McGUIREWOODS

March 23, 2017

Michael S. Piwowar
Acting Chairman
Securities and Exchange Commission
100 F Street, N.E.
Washington, DC 20549

Re: Reconsideration of Pay Ratio Rule Implementation, February 6, 2017

Dear Acting Chairman Piwowar:

The Securities and Exchange Commission (the "SEC") adopted the Final Pay Ratio Disclosure Rule (the "Final Regulations") in August 2015 to implement Section 953(b) of the *Dodd-Frank Wall Street Reform and Consumer Protection Act* (the "Dodd-Frank Act").[1] On February 6, 2017, you issued a Statement on Reconsideration of Pay Ratio Rule Implementation to solicit public input on any unexpected challenges posed by the Final Regulations. McGuireWoods, LLP hereby submits this letter in response to your request for detailed comments.

Executive Summary

In the United States, policymakers strive to promulgate financial regulations that promote a safe and sound financial system that protects investors, consumers, and taxpayers. Regulations should be efficient, effective, and appropriately tailored to achieve this goal. In developing regulations that reflect these core principles, policymakers should avoid promulgating overly complex and prescriptive mandates that do not effectively achieve their stated objectives. When regulations deviate from their intended purpose, they can harm investors and consumers and impose unnecessary costs on U.S. taxpayers.

Since the SEC adopted the Final Regulations on August 15, 2015, it has become clear that the complexity of the Final Regulations has led to significant challenges and costs for registrants as they work to implement the rule. Furthermore, we have no information indicating that the disclosure required under the Final Regulations provides any benefit to investors. In view of the implementation challenges and the limited benefits of the Final Regulations, the SEC should delay implementation, withdraw the Final Regulations, and re-propose new pay ratio disclosure rules that promote the Core Principles for Regulating the United States Financial System set forth in President Donald Trump's Executive Order ("E.O.") issued on February 3, 2017.

[1] 80 Fed. Reg. 50,103 (August 18, 2015).

While not exhaustive, this letter provides a detailed look into the implementation challenges and costs of the Final Regulations. For example:

- The inclusion of non-U.S. employees in the median employee calculation imposes tremendous costs, distorts the pay ratio calculation, and is not supported by legislative history.

- The Final Regulations are vague as to how furloughed individuals or individuals on a leave of absence should be treated.

- The inclusion of part-time and seasonal employees, as well as employees who have not worked for the entire measurement period, does not provide a meaningful comparison of the Principle Executive Officer's ("PEO") pay to median employee pay.

We are concerned that these methodological issues will create unintended consequences, including the enactment of tax laws that unfairly penalize companies based on disclosed pay ratios that, for the reasons described below, may provide a distorted picture of a company's actual pay practices. Thus, at a minimum, the SEC should adopt a safe harbor rule that permits a registrant to calculate its pay ratio by reference to its PEO's total compensation compared to the median earnings of a U.S. worker in its respective industry, as calculated by the Bureau of Labor Statistics.

We offer a more detailed explanation of our concerns in the sections below and provide a set of recommendations to address the implementation difficulties posed by the Final Regulations.

I. Consistent with the Executive Order on Core Principles for Regulating the United States Financial System, the SEC should delay the implementation of the pay ratio rules, withdraw the Final Regulations, and re-propose new pay ratio regulations that reduce compliance costs, reflecting the minimal benefits received by investors.

On February 3, 2017, President Trump issued an Executive Order on Core Principles for Regulating the United States Financial System.[2] Under this E.O., the Secretary of the Treasury is instructed to consult with the heads of the member agencies of the Financial Stability Oversight Council and report to the President on:

> the extent to which existing laws, treaties, regulations, guidance, reporting and recordkeeping requirements, and other government policies promote the Core Principles and what actions have been taken, and are currently being taken, to promote and support the Core Principles. That report … shall identify … government policies that inhibit Federal regulation of the United States financial system in a manner consistent with the Core Principles.[3]

[2] Presidential Executive Order on Core Principles for Regulating the United States Financial System, https://www.whitehouse.gov/the-press-office/2017/02/03/presidential-executive-order-core-principles-regulating-united-states System (February 3, 2017).
[3] Id.

One of the core principles set forth in the E.O. requires the Trump Administration to regulate the financial system in a manner that is "***efficient, effective, and appropriately tailored***."[4] We believe that the Final Regulations issued to implement Section 953(b) of the *Dodd-Frank Act* violate this core principle. The Final Regulations are overly complex, costly to implement, and not appropriately tailored to meet the objective of the statute.

A. The benefits cited by the SEC in its Final Regulations consist solely of hypothetical statements regarding possible benefits for investors.

The Preamble to the Final Regulations acknowledges that neither the statute nor the legislative history expressly states the Congressional purpose of Section 953(b).[5] The Preamble concludes that "based on our analysis of the statute and comments received, … Section 953(b) was intended to provide shareholders with a company-specific metric that can assist in their evaluation of a registrant's executive compensation practices."[6] The Preamble further concludes that Section 953(b) was particularly intended to "provide new data points that shareholders may find relevant and useful when exercising their [say-on-pay] voting rights under Section 951."[7] However, as the Final Regulations admit, the SEC was "unable to quantify the benefit."[8] Moreover, no commenters on the original proposed rules provided the SEC with data that quantified any potential benefits, nor did any commentator suggest a source of data or methodology that could be used to quantify the benefits of the rule. Thus, the Final Regulations confirm that any supposed benefit of the additional disclosures are unquantified and speculative.

As the Preamble correctly notes, information regarding the pay ratio of the median of the annual total compensation of all employees to the annual total compensation of the PEO is supplemental, and thus, only one factor that should be taken into account in evaluating a registrant's executive compensation. The conclusion that investors need, want, or will use this pay ratio information is not supported by the evidence. Comparable data is already publicly available but has not previously been requested or noted as critical or useful by any proxy advisors or institutional investors. In other contexts, certain types of disclosures were requested or demanded by shareholders first and then codified in legislation. For example, the clawback disclosures addressed by Section 954 of the *Dodd-Frank Act* were actually first implemented by a majority of registrants because of shareholder demand.[9] This is evidenced by the fact that a majority of registrants have adopted clawback policies and describe them in SEC filings currently, despite the fact that there is not yet any legal obligation to do so.

