



## Securities Law ADVISORY ■

**OCTOBER 25, 2016**

### Division of Corporation Finance Issues Five FAQs Related to CEO Pay Ratio Rules

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On October 18, 2016, the Division of Corporation Finance issued five new Compliance and Disclosure Interpretations (C&DIs) related to the CEO Pay Ratio Rules. The CEO Pay Ratio Rules, which became effective on October 19, 2015, will require most public companies to calculate and disclose a ratio that compares the annual total compensation of their “median employee” to that of their CEO. Registrants must comply with the final rules for the first fiscal year beginning on or after January 1, 2017 (which means that, for most public companies, the information will be included in proxy statements filed in 2018).

The Pay Ratio Rules require disclosure of three specific amounts:

- The median of the annual total compensation of all employees of the registrant (other than the CEO).
- The annual total compensation of the CEO.
- The ratio of the first amount to the second amount.

The five new C&DIs focus on the identification of the median employee, the most critical, and likely most difficult, part of the pay ratio analysis. The first step of identification is determining the applicable employee population. To this end, two of the five C&DIs address furloughed employees and determining whether a worker is an “employee” for purposes of the rule. As reflected in these two C&DIs:

- Whether a furloughed worker should be considered part of the employee population used to identify the median employee will depend on the registrant’s particular facts and circumstances. If the furloughed worker is determined to be an employee of the registrant on the date the employee population is determined, then his or her compensation should be determined by the same method as for a non-furloughed employee.
- The registrant must consider the composition of its workforce and its overall employment and compensation practices in determining when a worker is an “employee” of the registrant under the rule. If a registrant or one of its subsidiaries determines the compensation of a worker, then the registrant should include the worker as an employee, regardless of whether the worker would be considered an “employee” for tax or employment law purposes or under other definitions of that term. If a registrant obtains the services of workers by contracting with an unaffiliated third party that employs the workers and the registrant has limited involvement in the determination of those workers’ pay, then the registrant is not determining the workers’ compensation for purposes of the rule. An example of limited involvement would be if the registrant only specifies that those workers receive a minimum level of compensation.

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Registrants must then determine the median employee of the identified employee population. The Pay Ratio Rules provide that registrants may identify the median employee by using annual total compensation, as determined under Item 402(c) (2)(x) of Regulation S-K, or another consistently applied compensation measure (CACM). Three of the five C&DIs focus on a registrant's use of a CACM rather than annual total compensation. As reflected in these three C&DIs:

- A CACM must reasonably reflect the annual compensation of employees. Whether a CACM is appropriate will depend on the registrant's particular facts and circumstances.
- A registrant may not use hourly or annual rates of pay alone as its 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.

Public companies should be mindful of this new guidance as they continue their preparation for the fast-approaching pay ratio disclosure. The new C&DIs, while limited in scope, are likely welcomed by public companies as they undertake the complicated analysis.

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