

October 21, 2016

SEC Issues Guidance on Pay Ratio Disclosure Rule

On October 18, 2016, the Division of Corporation Finance of the Securities and Exchange Commission issued five new compliance and disclosure interpretations (C&DIs) regarding the pay ratio disclosure rule, which will require a public company to disclose the ratio of the CEO's compensation to the median compensation of its employees. The new C&DIs provide guidance on matters relating to the selection and use of a consistently applied compensation measure, the treatment of furloughed employees, and determining whether a worker that provides services to a company but is employed by an unaffiliated third party (or by him or herself) will be treated as an employee for purposes of the pay ratio determination. These C&DIs should assist companies that are currently preparing for compliance with the pay ratio disclosure rule.

Following are key points that were highlighted by the new C&DIs (Questions 128C.01 through 128C.05) (available [here](#)):

- **Consistently Applied Compensation Measures (CACMs).** Item 402(u) of Regulation S-K permits companies to use a CACM other than annual total compensation as used in the Summary Compensation Table to identify the median employee, for example, information derived from a company's tax and/or payroll records. The staff noted that total cash compensation could be a CACM, unless the company also distributed annual equity awards widely among its employees, and stated that the appropriateness of any CACM will depend on a company's particular facts and circumstances. In addition, the exclusive use of hourly or annual rates of pay without taking into account factors such as the actual number of hours worked generally would not be an appropriate CACM to identify the median employee.
- **Time Period to Identify Median Employee.** In calculating the required pay ratio, a company must first select a date, which must be within three months of the end of its fiscal year, to determine the employee population from which to identify the median employee. A company is not required to use a period that includes the date on which the employee population is determined nor is it required to use a full annual period in applying the CACM to then identify the median employee. A CACM may consist of annual total compensation from the company's prior fiscal year so long as there were no material changes to its employee population or compensation arrangements.
- **Furloughed Employees.** Item 402(u) of Regulation S-K identifies four classes of employees – full-time, part-time, temporary and seasonal – but does not define “furloughed” employees. Whether furloughed employees should be included as employees will be based on the facts and circumstances. A company must determine in which class the furloughed employee belongs on the date the employee population is determined and then determine that furloughed employee's compensation using annual total compensation or another CACM. The staff noted that a company may not annualize total compensation for furloughed employees that are the equivalent of seasonal or temporary employees, or otherwise make a full-time equivalent adjustment for any employee.
- **Independent Contractors.** Based on the language in the final pay ratio rule, there has been some discussion of, under what circumstances, if at all, independent contractors could be required to be included as employees of the company when calculating the pay ratio. In determining when a worker is an “employee” of the company, the company must consider the composition of its workforce and its overall employment

and compensation practices. “Employees” should include those workers whose compensation the company or one of its consolidated subsidiaries determines (regardless of whether these workers would be considered “employees” for tax or employment law purposes). The staff does not believe that a company is properly determining compensation for purposes of the pay ratio rule if the company obtains services by contracting with an unaffiliated third party that employs workers and only specifies that those workers receive a minimum level of compensation. In addition, the staff stated that an individual who is an independent contractor may be the unaffiliated third party who determines his or her own compensation.

As a reminder, pay ratio disclosures will not be required until 2018. In general, a public company will be required to include pay ratio disclosure in its annual proxy statement (or in its Form 10-K if it does not file a proxy statement) with respect to its first fiscal year commencing on or after January 1, 2017. Emerging growth companies, smaller reporting companies and foreign private issuers are exempt from the pay ratio disclosure requirement. For more details on the pay ratio disclosure rule, please refer to our earlier Alert [here](#).

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