Client Alert | Public Company Advisory

The SEC's New Guidance Provides Additional Flexibility for Compliance With CEO Pay Ratio Disclosure

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On September 21, 2017, the Securities and Exchange Commission ("SEC") issued an interpretive release and the staff of the Division of Corporation Finance (the "Staff") published separate guidance and revised Compliance and Disclosure Interpretations ("C&DIs") to assist companies in preparing the pay ratio disclosure required by the Dodd-Frank Wall Street Reform and Consumer Protection Act (the "Dodd-Frank Act"). Overall, the new interpretive guidance provides companies with additional flexibility in complying with the requirements, as well as reassurance that the SEC will not pursue enforcement action related to such disclosure as long as a company acts in good faith and has a reasonable basis for its disclosure.

Specifically, the new interpretive guidance clarifies, among other things:

- the significant flexibility companies have in determining appropriate methodologies for identifying the median employee and calculating such employee's annual total compensation;
- that use of reasonable estimates, assumptions, methodologies and statistical sampling will not provide a basis for SEC enforcement unless the disclosure was made without a reasonable basis or not in good faith;
- that a company may use appropriate existing internal records, such as tax and payroll records, in determining the median employee and whether to include or exclude non-US employees; and
- that the determination of whether an independent contractor is to be treated as an employee for purposes of these disclosure requirements can be based upon widely recognized employment tests such as those used for tax or employment law purposes.

This Client Alert summarizes the material features of the new interpretive guidance, and outlines certain practical considerations for companies in complying with the disclosure requirements.

Background

In 2015, the SEC adopted final rules (the "Rules") implementing the pay ratio provision of the Dodd-Frank Act by amending Item 402 of Regulation S-K to require each company to disclose:

- the median of the annual total compensation of all of the company's employees, excluding the CEO or equivalent position;

- the annual total compensation of the CEO or equivalent position; and
- the ratio of these two amounts.

Companies must provide the new pay ratio disclosure in any registration statement, proxy and information statement and annual report that are required to include executive compensation information pursuant to Item 402 of Regulation S-K. This disclosure must be provided for a company's first full fiscal year commencing on or after January 1, 2017, meaning that for a company with a fiscal year ending on December 31, the pay ratio disclosure will be required as part of its executive compensation disclosure in proxy statements or Form 10-Ks filed in 2018.[1] Foreign private issuers, registered investment companies, emerging growth companies and smaller reporting companies are exempt from the pay ratio disclosure requirements.

New Interpretive Guidance

The SEC's new interpretive guidance on the Rules includes (i) an interpretive SEC release,[2] (ii) separate guidance on the calculation of pay ratio disclosure, including guidance on the use of statistical sampling to identify the median employee, published by the Staff[3] and (iii) two new C&DIs and a withdrawal of one C&DI.[4]

Reasonable Estimates, Assumptions and Methodologies

The new interpretive guidance confirms that the Rules were designed to provide companies with the flexibility to use reasonable estimates to identify the median employee, including the use of statistical sampling and other reasonable methods. Companies are required to disclose the methodology used to identify the median employee, as well as any material assumptions and estimates used to determine elements of the median employee's total compensation. However, the SEC did not specify the "other reasonable methods" or prescribe the specific sampling methodology, thereby allowing each company to use the method, or a combination of methods, that best suits the company's own circumstances. Furthermore, companies are not required to provide any technical analyses or disclose the formulas used to arrive at such figures.

In order to provide further guidance on how to use statistical sampling and other reasonable methods, the Staff outlined a series of examples of reasonable methodologies companies can use to determine the population of employees from which the median employee is identified. These include common statistical techniques such as:

- making one or more distributional assumptions;
- relying on reasonable methods of imputing or correcting missing values; or
- using reasonable methods of addressing outliers.

The Staff also provided examples of acceptable sampling methods to determine median employee compensation including:

- simple random sampling of all employees;
- stratified sampling (sampling within categories of employees based on role, location, etc.);
- cluster sampling (sampling within appropriate subsets of employee categories); and
- systemic sampling (sampling at fixed intervals based on appropriate employee groupings).

The Staff offered a non-exhaustive list of situations when the use of reasonable estimates may be most appropriate, including:

- analyzing the company's workforce composition;
- assessing the statistical distribution of compensation of the company's employees;

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[1] For a summary of the Rules, please see our prior alert, available here.

[2] The full text of the SEC's interpretive release can be found here.

[3] The full text of the guidance issued by the Staff of the Division of Corporation Finance can be found here.

[4] The full text of the C&DIs can be found here.

- calculating a consistently applied compensation measure ("CACM") and median employee's annual total compensation or its elements;
- evaluating the likelihood of year-over-year changes in employee compensation;
- identifying the median employee or multiple employees around the middle of the compensation spectrum; and
- using the mid-point range to estimate compensation.

The new interpretive guidance confirms that in determining the employee population from which the median employee is identified, as well as for determining the elements of the median employee's annual total compensation, companies are permitted to use a combination of statistical sampling and other reasonable methods.

Finally, the Staff provided a series of hypothetical examples illustrating the application of the Rules to various specific situations.

Use of Internal Records

Under the Rules, a company must identify the median employee using annual total compensation, or another CACM. The new interpretive guidance makes clear that companies may use existing internal records, such as tax and/or payroll records, to determine the median employee and the annual total compensation of their employees.

