

Client Alert

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SEC Issues Guidance on CEO Pay Ratio Rule

On September 21, 2017, the Securities and Exchange Commission (SEC) and the staff of the SEC's Division of Corporation Finance issued [interpretive guidance](#), [staff guidance](#) and an updated [Regulation S-K Compliance & Disclosure Interpretation](#) (C&DI) to assist public companies with complying with the "pay ratio" rule and to address compliance concerns with respect to the rule's flexible framework. According to the [SEC press release](#), "[the] guidance on pay ratio . . . encourages companies to use the flexibility incorporated in our prior rulemaking to reduce costs of compliance." The interpretive guidance also reiterates that in adopting the final rule, the Commission "sought to provide flexibility in a manner that would 'reduce costs and burdens for registrants while preserving what we perceive to be the purpose and intended benefits' of the statutorily mandated disclosure."

Interpretive Guidance

In 2015, the SEC adopted a rule implementing the "pay ratio" disclosure requirement mandated by Section 953(b) of the Dodd-Frank Act. As we discussed in a previous [alert](#), the final rule requires registrants to disclose the ratio of the annual total compensation of the company's CEO to the median annual total compensation of all of the company's employees.

The interpretive guidance addresses three main topics: (i) the use of reasonable estimates, assumptions and methodologies, and statistical sampling to identify the median employee and to calculate the median employee's annual total compensation (ii) the use of internal records, such as tax and payroll records, to identify the median employee; and (iii) the use of widely recognized tests to determine whether workers are "employees" under the rule.

Use of Reasonable Estimates. Acknowledging companies' concerns about "compliance uncertainty and potential liability" resulting from the "degree of imprecision" involved in using estimates, assumptions, adjustments and statistical sampling for pay ratio disclosures, the interpretive guidance reiterates the "significant flexibility" provided to companies in the final rule in determining appropriate methodologies to identify the median employee and calculating the median employee's annual total compensation. Indeed, the SEC opined that "[i]n our view, if a registrant 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."

The guidance also clarifies three points. First, the guidance states that the rule allows 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. Second, the guidance provides that the rule permits companies to use reasonable estimates in calculating the annual total compensation or any elements of annual total compensation for employees. Third, the guidance states that a company may change its methodology or material assumptions, adjustments or estimates so long as it briefly describes the change and the reasons for the change if the effects are significant.

Use of Internal Records. The interpretive guidance clarifies that companies may use appropriate existing internal records, such as tax or payroll records, that reasonably reflect annual compensation to

identify the median employee, even if the internal records do not include every element of compensation, such as equity awards widely distributed to employees. The guidance also notes that if the use of a consistently applied compensation measure based on internal records identifies a median employee with total compensation that is not likely representative of the median due to certain anomalous characteristics of the employee's compensation, the company is permitted to substitute another employee with substantially similar compensation to the original identified median employee based on the compensation measure it used to identify the median employee. The company, however, must disclose the substitution as part of its brief description of the methodology used to identify the median employee.

With respect to non-US employees, the final rule also permits companies to exempt non-US employees from its employee pool where these employees account for 5 percent or less of the company's total US and non-US employees, with certain limitations. The interpretive guidance clarifies that a company may use appropriate existing internal records in determinations about the inclusion of non-US employees (i.e., whether the 5 percent de minimis exemption is available).

Use of Widely Recognized Tests to Determine "Employees." The final rule excludes from the definition of "employee" independent contractors and leased workers. Recognizing that "registrants already make determinations as to whether a worker is an employee or independent contractor in other legal and regulatory contexts, such as for employment law and tax purposes," the interpretive guidance provides that the SEC "believe[s] it would be consistent with Item 402(u) [of Regulation S-K] for a registrant to apply a widely recognized test under another area of law that the registrant uses to determine whether its workers are employees." Consequently, a company may, for example, use the Internal Revenue Service guidance with respect to independent contractors in determining whether workers are "employees." This guidance is a significant change that reverses an earlier staff interpretation that provided for a much more restrictive test.

Staff Guidance

The staff of the Division of Corporation Finance also issued guidance on the pay ratio rule and hypothetical examples of the use of statistical sampling methodologies and other reasonable methods. According to the [SEC press release](#), Bill Hinman, Director of the Division of Corporation Finance, stated that "[t]his additional staff guidance, which includes examples illustrating how reasonable estimates and statistical methodologies may be used, is intended to assist companies with their compliance efforts and reduce the costs associated with preparing disclosures."

In particular, the staff guidance:

- clarifies that a company is permitted to use statistical sampling, other reasonable methods or a combination of statistical sampling and other reasonable methods;
- provides a nonexhaustive list of examples of the sampling methods that can be used, including simple random sampling, stratified sampling, cluster sampling and systematic sampling;
- outlines a nonexhaustive list of examples of situations where companies may use reasonable estimates, including analyzing the composition of the company's workforce, calculating a consistent measure of compensation and annual total compensation or elements of the annual total compensation of the median employee, identifying the median employee and evaluating the likelihood of significant changes in employee compensation from year to year;
- provides a nonexhaustive list of examples of other reasonable methodologies a company may use, including reasonable methods of imputing or correcting missing values and reasonable methods of addressing extreme observations, such as outliers; and

- describes hypothetical examples of the use of reasonable estimates, statistical sampling and other reasonable methods.

Regulation S-K C&DI

The staff of the Division of Corporation Finance also updated the [Regulation S-K C&DI](#) addressing pay ratio disclosure to reflect the guidance issued by the Commission and the staff. Specifically, the updated C&DI:

- revised Question 128C.01 to add a reference to the new interpretive guidance clarifying that “a 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”;
- withdrew Question 128C.05, which addressed the staff’s interpretations regarding independent contractors and employees; and
- added Question 128C.06 to address whether the staff would object to a registrant describing a pay ratio as an “estimate.”

Key Takeaways

Despite early optimism that the SEC might delay effectiveness of pay ratio reporting, this latest guidance makes it clear that the rule will take effect on schedule. Accordingly, most registrants will be required to begin making pay ratio disclosures in 2018. Still, the new guidance affirms that the SEC as an agency appreciates the difficulty and burden in making some of the mathematical calculations to produce the required disclosure, and the additional flexibility afforded by the guidance comes as a welcome relief.

Reporting companies should take comfort in the SEC’s effort to encourage them to use this flexibility to alleviate some of the compliance and liability concerns that accompany the disclosure. Perhaps most notably, the guidance indicates that the SEC will seek enforcement action against a company for its pay ratio disclosures only when the disclosure was made or reaffirmed without a reasonable basis or was not otherwise provided in good faith. Public companies that have not begun preparing to make the disclosure should begin taking steps to do so without further delay.

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