

INSIGHTS

SEC Releases New Interpretations on CEO Pay Ratio Disclosure

October 21, 2016

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On October 18, 2016, the staff of the Division of Corporation Finance of the Securities and Exchange Commission published five new Compliance & Disclosure Interpretations (CDIs) related to CEO pay ratio disclosures. The CDIs provide some clarity on how companies can begin collecting the information necessary to calculate the pay ratio. We've summarized the CDIs below, and the full text can be found [here](#).

The Rule: CEO pay ratio disclosure is required by Section 953(b) of the Dodd-Frank Wall Street Reform and Consumer Protection Act. The final rule was adopted in August of 2015 as Item 402(u) of Regulation S-K. It requires public companies to report the ratio of their CEO's annual total compensation to the median annual total compensation of their other employees.

Initial Compliance Date: For most companies, disclosure is required with respect to the first fiscal year commencing on or after January 1, 2017. This means that for a calendar-year company, the disclosure must first appear in its proxy statement for its 2018 annual meeting of shareholders or its Form 10-K for 2017.

Because of the complexity involved in determining the median employee's compensation, we recommend that public companies take this opportunity to begin putting procedures in place to obtain the information necessary to calculate the ratio.

For additional information regarding the rule, its applicability, compliance dates and what companies should be doing now, see Bracewell's previous CEO Pay Ratio update [here](#).

Consistently Applied Compensation Measures for Identifying the Median Employee: One controversial aspect of the rule is the complication inherent in identifying the median annual total compensation of a company's employees and the potentially high compliance costs associated with the task. Companies must identify the median compensation using annual total compensation calculated pursuant to Item 402(c)(2)(x) of Regulation S-K or using another "consistently applied compensation measure" (CACM). The company must then briefly describe the CACM in its disclosure.

The new guidance explains that an appropriate CACM can be "any measure that reasonably reflects the annual compensation of employees," with the appropriateness of the CACM depending on the facts and circumstances of the company's compensation arrangement.

The Staff offers the following examples:

- total cash compensation may not be appropriate where a company widely distributes equity awards among its employees.
- Social Security taxes are not an appropriate metric unless all the company's employees earn less than the Social Security wage base.

The Staff goes on to note that a company may not exclusively use hourly or annual rates of pay as its CACM without taking into account the number of hours actually worked or whether employees worked for the entire year.

The Period Used to Measure Total Compensation: In determining the median total compensation of their employees, companies must first select a date within three months of the end of their fiscal year and identify their total employee population on that date. Using the population on that date, they must then determine the total median compensation using annual total compensation or an appropriate CACM. The Staff clarifies that the period used in applying the CACM need not be an annual period or include the date on which the total population was determined. Companies may look to their prior fiscal year so long as there has not been a significant change to their employee population or compensation arrangements.

Determining the Relevant Employee Population: The guidance explains that Item 402(u) of Regulation S-K identifies only four classes of employees: full-time, part-time, temporary and seasonal. Companies with other classes of workers, such as "furloughed employees," must determine in which class those workers fit based on their facts and circumstances. The company then must calculate the total annual compensation or other appropriate CACM in accordance with the instructions and guidance for that class of employee.

The guidance also notes that a company may exclude workers who provide services to the company as independent contractors and "leased" workers as long as they are employed, and their compensation is determined, by an unaffiliated third party.