Non-US Employees

Under the Rules, non-US employees may be excluded from the determination of a company's median employee if non-US employees comprise five percent or less of the company's total US and non-US workforce. The SEC's new interpretive guidance clarifies that companies may rely on existing internal records to determine whether the five percent *de minimis* exemption is available.

Median Employees

The Rules permit companies to identify the median employee using a CACM. The SEC acknowledges that internal records that reasonably reflect annual compensation may be used to identify the median employee, even if such records do not include every element of compensation, such as equity awards widely distributed to employees. Notably, the SEC withdrew its previous guidance that cash compensation could not serve as a CACM if annual equity awards represent a widely distributed element of compensation. This clarification should be a welcome change for many companies and appears to represent a shift in the SEC's initial position on this point. Further, if the company determines that the identified median employee's compensation contains anomalous characteristics that have an impact on the pay ratio, instead of concluding that the CACM it relied on was unsuitable for this analysis, it may substitute another employee with substantially similar compensation to the originally identified median employee based on the compensation measure it used to select the median employee. This point was reiterated in the revised C&DI Question No. 128C.01, which now provides that "any measure that reasonably reflects the annual compensation of employees" can be used as a CACM.

Independent Contractors

The Rules provide that an "employee" is "an individual employed by the registrant or any of its consolidated subsidiaries"[5] and the employees considered in a company's calculations must include any full-time, part-time, seasonal or temporary worker employed by the company or any of its consolidated subsidiaries in both the United States and abroad, subject to certain exemptions. Under the Rules, independent contractors may be excluded from the definition of "employee" if: (i) the independent contractor is employed by a third party; (ii) the independent contractor's compensation is determined by a third party; and (iii) the third party is unaffiliated with the company. The SEC's new interpretive guidance makes clear that this provision "was not intended to serve as an exclusive basis for determining whether a worker is an employee of the registrant."[6] This is a practical clarification reflective of the employment arrangements of many companies today, where individuals

5 17 CFR 402(u)(3).

6 SEC's interpretive release.

are paid by third parties but would otherwise be considered employees for all other purposes. Many companies currently make determinations as to which workers are "employees" in other legal and regulatory contexts, such as for employment law or tax purposes, and the SEC's new interpretive guidance confirms 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 for purposes of the Rules. The SEC also withdrew its previously released C&DI Question No. 128C.05, which addressed the classification of a worker as an independent contractor vs. an employee, but did not contain the flexibility to use other widely recognized tests to determine if an individual is an employee for purposes of the Rules.

Enforcement Action

To alleviate companies' concerns about the potential liability associated with the pay ratio disclosures arrived at using estimates, assumptions, adjustments and statistical sampling, the SEC's newly issued interpretive release recognizes that calculating pay ratio disclosures may involve a degree of imprecision. The release states that so long as 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 SEC enforcement action unless the disclosure was made or reaffirmed without a reasonable basis or was provided other than in good faith. C&DI Question No. 128C.06 further provides that companies may identify the pay ratio as an "estimate" in their disclosure.

Practical Considerations

Given that the Final Rules were released in 2015, most companies have already started the process of identifying the median employee and calculating annual total compensation. However, the SEC's new interpretive guidance should help reduce costs and streamline compliance efforts in preparing for the upcoming annual reporting season.

Reasonable Basis for Disclosure

Importantly, the new interpretive guidance also alleviates some concern that an enforcement action might arise as a result of the pay ratio disclosure, and confirms that companies should not be concerned about a heightened risk of liability unless the disclosure was made or reaffirmed without a reasonable basis or was provided other than in good faith. However, while the new interpretive guidance signals a certain degree of flexibility, companies should remain mindful that the SEC may still question the reasonableness of the estimates or methodologies or the basis for the company's disclosures.

Flexibility to Streamline and Simplify Determinations

The SEC's clarification that companies may use existing internal records in certain circumstances should provide significant cost savings and reduce administrative burdens for companies, as existing payroll and/or tax records (such as W-2s) may provide all the necessary information.

A company's ability to rely on a combination of reasonable estimates, assumptions and methodologies is likely to aid in streamlining the compliance efforts. In determining the most appropriate and cost-effective methodology, under the new interpretive guidance, companies now have sufficient flexibility to rely on different types of methodologies for different elements of pay ratio disclosures. For example, companies may determine that it is appropriate to rely on statistical sampling to identify a median employee and then use estimates in determining total annual compensation or any element of such compensation.

A company's ability to rely on other widely recognized tests to determine whether a worker should be considered an "employee" should make the initial "employee" determinations much simpler, as most companies are already using such tests to classify employees for tax or employment law purposes. Coupled with the guidance on the use of statistical sampling and other reasonable methods, companies should have a much clearer idea of how to determine their employee population, identify the median employee and calculate the required pay ratio.

Prepare for Public Scrutiny

Although the new interpretive guidance clarifies a number of points to simplify compliance, it is important to note that the core rule remains in place and companies should prepare for the potential impact of the public

dissemination of their pay ratio disclosure. Specifically, companies may have to address employee relations issues and may be subject to broader public and media scrutiny and critiques, both of the pay ratio number itself and possibly the methodology used as well. Companies should carefully consider the methodologies they employ, as well as how this information will be disclosed in their proxy statement. They should be prepared to address questions and critiques, and should consider proactively communicating with shareholders or other stakeholders to address their concerns and mitigate perception risks.

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