private issuers, smaller reporting companies, emerging growth companies, or investment companies.

Key Takeaways

- Despite the SEC's attempt to somewhat blunt the impact of the rule, companies will still incur significant costs to comply with the rule.
- For most companies, their first pay ratio disclosure will be in 2018, which is later than expected under the proposed rule. There is no real upside to early disclosure.
- Due to the expansive definition of "employees" and the burdens on companies doing business in non-U.S. jurisdictions with data privacy laws, companies should not wait too long to begin work in order to comply with this new rule.

The final rule varies in some important respects from the proposed rule published by the SEC in September 2013,[4] with the most notable changes being added flexibility in calculating employees' median compensation, reducing the frequency of the calculation, and some easing of the burden on companies with non-U.S. employees.

Compliance with the Rule

Companies must perform an analysis to determine the compensation of "the median employee[5]" once every three years unless there has been a significant change in employee population or compensation arrangements. This calculation must be done as of a specified date (rather than on a rolling basis); a company is permitted to choose any date within the final three months of its most recently completed fiscal year as the specified date.

In an attempt at cost-efficiency, the SEC adopted a flexible methodology for calculating the median employee. Instead of using its entire employee population, a company may use statistical sampling or "other reasonable methods." Companies may use reasonable estimates to identify the median employee and calculate compensation. It should be noted that companies will be required to describe the calculation methodology in the disclosure. Finally, companies may generally omit the employees of a newly acquired entity for the fiscal year in which the acquisition occurs.

Many of the commentators to the proposed rule expressed concern surrounding the inclusion of non-U.S. employees in the calculation of the median employee, on the grounds that including them could significantly distort the reported ratio and that capturing and analyzing the data for some employees in some countries could constitute a violation of those nations' privacy laws. In response, the SEC made several changes to the proposed rule. First, if the disclosure would violate foreign privacy laws, the company does not have to include those employees. In addition, if five percent or less of a company's workforce is located outside of the United States, there is no need to include the foreign workforce in the calculation. Furthermore, even if non-U.S. employees account for more than five percent, a company can still exclude up to five percent of non-U.S. workforce.[6] Finally, a company is allowed to make cost-of-living adjustments to the compensation of its non-U.S. workers. However, the company must disclose these adjustments, the methodology of determining the adjustments, and the pay ratio on an unadjusted basis.

Preparing for 2018

As an initial matter, companies should analyze applicable foreign data privacy laws in the jurisdictions in which they operate as early as this year.[7] Prior to excluding non-U.S. employees in such jurisdictions from the calculation, companies must seek an exemption or other relief from the applicable government to include the data. If a company is unable to obtain this relief, it will need to disclose the conflicting law or regulation and obtain a legal opinion stating that disclosure would be a violation of that law or regulation and that they were unable to get an exemption. Companies should engage their foreign offices and legal advisors early to ensure they will be able to provide the required disclosure.

In addition, companies should determine how the data privacy exemption will relate to the five percent *de minimis* exemption. In this regard, any non-U.S. employees exempted under the data privacy exemption are counted against the availability of the *de minimis* exemption. For example, if a company has 80 employees in the United States, 15 in Germany, which has strict data privacy rules, and five in a country that does not have any applicable privacy rules, the compensation figures for those five employees would still need to be included as a result of the *de minimis* exemption being used by the 15 German employees.

Companies should determine the preferred method for computing the factor to be used for cost-of-living adjustments for non-U.S. employees. At implementation, market practice on these points is likely to vary significantly.

Challenges Ahead

Since its conception, the pay ratio rule adopted by the SEC has been highly controversial and is certain to be challenged in court under the Administrative Procedure Act. When such a challenge takes place, the pay ratio rule will be vacated if the court finds that the SEC acted arbitrarily in determining the likely economic consequences of the rule and failed to connect those consequences to the SEC's stated goals of efficiency, competition, and capital formation.[8]

Although the SEC attempted to make the calculation of median income less costly, the aggregate initial cost for performing these procedures may exceed $1 billion with ongoing costs of more than $500 million annually. Furthermore, the SEC is still unable to quantify the benefits, if any, of this disclosure.[9] While some argue that pay ratios would alter the total mix of information available to investors due to supposed comparability, the flexibility that the SEC has provided may render such comparisons useless. It continues to be a dubious proposition that this rule will provide meaningful disclosure to the market and to investors.[10]

We await with interest the likely legal challenges to this rule, given that it does little more than pander to special interests and attempts to play the "shame card" to embarrass business leaders and reduce the gap between employee and CEO compensation.[11] This is not an appropriate goal for federal legislation, nor the SEC's rulemaking efforts.

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Adam Berkaw, an associate in the New York Office, assisted in the preparation of this Commentary.

Endnotes

1 The final rule is available here.

2 Compensation will be calculated using the requirements of Item 402(c)(2)(x) of Regulation S-K. This is the same calculation performed for executive officers in a proxy statement.

3 When the CEO of a company is replaced, the rule allows two options to calculate the CEO's total compensation for that year. In the first, the two sets of compensation are added together. In the second, a company may look at the CEO on the date it determines its median employee and annualize that CEO's compensation.

4 The full release of the proposed rule is available here.

5 In determining the company's median employee, a company must include both U.S. and non-U.S. employees; part-time, seasonal, and temporary employees; direct employees; and employees of any consolidated subsidiary.

6 A company cannot pick and choose which non-U.S. employees to exclude from each jurisdiction—if it excludes one employee from a given jurisdiction, it must exclude all employees from that jurisdiction and must still be able to satisfy the applicable threshold.

7 For example, some countries in the European Union, and Germany in particular, may have rules that do not allow sending compensation data to a company's central HR system.

8 This was the case when the D.C.-based court of appeals vacated the SEC's proxy-access rules. The court's opinion can be found here.

9 The SEC admits in the adopting release that Congress "did not expressly state the specific objectives or intended benefits of the rule" and that they are "unable to quantify this benefit."

10 We agree with Commissioner Gallagher that the impact of the pay ratio rule may even be negative due to the possibility that the additional immaterial information may obscure material information about chief executive pay and is likely to be misused.

11 Our prior *Commentary* on the proposed rule is available here.