

August 7, 2015

SEC Adopts CEO Pay Ratio Rule

New Rule Will Not Be Effective Until 2018 Proxy Season

SUMMARY

On Wednesday, the SEC published the text of its final rule, adopted that morning by a three-to-two vote, that U.S. public companies disclose:

- the median of the annual total compensation of all employees of the issuer, except the issuer's CEO;
- the annual total compensation of the issuer's CEO; and
- the ratio of those two amounts.

Disclosure will be required with respect to the first fiscal year beginning on or after January 1, 2017; accordingly, the rule will not be effective until the 2018 proxy season. The requirement will not apply to emerging growth companies, smaller reporting companies, foreign private issuers, filers under the U.S.-Canadian Multijurisdictional Disclosure System and registered investment companies.

Notable highlights of the final rule include:

- Median employees are now required to be identified only once every three years unless there has been a change in the issuer's employee population or employee compensation that it reasonably believes would result in a significant change to the pay ratio.
- Full-time, part-time, temporary, seasonal, U.S. and non-U.S. employees continue to be included, but issuers may now exclude up to 5% of non-U.S. employees (or more to the extent necessary to comply with foreign data privacy laws).
- Cost-of-living adjustments are now permitted in determining the compensation of employees but the issuer must simultaneously disclose the pay ratio without any cost-of-living adjustments applied.
- An issuer may continue to select a methodology for identifying the median employee that is appropriate to its size, structure and compensation practices, including statistical sampling or consistently applied compensation measures (such as payroll or tax measures).

SULLIVAN & CROMWELL LLP

- An issuer will be required to calculate the total annual compensation of its median employee using the same rules that apply to the CEO's compensation, although reasonable estimates are permitted for calculating the compensation of the median employee.
- Pay ratio disclosure must be included in SEC filings that would otherwise include executive compensation information required by Item 402(c)(2)(x) of Regulation S-K. The disclosure must identify the methodology used to determine the median employee and any material assumptions, adjustments or estimates used to identify the median employee or to determine total compensation.

BACKGROUND

Section 953(b) of the Dodd-Frank Wall Street Reform and Consumer Protection Act directs the SEC to amend Item 402 of Regulation S-K to require disclosure of (1) the median of the annual total compensation of all employees of the issuer, except the issuer's CEO (or any equivalent position of the issuer); (2) the annual total compensation of the issuer's CEO (or any equivalent position of the issuer); and (3) the ratio of those amounts. Total compensation is to be determined in accordance with Item 402(c)(2)(x) of Regulation S-K as in effect on July 20, 2010, which captures all compensation disclosed in the summary compensation table, including salary, bonuses, stock and option grants, non-equity incentive plan compensation, change in pension value, nonqualified deferred compensation earnings and certain other compensation, including perquisites. The SEC published its proposed rule under Section 953(b) on September 18, 2013 and adopted the final rule on August 5, 2015.¹

FINAL RULE

SEC Chairman Mary Jo White and Commissioners Luis A. Aguilar and Kara M. Stein voted in favor of the final rule, and Commissioners Daniel M. Gallagher and Michael S. Piwowar voted against. The SEC published the text of the final rule on August 5, 2015, the same day that it was approved. The rule adds Item 402(u) to Regulation S-K.

TIMING AND COVERAGE

Timing. Issuers will be required to report the pay ratio disclosure for their first fiscal year beginning on or after January 1, 2017. This is a delay relative to the proposed rule, which would have required disclosure beginning for the first fiscal year beginning on or after the effective date of the final rule. Pay ratio disclosure will not need to be updated following the completion of a fiscal year until the issuer files its annual report for that fiscal year or, if within 120 days following the end of the fiscal year, its definitive proxy or information statement relating to its next annual meeting of shareholders.

Exempt Companies. The disclosure requirement applies to all companies required to provide executive compensation disclosure under Item 402(c)(2)(x) of Regulation S-K. Emerging growth companies,

¹ See Pay Ratio Disclosure, Rel. Nos. 33-9877; 34-75610 (August 6, 2015), available at <https://www.sec.gov/rules/final/2015/33-9877.pdf>.

