SEC Provides New Guidance on Pay Ratio Disclosure Rule

By David Engvall, Keir Gumbs, Reid Hooper, and Julie Plyler

On September 21, 2017, the Securities and Exchange Commission (SEC), as well as the SEC's Division of Corporation Finance (the Staff), published new interpretive guidance to assist public companies in complying with the SEC's pay ratio disclosure rule. The new guidance addresses many questions that have been raised regarding the rule, including how a company may identify the median employee whose compensation is to be disclosed under the rule, as well as the SEC's enforcement posture with respect to pay ratio disclosures.

Background

In 2015, the SEC adopted a rule that requires that a public company disclose the annual total compensation of its median employee, as well as the ratio of such compensation to the annual total compensation of its principal executive officer (the Pay Ratio Rule).[1] Companies will first be required to provide such disclosures in proxy statements to be filed in 2018, reflecting compensation paid during the fiscal year that began on or after January 1, 2017. For a detailed summary of the requirements of the Pay Ratio Rule, please see our client alert published on August 10, 2015.

While there had been some speculation that the White House or the SEC might delay or suspend implementation of the Pay Ratio Rule, SEC Chairman Jay Clayton made clear on September 26, 2017 that companies will have to comply with the rule as originally planned.[2] As a result, companies that have not already done so should begin the process of preparing for the Pay Ratio Rule.

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The SEC's Interpretive Guidance

The SEC published three types of guidance: an interpretive release from the SEC's Commissioners (Interpretive Release), additional guidance from the Staff (Staff Guidance), and updated Compliance and Disclosure Interpretations (C&DIs) issued by the Staff.

SEC Interpretive Release

Good Faith Estimates, Assumptions, or Methodologies Will Not Provide a Basis for Enforcement Action

The Pay Ratio Rule gives companies significant flexibility in choosing methodologies

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to identify the median employee and calculate the median employee's annual total compensation by permitting companies to use statistical sampling and reasonable estimates to compile the information required to comply with the rule. Notwithstanding this flexibility, many companies and practitioners have expressed concerns regarding the extent to which the SEC or the Staff might second-guess such sampling or estimates. In the *Interpretive Release*, the SEC expressed its informal enforcement posture regarding the use of such techniques, noting that "In 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." Much of the remainder of the Interpretive Release, as well as the Staff Guidance, offers more specific guidance regarding what constitutes "reasonable" estimates, assumptions, and methodologies.

Internal Records

The Pay Ratio Rule permits a company to identify its median employee using a consistently applied compensation measure, such as information reported in internal tax or payroll records. The Interpretive Release addresses two applications of the use of such internal records to make this determination.

Non-U.S. Employees. The Pay Ratio Rule includes a *de minimis* exemption allowing a company to exclude non-U.S. employees where these employees account for 5 percent or less of the company's total number of both U.S. and non-U.S. employees. The Interpretive Release makes clear that a company may use "appropriate existing internal records," which include tax and payroll records, in determining whether the *de minimis* exemption is available.

Median Employee. The Interpretive Release clarifies that a company may rely on existing internal records (such as tax or payroll records) that "reasonably reflect annual compensation" in order to identify its median employee, even if such internal records do not reflect every element of total compensation, such as, for example, equity awards. The SEC also noted that the identified median employee's compensation may include "anomalous characteristics" that may have a significant impact on the reported pay ratio. In this situation, the SEC confirmed that a company may use its internal records to substitute another employee with substantially similar compensation to the originally identified median employee.

Independent Contractors

Item 402(u)(3) of Regulation S-K excludes from the definition of "employee" a worker who is employed, and whose compensation is determined, by an unaffiliated third party but who provides services to the company as an independent contractor or "leased" worker.[3] The SEC acknowledged that this definition of "employee" may not align with the definition used by a company in other legal or regulatory contexts, and that many companies make determinations as to the status of their workers for tax and other reasons.

The Interpretive Release clarifies that the provision noted in Item 402(u) of Regulation S-K expressly excluding one category of workers from the definition of "employee" under the Pay Ratio Rule is not the exclusive means of determining whether a worker is an employee. Accordingly, a company may apply a "widely recognized test"—including, for example, a test derived from Internal Revenue Service guidance—to determine which of its workers are employees for purposes of the Pay Ratio Rule. This guidance represents a more flexible approach on this point than that articulated in a previous C&DI, now withdrawn (as described later).

