

KIRKLAND ALERT

November 2015

SEC Adopts Final CEO Pay Ratio Rule

On August 6, 2015, the SEC adopted final rules implementing the “CEO pay ratio” disclosure requirements mandated by Section 953(b) of the Dodd-Frank Act, which will, in most cases, be effective for fiscal year 2018 annual proxy statements.

Effective Date

The final rules will go into effect for proxy statements (or other SEC filings that require executive compensation disclosure pursuant to Item 402 of Regulation S-K) for registrant’s fiscal years beginning on or after January 1, 2017 (i.e., 2018 annual proxy statement filings for registrants with calendar year fiscal years). In addition, the final rules provide transition periods for newly public companies and companies engaging in acquisitions or business combinations. Specifically, newly public companies will be required to disclose the CEO pay ratio with respect to compensation for the first fiscal year commencing on or after the date the company became public, rather than in registration statements on Form S-1 or Form S-11 for an initial public offering or a registration statement on Form 10 and a registrant that engages in a business combination and/or acquisition may omit the employees of a newly acquired entity from the pay ratio calculation for the fiscal year in which the business combination or acquisition is consummated.

Required Disclosure

The final rules require publicly traded companies, other than emerging growth companies, smaller reporting companies and foreign private issuers, to disclose the following information:

- the median of the annual total compensation of all employees (excluding the CEO);
- the annual total compensation of the CEO; and
- the ratio of the median to the CEO’s annual total compensation, disclosed as a ratio (e.g., 100:1 or 100 to 1), or as a multiple (e.g., 100 times that of the median employee).

The SEC rules require registrants to calculate the annual total compensation their median employee in the same manner as for named executive officers. The rules, however, permit registrants to use reasonable estimates and cost of living adjustments in identifying their median employee and calculating annual total compensation. In addition to disclosing the ratio, registrants are required to describe the methodologies used to identify the median employee and calculate annual total compensation, including any material estimates or cost of living adjustments. The

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final rules also permit registrants to disclose additional ratios or information, to the extent any additional ratios or information is clearly identified and not misleading.

Median Employee

The final rules define “Employee” as any U.S. or non-U.S. employee of a registrant (other than the CEO) who was employed as of the last day of the registrant’s fiscal year, including any full-time, part-time, seasonal or temporary employees, and a registrant may use any date within three months prior to the last day of the registrant’s last completed fiscal year to identify the median employee. Companies need not include non-U.S. employees in the event that foreign data privacy laws or regulations prohibit the company from collecting the necessary information. A registrant may also generally exclude up to 5 percent of its non-U.S. employees pursuant to a *de minimis* exemption.

The final rules allow registrants to identify the median employee by analyzing their full employee population or by using statistical sampling or another reasonable method, which, as noted above, must be briefly described in the narrative disclosure accompanying the pay ratio disclosure.

Although the final rules require registrants to calculate their median employee’s annual total compensation on an annual basis, the final rules allow registrants to identify the median employee once every three years, unless there has been a change in its employee population or compensation arrangements that the registrant reasonably believes would result in a significant change in the pay ratio disclosure. In addition, in the event that the median employee’s compensation or position has significantly changed during the three-year period, the registrant is permitted to use an employee who is similarly compensated for purposes of the pay ratio disclosure for the following years.

Next Steps

Although, in most cases, disclosure of the CEO pay ratio will not be required for more than two years, compliance with the rules will likely be complicated and time-consuming. Accordingly, registrants are advised to begin working on establishing effective processes for identifying median employees and collecting the requisite compensation information, including:

- identifying the internal employees involved in the identification process (from internal HR and legal teams to external counsel, compensation consultants and accountants);
- evaluating methodologies for identifying the median employee, including alternative methods like statistical sampling;
- considering cost of living adjustments and whether to exclude non-U.S. employees for multinational registrants;

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- selecting a testing date for purposes of identifying the median employee;
- calculating total compensation of the median employee using the same rules as apply to the CEO's compensation in the Summary Compensation Table; and
- drafting basic disclosure required by the final rules.

If you have any questions about the matters addressed in this *Kirkland Alert*, please contact the following Kirkland authors or your regular Kirkland contact.

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