There is also no evidence that requiring the disclosure of the ratio of the PEO's annual total compensation to that of a single employee with significantly different duties, skills, authority, performance expectations, and contributions is desired by shareholders or will provide any incremental benefit to investors. Therefore, it is clear that the purpose of the pay ratio disclosure

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[4] Id (emphasis added).
[5] *See* 80 Fed. Reg. at 50,105.
[6] Id.
[7] 80 Fed. Reg. at 50,106.
[8] 80 Fed. Reg. at 50,153.
[9] *See, e.g.,* 2015 Corporate Governance and Incentive Design Survey, Meridian Compensation Partners, LLC http://www.meridiancp.com/insights/research/2015-corporate-governance-incentive-design-survey/.

and the desire for the information required under Section 953(b) is, at best, limited. The rules under Section 953(b) should be appropriately tailored to meet this limited benefit.

B. The Final Regulations impose massive new administrative costs because of the volume and complexity of the calculations necessary to provide the contemplated pay ratio disclosures.

The cost benefit analysis contained in the Final Regulations estimates that the total initial compliance costs will be more than $1.3 billion, while ongoing compliance burdens are estimated to be 40% of the initial burden—totaling more than $500 million each year.[10] This equates to approximately $368,159 spent per registrant on preparing and reviewing the disclosure in the initial year of compliance and approximately $147,236.20 per registrant in the second year and each year thereafter.[11] Over a three-year period, a registrant can expect to incur $662,686.20 in order to comply with Section 953(b).

While our clients have reported that the significant and unanticipated costs they are incurring to comply with the Final Regulations will be much higher than estimated, the current estimates are massive as is and underscore that the Final Regulations are overly burdensome and costly to implement. The SEC should not be imposing such costs on registrants when the benefits, if any, of the pay ratio disclosures are so limited. Spending these resources on data that provides limited value, if any, will have an adverse impact on businesses' ability to grow and provide meaningful jobs and value to shareholders.

C. In light of the limited benefits, if any, generated by the disclosures compared to the significant costs imposed by the Final Regulations, the SEC should delay the effective date of the Final Regulations, withdraw the Final Regulations, and re-propose new pay ratio guidance that reduces costs by streamlining the median employee calculation procedure.

Given the high cost of implementing the Final Regulations in comparison to its limited value, the SEC should delay the implementation of the pay ratio rules, withdraw the Final Regulations, and re-propose new pay ratio regulations. We believe the SEC has the authority to develop administrative guidance that provides safe harbor rules that streamline the median employee determination process and reduce costs incurred by registrants to perform the associated calculations.[12] Developing safe harbors for registrants to follow will allow the SEC to be better able to develop rules that are appropriately tailored to fit the statutory purpose. Once these rules are re-evaluated, the SEC should re-propose the rules and seek public comment.

While we believe the best course of action is for Congress to reconsider Section 953(b) altogether, we also believe that if Congress does not reconsider Section 953(b), the modifications we are proposing to the Final Regulations, including the development of safe harbor rules for calculating the median employee's compensation, are necessary in order for the rules to be

[10] *See* 80 Fed. Reg. at 50,180-81.
[11] Id.
[12] Section 36 of the Securities Exchange Act of 1934.

implemented in an efficient, effective, and appropriately tailored manner, which is consistent with the President's E.O. on Core Principles for Regulating the United States Financial System.

II. The SEC should exclude non-U.S. employees from the median employee calculation as their inclusion imposes tremendous costs, distorts the pay ratio calculation, and is not supported by legislative history evidencing Congress's intended application of Section 953(b).

In the Preamble, the SEC concludes that when determining the median of the annual total compensation of all employees, it will "include in the final rule's definition of 'employee' a registrant's U.S. and non-U.S. employees."[13] We represent a variety of registrants, many of which are large, multinational companies with well over 100,000 employees in multiple jurisdictions throughout the world. In helping those registrants comply with the disclosure requirements, we have determined the most costly and time-consuming aspect of the Final Regulations is determining the median employee. One major component of these excessive costs is the added analysis and complexity associated with including non-U.S. employees when determining the median employee. Our clients have reported significant and unexpected costs associated with analyzing the compensation arrangements of these non-U.S. employees and attempting to aggregate them across jurisdictions.

A. Non-U.S. employees should be excluded from the median employee calculation because of the significant costs and increased complexity they add to the process of determining a registrant's median employee.

i. *Exorbitant costs result from the need to develop and implement new software and central databases to aggregate and analyze the compensation of employees across multiple jurisdictions*.

Registrants typically do not have one central database that contains all of the compensation information for every employee. Most registrants maintain many different databases of compensation information for a variety of legitimate business purposes, including databases dedicated to different jurisdictions, different divisions, or different U.S. locations. To require registrants to develop and implement the software needed to consolidate all of the information solely for purposes of the pay ratio rule is costly alone. To add in the time that must be spent and analysis that must be done to determine whether the compensation calculations are appropriately adjusted to ensure consistency across jurisdictions drastically increases the financial and administrative burden. For example, certain jurisdictions such as Japan typically offer a lower base salary but provide more substantial and more valuable perquisites and other benefits to their employees. Employees located in India, on the other hand, are often provided the option of receiving various perquisites, such as a housing allowance or receiving the corresponding amount as a cash payment. In addition, various non-U.S. jurisdictions have government-sponsored retirement programs that have contribution requirements, tax treatments, and distribution terms that differ from U.S. Social Security or employer-sponsored pension plans.

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[13] 80 Fed. Reg. at 50,122.

As a result of these different compensation practices, a registrant must analyze each component of a non-U.S. employee's compensation to determine in what form it is paid, why it is paid in such form, what would be considered a comparable form of compensation for a U.S. employee, and whether associated amounts should be included in the median employee determination to align the U.S. employee compensation calculations with that of non-U.S. employees. To complete this analysis within each jurisdiction and then for each non-U.S. employee is cumbersome and unwieldy, especially considering it must be done each year and during the compressed three-month median employee determination period. In conversations with our clients, we have learned that some have already been forced to expend many hundreds of employee hours on this process and have not yet finished their review. Requiring the analysis be performed during the three-month median employee determination window means a portion of the registrant's workforce will more than likely be unavailable to perform their regular responsibilities during this compressed time frame and additional assistance will be needed, indirectly increasing costs even more.

