

# Memorandum

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## SEC Issues Guidance on Pay Ratio Disclosure

October 24, 2016

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On October 18, 2016, the Securities and Exchange Commission (“SEC”) issued for the first time Compliance and Disclosure Interpretations (“C&DIs”) on the pay ratio disclosure requirement codified in Item 402(u) of Regulation S-K.<sup>1</sup> In five new C&DIs, the SEC provides additional clarity with regard to two key aspects of the pay ratio disclosure requirement:

1. The determination of which employees are required to be included in the pay ratio calculation; and
2. The identification of the median employee through a “consistently applied compensation measure” (“CACM”).

### I. Employees to be Included in the Pay Ratio Calculation

The pay ratio rule indicates that when identifying the median employee, registrants must include all full-time, part-time, seasonal, and temporary employees of the company or any of its consolidated subsidiaries, unless one of the rule’s tailored exemptions for certain foreign employees applies. The rule also specifies that individuals who provide services to the registrant or any of its consolidated subsidiaries as independent contractors or “leased” workers are not considered employees for purposes of the pay ratio rule, so long as those workers “are employed, and their compensation is determined, by an unaffiliated third party.” Two of the SEC’s new C&DIs further clarify which workers should or should not be included in the registrant’s employee population for the purpose of identifying the median employee.

- **Furloughed Workers.** Addressing furloughed workers for the first time, the SEC’s new guidance explains that, because the definition of “furlough” differs among employers, the determination of whether furloughed workers should be counted as employees is dependent on the facts and circumstances involved.

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<sup>1</sup> See [Compliance and Disclosure Interpretations on Regulation S-K](#), Section 128C. For a summary of the SEC’s final rule on pay ratio disclosure, see Simpson Thacher & Bartlett LLP, [“SEC Issues Rule on Pay Ratio Disclosure”](#) (Aug. 25, 2015).

The SEC's guidance provides that, "[i]f 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." In other words, the registrant must determine whether the furloughed employee is a full-time, part-time, temporary or seasonal worker on the date the employee population is identified and must then determine that individual's compensation "using annual total compensation or another CACM," in accordance with the instructions to the pay ratio rule. Specifically, as provided in Instruction 5 to Item 402(u):

- A registrant may annualize the total compensation for permanent full-time and part-time employees who "were employed by the registrant for less than the full fiscal year or who were on an unpaid leave of absence during the period." Annualization is not permitted, however, for seasonal or temporary employees.
- Under no circumstances may a registrant make a full-time equivalent adjustment (i.e., project what a part-time employee would make if that employee worked full-time).
- **Independent Contractors and Leased Workers.** Seeking to illuminate under what circumstances a worker is employed and his or her compensation determined by "an unaffiliated third party," the SEC's new guidance advises that a registrant should include in its pay ratio calculation "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." The SEC also provides guidance on specific situations that were not addressed in the pay ratio rule:
  - When a registrant obtains "the services of workers by contracting with an unaffiliated third party that employs the workers," it is not 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."
  - "[A]n individual who is an independent contractor may be the 'unaffiliated third party' who determines his or her compensation."

## II. Use of a "Consistently Applied Compensation Measure"

The pay ratio rule provides that, to identify the median employee, registrants may use either annual total compensation or "any other compensation measure that is consistently applied to all employees included in the calculation," such as information derived from tax or payroll records provided that they disclose the measure of compensation used. In three C&DIs, the SEC provides further guidance on the selection and application of CACMs.

- **Selection of a CACM.** The SEC's new guidance indicates that "[a]ny measure that reasonably reflects the annual compensation of employees could serve as a CACM"; it is not necessary, however, that the CACM necessarily identify the same median employee as annual total compensation. While noting that the appropriateness of any given measure "will depend on the registrant's particular facts and

circumstances,” the SEC provides guidance with regard to two specific measures:

- **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.”
- **Hourly or Annual Rates of Pay.** The new C&DIs specify that an hourly or annual pay rate is generally not an appropriate CACM to identify the median employee. According to the SEC, “[u]sing 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.”
- **Time Period Covered by the CACM.** The SEC’s new guidance clarifies that, “[i]n 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.” Moreover, a registrant may use, as its CACM, annual total compensation from its 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.”

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If you have any questions or would like additional information, please do not hesitate to contact **Yafit Cohn** at +1-212-455-3815 or [yafit.cohn@stblaw.com](mailto:yafit.cohn@stblaw.com), or any other member of the Firm’s Public Company Advisory Practice.

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