WRMarketplace

An AALU Washington Report

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TOPIC: What Is the Pay Ratio Rule & Why Should You Care?

MARKET TREND: The increased and sustained focus on executive compensation since the enactment of the Dodd-Frank Wall Street Reform and Consumer Protection Act ("Dodd-Frank") likely will gain momentum in light of the impending requirement under Section 953(b) of Dodd-Frank that such companies disclose information comparing their CEO's compensation to the median compensation of their other employees (the "pay-ratio rule").

SYNOPSIS: Although the disclosure under the pay-ratio rule for calendar-year reporting companies likely will not be required until the spring of 2018 when such companies file their proxy statements in respect of 2017, in light of the complexity and anticipated implications associated with the disclosure, companies are advised to begin formulating their implementation approach now. The rules include flexibility on methodology with respect to identifying a median employee, and the approach to selecting a methodology that best fits the company is likely to vary due to multiple factors, including industry.

TAKE AWAYS: Companies required to disclose under the pay-ratio rule should take the following steps:

- Reporting companies are advised to begin discussing implementation approaches with their compensation committees well in advance of the time in which the 2017 proxy is prepared. Thoughtful consideration should be given to the employee profile of the company and whether such profile is typical to the industry and/or the company's peer group. If the company or the compensation committee engages a compensation consultant, he or she may be in a position to provide data on models and methodologies found to be best suited to an industry to illustrate accurately the ratio and median employee compensation.

- In many cases, companies may benefit from analyzing 2016 compensation to estimate the likely ratio, experimenting with different methodological approaches.

- Under the pay-ratio rule, a registrant is permitted to supplement the required disclosure with explanatory narrative discussion or additional ratios, provided that such additional disclosure is not misleading, is clearly identified, and is not presented with greater prominence than the require disclosure. Accordingly, thought should be given to a complementary narrative disclosure that will help round out for shareholders whether and how the ratio reflects the company's pay philosophy, efficiency, and other similar considerations.

- As with the introduction of any new and recurring disclosure, the manner of presenting the information and the methodology employed should be determined with an eye to consistency across disclosure years, as any change in approach in future years likely will trigger explanatory disclosure regarding the change.

- Regardless of what methodology is ultimately chosen, companies should consider any potential implications indirectly resulting from the required disclosure (for example, if the employee population is unionized in whole or part, the disclosure may impact collective agreements, and in any event, may create employee relations concerns and/or disrupt periodic pay negotiations for those whose pay is below the median).

- Companies may wish to stay apprised of developing positions within the institutional shareholder and proxy advisor communities regarding ratios that are deemed unacceptable or egregious.

MAJOR REFERENCES: Section 953(b) of the Dodd-Frank Wall Street Reform and Consumer Protection Act; Item 402 of Regulation S-K of the U.S. Securities Act of 1933; Compliance & Disclosure Interpretations for Regulation S-K updated October 18, 2016.

OVERVIEW

Objectives. In August 2015, the Securities Exchange Commission ("**SEC**") adopted a final rule regarding implementation of Dodd-Frank's pay-ratio disclosure rule, which may impact many public companies. Broadly understood, the intent of this rule is to increase transparency on compensatory practices within a public company, to contextualize CEO pay within the company, and to provide shareholders with information that may assist them in conducting the advisory "say on pay" vote also required pursuant to Dodd-Frank.

Requirements. Under the pay-ratio rule, in addition to existing disclosure obligations with respect to the compensation of CEOs and certain other executives, reporting companies generally must disclose (1) the annual total compensation of the CEO, (2) the median of the annual total compensation of its employees (other than the CEO), and (3) the ratio of those two amounts.

Application & Timing. The pay-ratio rule is applicable with respect to a registrant's first fiscal year beginning on or after January 1, 2017, and the disclosure is required in registration statements, proxy and information statements, and annual reports that require executive compensation disclosure. As a practical matter, the required disclosure generally will begin showing up in filings around spring 2018. Under the pay-ratio rule, certain reporting companies are exempted from the disclosure obligation, including any company that qualifies as a smaller reporting company, emerging growth company, or foreign private issuer.

