Securities Regulation Daily Wrap Up, TOP STORY—SEC adopts final pay ratio rule without adjustment for part-timers, (Aug. 5, 2015)

Securities Regulation Daily Wrap Up

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By Anne Sherry, J.D.

The SEC today approved 3-2 a final rule requiring companies to disclose the ratio between the CEO's pay and the median compensation of all other employees. The Dodd-Frank-mandated regulation solidifies the proposed rule's contentious prohibition against adjusting part-time and seasonal workers' pay to a full-time equivalent, but it differs from the proposal in that it permits companies to make cost-of-living adjustments and to exclude certain non-U.S. workers from the median determination. Commissioners Gallagher and Piwowar, who voted against the proposal, also attempted to block the final rule, but they could not overcome the yes votes of Chair Mary Jo White and the two Democratic commissioners.

Debate over proposal. The pay-ratio mandate was a controversial measure that flooded SEC staff inboxes with over 287,000 comments. While investor advocates welcomed the disclosure requirement, issuers expressed concerns about the proposed rule's median-employee calculation. The proposal complied with Dodd-Frank's language requiring inclusion of "all employees" in determining the median, but many opponents argued that including non-U.S. employees would complicate compliance and possibly violate foreign privacy-protection laws. Commenters also protested that the inclusion of part-time and seasonal employees without any adjustment to a full-time equivalent would skew the median lower, which would result in an unfair comparison against the pay of a full-time CEO.

Non-U.S. employees. The final rule addresses some of these concerns by permitting companies to exclude non-U.S. employees from the median determination in two circumstances. First, if a company obtains a legal opinion from counsel to the effect that the company cannot obtain or process the information necessary for compliance with the pay-ratio rule without violating another jurisdiction's data-privacy laws, it may exclude workers employed in that jurisdiction from the calculation. Second, a company may exclude up to 5 percent of its non-U.S. employees from the median determination. If it excludes any employee in a particular jurisdiction, it must exclude all employees in that jurisdiction.

New, part-time, and seasonal workers. Furthermore, companies may annualize the total compensation of a permanent employee who did not work the entire year, such as a new hire. However, the rule does not permit companies to make full-time equivalent adjustments to part-time employees' pay or annualize the pay of temporary and seasonal workers. Employees of consolidated subsidiaries must be included in the pool of employees from which the median will be identified, but companies may exclude employees of unaffiliated third parties and independent contractors.

Cost-of-living adjustments. In a significant change from the proposed rule, companies will be allowed to apply a cost-of-living adjustment to the compensation measure used to identify the median employee. If the company elects to do so, it must use the same adjustment in calculating the median employee's annual total compensation. Finally, the company must also disclose the median employee's annual total compensation and pay ratio without the cost-of-living adjustment.

Methodology. The rule gives companies flexibility to select a methodology for identifying the median employee that is appropriate to their particular facts and circumstances. Companies may use total employee population or a statistical sampling. They will be required to describe the methodology and any estimates they used to identify the median employee, and they may supplement the required disclosure with a narrative discussion or additional ratios. The median calculation must occur at least once every three years, or more often if a change in employee population or compensation arrangements results in a significant change to the pay-ratio disclosure. If the

median employee's compensation changes within the three years, the company may use another employee with substantially similar compensation as the median. The company may select a date within the last three months of its last completed fiscal year on which to determine the employee population for purposes of identifying the median employee.

Affected companies, filings, and dates. All companies required to provide executive compensation disclosure under Item 402(c)(2)(x) of Regulation S-K will be required to include the pay-ratio disclosure in registration statements, proxy and information statements, and annual reports. Smaller reporting companies, foreign private issuers, Multijurisdictional Disclosure System filers, emerging growth companies, and registered investment companies will not be subject to the requirement. The disclosure will be required beginning in companies' first fiscal year beginning on or after January 1, 2017. A company that is not already a reporting company will be required to report the pay ratio for the first fiscal year after it becomes subject to SEC reporting requirements.

