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Re: Comments on Item 402(u) of Regulation S-K (Pay Ratio Disclosure); File Number S7-07-13

March 23, 2017

VIA E-MAIL: rule-comments@sec.gov

The Honorable Michael S. Piwowar
Acting Chairman
Securities and Exchange Commission
100 F Street, NE
Washington, D.C. 20549-1090

Dear Chairman Piwowar:

We are submitting this letter in response to your February 6, 2017 request for public comments on the implementation of the final rule that requires a public company to disclose the ratio of the median of the annual total compensation of all employees to the annual total compensation of the chief executive officer (the "**Final Rule**"), which was adopted by the Securities and Exchange Commission (the "**Commission**") pursuant to Section 953(b) of the Dodd-Frank Wall Street Reform and Consumer Protection Act.

In view of the focus of your letter, our submission focuses on the implementation challenges associated with compliance with the Final Rule and does not attempt to address the various substantive concerns raised by the Final Rule. The efforts that registrants with calendar year-ends have already undertaken to implement the Final Rule in order to make the requisite disclosure in their 2018 proxy statements underscore the significant administrative burdens they face. We respectfully urge the Commission to consider the following issues and recommendations as it evaluates the Final Rule:

- Collecting the data necessary to compute the median employee is imposing substantial costs and administrative burdens on registrants, even with the use of statistical sampling[1];
- The Commission's guidance on the selection of a consistently applied compensation measure creates more confusion than flexibility;
- The Final Rule, to the extent implemented, should exclude independent contractors from the median employee determination, as we believe these individuals are clearly outside the statutory scope of Section 953(b) of the Dodd-Frank Act;
- The Final Rule, to the extent implemented, should limit the requirement to determine the median employee to every three years and should broaden the transition relief in the event of corporate transactions and other significant events; and

[1] At the time of the proposed release, we do not believe the Commission was in a position to understand the costs, which have become more apparent as companies have begun in earnest to prepare for the disclosure that would be required next year.

- The Final Rule, to the extent implemented, should provide that the pay ratio disclosure be "furnished" rather than "filed."

In any case, we would encourage the Commission to consider the costs of compliance with the Final Rule. In light of the congressional focus on Section 953(b) of the Dodd-Frank Act and some uncertainty as to its implementation, the Commission should consider a delay to prevent unnecessary spending on preparing for the rule.

■ *The Administrative and Financial Burden of Compliance with the Final Rule, Even with Statistical Sampling, Is Significant*

The Final Rule requires registrants to identify their median employee by computing the annual total compensation of all employees, including full-time, part-time, temporary and seasonal employees, both within and outside the United States. For registrants, especially those with international operations and multiple payroll platforms, this undertaking is posing a heavy administrative burden and is requiring the use of significant financial and staffing resources, diverting those resources from being used elsewhere to implement companies' business plans. Based on our discussions with clients, the out-of-pocket and other costs associated with the first year of compliance with the Final Rule is anticipated to be in many cases significantly in excess of the Commission's estimated initial cost of compliance for the average registrant at $368,159.[2]

Employees have been sidetracked from their existing responsibilities, as compliance with the Final Rule requires the services of employees from across a company's operations, including human resources, finance, information systems and legal departments. Companies have had to hire costly experts, such as compensation consultants, statisticians and outside legal counsel. Companies have had to modify their operating budgets to accommodate the costs of implementing the Final Rule.

All of this is necessary because many global companies do not maintain centralized payroll systems. This is further complicated by non-U.S. jurisdictions using different tax years for payrolls, and the need to translate and account for foreign currency fluctuations. To comply, companies must aggregate compensation data across a multitude of payroll systems, develop a centralized system to house this data and normalize the data before they can even begin to determine the identity of the median employee.

Adding to the burden is the requirement to include non-full-time employees (e.g., part-time employees, temporary and seasonal employees, or interns). These additional employees are often paid under different compensation and benefit regimes (e.g., lump-sum stipends versus regular salaries or wages), which make them difficult to compare with full-time employees. Most registrants are developing their compliance programs to gather data for part-time employees from scratch.

At least so far, we have found that statistical sampling has done little to reduce costs. While this may change over time, it does not alleviate the costs imposed on a registrant in its first year of compliance. In order to develop a statistically reliable sampling model, registrants are still required to go through the same process of aggregating, centralizing, normalizing and analyzing their compensation data across their entire employee base. Only after that project is completed can a reliable statistical sample be developed.

Even in the years that follow, we anticipate that statistical sampling models will need to be continually reviewed and updated as registrants' businesses and compensation structures change. For example, a registrant that acquires or disposes of businesses, and hires or downsizes employees in the process, will need to begin the median employee calculation anew. As a result, our view is that the man-hours and monetary cost required to identify the median employee are not meaningfully reduced by the use of statistical sampling.

[2] Pay Ratio Disclosure, 80 Fed. Reg. 50104, 50161 (Aug. 18, 2015) (to be codified at 17 C.F.R. pts. 229, 240, 249).

■ *Developing a Compliant "Consistently Applied Compensation Measure" Is Confusing for Registrants*

Instruction 4 to the Final Rule permits a registrant to use any reasonable method, including a consistently applied compensation measure ("**CACM**"), such as payroll or tax records, to identify its median employee. While the use of a CACM may appear initially to be helpful, we believe that the guidance around the CACM has ultimately proven confusing and burdensome.

In response to a question addressing how a registrant should select its CACM, the SEC staff issued a Compliance and Disclosure Interpretation ("**C&DI**") providing, in part, the following guidance: "Any measure that reasonably reflects the annual compensation of employees could serve as a CACM. The appropriateness of any measure will depend on the registrant's particular facts and circumstances. For example, total cash compensation could be a CACM unless the registrant also distributed annual equity awards widely among its employees."

