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SEC Has Adopted Final Pay Ratio Disclosure Rules

The following is written by Laura Anthony, Esq., a going public attorney focused on OTC listing requirements, direct public offerings, going public transactions, reverse mergers, Form 10 and Form S-1 registration statements, SEC compliance and OTC Market reporting requirements.

On August 5, 2015, the SEC published and adopted final pay ratio disclosure rules. The final rules are substantially the same as the proposed rules which were published in September 2013. The rules will require inclusion of the new disclosures in proxy materials, registration statements and annual reports beginning in the fiscal year starting on or after January 1, 2017.

The proposed new rules implement Section 953(b) of the Dodd-Frank Wall Street Reform and Consumer Protection Act ("Dodd-Frank") by amending Item 402 of Regulation S-K. The recently proposed "pay vs. performance" rules, which I discussed in my blog HERE would also amend Item 402. As an Item 402 disclosure, the new pay ratio disclosure will also be the subject of the "say on pay" advisory vote. My blog on say on pay for smaller reporting companies can be read Here.

Interestingly, in the final published rules, the SEC makes a point of stating that Congress did not state the specific objectives or intended benefits of Section 953(b) and the legislative history for the rule also does not disclose the Congressional purpose. Accordingly, the SEC made its own analysis and decided that the purpose must be to provide shareholders with a company-specific metric to assist in the evaluation of that company's executive compensation practices. In that regard, the new pay ratio disclosure requirements are also meant to complement and provide additional information that will be helpful in exercising shareholder say on pay advisory votes. The disclosure information is not designed to, and is not expected to, facilitate a comparison from one company to another.

A reading of the final rule release makes it abundantly clear that the SEC is not convinced that the information is in fact useful, but that Congress mandated implementation of the rules and so the SEC followed its mandate.

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Companies Subject to the Pay Ratio Disclosure Rule

The pay ratio rules do not apply to emerging growth companies, smaller reporting companies, foreign private issuers, U.S-Canadian Multijurisdictional Disclosure System filers, and registered investment companies. All other reporting companies are subject to the new rules.

Reports Requiring the Pay Ratio Disclosure

The disclosure must be made in any annual report, registration statement or proxy or information statement in which Item 402 disclosure is included. The pay ratio disclosure is not required in a report that does not otherwise require Item 402 disclosure, such as Form 8-K or quarterly 10-Q. The pay ratio disclosure must be placed in the report in the same section with other executive compensation disclosures.

Basic Disclosure Requirement and Determination of Median Employee

The pay ratio rules require companies to disclose (i) the annual total compensation of the employee identified as having received the median compensation based on all employees of the company and the total compensation for all employees excluding the chief executive officer (CEO); (ii) the total annual compensation of the CEO as determined by Item 402 of Regulation S-K; and (iii) the ratio of that median of the total compensation of the median employee to the annual total compensation of the CEO.

The pay ratio itself must be reported as either (i) a ratio in which the annual total compensation of the median employee is equal to one (for example "100 to 1"); or (ii) a narrative of the multiple of the CEO's compensation to the median employees compensation (for example "the CEO's compensation is 50 times that of the median of the annual total compensation of all employees").

Determining Median Employee and Disclosure of Such Determination

The SEC recognizes that calculating the median of the annual total compensation to all employees could be difficult and expensive. Generally speaking, a "median employee" is an employee that is at the 50th percentile or the "middle employee," with half the employees having a higher compensation and the other half having a lower compensation. An "employee" is any full-time, part-time, seasonal, or temporary worker employed by the company and any of its consolidated subsidiaries employed by the company as of the last day of the most recent completed fiscal year. Employees include all salaried and non-salaried employees throughout the world. Independent contractors are generally not considered employees.

Companies are permitted to select a methodology for identifying the median employee that is appropriate to the size and structure of their business and their particular payroll system. A company is permitted to identify the median employee by (i) analyzing their full employee population; (ii) using a statistical sampling and a consistent compensation measure to identify the median employee and reasonable estimates to calculate the total compensation; or (iii) any reasonable method.

