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SEC staff issues new guidance on CEO pay ratio disclosure requirements

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On October 18, more than a year after the SEC amended Item 402 of Regulation S-K to require most public companies to disclose annually the ratio of the CEO's annual total compensation to the median of the annual total compensation of all other employees, the staff of the SEC's Division of Corporation Finance published its first interpretive guidance concerning the rule. The guidance is presented in the form of five new Compliance and Disclosure Interpretations (CDIs) under Regulation S-K. The interpretations provide the staff's views regarding (1) the selection and use of a "consistently applied compensation measure" to identify the representative "median employee," (2) the identification and treatment of furloughed workers, and (3) the identification and treatment of independent contractors or leased workers.

Companies are required to include pay ratio disclosure under Item 402(u) with respect to compensation for their first full fiscal year that begins on or after January 1, 2017. They therefore generally will make their first pay ratio disclosure in the annual reports on Form 10-K or annual proxy statements they will file in 2018.

The new CDIs are identified as Questions 128C.01 to 128C.05 and are available here.

Background

The pay ratio disclosure rule was mandated by Section 953(b) of the Dodd Frank Act, which had the stated objective of providing a company's shareholders with a "company-specific metric" that can assist them in evaluating the company's executive compensation practices and casting their say-on-pay votes. The rule added a new paragraph (u) to Item 402 of Regulation S-K, which prescribes the disclosure requirements for executive compensation. Item 402(u) requires companies to disclose, for the most recently completed fiscal year, three values that constitute the components of the pay ratio disclosure:

- Median of the annual total compensation of all employees of the company other than the CEO
- Annual total compensation of the CEO
- The ratio of these two amounts

The rule does not apply to emerging growth companies, smaller reporting companies, foreign private issuers or companies filing under the U.S.-Canadian Multijurisdictional Disclosure System. We discussed the pay ratio rule in the *SEC Update* we issued on August 11, 2015.

New guidance

Clarifications regarding consistently applied compensation measures (CACMs)

Item 402(u) requires a company to use a reasonable method to identify the "median employee," an actual employee whose compensation will represent the median of the annual total compensation of all employees other than the CEO. The SEC acknowledged in its 2015 release

adopting the rule that a "one-size-fits-all approach" to the median employee determination would not be appropriate, and approved a number of accommodations intended to afford companies flexibility in choosing how to identify the median employee. The rule permits a company to identify the median employee using annual total compensation (as calculated in accordance with Item 402(c)(2)(x) of Regulation S-K) or any other compensation measure that is consistently applied to all employees included in the calculation, such as a compensation measure derived from tax and/or payroll records, so long as the company discloses the compensation measure it used. In the new CDIs, the SEC staff provides a number of clarifications with respect to the selection and use of such "consistently applied compensation measures," which the staff refers to as "CACMs."

Selection of a CACM. In the first CDI, the SEC staff states that any measure that reasonably reflects the annual compensation of employees may serve as a CACM, and that the "appropriateness of any measure will depend on the registrant's particular facts and circumstances." The staff notes, as examples, that (1) total cash compensation *could* be an appropriate CACM, but not if the company also distributed annual equity awards widely among its employees, and (2) Social Security taxes withheld likely would *not* be an appropriate CACM, unless all employees earned less than the Social Security wage base. The staff also indicates that "it is not expected" that the CACM would necessarily identify the same median employee that would be identified if the company were to use annual total compensation as calculated in accordance with Item 402(c)(2)(x) of Regulation S-K. (Question 128C.01)

Use of hourly or annual pay rates. The new guidance also states that, although an hourly or annual pay rate may be a component used to determine an employee's overall compensation, "the use of the pay rate alone generally is not an appropriate CACM to identify the median employee." The staff reasons that (1) using an hourly rate only, without taking into account the number of hours actually worked, is similar to making a full-time equivalent adjustment for part-time employees, which is not permitted by the rule, and (2) using an annual rate only, without regard to whether the employees worked the entire year and were actually paid that amount during the year, is similar to annualizing pay, which the rule permits only in limited circumstances. (Question 128C.02)

Identification of period for applying a CACM. To determine the employee population for purposes of identifying the median employee, a company must select a date that is within three months of the end of its fiscal year. The company then must identify the median employee from that population using either annual total compensation or another CACM. The new guidance clarifies that, in applying the CACM to identify the median employee, a company is *not* required to use (1) a period that includes the date on which the employee population is determined or (2) a full annual period. The staff also indicates that a CACM may consist of annual total compensation from the company's prior fiscal year, "so long as there has not been a change in the registrant's employee population or employee compensation arrangements that would result in a significant change of its pay distribution to its workforce." (Question 128C.03)

Identification and treatment of furloughed workers

The rule does not address whether furloughed employees must be included in the employee population when identifying the median employee or calculating the total annual compensation of all employees other than the CEO. The staff addresses both of these questions.

In considering the inclusion of furloughed workers in the employee population, the staff states that, because a "furlough" could have different meanings for different employers, companies "will need to determine whether furloughed workers should be included as employees based on the facts and circumstances." If the company determines that a furloughed worker is an

employee on the date used for the determination of the employee population, the staff advises that a furloughed worker's compensation should be determined by the same method as the compensation of a non-furloughed employee. The company will have to evaluate whether the employee should be classified as full-time, part-time, temporary or seasonal on that determination date, and then calculate the employee's compensation using annual total compensation or another CACM in accordance with Instruction 5 of Item 402(u). Instruction 5 provides that a company may annualize the total compensation for all full-time or part-time employees that were employed by the registrant for less than the full fiscal year or who were on an unpaid leave of absence during the period. A company may not, however, annualize the total compensation for employees in temporary or seasonal positions. The staff also notes that companies may not make a full-time equivalent adjustment for any employee. (Question 128C.04)

Identification and treatment of independent contractors or leased workers

Much of the pay ratio rulemaking process focused on the task of defining the terms "employee" and "employee of the registrant" for purposes of designating the employee population the company must use in identifying the median employee. Workers who are employed by an unaffiliated third party and whose compensation is determined by that third party do not fall within the scope of "employee." The pay ratio rule therefore excludes independent contractors or "leased" workers from the employee population. The SEC indicated in the release adopting the rule, however, that companies may discuss their reliance on "leased" workers in the pay ratio disclosure and may present additional pay ratios that reflect the inclusion of those workers in the calculation so long as any additional ratios are not misleading and are not disclosed more prominently than the required pay ratio.

The final new CDI addresses the circumstances in which (1) a worker would be considered an independent contractor or leased worker and (2) a company is considered to be determining the worker's compensation. The staff reiterates the observation in the rule's adopting release that the pay ratio disclosure was intended to provide shareholders with a "company-specific metric" and adds that, in accordance with this objective, a company must consider the composition of its own workforce and its overall employment and compensation practices in determining when a worker is an "employee" under the rule. The staff advises that a company should include as employees those workers whose compensation is determined by it or by one of its consolidated subsidiaries, "regardless of whether these workers would be considered 'employees' for tax or employment law purposes or under other definition of that term." The staff goes on to state, however, that when a company obtains the services of workers by contracting with an unaffiliated third party that employs the workers, the company would not be deemed to determine the workers' compensation for purposes of the rule if the company were, for example, simply to specify that those workers receive a minimum level of compensation. The staff also clarifies that, for purposes of the rule, an individual who is an independent contractor may be the "unaffiliated third party" who determines his or her own compensation. (Question 128C.05)

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