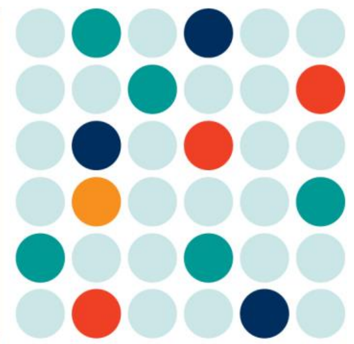
LEGAL UPDATE

August 2015 By: Michael T. Campoli



FINAL PAY RATIO DISCLOSURE RULES FOR PUBLIC COMPANIES ADOPTED BY THE SEC

On August 5, 2015, the U.S. Securities and Exchange Commission (the "SEC") adopted final amendments to Item 402 of Regulation S-K to require disclosure by certain U.S. public companies of: (i) the median of the annual total compensation of all employees of the applicable company (excluding the principal executive officer ("PEO")[1]), (ii) the annual total compensation of that company's PEO, and (iii) the ratio of the median of the annual total compensation of all employees to the annual total compensation of the PEO. The new rules were mandated by Section 953(b) of the Dodd-Frank Wall Street Reform and Consumer Protection Act of 2010.

COVERED ISSUERS

Only those public companies required to include summary compensation table disclosures in their public filings pursuant to Item 402(c) of Regulation S-K will be subject to the pay ratio disclosure rules. Thus, emerging growth companies, smaller reporting companies, foreign private issuers and registered investment companies will not have to disclose their pay ratios.[2] The pay ratio disclosure will be considered "filed", rather than "furnished", for purposes of the Securities Act of 1933 and the Securities Exchange Act of 1934 and, accordingly, will be subject to potential liabilities thereunder.

COVERED FILINGS

Pay ratio disclosure will be required in filings that mandate executive compensation disclosure under Item 402 of Regulation S-K, including annual reports on Form 10-K, and registration, proxy and information statements to the extent that disclosure under Item 402 is required therein.

COVERED EMPLOYEES

All employees of the applicable public company and its consolidated subsidiaries, as of a date chosen by the company within the last three months of its last completed fiscal year, must be included in the process of identifying median total compensation. This includes full-time, part-time, temporary and seasonal employees, as well as employees outside the United States (with limited exceptions, as described immediately below) and officers other than the PEO. Independent contractors and leased employees are excluded.

Companies will be permitted to exclude non-U.S. employees from the median employee determination in the following two limited circumstances:

- the exclusion of non-U.S. employees that are employed in a jurisdiction with data privacy laws that make the company unable to comply with the rule without violating those laws[3]; and

[1] The final rules use the term "PEO", instead of the term "chief executive officer" as used in Section 943(b) of the Dodd-Frank Act, for consistency with existing Item 402 requirements.

[2] Companies that file with the SEC in accordance with the requirements of the U.S.-Canadian Multijurisdictional Disclosure System also would not be required to provide the pay ratio disclosures.

[3] If a company relies on this exemption, it would be required to obtain a legal opinion from counsel regarding its inability to obtain or process the information necessary to comply with the rule without violating the applicable jurisdiction's data privacy laws or regulations, and file such opinion as an exhibit to the filing in which the pay ratio disclosure is included. Before relying on this exemption, reasonable efforts must first be made to seek an exemption or other relief under the foreign data privacy laws.

- a de minimis exclusion of up to 5% of non-U.S. employees, including any non-U.S. employees excluded using the data privacy exemption

If a company excludes any non-U.S. employee in a particular jurisdiction, it must exclude all non-U.S. employees in that jurisdiction. If more than 5% of a company's issuer's employees are located in any one non-U.S. jurisdiction, such company may not exclude any employees in that jurisdiction under the de minimis exclusion.

Companies may, but will not be required to, annualize the total compensation for permanent employees who did not work for the entire year, such as new hires or employees who took an unpaid leave of absence during the applicable year. However, companies may not annualize the total compensation for temporary or seasonal employees. Full-time equivalent adjustments for part-time employees are also prohibited.

