

Additional SEC Guidance on Pay Ratio Disclosure

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As issuers prepare for the pay ratio disclosures that will be required with respect to fiscal years beginning on or after January 1, 2017, the Division of Corporation Finance issued new Compliance & Disclosure Interpretations (“C&DIs”) on October 18, 2016 that provide additional guidance on this topic. The C&DIs focus primarily on the use of a “consistently applied compensation measure” (“CACM”) to identify the median annual compensation of all employees except the chief executive officer.

As a reminder, the “pay ratio rule” will require public companies (other than smaller reporting companies, foreign private issuers, emerging growth companies and registered investment companies) to disclose the ratio of annual total compensation of the CEO to the median of the annual total compensation of the company’s employees. (See Foley Hoag Securities Alert: **SEC Adopts Pay Ratio Disclosure Rule.**) Issuers have some discretion in their method of determining their median employee under the rule, including the manner of calculating annual total compensation. Each employee’s compensation may be calculated using either the standard set forth in Item 402(c)(2)(x) of Regulation S K, which is the method used for the disclosure of a named executive officer’s total annual compensation, or any CACM.

The C&DIs provide the following additional guidance on selecting a CACM to identify the median employee:

- Any measure that reasonably reflects the annual compensation of employees could serve as a CACM.
- The appropriateness of any measure depends on the issuer’s particular facts and circumstances.

As examples, the C&DIs note that total cash compensation would not be a reasonable CACM if the issuer also distributed annual equity awards widely among its employees. In addition, Social Security taxes withheld would likely not be a reasonable CACM unless all employees earned less than the Social Security wage base. These particular examples make clear that issuers cannot simply default to the most readily available measure absent a determination that it is reasonable based on the issuer’s specific compensation practices. The C&DIs also confirm that an hourly or annual rate of pay is not an acceptable CACM.

Additional detail regarding the process that issuers must undertake to calculate the pay ratio was also provided. The C&DIs clarify the process as follows:

- **Set the population determination date.** Issuers must select a date within three months of the end of its fiscal year to determine the population of employees from which the issuer will identify the median employee.
- **Identify the median employee.** After developing a methodology to determine compensation (using either annual total compensation or another CACM), the issuer must identify the median employee.
- **CACM time period.** The CACM period is not required to (i) include the date on which the employee population is determined, (ii) reflect a full annual period or (iii) reflect the current fiscal year. A prior fiscal year would not be appropriate to use, however, if there has been a change in the issuer’s employee population or employee compensation arrangements that would result in a significant change in the pay distribution to its workforce.

Lastly, the C&DIs clarify how issuers should reflect furloughed personnel and determine whether employees should be considered independent contractors or leased workers under the rule.

- **Furloughed employees.** Issuers will need to determine, based on the specific facts and circumstances, whether a furloughed employee should be categorized as full time, part time, temporary or seasonal. A furloughed employee’s compensation may be annualized if the employee is a permanent employee (whether full or part time) but not if the employee is a temporary or seasonal

employee.

- **Independent contractors/leased workers.** Issuers must evaluate their overall compensation practices to determine whether they are so involved in the determination of the compensation of independent contractors and leased employees that such personnel should be included as employees for purposes of the pay ratio rule. Whether an employee is identified as an independent contractor or leased employee for tax or employment law purposes is not determinative.

The C&DIs provide additional useful guidance to issuers as they prepare to make their initial pay ratio disclosures. The C&DIs' focus on the use of CACMs suggests that the staff expects that most issuers will use a CACM rather than annual total compensation, perhaps because of the significant challenges of calculating the latter on a company wide basis. Issuers that will be subject to the pay ratio rules should begin now to assess the alternative methodologies that they could use to comply with these rules to ensure that they provide stockholders with pay ratio calculations that make the most sense in the context of their specific circumstances. Issuers may also consider disclosing additional ratios if they determine that other ratios might be more useful or informative to investors than those mandated by SEC regulations, such as ratios limited to U.S. employees or full-time employees.

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