Once the compensation information has been reviewed, analyzed, and compiled, the registrant then has the option to account for cost-of-living adjustments. While this may be necessary to attempt to mitigate the distorted figures resulting from the differences in compensation practices and economic conditions across jurisdictions (as discussed in greater detail below), this extra layer of analysis further increases the already excessive compliance costs because even if a registrant uses a cost-of living adjustment, it still must disclose the calculations without the cost-of-living adjustment. Requiring two sets of disclosure clearly leads to increased compliance costs.

ii. *The exemptions available under the Final Regulations do not eliminate any substantial compliance costs and in fact, utilizing them will result in increased administrative and financial burdens.*

The SEC previously attempted to alleviate some of the costs associated with the Final Regulations by providing certain exemptions to the general requirement to include non-U.S. employees—one exemption for jurisdictions where the registrant has a "*de minimis*" number of employees and one for jurisdictions where data privacy laws prohibit the collection of the necessary information.[14] The *de minimis* exemption, by design, only results in the exclusion of a *de minimis* number of employees—meaning it also only results in the elimination of a *de minimis* percentage of the cost.

The exemption for certain non-U.S. jurisdictions where data privacy laws or regulations make it unlawful to obtain or process the required information is necessary to ensure registrants do not have to violate a non-U.S. jurisdiction's law to comply with the Final Regulations. The steps required to ensure compliance with non-U.S. regimes and use this exemption, however, drastically increase the financial and administrative costs. First, any registrant with non-U.S. employees must perform research and/or hire outside legal counsel to research whether there are any potential barriers to obtaining the necessary data in every non-U.S. jurisdiction where it has employees. This analysis is not limited to every country, state, or province where employees are located as even local laws and regulations must be reviewed and analyzed. If any restrictive laws

[14] Id.

or regulations exist, the registrant must then analyze whether there is any exemption or other relief available such that the information may be obtained. If any such relief is available or potentially available, the registrant must attempt to avail themselves of it.[15] This process alone will clearly result in a significant increase in outside counsel fees as registrants will be required to work with multiple law firms across multiple jurisdictions to research, review, and analyze the local laws and regulations.

Finally, if the registrant and/or its legal counsel determines that it must exclude any group of non-U.S. employees under the data privacy law exemption, the registrant is required to obtain a legal opinion stating that the registrant is unable to obtain or process the necessary information without violating the applicable jurisdiction's laws or regulations.[16] This legal opinion must be signed by local counsel and filed with the SEC. Even if a registrant is willing to pay the associated fees, finding local counsel that is willing and able to provide the required opinion will be difficult in many jurisdictions, if not impossible.

Each of these steps must be repeated during each median employee determination period as laws and regulations are constantly being adopted or repealed. Our clients have informed us that they have already been forced to engage outside counsel to perform multi-jurisdiction employee data privacy surveys, often at great expense. For example, one client reported that it engaged outside counsel to perform such a survey of over 50 non-U.S. jurisdictions at a cost of over $150,000. Unfortunately, registrants have come to realize that due to the requirements of the Final Regulations, they must perform similar surveys on an annual basis to ensure compliance with applicable non-U.S. law regarding collection of employee compensation data. This unexpected annual expense far outweighs the potential benefits, if any, of the contemplated disclosures, especially considering this is only a portion of the costs.

B. Including non-U.S. employees distorts the pay ratio calculation due to the variations in compensation practices across multiple jurisdictions and around the globe.

The Final Regulations attempt to fit a square peg into a round hole by forcing registrants to analyze multiple compensation structures under a single system tailored to U.S. corporations and employees. Exclusion of non-U.S. employees is not only an appropriate and justifiable means to reduce the financial and administrative burden on registrants, it is also necessary to prevent distorted or misleading disclosures. As noted above, the typical compensation structure varies significantly across non-U.S. jurisdictions. Two employees with the same position within an organization may receive what appears to be different levels of compensation when calculated to determine the median employee, while in actuality, each individual's total compensation package has been carefully tailored to address local customs, variances in local compensation structures and economic conditions, and to comply with local laws and regulations.

[15] Id.
[16] Id.

Example:

Assume John Doe is a systems analyst for Company, Inc. ("Company"), is based in the United States, earns $150,000 in taxable wages during the measurement period, and elects to contribute 10% of his compensation to a tax-qualified 401(k) retirement plan. Mr. Doe's annual total compensation would be $150,000.

Assume Jane Smith is also a systems analyst for Company, but she is based in Norway, earns $100,000 in taxable wages during the measurement period and does not contribute to any voluntary retirement arrangements because Norway has a national pension scheme. During the measurement period, Ms. Smith accrues $50,000 in benefits under the national pension scheme of Norway, which is funded by the government through employer payroll taxes and other sources of revenue.

When determining the median employee, Company uses taxable wages as a consistently applied compensation measure. Therefore, Mr. Doe and Ms. Smith are treated as having different compensation amounts when, from Company's perspective, these two compensation packages have been purposefully designed to provide each employee with a substantially similar compensation package. If Company has a large employee base in Norway, this would cause the median employee to be skewed downwards – distorting the disclosure.

Moreover, if Ms. Smith is the median employee, and her annual total compensation under Item 402 of Regulation S-K is compared to the annual total compensation of the PEO based in the United States, this creates even more confusion because the effect of the national pension scheme on compensation is not accounted for under Item 402.

In addition, rather than helping to reduce the confusion and disparity that results from the inclusion of non-U.S. employees, the data privacy law exemption only further distorts the disclosure. First, as described above, the application of various data privacy laws and regulations must be analyzed on a jurisdiction-by-jurisdiction basis. As has been demonstrated in almost every area of legal analysis, multiple legal counsel can review the same set of laws and regulations but come to different conclusions regarding their meaning and application. A definitive, specific statement from the relevant legal authority in each jurisdiction worldwide declaring whether the information required under the Final Regulations can be compiled would be required to ensure consistency. Otherwise, there is a distinct possibility that two registrants may have employees in the same non-U.S. location with one registrant including its employees located in that jurisdiction while the other registrant excludes its employees under the data privacy law exemption.

