

SEC Provides Further Guidance on Pay Ratio Disclosure

by Jason Brenkert

On September 21, 2017, the Securities and Exchange Commission issued additional guidance on the CEO pay ratio rule, which will require most public companies to report the pay ratio of their CEO to their median employee in their 2018 proxy statements, for the first fiscal year beginning on or after January 1, 2017. The newly released guidance from the Commission includes: (i) Commission Guidance on Pay Ratio Disclosure, (ii) Division of Corporation Finance Guidance on Calculation of Pay Ratio Disclosure and (iii) Updated Compliance and Disclosure Interpretations (CDIs).

This guidance follows upon recent comments from Bill Hinman, Director of the SEC's Division of Corporation Finance, indicating that the Commission will not be delaying implementation of the CEO pay ratio rule. Since companies need to continue to prepare for upcoming compliance with the new rule, these new interpretations provide additional guidance on the range of acceptable pay ratio methodologies.

Companies should note the recently released results from Institutional Shareholder Services's (ISS) annual global benchmark voting policy survey, which discloses that close to 75 percent of investor respondents indicated that they intend to review and utilize pay ratio disclosure in analyzing executive compensation matters. Many expected investors largely to disregard the pay ratio disclosure, but this survey may indicate a deeper interest in the disclosure than companies have anticipated.

Companies should strategize carefully regarding the methodology they employ to identify the median employee and calculate his or her annual compensation, how they will disclose the methodology and pay ratio in their proxy statement and what additional information the company may want to prepare to address the potential concerns of their employees and investors.

Use of Reasonable Estimates, Assumptions and Methodologies and Statistical Sampling

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Flexibility in Determining Appropriate Methodologies

The Commission's interpretive release begins by reiterating that the final pay ratio rule provides significant flexibility to companies in determining appropriate methodologies to identify the median employee and calculating the median employee's annual total compensation. Companies may base required disclosure on the company's reasonable beliefs, estimates, assumptions, and methodologies.

Specifically, the Commission interpretive guidance notes that the final rule permits companies to:

- use reasonable estimates to identify the median employee, including by using statistical sampling and a consistently applied compensation measure, such as payroll or tax records;
- use reasonable estimates in calculating the annual total compensation or any elements of annual total compensation for employees; and
- change their methodology or their material assumptions, adjustments or estimates, as long as the company briefly describes the change and the reasons for the change if its effects are significant.

Description of the Pay Ratio as an Estimate

In new CDI 128C.06, the Staff states that it would not object if a company describes its pay ratio disclosure as an estimate. As stated in the Commission interpretive release, due to the use of estimates, assumptions, adjustments, and statistical sampling permitted by the final rule, pay ratio disclosures may involve a degree of imprecision. Therefore, the Staff would not object if a company states in any required disclosure that the pay ratio is a reasonable estimate calculated in a manner consistent with Item 402(u).

Combining Reasonable Estimates with Statistical Sampling and other Methodologies

In the Staff's guidance on calculating pay ratio disclosure, the Staff affirmed that companies may combine the use of reasonable estimates with the use of statistical sampling or other reasonable methodologies. For example, in determining the employees from which the median employee is identified, a company may use its employee population or statistical sampling or other reasonable methods. The Staff clarified that the use of "and/or" in the instructions to the final rule indicates that a company is permitted to use statistical sampling, other reasonable methods or a combination of statistical sampling and other reasonable methods. Further, in adopting the "other reasonable methods" language, the Staff notes that the SEC indicated that it did not specify "other reasonable methods" that may be appropriate to allow each company the flexibility to determine the method that best suits its own facts and circumstances so long as such method was reasonable.

The Staff's guidance provides three hypothetical examples to illustrate how a company might consider its particular facts and circumstances in determining when to use estimates in combination with statistical sampling and other methodologies. The Staff

emphasizes that any determination on the use of estimates, statistical sampling and methodologies must be reasonable. The Staff's guidance notes that some of the techniques in the examples may be more suitable for larger companies with complex workforces, and reminds companies that simpler approaches may be better in determining the pay ratio.

Examples of Statistical Sampling Methods

The Staff's guidance provides the following examples of the statistical sampling methods that could be used (alone or in combination) to identify the median employee, depending on the company's particular facts and circumstances:

- simple random sampling (drawing at random a certain number or proportion of employees from the entire employee population);
- stratified sampling (dividing the employee population into strata, e.g., based on location, business unit, type of employee, collective bargaining agreement, or functional role and sampling within each strata);
- cluster sampling (dividing the employee population into clusters based on some criterion, drawing a subset of clusters, and sampling observations within appropriately selected clusters; cluster sampling may be conducted in one stage or multiple stages); and
- systematic sampling (the sample is drawn according to a random starting point and a fixed sampling interval, every nth employee is drawn from a listing of employees sorted on the basis of some criterion).

