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Executive Compensation

It's Almost 2018—Do You Have a Plan For Your Pay Ratio Disclosure?

BY KERRY HALPERN AND BRYAN K. BROWN

In August 2015, the SEC released final rules relating to the annual disclosure of the ratio of the median employee's annual total compensation to the annual total compensation of the Chief Executive Officer (also known as the "Pay Ratio Disclosure"). These rules implement a section of the Dodd-Frank Wall Street Reform and Consumer Protection Act. Registrants must comply with this rule beginning with the registrant's first fiscal year beginning on or after January 1, 2017. For companies with a fiscal year ending on December 31st, this means that their annual report on Form 10-K for the fiscal year ending December 31, 2017 or the proxy statement for that year's annual meeting will have to include the Pay Ratio Disclosure.

From the time that Dodd-Frank was passed, the Pay Ratio Disclosure rule has been very controversial, and there have been questions as to whether the Pay Ratio Disclosure rule would be revoked or postponed. However, it is now clear that the rule will not be delayed,

and that the Pay Ratio Disclosure will be required, beginning in 2018.

Preparing the Pay Ratio Disclosure is likely to be complicated and time consuming, particularly in the first year that the pay ratio is calculated and disclosure is made. Identifying the median employee, whose annual total compensation is compared to the annual total compensation of the CEO, will mean examining and comparing the compensation of all employees of the registrant, or developing a methodology to take a statistical sample of employees. At this time, companies should be preparing to identify a "median employee" under the Pay Ratio Disclosure rules. This article summarizes the requirements of the Pay Ratio Disclosure rules that relate to the identification of the median employee and the elements of the disclosure itself.

Pay Ratio Disclosure—In General

The Pay Ratio Disclosure is required to be included in any annual report, proxy statement, information statement, or registration statement where executive compensation disclosure is required, starting with the first full fiscal year beginning on or after January 1, 2017. This disclosure will not be required for emerging growth companies, smaller reporting companies, foreign private issuers, MJDS filers, and registered investment companies, and the SEC has provided a transition period for newly public companies and for companies once they no longer qualify as smaller reporting companies or emerging growth companies.

The Pay Ratio Disclosure requires that a registrant disclose the total annual compensation of an identified median employee, the total annual compensation of the registrant's CEO, and the ratio of these amounts, as well as details that relate to how the registrant identified the median employee for purposes of the disclosure.

What to Focus on Now: Identification of the Median Employee

Registrants must first identify the "median employee" whose annual total compensation will be compared to the annual total compensation of the CEO in the Pay Ratio Disclosure.

All Employees Must Be Considered in the Determination of the Median Employee

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Generally, the median employee is the employee with median annual total compensation when taking into account the annual total compensation of all employees of the registrant. For purposes of the Pay Ratio Disclosure, “all employees” includes all US and non-US employees, all full-time, part-time, and temporary workers, and all seasonal workers of the registrant and its consolidated subsidiaries. In certain circumstances, independent contractors must also be included. In the case of a company merger or acquisition, employees of the acquired entity may be excluded for the fiscal year in which the transaction becomes effective.

Alternate Method of Identifying Employee Group

The final regulations permit registrants to use a statistical sample of employees for purposes of identifying the median employee, or another reasonable approach to estimate a sample size. For registrants with a large number of employees, using a statistical sample or a smaller employee group to identify the median employee will simplify the administrative processes involved with this identification. However, if a sampling of employees is used, the registrant must describe in the Pay Ratio Disclosure how the sample was selected. Registrants have considerable flexibility with respect to the approach used for the identification of the median employee, and are permitted to use both statistical sampling and reasonable estimates. The SEC has released guidance that states that the use of reasonable estimates, assumptions or methodologies in the identification of the median employee will not provide the basis for an SEC enforcement action, unless the registrant’s Pay Ratio Disclosure was made without a reasonable basis or provided in other than good faith.

Identification Date for Employee Population

A registrant may use any date within the three months prior to the end of the fiscal year to determine the employee population from which the median employee will be determined.

Special Rules for Non-US Employees

Non-US employees may be excluded under certain circumstances where gathering data necessary to complete the pay ratio calculation would violate data privacy laws of the foreign jurisdiction (the foreign data privacy exemption) or the non-US employees represent 5% or less of the registrant’s total workforce (the *de minimis* exemption). The *de minimis* exception has a few specific rules of its own:

- If a company with 5% or fewer non-US employees excludes any non-US employees under this exemption, it must exclude them all.

- If non-US employees constitute more than 5% of a company’s workforce, the company may exclude non-US employees up to the 5% threshold, but if it excludes any non-US employees in a particular jurisdiction, it must exclude all non-US employees in that jurisdiction.

- Employees excluded under the foreign data privacy exemption count against the available exclusions under the *de minimis* exemption.

Compensation Used to Determine Median Employee

The compensation used to identify the median employee can be determined by any reasonable measure, including the employees’ annual total compensation, or the use of the registrant’s payroll or tax records (such as the W-2 earnings of employees). Whichever mea-

surement is chosen must be consistently applied to the entire employee population (as identified above). Registrants may use internal records, such as tax or payroll records, to identify the median employee, even if such internal records do not include every element of compensation (such as equity awards which are broadly granted to employees).