SULLIVAN & CROMWELL LLP

smaller reporting companies, foreign private issuers, filers under the U.S.-Canadian Multijurisdictional Disclosure System and registered investment companies are not subject to the requirement.

Transition Periods. An issuer that becomes subject to the requirements of Section 13(a) or 15(d) of the Exchange Act, and an issuer that ceases to be a smaller reporting company or emerging growth company, will be required to comply with the pay ratio disclosure rules with respect to compensation for the first fiscal year following the year in which it became subject to such requirements or exited such status (but not for any fiscal year commencing prior to January 1, 2017). Pay ratio disclosure is not required to be disclosed in a registration statement on Form S-1 or Form S-11 for an initial public offering or an initial registration statement on Form 10.

Location of Disclosure. Pay ratio disclosure must be included in any registration statements, proxy and information statements and annual reports that already must include executive compensation information as set forth under Item 402(c)(2)(x) of Regulation S-K. For most issuers, this means the disclosure will appear in the annual proxy statement, and will be incorporated by reference into the Form 10-K and registration statements under the Securities Act.²

IDENTIFYING THE MEDIAN EMPLOYEE

Covered Employees. In determining the median employee, issuers generally will be required to include all full-time, part-time, temporary, seasonal, U.S. and non-U.S. employees employed by the issuer or any of its consolidated subsidiaries. Workers who provide services to the issuer as independent contractors and “leased” workers are excluded as long as they are employed, and their compensation is determined, by an unaffiliated third party. In addition, an issuer may omit any employees that became its employees in a business combination or acquisition for the fiscal year in which the transaction becomes effective but must identify the acquired business and disclose the approximate number of employees it is omitting.

Non-U.S. Employees. In a change from the proposed rule, the final rule permits issuers, when determining the median employee, to exclude non-U.S. employees pursuant to two exemptions:

- **Foreign Data Privacy Law Exemption.** Issuers may exclude non-U.S. employees that are employed in a jurisdiction with data privacy laws that make the issuer unable to comply with the rule without violating those laws. An issuer must use reasonable efforts to use or seek an exemption or other relief under the foreign data privacy laws before it may rely on this exemption. If an issuer excludes any non-U.S. employees in a particular jurisdiction under the data privacy exemption, it must exclude all non-U.S. employees in that jurisdiction. Any

² General Instruction G(3) of Form 10-K allows the information required by Part III of Form 10-K (including information required under Item 402 of Regulation S-K) to be incorporated by reference from the issuer’s definitive proxy statement filed pursuant to Regulation 14A or a definitive information statement filed pursuant to Regulation 14C if that statement involves the election of directors and is filed no later than 120 days after the end of the fiscal year. If the issuer does not file its proxy statement within 120 days of the end of the fiscal year, it would need to include the pay ratio in its Form 10-K or an amendment thereto.

issuer that excludes non-U.S. employees due to data privacy laws must obtain a legal opinion from counsel that opines on the inability to comply with the rule without violating those laws, including the inability to obtain an exemption or other relief from the data privacy laws. The legal opinion must be filed as an exhibit to the filing in which the pay ratio disclosure is included.

- ***De Minimis Exemption.*** Issuers may exclude up to five percent of the issuer's non-U.S. employees, including any non-U.S. employees excluded using the data privacy exemption. If an issuer whose non-U.S. employees represent five percent or less of its total employee population excludes any non-U.S. employees under this exemption, it must exclude all non-U.S. employees. An issuer whose non-U.S. employees represent more than five percent of its total employee population may exclude non-U.S. employees up to the five percent threshold, but it must exclude all employees in any jurisdiction affected. If more than five percent of an issuer's employees are located in any one jurisdiction, the issuer may not exclude any employees in that jurisdiction under this exemption. If the number of employees excluded under the data privacy law exemption equals or exceeds five percent of the issuer's total employees, the issuer may not use the de minimis exemption.

