ALERT

OCTOBER 26, 2016

SEC RELEASES HELPFUL GUIDANCE WITH RESPECT TO APPLICATION OF NEW PAY RATIO RULE

On October 18 the SEC issued guidance in the form of new Compliance and Disclosure Interpretations (CDIs) that may significantly simplify the application of the new pay ratio disclosure rule. The pay ratio rule was enacted by the Dodd-Frank Act and generally applies to proxy statements issued in 2018. The rule requires a registrant to compute the ratio of the CEO's pay to that of the median employee and presents a number of technical issues with respect to correctly computing the ratio in a way that is not overly burdensome. The new CDIs contain additional guidance with regard to (1) the treatment of furloughed employees (2) when compensation can be computed using a method different than that used to compute the compensation reported in the Summary Compensation Table (SCT), (3) permissible time periods over which compensation can be measured, and (4) treatment of independent contractors and leased employees.

Background

The SEC issued final regulations with respect to the new pay ratio rule on August 5, 2015,[1] and since then a number of questions have arisen with respect to the mechanics of actually doing the necessary calculations. The new CDIs provide helpful guidance with respect to some of these questions.

Before turning to the CDIs, it is useful to review the type of calculation that could be required under the final rule in 2018 proxy statements for calendar year companies (to simplify discussion, this Alert will assume that fact pattern):

- The registrant needs to determine its employee census as of a date within the last three months of 2017.
- The median employee would need to be determined by computing "annual total compensation" (ATC) for each employee unless the registrant uses another "compensation measure that is consistently applied to all employees." ATC is computed by taking into account all the elements of compensation

[1] The final regulations were the subject of a prior FW Cook Alert, "SEC Finalizes CEO Pay Ratio Disclosure Rule," published August 13, 2015. http://www.fwcook.com/content/Documents/Publications/SEC_Finalizes_CEO_Pay_Ratio_Disclosure_Rule_8-13-15.pdf

used in preparing the SCT, which would, for example, require determining pension values, equity values, and perquisite values for all employees, so it is important to know what other types of compensation measures might be allowable.

- An important issue is determining the time period for measuring compensation. The default time period is the 12 months ending 12/31/17. If the registrant must wait until then to do its computations, the time period for doing the computations is quite compressed, since the result of the pay ratio calculation has to be in the proxy statement.
- The final rule indicated that, at least under some circumstances, leased employees and independent contractors had to be included in the computation, which has created much uncertainty as to when such individuals need to be included.

Who Is an Employee on the Date of the Employee Census?

Suppose employee status is being determined as of October 1, 2017 and an employee is on a leave of absence on that date. Is he or she counted?

To the extent registrants hoped they could exclude employees on a leave of absence on a blanket basis, the SEC's guidance is a disappointment. The SEC guidance refers to "furloughed" employees, rather than employees on a leave of absence, but the two concepts are sufficiently similar so that the guidance would appear to apply to both. The SEC states that a registrant must determine whether a furloughed employee should be included based on the "facts and circumstances," but does not elaborate what facts and circumstances are relevant. One approach that a registrant might consider taking is to decide which employees to count based on the end date of the leave of absence or furlough, for example, not counting an employee unless the furlough/leave of absence has a definite end date or ends within a specified time period (for example, one year). So long as the registrant describes its methodology in the proxy (the final rule requires the registrant to briefly describe its methodology for selecting the median employee), one would expect the SEC to accommodate a range of approaches, at least in the first compliance year.

The SEC further noted that (as permitted under the final rule), if the furloughed employee had previously been working as a permanent employee on full-time or part-time status, the registrant has the option of computing compensation by annualizing total compensation.

Alternatives to Annual Total Compensation

The SEC discusses several potential alternatives to ATC that might qualify as a "consistently applied compensation measure" (CACM) that could be used to identify the median employee.

