

Complying With the CEO Pay Ratio Disclosure Requirement

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 the Chief Executive Officer) and the annual total compensation of their Chief Executive Officer. This initial disclosure will be based on the compensation paid for the first fiscal year beginning on or after January 1, 2017.

While disclosing the required pay ratio and the related compensation information upon which it is to be calculated will be relatively straightforward, you may encounter significant challenges in identifying the “median employee” whose pay is to be compared to that of your CEO. To complete this disclosure, you must undertake an entirely new task - identifying an actual employee as your “median employee” and calculating his or her actual total compensation for the last completed fiscal year.

To help you comply with this new disclosure requirement, we have put together the following five-step guide. This approach is current as of September 27, 2017, takes into consideration the guidance of the Securities and Exchange Commission and the Staff of its Division of Corporation Finance issued on September 21, 2017, and is based on our understanding of the final pay ratio rule (the “Pay Ratio Rule”).

We strongly recommend that companies focus on what they will need to do to comply with the new disclosure requirement (the vast majority of which will involve identifying the “median employee”) now. This will ensure adequate time to both assess and document the various decisions that must be made and to identify and address any questions or other issues that arise in developing an effective compliance process. It will also enable you to incorporate this new disclosure item into your overall schedule for preparing your proxy statement. Your documentation of this process will be useful when describing how you arrived at the pay ratio that is ultimately disclosed, as well as ensuring that you are able to repeat the process in subsequent years.

Gather Your Worker and Compensation Data

The key to satisfying the Pay Ratio Rule is developing a process for identifying your “median employee” that is reasonable, defensible, and repeatable. To begin, it is critical that you determine the number of workers who performed services for your company in each country where you operated or maintained a business presence for the last completed fiscal year. This will enable you to determine the employee population from which your “median employee” will be identified.

► **Compliance Tip:** Remember, the Pay Ratio Rule permits you to identify your “median employee” only once every three years (unless your employee population or compensation arrangements have changed significantly). Thus, this data collection and employee identification effort should be thoughtful and thorough.

The data to gather should include:

- **Number** – the number of workers in each country;
- **Status** – the status of each worker (U.S. employee, non-U.S. employee, independent contractor, leased worker, or other category);
- **Full or Part-Time** – whether the worker is full-time or part-time; and
- **Temporary or Seasonal** – whether the worker is a temporary or seasonal worker (and, if so, the period during the year for which the worker performed services).

In addition, you will need to determine how these workers are compensated, and understand where their compensation data resides (that is, in which payroll or HRIS systems is their pay data maintained). As explained in the following sections, the former information will be necessary to determine the methodology for identifying your “median employee,” while the latter information will be helpful in selecting a specific date for determining your employee population from which the “median employee” will be identified.

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Depending on the complexity of your organizational structure (which must include your company as well as all of your consolidated subsidiaries), this data collection and analysis may be both challenging and time-consuming. Thus, you will need to develop an understanding of this process well before you are required to determine the “median employee” for your 2018 proxy statement so that you can identify any actual or potential problems and either adjust your compliance timetable and/or fashion any needed solutions.

Determine Your Employee Population

Once you have gathered the data described above, you will need to determine your employee population. This is the group of individuals from which you are required to identify your “median employee.” Note that while the “median employee” is to be identified from “all employees,” not all of your “workers” are necessarily going to be included in your employee population.

Compliance Tip: The Pay Ratio Rule permits certain categories of workers to be excluded from the employee population to be used to identify your “median employee” (and, conversely, may necessitate certain workers who may not ordinarily be considered employees to be included in the employee population). Note that the SEC’s September 2017 guidance has probably dramatically reduced the number of workers who are not otherwise considered employees who may need to be included in your employee population. However, where you have non-U.S. workers who don’t fit neatly into an “employee/non-employee” classification, some additional analysis may be necessary.