IDENTIFYING MEDIAN EMPLOYEES

The pay-ratio rule provides some flexibility in identifying the median employee:

- While the rule makes clear that, in establishing the relevant employee population, the company must take into account all of its employees and those of its consolidated subsidiaries (regardless of whether full- or part-time, temporary or permanent, seasonal or otherwise, and U.S. or non-U.S. (subject to two limited exceptions)), the company may determine such employees as of any date within the last three months of its last completed fiscal year.

- In addition, although the annual total compensation for the median employee must be calculated consistently with the existing rules under Item 402(c)(2)(x) of Regulation S-K for the CEO's compensation, the company may use reasonable estimates in calculating the elements comprising annual total compensation.

- Finally, although the median employee must be an actual employee, the employee group from whom the median employee is selected may be the full population, or the company could instead use another reasonable method (such as statistical sampling or reasonable estimates), and the company may identify the median employee from the relevant population or sample using annual total compensation determined as described above or another compensation measure, provided it is consistently applied.

The median employee need ***only be identified every three years*** absent a change in the employee population or compensation arrangements that would materially impact the pay ratio disclosure. Note that the ***company will need to disclose and explain its choices*** in these matters, including any material assumptions, permitted adjustments (such as cost-of-living adjustments in certain cases), and estimates involved.

RECENT GUIDANCE

On October 18, 2016, SEC staff of the Division of Corporate Finance published interpretive guidance on the pay-ratio rule. The five Compliance & Disclosure Interpretations ("**CDIs**") further clarified the parameters for determining the median employee:

- The first CDI addresses the use of a "consistently applied compensation measure" other than annual total compensation in identifying the median employee. It notes that the latitude on this point was due in part to concerns over compliance costs had the rule required the company to calculate the annual total compensation for all employees. This CDI confirms that any measure that reasonably reflects the annual compensation of employees is permissible, although the appropriateness of an alternative measure will be assessed based on the facts and circumstances of the company (such that, for example, a company that routinely grants equity awards to a significant number of employees could not reasonably rely only on cash compensation as the applicable measure).

- The second CDI makes clear that a registrant may not rely exclusively on hourly or annual rates of pay as the alternative compensation measure, although reliance on such rates may be acceptable as an element of the measure where actual time worked is also factored in (thereby avoiding a measure based on annualized pay rather than actual pay).

- The third CDI clarifies that, in applying the alternative compensation measure, the registrant is not required to use a time period that includes the same date on which the employee population is determined, and is not required to use a full annual period.

- The fourth and fifth CDIs address individuals who are furloughed or independent contractors as of the date the employee population is determined, and conclude that the registrant must apply a facts and circumstances analysis to whether the individual should be included as an employee for purposes of the rule (although the rule generally does exclude workers who are employed, and whose compensation is determined, by a third party who is unaffiliated with the registrant, but who provide services to the registrant's consolidated group as independent contractors or "leased" workers).

CONSIDERATIONS

On its face, the disclosure required by the pay-ratio rule is relatively straightforward. However, the apparent simplicity of this requirement belies a fair amount of complexity and certainly will require reporting companies to make meaningful and considered determinations regarding implementation. The expectation among commentators and practitioners is that the disclosure is likely to draw general scrutiny, including significant attention from shareholders. Accordingly, it is of strong importance that companies take deliberate steps in advance of the disclosure to ensure that what they ultimately file fairly and accurately reflects their practices. We note, however, that President-elect Trump has made broad statements regarding plans to change or eliminate many of the Dodd-Frank rules, which may impact implementation of the pay-ratio rule. As the scope and timing of any changes is far from certain, AALU will continue to track and provide updates on any notable developments.

TAKE AWAYS – STEPS TO TAKE:

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