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New SEC Guidance on Pay Ratio Disclosure

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On October 18, 2016, the ***Securities and Exchange Commission*** Staff updated its *Compliance and Disclosure Interpretations* to provide guidance on pay ratio disclosure under Item 402(u) of ***Regulation S-K***. Mandated by the ***Dodd-Frank Act***, the Pay Ratio rule requires a public company to disclose the median annual total compensation of its employed workforce, the annual total compensation of its CEO, and the ratio of those two amounts. Companies must disclose this information in registration statements, proxy and information statements, and annual reports for fiscal years beginning on or after January 1, 2017.

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As adopted, Item 402(u) provides companies with substantial flexibility in calculating the required disclosures. For example, a company is permitted to select any reasonable methodology for identifying its median employee,including through statistical sampling of its employee population. Rather than having to calculate the total annual compensation of every employee just to identify the median, the rule permits a company to base its median employee determination on any "consistently applied compensation measure" (CACM) reasonably chosen by the company. The rule allows companies to exclude non-U.S. employees from countries in which data privacy laws or regulations prevent compliance with the rule, notwithstanding a company's reasonable efforts, and provides a de minimis exemption for non-U.S. employees. Absent a material change in compensation practices or workforce, a company need only identify its median employee once every three years.

The guidance issued by the Staff of the Commission's Division of Corporation Finance is in keeping with the Commission's flexible approach:

> First, the Division stated that any measure that reasonably reflects the annual compensation of employees may serve as a CACM. Any such measure should be briefly described with the company's pay ratio disclosures. The appropriateness of that measure will depend on the facts and circumstances. For example, many companies should be able to use total cash compensation as a CACM, instead of total compensation as defined in the rules. However, a company that distributes annual equity awards widely among employees may find that calculating the median employee based solely on cash compensation would not be appropriate. Importantly, the Division confirmed that if the CACM is otherwise reasonable, the use of that CACM does not have to result in selection of the same median employee that would have been identified if the median were based on annual total compensation.

As the new guidance makes clear, a company may not use hourly pay rates as a CACM, as that would have the same effect as adjusting the compensation of part-time employees to their full-time equivalents. Similarly, annual compensation rates would not be an appropriate CACM, as that would effectively annualize the pay for an employee who only worked a portion of the year. Such adjustments are expressly prohibited by the rule.

The Division also confirmed that the period used to determine the median employee need not include the date on which the employee population is determined and need not be a full annual period. The Division's guidance also addressed the treatment of furloughed employees.

As adopted, the Pay Ratio rule excludes from the definition of "employee" those workers who are employed, and whose compensation is determined, by an unaffiliated third party but who provide services to the company and its subsidiaries as independent contractors or "leased" workers. The Division's new guidance notes that the primary purpose of the pay ratio disclosure is to provide shareholders with a company-specific metric for use in

evaluating the compensation of the company's CEO. Thus, in determining whether a worker is an "employee" of the company under the rule, the company must consider its overall employment and compensation practices. The guidance notes that this determination does not rely on whether a worker would be considered an "employee" for tax or employment law purposes or under other definitions of that term, and a company will not be deemed to be determining the compensation of leased workers and employees of independent contractors, simply because the company specifies a minimum level of compensation for such workers. The Division further notes that an individual who is an independent contractor may be the "unaffiliated third party" who determines his or her compensation.

Notwithstanding the flexibility provided by the rule and the recent guidance, the process of gathering employee compensation data across the entire employee population and determining the median employee is expected to be complicated and time-consuming for many companies. In fact, the ability for a company to apply its own judgment weighs in favor of thinking through these issues carefully.

The Division's guidance has been codified as Section 128C of the Compliance and Disclosure Interpretations for Regulation S-K. To view the complete guidance, please visit the Securities and Exchange Commission's website here.