Complying With the CEO Pay Ratio Disclosure Requirement

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 annual total compensation of their Chief Executive Officer to the median of the annual total compensation of their other employees. 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 assist you with this new disclosure requirement, we have put together the following five-step guide. This approach is current as of July 25, 2017, takes into consideration the guidance of the Staff of the SEC's Division of Corporation Finance published on October 18, 2016, 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.

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, requires certain workers who may not be employees for tax or employment law purposes to be included in the employee population).

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. Otherwise, these workers will need to be evaluated for possible inclusion in your employee population. In determining whether an independent contractor should be included in your employee population for purposes of the Pay Ratio Rule, you should consider the composition of your workforce (that is, how the company makes use of workers to produce/sell/deliver its products and/or services) and your overall employment and compensation practices. Ultimately, the results of this evaluation will depend on your particular facts and circumstances.
- **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 from your employee population 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 required 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 some subset 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 (although no such other "reasonable" method is identified in the rule) to come up with this subset.

Statistical Sampling. Statistical sampling involves a process for selecting 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 population.

The decision to use statistical sampling will likely be based on your 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 include whether your company has a single or multiple business lines, 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 employees receive.

The goal is to fashion a representative sample of your employees that reflects the principal characteristics of the entire population. To accomplish this, you will likely need a thorough understanding 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.

Ultimately, a statistically valid sample will reflect the characteristics of your company and its 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.

Identify Your "Median Employee"

To identify your "median employee," you will need to evaluate the compensation arrangements of either your employee population (as previously determined) or, if you elect to use statistical sampling, your sample group to select a compensation measure that best reflects 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 group will probably be easier than calculating annual total compensation for every employee. You are permitted to use any measure 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 may be combined with the number of hours actually worked by an employee to reasonably approximate his or her annual pay.

In all likelihood, the preferred 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 selected employee group. This determination will be largely influenced by three factors – your company's actual compensation arrangements, the distribution of these arrangements across your workforce, and your accessibility to the specific compensation data for your 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 hierarchy. In such a situation, base salary combined with annual cash incentives may be a more accurate measure.

In addition, where the annual compensation of your employee population includes a significant non-cash item (such as an equity award), it may not be reasonable to ignore this pay element when selecting a compensation measure. In particular, companies that grant annual equity awards widely among their employees (a practice that is common among many technology and life sciences companies) may need to include such awards when selecting a compensation measure. (While the contours of what it means to grant equity awards "widely" is unclear, presumably this means to grant such awards to a majority (or more) of a company's employees.)

- **Compliance Tip**: Note that the selected compensation measure should reflect both the amount paid or earned during the last completed fiscal year and the structural differences in compensation in the organization's 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 would not be appropriate to use base salary as your "consistently-applied compensation measure," (in part because such a measure would not reasonably reflect the actual 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 could 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** – You 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 can be annualized. You are 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, you may make cost-of-living adjustments ("COLA") to the compensation of employees in countries other than the country in which your CEO resides so that the compensation is adjusted to the cost of living in the country in which he or she resides (for example, the United States). If you opt to use a COLA, however, you must apply it to 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 also requires you to 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."

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.

- **Compliance Tip** – While calculating this amount for your CEO should be relatively straightforward, you will need to apply the same approach to calculate the 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, health care benefits, and perquisites. In the case of retirement plans and health care 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.

In the case of perquisites, current SEC rules permit the exclusion of perquisites and other personal benefits not exceeding $10,000 in the aggregate from the disclosure of your 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 you used a COLA to identify the "median employee" and he or she is located in a country other than the country of your CEO, you 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 your CEO);
- The annual total compensation of your 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 your CEO. For example, if the ratio of your CEO's annual total compensation to your "median employee's" annual total compensation is 100 to 1, it can be expressed numerically as "1 to 100" or 1:100, or narratively as "the CEO's annual total compensation is 100 times that of the median of the annual total compensation of all employees."

In addition, you must provide a "brief" description of the methodology that you used to identify your "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 could be quite lengthy. In addition, the exceptions for non-U.S. employees and other aspects of the Pay Ratio Rule which simplify the identification of the "median employee" are conditioned upon disclosure of the specific choices or methodological alternative selected by the company. 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 you are not required to disclose any personally identifiable information about your "median employee" (other than his or her annual total compensation). You may disclose his or her position within your company, unless doing so would reveal his or her identity.

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 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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