

The CEO Pay Ratio Rule: Determining Your Employee Population

This Thoughtful Disclosure Alert has been revised to reflect the guidance issued by the Securities and Exchange Commission on September 21, 2017.

Starting in 2018, public companies will be required to disclose in their annual report on Form 10-K and definitive proxy statement the ratio of the median of the annual total compensation of their employees (other than their Chief Executive Officer) and the annual total compensation of their Chief Executive Officer (the “Pay Ratio Rule”). This initial disclosure will be based on the compensation paid for the first fiscal year beginning on or after January 1, 2017.

To assist you in understanding and complying with this new disclosure requirement, we have put together a guide, *Complying with the CEO Pay Ratio Disclosure Requirement*.

To determine the “median of the annual total compensation of their employees,” companies subject to this new disclosure requirement must first identify the “median employee” whose pay is to be compared to that of their CEO. For this purpose, the “median employee” is to be selected from *all* of a company’s employees.

Scope of “All Employees” Requirement

As a general matter, “all” employees means every individual employed by the company or any of its consolidated subsidiaries as of a date within the last three months of the company’s last completed fiscal year as selected by the company. Specifically, these individuals are to include:

- all full-time U.S. and non-U.S. employees;
- all part-time U.S. and non-U.S. employees;
- all seasonal U.S. and non-U.S. employees; and
- all temporary U.S. and non-U.S. employees.

Employees of Consolidated Subsidiaries

For purposes of the Pay Ratio Rule, a company’s employee population consists of all workers employed by the company and any of its consolidated subsidiaries. For this purpose, a “consolidated subsidiary” is a subsidiary whose financial results are consoli-

dated in the financial statements of the subject company (which, under generally accepted accounting principles, occurs where the subject company holds a controlling financial interest (typically through majority ownership of over 50% of the outstanding voting shares) in the subsidiary).

Employees of Acquired Businesses

For purposes of the Pay Ratio Rule, a company may omit any employees from its employee population that become its employees as a result of a business combination or acquisition of a business for the fiscal year in which the transaction becomes effective. To ensure transparency, the company must include in the narrative disclosure that must accompany the CEO pay ratio the approximate number of employees that are being omitted as a result of the business combination or acquisition.

Treatment of Independent Contractors and “Leased” Employees

In determining a company’s employee population, the Pay Ratio Rule indicates that you may need to include workers who provide services to the company or its consolidated subsidiaries as independent contractors and “leased” workers unless:

- The individual is employed by a third party;
- The third party determines the individual’s compensation; and
- The third party is unaffiliated with the company (or consolidated subsidiary).

It is important to note that the foregoing exception is only one means of excluding workers from a company’s employee population. It is not intended to serve as the exclusive basis for determining the appropriate treatment of independent contractors.

Based on guidance from the SEC issued on September 21, 2017, to determine whether a worker who does not qualify for the exception is an employee or independent contractor a company may apply a “widely recognized test” under another area of the law (such as the guidance published by the Internal Revenue Service

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with respect to independent contractors) that it otherwise uses to determine whether its workers are employees.

Compliance Tip No. 1: The SEC's September 2017 guidance should significantly simplify the evaluation of workers who are not formal employees of your company to determine whether they must be included as part of your employee population. In most cases, the treatment of independent contractors will be based on the test that your company already uses to determine whether its workers are employees or independent contractors in other legal or regulatory contexts (such as for tax or employment law purposes).

Compliance Tip No. 2: In many cases, it will be clear when the exception for workers retained through an unaffiliated third party will apply. In other cases, the analysis may be more opaque. Notably, the SEC Staff has indicated that, for purposes of this exception, an individual who is an independent contractor who determines his or her own compensation, may be the "unaffiliated third party" referenced in the exception. This should enable a company that has engaged an external advisor to provide specific services for the organization (such as an attorney or consultant) to exclude such an individual from its employee population. We believe that this will be true even where his or her final compensation is the result of negotiations between the company and the contractor.

Compliance Tip No. 3: To determine the degree of attention to allocate to analyzing the appropriate treatment of independent contractors who provide services to your company, it is important to understand the location and number of such individuals, as well as how they fit into your workforce. In the case of U.S. workers, it is likely that you will have already determined their status for tax and/or employment law purposes. Consequently, it may be possible to use the "widely recognized test" applied for this purpose to conclude that these individuals should not be included in your employee population for purposes of the Pay Ratio Rule. This may be particularly helpful in situations where obtaining data on individuals working as independent contractors is proving to be a challenge.

While the same approach is available to determine the appropriate classification of non-U.S. workers, how you proceed will also be influenced by other factors, such as whether such workers represent a significant portion of your overall workforce, the various categories into which such workers fit under local law, the relative ease of applying a "widely recognized test" to determine such workers' status, and the relative ease or difficulty in obtaining information about such workers' retention by your company and their compensation arrangements.

Need Assistance?

Compensia can assist companies in preparing their CEO pay ratio disclosure, including developing a process for identifying their "median employee." If you would like assistance in understanding how the CEO pay ratio disclosure requirement will affect your company, preparing your initial CEO pay ratio disclosure, or if you have any questions on the subjects addressed in this Thoughtful Disclosure Alert, please contact Mark A. Borges. ■

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