

SEC Issues Additional Guidance on CEO Pay-Ratio Disclosure Rule under Dodd-Frank

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On October 18, 2016, the Division of Corporation Finance of the Securities and Exchange Commission (the “SEC”) issued five new Compliance and Disclosure Interpretations (“C&DIs”) regarding the pay-ratio disclosure requirement under Item 4.02(u) of Regulation S-K. The new C&DIs provide additional guidance to companies on how to identify the median employee through a “consistently applied compensation measure” (“CACM”) and determine which employees to include in the pay-ratio calculation. The full text of the new C&DIs, Questions 128C.01 through 128C.05, is available [here](#).

Background

On August 5, 2015, the SEC adopted a final rule (the “Final Rule”) to implement Section 953(b) of the Dodd-Frank Wall Street Reform and Consumer Protection Act (“Dodd-Frank”) with respect to chief executive officer pay-ratio disclosures. The Final Rule amended Item 402 – “*Executive Compensation*” of Regulation S-K by adding a new paragraph (u) to Item 402, which, consistent with Section 953(b) of Dodd-Frank, requires publicly-traded companies (“registrants”) to calculate and disclose on an annual basis:

- The median of the annual total compensation of all employees of the registrant (excluding the principal executive officer, or “PEO”);
- The annual total compensation of the registrant’s PEO; and
- The ratio between these two amounts.

Most public companies must comply with the Final Rule for their first fiscal year beginning on or after January 1, 2017. Consequently, most registrants must include pay-ratio disclosures in their 2018 proxy statements. For more information related to the pay-ratio disclosure rule, please refer to our earlier Alert, “SEC Adopts Final Rule for CEO Pay-Ratio Disclosures under Dodd-Frank,” available [here](#).

New Guidance on CEO Pay-Ratio Disclosure Rule

Although the SEC issued five individual C&DIs to clarify the Final Rule, the new C&DIs addressed two general issues: (1) identifying the median employee through a CACM, and (2) determining which employees to include in the pay-ratio calculation.

Identifying the Median Employee through a CACM

Under Item 402(u), a registrant may use annual total compensation or another CACM, such as information derived from tax or payroll records, to identify the median employee. However, if a registrant uses a CACM, it must disclose the compensation measure it used. In C&DI [128C.01](#), the

SEC noted that “[a]ny measure that reasonably reflects the annual compensation of employees could serve as a CACM.” Whether that measure is appropriate or not will depend upon the particular facts and circumstances of the registrant. For instance, the SEC observed that “total compensation could be a CACM unless the registrant also distributed annual equity awards widely among its employees.” Conversely, “Social Security taxes withheld would likely not be a CACM unless all employees earned less than the Social Security wage base.” The SEC further noted that, while the CACM must “reasonably reflect” annual compensation, it does not expect that the CACM would necessarily identify the same median employee that would be identified if the registrant were to use annual total compensation.

Additionally, in C&DI [128C.02](#), the SEC explicitly prohibited the exclusive use of hourly or annual rates of pay to determine an employee’s overall compensation. In reaching this conclusion, the SEC noted that “using an hourly rate without taking into account the number of hours actually worked would be similar to making a full-time equivalent adjustment for part-time employees, which is not allowed.” Registrants may nevertheless use hourly or annual pay rate as a component in determining an employee’s overall compensation.

Finally, in C&DI [128C.03](#), the SEC addressed the time period to identify the median employee through a CACM. The registrant must first select a date that is within three months of the end of its fiscal year to determine the population from which to identify the median employee. Then, the registrant must identify the median employee from that population by using either annual total compensation or another CACM. In applying the CACM, the registrant is not required to use a period that includes the date on which the employee population is determined or a full annual period. Moreover, a CACM may consist of annual total compensation from a prior fiscal year so long as there has not been a change in the registrant’s employee population or compensation arrangements that would result in “a significant change of its pay distribution to its workforce.”

Determining which Employees to Include in the Pay-Ratio Calculation

The final two C&DIs addressed the treatment of “furloughed workers,” independent contractors, and leased workers in calculating the employee population. C&DI [128C.04](#) addresses furloughed workers. Since “furlough” has “different meanings for different employers,” employers must determine whether furloughed workers should be included as employees based on the facts and circumstances. If the registrant concludes that the furloughed worker is an employee on the date the employee population is determined, the worker’s compensation should be calculated using the same method as for a non-furloughed employee. This means that the registrant must determine whether the furloughed worker is a full-time, part-time, temporary or seasonal employee on the employee population date and calculate the worker’s annual total compensation or another CACM in accordance with Instruction 5 of Item 402(u). Instruction 5 permits a registrant to annualize the total compensation for all permanent employees, full-time or part-time, employed by the registrant for less than the full fiscal year or who were on an unpaid leave of absence during the period. By contrast, a registrant is prohibited from annualizing the total compensation for employees in temporary and seasonal positions. Registrants are further prohibited from making full-time equivalent adjustments for any employee.

Lastly, the SEC addressed whether to include the compensation of independent contractors and leased workers in C&DI [128C.05](#). Item 402(u)(3) excludes from its definition of “employee” workers who are “employed, and whose compensation is determined, by an unaffiliated third party.” The SEC acknowledged that registrants often obtain the services of workers by contracting with an unaffiliated third party that employs such workers. Consequently, to determine whether a worker is an “employee,” the registrant must consider “the composition of its workforce and its overall

employment and compensation practices.” Registrants should include workers whose compensation it or one of its subsidiaries determines, regardless of whether they are considered “employees” for tax or employment law purposes. However, the SEC does not believe a registrant “determines compensation” by simply specifying the minimum level of compensation the worker must receive. The SEC also noted that an individual who is an independent contractor may be the “unaffiliated third party” who determines his or her own compensation.

Conclusion

These new C&DIs on pay-ratio disclosure provide helpful guidance on important pay-ratio issues for companies preparing to comply with the Final Rule beginning on or after January 1, 2017. Nevertheless, the Final Rule remains a complex compliance challenge that demands diligence and proper attention. Therefore, if you have any questions about this topic, please contact a member of our [Capital Markets and Securities Practice Group](#).