

August 7, 2015

## Final Pay Ratio Rule

On August 5, 2015, the SEC voted 3 to 2 to adopt a final pay ratio rule. The final rule retains the flexibility provided for in the proposed pay ratio rule in terms of identification of a registrant's median employee, but differs in a number of important respects from the proposed rule, as described below.

A covered registrant will be required to include pay ratio disclosure with respect to its first fiscal year commencing on or after January 1, 2017. For most registrants, this will mean that pay ratio disclosure will be included in their 2018 proxy statements (*i.e.*, the proxy statement relating to the 2017 fiscal year).

### What disclosure does the rule require?

The final rule requires disclosure of the median of the annual total compensation of all employees of the registrant (except the CEO), the annual total compensation of the CEO and the ratio of the median to the CEO's annual total compensation. The ratio must be presented so that the median equals one (*e.g.*, 100 to 1), or expressed narratively by stating the CEO's compensation as a multiple of the median (*e.g.*, 100 times that of the median employee).

Like the proposed rule, a registrant will first need to identify its employees (as defined in the rule and described below), then identify the median employee, and then determine the annual total compensation of that median employee under Item 402 of Regulation S-K (with certain estimates permitted). If a registrant had more than one CEO in its most recent fiscal year, it can either combine the total compensation of each CEO, as reported in the summary compensation table, or use the annualized compensation of the CEO who is serving in that position on the date that it selects to identify its employees for purposes of determining pay ratio disclosure (described below).

### Are all registrants covered?

The final rule, like the proposed rule, exempts emerging growth companies, smaller reporting companies and foreign private issuers. Companies will not be required to provide pay ratio disclosure in registration statements on Form S-1 or Form S-11 for an initial public offering or a registration statement on Form 10. A new registrant will be required to first comply with the pay ratio disclosure rules with respect to compensation for the first fiscal year commencing after the year in which it becomes subject to the requirements of Section 13(a) or Section 15(d) of the Exchange Act, but no earlier than the year commencing January 1, 2017. A registrant that ceases to be a smaller reporting company or an emerging growth company will not be required to provide pay ratio disclosure until after the first full fiscal year after exiting such status and not for any fiscal year commencing before January 1, 2017.

### When must a registrant include pay ratio disclosure?

A registrant must include pay ratio disclosure in registration statements, proxy and information statements and annual reports that require Item 402 executive compensation disclosure. Generally, this means a registrant will include pay ratio disclosure in its annual proxy statement (or in an amendment to its Form 10-K if a registrant does not file a proxy statement or does not file it within 120 days of the end of its fiscal year), or, if a registrant does not file a proxy statement (for example, in the case of a voluntary filer), in its Form 10-K.

### What are some of the key changes from the proposed rule?

#### *Definition of Employee*

Like the proposed rule, "employee" is defined to include any full-time, part-time, seasonal or temporary employee of a registrant, including any non-US employees. Only employees (as defined) employed by the registrant and its

consolidated subsidiaries need to be included in determining the median employee. Independent contractors and leased employees are generally excluded from the definition of “employee”.

The proposed rule defines “employee” as any individual employed as of the last date of a registrant’s fiscal year. Under the final rule, a registrant can choose a date within the three-month period preceding the last day of its fiscal year to identify its employees. Registrants will need to disclose the date chosen and also to disclose any changes to the identification date and the reasons for changing it.

A registrant may omit those employees who become employed as a result of a business combination or acquisition for the fiscal year in which the transaction becomes effective and, if it does so, it must disclose the approximate number of employees it is omitting.

#### *Non-US Employees*

As noted above, non-US employees are included in the definition of employee. The final rule provides two important exemptions regarding non-US employees. Registrants may exclude from their determination of the median employee an employee who is employed in a non-US jurisdiction in which the laws or regulations governing data privacy prohibit the registrant from obtaining the information necessary for compliance with the final rule. In order to take advantage of this exemption, among other requirements, the registrant must obtain a legal opinion from counsel regarding the inability to obtain or process the required information. If any employee is excluded under the data privacy exemption, all employees in the relevant jurisdiction must be excluded. The final rule also includes a *de minimis* exemption for non-US employees that permits a registrant to exclude non-US employees from its pay ratio calculations if these employees account for 5% or less of its total employees (or, if a registrant’s non-US employee population is in excess of 5%, it can exclude up to 5%). If a registrant chooses to exclude any non-US employees in a particular foreign jurisdiction under this exemption, it must exclude all employees in that jurisdiction and provide certain additional required disclosure. If excluding all such employees would result in exceeding the 5% threshold, then no such employee can be excluded under this exemption. Any employee excluded under the data privacy exemption counts toward the 5% *de minimis* limit.

#### *Identification of Median Employee*

Although the pay ratio disclosure must be included each year, a registrant may identify the median employee once every three years unless there has been a change in its employee population or compensation arrangements that the registrant reasonably believes would significantly change the pay ratio disclosure. If the median employee changes his or her position or is no longer employed by a registrant during that three-year period, the registrant may select another employee with substantially similar compensation to the original median employee to serve as the median employee.

The final rule also permits registrants to make cost-of-living adjustments to the compensation of employees in jurisdictions other than where the registrant’s CEO resides to identify the median employee. If a registrant applies a cost-of-living adjustment, the compensation of these employees will have to be adjusted to the cost of living in the jurisdiction in which the CEO resides. In addition, the registrant must briefly describe such adjustment, including the measure used as the basis for the cost-of-living adjustment. It must also disclose the country in which the median employee is located and the median employee’s annual total compensation and the pay ratio calculated without applying the cost-of-living adjustment.

The final rule provides a registrant flexibility to select a methodology for identifying the median employee based on the registrant’s particular facts and circumstances. The registrant is permitted to use the total employee population or a statistical sample of that population or other reasonable methods, and, in determining annual total compensation, may use consistently applied measures, such as information derived from tax and/or payroll records or existing executive compensation rules. The registrant is permitted to annualize the compensation of a permanent (full- or part-time) employee who worked for part of the registrant’s fiscal year, but a temporary or seasonal employee’s compensation cannot be annualized.

### What narrative disclosure must accompany the pay ratio disclosure?

A registrant will be required to summarize the methodology used to identify the median employee, and any material assumptions, adjustments or estimates used to identify the median employee or used to calculate the annual total compensation. A registrant that uses a compensation measure other than annual total compensation to identify the median employee will be required to disclose the measure that was used. Any estimates used by a registrant must be clearly identified.

The final rule permits, but does not require, a registrant to present additional ratios or additional information regarding the required pay ratio. Any additional ratio must be clearly identified, may not be misleading and may not be more prominent than the required pay ratio.

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