MERIDIAN
COMPENSATION PARTNERS, LLC

VOLUME 6, ISSUE 12
AUGUST 14, 2015

Meridian Client Update

SEC Issues Final Rule on CEO Pay Ratio

In our Client Update of August 5, 2015, we reported on testimony provided at a hearing of the Securities and Exchange Commission (SEC) during which the Democratic Commissioners approved a final rule that would require public companies to disclose the ratio of CEO pay to the median employee pay ("Pay Ratio"). This Client Update summarizes the release of the final rule ("Final Rule") that was published following the SEC hearing.

Background

The Pay Ratio disclosure is one of several disclosures on executive compensation and related governance matters mandated under the Dodd-Frank Wall Street Reform and Consumer Protection Act ("Dodd-Frank"). This mandated disclosure did not become effective with the passage of Dodd-Frank. Rather, Dodd-Frank directed the SEC to write rules on the Pay Ratio disclosure that would include the disclosure's effective date. In accordance with this direction, the SEC issued proposed rules on the CEO Pay Ratio on September 18, 2013 and approved the Final Rule on August 5, 2015. The Final Rule requires the Pay Ratio to be disclosed in any annual report, proxy or information statement, or registration statement that requires the disclosure of executive compensation pursuant to Item 402 of Regulation S-K.

A detailed discussion of the Final Rule follows.

The Future of the Pay Ratio – Is it Here to Stay?

Despite the SEC's adoption of the final rule, the debate has begun in earnest as to whether companies will in fact ever actually be required to disclose their Pay Ratios. Since the passage of Dodd-Frank through the adoption of the Final Rule, the Pay Ratio disclosure requirement has faced withering criticism from business organizations, many Republicans in Congress and even the Republican SEC Commissioners. We do not believe the Final Rule will quell this criticism. We anticipate that the Final Rule will be subject to the following two-prong attack:

- First, one or more business organizations (or business entities) may sue the SEC to prohibit the implementation of the Final Rule on the grounds that the SEC failed to adequately assess the economic effects of the Final Rule. These were the same grounds under which a Federal Court struck down the SEC's proxy access rule in 2011. By the SEC's own estimation, the Final Rule's first year aggregate compliance cost will run a staggering $1.3 billion (likely an understatement of the true cost). Moreover, the SEC has been hard pressed to identify meaningful benefits associated with the Final Rule that would clearly offset such compliance costs. This cost-benefit misalignment might serve to motivate the filing of suits seeking to shut down the Pay Ratio disclosure requirement.

- Second, if Republicans should gain control of the White House in 2016 and maintain control of Congress, the outright repeal of the Dodd-Frank mandate would likely increase. In fact, a bill is pending in the House that calls for the repeal of the Pay Ratio requirement (which, if passed, would surely be vetoed by the President). After the presidential election, we would anticipate future repeal attempts; however, then current legislative priorities could potentially derail or postpone repeal efforts.

We will not attempt to handicap the outcome of this two-prong attack on the Pay Ratio requirement, but will be watching and reporting on future developments.

©Meridian Compensation Partners, LLC

Details of Final Rule on the Pay Ratio Disclosure

The below discussion of the Final Rule covers the following items:

- Overview of Final Rule
- Timing of Initial Disclosure of the Pay Ratio
- Employees Included in the Identification of the Median Employee
- Identification of Median Employee
- Determination of Median Employee's Total Annual Compensation
- Determination of CEO Total Annual Compensation
- Determination of Pay Ratio
- Required Disclosures
- Placement of Required Disclosures
- Public Companies Subject to and Exempt from the Pay Ratio Disclosure Requirement
- Pay Ratio Disclosures Deemed "Filed" not "Furnished"

Overview of Final Rule

The Final Rule requires every public company (subject to certain exceptions) to disclose the ratio of CEO proxy-disclosed total annual compensation to the median employee's total annual compensation. The determination of who is the median employee must take into account a public company's worldwide workforce, subject to certain narrow exceptions. However, the Final Rule allows public companies to use any reasonable method (e.g., statistical sampling techniques) to determine the employee pool from which to identify the median employee and to calculate each employee's compensation. In calculating each employee's compensation, a company may apply cost-of-living adjustments to each employee's compensation under certain circumstances.