In determining your employee population, the following rules apply:

- **Employees** – All full-time, part-time, temporary, and seasonal employees of the company and its consolidated subsidiaries (whether in the U.S. or any other country) must be included in your employee population if employed on the “determination date” (see below).
- **Independent Contractors** – Independent contractors and “leased” workers who are employed, and whose compensation is determined by, an unaffiliated third party may be excluded from your employee population. In the case of workers who did not qualify for this exemption, you generally may apply a “wide recognized test” under another area of law (such as for tax or employment law purposes) to determine whether these workers are to be considered “employees” for purposes of the Pay Ratio Rule.
- **Data Privacy Exception** – Any non-U.S. employees in a country with data privacy laws that prevent you from obtaining or processing the relevant compensation data may be excluded from your employee population if certain conditions are satisfied.
- **De Minimis Exception** – Any non-U.S. employees in one or more countries that, in the aggregate, account for 5% or less of your total employee population may be excluded if certain conditions are satisfied.
- **Acquired companies** – Employees of an acquired company may be excluded from your employee population for the fiscal year in which the acquisition transaction becomes effective.
- ▶ **Compliance Tip:** Note that the exemptions for non-U.S. employees are subject to certain conditions, including, in each case, required additional disclosure and, in the case of the data privacy exemption, a requirement to obtain an opinion of legal counsel confirming that local law prevents you from obtaining or processing the relevant compensation data.

In addition to determining which categories of workers to include in your employee population, you will also need to select the specific date for evaluating your employee population to identify your “median employee.” You are not required to include within your employee population workers who are not employed on the selected date.

The Pay Ratio Rule permits you to select this so-called “determination date” from any date within the last three months of your last completed fiscal year. The selection of this determination date will be influenced by a number of factors, including the nature and seasonality of your business, the composition of your workforce, and the relative ease (or difficulty) in accessing the compensation data necessary to identify your “median employee.” For example, the more difficult it is to collect the compensation data for your employee population, the earlier during this three-month period you may want to establish your determination date.

- ▶ **Compliance Tip:** Once you have evaluated the potential size of your employee population, you will need to determine whether to use this entire group – or one or more subsets of the group – to identify your “median employee.” Instead of drawing your “median employee” from your entire employee population, the Pay Ratio Rule permits you to use a statistical sample of this group or any other “reasonable method” to identify the “median employee.”

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Statistical Sampling. Statistical sampling involves a process for selecting a subset of a group (in this case, a subset of employees from your entire employee population) in a way that provides a reasonable degree of confidence that the subset selected is representative of the entire group.

The decision to use statistical sampling will likely be based on your company's particular facts and circumstances. If your workforce is entirely or predominantly located in the U.S. and your compensation data is readily available from a comprehensive payroll or HRIS system, you may conclude that using your entire employee population to identify your "median employee" is both reasonable and relatively cost-effective.

On the other hand, as the size and complexity of your organization increases, and particularly where you have a global workforce or employees in multiple countries, other considerations may prevail. Factors that may influence a decision to use statistical sampling, either in whole or in part, include whether your company has a single or multiple business lines, segments, or geographic units, the ease or difficulty of obtaining workforce and/or pay data for multiple countries in a timely manner, the number and accessibility of payroll or HRIS systems throughout the company, the stratification of pay levels across the company, and the various forms of compensation that your employees receive.

The goal is to fashion a representative sample of your employee population that reflects the principal characteristics of the entire population. To accomplish this, you will likely need a thorough understanding of your workforce demographics. You will also want to identify an internal or external resource that can assist you in constructing your sample – including establishing a confidence level and degree of reliability for your sample, selecting an appropriate compensation measure (as described below) to apply to the sample, and then gauging the reasonability of the sample. Finally, as the SEC's September 2017 guidance makes clear it is permissible to use more than one statistical sampling approach, as long as each approach is reasonable for the segment, unit, or group to which it is being applied.

Ultimately, a statistically valid sample (either alone or in combination) should reflect the characteristics of your company and its stage of development. Remember that the investment you make now in developing a valid, reliable, and repeatable sampling process may help you streamline the compliance process in future years. The SEC's September 2017 guidance expands on the use of statistical sampling in combination with reasonable estimates, assumptions, and other methodologies to determine their employee population and provides several helpful illustrations of

how a combination of these approaches might be applied to companies with both U.S. and non-U.S. employees.

Identify Your "Median Employee"

To identify your "median employee," you will need to evaluate the compensation arrangements of either your entire employee population (as previously determined) or, if you elect to use statistical sampling, your sample group or groups to select a compensation measure that best suits your company. For this purpose, you may use the annual total compensation of each employee or any other compensation measure that is consistently applied to all employees included in the calculation, such as information derived from your tax and/or payroll records.

For most companies, selecting a specific compensation measure to be applied across the relevant employee pool or group will probably be easier than calculating annual total compensation for every employee. For this purpose, you are permitted to use any measure (or measures) that "reasonably reflects" the annual compensation of your employees. The propriety of any measure will depend on your particular facts and circumstances. You are not permitted to use a rate of pay alone, however, as a compensation measure. Instead, a pay rate may be a component used to determine an employee's overall compensation or, in the case of an hourly wage rate, may be combined with the number of hours actually worked by an employee to reasonably approximate his or her annual pay.