A company must describe the methodology used, any material assumptions, adjustments or estimates, the compensation measure used (for example, tax or payroll records), and the date used to determine the median employee. A company may make cost-of-living adjustments for the compensation of employees other than in the jurisdiction where the CEO resides.

Determining Compensation of the Median Employee

Once the median employee is identified, the company must calculate the median employee's compensation in accordance with Item 402 of Regulation S-K as if it were including such information in its summary compensation table. A company may use reasonable estimates, assumptions and adjustments in its calculation, but any such estimates, assumptions and adjustments must be identified and disclosed. Note that the CEO's compensation is also determined in accordance with Item 402 and the ratio should be based on the Item 402 reported CEO total compensation.

Frequency of Determination of Median Employee

A company only has to make the median employee determination once every three years and can choose any date within the fourth quarter of the company's fiscal year to make such median employee determination. A company need not disclose the reason for using a particular date, but in the event the date changes from one year to another, such change and reason for the change must be disclosed.

In the event of a material change in the employee population or compensation arrangements, either a new determination must be made, or an explanation provided as to why the old calculation is still reliable.

Treatment of New Hires, Temporary or Seasonal Workers

For full-time workers that do not work the full year, a company may annualize such employees' compensation as long as it does so consistently for all permanent full-time employees that have not worked a full year. Companies may not annualize seasonal, temporary or part-time employees' compensation.

Exclusion of Non-U.S. Employees

Moreover, the rules provide for a de minimis (up to 5%) exemption for non-U.S. employees and an exemption for companies that, despite best efforts, cannot obtain the information without violating a foreign company's laws or regulations governing data privacy. In the event that a company is relying on this exemption, they must obtain a legal opinion supporting their conclusion.

Additional and Supplemental Disclosure

The SEC recognizes that based on the facts and circumstances of a company's workforce and corporate operations, additional information may be necessary to ensure that the pay ratio disclosure is a meaningful data point, especially for investors when making their "say on pay" votes. The reporting company may, but is not required to, provide additional and supplemental disclosure to the extent that such additional disclosure is useful to an understanding of the pay ratio discussion. As with any information, the additional information cannot be misleading or detract from the basic disclosure elements required by the new rules.

Transition Period

The rule allows for a transition period for new registrants and registrants engaging in business combinations or acquisition. A new registrant must comply with the pay ratio disclosure following its first full fiscal year beginning after the issuer has: (i) been subject to reporting requirements of the Exchange Act for at least 12 months beginning on or after January 1, 2017; and (ii) filed at least one annual report that does not contain the pay ratio disclosure.

Moreover, the rules provide for a transition period for companies that cease being emerging growth companies or smaller reporting companies and, as such, become subject to the new disclosure requirements. In particular, such companies do not need to include the disclosure until completion of the first full fiscal year after they exit that status.

Conclusion

Implementation of the new rules will be difficult and expensive for companies. During the time period beginning now and through the first required disclosure, companies should prepare by determining the best methodologies for calculations and putting procedures and processes into place for compliance.

Practitioners will need to pay careful attention to the new Item 402 rules as they are implemented by the SEC, as the requirements and disclosures are not consistently applied. In particular, the pay ratio rules require disclosure in all annual reports, registration statements and proxy materials where Item 402 disclosure is required, whereas the pay vs. performance rules only require disclosure in proxy materials and not in regular Exchange Act reports such as Forms 10-K or 10-Q. In addition, the pay ratio rules do not apply to emerging growth companies, smaller reporting companies or foreign private issuers, whereas the pay vs. performance rules also do not apply to emerging growth companies or foreign private issuers but do apply to smaller reporting companies but have scaled back disclosure requirements for those smaller reporting companies.

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Securities Law Blog is written by Laura Anthony, Esq., a going public lawyer focused on OTC Listing Requirements, Direct Public Offerings, Going Public Transactions, Reverse Mergers, Form 10 Registration Statements, and Form S-1 Registration Statements. Securities Law Blog covers topics ranging from SEC Compliance, FINRA Compliance, DTC Chills, Going Public on the OTC, and OTCQX and OTCQB Reporting Requirements. Ms. Anthony is also the host of LawCast.com, the securities law network.

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