Timing of Initial Disclosure of the Pay Ratio

A public company's **first reporting period** for the Pay Ratio disclosure will be its first full fiscal year beginning on or after January 1, 2017. For a calendar year company, this means that the initial Pay Ratio disclosure would relate to calendar year 2017 compensation and would be **disclosed in the company's 2018 proxy**.

Employees Included in the Identification of the Median Employee

The Final Rule generally provides that nearly all employees of a public company and its consolidated entities must be included in the pool of employees from which the company will identify the median employee. However, in certain instances, a company may exclude foreign-based employees and may temporarily exclude employees that became its employees as a result of a business combination or acquisition.

- **General Rule**. To determine who is the median employee, a public company must take into account individuals (i) who are employed by the company and any of its consolidated subsidiaries (all on a worldwide basis) as of a date chosen by the company within the last three months of the company's last completed fiscal year and (ii) who fall into one of the following employment classifications:

  — Full-time employees,
  — Part-time employees,
  — Seasonal employees, and
  — Temporary workers.

If a company should change the date it uses to identify the median employee, the company would be required to disclose this change and the reasons for the change.

Employees do not include independent contractors or “leased” workers or other temporary workers who are employed by an unaffiliated third party.

- **Exclusion of Non-U.S. Employees**. A public company ***may*** exclude foreign-based employees (“Non-U.S. employee”) in accordance with the following rules:

  — *Collecting non-U.S. employee pay data would violate local privacy data laws (“Data Privacy Exemption”)*. A company may exclude from its determination as to who is the median employee Non-U.S. employees if the collection of such employees’ pay data would violate local jurisdiction data privacy laws; provided that the following requirements are met:

  - The company has used “reasonable efforts” to obtain or process the information necessary for compliance with the Final Rule and the company is unable to do so without violating local jurisdiction data privacy laws or regulations.
  - The company’s reasonable efforts must include, at a minimum, using or seeking an exemption or other relief under any governing data privacy laws or regulations.
  - The company must disclose the excluded jurisdictions, identify the specific data privacy law or regulation, explain how complying with the Final Rule violates such data privacy law or regulation (including the efforts made by the registrant to use or seek an exemption or other relief under such law or regulation) and provide the approximate number of employees exempted from each jurisdiction based on this exemption.
  - If a company excludes any Non-U.S. employees in a particular jurisdiction due to privacy data laws, it must exclude all Non-U.S. employees in that jurisdiction.
  - The company must obtain a legal opinion from counsel that opines on the inability of the registrant to obtain or process the information necessary for compliance with the Final Rule without violating the jurisdiction’s laws or regulations governing data privacy, including the company’s inability to obtain an exemption or other relief under any governing laws or regulations. The company must file the legal opinion as an exhibit to the filing in which the Pay Ratio disclosure is included.

  — *Exclusion of Non-U.S. employees (“De Minimis Exemption”)*.

  - *Non-U.S. employees comprise 5% or less of a company’s worldwide workforce*. If Non-U.S. employees comprise 5% or less of a company’s worldwide workforce, the company may exclude all (but not less than all) Non-U.S. employees in its determination of the median employee.
  - *Non-U.S. employees when such employees comprise more than 5% of a company’s worldwide workforce*. If a company’s Non-U.S. employees exceed 5% of the company’s worldwide workforce, it may exclude up to 5% of its total employees who are Non-U.S. employees. However, if a company excludes any Non-U.S. employees in a particular jurisdiction, it must exclude all Non-U.S. employees in that jurisdiction. If more than 5% of a registrant’s employees are located in any one non-U.S. jurisdiction, a company may not exclude any employees in that jurisdiction in its determination of the median employee.

