NOVEMBER 2016 UPDATE

PAY RATIO CDI: What You Need to Know

In August 2015, the Securities and Exchange Commission (SEC) released the final ruling for the CEO pay ratio disclosure, which will take effect for companies' fiscal years beginning on or after January 1, 2017.

Then, on October 18, 2016, the SEC released additional guidance intended to clarify some of the ambiguities left by the final ruling. This new guidance is in the typical Q&A format of Compliance & Disclosure Interpretations (CDI), with five questions and corresponding answers. Here they are, followed by our perspective on what each one means for companies as they decide how to determine the median employee.

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Question 128C.01

If a registrant does not use annual total compensation calculated using Item 402(c)(2)(x) of Regulation S-K ("annual total compensation") to identify the median employee, how should a registrant select another consistently applied compensation measure ("CACM") to identify the median employee?

Item 402(u) requires registrants to identify the median employee using annual total compensation or another CACM, such as information derived from the registrant's tax and/or payroll records. Because of concerns about the expected compliance costs if registrants had been required to calculate annual total compensation for all employees, the Commission permitted registrants to use a CACM other than annual total compensation as a reasonable alternative to identifying the median employee. Any measure that reasonably reflects the annual compensation of employees could serve as a CACM. The appropriateness of any measure will depend on the registrant's particular facts and circumstances. For example, total cash compensation could be a CACM unless the registrant also distributed annual equity awards widely among its employees. Social Security taxes withheld would likely not be a CACM unless all employees earned less than the Social Security wage base. The registrant must also briefly disclose the compensation measure used. Although the CACM must reasonably reflect annual compensation, it is not expected that the CACM would necessarily identify the same median employee as if the registrant were to use annual total compensation.

Our view:

Up until now, many professionals read the initial rule as allowing almost any measure of CACM to be used to identify the median employee, as long as that measure is used consistently. The new CDI introduces principles that say the chosen measure of compensation should result in a median employee that is reasonably similar to the one that would be selected if the full summary compensation table framework were applied.

In the SEC's example above, using Social Security taxes as a measure is inconsistent if some employees earn more than the Social Security wage base. In the other example, total cash compensation, excluding equity, would be inappropriate if equity were widely granted among the employee population. "Widely" likely means more than 50%. But we encourage firms to incorporate equity awards if they are granted to more than 25% of employees.

Another example is fringe benefits and overtime. Especially in non-US countries, these can account for a large portion of an employee's take-home pay. For example, energy and petroleum companies that

operate in the Middle East and Russia deliver substantial fringe benefits to their employees. Expats often have rich benefits as well.

In any case, make sure you choose a CACM that accurately represents your company's pay practices and is capable of honing in on the identity of the median employee.

Question 128C.02

May a registrant exclusively use hourly or annual rates of pay as its CACM?

No. Although an hourly or annual pay rate may be a component used to determine an employee's overall compensation, the use of the pay rate alone generally is not an appropriate CACM to identify the median employee. 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 permitted. Similarly, using an annual rate only, without regard to whether the employees worked the entire year and were actually paid that amount during the year, would be similar to annualizing pay, which the rule only permits in limited circumstances.

Our view:

Hourly rates ignore the number of hours worked per week, which can vary greatly among the employee population. In addition, an hourly wage does not distinguish between a seasonal or temporary employee and a part- or full-time year-round employee.

Annual rates don't appropriately identify whether an employee worked for the entire year and lead to similar ambiguity as to the true compensation for the individual.

While the CDI clearly wants a true picture of the dollars actually paid to employees, it doesn't specify how to arrive at that. For example, some companies have asked whether it's appropriate to multiply hourly rates at the individual level by an average number of hours worked by all hourly employees.

The problem with this approach is that companies must then prove there is low to no dispersion in the average hours worked across hourly employees. But doing so requires analyzing the same detailed data that an aggregated approach is looking to bypass. So, unless there is contractual evidence that all hourly employees work roughly the same number of hours each year, our view is that person-level data on the number of hours worked is necessary.

Question 128C.03

When a registrant uses a CACM to identify the median employee, what time period may it use? Must the period include the date on which the employee population is determined? Must it always be for an annual period? May it use the prior fiscal year?

To calculate the required pay ratio, a registrant must first select a date, which must be within three months of the end of its fiscal year, to determine the population of its employees from which to identify the median. Once the employee population is determined, the registrant must then identify the median employee from that population using either annual total compensation or another CACM. In applying the CACM to identify the median employee, a registrant 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. A CACM may also consist of annual total compensation from the registrant's prior fiscal year so long as there has not been a change in the registrant's employee population or employee compensation arrangements that would result in a significant change of its pay distribution to its workforce.

Our view:

Since all of the aspects of the rule can easily run together, this interpretation clarifies that there are three distinct time periods involved in calculating the pay ratio:

1. ***Employee population.*** This must be determined within three months of the fiscal year end (called the "determination date" in the ruling).
2. ***The CACM and identifying the median employee.*** The timeframe for this can be the company's current full fiscal year, the previous fiscal year, or other time periods that closely resemble current compensation practices and the employee population.
3. ***Resulting median employee using the Summary Compensation Table (SCT) rules.*** Here, the timeframe is the full fiscal year covered by the proxy statement.

These time periods can be the same, but they don't have to be.

