

Practice Update

SEC Issues Guidance on Pay Ratio Disclosure

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On September 21, 2017, the U.S. Securities & Exchange Commission (the Commission) issued guidance assisting registrants in their efforts to comply with the pay ratio disclosure mandated by the Dodd-Frank Wall Street Reform and Consumer Protection Act (the Dodd-Frank Act).

The Commission's guidance consists of the following three parts:

- *Commission's interpretative guidance* – The Commission's guidance provides (1) flexibility in identifying the median employee and calculating such employee's annual total compensation (including the use of reasonable estimates, assumptions and methodologies and statistical sampling), (2) that appropriate existing internal records, including tax and payroll records, may be used to determine the identification of the median employee and in determining whether to exempt non-U.S. employees under the 5% *de minimis* exemption and (3) that widely recognized tests which the registrant uses in other legal and regulatory contexts may be used to determine whether an individual is an "employee."
- *Staff guidance from the Division of Corporate Finance* – The staff's guidance clarifies that a broad range of statistical sampling methods and

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other reasonable methods may be used and reasonably combined to determine the employees from which the median employee is identified and provides detailed hypothetical examples illustrating how reasonable estimates, statistical samples and other reasonable estimates may be used.

- *Revised Compliance and Disclosure Interpretations (C&DIs)* – The Commission amended a number of prior C&DIs published on October 18, 2016, including withdrawing prior CD&I Question 128C.05 relating to independent contractors.

We expect that the Commission's guidance, which gives registrants flexibility in the manner in which they identify their median employee and calculate such employee's annual total compensation, will come as a relief to registrants. The Commission's guidance also serves as a reminder for calendar-year companies to continue to prepare for compliance with the pay ratio disclosure requirements during the 2018 proxy season.

Background

On August 5, 2015, the Commission adopted final rules mandating pay ratio disclosures pursuant to Section 953(b)(1) of the Dodd-Frank Act. The rules added Item 402(u) to Regulation S-K, pursuant to which registrants will be required to disclose annually the median of the annual total compensation of all of their employees excluding the principal executive officer (PEO), the annual total compensation of the PEO, and the ratio of the median of the annual total compensation of all of their employees excluding the PEO to the annual total compensation of the PEO. The pay ratio may be disclosed as a numerical ratio in which the annual total compensation of the median employee is equal to one or, alternatively, as a statement of the multiple that the PEO's annual total compensation bears to

the annual total compensation of the median employee.

These pay ratio disclosures are required in any annual report, proxy statement, information statement or registration statement in which executive compensation disclosure is required for the first fiscal year beginning on or after January 1, 2017. Emerging growth companies, foreign private issuers, smaller reporting companies, Multijurisdictional Disclosure System filers and investment companies are exempt from the pay ratio disclosure rules.

The pay ratio disclosures are treated as “filed” rather than “furnished” for purposes of the Securities Act of 1933, as amended, and the Securities Exchange Act of 1934, as amended, and are subject to potential liabilities under these statutes.

Our client alert providing information about the final rules can be found [here](#).

Highlights of the Commission’s Guidance on Pay Ratio Disclosure

A registrant may use widely recognized tests to determine which of its workers are “employees.”

Item 402(u) of Regulation S-K defines “employee” or “employee of the registrant” as “an individual employed by the registrant or any of its consolidated subsidiaries, whether as a full-time, part-time, seasonal, or temporary worker, as of a date chosen by the registrant within the last three months of the registrant’s last completed fiscal year.” 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 are excluded from such definition. The Commission’s interpretive guidance clarifies that a registrant may use widely recognized tests to

determine who is an “employee.” Such tests include those that a registrant uses in other legal and regulatory contexts, such as for employment law or tax purposes. As a result, the Commission withdrew a C&DI related to the previous test for determining whether a worker qualified as an independent contractor.

A registrant has significant flexibility in determining the appropriate methodologies to identify the median employee and in calculating such employee’s annual total compensation.

Instruction 4(2) to Item 402(u) of Regulation S-K provides that “[i]n determining the employees from which the median employee is identified, a registrant may use its employee population or statistical sampling and/or other reasonable methods.” Staff guidance clarifies that statistical sampling, other reasonable methods or a combination of the two may be used.

