SIDLEY
150 YEARS

October 19, 2016

SIDLEY UPDATE

SEC Staff Provides Guidance on CEO Pay Ratio Disclosure Rule

On October 18, 2016, the Staff of the Division of Corporation Finance (Division) of the Securities and Exchange Commission (SEC) published five new Compliance & Disclosure Interpretations (C&DIs) relating to the CEO pay ratio disclosure rule. The controversial rule was adopted by the SEC in August 2015 as required by Section 953(b) of the Dodd-Frank Act. It requires public companies to disclose the "pay ratio" between the CEO's annual total compensation and the median annual total compensation of all other employees. See our previous Sidley Update for a detailed description of the rule. For calendar-year companies, the first disclosure will typically be required in their 2018 annual meeting proxy statements and will be based on 2017 compensation.

Although the rule provides companies with considerable latitude regarding how to identify the median employee, compliance is burdensome, particularly for large or multinational companies. The new C&DIs resolve a number of important questions and provide some clarity to companies as they prepare for compliance with the rule. Nevertheless, the scope of the C&DIs is limited and a significant number of open questions remain. The new C&DIs are summarized below and their full text is available here.

Selecting a "Consistently Applied Compensation Measure" to Identify the Median Employee

To calculate the required pay ratio, a company must select a date within three months of the end of its fiscal year on which to determine the employee population from which to identify the median employee. It must then identify the median employee using either (x) annual total compensation calculated pursuant to Item 402(c)(2)(x) of Regulation S-K or (y) another "consistently applied compensation measure" (CACM), such as information derived from the company's tax or payroll records. It must also briefly disclose the compensation measure used.

When selecting a CACM, the new C&DIs clarify that:

- Any measure that reasonably reflects the annual compensation of employees could serve as a CACM and that the appropriateness of any measure will depend on the company's particular facts and circumstances.
- A company may not use hourly or annual pay rates alone as its CACM without taking into account the number of hours or days actually worked during the period.

Examples Provided by the Division
Total cash compensation could be a CACM unless the company 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 Division specifically acknowledged that a company would not necessarily identify the same median employee using annual total compensation versus another CACM.

Relevant Time Period When Using a CACM

If a company uses a CACM rather than annual total compensation to identify the median employee, a new C&DI clarifies that the time period used does *not* have to be a full annual period nor include the date on which the employee population is determined.

Example Provided by the Division
A CACM may consist of annual total compensation from the company's prior fiscal year so long as there has not been a change in its employee population or compensation arrangements that would result in a significant change of its pay distribution to its workforce

Determining the Employee Population

The rule provides that the employee population used to identify the median employee must include all full-time, part-time, temporary and seasonal employees of the company and its consolidated subsidiaries. Independent contractors and leased workers providing services to the company are excluded from the definition as long as they are employed by an unaffiliated third party and their compensation is determined by such party.

A company may annualize compensation for its permanent (part-time and full-time) employees who were not employed during the entire fiscal year or who were on an unpaid leave of absence during the period, but may not annualize the compensation of its temporary or seasonal employees or make any full-time equivalent adjustments.

When determining whom to include in the employee population, the new C&DIs explain that a company must consider the composition of its workforce and its overall employment and compensation practices. Specifically:

- Companies must determine whether furloughed workers should be considered employees based on the particular facts and circumstances. If determined to be an employee, the company should calculate the compensation of a furloughed worker in the same manner as a non-furloughed worker.
- Companies should consider a worker an "employee" for purposes of the rule if his or her compensation is determined by the company or one of its consolidated subsidiaries regardless of whether the worker would be considered an "employee" for tax, employment law or other purposes.

Examples Provided by the Division
If a company obtains the services of workers by contracting with an unaffiliated third party that employs the workers and the company merely specifies that they receive a minimum level of compensation, the Division will not view the company as determining their compensation for purposes of the rule
An individual who is an independent contractor may be deemed an "unaffiliated third party" who determines his or her own compensation and therefore not an "employee" for purposes of the rule

If you have any questions regarding this Sidley Update, please contact the Sidley lawyer with whom you usually work, or

Holly J. Gregory
Partner
holly.gregory@sidley.com
+1 212 839 5853

John P. Kelsh
Partner
jkelsh@sidley.com
+1 312 853 7097

Thomas J. Kim
Partner
thomas.kim@sidley.com
+1 202 736 8615

Corey Perry
Partner
cperry@sidley.com
+1 312 853 7797

Rebecca Grapsas
Counsel
rebecca.grapsas@sidley.com
+1 212 839 8541

Claire H. Holland
Special Counsel
cholland@sidley.com
+1 312 853 7099

Sidley Corporate Governance and Executive Compensation Practice

Lawyers in Sidley's Corporate Governance and Executive Compensation practice regularly advise corporate management, boards of directors and board committees on a wide variety of corporate governance matters, including shareholder activism and engagement, fiduciary duties, board oversight responsibilities, board investigations and special committees, SEC disclosure, legal compliance, corporate responsibility, board evaluation, board and committee structures and issues arising under Sarbanes-Oxley and Dodd-Frank. Our advice relates to the procedural aspects as well as the legal consequences of corporate and securities transactions and other corporate actions, including takeover defenses, proxy contests, SEC filings and disclosure issues, stock option issues and general corporate law matters. Our broad client base allows us to provide advice regarding best practices and trends in such matters as directors' and officers' responsibilities, board and committee practices, disclosure controls and procedures, internal controls, executive compensation and other matters.