

## Practice Update

# SEC Adopts Final Rules Requiring Pay Ratio Disclosure

August 17, 2015

On August 5, 2015, the Securities and Exchange Commission adopted final rules mandating pay ratio disclosures pursuant to Section 953(b)(1) of the Dodd Frank Wall Street Reform and Consumer Protection Act. The rules add a new Item 402(u) to Regulation S-K pursuant to which reporting companies will be required to disclose annually the median of the annual total compensation of all of their employees excluding the principal executive officer (PEO), the annual total compensation of the PEO, and the ratio of the annual total compensation of the median employee to the annual total compensation of the PEO. The pay ratio may be disclosed as a numerical ratio in which the annual total compensation of the median employee is equal to one or, alternatively, as a statement of the multiple that the PEO's annual total compensation bears to the annual total compensation of the median employee.

The new pay ratio disclosures are required in any annual report, proxy statement, information statement or registration statement in which executive compensation disclosure is required. Emerging growth companies, foreign private issuers, smaller reporting companies, MJDS filers, and investment companies are exempt from the pay ratio disclosure rules.

The pay ratio disclosures will be treated as "filed" rather than "furnished" for purposes of the

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Securities Act of 1933 and the Securities Exchange Act of 1934 and will be subject to potential liabilities under these statutes.

### **Determination of the Employee Base and Identification of the Median Employee**

Central to compliance with the new disclosure requirements is an issuer's identification of the median employee. A great deal of controversy surrounding the adoption of the pay ratio rules has focused on the cost and complexity of doing so. The final rules do not specify any required methodology for identifying the median employee and instead permit issuers to choose a method suitable to them.

A registrant may identify the median employee using annual total compensation or any other compensation measure that is consistently applied to all employees included in the calculation, such as information derived from the registrant's tax and/or payroll records. If a compensation measure other than annual total compensation is used to identify the median employee, the issuer must disclose the compensation measure used. Issuers are required to briefly describe their methodology for identifying the median employee, including material assumptions, adjustments, and estimates.

As a general matter, all employees other than the PEO must be taken into account in formulating the required pay ratio disclosure, including part-time, seasonal, and temporary employees. Issuers may annualize compensation for permanent employees who worked for part of the year but may not annualize compensation for temporary or seasonal employees and may not apply full-time equivalent adjustments for part-time employees. Employees of the issuer and its consolidated subsidiaries are taken into account. Independent contractors and leased workers who are compensated by third parties are excluded.

An issuer is required to identify its median employee only once every three years as long as there has

been no change in its employee population or employee compensation arrangements that it reasonably believes would result in a significant change to its pay ratio disclosure. An issuer may choose any date within the last three months of the fiscal year to identify the median employee.

A non-U.S. employee may potentially be excluded from consideration under two exemptions. The first covers employees in foreign jurisdictions in which the laws or regulations governing data privacy are such that, despite its reasonable efforts to obtain or process the information necessary for compliance, the issuer is unable to do so without violating such data privacy laws or regulations. To take advantage of this exemption, the issuer must, at a minimum, use or seek an exemption or other relief under any governing data privacy laws or regulations. If an issuer excludes any employees using this exemption, it must make detailed disclosures about the applicable data privacy laws and the issuer's efforts to secure relief from those laws and must obtain and file as an exhibit a legal opinion from counsel as to the issuer's inability to obtain and process information regarding the excluded employees without violating data privacy laws. The second exemption is a *de minimis* exemption for non-U.S. employees accounting for five percent or less of the issuer's total employees. Under the *de minimis* exemption, if the issuer excludes any non-U.S. employees, it must exclude all non-U.S. employees, provided that if the issuer's non-U.S. employees exceed five percent of the issuer's total employees, the issuer may exclude up to five percent of its total employees who are non-U.S. employees as long as - if any non-U.S. employees in a particular jurisdiction are excluded - all employees in that jurisdiction are excluded. If more than five percent of an issuer's employees are located in any one non-U.S. jurisdiction, the issuer may not exclude any employees in that jurisdiction under the *de minimis* exemption. Employees excluded under the data privacy exemption count against availability under the *de minimis* exemption.

An issuer may omit from its employee base anyone who became an employees in a business combination transaction for the year in which the transaction became effective. An issuer relying on this exception must identify the acquired business and disclose the approximate number of employees being excluded.

### **Determination of Annual Total Compensation**

Annual total compensation for the median employee must be calculated using the same rules that apply to the determination of total compensation for the PEO. Issuers must briefly describe any material assumptions, adjustments, or estimates used to determine annual total compensation. Issuers also must disclose and describe the reasons for significant changes in any methodology, significant assumption, adjustment, or estimate from the prior year. Issuers may use reasonable estimates and may use annual total compensation or any other compensation measure that is consistently applied to identify the median.

### **Compliance Dates**

Companies will be required to comply with the pay ratio disclosure requirements for their first full fiscal year beginning on, or after, January 1, 2017.

Accordingly, a calendar year-end company will first be required to include pay ratio disclosures in its Form 10-K or proxy statement filed in 2018. An IPO issuer or an issuer that ceases to be exempt from the pay ratio rules (for example, because it ceases to be an emerging growth company or a smaller reporting company) must comply with the pay ratio disclosure rules for the first fiscal year following the year in which it becomes subject to the rules and may omit pay ratio disclosures from any filing prior to its Form 10-K for such following fiscal year or, if later, its annual meeting proxy statement for the succeeding year, as long as the required disclosures are made not later than 120 days after the end of such following fiscal year.

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