

New SEC Staff Guidance on CEO Pay Ratio Disclosure Rules – Determining the Median Employee

Guidance clarifies how to determine the employee population and median employee for the ratio, though questions remain.

The staff of the Division of Corporation Finance of the Securities and Exchange Commission (SEC) has issued new guidance on the SEC's rules requiring companies to disclose the pay ratio between their CEO and median compensated employee. The staff's new Compliance and Disclosure Interpretations (the C&DIs) provide helpful clarity on how to determine the relevant employee population and the median employee for purposes of the ratio, although questions remain.

Background

In August 2015, pursuant to Section 953(b) of the Dodd Frank Act, the SEC adopted the CEO pay ratio rules (the Rules), which added a new Item 402(u) of Regulation S-K requiring companies to disclose annually the:

- Median of the annual total compensation for all employees of the company except the CEO
- Annual total compensation of the chief executive officer (the CEO)
- Ratio of the two

The Rules are effective for fiscal years beginning on or after January 1, 2017, so the CEO pay ratio disclosure will be required in the 2018 proxy season. Companies subject to the Rules should begin to evaluate their ability to comply and their disclosure strategies.

Emerging growth companies, smaller reporting companies, foreign private issuers, registered investment companies and US-Canadian Multijurisdictional Disclosure System filers are exempted from this disclosure requirement.

Key Determinations and Impact of the C&DIs

Determining the employee population

For purposes of calculating the pay ratio, companies are required to determine the relevant employee population from which to find the median employee based on all employees (including all worldwide full-time, part-time, seasonal or temporary workers, subject to certain limited exceptions) employed as of a date selected by the company within the last three months of the company's last completed fiscal year.

Under the Rules, independent contractors and “leased” workers who are employed by, and whose compensation is determined by, an unaffiliated third party are excluded from the determination of “all employees” for purposes of the pay ratio calculation.

- *Guidance on inclusion of independent contractors.* The C&DIs clarify that the services of workers obtained by contracting with an unaffiliated third party may be excluded even if the company specifies that those workers receive a minimum level of compensation.

The C&DIs also clarify that an individual who contracts directly with the company as an independent contractor may also be excluded, if the individual determines his or her own compensation. However, contractors whose pay is pre-set by the company, without deviation, likely cannot be excluded. The rules are ambiguous on how to treat contractors who negotiate their compensation, and whether or not a particular contractor or set of contractors is excluded is likely a case-by-case facts-based determination.

Finding the “median employee”

The Rules do not mandate any specific method for identifying the median employee. The median employee may be identified using annual total compensation or any other consistently applied compensation measure (CACM) to all employees included in the calculation, such as information derived from tax or payroll records (e.g., W-2 reportable wages). Also, in determining the employees from which the median is identified, a company is permitted to use its employee population, statistical sampling or other reasonable methods.

Under the Rules, companies may annualize the compensation for all permanent employees (other than those in temporary or seasonal positions) who were not employed for the entire fiscal year, such as a new hire or an employee who took an unpaid leave of absence during the period. However, the Rules do not permit full-time equivalent adjustments for part-time employees, or annualizing adjustments for temporary or seasonal employees.

- *Guidance on consistently applied compensation measure or CACM.* The C&DIs provide that any measure that reasonably reflects the annual compensation of employees can serve as a CACM, and that the appropriateness of the measure will depend on the company’s particular facts and circumstances. The C&DIs provide two examples: (1) total cash compensation could be a CACM unless the company distributed annual equity awards widely among its employees; and (2) Social Security taxes withheld would not be a CACM unless all employees earned less than the Social Security wage base.
- *Period for measuring CACM.* The C&DIs also clarify that a CACM used to identify the median employee may cover a time period that is not a full annual period, and does not need to include the date on which the employee population was determined. In addition, the CACM may cover the company’s prior fiscal year so long as there has not been a change in the company’s employee population or employee compensation arrangements that would result in a significant change of its pay distribution to its workforce. This helps clarify that companies may use shorter periods than annual periods for determining the CACM. For example, based on this guidance an employer could choose a selected representative month’s payroll as a CACM, as long as the month is reasonably reflective of the annual compensation of the employees.
- *Hourly or annual rates of pay not an appropriate CACM.* The C&DIs provide that a company may not use an hourly rate of pay as a CACM without taking into account the number of hours actually worked as that would be similar to making a full-time equivalent adjustment for part-time employees, which is

not permitted by the Rules. Similarly, a company may not use an annual rate of pay without taking into account whether the employees worked the entire year and the amount actually paid during that time, as this is similar to annualizing pay, which is only permitted in the limited circumstances described above.

- *Adjustments to pay for furloughed employees.* The C&DIs provide that the treatment of furloughed employees depends on the categorization of the employee (*i.e.*, full-time, part-time, temporary or seasonal). A company may annualize the total compensation for all permanent employees (full-time or part-time) that were employed by the registrant for less than the full fiscal year, or who were on an unpaid leave of absence during the period. In contrast, a company may not annualize the total compensation for employees in temporary or seasonal positions.

Determining the median employee's and the CEO's total compensation per Item 402 of Regulation S-K, and disclosing the CEO pay ratio

Although a CACM can be used to determine the median employee, once the median employee is identified, the company then needs to calculate that one median employee's annual "total compensation" in accordance with the requirements of Item 402 of Regulation S-K in order to determine the pay ratio. A CACM cannot be used for this purpose.

For more details regarding the Rules please see our prior *Client Alert* "[SEC Adopts CEO Pay Ratio Disclosure Rules](#)."

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