The surprising part of this response is that companies can identify the median employee using compensation data from a fiscal year other than the current fiscal year. That's assuming there are no significant changes to the employee population or compensation practices. One advantage to using past compensation data is you needn't wait until after the determination date to begin calculation and analysis. The disadvantage is that you need to prove there has been no significant change in the pay distribution, which requires looking at the current period data.

There are some cases where taking advantage of this flexibility makes sense and other cases where it does not. Consider a company with a fiscal year end of March 31 who elects to determine its employee population as of March 31 in order to avoid counting seasonal workers. Such a company may choose to use W-2 wage data for the prior calendar year, which is readily available—in this case, using a different determination date and pay period could make sense.

Conversely, consider a December 31 fiscal year company who uses a September 30 determination date. If this company were to consider using the prior calendar year's W-2 data, they would encounter a problem: what to do with newly hired employees? If W-2 data is not available, a different figure would need to be used for those employees, so the compensation measure would no longer be "consistently applied." This issue is more problematic the longer the gap between pay period date and determination date.

Overall, when it comes to applying the CACM to identify the median employee, we think using prior compensation data is only worthwhile in certain circumstances. However, the flexibility to not use a full annual period is more likely to be useful, as it allows companies to use year-to-date pay amounts when using a determination date ahead of the end of the year.

Question 128C.04

When someone is furloughed on the date that the registrant uses to determine the population of its employees from which it is required to identify the median, must the registrant include the furloughed person in the employee population used to identify the median employee, and, if included in the population, how should the furloughed employee's compensation be calculated?

Item 402(u) does not define or even address furloughed employees. Because a furlough could have different meanings for different employers, registrants will need to determine whether furloughed workers should be included as employees based on the facts and circumstances. If the furloughed worker is determined to be an employee of the registrant on the date the employee population is determined, his or her compensation should be determined by the same method as for a non-furloughed employee. Item 402(u)(3) of Regulation S-K identifies four classes of employees: full-time, part-time, temporary, and seasonal. The registrant must determine in which class the employee belongs on that date and determine that individual's compensation using annual total compensation or another CACM in accordance with Instruction 5 of Item 402(u). That instruction states that a registrant 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 registrant may not annualize the total compensation for employees in temporary or seasonal positions. A registrant may not make a full-time equivalent adjustment for any employee.

Our view:

If it walks like a duck and talks like a duck, disclose it as a duck. Since “furlough” means different things in different organizations, there is no blanket rule for treatment. If the furlough is effectively a leave of absence, it can be treated as such and annualized. If it’s essentially a reduction of hours, then it needs to be reflected as a reduction in compensation. And if it effectively turns employees into seasonal or temporary workers, then no annualization should occur. The only case for excluding furloughed employees is if they were functionally terminated, which would be an unusual use of the term “furlough.”

Question 128C.05

Under what circumstances is a worker employed and his or her compensation determined by an unaffiliated third party such that the worker is considered an independent contractor or leased worker under the rule? When is a registrant considered to be determining the compensation of a worker?

In the release, the Commission noted its belief that the primary benefit of the pay ratio disclosure is to provide shareholders with a company-specific metric that they can use to evaluate the compensation paid to the PEO within the context of their company. Therefore, in determining when a worker is an “employee” of the registrant under the rule, the registrant must consider the composition of its workforce and its overall employment and compensation practices. In furtherance of this, a registrant should include those workers whose compensation it or one of its consolidated subsidiaries determines regardless of whether these workers would be considered “employees” for tax or employment law purposes or under other definitions of that term. Frequently, a registrant will obtain the services of workers by contracting with an unaffiliated third party that employs the workers. When a registrant obtains services in this way, we do not believe it is determining the workers’ compensation for purposes of the rule if, for example, the registrant only specifies that those workers receive a minimum level of compensation. Further, an individual who is an independent contractor may be the “unaffiliated third party” who determines his or her own compensation.

Our view:

Today’s “gig economy” is testing traditional notions of employment, which is why the SEC is stating they don’t wish to use the same yardstick as that used in employment or tax law. Instead, the SEC introduced a principles-based approach of considering the way the company does business and who realistically renders employment services.

A company's outside legal counsel is not part of the company's workforce; they're a service provider. But a company like Uber clearly has a workforce broader than just those people working out of its corporate headquarters in San Francisco. Principles like this will be hard to apply in many cases, and of course reasonable people can disagree. One factor to use when distinguishing between an employee and independent contractor is to verify who determines the compensation of the employee in question.

For example, let's say your company hires a consultant to complete a series of projects, which ends up costing your company $50,000. The firm that you hired dictates the compensation of its consultant, even though you had some to degree of control over how much to pay for those services. In cases like this, the consultant would be an independent contractor and would not be included in the pay ratio calculations.

Now, let's switch back to the Uber example. First, you are determining the compensation for the population of drivers, since the mothership can unilaterally adjust revenue splits. Second, there's an expectation that the drivers will stick around indefinitely, versus solving a well-defined problem and then parting ways until the next time their services are needed.

Not all cases related to independent contractors are as black and white as the example listed here, so make sure to discuss any concerns related to this with your counsel.

Closing remarks:

The 2018 proxy season is rapidly approaching, and the tone of the SEC's CDI indicates that methodology matters to the SEC. This means now is the time to begin preparing, so that you have time to stress-test alternative methodologies and then set up a repeatable and well-controlled process.

If you have any questions about your facts and circumstances, please contact us.

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