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Executive Compensation and Employee Benefits Group Client Alert: SEC Final CEO Pay Ratio Rules

On August 5, 2015, the United States Securities and Exchange Commission (the “SEC”) adopted final rules under Section 953(b) of the Dodd-Frank Wall Street Reform and Consumer Protection Act regarding disclosure of the ratio of the chief executive officer’s annual total compensation to the median annual total compensation of the registrant’s other employees. Absent Congressional or judicial intervention, or further SEC action, the final rules will generally require pay ratio disclosure beginning with proxies filed in 2018.

INTENDED EFFECT OF THE RULES

The SEC states that pay ratio disclosure is “intended to provide shareholders with a company-specific metric that can assist in their evaluation of a registrant’s executive compensation practices.” In particular, the SEC notes that shareholders may find these new pay ratio data points useful when making “say-on-pay” advisory voting decisions. As expressed in some of the more than 287,400 comment letters that the SEC received following its original pay ratio rule proposal on October 1, 2013, one aim of those who support pay ratio disclosure is to “reduce the inequitable wealth distribution in the U.S.” To that end, it is interesting to note that more than 99.4% of the comment letters received by the SEC were “form letters” (of 12 different variations) in support of the pay ratio disclosure proposal that were likely prepared by interested organizations such as labor unions.

Given that the gap between the compensation of a chief executive officer and the median compensation of all other employees (i) provides little insight about the chief executive officer’s performance or appropriate level of compensation and (ii) is likely irrelevant as a comparison tool among registrants, the crux of the pay ratio disclosure really boils down to just one statement – a chief executive officer makes significantly more than the average company employee. This should not be news to anyone who has

actually considered the relative roles and responsibilities of the chief executive officer compared to those of the average company employee. But quantifying the disparity into a simple pay ratio could encourage unwarranted focus on a single number and give policy advocates new sound bites in the debate over inequality of wealth and income in the United States.

COSTS & COMMENTARY

Unfortunately, the very limited benefits of the pay ratio rules come at a steep cost – both time and cash expense. The SEC estimates that “the total annual increase in the paperwork burden for all affected companies to comply with the collection of information requirements in our final rule is approximately 2,367,573 hours of company personnel time and approximately \$315,390,720 for the services of outside professionals.” Those figures are additive and are per year.

The one question that must be asked is whether the limited benefits of pay ratio disclosure outweigh these massive and ongoing financial costs and administrative burdens. We believe the answer to be a resounding “no” – and we believe that these new pay ratio disclosures will only serve to further complicate an already-expansive executive compensation disclosure regime for U.S. publicly-traded companies.

The remainder of this memo is a summary of the key provisions and requirements of the final pay ratio rules.

APPLICATION

The final pay ratio rules apply to registrants required to provide executive compensation disclosure under Item 402(c)(2)(x) of SEC Regulation S-K. Thus, smaller reporting companies, foreign private issuers, U.S.-Canadian Multijurisdictional Disclosure System filers, emerging growth companies, and registered investment companies are exempt. For applicable registrants, pay ratio disclosure is required in any filing described in Item 10(a) of Regulation S-K that calls for executive compensation disclosure under Item 402 of Regulation S-K, including annual reports on Form 10-K, registration statements (other than a Form S-1 or Form S-11 filed in connection with an initial public offering or a Form 10 for a new registrant), and proxy and information statements, as applicable. If a registrant loses its status as an emerging growth company or smaller reporting company, that registrant will be required to comply with the final rules beginning with the first fiscal year after losing such status.

COMPLIANCE DATE

Subject to additional delay for new registrants or registrants first becoming subject to the final rules, the pay ratio disclosure is required beginning with the registrant's first fiscal year commencing on or after January 1, 2017. As such, for registrants that are currently subject to the final rules, it is likely that no pay ratio disclosure will be required until the registrant's proxy filing in 2018.

PAY RATIO DISCLOSURE

The final rules add a new Item 402(u) to Regulation S-K, which requires disclosure of:

- The median of the annual total compensation of all employees of the registrant, except the principal executive officer ("PEO") of the registrant;
- The annual total compensation of the PEO of the registrant; and
- The ratio of these two prior amounts.

ANNUAL TOTAL COMPENSATION

Annual total compensation for the registrant's applicable fiscal year is generally determined in accordance with existing rules under Item 402(c)(2)(x) of Regulation S-K. However, the registrant may, in its discretion, include personal benefits that aggregate less than \$10,000 and compensation under non-discriminatory benefit plans in calculating annual total compensation (as long as (i) those items are included in both the median employee and PEO annual total compensation calculations and (ii) the registrant explains any material difference between the PEO's annual total compensation used in the pay ratio disclosure and the total compensation amounts reflected in the Summary Compensation Table). If the registrant relies on Instruction 1 to Item 402(c)(2)(iii) and (iv) of Regulation S-K (which provides for subsequent disclosure on Form 8-K if the amount of salary or bonus earned in a given fiscal year is not calculable at the applicable time) in connection with the salary or bonus of the PEO for the last completed fiscal year, then the pay ratio disclosure will be similarly delayed and must instead be included in the applicable Form 8-K disclosure. In that case, the registrant must disclose (i) that the pay ratio is not calculable until the applicable element of the PEO's compensation is determined and (ii) the date that the PEO's actual total compensation is expected to be determined.