An issuer that excludes non-U.S. employees from its determination of the median employee must disclose the excluded jurisdictions, the approximate number of employees exempted from each jurisdiction, the total number of its U.S. and non-U.S. employees (irrespective of such exemptions) and, if relying on the de minimis exemption, the total number of its U.S. and non-U.S. employees used for the pay ratio calculation. Additionally, issuers relying on the foreign privacy law exemption must identify the specific data privacy law at issue and how compliance with the rules violates such law (including the efforts made to seek relief).

Methodology for Selecting Employee Population. The final rule does not specify any required methodology for issuers to use in identifying the median employee and allows issuers to select a methodology based on their own facts and circumstances. In determining the employees from which the median is identified, an issuer may use its total employee population or a statistical sampling of that population and/or other reasonable methods. The final rule does not set forth specific parameters for statistical sampling methods. The adopting release for the final rule states that the issuer must determine what sampling methods are appropriate based on its facts and circumstances; provided that all statistical sampling approaches should draw observations from each business or geographical unit with a reasonable assumption on each unit's compensation distribution, and infer the issuer's overall median based on those observations.

Methodology for Identifying Median Employee. An issuer may identify the median of its population or sample using annual total compensation as determined under existing executive compensation rules or any other consistently applied compensation measure, including from compensation amounts reported in its payroll or tax records. The annual total compensation or other compensation measure may be determined based on reasonable estimates, and may be defined differently across jurisdictions, as long as the measure is consistently applied within each jurisdiction.

SULLIVAN & CROMWELL LLP

- **Annualizing Adjustments Permitted for Permanent Employees.** Issuers may annualize the total compensation for permanent employees (full-time and part-time) who did not work for the entire year, such as new hires, employees called for active military leave and employees on a leave of absence. Full-time equivalent adjustments for part-time workers and annualizing adjustments for temporary and seasonal workers are not permitted.
- **Cost-of-Living Adjustments Permitted.** Cost-of-living adjustments are permitted in determining the compensation of employees in jurisdictions other than the jurisdiction where the CEO resides. However, an issuer that takes advantage of this methodology also must separately identify the median employee without using any cost-of-living adjustment and disclose the resulting pay ratio. If the compensation used to identify the median employee is adjusted for cost of living, the adjustment must be consistently applied to all employees and, if the median employee is in a jurisdiction other than the jurisdiction where the CEO resides, then the compensation used for purposes of the ratio also must be adjusted for cost of living.

Identification Date. An issuer may select a date within the last three months of its last completed fiscal year on which to determine the employee population for purposes of identifying the median employee. This is a change from the proposed rule, which would have required the issuer to make such a determination on the last day of its fiscal year. An issuer will be required to disclose the date used. If an issuer changes the date it uses to identify the median employee from the prior fiscal year, the change and a brief explanation about the reason for the change also must be disclosed.

Frequency. An issuer only needs to identify its median employee once every three years, unless there has been a change in its employee population or employee compensation arrangements that it reasonably believes would result in a significant change to its pay ratio disclosure. Within those three years, if the median employee's circumstances change and the issuer reasonably believes the change would result in a significant change in the pay ratio disclosure, then the issuer may use another employee with substantially similar compensation to the original median employee. Under the proposed rule, issuers would have been required to undertake the full process of identifying the median employee for each completed fiscal year.

TOTAL COMPENSATION CALCULATION

Issuers will be required to calculate the total annual compensation for their median employees using the same rules in Item 402(c)(2)(x) of Regulation S-K that apply to calculating the CEO's compensation and may use reasonable estimates when calculating any elements of compensation.

In accordance with existing compensation disclosure rules, "total compensation" may, but is not required to, exclude the value of personal benefits, if the total value is less than \$10,000, and compensation under non-discriminatory benefit plans.³ The calculation of total compensation for the CEO must be consistent, however, with the calculation used for the median employee. Additionally, the issuer must explain any

³ Issuers will also be permitted to exclude accrued pension benefits provided to a non-U.S. employee by a government under a government-mandated pension plan.

SULLIVAN & CROMWELL LLP

differences between the CEO total compensation used for the pay ratio disclosure and the total compensation reflected in the summary compensation table, if material.