In all likelihood, a reasonable compensation measure will involve a formulation of cash compensation, such as base salary, Form W-2 (or its foreign equivalent) wages, or actual annual cash compensation, which is consistent across the subject employee pool or group. This determination will be largely influenced by three factors – your company's actual compensation arrangements, the distribution of these arrangements across your employee pool or group, and your degree of access to the specific compensation data for your subject employees. For example, base salary (or its equivalent) data may be readily available for most of your employees. If these amounts are clustered within a relatively tight band for a significant number of employees, however, they may not adequately reflect your compensation distribution. In such a situation, base salary combined with annual cash incentives may better reflect the distribution of compensation across your employee population.

As noted in the SEC's September 2017 guidance, it is permissible to use existing internal records (such as tax and payroll records) that reasonably reflect annual compensation when using a consistently applied compensation measure to identify the "median

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employee,” even if those records do not include every element of compensation, such as equity awards widely distributed to employees.

- ▶ **Compliance Tip:** Note that the selected compensation measure (or measures) should reflect both the amount paid or earned during the last completed fiscal year and the structural distribution of annual compensation across your workforce. For example, if most of the employees in your company receive the same base salary and differences in role and responsibilities or performance are reflected in annual bonuses, it may not be appropriate to use base salary as your “consistently-applied compensation measure” (in part, because such a measure would not reasonably reflect the annual compensation of your employees).

Once you have selected a compensation measure, then you will need to select the period over which to calculate the total amount of compensation using that measure. To simplify this process, the Pay Ratio Rule provides that if you use a compensation measure other than annual total compensation and that measure is recorded on a basis other than your fiscal year, you may use the same annual period that is used to derive those amounts. Thus, even where a measure is defined differently in each country (for example, “annual wages”) or calculated for different time periods in each country, it may still be used if consistently applied in each country.

To further simplify compliance, you are not required to use a time period that includes your “determination date” (as described above) or even a full annual period (for example, you may use the period from the beginning of your fiscal year up to the “determination date”) to calculate the compensation being measured to identify your “median employee.” Finally, subject to the satisfaction of certain conditions, it may be possible to use compensation measured for the prior fiscal year (so long as there has not been a change in your employee population or employee compensation arrangements that would result in a significant change of the pay distribution of your workforce).

The Pay Ratio Rule provides the following additional flexibility in identifying your “median employee”:

Annualization of compensation – A company may annualize the total compensation for all permanent employees (whether full-time or part-time) that were employed for less than the full fiscal year. For example, in the case of a full-time employee who did not work the entire fiscal year, his or her pay may be annualized. A company is not permitted, however, to make a full-time

equivalent adjustment for any employee. Thus, a permanent part-time employee’s compensation may not be adjusted to reflect a full-time equivalent schedule

Cost-of-living adjustment – To account for the difference in underlying economic conditions among countries, a company may make a cost-of-living adjustment (“COLA”) to the compensation of employees in countries other than the country in which its CEO resides so that the compensation is adjusted to the cost of living in the country in which the CEO resides (for example, the United States). If a company opts to use a COLA, it must make a COLA adjustment for all non-U.S. employees included in the relevant employee group.

- ▶ **Compliance Tip:** If you are considering using a COLA to offset a significant cost-of-living difference, note that the Pay Ratio Rule requires you to also disclose your CEO pay ratio without the COLA. Because of this dual disclosure requirement, there is no assurance that your COLA-adjusted “median employee” will also be the unadjusted “median employee.” Consequently, you may have to identify two separate “median employees.”

The SEC’s September 2017 guidance provides that if, when calculating annual total compensation for the individual identified as the “median employee” using a consistently applied compensation measure based on internal records, a company determines that there are anomalous characteristics of the identified median employee’s compensation that have a significant higher or lower impact on the pay ratio, the company may, instead of concluding that the consistently applied compensation measure that was used was unsuitable to identify the “median employee,” substitute another employee with substantially similar compensation for the originally-identified “median employee” based on the compensation measure that was used.

Calculate Annual Total Compensation

Once you have identified your “median employee,” you will need to determine his or her annual total compensation, as well as that of your CEO, for the last completed fiscal year. This is required each year even if you are using a “median employee” identified in a prior year. The Pay Ratio Rule provides that “total compensation” is to be calculated using the same rules for determining the amount to be reported in the “Total Compensation” column of the Summary Compensation Table.