Measurement Period for Compensation Used to Determine Median Employee

For the purpose of identifying the median employee, registrants are required to compare the compensation of all employees as of a selected date during the three months prior to the end of the fiscal year. However, for purposes of identifying the compensation of each employee in that group, registrants are not required to use a period that includes the date on which the employee population is determined, nor are they required to use a full year. Instead, registrants can use compensation from a period of less than one year, or from the prior fiscal year (provided that there has not been a significant change in the registrant’s employee population or compensation since the last fiscal year).

For example, if the registrant selects September 30, 2017 as the date on which the employee population is identified, the registrant can choose to use the compensation of those employees from January 1, 2017 through September 30, 2017 to determine which employee is the median employee. This provides the registrant with the ability to identify the median employee prior to the last day of the fiscal year, and to have more time to craft the Pay Ratio Disclosure that will be included in the 2018 proxy statement.

Annualization of Compensation

Where part-time or full-time employees did not work for the entire year because they were hired or terminated during that year, their annual compensation may be annualized. However, full-time adjustments may not be made for part-time employees and temporary and seasonal employee compensation may not be annualized.

Cost-of-Living Adjustments

Because cost of living may vary across jurisdictions where a registrant has employees, the registrant may make cost-of-living adjustments to the compensation of employees in jurisdictions other than the jurisdiction where the CEO resides for the purposes of identifying the median employee. If cost-of-living adjustments are made, the registrant must disclose both the pay ratio without cost-of-living adjustments and the pay ratio with cost-of-living adjustments. The registrant will need to identify the median employee without using any cost-of-living adjustments in order to make this disclosure. The registrant must also describe the cost-of-living adjustments used to identify the median employee and to calculate such median employee’s annual total compensation.

Registrant May Use the Same Median Employee for Three Years

Once a median employee is identified, the registrant can continue to use that median employee for the Pay Ratio Disclosure for a total of three years, provided that there is no change to the employee or compensation that would significantly change the pay ratio calculations.

Next Steps: Crafting the Pay Ratio Disclosure

Once the median employee is identified, registrants can begin to craft the Pay Ratio Disclosure. This disclo-

sure must include both annual total compensation for the median employee and the annual total compensation for the CEO, and also the ratio of the two. The disclosure must also include details as to how the median employee was identified, with particular details regarding the issues mentioned above, including any cost-of-living adjustments, exclusion of non-US employees, or statistical sampling used to identify the employee population.

Annual Total Compensation for Purposes of Disclosure

The compensation of both the CEO and the median employee included in the disclosure must be calculated in the same manner as compensation during a fiscal year is calculated for the registrant's named executive officers in the Summary Compensation Table. For the median employee, some estimations may be used where actual values of an element of compensation are not available, and registrants may choose to include perquisites of the median employee that do not exceed \$10,000, provided that the compensation for the CEO in the Pay Ratio Disclosure must reflect the same approach. In addition, for non-US employees, amounts contributed to a government-sponsored pension plan are generally not included in the median employee's annual total compensation.

Telling the Story: How Pay Ratio is Disclosed May Be More Important than the Ratio Itself

While the SEC rules require only disclosure of the annual total compensation for the median employee and CEO, and the ratio of the two, as well as details regarding the identification of the median employee, registrants should consider including a narrative with respect to the Pay Ratio Disclosure that puts this ratio in context. It is likely that the pay ratio will vary a great deal between different industries, and registrants may have unique circumstances that affect this ratio. It is not yet known whether shareholder advisory firms will link the pay ratio between the median employee and the CEO of a registrant to the advisory firm's recommendation with respect to the say-on-pay vote.

Registrants should consider including the following types of information in their Pay Ratio Disclosure, to add context to this disclosure:

- A narrative explanation of how CEO and employee pay is determined, including an acknowledgment that the pay ratio itself is not a factor in determining anyone's compensation as well as a reiteration of the discussion of the factors that do contribute to the determination of CEO and rank and file compensation. Those factors often include relative negotiating power, experience, degree of responsibility, and comparable compensation data associated with the relevant labor market.

- A description of the employee population in general, including the number of employees and, if appropriate, the types of positions that a majority of the employees hold.

- Any events that affected the CEO pay for the year, including value of equity and one-time payments such as relocation packages or retention or sign-on awards that will not be continuing in future years.

- Any events that affected the employee population for the year, including any acquisitions of employees through mergers, large hiring initiatives, workforce restructuring, or reductions in force.

- The pay ratio of other companies in the registrant's peer group.

- Any other factors that offer additional details regarding the ratio between CEO compensation and the compensation of the median employee.

Conclusion

While some registrants have voluntarily included disclosure of the pay ratio between the median employee and the CEO in their compensation disclosure prior to 2018, most registrants will be making this disclosure of the first time. It is likely that the Pay Ratio Disclosure will garner a great deal of attention from shareholders and the general public during 2018. Given the complexity of the rules, and the challenge of collecting compensation data for all employees and determining the median employee, registrants should be preparing now for their 2018 Pay Ratio Disclosure.