Example:

Assume Inclusion, Inc. ("Inclusion") and Exclusion, Inc. ("Exclusion") each have 200,000 employees located in the United States and 50,000 employees located in France. Also assume that for each employee at Inclusion there is an employee at Exclusion with an identical compensation arrangement. If all 250,000 employees are included when calculating each company's pay ratio, the pay ratios of the median annual total compensation of all employees to the annual total compensation of the PEOs would be identical.

If, on the other hand, Inclusion includes all 250,000 employees when calculating the pay ratio but Exclusion is able to obtain the required legal opinion stating that the necessary information cannot be gathered without violating the laws of France, Exclusion would be able to exclude its 50,000 employees located in France. Assuming the exclusion of the 50,000 French employees alters the pay ratio of Exclusion, this would clearly create a misleading disclosure as two identical companies would now have two different pay ratios.

Even if all registrants agree that employees in a particular jurisdiction must be included when determining their median employee, changes in law may cause a shift in a registrant's pay ratio even though it has not made any changes to its compensation policy. This could give investors the false impression that a registrant's pay ratio has become more egalitarian or stratified. For example, if the majority of a registrant's employees work in a low-wage non-U.S. jurisdiction and that jurisdiction implements a data privacy law that prevents the registrant from obtaining the information necessary to perform the calculations, the registrant's pay ratio would dramatically decrease, despite no change in the registrant's workforce or compensation structure.

While the SEC can control whether it will require registrants to include non-U.S. employees, it cannot control the laws and regulations in non-U.S. jurisdictions. Therefore, to prevent pay ratios being distorted by unforeseen and uncontrollable changes in non-U.S. laws and regulations, the SEC should exclude non-U.S. employees altogether. This will avoid the risk and complications of having the median employee pool determined by variations or changes in non-U.S. laws outside of the SEC's control or influence.

C. Congress did not specify whether non-U.S. employees should be included and, as such, the SEC may conclude it is reasonable to exclude non-U.S. employees to prevent excessive compliance costs and mitigate the potential for distorted or misleading disclosures.

The Preamble to the Final Regulations acknowledges that the inclusion of non-U.S. employees will impose additional costs on registrants (although it does not address the level of increase), but then justifies the inclusion by concluding that Congress's intent was to include non-U.S. employees based on the use of the phrase "all employees."[17] There is little legislative history

[17] *See* 81 Fed. Reg. at 50,122.

on Congress's intent as there were no hearings held on Section 953(b) of the *Dodd-Frank Act* and its provisions were never debated in the conference committee on the *Dodd-Frank Act*. Congress never specifically defined the phrase "all employees" or discussed or explained its intended meaning. Therefore, the phrase "all employees" is left to the interpretation of the SEC as a part of its regulatory authority. If the SEC determines that it is too administratively and financially burdensome to include non-U.S. employees and/or that their inclusion actually distorts the pay ratio disclosure, it would not be "second-guessing Congress," as claimed in the Preamble, but rather would be reasonably interpreting the phrase "all employees" to mean all employees of the registrant within the United States – the jurisdiction where the law is taking effect.

Thus, excluding non-U.S. employees is appropriate considering all of the circumstances, including the lack of any express intent by Congress, the excessive compliance costs, the misleading effect on disclosures and the E.O.'s core principles.

III. Furloughed individuals should be excluded from the median employee calculation determination to significantly reduce compliance costs and complexities.

A. Neither the statute, Final Regulations, nor Item 402(u) define or address furloughed individuals and existing SEC guidance is vague and unworkable.

In the Preamble to the Final Regulations, the SEC stated "that the final rule's definition of 'employee' should include the full-time, part-time, seasonal, and temporary employees employed by the registrant or any of its consolidated subsidiaries."[18] As noted by the SEC, Section 953(b)(1)(A) "expressly directs disclosure of the median of the annual compensation of 'all employees of the registrant, except the chief executive officer (or any other equivalent position) of the registrant.'"[19]

Following the release of the Final Regulations, the SEC released Compliance and Disclosure Interpretation ("CDI") 128C.04 addressing the treatment of individuals considered on a furlough. While CDI 128C.04 uses the term "furloughed" with respect to such individuals, we understand that this term would also potentially apply to individuals considered on a leave of absence. For purposes of this letter, our use of the term "furloughed" should be deemed to mean both individuals classified as on a furlough and those classified as on a leave of absence as of the median employee determination date.

In CDI 128C.04, the SEC Staff (the "Staff") interpreted the Final Regulations with respect to furloughed individuals as follows:

> **Question:** When someone is furloughed on the date that the registrant uses to determine the population of its employees from which it is required to identify the median, must the registrant include the furloughed person in the employee population used to identify the median employee, and, if included in the population, how should the furloughed employee's compensation be calculated?

[18] 80 Fed. Reg. at 50,117.
[19] Id.

Answer: Item 402(u) does not define or even address furloughed employees. Because a furlough could have different meanings for different employers, registrants will need to determine whether furloughed workers should be included as employees based on the facts and circumstances. If the furloughed worker is determined to be an employee of the registrant on the date the employee population is determined, his or her compensation should be determined by the same method as for a non-furloughed employee. Item 402(u)(3) of Regulation S-K identifies four classes of employees: full-time, part-time, temporary and seasonal. The registrant must determine in which class the employee belongs on that date and determine that individual's compensation using annual total compensation or another [consistently applied compensation measure] in accordance with Instruction 5 of Item 402(u). That instruction states that a registrant may annualize the total compensation for all permanent employees (full-time or part-time) that were employed by the registrant for less than the full fiscal year or who were on an unpaid leave of absence during the period. In contrast, a registrant may not annualize the total compensation for employees in temporary or seasonal positions. A registrant may not make a full-time equivalent adjustment for any employee. [October 18, 2016][20]

Neither the text of Section 953(b), Item 402(u), nor the Final Regulations "define or even address" furloughed individuals. Unfortunately, the CDI indicates that registrants must review all individuals classified as "furloughed" and determine whether they fit within one of the four classes of employees: full-time, part-time, temporary or seasonal. As discussed in greater detail below, this guidance is vague and unworkable and may cause registrants to experience significant and unanticipated difficulties complying with the required determination process.

B. The facts and circumstances determination requirement imposes significant and unexpected cost burdens on registrants with respect to traditional furloughed individuals.