Staff Guidance

For purposes of determining the universe of employees from which the median employee is identified, the Staff Guidance clarifies that a company is permitted to use statistical sampling, reasonable estimates, or other reasonable methods or a combination of statistical sampling, reasonable estimates, and other reasonable methods. The Staff Guidance notes that the SEC did not specify the "other reasonable methods" that may be appropriate because it wanted to allow companies the flexibility to determine the most suitable method based on their own facts and circumstances.

Sampling Methods

The Staff Guidance includes a non-exhaustive list of sampling methods that could be appropriate, alone or in combination, depending on the company's particular facts and circumstances. These include:

- **A simple random sampling** of a certain number or proportion of employees from the entire employee population;

- **A stratified sampling** based on a division of employees across different locations, business units, type of employee, collective bargaining unit, or functional role, and sampling within each segment;

- **A cluster sampling** based on a division of employees into clusters based on certain criteria, drawing a subset of clusters and sampling observations within appropriately selected clusters; and

- **Systematic sampling** of employees from a random starting point and a fixed sampling interval (*i.e.*, every 20th employee is drawn from a list of employees sorted based on some criterion).

Reasonable Estimates

The Staff Guidance provides a non-exhaustive list of examples of situations in which a company may use reasonable estimates to identify the median employee, and in calculating the annual total compensation or any elements of total compensation for employees other than the principal executive officer, under the appropriate facts and circumstances. These examples include:

- Analyzing the composition of a company's workforce by geographic unit, business unit, or employee type;

- Evaluating the likelihood of significant changes in employee compensation from year to year;

- Identifying multiple employees around the middle of the compensation spectrum; and

- Using the mid-point of a compensation range to estimate compensation.

Other Reasonable Methodologies

The Staff Guidance provides certain examples of other reasonable methodologies, including:

- Making one or more distributional assumptions;

- Reasonable methods of imputing or correcting missing values; and

- Reasonable methods of addressing extreme observations, or outliers.

Finally, the Staff Guidance provides three hypothetical examples intended to illustrate the use of reasonable estimates, statistical sampling, and other reasonable methods, or a combination thereof. These hypothetical examples, which involve companies with both U.S. and non-U.S. employees, are attached as Appendix A.

Updated Compliance & Disclosure Interpretations

Concurrently with the publication of the Pay Ratio Guidance, the Staff also published updates to certain C&DIs regarding the Pay Ratio Rule, which were initially published in 2016. A new C&DI helpfully confirms that the Staff would not object to a company's characterization of its pay ratio figure in a required disclosure as a "reasonable estimate" calculated in accordance with Item 402(u).[4]

The Staff also withdrew a C&DI that had addressed the issue of how a company should determine which workers constitute "employees" for purposes of the Pay Ratio Rule, as that issue is now addressed by the Interpretive Release, as described previously. Finally, the Staff revised a previously issued C&DI addressing the identification of the median employee, in light of the Interpretive Release, to clarify that a company may rely on existing internal records (such as tax or payroll records) that reasonably reflect annual compensation to identify its median employee, even if such internal records do not reflect every element of total compensation.[5]

Appendix A

The Staff Guidance provides the following three hypothetical examples as illustrations of the application of reasonable estimates, statistical sampling, other reasonable methods, or a combination of reasonable approaches:

Company A Has Employees in the U.S. and Outside the U.S. within Three Business Units and 21 Geographic Units, Covered by Multiple Payroll Systems

- One approach would be for the company to perform sampling from each of the three business units. In obtaining samples of compensation data from each of the three business units, the company selects samples from the geographic locations whose employee pay is generally representative of employee pay within the entire business unit.

