

The CEO Pay Ratio Rule: Determining Your Employee Population

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 (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 chosen by the company within the last three months of the company’s last completed fiscal year. Specifically, this includes:

- 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 consolidated 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, you may omit any employees from the employee population that became your 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, you must include in the narrative disclosure that must accompany the CEO pay ratio the approximate number of employees that you are omitting as a result of the business combination or acquisition.

Treatment of Independent Contractors and “Leased” Employees

In determining your 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).

The SEC Staff has indicated that whether a worker providing services to a company as an independent contractor is to be included in its employee population is to be determined by considering the composition of the company’s workforce and its overall employment and compensation practices. Further, this determination is to be made without regard to whether the worker would be considered an “employee” for tax or employment law purposes.

Compliance Tip No. 1: Determining whether to include independent contractors in your employee population is likely to be one of the most challenging aspects of

The CEO Pay Ratio Rule: Determining Your Employee Population (continued)

identifying the “median employee.” In most cases, the treatment of independent contractors will depend upon the particular facts and circumstances of your company’s specific relationship with these individuals.

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 will 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 the independent contractors who provide services to your company, it is important to understand how these individuals fit into the composition of your overall workforce.

If such individuals represent a significant portion of your workforce, it may be inconsistent with the objectives of the disclosure to exclude them from your employee population, particularly where the company controls the working conditions and level of compensation these workers are paid. On the other hand, where such workers make up a nominal portion of a company’s workforce, their exclusion may be appropriate even where the unaffiliated third party exception is not otherwise satisfied.

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. ■

The CEO Pay Ratio Rule: Determining Your Employee Population (continued)

About Compensia

Compensia, Inc. is a management consulting firm that provides executive compensation advisory services to Compensation Committees and senior management.

Silicon Valley

125 S. Market Street
Suite 1000
San Jose, California 95113
408.876.4025

Timothy J. Sparks, President
tsparks@compensia.com
408.876.4024

Thomas G. Brown
tbrown@compensia.com
408.876.4023

Susan Gellen
sgellen@compensia.com
408.907.4302

Tom LaWer
tlawer@compensia.com
408.907.4309

Greg Loehmann
gloehmann@compensia.com
408.907.4319

San Francisco

1550 Bryant Street
Suite 740
San Francisco, California 94103
415.462.2990

Mark H. Edwards, Chairman
medwards@compensia.com
415.462.2985

Mark A. Borges
mborges@compensia.com
415.462.2995

Erik Beucler
ebeucler@compensia.com
408.907.4314

Amanda Feyerabend
afeyerabend@compensia.com
415.462.2988

Southern California

Ralph Barry
rbarry@compensia.com
858.603.2288

Pacific Northwest

Jason Borrevik
jborrevik@compensia.com
408.876.4035