MULTIPLE CEOS

If an issuer has more than one CEO in a fiscal year, the issuer must calculate the total compensation of the CEO for purposes of the ratio in one of two ways. The issuer may use the aggregate compensation paid to all CEOs for the year for the period in which each served as CEO, or may annualize the compensation paid to the CEO who was serving in that position on the date used to identify the median employee. The issuer must disclose the method used and how the CEO's compensation was calculated.

PAY RATIO PRESENTATION

The final rule allows issuers to present the pay ratio either as a numerical ratio, where the median employee's compensation is 1 ("X to 1" or "X:1"), or as a multiple in narrative form ("CEO pay is X times the median employee pay"). The pay ratio may not be expressed as a percentage.

DISCLOSURE OF METHODOLOGY, ASSUMPTIONS AND ESTIMATES

Issuers will be required to briefly describe the methodology used to identify the median employee, and any material assumptions, adjustments (including cost-of-living adjustments) or estimates used to identify the median employee or to determine annual total compensation or the elements of total compensation. The adopting release for the final rule states that the level of disclosure must be sufficient for a reader to evaluate the appropriateness of methodologies used, but need not include technical analyses, formulas, confidence levels or the steps used in data analyses.

If an issuer identifies a median employee based on a consistently applied compensation measure, it will be required to disclose the measure used. Additionally, if the issuer changes the methodology or material assumptions, adjustments or estimates from those used in the prior fiscal year, and if the effects of such change are significant, then the issuer must briefly describe the change and reasons for the change. This disclosure must include any change to using, or not using, a cost-of-living adjustment.

Issuers will be permitted, but not required, to supplement the required disclosure with a narrative discussion or additional ratios so long as the supplemental disclosure is clearly identified, not misleading and not presented with greater prominence than the required pay ratio. General information regarding the median employee may be disclosed to put the employee's compensation in context, but issuers are not permitted to disclose any personally identifiable information about that employee.

OTHER MATTERS

The final rule permits issuers to omit pay ratio disclosure until the salary or bonus of their CEO's total compensation is determined in cases in which the salary or bonus of the CEO is not calculable until a later date.⁴ This requirement is reflected in a conforming amendment to Item 5.02(f) of Form 8-K.

The final rule also states that the pay ratio disclosure will be deemed "filed" and not "furnished." Accordingly, an issuer would be subject to liability under Section 18 of the Exchange Act for false or misleading disclosure unless it can establish that it acted in good faith and had no knowledge that the disclosure was false or misleading.

* * *

Copyright © Sullivan & Cromwell LLP 2015

⁴ Instruction 1 to Items 402(c)(2)(iii) and (iv) provide that if the amount of salary or bonus earned in a given fiscal year is not calculable through the latest practicable date, a footnote must be included to the Summary Compensation Table disclosing that the amount is not calculable and providing the date that the amount is expected to be determined. Such amount must then be disclosed in a filing under Item 5.02(f) of Form 8-K.

SULLIVAN & CROMWELL LLP

ABOUT SULLIVAN & CROMWELL LLP

Sullivan & Cromwell LLP is a global law firm that advises on major domestic and cross-border M&A, finance, corporate and real estate transactions, significant litigation and corporate investigations, and complex restructuring, regulatory, tax and estate planning matters. Founded in 1879, Sullivan & Cromwell LLP has more than 800 lawyers on four continents, with four offices in the United States, including its headquarters in New York, three offices in Europe, two in Australia and three in Asia.

CONTACTING SULLIVAN & CROMWELL LLP

This publication is provided by Sullivan & Cromwell LLP as a service to clients and colleagues. The information contained in this publication should not be construed as legal advice. Questions regarding the matters discussed in this publication may be directed to any of our lawyers listed below, or to any other Sullivan & Cromwell LLP lawyer with whom you have consulted in the past on similar matters. If you have not received this publication directly from us, you may obtain a copy of any past or future related publications from Stefanie S. Trilling (+1-212-558-4752; trillings@sullcrom.com) in our New York office.