  — *Interaction of Exclusion Rules*. If a company should decide to exclude Non-U.S. employees under one or more of the foregoing rules, care should be taken to ensure that the exclusion of such employees meets the following additional requirements:

©Meridian Compensation Partners, LLC

- Non-U.S. employees who are excluded under the Data Privacy Exemption count against the 5% exclusion limit set forth under the De Minimis Exemption. For example, if a company excludes 3% of its worldwide workforce under the Data Privacy Exemption, the company could exclude no more that 2% of its worldwide workforce under the De Minimis Exemption. In cases where a company excludes 5% or more of its worldwide workforce under the Data Privacy Exemption, the company would be unable to exclude any employees under the De Minimis Exemption.

- The 5% limit under the De Minimis Exemption does not apply to the Data Privacy Exemption. That is, a company may exclude employees under the Data Privacy Exemption even if the number of excluded employees exceeds 5% of the company's worldwide workforce.

- **Exclusion of Employees of Acquired Companies**. A company may exclude any employees that became its employees as the result of a business combination or acquisition of a business for the fiscal year in which the transaction becomes effective. A company must disclose the approximate number of employees it is omitting and the identity of the acquired business. Those employees must be included in the total employee count for the triennial identification of the median employee in the fiscal year following the transaction for purposes of evaluating whether a significant change in the employee population had occurred in such fiscal year (see below regarding discussion on triennial identification of median employee).

Identification of Median Employee

The cornerstone of the Final Rule is the identification of the median employee. The identification process will be the most time consuming and costly aspect of public companies' compliance with the new disclosure rule. However, the SEC has included in the Final Rule two provisions that are intended to mitigate compliance time and costs: (i) triennial identification of median employee and (ii) simplified methodologies to identify the median employee.

- **Triennial Identification of Median Employee**. Companies will need to identify the median employee ***only once every three years*** and to calculate total compensation for that employee each year. However, triennial identification is subject to the following requirements:

— A median employee identified in year one may be used in year two and year three if:

- During the company's last completed fiscal year (i.e., year two or year three, as applicable) there has been no change in its employee population or employee compensation arrangements that the company reasonably believes would result in a significant change to its Pay Ratio disclosure, and

- The company discloses that it is using the same median employee from year one in its Pay Ratio calculation and describes briefly the basis for the above referenced reasonable belief.

— Conversely, a median employee identified in year one **may not** be used for year two or year three, as applicable, if there has been a change in the company's employee population or employee compensation arrangements in year two or year three, as applicable, that the company reasonably believes would result in a significant change in its Pay Ratio disclosure. In such a case, the company must re-identify the median employee for the applicable fiscal year.

— If it is no longer appropriate for a company to use the median employee identified in year one as the median employee in years two or three because of a change in the original median employee's circumstances that the company reasonably believes would result in a significant change in its Pay Ratio disclosure, the company may use another employee whose compensation is substantially

©Meridian Compensation Partners, LLC

similar to the original median employee based on the compensation measure used to select the original median employee.

- **Methodologies that May Be Used to Identify the Median Employee**. Under the Final Rule, public companies may use various methodologies to determine (i) the employee population from which to identify the median employee and (ii) the compensation of these employees. Notably, the Final Rules do not require companies to use any particular statistical or estimation methods in determining the median employee.

— *Determination of Employee Pool from Which to Identify the Median Employee***.** A company may identify the median employee based on:

- Its entire worldwide employee population, or
- A portion of its entire population determined under statistical sampling techniques and/or any other reasonable method.

— *Determination of Employee Compensation*. Once the employee pool is determined, a company will need to determine the compensation of each employee in the pool in order to identify the median employee. For this purpose, the Final Rule does not mandate that companies use a specific defined measure for employee compensation (e.g., taxable wages) or specific methodology for estimating employee compensation. Rather, companies may use any one of the following measures or techniques to develop employee compensation levels:

- ***Annual total compensation*** based on the proxy rules applicable to the determination of total compensation for a company's named executive officers.
- ***A compensation measure consistently*** applied to all employees, such as base salary or W-2 wages. The compensation measure may be based on payroll or tax records even if the period covered by such records differs from a company's fiscal year. A company must disclose the compensation measure used if it differs from proxy-compliant annual total compensation.
- ***Total compensation or any element of total compensation developed through a company self-determined statistical sampling or estimation techniques***, provided that such sampling or estimation techniques are applied on a consistent basis.