Some consultants had hoped that the median employee could be determined by just looking at hourly or annual pay rates. The guidance specifically disallows that approach based on the rationale that such an approach could result in annualizing compensation (which is generally not permitted under the final rule). This rationale appears to suggest that use of hourly rates or annual salary may be permitted if (1), in the case of hourly paid employees, the number of hours worked is actually computed and (2), in the case of salaried employees, the actual salary paid is computed.

The guidance further states that total cash compensation could be a CACM unless the registrant also distributes annual equity awards "widely" among its employees.

While the guidance indicates that Social Security taxes withheld would "likely" not be a CACM unless all employees earned less than the Social Security wage base,[2] this position suggests that a registrant should be able to determine the median employee by looking at Hospital Insurance (HI) taxes withheld. Unlike Social Security tax withholding, there is no limit on the amount of compensation subject to HI withholding, which starts at 1.45% and increases to 2.35% on wages above a certain threshold ($250,000 for married couples filing jointly). To the extent it is easier for a registrant to aggregate HI withholding data than W-2 taxable income data, this approach might be helpful. It should be noted that this exception may not be of much help if foreign employees need to be taken into account (generally, if foreign employees are more than 5% of total employees, they will need to be counted).

Time Period for Measuring Compensation

Because the general rule would require determining compensation for the twelve months ending December 31, 2017, which doesn't leave much time, there is great interest in determining if alternative measurement periods can be used. The CDIs approve a number of alternatives, stating that 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." This appears to clearly indicate that one permissible period would be the nine months ending September 30, 2017, which would give the registrant significantly more time to do the necessary computations.

The guidance further states that 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." This might allow, for example, simply looking at the 2016 W-2 data. While the guidance refers to "annual total compensation" (which is the SCT definition), it is difficult to see why other measures of 2016 compensation could not be used so long as they would otherwise qualify as a CACM.

Leased Employees and Independent Contractors

As reported in our previous alert, the final rule surprised most practitioners by indicating that, at least under some circumstances, employees that had to be counted included leased employees and independent contractors. The final rule gave little guidance as to which leased employees and independent contractors had to be counted, indicating only that they did not need to be counted if they were workers who were "employed, and whose compensation is determined by an unaffiliated third party." The CDIs appear to significantly narrow the number of leased employees and independent contractors that may need to included.

[2] The logic of this position is unclear since, for example, if 20% of the employees earned more than the Social Security wage base, the median employee is obviously someone earning below the Social Security wage base, so the fact that 20% of the employees can't be distinguished is irrelevant.

With respect to leased workers, the guidance states that the SEC does not consider the registrant to be determining the workers' compensation if "the registrant only specifies that those workers receive a minimum level of compensation." Literally, this suggests that contracts with leasing companies should not raise problems if (1) the contract only specifies an amount payable per hour, day, or other time interval without indicating what amount of the payment should go to the leased worker or (2) specifies the minimum amount the leased worker should receive but specifically allows the leasing company to pay more.

With regard to independent contractors, employers have worried that all independent contractors would need to be counted since it is difficult to see how there could be an unaffiliated third party when only two parties were involved in the transaction, i.e., the registrant and the individual independent contractor. The guidance states, however, that the independent contractor may himself or herself be the "unaffiliated third party" determining his or her own compensation. While this is clearly better than a rule that all independent contractors are counted, exactly what this means is unclear.

One possible interpretation would focus on the extent to which the registrant sets the compensation. At one extreme may be employers that hire many independent contractors to perform the same services and have a uniform take-it-or-leave-it compensation package compensation package applicable to all independent contractors (it is our understanding that this is the approach of at least some of the driving service companies). This may be a difficult fact pattern for claiming that the independent contractor is the unaffiliated third party determining his or her own compensation.

The other extreme would be an independent contractor that performs work for numerous clients and that has a fixed hourly compensation schedule from which he or she never deviates. In this case it appears that the SEC is saying that the independent contractor is excluded.

The intermediate case would the one where the independent contractor has a fixed hourly rate but, from time to time, agrees to different rates. The strongest case for exclusion from the pay ratio rules would exist if, in fact, the registrant paid according to the standard fee schedule.

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