Until the C&DI was issued, many registrants had intended to use their raw payroll or tax records to identify their median employee, as this data is typically readily available and can be easily aggregated. Since the C&DI was issued, however, registrants have been left to infer whether the use of payroll or tax records is compliant with the Final Rule, or whether such data would need further massaging. The Commission should clarify the staff's guidance to confirm that registrants may use their raw payroll or tax records as their CACM. In this vein, the Commission should also consider clarifying that base compensation is an appropriate CACM as it is also more easily obtainable and comparable across employee populations, and it "reasonably reflects" employee annual compensation.

We believe that the Final Rule and the C&DI are too ambiguous to meaningfully provide the guidance and flexibility that the Commission intended for registrants that select their own CACMs. We respectfully request that the Commission revisit this guidance and delay implementation of the Final Rule until such considerations are complete.

■ *Independent Contractors Should Not Be Included in the Definition of "Employee"*

Section 953(b) of the Dodd-Frank Act requires registrants to disclose the median of the annual total compensation of their "employees." However, the Final Rule, together with a C&DI, expanded the notion of "employees" to include those that companies would characterize as independent contractors. We believe that inclusion of independent contractors in any form is inconsistent with the statutory mandate of Section 953(b).

The Final Rule captured some independent contractors by defining "employee" to exclude "those workers who are employed, and whose compensation is determined, by an unaffiliated third party but who provide services to the registrant or its consolidated subsidiaries as independent contractors or 'leased' workers." The definition suggests, by negative inference, that all workers (including independent contractors) are employees unless they satisfy the "unaffiliated third party" prong of the definition.[3]

Using a different definition of "employee" than the widely recognize tests under tax and employment law adds an unnecessary layer of complexity and confusion. Because registrants already classify their workers as employees or independent contractors for purposes of tax and employment laws, it would be unreasonable to require registrants to conduct a separate analysis on a person-by-person basis, solely for purposes of disclosing the pay ratio. Using a different test for distinguishing independent contractors from employees than that used for tax and employment law purposes also introduces legal risk to employers. Employers carefully weigh numerous factors to determine the most appropriate classification based on a long history of tax decisions and case law, and the test for classifying workers as independent

[3] In response to questions raised, the SEC staff issued a C&DI stating that, for purposes of determining who is an employee under the Final Rule, "a registrant should include those workers whose compensation it or one of its consolidated subsidiaries determines regardless of whether these workers would be considered 'employees' for tax or employment law purposes or under other definitions of that term."

contractors or employees is facts-and-circumstances-driven under those laws. Imposing a different standard solely for purposes of the pay ratio disclosure risks further muddying the waters in a legal area that is already fraught with litigation risk and uncertainty for employers.

Beyond the classification issue, incorporating any independent contractors' compensation into the pay ratio analysis would also be administratively burdensome. Independent contractors are typically not on the same payroll systems as employees. Independent contractor contracts are often not even handled by HR personnel, but rather by the business divisions and functions that directly contract with these individuals.

For all of these reasons, the Commission should reconsider the definition of "employee" for purposes of the pay ratio rule and should clearly exclude independent contractors from the definition of "employees," allowing companies to defer to the long-standing common law and tax law definitions and tests for making that determination.

- *The Determination of the Median Employee Should Not be Required More Frequently Than Every Three Years*

Under the Final Rule, the Commission gave registrants the ability to make their median employee determination once every three years, provided that "during a registrant's last completed fiscal year there has been no change in its employee population or employee compensation arrangements that it reasonably believes would result in significant change to its pay ratio disclosure." Further, there is a transition period for registrants that engage in business combinations and acquisitions. While this is helpful, we request that the Commission provide more relief in both respects.

First, we think that the median employee determination should only be required to be conducted once every three years, regardless of changes in the registrant's employee population or compensation arrangements during that three-year period. Companies evolve naturally by expanding and contracting their businesses, which results in changes to their employee populations. Other changes also include compensation arrangements in response to market conditions, shareholder concerns, and on-the-ground business realities and opportunities. All are necessary to conduct business, and may result in some changes that could, or could not be, reasonably expected to result in a "significant change" to the pay ratio. Changes in employee populations due to business necessity should not come with an administrative burden of recalculating the pay ratio.

Second, the transition rule for business combinations and acquisitions is too short – it is only provided for the fiscal year in which the transaction becomes effective. While this may be sufficient for a registrant that is effecting a relatively discrete business combination or acquisition, where the employees are all located in one jurisdiction or are on a common payroll, this transition period is likely to be insufficient for a registrant that is engaging in a transaction that involves non-U.S. jurisdictions and/or employees who are not on a common payroll. Moreover, the transition rule does not cover other transactions that could be as disruptive, such as a major disposition, spin-off, reduction in force, large hiring of employees as part of a build-out of a business line and other significant events. Therefore, the transition rule for business combinations and acquisitions should apply for at least two fiscal years and should apply to other significant transactions and events.

- *The Pay Ratio Disclosure Should Not Need to Be "Filed," But Instead "Furnished"*

Under the Final Rule, the pay ratio disclosure is required to be "filed," not "furnished." As discussed above, given the administrative burden associated with complying with this disclosure rule, as well as the significant number of estimates and assumptions that will be necessary to prepare the disclosure, we respectfully request that the disclosure not be covered by the CEO and CFO certification that is called for "filed" information.

* * *

We appreciate the opportunity to participate in this process, and would be pleased to discuss our comments or any questions the Commission may have with respect to this letter. Any questions about this letter may be directed to Kyoko Takahashi Lin or Veronica Wissel at 212-450-4000.

Very truly yours,

Davis Polk & Wardwell LLP

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