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Legal Update
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SEC Provides Pay Ratio Disclosure Guidance

Under the rules of the US Securities and Exchange Commission (SEC), companies will be required to include pay ratio disclosure in their proxy statements with respect to compensation for their first full fiscal year that begins on or after January 1, 2017. Therefore, companies generally will first be required to include pay ratio disclosure in their 2018 proxy statements.[1] On October 18, 2016, the staff (Staff) of the Division of Corporation Finance of the SEC issued five new compliance and disclosure interpretations (C&DIs) providing guidance on the methodology for applying compensation measures and determining the employee population to identify the median employee.[2] These C&DIs are summarized below.

The pay ratio disclosure rule, which is contained in paragraph (u) of Item 402 of Regulation S-K, will require public companies to disclose:

- The median of the annual total compensation of all employees other than the chief executive officer for the most recently completed fiscal year;
- The annual total compensation of the chief executive officer for the most recently completed fiscal year; and
- The ratio of these amounts.

For more information on the details of the SEC's pay ratio disclosure rule, see our Legal Update, "Understanding the SEC's Pay Ratio Disclosure Rule and its Implications," dated August 20, 2015.[3]

Summary of the Pay Ratio Disclosure C&DIs

The C&DIs provide guidance on three areas of pay ratio disclosure:

- The use of consistently applied compensation measures;
- The treatment of furloughed workers; and
- The treatment of independent contractors and leased workers.

CONSISTENTLY APPLIED COMPENSATION MEASURES

The pay ratio disclosure rule permits a company to identify the median employee based either on annual total compensation calculated using Item 402(c)(2)(x) of Regulation S-K or on another consistently applied compensation measure (CACM), such as information derived from the company's tax and/or payroll records, that the company selects.[4] If a company decides to use a CACM, it must briefly disclose the compensation measure used.[5]

Selection of CACM. C&DI 128C.01 addresses how a company should select a CACM to identify the median employee. This C&DI observes that any measure that reasonably reflects the annual compensation of employees could serve as a CACM, with the appropriateness of the measure dependent on the company's particular facts and circumstances. For example, according to this C&DI, total cash compensation could be a CACM but not if the company also distributed annual equity awards widely among its employees. This

C&DI states that the amount of Social Security taxes withheld "would likely not be a CACM unless all employees earned less than the Social Security wage base." C&DI 128C.01 expressly recognizes that CACM would not necessarily identify the same median employee that would be identified based on annual total compensation calculated in accordance with Item 402(c)(2)(x) of Regulation S-K.

Rates of Pay as CACM. According to C&DI 128C.02, a company may not exclusively use hourly or annual rates of pay as its CACM. While the pay rate may be a component of overall compensation, this C&DI compares using an hourly rate without reflecting the number of hours actually worked to making a full-time equivalent adjustment for part-time employees, which the pay ratio disclosure rule does not permit. C&DI 128C.02 states that "using an annual ***rate*** only, without regard to whether the employees worked the entire year and were actually paid that amount during the year, would be similar to annualizing pay, which the rule only permits in limited circumstances."

Time Period of CACM. C&DI 128C.03 discusses time period issues involved in identifying the median employee through a CACM. This C&DI observes that a company must select a date that is within three months of the end of its fiscal year[6] to determine the employee population from which it will identify its median employee and then identify the median employee from that population using either annual total compensation or another CACM. C&DI 128C.03 provides that when a company uses a CACM to identify its median employee, it does not have to use a period that includes the employee population determination date or a full annual period. This C&DI also notes that a CACM may consist of annual total compensation from a prior fiscal year so long as there has not been a change in the company's employee population or compensation arrangements that "would result in a significant change of its pay distribution to its workforce."

