

New CDIs Help Issuers With Pay Ratio Disclosure, A Little

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On October 19th, the SEC released five new Compliance and Disclosure Interpretations (“CDIs”) relating to the upcoming “Pay Ratio Disclosure” requirements in Item 402(u) of Regulation S-K. Item 402(u) Pay Ratio Disclosure requirements, mandated by the Dodd-Frank Wall Street Reform and Consumer Protection Act, require each covered public company to make annual disclosure of the ratio of its principal executive officer’s total annual compensation to the total annual compensation of an individual whose compensation is determined to be the median compensation of all of the company’s employees. Our update on the Pay Ratio Disclosure rules and link to the related webinar can be found [here](#) and [here](#), respectively. The SEC’s adopting release for the final Pay Ratio Disclosure rule was issued in August 2015 and can be found [here](#).

In order to disclose the ratio required by Item 402(u), each affected public company must determine who it will treat as its “median employee.” Because of the size of many public companies’ workforces, the many possible elements of compensation and other complicating factors, the SEC allows each public company to identify its median employee either through calculating every employee’s annual total compensation under Item 402(c)(2)(x) of Regulation S-K (“Item 402 annual total compensation”) or through another consistently applied compensation measure (“CACM”). In addition, to identify the median employee, a public company must determine the employees who constitute its total workforce as of a given date. The new CDIs focus primarily on the identification of the median employee through the use of consistent annual compensation measures and the determination of “all employees” in order to do so. The new CDIs can be found [here](#).

The new CDIs provide the following guidance and clarifications:

- **Choice of CACM.** A reporting company that elects to use a CACM may use any measure “that reasonably reflects the annual compensation of [the company’s] employees.” Whether any particular measure is appropriate depends the particular circumstances of each public company and its compensation system. Total cash compensation could be an appropriate measure for a company to use as a CACM, provided that the company does not also widely distribute annual equity awards or

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other non-cash compensation among its employees. By contrast, Social Security taxes withheld would not be appropriate (unless *all* employees earned less than the Social Security wage base). The SEC recognizes that a CACM will not necessarily identify the same median employee as if the registrant were to use Item 402 annual total compensation.

- *Use of Hourly or Annual Rates as CACM.* A public company may not *exclusively* use hourly or annual rates of pay as its CACM. The CDIs indicate that exclusive use of hourly pay rates without accounting for actual numbers of hours worked would be similar to making full-time equivalent adjustments for part-time employees, which the SEC's rule prohibits. In addition, the new CDIs indicate that exclusively using an annual rate of pay, without regard to whether an employee worked and were actually paid at that rate for a full year, would be similar to annualizing pay, which the SEC's rule permits only in limited circumstances. Of course, hourly and annual pay rates are likely to be components of an appropriate CACM, the use of the pay rate alone to determine an employee's overall compensation is unlikely to be appropriate.
- *Date of Population Determination vs. Date of CACM.* To calculate the required pay ratio, a public company must select a date within three months of the end of its fiscal year, to determine the population of its employees from which to identify the median employee. The new CDIs make it clear, however, that in determining the Item 402 annual total compensation or CACM of its employees, the company is not required to use a pay period that includes the date on which the employee population is determined. The company may, for example, use Item 402 annual total compensation or another CACM from the company's prior fiscal year, assuming that there has not been any change in its employee population or compensation arrangements that would result in a significant change of its pay distribution to its workforce. Furthermore, the pay period used is not required to be a full fiscal year or other annual period.
- *Furloughed Employees.* Public companies must make a determination, based on their specific facts and circumstances, whether a furloughed person is an employee who must be included in the employee population used to identify the median employee, and, if so, whether the furloughed worker is a full-time, part-time, temporary or seasonal. After determining the class of employee a furloughed worker belongs in, the company should then determine that individual's compensation based on the rule and instructions applicable to that particular class of employees.
- *Classification of Workers of Unaffiliated Third Parties as Independent Contractors or Leased Workers.* The determination whether a particular worker is an "employee" depends on the circumstances of each public company, the composition of its workforce and its overall employment and compensation practices. A public company must also include workers whose compensation is determined by the company or one of its consolidated subsidiaries, regardless of whether the workers are considered "employees" for purposes of tax or employment law. If a public company obtains services from an unaffiliated third party, but specifies that those workers receive a minimum level of compensation, as long as the third party determines the actual amount of the workers' compensation, the workers will not need to be included in the company's workforce. The new CDIs also clarify that an individual who is an independent contractor may be the "unaffiliated third party" who determines his or her own compensation.

Compliance with the pay ratio disclosure requirement will be a significant additional burden on reporting companies. Most public companies will be required to make the pay ratio disclosure following their first full fiscal year beginning on or after January 1, 2017.¹ For a typical, calendar-year reporting company, the first pay ratio disclosure would be made in its proxy statement for its 2018 annual meeting. These five new CDIs provide

helpful, but limited, guidance. Pay ratio disclosure will be a significant new compliance challenge for public companies—and is likely to continue evolving for several years.

¹ Smaller reporting companies, emerging growth companies and foreign private issuers are exempt from the disclosure requirements and are given a one-year transition period to comply with the disclosure requirements if they lose their exempt status.