IDENTIFICATION OF THE MEDIAN EMPLOYEE

A registrant must identify its median employee once every three years, provided that there were no changes to the registrant's employee population or compensation arrangements during the last fiscal year that would result in significant change to the pay ratio disclosure. For this purpose, the registrants "employees" means all individuals employed by the registrant or any of its consolidated subsidiaries (whether full-time, part-time, seasonal, or temporary) as of a date chosen by the registrant and within the last three months of the registrant's last completed fiscal year. This excludes independent contractors or "leased" workers who provide services to the registrant or its controlled subsidiaries, but who are employed, and whose compensation is determined by, an unaffiliated third party. The registrant must disclose the date selected for its median employee determination, and must disclose any change in the date used from the prior year, along with the reason(s) for the change.

TRANSACTION EXCEPTION

The registrant may omit any employees that became its employees due to an acquisition or business combination for the fiscal year of the transaction, but must disclose (i) the approximate number of employees omitted and (ii) the acquired business being excluded.

NON-U.S. EMPLOYEES

Subject to the following two exceptions, employees located in a jurisdiction outside the United States must be included by the registrant in making its median employee annual total compensation determination.

- Employees may be excluded if they are employed in a foreign jurisdiction in which applicable data privacy laws prohibit compliance with the final pay ratio rules. To be eligible for this exception: (i) the registrant must use reasonable efforts to obtain or process the necessary information, which must include using or seeking an exemption or other relief under applicable data privacy laws; (ii) all employees in the applicable jurisdiction must be excluded; (iii) the registrant must identify the applicable data privacy law, explain how its pay ratio disclosure process would violate the law, and disclose the approximate number of employees excluded based on this exception; and (iv) the registrant must obtain and file as an exhibit a legal opinion from counsel that opines on the inability of the registrant to obtain or process the necessary information without violating the applicable data privacy law.

- All employees located in a jurisdiction outside of the United States may be excluded if those individuals account for 5% or less of the registrant's and its consolidated subsidiaries' total employees, but only if all non-U.S. employees are excluded. Alternatively, if non-U.S. employees exceed 5% of the registrant's and its consolidated subsidiaries' total employees, then up to 5% of total employees may be excluded who are non-U.S. employees, but if any employee from a particular jurisdiction is excluded, then all employees in that jurisdiction must be excluded. Non-U.S. employees may be excluded by this "de minimis" exception only as long as the aggregate of non-U.S. employees excluded under this exception (together with the data privacy law exception) does not exceed 5% of the total employees of the registrant and its consolidated subsidiaries. If any non-U.S. employees are excluded under this *de minimis* exception, then the registrant must disclose (i) the jurisdiction(s) being excluded, (ii) the approximate number of employees excluded from each jurisdiction, (iii) the total number of U.S. and non-U.S. employees (irrespective of any exceptions), and (iv) the total number of U.S. and non-U.S. employees used for the 5% *de minimis* calculation.

MEDIAN DETERMINATION METHODOLOGIES & FLEXIBILITY

The final pay ratio rules provide a degree of flexibility in the methods used to determine the median employee annual total compensation. The registrant may use reasonable estimates both in the methodology used to identify the median employee and in calculating the annual total compensation or any elements of total compensation for employees other than the PEO. In determining the employees from which the median employee is identified, the registrant may use its employee population, statistical sampling, and/or other reasonable methods. The registrant may identify the median employee using annual total compensation or any other compensation measure that is consistently applied to all employees included in the calculation, but the registrant must disclose any other compensation measure used. In addition, the registrant must briefly describe (i) the methodology used to identify the median employee; (ii) any material assumptions, adjustments, or estimates used to identify the median employee or determine total compensation or any elements of total compensation; and (iii) any significant effects flowing from a change in the methodology or material assumptions, adjustments, or estimates from those used in the prior fiscal year, together with the reason(s) for the change.

COST-OF-LIVING ADJUSTMENT

The registrant may make cost-of-living adjustments to the compensation of employees in jurisdictions other than the jurisdiction in which the PEO resides. However, the registrant must (i) use the same cost-of-living adjustment to determine the median

employee and to calculate the median employee's annual total compensation, (ii) disclose the median employee's jurisdiction, (iii) describe the cost-of-living adjustment, (iv) disclose the median employee's annual total compensation and the pay ratio without the cost-of-living adjustment, and (v) disclose any change from using a cost-of-living adjustment to not using one (or vice-versa).

ANNUALIZING ADJUSTMENTS

Total compensation may be annualized for all permanent employees (full-time or part-time) employed for less than the full fiscal year, such as newly-hired employees or employees on unpaid leave during the year. However, the registrant may not annualize total compensation for employees in temporary or seasonal positions, and may not make a "full-time equivalent" adjustment for any part-time employee. These prohibitions will have the effect of increasing the final pay ratio figure, in particular for registrants with a significant part-time and/or seasonal employee population that cannot be muted by the registrant's ability to select its own median employee determination date.

MULTIPLE PEOs

If there is more than one non-concurrent PEO during a fiscal year, the registrant may calculate the annual total compensation for its PEO by either (i) combining each PEO's compensation during the applicable year or (ii) annualizing the compensation of the PEO serving on the date selected for the median employee determination. In either case, the registrant must disclose the method selected, as well as how the PEO's annual total compensation was calculated.

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