As mentioned earlier, we represent a variety of registrants, many of which are large, multinational companies with well over 100,000 employees in multiple jurisdictions throughout the world. Inherent in the size and complexity of these organizations is the fact that at any point in time there are potentially thousands of individuals who are considered furloughed for purposes of the Final Regulations and CDI. We note that it is typical for a registrant with 250,000 employees to have 1,000 individuals classified as furloughed at any one time and such individuals would only constitute 0.4% of the registrant's total workforce.

According to the CDI, each registrant is required to make a facts and circumstances determination as to whether each individual characterized as furloughed fits within one of the four categories of employees who must be included in the median employee pool. While a facts and circumstances determination standard may appear reasonable on its face, our clients have reported significant and unexpected costs associated with making such a determination. Specifically, our clients have noted that to make such a determination, they would be required to review each furloughed individual's human resources file and consider such factors as:

[20] CDI 128C.04, https://www.sec.gov/divisions/corpfin/guidance/regs-kinterp.htm (October 18, 2016).

- How long has the individual been on furloughed status?
- What are the circumstances that resulted in the individual being placed on furloughed status?
- Is there any expectation that the individual may return to work?
- How has the individual been treated under the registrant's various employee benefits / retirement plans?
- Does the individual have any legal rights to return to employment?

As a result, making a facts and circumstances determination with respect to each individual characterized as being furloughed imposes significant and unexpected costs on registrants. Imagine the amount of time a registrant's legal and human resources department must expend collecting the information outlined above, which may be held in a variety places throughout an organization and beyond. Once the information is collected, a registrant must then review the information applicable to each furloughed individual and perform a case-by-case analysis before deciding whether or not such person should be included in the median employee pool.

<u>Example</u>:

A large, multinational registrant employs 300,000 persons world-wide. The registrant learns that its payroll records show that there are 1,500 persons coded as either furloughed or on a leave of absence (0.5% of its total workforce). As a result, the registrant must collect all applicable information regarding the status of each of the 1,500 persons in order to determine whether to include or exclude each person from the median employee pool.

As a result, the registrant expects the data collection, review and analysis with respect to each individual characterized as furloughed will take 2 hours of man-time. Thus, the registrant will need to commit 3,000 hours of employee time each year to comply with the Final Regulations solely with respect to individuals characterized as furloughed.

Assuming the analysis will cost $300 per hour (which represents a blended rate between the value of employee time and the cost of professional legal services), the annual compliance cost for the registrant, solely with respect to furloughed persons, would total $900,000.

Thus, the potential inclusion of furloughed individuals in the median employee pool creates a significant burden for registrants due to the time that must be expended collecting, reviewing and analyzing individual information associated with each person characterized as being furloughed before being able to make a facts and circumstances determination to include or exclude such person from the median employee pool.

C. Common payroll practices compound the unexpected and significant costs associated with the facts and circumstances determination requirement.

Our clients have indicated that the significant costs outlined above may be compounded due to common payroll practices. Companies have reported that their payroll systems often characterize certain individuals who have largely departed from the organization as on a leave of absence, rather than terminated or retired. The result is that registrants may have many thousands more individuals coded on their payroll systems as being furloughed than originally expected.

While the CDI indicates that individuals who are not expected to return to employment could be excluded based on the "facts and circumstances," this would require registrants to undertake a massive review of payroll records with respect to each individual coded as furloughed or on a leave of absence to determine whether or not such individual should be included or excluded from the median employee pool. Such a review will undoubtedly require a tremendous expenditure of internal resources, as registrants must review the particular facts and circumstances applicable to each individual coded as furloughed before including or excluding him or her from the median employee pool.

Example:

Take the same facts as above, but assume that the registrant's payroll system characterizes employees eligible for retiree medical benefits as being furloughed or on a leave of absence. The practice is relatively common as an administrative convenience for employers to ensure proper accounting and tracking of benefits. As a result, the registrant's payroll records show that there are currently 20,000 persons coded as being on furlough or leave of absence status. The existing SEC guidance appears to require the registrant to review all 20,000 individuals on a facts and circumstances basis to accurately construct the median employee pool.

Assuming the registrant may expedite its data collection, review and analysis efforts to 15 minutes per person, it would require 5,000 hours of employee time to comply with the Final Regulations.

Assuming the analysis will cost $300 per hour (assuming the same blended rate as described above), the annual compliance cost for the registrant, solely with respect to furloughed persons, would total $1,500,000.

D. The Final Regulations' median employee determination window forces registrants to undertake these significant time expenditures in a tightly-compressed period.

The Final Regulations require that the median employee be determined as of "any date of the registrant's choosing within the last three months of the registrant's last completed fiscal year."[21] While we recognize that this three-month determination window provides flexibility to

[21] 80 Fed. Reg. at 50,112.

registrants in determining their median employee, and is certainly a welcome improvement over the initial Proposed Regulations' requirement to make such determination on the last day of the registrant's fiscal year, the three-month determination period presents unique and unexpected challenges when applied to the requirement that furloughed or leave of absence individuals potentially be included in the median employee pool.

As noted above, registrants are experiencing significant time and resource pressures due to the potential inclusion of furloughed individuals in the median employee pool. The three-month median employee determination window rule forces registrants to conduct the massive review of furloughed employees during this window period, as they will not have all of the relevant facts and circumstances to make a good faith determination as to a particular individual until the window period.

> **Example**:
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> A registrant sets its median determination date as December 1. On June 1 of that year Herbert Jones, an employee of the registrant, is placed on furlough to allow him to undergo medical treatments while remaining on the registrant's group health plan. Mr. Jones' illness is serious and the medical treatments continue through November 15. Fortunately, Mr. Jones makes a full recovery and returns to work on November 30.
>
> According to the SEC's facts and circumstances test, it appears that Mr. Jones should be included in the median employee pool. However, there is no way a registrant would be able to make such a determination earlier in the year because it could not predict whether or when Mr. Jones would return to work.

Thus, the existing guidance appears to require that registrants expend a tremendous amount of time and resources making determinations concerning furloughed individuals in a highly-compressed timeframe centered on the registrant's median employee determination date. This tight timeframe in which registrants are required to perform the contemplated facts and circumstances test compounds the time and budgetary pressures associated with making such determinations.

E. SEC guidance imposes significant and unanticipated costs associated with monitoring applicable legal obligations with respect to furloughed individuals.