FURLOUGHED WORKERS

C&DI 128C.04 addresses whether furloughed workers should be included as part of the employee population that a company uses to identify its median employee and, if so, how the furloughed employee's compensation should be calculated. This C&DI specifies that a company must first determine whether its furloughed workers should be treated as employees, which is a matter of facts and circumstances. To the extent that a company concludes that a furloughed worker is one of its employees on the date it selects to determine its employee population, the company should calculate such furloughed worker's compensation using the same method as for a non-furloughed employee. This means that the company would have to analyze whether the furloughed worker is a full-time, part-time, temporary or seasonal employee on the determination date for its employee population and then calculate that individual's compensation in accordance with Instruction 5 of Item 402(u). Instruction 5 allows a company to annualize the total compensation for all permanent employees, whether full-time or part-time, who it employed for less than the full fiscal year or who were on an unpaid leave of absence during the period. On the other hand, Instruction 5 specifies that a company may not annualize the total compensation for employees in temporary or seasonal positions. Companies are not permitted full-time equivalent adjustment for any employee.

INDEPENDENT CONTRACTORS AND LEASED WORKERS

The pay ratio disclosure rule excludes from its definition of "employee" any workers who are employed by, and whose compensation is determined by, an unaffiliated third party.[7] C&DI 128C.05 observes that companies frequently obtain the services of workers by contracting with an unaffiliated third party that employs the workers and addresses when a worker employed and compensated by a third party will be considered an independent

contractor or a leased worker under the rule and when the company will be considered to be determining the compensation of such workers. The company must consider the composition of its workforce and its overall employment and compensation practices in determining whether the worker is an "employee" under the rule and should include all workers whose compensation it or one of its consolidated subsidiaries determines, whether or not they are considered "employees" for tax, employment law or other purposes. According to this C&DI, the Staff does not believe that a company determines compensation for the purposes of the pay ratio disclosure rule if, for example, the company only specifies a minimum level of compensation for workers who the company obtains by contracting with an unaffiliated third party that employs such workers. The Staff also states that an individual who is an independent contractor may be the "unaffiliated third party" who determines his or her own compensation.

Practical Considerations

The recent C&DIs on pay ratio disclosure provide guidance on important pay ratio topics that many companies will face when gathering the information needed to prepare the required disclosure. Therefore, companies should review the new C&DIs carefully. It is possible that the Staff may issue further pay ratio disclosure guidance in the future, so companies should monitor developments in this area.

The pay ratio disclosure rule is complex. Companies should consider conducting trial calculations to develop appropriate methodology and assumptions. They may also want to consider preparing supplemental narrative information, including additional ratios, which is permitted as long as clearly identified, not misleading and not presented with greater prominence than the required disclosure. To the extent a company identifies an ambiguity or a question in how this rule should be applied, it may be worthwhile reaching out to the Staff for an interpretation.

Although pay ratio disclosure is not required in 2017 proxy statements, some companies may voluntarily include this disclosure. Companies may find it useful to review any such precedent, but they should be aware that voluntary early disclosure provided by other companies may not be fully compliant with the SEC's rule.

The timing of the Staff's issuance of these new C&DIs should serve as a reminder that preparing for the upcoming requirement will take a great deal of time and effort. Companies need to determine the methodology they will use to comply with the rule and then fine-tune the details. Companies should be working on the mechanics of pay ratio disclosure and implementing corresponding disclosure controls and procedures now so that they will be ready to comply with the new requirement in time for the 2018 proxy season.

For more information about the topics raised in this Legal Update, please contact the author of this Legal Update, Laura D. Richman, at +1 312 701 7304, or any of the following lawyers.

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Endnotes

[1] The adopting release for the SEC's pay ratio disclosure rule is available at https://www.sec.gov/rules/final/2015/33-9877.pdf.

[2] See "Section 128C — Item 402(u) Pay Ratio Disclosure" of the Regulation S-K compliance and disclosure interpretations, available at https://www.sec.gov/divisions/corpfin/guidance/regs-kinterp.htm.

[3] Available at https://www.mayerbrown.com/files/Publication/a9183a67-efc1-4bcc-859a-f11c0a28e776/Presentation/PublicationAttachment/c3ae9779-28c6-4ee2-996a-efbd405d4952/150820-UPDATE-CS-EB.pdf.

[4] Paragraph 3 of Instruction 4 to Regulation S-K Item 402(u).

[5] *Id.*

[6] Regulation S-K Item 402(u)(3).

[7] *Id.*