

SEC Issues Interpretative Guidance on Pay Ratio Rules, Reinforcing Flexibility and Providing Relief

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As companies are coming to grips with the reality that the pay ratio rules will not be delayed, the SEC yesterday issued interpretative guidance that went a long way toward reassuring companies that they have sufficient flexibility and can exercise their best judgment in determining the median employee and the resulting pay ratio, thereby reducing compliance costs.

This came in the form of a [brief Commission guidance](#) and separate [Staff interpretations](#). In addition, although no mention was made in the press release touting these SEC actions, the [Staff also updated](#) and in one case withdrew its prior pay ratio guidance in the Division of Corporation Finance compliance and disclosure interpretations (CDIs) from last year (see Section 128C).

We will issue a more detailed client memo shortly. The key elements of the Commission guidance include:

Use of reasonable estimates and statistical sampling. The SEC recognizes that the degree of imprecision necessary when using estimates, assumptions, adjustments and statistical sampling may lead to concerns about compliance uncertainty and potential liability. In the Commission's view, the pay ratio and related disclosure that results from using these reasonable methods "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."

Independent contractors. As we have long argued and reiterated in our comment letter that is cited in the Commission guidance, the pay ratio rule definition of "employee" may capture individuals who companies otherwise decide are independent contractors in other legal and regulatory contexts, such as in compliance with IRS rules. The Commission guidance now makes clear that the pay ratio rules, which exempt workers who are employed by an unaffiliated third party that determines their compensation only describes one category of individuals who are expressly excluded from the definition of employees. It is not the exclusive means. Companies may also "apply a widely recognized test under another area of law" that they "otherwise us[e]" to decide who is, or is not, an employee.

Selecting a different median employee. If companies find that the median employee's compensation contains atypical or unusual elements that have a significantly higher or lower impact on the pay ratio, companies "may substitute another employee with substantially similar compensation to the original identified median employee" based on the compensation measure used to select the first median employee.

Use of internal records for non-U.S. employees. Companies may use appropriate existing internal records, such as tax or payroll records, in determining whether the 5% *de minimis* exemption is available.

Use of internal records for median employees. Companies 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."

The Staff interpretations issued with the Commission guidance clarified that companies may combine the use of reasonable estimates with the use of statistical sampling or other reasonable methodologies, meaning a company may use sampling for one business unit and other methodologies or estimates for another business unit. The Staff also

indicated that companies may use a wide variety, and a combination, of different sampling methods and provide examples of situations where companies may use reasonable estimates or a combination of reasonable estimates.

Updates to last year's CDIs include the withdraw of a Q&A on independent contractors, and references to the Commission guidance in the responses to questions on the appropriateness of the compensation measure used and the ability to describe the pay ratio as an estimate.

If you have any questions regarding the matters covered in this publication, please reach out to any of the lawyers listed below or your usual Davis Polk contact.

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