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► **Compliance Tip** – While calculating this amount for your CEO should be relatively straightforward, you will need to apply the same approach to calculate the annual total compensation of your “median employee.” For this purpose, you may use reasonable estimates or assumptions in calculating his or her total compensation or any elements of total compensation (as long as these estimates and assumptions approximate his or her actual compensation for the last completed fiscal year).

Three items warrant special attention – retirement benefits, healthcare benefits, and perquisites. In the case of retirement plans and healthcare benefits, if the “median employee” is a participant in any such plans and/or is eligible to receive such benefits, it is permissible to use a reasonable estimate to determine the approximate aggregate change in the actuarial present value of his or her plan interest and/or the value of such benefits, respectively.

In the case of perquisites, current SEC rules permit perquisites and other personal benefits not exceeding \$10,000 in the aggregate to be excluded from the disclosure of a CEO’s compensation in the Summary Compensation Table. In the case of the “median employee,” however, it may be advantageous to include such amounts as part of his or her total compensation (even though, technically, these amounts would not be disclosable) because of their size relative to the rest of his or her compensation. If you decide to include any perquisites valued at less than \$10,000 in the calculation of your “median employee’s” total compensation, you must also include the benefits valued at less than \$10,000 in your CEO’s total compensation (to the extent that they are not already so included).

Finally, if a COLA is used to identify the “median employee” and he or she is located in a country other than the country of the CEO, a company must use the same adjustment in determining his or her annual total compensation.

Draft Your Disclosure

The required CEO pay ratio disclosure consists of two parts: (1) the pay ratio and (2) the supporting explanation of how the ratio was calculated.

The pay ratio disclosure itself must consist of the following:

- The median of the annual total compensation of all employees of the company (except the CEO);
- The annual total compensation of the CEO; and
- The ratio of these two amounts.

For purposes of this presentation, the amount of the annual total compensation of the “median employee” must equal one, or, alternatively, the ratio may be expressed narratively as the multiple that the annual total compensation of the “median employee” bears to the annual total compensation of the CEO. For example, if the ratio of the CEO’s annual total compensation to the “median employee’s” annual total compensation is 100 to 1, it can be expressed as “1 to 100,” 1:100, or “the CEO’s annual total compensation is 100 times that of the median of the annual total compensation of all employees”

In addition, this disclosure must be accompanied by a “brief” description of the methodology that was used to identify the “median employee,” as well as any material assumptions, adjustments, or estimates used for this purpose or to determine total compensation or any elements of total compensation.

► **Compliance Tip** – Depending on the complexity of your workforce structure, this disclosure may be quite lengthy. In addition, the exceptions for non-U.S. employees and other aspects of the Pay Ratio Rule which purport to simplify the identification of the “median employee” are conditioned upon disclosure of the specific choices or methodological alternative selected. Consequently, the length – and complexity – of this disclosure will vary among companies and depend largely on the process that you ultimately used to identify the “median employee.”

Note that companies are not required to disclose any personally identifiable information about their “median employee” (other than his or her annual total compensation). Further, a “median employee’s” position within the company may be disclosed, unless doing so would reveal his or her identity.

Finally, the Staff of the SEC’s Division of Corporation Finance has indicated that it is permissible to state in any required disclosure that the pay ratio is a reasonable estimate calculated in a manner consistent with the SEC’s rules. In view of the degree of imprecision that may result from the extensive use of estimates, assumptions, adjustments, and statistical sampling to identify the “median employee” and then calculate his or her annual total compensation, this latitude is eminently reasonable.

► **Compliance Tip** – This potential “imprecision” has led the SEC to assure companies that the pay ratio and related disclosure that results from the use of estimates, assumptions, adjustments, and statistical sampling in the compliance process will not provide the basis for enforcement action unless presented without a reasonable basis or provided other than in good faith. Together with the ability to characterize the pay ratio as an

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estimate, this should make it easier for companies to devise an approach for identifying their “median employee” and then determine his or her annual total compensation in a manner that is suitable for their particular facts and circumstances.

Other Considerations

One additional consideration that should not be overlooked is the employee communication that may be necessary before and after your initial pay ratio disclosure. If your company does not have a history of communicating your compensation philosophy or structure to your employees, their morale may suffer when half your workforce discovers that their pay is below median. If this is a concern for your organization, it may be worthwhile to consider implementing a communication strategy or enhancing your existing strategy in conjunction with your pay ratio disclosure to address the questions and concerns that the disclosure may trigger.

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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