

To the Point

SEC – final rule

SEC finalizes 'pay ratio' rule

'The final rule ... provides companies with substantial flexibility in determining the pay ratio, while remaining true to the statutory requirements.'

– SEC Chair Mary Jo White

What you need to know

- ▶ The SEC finalized a rule that requires most registrants to disclose the ratio of their principal executive officer's total annual compensation to the total annual compensation of their median employee.
- ▶ Emerging growth companies, smaller reporting companies, foreign private issuers and most registered investment companies are exempt from the requirement.
- ▶ The final rule does not dictate how companies must identify the median employee and calculate that employee's total annual compensation, but it gives companies the flexibility to use various methods and estimates, with related disclosure.
- ▶ The rule will be effective for annual periods beginning after 1 January 2017.

Overview

The Securities and Exchange Commission (SEC or Commission) voted 3-2 to finalize the [pay ratio rule](#) requiring most registrants to calculate and disclose the median total annual compensation of all of its employees (excluding the principal executive officer (PEO)), the annual total compensation of its PEO and the ratio of these two amounts.

The rule was mandated by Section 953(b) of the Dodd-Frank Wall Street Reform and Consumer Protection Act (the Dodd-Frank Act). The requirement has generated considerable controversy, including over 287,000 comment letters.

Key considerations

The rule creates new Item 402(u) of Regulation S-K outlining the requirements for the pay ratio disclosure. The rule will allow companies to consider individual facts and circumstances in determining the appropriate approach when identifying the median employee and calculating that employee's total annual compensation.

Scope of SEC filings and registrants affected

The final rule, which closely resembles the proposal issued in September 2013, will require pay ratio disclosures in SEC filings that require executive compensation information required by Item 402 of Regulation S-K. Such filings include annual reports on Form 10-K, registration statements and proxy and information statements.¹ Smaller reporting companies, emerging growth companies (EGCs), foreign private issuers and registered investment companies (except for business development companies) will not be required to provide the pay ratio disclosure.

Calculating the pay ratio disclosure

Item 402(u) of Regulation S-K will require disclosure of:

- ▶ The median of the annual total compensation of all of a registrant's employees, excluding the PEO²
- ▶ The annual total compensation of the registrant's PEO (i.e., the amount also disclosed in the Summary Compensation Table under Item 402(c) of Regulation S-K)
- ▶ The ratio of these two amounts

The rule will allow registrants to express the comparison as a ratio or as a multiple of the PEO's compensation to the median. For example, if the median is \$45,000, and the PEO's annual total compensation is \$12,000,000, the pay ratio would be 1 to 267. The disclosure could be expressed as that ratio or by stating it narratively as a multiple, such as "the PEO's annual total compensation is 267 times that of the median of the annual total compensation of all employees."

Employees included in median calculation

Consistent with the proposal, the rule will require the median calculation to include *all* employees who were employed at the determination date, including full-time, part-time, temporary and seasonal employees.³ Employees include those employed by a registrant's consolidated subsidiaries and foreign locations but exclude independent contractors or "leased" workers if they are paid by a third party (e.g., a temp agency).

While non-US employees in foreign locations will have to be included in the median calculation, a *de minimis* (<5%) population of non-US employees can be excluded. If a registrant's non-US employee base makes up 5% or less of the total employees, the registrant will be able to exclude all or none of its non-US employees from the calculation. If its foreign employees exceed 5% of the total, it can exclude all employees in certain jurisdictions, provided that they don't aggregate to an amount that exceeds 5%. Therefore, a company may not exclude any employees in a foreign jurisdiction that individually represents more than 5% of total employees.

Employees in foreign jurisdictions where data privacy laws prohibit companies from obtaining or disclosing information needed to calculate the ratio also may be excluded from the calculation.⁴

It is important to note that any exemptions based on data privacy laws count toward the *de minimis* exception as well. For example, if 2% of a registrant's employees are in a foreign jurisdiction that is excluded from the median calculation due to data privacy laws, the registrant may only exclude an additional 3% in other foreign jurisdiction using the *de minimis* exception. It also is important to note that the final rule does not allow for picking and choosing to include

or exclude certain employees in foreign jurisdictions from the calculation. If a registrant excludes any non-US employees in a particular jurisdiction under the exemptions, it must exclude all non-US employees in that jurisdiction.

Registrants will be able to use estimates to determine the median compensation, including annualizing compensation for new hires and other permanent employees who were not employed for the entire fiscal year. Annualizing adjustments will not be allowed for seasonal and temporary employees. Registrants will not be permitted to make adjustments that would change a worker's status. For example, a registrant could adjust the compensation of a new permanent part-time employee to reflect annualized compensation on a part-time basis, but it could not make an adjustment reflecting a full-time schedule for that employee. If a registrant elects to annualize compensation, it must do so for all eligible employees.