The SEC's facts and circumstances test forces registrants to incur significant and unanticipated legal costs associated with monitoring world-wide and ever-changing legal requirements applicable to employees on furloughed or leave of absence status. Inherent in making a facts and circumstances determination as to whether a furloughed individual should be considered an employee to be included in the median employee pool, is whether such person has a legal right to return to employment with the registrant. Thus, the SEC guidance requires that registrants constantly monitor all applicable employment laws that could grant a furloughed individual a legal right to return to work.

We believe that such an obligation is unreasonable and the legal costs associated with monitoring laws, which may change from year to year and jurisdiction to jurisdiction, are excessive in light of the minimal benefits provided to investors by potentially including furloughed individuals in the median employee pool.

F. Current SEC guidance is incomplete with respect to calculating compensation attributable to a furloughed individual and needs additional explanation.

The Final Regulations and CDI guidance do not address how to calculate a furloughed employee's compensation in the event that such employee has not performed any services or received any compensation during the applicable measurement period. Though the guidance indicates that such an individual's compensation may be annualized if they are considered full-time or part-time and were paid during the measurement period, it does not contemplate a common circumstance in which such individual does not receive any compensation. Thus, registrants are not certain whether such an employee should be attributed compensation at their last rate of pay, or if they should be treated as having no pay for the applicable measurement period.

> **<u>Example</u>**:
>
> Country X adopts a parental leave policy similar to that currently in effect in Sweden in which parents are entitled to 480 days of parental leave. Unlike the Swedish policy, however, Country X only provides that 115 days of the parental leave is paid.
>
> Thus, a registrant with employees in Country X may have employees who have taken parental leave, but received no compensation during the applicable measurement period.

While it is arguable that the most conservative approach for a registrant in such a position would be to attribute no compensation to a furloughed employee who did not receive compensation during a measurement period, we believe that such an approach would inappropriately skew the median employee determination downwards.

As noted earlier, we believe that the most cost-efficient manner of addressing furloughed employees is to exclude them from the median employee calculations altogether and that their exclusion will have no meaningful impact on a registrant's pay ratio disclosures. To the extent that furloughed individuals are included at all in the median employee pool, the SEC should clarify that registrants may use the last rate of pay received by such individual in the event that they have no compensation during the measurement period.

IV. Part-time and seasonal employees, as well as employees who have not worked for the entire measurement period, should be excluded from the median employee calculation to provide a more meaningful comparison of PEO pay to median employee pay, to eliminate unintended distortions, to minimize costs and to reduce the risk of errors.

A. Part-time and seasonal employees should be excluded from the median employee pool to provide for a more meaningful comparison of PEO pay to median employee pay.

The PEO of a publicly-traded company is a full-time position. As such, compensation structures applicable to a PEO are based on such person's status as a full-time employee of the organization. On the contrary, part-time and seasonal employees are, by definition, not full-time employees and have different compensation structures that reflect their limited engagement with a registrant. For example, full-time employees are typically eligible to participate in tax-qualified retirement plans and health and welfare programs generally available to a broad-base of employees.

Thus, any full-time employee's compensation when viewed against a part-time or seasonal employee's compensation is inherently an "apples to oranges" comparison. Likewise, comparing PEO compensation to a group that includes part-time and seasonal employees distorts the ratio and obfuscates a potential investor's insights regarding pay practices within a registrant. Therefore, we believe that the SEC should modify the Final Regulations to exclude part-time and seasonal employees from the median employee pool.

B. Including part-time and seasonal employees can create unintended distortions in pay ratio calculations among registrants.

Including part-time and seasonal employees in the median employee pool may result in significant and unintentional distortions in pay ratio disclosures among registrants. The SEC recently released CDI 128C.03 concerning utilizing a "consistently applied compensation measure" ("CACM") to identify a registrant's median employee. The CDI provides the following guidance:

> **Question:** When a registrant uses a CACM to identify the median employee, what time period may it use? Must the period include the date on which the employee population is determined? Must it always be for an annual period? May it use the prior fiscal year?
>
> **Answer:** To calculate the required pay ratio, a registrant must first select a date, which must be within three months of the end of its fiscal year, to determine the population of its employees from which to identify the median. Once the employee population is determined, the registrant must then identify the median employee from that population using either annual total compensation or another CACM. In applying the CACM to identify the median employee, 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. 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. [October 18, 2016][22]

As noted in the guidance, registrants are free to select any date they wish within the final three months of their fiscal year on which to determine the median employee. Moreover, registrants are not required to use a full annual period over which to determine the median employee. As a result, a registrant who employs a significant number of part-time and seasonal employees at the end of its fiscal year may report dramatically different pay ratio results than a registrant who employs part-time and seasonal employees either throughout the year or during an earlier period during its fiscal year. This potential distortion in pay ratio results further erodes the little, if any, value investors may obtain from the pay ratio disclosures.

Example:

Christmas Time, Inc. ("Christmas Time") is a publicly-traded company with a calendar fiscal year that specializes in holiday merchandise, with a focus on Christmas collectibles and gifts. As a result of its operations, Christmas Time doubles its workforce during the months of November and December via hiring seasonal employees. Under the SEC's guidance, Christmas Time selects a median employee determination date of October 1 and measures compensation received during January 1 through September 30 to determine its median employee. As a result, no seasonal employees are included in Christmas Time's median employee pool.

Easter Bunnies R Us, Inc. ("Easter Bunnies") is also a publicly-traded company with a calendar fiscal year that specializes in holiday merchandise, with a focus on Easter collectibles and gifts. Easter Bunnies also doubles it workforce, but during the months of March and April, via hiring seasonal employees. Easter Bunnies uses the same median employee determination date and compensation measurement period as Christmas Time. As a result, all of Easter Bunnies' seasonal employees are included in its median employee pool.

The example above demonstrates how two similar companies, both in the holiday merchandise business, may report wildly different pay ratios due to the current SEC guidance. This result is an unexpected and surprising consequence of the SEC's latest guidance concerning the Final Regulations and demonstrates the unanticipated consequences that are inherent in including part-time and seasonal employees in the median employee pool.

Therefore, we recommend that the SEC modify the Final Regulations to exclude all part-time and seasonal employees from the median employee pool.