A. Statistical sampling and other reasonable methods

Statistical sampling methods that may be used include, but are not limited to simple random sampling (drawing at random a certain number or proportion of employees), stratified sampling (dividing employees into strata based on certain criteria like geographic location, business unit, functional role, type of employee and collective bargaining agreement, and sampling within each strata), cluster sampling (dividing the employee population into clusters using selected criteria, drawing a subset of clusters and sampling observations within appropriately selected clusters) and systemic sampling (sample is drawn with a random starting point and a fixed sampling interval). Other reasonable methods which may be used include, but are not limited to making one or more distributional assumptions (if the registrant determines that the use of such assumption is appropriate), reasonably imputing or correcting missing values and reasonably addressing extreme

observations (e.g. outliers). Registrants have flexibility in the use and combination of statistical sampling methods and other reasonable methods as long as such use and/or combination is reasonable.

B. Reasonable estimates

Instruction 4(1) to Item 402(u) of Regulation S-K provides that registrants may also use “reasonable estimates both in the methodology used to identify the median employee and in calculating the annual total compensation or any elements of total compensation for employees other than the PEO.” Staff guidance clarifies that such reasonable estimates, which may be used under the appropriate facts and circumstances, include but are not limited to analyzing the composition of the registrant’s workforce, characterizing the statistical distribution of compensation of the registrant’s employees and its parameters, calculating a consistent measure of compensation and annual total compensation or elements of the annual total compensation of the median employee, 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.

C. Hypothetical examples

Hypothetical examples illustrating the use of reasonable estimates, statistical sampling and other reasonable methods are provided under Question 5 in the Staff’s Guidance. Specifically, the Staff provided three examples of companies with employees both in the U.S. and outside the U.S. with different factors and considerations regarding their business units, geographic units, workforce composition and payroll systems. The examples provided therein are not meant to suggest that registrants follow any particular approach. Application of the principles therein should be tailored to a specific registrant’s facts and circumstances.

D. Enforcement by the Commission

The Commission clarified that in its view, the pay ratio and related disclosure that results from the use of reasonable estimates, assumptions and methodologies will not provide a basis for enforcement action by the Commission, unless such disclosure was made or reaffirmed without a reasonable basis or was not provided in good faith. In addition, the Commission clarified that it will not object if a registrant describes the pay ratio as a reasonable estimate calculated in a manner consistent with Item 402(u) of Regulation S-K.

A registrant may change the methodologies it uses to identify the median employee and in calculating such employee's annual total compensation.

If a registrant changes its material assumptions, adjustments or estimates and the effects are significant, the registrant must briefly describe the change and the reasons for the change.

A registrant may use its existing internal records which reasonably reflect annual compensation to identify its median employee

Instruction 4(3) to Item 402(u) of Regulation S-K indicates that registrants may identify the median employee using annual total compensation or another consistently applied compensation measure (CACM), such as information derived from the registrant's tax and/or payroll records. Any measure that reasonably reflects the annual compensation of employees could serve as a CACM. The Commission clarified that the appropriateness of any measure will depend on the registrant's particular facts and circumstances and that the registrant 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.

In addition, the Commission clarified that such internal records may be used to determine whether the 5% *de minimis* exemption¹ is available pursuant to Item 402(u)(4) of Regulation S-K.

A registrant may substitute another employee with substantially similar compensation to the original identified median employee if it determines that there are anomalous characteristics of the original identified median employee's compensation.

Item 402(c)(2)(x) of Regulation S-K sets forth how total compensation is calculated for the identified median employee. If a registrant determines that there are anomalous characteristics of such identified median employee's compensation that have a significant higher or lower impact on the pay ratio, the registrant may substitute another employee with substantially similar compensation to the original identified median employee based upon the compensation measure it used to select the median employee.

¹ In cases where non-U.S. employees account for 5% or less of a registrant's total U.S. and non-U.S. employees, the 5% *de minimis* exemption permits a registrant to exempt its non-U.S. employees from being included in the population of employees from which the median employee is identified, subject to certain limitations.

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