

LEGAL UPDATES AND NEWS

SEC Finalizes Rule on CEO Pay Ratio Disclosure

On August 5, 2015, the Securities and Exchange Commission (the “SEC”) finalized its CEO pay ratio disclosure rules to require public companies (other than emerging growth companies, smaller reporting companies and foreign issuers) to annually disclose: (i) the median of the annual total compensation of all employees (excluding the CEO), (ii) the annual total compensation of the CEO, and (iii) the ratio of the median employee compensation to the CEO’s compensation. These rules are required by Section 953(b) of the Dodd-Frank Act and will be incorporated into new Item 402(u) of Regulation S-K. Public companies must provide the required disclosure for their first fiscal year beginning on or after January 1, 2017.

Determining “All” Employees

Under the new rules, a public company will be required to determine and disclose the median of the annual total compensation for *all* of its employees (excluding the CEO).

- *All* employees includes full-time, part-time, temporary and seasonal employees of a company and its consolidated subsidiaries.
- Companies may annualize the total compensation for permanent employees (including part-time employees) who did not work the entire fiscal year (e.g., new hires), but *may not* make full-time equivalent adjustments for part-time employees or annualize compensation of temporary or seasonal workers.
- Independent contractors, consultants and workers employed by a third party, such as leased employees (as long as their compensation is determined by an unaffiliated third party), can be excluded.
- Employees that a company has acquired as a result of a business combination can also be excluded, but only for the fiscal year in which the transaction occurred.
- Any date within the last three months of a company’s most recently completed fiscal year can be selected for determining the employee population.

Determining Median Annual Compensation/Median Employee

From the employee population, companies must then determine the median annual total compensation of all employees. A company may use its total employee population or a statistical sampling of that population and/or other reasonable methodologies to determine the median employee.

- Companies must briefly describe the methodology used to identify the median employee, and any material assumptions, adjustments or estimates used.
- The same median employee can be used for three consecutive years, so long as there have been no changes that the company reasonably believes would create a significant change in the pay ratio disclosure. If the median employee discontinues employment, a company is permitted to identify its median employee from among employees that had similar compensation.

Determining Total Compensation of the Median Employee and the CEO

Once a company has determined its median employee, total annual compensation for the median employee will be determined using the same rules that apply to the CEO’s compensation that is disclosed in the Summary Compensation Table (“SCT”) under Item 402(c)(2)(x) of Regulation S-K.

- Companies may include compensation for the median employee otherwise excluded from SCT calculations such as: (i) personal benefits that aggregate less than \$10,000, and/or (ii) compensation

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under nondiscriminatory benefit plans. However, if this approach is selected, a company must apply the same treatment to its disclosure of the CEO's compensation and explain any difference between the CEO's total compensation used for pay ratio disclosure and his/her total compensation in the SCT.

- For CEOs replaced in mid-year a company may either: (i) combine total compensation of each CEO listed in the SCT, or (ii) annualize the compensation of the CEO serving at the time the employee population was measured.

Pay Ratio Disclosure Compliance and Timing

- The pay ratio disclosure must be included in annual reports, proxy statements and registration statements whenever Item 402 executive compensation disclosures are required.
- The pay ratio disclosure must be made for first fiscal years beginning on or after January 1, 2017. Thus, companies with calendar year fiscal years would first be required to include the disclosure in Form 10-K's for the year ended December 31, 2017 or their 2018 annual meeting proxy statement.
- Importantly, registration statements can be declared effective following a fiscal year end and before the next annual report or proxy statement is filed without the need to update the pay ratio disclosure for the most recently completed fiscal year.

Additional Exemptions

Following the January 1, 2017 effective date, certain reporting companies will have transition periods for their pay ratio disclosure.

- Pay ratio disclosure is not required in a Form S-1 registration statement for an initial public offering. New public companies will be required to disclose their pay ratio beginning after the company has (i) been subject to the requirements of the Securities Exchange Act for at least 12 months beginning on or after January 1, 2017, and (ii) filed at least one annual report pursuant to the Exchange Act that does not contain the pay ratio disclosure.
- The pay ratio disclosure rules do not apply to smaller reporting companies or emerging growth companies (or foreign private issuers, U.S.-Canadian Multijurisdictional Disclosure System filers or registered investment companies). Smaller reporting companies and emerging growth companies will be required to disclose their pay ratio for their first full fiscal year commencing on or after exiting such status.

Conclusion and Comments

Given the length of time before the CEO pay ratio rules become effective, issuers may want to assume a "wait and see" approach because of the rule's complexity and costs. Even prior to the release of the final rule, bills were introduced into both houses of Congress to repeal the pay ratio disclosure requirement. Given the expected cost of compliance - the SEC estimates a cost of up to \$1.3 billion - the repeal movement may gain momentum. Political developments and the 2016 elections could determine the fate of this disclosure obligation.

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