Adopting commissioners. At the open meeting on the pay-ratio vote, Chair White and Commissioners Aguilar and Stein approved the measure as striking an appropriate balance between effecting the intent of Congress and easing the compliance burden on companies. Anticipating the dissenting commissioners' objections to the timing of the rulemaking, White observed that the absence of a specific statutory deadline does not diminish the agency's obligation to carry out the mandate. Aguilar acknowledged that the ratio that will result from the rule is a deceptively simple number that requires effort on the part of companies but cited the flexible methodology, the *de minimis* exclusion for non-U.S. employees, and the three-year expiration date on the median determination as provisions meant to reduce the costs of the rule. Stein noted that investors are increasingly focused on corporate governance and executive compensation issues; the rule will provide data that investors can use on other fronts, such as say-on-pay.

Dissenting commissioners. Gallagher described Dodd-Frank Section 953 as a "name-and-shame" provision resulting from lobbying on the part of the AFL-CIO. Addressing inequality is not part of the SEC's core mission, he said, and the executive compensation rules "hog the precious bandwidth of the Commission" while other policymaking matters languish. As to the rule itself, Gallagher indicated that he could have grudgingly supported a pay-ratio rule limited to full-time, U.S. employees. Although Section 953 refers to "all employees," the statute does not define the term, and the SEC could have used its definitional, interpretive, and exemptive authority to limit the scope of the rule. Although he would not go so far as to say this disclosure would have been useful, he said it would be "marginally less useless." Gallagher cited the estimated $1.3-billion compliance cost of the rule and noted that the cost of compliance if part-time, temporary, and non-U.S. workers were excluded would be cut by more than half. The release does no work to explain how the benefits of including those workers justify an additional $780 million in compliance costs, he concluded.

Piwowar said that the pay-ratio rule is "literally a page from [the] big labor playbook" and warned that the concept was spreading, citing a California bill that would tie state tax rates for publicly held corporations to the CEO pay ratio and a bill in Rhode Island that would give preference to government contractors with pay ratios under a certain threshold. The commissioner also said that if the SEC really cared about the costs and benefits of the rule, it would have engaged in investor testing as facilitated by Dodd-Frank Section 912. Finally, Piwowar noted congressional attempts to repeal the pay-ratio mandate and suspected that the SEC's open meeting was deliberately timed to coincide with the House and Senate's summer recesses.

Menendez supporting statement. Senator Bob Menendez (D-NJ), who drafted the Dodd-Frank pay-ratio provision and has repeatedly pressed the SEC to finalize its rule, praised today's vote as "an important step towards fairness and transparency." The lawmaker promised to review the rule closely to ensure that it balances flexibility and accountability and does not open loopholes where it was intended to facilitate compliance. "We have middle class Americans who have gone years without seeing a pay raise, while CEO pay is soaring," Sen. Menendez said. "This simple benchmark will help investors monitor both how a company treats its average workers and whether its executive pay is reasonable."

Hensarling opposing statement. House Financial Services Committee Chairman Jeb Hensarling (R-Tex) issued a statement calling the adoption of the rule "the latest example of the SEC squandering its resources

on rulemakings that do nothing to help small business startups and will instead harm U.S. companies and investors." Chairman Hensarling worries that businesses will seek to compensate for compliance costs by reducing their workforce. "I'm guessing that a worker who loses his or her job will take little comfort in knowing the ratio between the CEO's pay and the salary that they are no longer receiving," he said. H.R. 414, which would repeal the pay-ratio mandate, garnered six more cosponsors last week to bring the total to 23. The bill has been referred to the Financial Services Committee.

Industry reactions. Heather Corzo, director of AFL-CIO's Office of Investment, took to Twitter to celebrate the rule as well as question several of its provisions. In particular, she observed that issuers' ability to select a specific date within a three-month window for purposes of the median calculation could allow for the omission of seasonal employees. Americans for Financial Reform said that the rule will give investors and the public "an important new set of data points" about pay practices. The U.S. Chamber of Commerce, however, voiced disappointment in the rule adoption. David Hirschmann, who leads the chamber's Center for Capital Markets Competitiveness, said in a statement that the disclosure mandate is a misguided "favor to union lobbyists" that will fail to provide investors with useful data: "For example, a domestic company might have a better pay ratio than a multinational company due to legal, currency or cost of living differences, creating a situation that is like trying to compare baseball to basketball stats."

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