— *Special Rules Applicable to the Determination of Employee Compensation*. The determination of employee compensation is subject to the following special rules:

- **Cost-of-Living Adjustments**. A company may (but is not required to) make cost-of-living adjustments to the compensation of employees who reside in jurisdictions other than the jurisdiction in which the company's CEO resides, regardless of the method for determining employee compensation (e.g., total annual compensation, consistently applied compensation measure). The adjustments to employee compensation should reflect the cost of living in the jurisdiction in which the CEO resides. If a company makes cost-of-living adjustments to employee compensation, the company is required to disclose the cost-of-living adjustments, including the measure used as the basis for the cost-of-living adjustment. In addition, the company must disclose the Pay Ratio and the median employee's total annual compensation with and without the cost-of-living adjustment.
- **Permitted Annualizing of Compensation**. A company may (but is not required to) annualize total compensation for all permanent full-time or part-time employees who were employed for less than

the full fiscal year for purposes of determining each employee's compensation and identifying the median employee. If a company chooses to annualize total compensation, then it would be required to do so for all similarly situated employees. However, the proposed rules would not allow companies to annualize pay for other classifications of employees, such as seasonal and temporary employees. In addition, a company may not make a full-time equivalent adjustment for any employee.

Determination of Median Employee's Total Annual Compensation

Once the median employee has been determined, public companies must then determine the median employee's total annual compensation in accordance with the following rules:

- **Total Annual Compensation Calculated in Accordance with Proxy Disclosure Rules**. The median employee's total compensation must be calculated pursuant to the proxy disclosure rules for calculating a named executive officer's total compensation. This means each of the elements of compensation subject to disclosure in a company's summary compensation table must be computed for the median employee.

- **Inclusion of Personal Benefits of Less than $10,000 and Non-Discriminatory Benefit Plans**. A company may (but is not required to) include personal benefits that aggregate less than $10,000 and compensation under non-discriminatory benefit plans (e.g., health and welfare arrangements) in calculating the annual total compensation of the median employee, provided that these items are also included in calculating the CEO's annual total compensation. A company must disclose and explain any difference between the CEO total compensation used in the Pay Ratio disclosure and the CEO's total compensation reflected in the company's summary compensation table, if material.

- **Required Cost-of-Living Adjustment**. The median employee's annual total compensation must be subject to a cost-of-living adjustment if (i) a company used cost-of-living adjustments to identify the median employee and (ii) the median employee and the CEO do not reside in the same jurisdiction. In cases where the median employee's annual total compensation is subject to a cost-of-living adjustment, a company will be required to describe such cost-of-living adjustment, the measures used as the basis for the cost-of-living adjustment and the median employee's jurisdiction.

Determination of CEO's Total Annual Compensation

To ensure comparability of total annual compensation of the median employee and a company's CEO, the CEO's total annual compensation must be calculated in the same manner as is the median employee's total annual compensation (except that discretionary cost-of-living adjustment solely applies to median employee compensation). That is, a CEO's total annual compensation must equal the sum of the following items:

- The CEO's total compensation as disclosed in the company's summary compensation table,

- The value of personal benefits of less than $10,000 if the value of such benefits is included in the median employee's total annual compensation, and

- The value of compensation under non-discriminatory benefit plans if the value of such compensation is included in the median employee's total annual compensation.

Determination of Pay Ratio

The Final Rule requires the Pay Ratio to be expressed in the form of a ratio where the median employee is equal to one or expressed narratively in terms of the multiple that the CEO total annual compensation bears to the median employee's total annual compensation. For example, if the total annual compensation

©Meridian Compensation Partners, LLC

of a company's CEO was $7 million and the median employee's total compensation was $35,000, the proposed rule would require the CEO pay ratio to be expressed in one of the following ways:

- The CEO's total annual compensation is 200 times that of the median employee's total annual compensation, or
- 1 to 200.

