

VOLUME 7, ISSUE 14  
OCTOBER 28, 2016

# Meridian Client Update

## SEC Issues Interpretative Guidance on the CEO Pay Ratio Rule

**The Securities and Exchange Commission (“SEC”) staff has issued interpretive guidance on the final CEO pay ratio rule (“Final Rule”). The Final Rule requires public companies to disclose the ratio of CEO pay to the median employee pay (“Pay Ratio”).**

The SEC staff’s interpretive guidance clarifies the following aspects of the Pay Ratio calculation: (1) the employees included in the identification of the median employee, (2) the use of a consistently applied compensation measure in identifying the median employee and (3) the period used in calculating a consistently applied compensation measure.

Under the Final Rule, a public company’s **first reporting period** for the Pay Ratio disclosure will be its first full fiscal year beginning on or after January 1, 2017. For a calendar year company, this means that the initial Pay Ratio disclosure would relate to calendar year 2017 compensation and would be **disclosed in the company’s 2018 proxy**.

## Employees Included in the Identification of the Median Employee

To determine who is the median employee, a public company must consider its worldwide workforce of full-time, part-time, seasonal and temporary employees (including employees of consolidated subsidiaries of the company) (“Employee Population”) as of a company-selected date that occurs at any time during the company’s fourth fiscal quarter. The SEC staff’s recent interpretive guidance clarifies the circumstances in which the following two categories of workers should be included in the Employee Population: (1) independent contractors and leased workers and (2) furloughed workers.

### Independent Contractors and Leased Workers

The Final Rule excludes from a company’s Employee Population independent contractors, “leased” workers and certain temporary workers. To qualify under this exclusion, a worker must be employed by, and have their compensation determined by, an unaffiliated third party. The SEC staff has provided the following guidance as to whether a worker meets the criteria for exclusion from the Employee Population.

- A company should include in the Employee Population any worker whose compensation it or one of its consolidated subsidiaries determines, regardless of whether the worker would be considered an “employee” for tax or employment law purposes or under other definitions of that term.
- Generally, a worker whose services are obtained through contracting with an unaffiliated third party who employs the worker and who sets the worker’s compensation will not be included in the Employee Population. This is the case even when a contract between an employer and the unaffiliated third party expressly sets forth the compensation of such workers. For example, an employee leasing entity and an employer enter into an agreement under which the leasing entity agrees to lease 10 of its workers

to the employer and agrees to pay each worker at the rate of \$30.00 per hour. In this case, such leased employees would not be included in the employer's Employee Population.

- An individual who is an independent contractor may be the "unaffiliated third party" who determines his or her own compensation and, therefore, should be excluded from the Employee Population (e.g., an outside lawyer or a consultant who advises the company would be excludable from the employee population).

### Furloughed Employees

The Final Rule does not define or address the treatment of "furloughed" employees. The SEC staff has provided the following guidance on determining whether furloughed employees should be included in the Employee Population and the determination of such employee's compensation if so included:

- The SEC staff notes that because a furlough could have different meanings for different employers, a company will need to determine whether a furloughed worker should be included in the Employee Population based on the underlying facts and circumstances.
- If a company determines that a furloughed worker should be included in the Employee Population, the worker's compensation should be determined by the same method as for a non-furloughed employee. This means that the company must first determine whether the furloughed worker is a full-time, part-time, temporary or seasonal employee and calculate the furloughed worker's compensation consistent with the methodologies permitted under the Final Rule. For example, the company may annualize the furloughed worker's compensation if he or she is a full-time or part-time permanent employee; however, a company may not annualize a furloughed worker's compensation if the furloughed worker is a temporary or seasonal employee.

### Use of a Consistently Applied Compensation Measure

After the Employee Population is determined, a company must determine the compensation of each employee in order to identify the median employee. Under the Final Rule, a company may determine each includible employee's compensation based on either (i) the proxy rules applicable to the determination of total compensation for a company's named executive officers or (ii) another compensation measure consistently applied to all employees.

The SEC staff's guidance addresses (1) how a company may select a consistently applied compensation measure to identify the median employee and (2) whether a company may use rates of pay as a consistently applied compensation measure.

### Selection of a Consistently Applied Compensation Measure

The SEC staff's guidance sets forth the following analytical framework for determining includible employee compensation based on a "consistently applied" compensation measure.

- A consistently applied compensation measure must **reasonably reflect** the annual compensation of the Employee Population. The SEC staff guidance does not define the term "reasonably reflects".
- The appropriateness of any measure will depend on the company's particular facts and circumstances, including **other elements of total compensation** awarded to employees.

Although a consistently applied compensation measure must reasonably reflect annual compensation, the SEC staff guidance notes that it is not expected that the use of such a measure would necessarily identify the same median employee as if a company were to use annual total compensation.

The SEC staff guidance includes the following two examples of when other elements of total compensation awarded to employees affect whether a compensation measure would reasonably reflect the annual compensation of employees.

- Total cash compensation could be a consistently applied compensation measure **unless** the company also distributed annual equity awards widely among its employees.
- Social Security taxes withheld would likely not be a consistently applied compensation measure unless all employees earned less than the Social Security wage base.

### **Rates of Pay as a Consistently Applied Compensation Measure**

The SEC staff has also clarified that a company may **not** exclusively use hourly or annual **rates** of pay as a consistently applied compensation measure. The SEC staff notes that the use of an hourly rate without taking into account the number of hours an includible employee actually worked would be similar to making a full-time equivalent adjustment for a part-time employee, which is not permitted under the Final Rule. Similarly, using an annual rate only, without regard to whether the employee worked the entire year and was actually paid that amount during the year, would be similar to annualizing pay, which the Final Rule only permits in limited circumstances.

### **Period Used in Calculating a Consistently Applied Compensation Measure**

Under the Final Rule, a company must select a date that occurs any time during the company's fourth fiscal quarter to determine the Employee Population from which it will identify its median employee ("Determination Date"). After the Employee Population is set, a company must determine each includible employee's compensation, which may be determined based on a consistently applied compensation measure. The Final Rule does not specify over which period a consistently applied compensation measure may or must cover. The SEC staff provides the following guidance:

- The period need **not** include the Determination Date or **cover a full annual period**.
- The period may be a company's prior fiscal year provided that there has not been a change in the company's Employee Population or employee compensation arrangements that would result in a significant change of the pay distribution among its workforce.

The SEC staff guidance does not preclude a company from determining includible employees' compensation over the fiscal period or annual period that includes the Determination Date.

**Meridian Comment.** The SEC interpretive guidance addresses narrow issues related to the identification of the median employee for purposes of the Pay Ratio calculation. As these questions do not address other key substantive issues that many companies are confronting in preparing for the Pay Ratio disclosure, the SEC's staff may provide further guidance on the Final Rule in the future.

A company should assess whether the compensation measure that it selects to identify the median employee in preliminary pay ratio calculations meets the standard set forth in the SEC's guidance. Many companies have assumed that using a base salary or a cash compensation measure would comply with the Final Rule. However, the SEC's guidance suggests that such a compensation measure may not reasonably reflect the annual compensation of employees under limited circumstances, such as where equity awards are broadly granted to employees.

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The *Client Update* is prepared by Meridian Compensation Partners' Technical Team led by Donald Kalfen. Questions regarding this Client Update or executive compensation technical issues may be directed to Donald Kalfen at 847-235-3605 or [dkalfen@meridiancp.com](mailto:dkalfen@meridiancp.com).

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