[22] CDI 128C.03, https://www.sec.gov/divisions/corpfin/guidance/regs-kinterp.htm (October 18, 2016).

C. The SEC should modify the Final Regulations to allow registrants to exclude employees who have not worked for the entire measurement period to reduce costs and minimize risk of inadvertent errors.

The Final Regulations permit registrants to annualize compensation received by permanent full-time and part-time employees who have not been employed for the full year. While annualization is helpful to minimize inadvertent distortions in the pay ratio calculations, registrants have informed us that they anticipate its application greatly increases costs and increases the chances of inadvertent errors.

Annualizing permanent employee compensation increases costs due to the additional time constraints it places on registrants in order to determine the median employee. To properly determine the median employee, a registrant must annualize all compensation received by permanent employees who have not worked for the entire year. Thus, a registrant whose workforce consists of large numbers of full-time and part-time employees, but whose turnover rates for such employees is high (e.g., a supermarket company, hospitality company or any company whose business includes a retail presence), will likely be required to perform a large number of annualization calculations in order to properly construct the median employee pool.

Performing such annualization calculations is inherently a "case by case" exercise, meaning that registrants must look at the particular facts surrounding each employee who has not worked for the full year. Pertinent facts could include the following, among others:

- When was the employee hired?
- What was the employee's base rate of pay?
- Did the employee receive a bonus?
- Would the employee have received a bonus if he or she had been employed for the full measurement period? If so, what would have been the amount of such bonus?
- Did the employee receive overtime pay?
- Would the employee have received comparable amounts of overtime pay if he or she had been employed for the full measurement period?
- Would have the employee received any other compensation or been entitled to participate in other benefit plans if the employee had worked for the full measurement period (e.g., medical benefit or retirement plan contributions)?

Simply based on the list above, it is apparent that performing an annualization calculation will involve a significant expenditure of internal resources, all of which comes at a cost to the registrant.

Example:

Gretchen's Groceries, Inc. ("Gretchen's Groceries") is a publicly-traded company that operates 500 supermarkets and employs 10,000 people throughout the Southwest portion of the United States. Gretchen's Groceries employees tend to be full-time and part-time permanent employees, though there is significant turnover each year. As a result, Gretchen's Groceries typically hires 2,500 new permanent employees each year, representing a 25% employee turnover rate.[23]

In order to accurately construct the median employee pool, Gretchen's Groceries must individually review each permanent employee who did not work for the full year and annualize his or her compensation. Under a best case scenario, Gretchen's Groceries must spend 1 hour per new employee to determine each employee's applicable hire date, gather all relevant compensation information (in some instances a seasonal employee will work off and on during busier seasons), and perform the annualization calculation.

Thus, Gretchen's Groceries will need to devote an average of 2,500 employee hours each year to construct the median employee pool. Assuming each employee hour is worth $150, the annual compliance cost for the registrant, solely with respect to permanent employees who have not worked for an entire year, would total $375,000.

In addition to the significant costs registrants expect to incur with respect to annualizing permanent employee pay, performing the calculations inherently involves making assumptions and estimates and is ripe for potential errors, which would skew the median employee determination. For example, determining the value of a bonus an employee might have received had he or she worked for the entire year may not be a straightforward exercise. What if the employee was hired mid-year and was eligible for the bonus plan but had no target bonus? What assumptions may a registrant make with respect to amounts of matching contributions the employee would have received had he or she worked for the entire year? Likewise, how should employers annualize pay in the event that employees receive mandated raises following a specified period of employment (e.g., following a specified probationary period)?

The consequences of these decisions and assumptions may play a significant role in shaping the median employee pool and ultimate determination of the median employee. Given the uncertainty surrounding these issues, we foresee the potential for inadvertent mistakes that could skew the median employee determination results.

Only as companies have gotten closer to implementing the Final Regulations and performing the median employee calculations have these questions and issues emerged. If the Final Regulations become effective, it is likely even more questions and issues will arise. Therefore, we recommend the SEC revise the Final Regulations to exclude all employees who

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[23] This turnover rate is likely significantly less than an actual grocery store's turnover rate. See, http://www.workforce.com/2004/01/30/turnover-in-supermarkets/.

have not worked for the entire period to minimize costs associated with annualizing compensation and reducing the risk of inadvertent errors in performing the calculations.

V. The Final Regulations damage shareholder value by enabling state and local governments to impose millions of dollars in additional, unintended tax liability on registrants each year based on their pay ratio.

In approximately 10 state or local jurisdictions, including business centers such as New York, California and Illinois, legislation has been adopted, or is under consideration, that would impose increased tax liability or limit a registrant's ability to utilize certain tax deductions based on its pay ratio. Many of these proposals provide for a corresponding increase in tax liabilities as an employer's pay ratio increases. For example, the City of Portland, Oregon has already enacted legislation imposing an incremental business tax on employers who are required to comply with the Final Regulations. Connecticut has proposed legislation that taxes employers at a state corporate income tax rate of 5% if its pay ratio is less than 25:1, a rate of 7% if its pay ratio falls between 25:1 and 100:1, a rate of 10% if its pay ratio falls between 100:1 and 250:1, and a rate of 25% if the employer's pay ratio is over 250:1. In one instance, a large multi-national client quantified its expected increase in tax liabilities to be over $40 million per year. Assuming additional jurisdictions enact similar legislation, this figure can be expected to rise exponentially.

Thus, the Final Regulations unexpectedly provide a vehicle for state and local governments to impose potentially hundreds of millions of dollars per year in additional tax liability on registrants and consequently harm investors and shareholders—cutting directly against the purpose and justification for the Final Regulations. Even worse, these misguided state and local tax measures provide a perverse incentive for registrants to seek every available interpretation of the Final Regulations that would reduce their respective pay ratios and minimize corresponding tax liabilities associated with such disclosures. For example, in order to avoid these tax liabilities, a company may attempt to re-structure a PEO's compensation arrangement to provide for a lower annual total compensation, but put in place a separate arrangement that would pay after retirement.