If the median employee's total annual compensation was subject to a cost-of-living adjustment, a company would also be required to recalculate and disclose the Pay Ratio based on the employee's total annual compensation without such adjustment.

Required Disclosures

In addition to the required disclosures previously discussed, companies will be required to disclose the following information on the Pay Ratio and on any methodologies, assumptions, estimates and adjustments used to identify the median employee.

- **Pay Ratio Related Disclosure**

  — Pay Ratio;

  — The median employee's total annual compensation; and

  — The CEO's total annual compensation.

  If the median employee's total annual compensation was subject to a cost-of-living adjustment, the median employee's total annual compensation without such adjustment must also be disclosed.

  The Final Rule allows, but does not require, a company to include a narrative discussion or explanation of the Pay Ratio or the median employee's total annual compensation.

- **Disclosure on Methodology, Assumptions, Adjustment and Estimates**

  — Any methodology used to identify the median employee;

  — Any material assumptions, adjustments or estimates used to identify the median employee or to determine total compensation or any elements of total compensation; and

  — Any estimated amounts.

  If a company changes methodology or material assumptions, adjustments or estimates from those used in the previous fiscal year, and if the effects of any such changes are significant, the company would be required to briefly describe the change and the reasons for the change. In addition, a company will be required to disclose any change in the use of cost-of-living adjustments.

Placement of Required Disclosures

The Final Rule does not specify the placement of the Pay Ratio and related disclosures within a company's proxy or annual report. We believe that these disclosures could properly appear as a free-standing section within the company's annual proxy. However, in the release of the Final Rule, the SEC states that "the most meaningful way to present pay ratio disclosure is in context with other executive compensation disclosure, such as the Summary Compensation Table … and the Compensation Discussion and Analysis …, rather than provided on a stand-alone basis." We anticipate most companies will include the Pay Ratio disclosures as part of their Compensation Discussion and Analysis section of their annual proxy. Regardless of the placement of the Pay Ratio disclosures, some companies are likely to make volitional

©Meridian Compensation Partners, LLC

disclosures that will provide context for or further explain the Pay Ratio and the methodology used to develop it.

Public Companies Subject to and Exempt from the Pay Ratio Disclosure Requirement

Generally, the Pay Ratio disclosure requirements solely apply to those public companies that are required to include a summary compensation table in their proxy statements.

The following classes of public companies are exempt from the Pay Ratio disclosure requirements:

- Emerging growth companies (generally, an emerging growth company is a public company whose initial public offering occurred **after December 8, 2011** and whose annual gross revenues are less than $1 billion during its most recently completed fiscal year).
- Smaller reporting companies (generally, a smaller reporting company is a company with a public float of less than $75 million as of the last business day of its most recently completed second fiscal quarter).
- Foreign private issuers.
- MJDS filers (the term "MJDS filers" refers to registrants that file reports and registration statements with the SEC in accordance with the requirements of the U.S.-Canadian Multijurisdictional Disclosure System).

Pay Ratio Disclosures Deemed "Filed" not "Furnished"

The Pay Ratio disclosures will be deemed "filed" not "furnished" for purposes of the Securities Act of 1933 and Securities Exchange Act of 1934. Therefore, a public company's CEO and CFO would be required to "certify" the material accuracy and completeness of the Pay Ratio disclosure.

* * * * *

The ***Client Update*** is prepared by Meridian Compensation Partners' Technical Team led by Donald Kalfen. Questions regarding this Client Update or executive compensation technical issues may be directed to Donald Kalfen at 847-235-3605 or dkalfen@meridiancp.com.

This report is a publication of Meridian Compensation Partners, LLC, provides general information for reference purposes only, and should not be construed as legal or accounting advice or a legal or accounting opinion on any specific fact or circumstances. The information provided herein should be reviewed with appropriate advisers concerning your own situation and issues.

www.meridiancp.com