CONTACTS

New York

Robert E. Buckholz	+1-212-558-3876	buckholzr@sullcrom.com
Catherine M. Clarkin	+1-212-558-4175	clarkinc@sullcrom.com
Jay Clayton	+1-212-558-3445	claytonwj@sullcrom.com
H. Rodgin Cohen	+1-212-558-3534	cohenhr@sullcrom.com
Audra D. Cohen	+1-212-558-3275	cohenad@sullcrom.com
Heather L. Coleman	+1-212-558-4600	colemanh@sullcrom.com
Donald R. Crawshaw	+1-212-558-4016	crawshawd@sullcrom.com
Robert W. Downes	+1-212-558-4312	downesr@sullcrom.com
William G. Farrar	+1-212-558-4940	farrarw@sullcrom.com
Matthew M. Friestedt	+1-212-558-3370	friestedtm@sullcrom.com
Joseph B. Frumkin	+1-212-558-4101	frumkinj@sullcrom.com
David B. Harms	+1-212-558-3882	harmsd@sullcrom.com
Alexandra D. Korry	+1-212-558-4370	korrya@sullcrom.com
Stephen M. Kotran	+1-212-558-4963	kotrans@sullcrom.com
John P. Mead	+1-212-558-3764	meadj@sullcrom.com
Scott D. Miller	+1-212-558-3109	millersc@sullcrom.com
James C. Morphy	+1-212-558-3988	morphyi@sullcrom.com
Robert W. Reeder III	+1-212-558-3755	reederr@sullcrom.com
Glen T. Schleyer	+1-212-558-7284	schleyerg@sullcrom.com
Marc Trevino	+1-212-558-4239	trevinom@sullcrom.com

SULLIVAN & CROMWELL LLP

Washington, D.C.

Janet T. Geldzahler	+1-202-956-7515	geldzahlerj@sullcrom.com
Eric J. Kadel Jr.	+1-202-956-7640	kadelej@sullcrom.com
Robert S. Risoleo	+1-202-956-7510	risoleor@sullcrom.com

Los Angeles

Patrick S. Brown	+1-310-712-6603	brownp@sullcrom.com
Eric M. Krautheimer	+1-310-712-6678	krautheimere@sullcrom.com
Alison S. Ressler	+1-310-712-6630	resslera@sullcrom.com

Palo Alto

Sarah P. Payne	+1-650-461-5669	paynesa@sullcrom.com
John L. Savva	+1-650-461-5610	savvaj@sullcrom.com

London

Nikolaos G. Andronikos	+44-20-7959-8470	andronikosn@sullcrom.com
Kathryn A. Campbell	+44-20-7959-8580	campbellk@sullcrom.com
Richard C. Morrissey	+44-20-7959-8520	morriseyr@sullcrom.com
John O'Connor	+44-20-7959-8515	occonnorj@sullcrom.com
David Rockwell	+44-20-7959-8575	rockwelld@sullcrom.com
George H. White III	+44-20-7959-8570	whiteg@sullcrom.com

Paris

William D. Torchiana	+33-1-7304-5890	torchianaw@sullcrom.com
----------------------	-----------------	--

Frankfurt

Krystian Czerniecki	+49-69-4272-5525	czernieckik@sullcrom.com
David Rockwell	+44-20-7959-8575	rockwelld@sullcrom.com

Melbourne

Robert Chu	+61-3-9635-1506	chur@sullcrom.com
------------	-----------------	--

Sydney

Waldo D. Jones Jr.	+61-2-8227-6702	jonesw@sullcrom.com
--------------------	-----------------	--

Tokyo

Izumi Akai	+81-3-3213-6145	akaii@sullcrom.com
Keiji Hatano	+81-3-3213-6171	hatanok@sullcrom.com

Hong Kong

William Y. Chua	+852-2826-8632	chuaw@sullcrom.com
Michael G. DeSombre	+852-2826-8696	desombrem@sullcrom.com
Chun Wei	+852-2826-8666	weic@sullcrom.com
John D. Young Jr.	+852-2826-8668	youngj@sullcrom.com

Beijing

Garth W. Bray	+86-10-5923-5958	brayg@sullcrom.com
---------------	------------------	--
