

SEC Issues Additional CEO Pay Ratio Disclosure Guidance, Affording Companies More Flexibility to Reduce Compliance Costs

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On September 21, 2017, the Securities and Exchange Commission (the “SEC”) issued new guidance on compliance with pay ratio disclosure requirements, including an SEC release (“Interpretative Release”), commentary from the SEC staff in question and answer format (“Q&A”) and updated Compliance and Disclosure Interpretations (“C&DIs”). The new guidance provides explanations and illustrations of how reasonable estimates, statistical sampling and internal records may be used and clarifies that the SEC interprets the pay ratio rule to offer broad flexibility in the identification of the median employee, which should ease the burden on registrants as they prepare to comply with the pay ratio rule.

Although it had been speculated that the pay ratio rule may be delayed or repealed following the election of the new administration, with the release of this guidance, registrants should be prepared to include pay ratio disclosures beginning with their 2018 filings.

The new guidance may be accessed at the following links: [Interpretative Release](#), [Q&A](#) and [C&DIs](#).

Background

On August 5, 2015, the SEC adopted a final rule concerning principal executive officer (“PEO”) pay ratio disclosures as mandated by Section 953(b) of the Dodd-Frank Wall Street Reform and Consumer Protection Act. The final rule added a new paragraph (u) to Item 402 of Regulation S-K, which requires registrants to disclose:

- The median of the annual total compensation of all employees of the registrant (excluding the PEO)
- The annual total compensation of the registrant’s PEO
- The ratio between these two amounts

Most registrants must comply with the pay ratio disclosure rule for their first fiscal year beginning on or after January 1, 2017.¹ Consequently, most calendar year-end filers must begin making this disclosure in their 2018 proxy statement.

For additional information regarding the pay ratio disclosure rule, see our Alerts “[SEC Adopts Final Rule for CEO Pay-Ratio Disclosures under Dodd-Frank](#)” and “[SEC Issues Additional Guidance on CEO Pay-Ratio Disclosure Rule under Dodd-Frank](#).”

New Guidance

Use of Reasonable Estimates, Assumptions, Methodologies and Statistical Sampling

The Interpretive Release confirms that for purposes of identifying the median employee and calculating the median employee's annual total compensation, the pay ratio rule permits the broad reliance upon the registrant's reasonable beliefs, estimates, assumptions and methodologies and statistical sampling. The Interpretive Release acknowledges that this amount of latitude may lead to a "degree of imprecision" in the data produced in the disclosures. The Interpretive Release states that if a registrant uses reasonable estimates, assumptions or methodologies, the pay ratio and related disclosure that result from such use would not provide the basis for an SEC enforcement action unless the disclosure was made or reaffirmed without a reasonable basis or was provided other than in good faith.

Use of Internal Records

Additionally, the Interpretive Release provides direction concerning the use of existing internal records for purposes of determining the median of the annual total compensation of the registrant's employees. Internal records, such as tax or payroll records, may be used to identify the registrant's median employee. Even if such records do not include every element of compensation, such as equity awards widely distributed to employees, they may be used so long as they reasonably reflect annual compensation. (Previous guidance issued by the staff, which was updated as a part of the new guidance, had stated that existing internal records could not be used if they did not reflect equity awards widely distributed to employees.) If the use of a consistently applied compensation measure based on internal records yields a median employee with anomalous characteristics that significantly impact the pay ratio, instead of concluding that the consistently applied compensation measure is unsuitable, the registrant may substitute an employee without such anomalous characteristics whose compensation is otherwise substantially similar to the median employee. Internal records may also be used to determine whether non-U.S. employees account for less than five percent of the total number of the registrant's employees.²

Independent Contractors

The pay ratio rule excludes from the definition of "employee" 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 Interpretive Release clarifies that this exclusion was not intended to be the exclusive means of determining whether a worker is an employee under the pay ratio rule. Instead, registrants may use widely recognized tests under another area of law, such as for tax or employment law purposes, that they otherwise use to determine whether workers are employees.

SEC Staff Q&A

The staff Q&A provides illustrative examples concerning how registrants may use statistical sampling methodologies and other reasonable methods. Registrants may combine the use of reasonable estimates with the use of statistical sampling or with any other methodology that is reasonable considering the facts and circumstances. Similarly, registrants may use any combination of sampling methods including methods such as simple random sampling, stratified sampling, cluster sampling and systematic sampling.³ The staff also provided a list of example situations in which it may be appropriate for a registrant to use reasonable estimates, including: identifying the median employee, identifying multiple employees around the middle of the compensation spectrum, analyzing the compensation of the registrant's workforce and evaluating the likelihood of significant changes in employee compensation from year to year. The Q&A also

contains detailed hypothetical examples concerning the application of the guidance to companies with employees outside of the U.S. and companies involved in multiple business lines.

Revisions to C&DIs

The SEC also updated its pay ratio C&DIs in light of the new guidance in the Interpretive Release as follows:

- Question 128C.01 was revised to clarify that internal records which reasonably reflect annual compensation may be used to identify the median employee even if the records used do not include every element of compensation.
- Question 128C.05 was withdrawn. This C&DI analyzed when a worker should be considered an employee or independent contractor and was superseded by the Interpretive Release.
- In light of the flexibility for registrants to use reasonable estimates, assumptions, adjustments and statistical sampling, Question 128C.06 was added and states that the SEC staff would not object if registrants describe the pay ratio in required disclosures as a reasonable estimate that was calculated in a manner consistent with Item 402(u) of Regulation S-K.

Conclusion

The new guidance clarifies that the SEC interprets the pay ratio rule to offer broad flexibility in the methods used by registrants to identify the median employee as long as they are reasonable and employed in good faith. This added flexibility should ease the burden on registrants as they prepare for the inclusion of pay ratio disclosures in upcoming filings.

If you have any questions about this topic, please contact a member of our [Capital Markets and Securities Practice Group](#).

To learn more about Haynes Boone's IPO Readiness Program, please [click here](#).

¹ Emerging growth companies, smaller reporting companies and foreign private issuers are exempt from the pay ratio disclosure requirements.

² If less than 5 percent of the registrant's global workforce is a non-U.S. employee, then the non-U.S. employees may be excluded for purposes of the pay ratio calculation.

³ For more information concerning these sampling methods, please see the SEC staff explanations found under question two of the Q&A, available [here](#).