A cost-of-living adjustment may be applied to the compensation measure used to identify the median employee, provided that the applicable company uses the same cost-of-living adjustment in calculating the median employee's annual total compensation. A company that elects to present the pay ratio in this manner must also disclose the median employee's annual total compensation and the pay ratio without the cost-of-living adjustment.

Identifying the "Median" Employee

Recognizing the numerous difficulties involved, the new rules do not prescribe a specific methodology for identifying the median employee in terms of annual total compensation for all employees. Instead, the SEC adopted a flexible approach that gives companies the discretion to utilize several alternative methods that are appropriate to the unique size and structure of their own businesses to identify the median employee in a cost effective manner, so long as each company consistently applies its chosen methodology to all employees included in the calculation.

Among the methods that may be used include: (i) calculating total compensation for each employee using Item 402(c)(2)(x) of Regulation S-K; (ii) using reasonable estimates of total compensation based on more readily identifiable figures, such as compensation amounts reported in payroll or tax records; and/or (iii) using statistical sampling.

Once the median employee is identified, his or her annual total compensation for purposes of the pay ratio disclosure must be calculated in accordance with Item 402(c)(2)(x) of Regulation S-K. However, companies may use reasonable estimates when calculating the annual total compensation and any element of total compensation of the median employee, so long as the estimation methods and any material assumptions or adjustments are disclosed.

Companies would be permitted to identify their median employee once every three years (rather than annually) unless there has been a change in employee population or employee compensation arrangements that the applicable company reasonably believes would result in a significant change to its pay ratio disclosure. Also, within those three years, if the median employee's compensation changes, the company may use another employee with substantially similar compensation as its median employee. In either event, the company would still have to calculate total compensation for the median employee and calculate the pay ratio on an annual basis.

Any employees obtained in a business combination or acquisition may be omitted from the pay ratio calculations for the fiscal year in which the transaction becomes effective. In such situations, the acquired business must be identified and the approximate number of employees being omitted must be disclosed.

Disclosure of Pay Ratio

The pay ratio must be expressed either as a ratio in which the annual total compensation of the median employee is equal to one (e.g., 50-1), or narratively in terms of the multiple that the PEO's total annual compensation bears to the annual total compensation of the median employee.

When Effective

Companies will be required to provide pay ratio disclosure in any public filing that calls for Item 402 disclosures for the first fiscal year commencing on or after January 1, 2017. For companies with a fiscal year ending on December 31, this would generally mean that pay ratio disclosure would first be required in the annual report on Form 10-K for the 2017 fiscal year, or in the proxy statement for

the 2018 annual meeting of stockholders.

Similarly, a new registrant that does not otherwise qualify for an exemption would be required to first comply with the rules for its first fiscal year following the year in which it becomes subject to the SEC's reporting requirements under the Securities Exchange Act of 1934, as amended, but not for any fiscal year commencing before January 1, 2017.

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If you would like to learn more about this topic or how Pryor Cashman LLP can serve your legal needs, please contact Michael T. Campoli at mcampoli@pryorcashman.com, or any Pryor Cashman attorney with whom you are working.

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Counsel Michael Campoli is a member of Pryor Cashman's Corporate and Investment Management Groups. He counsels public and private companies in a wide range of sectors, focusing on middle-market domestic and multinational entities. Mike's broad-based practice includes advising clients on securities law compliance matters, public company reporting and disclosures, M&A, public and private capital raising, entity formation and governance, joint ventures, limited liability companies and partnerships.

Whether advising on financial investments to fuel emerging enterprises or counseling mature companies on vital business opportunities, Mike finds creative solutions that fit real-world objectives. He closely monitors trends in capital formation - especially investments related to the JOBS Act and crowdfunding - in order to provide sound, strategic guidance.