The final rule acknowledges the differences in pay in various jurisdictions and will allow a registrant to make cost-of-living adjustments (COLA) when calculating median compensation. The COLA will bring the compensation of employees in other jurisdictions to an equivalent of the compensation where the PEO resides. This COLA will have to be applied consistently to all employees within a jurisdiction. However, if a registrant uses a COLA in determining the median, it also must determine the median without a COLA and disclose a second pay ratio using that amount.

The final rule will allow a registrant to make cost-of-living adjustments for non-US employees when calculating median pay.

Identifying the median employee

The rule attempts to strike a balance between concerns about compliance costs and the statutory requirement under the Dodd-Frank Act by giving registrants flexibility in how they determine their median employee. The rule includes provisions promoting flexibility that were not included in the original proposal, such as requiring a registrant to calculate the median employee only once every three years (unless there are changes in the employee population or compensation arrangements that it reasonably believes would result in a significant change in the pay ratio). The final rule also allows a registrant to identify the median employee at any date within the last three months of the registrant's fiscal year, provided it discloses such date and explains the reason for any change in subsequent determinations. In a subsequent year, if it is no longer appropriate to use the median employee previously identified because of a change in their circumstances that the registrant reasonably believes would result in a significant change in the pay ratio, the registrant may use another employee whose compensation is substantially similar to the median employee identified in the original selection. Otherwise, the registrant must disclose that it is using the same median employee in its subsequent year's pay ratio disclosure and its reasonable belief why such use would not result in a significant change in the pay ratio.

Consistent with the proposal, the final rule will give registrants the flexibility to use a "reasonable method" to identify the median employee that is appropriately tailored to their business, including identifying the median employee using statistical sampling or a consistently applied compensation measure. This approach will allow a registrant to use compensation information that is already available in its records (e.g., salary, wages and tips as reported on Form W-2 to the Internal Revenue Service or similar forms used in foreign locations). A registrant that chooses to use a statistical sample will have to carefully consider how to determine the appropriate sample size.

Calculating total annual compensation

Once a registrant determines its median employee, it will have to calculate total annual compensation under Item 402(c)(2)(x) only for that one employee. This calculation can be complex and currently is required only for the PEO and other named executive officers to prepare the summary compensation table for disclosure. The final rule will allow registrants to use estimates when determining total compensation as defined by Item 402(c)(2)(x)

(e.g., estimated change in actuarial present value of the median employee's defined pension benefit under a multi-employer plan). In addition, if a registrant uses a COLA to determine the median employee, it will have to use the same COLA when calculating the total annual compensation for that employee.

Required disclosures

The rule will require registrants to disclose:

- The method (e.g., compensation measure, determination date), material assumptions (e.g., foreign jurisdictions and approximate number of employees excluded), adjustments (e.g., cost-of-living adjustments) or estimates used to identify the median employee and calculate that individual's total annual compensation
- The effects of any changes (or lack thereof) from year to year in the method or material assumptions used, including a description of the changes and the reasons they were made

A registrant may generally identify the median employee's position to put that employee's compensation in context, but it should not do so if providing the information could identify any specific individual. However, that information must be clearly identified and not be misleading. It also must not be presented more prominently than the required ratio.

Compliance dates

Registrants will be required to make pay ratio disclosures for their first fiscal year beginning on or after 1 January 2017. Therefore, a calendar-year company will be required to disclose the pay ratio for 2017 for the first time in the proxy statement for its 2018 annual meeting.

Next steps

Companies should consider the requirements and begin gathering the necessary data to determine how to most efficiently calculate the pay ratio (particularly as it relates to non-US employees in foreign locations).

Companies with operations in foreign jurisdictions should consider if there are data privacy laws that could prevent obtaining the necessary information and require a legal opinion.

Endnotes:

- ¹ The pay ratio must be disclosed within 120 days after the end of a registrant's fiscal year, either in the proxy or information statement, or in the original or amended annual report on Form 10-K. After that, registration statements must provide the pay ratio for the last fiscal year. The pay ratio is not required to be disclosed in any initial public offering registration statements.
- ² The rule uses the term "principal executive officer" rather than "chief executive officer" to make it consistent with other disclosure requirements in Item 402 of Regulation S-K.
- ³ A registrant may omit employees from a business combination or acquisition of a business in that fiscal year provided it discloses the acquisition and approximate number of employees omitted.
- ⁴ In this case, a company still must make reasonable efforts to obtain the data, including, at a minimum, using or seeking an exemption or other relief. A company using this exclusion must obtain a legal opinion regarding its inability to comply and file it as an exhibit in each filing that discloses the pay ratio.

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