Example:

In 2016, Company Z, Inc. ("Company Z") reported total annual compensation for its PEO, Mr. Jordan, of $500,000. After the Final Regulations take effect and associated tax liabilities are triggered, Company Z decides to restructure Mr. Jordan's compensation for 2017 and subsequent years. Company Z negotiates with Mr. Jordan to provide a supplemental executive retirement plan (the "SERP"). The SERP is structured such that Mr. Jordan accrues a *de minimis* benefit during each year prior to his retirement, but accrues a dramatically increased SERP benefit of $5,000,000 upon his retirement in 2020. In exchange, Company Z reduces Mr. Jordan's compensation arrangements that are included in PEO total compensation (e.g., salary, bonus, equity awards). From 2017 through 2019, Company Z reports a minimal pay ratio. In January 2020, Mr. Jordan retires as PEO and is succeeded by Mr. William, who makes $500,000 each year.

Because the Final Regulations permit Company Z to use the annualized compensation of the new PEO to calculate the pay ratio, Company Z's pay ratio remains low despite the $5,000,000 SERP benefit accrued by Mr. Jordan in 2020.

Alternatively, a registrant may refuse to employ lower paid employees directly and/or outsource such positions to consultants or professional employer organizations as a means to minimize its pay ratio. These state and local tax laws are a completely unexpected consequence of the pay ratio disclosures contemplated by the Final Regulations and would likely diminish shareholder value due to the potential diminished executive talent retained by registrants and the significant increased tax burdens incurred by registrants.

As noted above, there is no evidence that shareholders have any interest or place any value on the contemplated pay ratio disclosures when making investment decisions or in say-on-pay voting rights under Section 951. If shareholders were informed that gathering and presenting the required information would come at a cost of hundreds of millions of dollars per year in additional tax liability (on top of compliance costs) and potential negative business consequences, it seems clear shareholders would view the limited benefit of the disclosure, if any, as far outweighed by the costs to registrants and, indirectly, to the shareholders and investors.

VI. If Section 953(b) is not eliminated, the SEC should provide administrative relief by adopting a safe harbor rule that permits registrants to calculate their pay ratio by reference to their PEO's total compensation compared to the median earnings of a U.S. worker in their respective industry, as calculated by the Bureau of Labor Statistics.

The Preamble to the Final Regulations provides that 1,105 internal burden hours will be spent on preparing and reviewing the pay ratio disclosure in the initial year of compliance. The Preamble also states that the pay ratio calculation is intended to be used as a factor in evaluating a registrant's executive compensation. Given the limited benefit of the pay-ratio calculation, it is critical to administer these rules in an effective manner.

The Final Regulations recognize that in order to administer the Final Regulations in a cost effective manner, the rules must allow for some flexibility in calculating the median pay. Specifically, the Final Regulations state "In implementing the statutory requirements, we have exercised ***our exemptive authority*** and provided flexibility in a manner that we expect will reduce costs and burdens for registrants…."[24] The SEC's general exemptive authority is codified in the Securities Exchange Act of 1934 (the "Exchange Act") and can be exercised upon any Exchange Act-related provisions.[25] The SEC has previously used this authority to provide for safe harbors in other contexts. For example, Rule 3a4-1 is a safe harbor under which certain associated persons of an issuer who perform limited securities sales for the issuer are deemed not to be "brokers" under Section 3(a)(4) and therefore, are not required to register in accordance with Section 15 of the Exchange Act.

A. Providing registrants with a safe-harbor rule that utilizes an already-available industry-specific statistic would significantly reduce compliance costs.

In order to reduce compliance costs, the SEC should adopt a safe harbor rule that allows registrants to utilize existing industry-specific statistics in order to calculate an employee's median income. The BLS's Occupational Employment and Wage Estimates database is a well-established and reliable source of such information. The BLS wage data is collected from a national survey of employers of every size, in every state, and in metropolitan and non-metropolitan areas. The survey produces estimates by combining data collected over a 3-year period.

For example, for a registrant in the financial services industry, occupations in the financial services industry are generally organized under the "Finance and Insurance" umbrella. The Finance and Insurance sector is further broken down into five major categories:

(1) Monetary Authorities – Central Bank;
(2) Credit Intermediation and Related Activities;
(3) Securities, Commodity Contracts, and Other Financial Investments;
(4) Insurance Carriers; and
(5) Funds, Trusts, and Other Vehicles.

In each of these categories, the BLS database provides information on the median hourly wages, average hourly wages, and annual average wages for occupations in various industries. This information, while industry-wide, provides shareholders with reliable and valuable data on the median earnings of an employee in a particular sector.

[24] 80 Fed. Reg. at 50,107.
[25] Section 36 of the Securities Exchange Act of 1934.

B. The proposed safe-harbor would continue to afford investors the ability to compare how a registrant's pay ratio compares to other registrants' pay ratios thereby yielding virtually the same benefits as the Final Regulations at a minimal cost to companies.

The Final Regulations provide that "while existing public data may permit shareholders to estimate median pay ratios across industry sectors, it does not allow for the particularized, registrant-specific assessment that, in our view, Section 953(b) was intended to facilitate."[26] We disagree. We believe that the BLS metrics provide shareholders and investors with useful data that allows them to make an informed decision.

<u>Closing</u>

If the ultimate goal of any financial regulation is to promote a safe and sound financial system, policymakers must ensure that regulations are developed in an efficient and effective manner. To be effective, regulations must be appropriately tailored, so that they actually achieve their stated purpose. When regulations are overly broad and complex, they may end up harming the investors and consumers that they intend to protect.

As detailed above, the Final Regulations impose significant challenges and costs to companies while providing little or no benefits to investors. Furthermore, the nature of the difficulties associated with the implementation of the Final Regulations goes against the Administration's core principle of "efficient, effective, and appropriately tailored" regulations. Therefore, we ask that the SEC delay the implementation of the Final Regulations, withdraw them, and re-propose new pay ratio disclosures rules that provide a more accurate and more helpful analysis of executive compensation at a lower compliance cost for the industry.

We would like to thank you for recognizing that the Final Regulations have raised serious compliance difficulties and for directing the Staff to reconsider their implementation. Thank you also for extending the public an opportunity to share our concerns. We welcome the opportunity to further discuss the concerns and recommendations set forth in this letter and hope that we can be a resource to the SEC as you review and consider all of the comments. If you have any questions, please do not hesitate to contact Taylor Wedge French at [redacted] or Rosemary Becchi at [redacted].

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Partner

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[26] 80 Fed. Reg. at 50,151.