Company B Has a Global Workforce with Employees Concentrated in the Following Geographic Units: North America, China, Europe, and Latin America

- The company may use a combination of statistical sampling and other methods to identify the median.
- When statistical sampling is used, the sampling method may be chosen so as to be reasonably representative of the employee population, based on the company's knowledge of the workforce distribution across jurisdictions, composition of full-time and part-time employees, distribution of employees among typical occupations, and the company's pay structures for typical occupations.
- Within the North America geographic unit, the company employs mostly management and administrative employees at headquarters and a workforce consisting mostly of sales employees in 25 other cities. The company identifies the most common occupations of employees working at headquarters and draws a stratified random sample of headquarters employees other than those employed by the professional employer organization in those occupations. Almost all employees outside headquarters are sales employees. Based on its understanding of employee pay outside headquarters, the company identifies three cities in which the distribution of employee pay and full-time and part-time employees is reasonably representative of the distribution of pay of employees outside headquarters. In those cities, the company randomly selects stores, from which a random sample of sales employees is drawn.
- For employees in the Europe geographic unit, the company draws a stratified random sample of employees in typical occupations identified based on the company's knowledge of its workforce and pay structure. Employees in the sample include managers, administrative personnel, service employees, and sales staff.
- For the China geographic unit, the company uses a sample of full-time and part-time employees reasonably believed to be around the middle of the pay scale.
- For the Latin America geographic unit, the information is drawn under a distribution assumption.
    - Based on the understanding of pay practices and workforce composition, employee

pay in the Latin America unit is estimated to follow a lognormal distribution.

- For example, the company may use reasonable estimates provided by regional managers to determine distribution parameters. When pay ranges are considered, the mid-point of the pay range is used.

- To identify the median employee, the company combines information from the North America, China, Europe, and Latin America geographic units, obtained as described previously.

Company C Has Employees in the U.S. and Asia

- Based on the company's information about its workforce composition and compensation policies, the company reasonably believes the distribution of employee compensation to be multimodal and approximately characterized as a mixture of lognormal distributions, weighted based on estimated workforce composition. The median may be identified based on the resulting distribution mixture.

- As an example, the company may identify four main cohorts of workers: full-time employees in the U.S.; part-time employees in the U.S.; full-time employees in Asia; and part-time employees in Asia.
  - For the U.S. employees, distribution assumptions are based on data regarding pay levels and hours of a typical full-time and part-time employee at the company.
  - For international workers, distribution parameters are based on reasonable estimates of a typical full-time and part-time employee's pay provided by regional managers.

Notes

1. *Pay Ratio Disclosure*, Rel. No. 33-9877 (Aug. 2015), available at *http://www.sec.gov/rules/final/2015/33-9877.pdf,* last accessed Nov. 12, 2017. The rule is codified in Item 402(u) of Regulation S-K.

2. *See* Testimony on "Oversight of the U.S. Securities and Exchange Commission," SEC Chairman Jay Clayton (Sept. 26, 2017): "To be clear, the SEC is required to implement rulemakings mandated by statute in accordance with applicable law, including the pay ratio disclosure rule adopted pursuant to Section 953(b) of the Dodd-Frank Act. This rule was adopted on August 5, 2015, and will continue to be implemented on schedule." The testimony is available at *https://www.banking.senate.gov/public/_cache/files/929816e6-9372-404f-ba97-c9d9ed453501/ADC20EE6B81BD706BEE66812F71FADDB.clayton-testimony-9-26-17.pdf,* last accessed Nov. 12, 2017.

3. Item 402(u)(3) of Regulation S-K defines an "employee" or "employee of the registrant" as "an individual employed by the registrant or any of its consolidated subsidiaries, whether 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."

4. *See* Compliance and Disclosure Interpretations, Regulation S-K, Question No. 128C.06 (Sept. 21, 2017), available at *https://www.sec.gov/divisions/corpfin/guidance/regs-kinterp.htm#128c.01,* last accessed Nov. 12, 2017.

5. *See* Compliance and Disclosure Interpretations, Regulation S-K, Question No. 128C.01 (Sept. 21, 2017), available at *https://www.sec.gov/divisions/corpfin/guidance/regs-kinterp.htm#128c.01,* last accessed Nov. 12, 2017. The full set of updated C&DIs regarding the Pay Ratio Rule is available at *https://www.sec.gov/divisions/corpfin/guidance/regs-kinterp.htm#128c.01,* last accessed Nov. 12, 2017.