Reasonable Estimates

Under the final rule, companies may use reasonable estimates both in the methodology for identifying the median employee and in calculating the annual total compensation (or any elements of annual total compensation for employees). The Staff's new guidance sets forth the following examples of situations where companies may use reasonable estimates under the appropriate facts and circumstances:

- analyzing the composition of the company's workforce (by geographic unit, business unit, employee type);
- characterizing the statistical distribution of compensation of the company's employees and its parameters (e.g., a lognormal, beta, gamma or another distribution, or a mixture of distributions—for example a mixture of two normal or lognormal distributions yielding a bimodal distribution);
- calculating a consistent measure of compensation and annual total compensation or elements of the annual total compensation of the median employee;
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- evaluating the likelihood of significant changes in employee compensation from year to year;
- identifying the median employee;
- identifying multiple employees around the middle of the compensation spectrum; and
- using the mid-point of a compensation range to estimate compensation.

Reasonable Methodologies

The final rule does not specify any required methodology and permits companies the flexibility to choose a method or combination of methods based on their facts and circumstances. The Staff guidance provides the following examples of common statistical techniques and methodologies that companies may consider:

- making one or more distributional assumptions, such as assuming a lognormal or another distribution provided that the company has determined that the use of the assumption is appropriate given its own compensation distributions;
- reasonable methods of imputing or correcting missing values; and
- reasonable methods of addressing extreme observations, such as outliers.

Compliance Issues and Potential Liability

In light of the use of estimates, assumptions, adjustments, and statistical sampling permitted by the rule, the Commission states in its interpretive release that it recognizes that pay ratio disclosures may involve a degree of imprecision. This has led some commenters to express concerns about compliance uncertainty and potential liability. Under the interpretive guidance, if a company uses reasonable estimates, assumptions or methodologies, the pay ratio and related disclosure that results from such use would not provide the basis for Commission enforcement action unless the disclosure was made or reaffirmed without a reasonable basis or was provided other than in good faith.

Determining Number of Non-U.S. Employees for De Minimis Exemption

The final rule defines the term “employee” to include U.S. employees and employees located in a jurisdiction outside the United States (“non-U.S. employees”). In the final rule release, the SEC acknowledged that the inclusion of non-U.S. employees would raise compliance costs for multinational companies and, to partially address such concerns, the rule, subject to certain limitations, permits companies to exempt non-U.S. employees where these employees account for 5% or less of the registrant’s total U.S. and non-U.S. employees. The Commission clarified in the new interpretative release that a company may use appropriate existing internal records, such as tax or payroll records, in determining whether the 5% *de minimis* exemption is available.

Median Employee

Use of Existing Internal Records to Identify the Median Employee

The final rule permits a company to identify its median employee using a consistently applied compensation measure (CACM), such as information derived from the company’s tax or payroll records. The Commission clarified in the new interpretive release that a company may use internal records that reasonably reflect annual compensation to identify the median employee, even if those records do not include every element of compensation, such as equity awards widely distributed to employees.

As a result of the new interpretive release, the Staff revised CDI 128C.01 by: (i) deleting a discussion that previously indicated that total cash compensation may not be an adequate CACM for a company that distributed annual equity awards widely among its employees and that withheld Social Security taxes would likely not be an appropriate CACM unless all employees earned less than the Social Security wage base, and (ii) adding a direct reference to the Commission interpretive release indicating that a company may use internal records even if those records do not include every element of compensation.

Anomalous Compensation Characteristics and Substituting a new Median Employee

The Commission recognized in the new interpretive release that, when calculating total compensation in accordance with the rule for a median employee identified using a CACM based on internal records, the company might determine that there are anomalous characteristics of the identified median employee's compensation that have a significantly higher or lower impact on the pay ratio. The Commission noted in such a circumstance, instead of concluding that the consistently applied compensation measure the company used was unsuitable to identify its median employee, the company may substitute another employee with substantially similar compensation to the original identified median employee based on the compensation measure it used to select the median employee.

Independent Contractors

The Commission's new interpretive guidance clarifies that a company may apply a widely recognized test under another area of law that the company otherwise uses to determine whether its workers are employees. This might include determinations already made for employment law or tax purposes. The Commission suggested that such a test might, for example, be drawn from guidance published by the Internal Revenue Service with respect to independent contractors.

As a result of the new interpretive release, the Staff removed old CDI 128C.05, which previously discussed that in determining when a worker is an employee of a company under the pay ratio rule, a company must consider the composition of its workforce and its overall employment and compensation practices and that a company 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.

Additional Resources for Companies

Dorsey's Summary of Final Pay Ratio Rule Requirements by Whitney Holmes and Jason Brenkert: <https://www.dorsey.com/newsresources/publications/client-alerts/2015/08/sec-issues-final-rule-for-pay-ratio-disclosure>

Dorsey's Pay Ratio Rules Seminar with Jason Brenkert, Whitney Holmes, Gary Tygesson and Cam Hoang:

<https://www.dorsey.com/newsresources/events/videos/2015/08/seminar-playback-sec-pay-ratio-disclosure-rules>

SEC Adopting Release: <https://www.sec.gov/rules/final/2015/33-9877.pdf>