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SEC ADOPTS FINAL PAY RATIO DISCLOSURE RULES

In a 3-2 vote on August 5, 2015, the Securities and Exchange Commission (SEC) adopted final rules to implement the pay ratio disclosure requirements of the Dodd-Frank Wall Street Reform and Consumer Protection Act. Companies will be required to provide their pay ratio disclosures for their first fiscal year beginning on or after January 1, 2017. The subject of much controversy and debate, the rules generated more than 287,400 comment letters, including more than 1,540 individual letters. The final rules retain the flexibility contemplated by the 2013 proposal and include a number of additions and modifications.

A summary of certain aspects of the new rules is provided below.

Overview of Required Disclosures

The rules require US public companies to disclose (i) the median of the annual total compensation of all employees (except the chief executive officer), (ii) the annual total compensation of the chief executive officer and (iii) the ratio of these two amounts. The annual total compensation for the median employee will be calculated using generally the same rules as those that apply to the chief executive officer's compensation, subject to reasonable estimates. Companies must briefly describe the methodology used to identify the median employee and any material assumptions, adjustments or estimates used to identify the median or determine annual total compensation. Companies also must disclose and describe the reasons for significant changes in any methodology, significant assumption, adjustment or estimate from the prior year. The disclosures must be included in registration statements, proxy and information statements and annual reports that require executive compensation disclosure. Smaller reporting companies, foreign private issuers, MJDS filers, emerging growth companies and registered investment companies will not be subject to the rules.

Rules Retain Flexible Framework for Identifying the Median Employee and Allow Companies to Identify the Median Employee Once Every Three Years

Consistent with the proposed rules, the final rules do not require companies to use a particular method to determine the median employee. Companies have flexibility to select a method based on their own facts and circumstances, and may use their entire employee population, a statistical sampling or other reasonable method. Companies may use reasonable estimates and may use annual total compensation or any other compensation measure that is consistently applied to identify the median.

In a change from the proposals, companies only need to identify their median employee once every three years, as long as there have been no changes they believe to be significant in their employee population or compensation arrangements. They still must calculate the total compensation for that employee each year, and may substitute another employee with substantially similar compensation if the median employee's compensation changes within those three years.

Companies May Select the Measurement Date From the Last Three Months of the Fiscal Year

The final rules permit a company to choose any date within the last three months of its last completed fiscal year on which to determine the employee population from which to identify the median employee. If the company changes the date it uses for this purpose in subsequent years, it must disclose and explain the change.

All Employees Count (with Limited Exemptions for Certain Non-US Employees and a Transition Period for Business Combinations and Acquisitions)

A company must include all the employees of itself and its consolidated subsidiaries as of its selected measurement date in determining its median employee. This includes all full-time, part-time, seasonal and temporary workers. This also includes US and non-US employees, subject to two limited exemptions:

- The first exemption – the foreign data privacy law exemption – may apply to employees in a foreign jurisdiction with data privacy rules that the company would violate if it were to obtain or process the information necessary to comply with the pay ratio rules. Companies must make reasonable efforts to obtain or process the necessary information to rely on the exemption, which must include (at a minimum) using or seeking an exemption or other relief under the applicable law or regulations. In addition, a company must obtain and file a legal opinion in order to rely on this exemption, and would be required to include additional disclosures relating to its use.
- The second exemption – a de minimis exemption – may allow a company to exclude up to 5% of its non-US employees, including any non-US employees who have been excluded under the foreign data privacy law exemption. Companies that exclude any non-US employee in a particular jurisdiction must exclude all non-US employees in that jurisdiction. Companies whose non-US employees represent 5% or less of their total employee population must exclude all non-US employees if they exclude any of them under the de minimis exemption. Certain additional disclosures also are required.

In addition to these exemptions, the rules provide a transition period for employees obtained in a business combination or acquisition, subject to making certain disclosures.

Cost-of-Living Adjustments, Annualization and Permitted Additional Disclosures

The rules permit certain cost-of-living adjustments in identifying the median and calculating annual total compensation for employees in jurisdictions other than where the chief executive officer resides, but companies making such adjustments must disclose them and must also determine and disclose the ratio without the cost-of-living adjustments. Companies may annualize total compensation for permanent employees who did not work the entire year, but may not annualize compensation for seasonal or temporary employees and may not make full-time equivalent adjustments. Companies may also provide additional pay ratios as long as they are clearly identified, not misleading and not presented with greater prominence than the required ratios.

Initial Compliance Date and Transition Periods

A company's first reporting period for the pay ratio disclosure is its first full fiscal year beginning on or after January 1, 2017. As a result, the disclosures for typical calendar year end companies will first be required in the Form 10-K or annual meeting proxy statement filed in 2018. In addition to the transition period for employees acquired in business combinations or acquisitions, the rules provide transition periods for newly public companies and companies that cease to be smaller reporting companies or emerging growth companies.

For additional information about the rules or help implementing the requirements, please contact your principal Squire Patton Boggs lawyer or any of the lawyers listed in this publication.

Contacts

Julia M. Tosi
T +1 216 479 8351
E julia.tosi@squirepb.com

Daniel G. Berick
T +1 216 479 8374
E daniel.berick@squirepb.com

Cipriano S. Beredo III
T +1 216 479 8280
E cipriano.beredo@squirepb.com

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