

SEC Staff Issues Guidance on Pay Ratio Disclosure Rules

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The staff of the **Securities and Exchange Commission's Division of Corporation Finance** (the staff) issued new compliance and disclosure interpretations (C&DIs) on October, 18, 2016, providing guidance to companies preparing to comply with the pay ratio disclosure rules adopted in 2015. The pay ratio disclosure rules will require publicly-traded companies to disclose the ratio of median compensation of all employees to the compensation of the principal executive officer for full fiscal years, beginning on and after January 1, 2017. The five new C&DIs provide guidance on three aspects of identifying the median employee for purposes of calculating the pay ratio.

What qualifies as a “consistently applied compensation measure” that may be used to identify the median employee?

The pay ratio rules require the median employee to be identified using annual total compensation or “any other compensation measure that is consistently applied to all employees included in the calculation,” such as information derived from tax and/or payroll records. The breadth of the category “any other compensation measure” created some uncertainty as to how literally it could be taken. The staff's new guidance reduces this uncertainty by addressing the types of compensation measures the staff will view as acceptable consistently applied compensation measures (CACMs).

Under the new C&DIs, any CACM must “reasonably reflect . . . the annual compensation of employees.” However, the chosen CACM does “not necessarily have to identify the same median employee as if the registrant were to use annual total compensation.” Beyond these parameters, there are few bright-line rules. Instead, “the appropriateness of any measure will depend on the registrant's particular facts and circumstances.”

In addition to these general principles, the C&DIs address three specific compensation measures in more detail:

- **Total cash compensation.** Total cash compensation could be a CACM *unless* the company widely distributed equity awards during the year.

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- **Social security taxes withheld.** Social security taxes withheld likely would not qualify as a CACM unless all employees earned less than the social security wage base.
 - **Hourly or annual rates of pay.** Hourly or annual rates of pay cannot be used *exclusively* as a registrant's CACM, without taking into account the number of hours actually worked, because this would be similar to making a full-time equivalent adjustment for part-time employees, which is otherwise prohibited by the rules.

What is the appropriate time period to consider when using a CACM?

Under the pay ratio disclosure rules, there are two independent time periods relevant to determining the median employee: (1) the date on which the employee population from which the median employee will be identified is determined and (2) the time period over which the registrant applies the CACM.

- **Selecting a date to determine the employee population.** The only requirement for selecting a date on which to determine the employee population from which to identify the median employee is that the date must be within three months of the end of the fiscal year.
- **Selecting a time period over which to apply the CACM.** In applying the CACM to identify the median employee from the population determined above, the C&DIs clarify that:
 - the company does not need to use a period that includes the date on which the employee population is determined;
 - the company is not required to use a full annual period when applying the CACM; and
 - the company may use annual total compensation from the prior fiscal year as long as there are no changes in the employee population or compensation arrangements that would create a significant change to the company's pay distribution.

Who is an employee for the purposes of determining “the median compensation of all employees?”

Two of the new C&DIs clarify the definition of employee under the pay ratio rules. One clarifies how to deal with furloughed workers and another describes how to identify workers who may be excluded from the calculation of the median employee as independent contractors or leased workers.

- **Furloughed workers.** The pay ratio disclosure rules divide employees into four classes—full-time, part-time, temporary, and seasonal. The rules do not define or address furloughed employees, so the C&DI advises that whether a furloughed worker should be included in the employee population depends on whether the worker falls into one of the four defined employee classes on the date that the employee population is determined, based on the specific facts and circumstances. If the company determines that the furloughed worker is an employee, then it should calculate his or her annual total compensation or other CACM just as it would for any other employee of the same class, keeping in mind the following points from the pay ratio disclosure rules:

- A company *may* annualize the total compensation for all permanent employees, whether full-time or part-time, who were either employed by the company for less than the full fiscal year, or who were on an unpaid leave of absence during the period.
- A company *may not* annualize the total compensation for employees in temporary or seasonal positions.
- A company *may not* make a full-time equivalent adjustment for any employee.
- **Independent Contractors and Leased Workers.** The pay ratio rules provide that workers who are employed by an unaffiliated third party and who provide services to the company as independent contractors or leased workers are not required to be included in the calculation of the median employee if their compensation is determined by the unaffiliated third party. The new staff guidance clarifies that it will not consider a company to be determining the compensation of workers for this purpose if the company obtains the workers' services by contracting with an unaffiliated third party that employs the workers and only specifies that those workers receive a minimum level of compensation. The guidance also clarifies that an individual who is an independent contractor may be the unaffiliated third party who determines his or her own compensation.