

Pay Ratio Disclosure Rule: The SEC's Latest Guidance Should Ease Compliance Costs for Companies

September 25, 2017

On September 21, 2017, the SEC issued guidance to assist companies in their efforts to comply with the pay ratio disclosure requirement mandated by the Dodd-Frank Act. Overall, the guidance should come as a relief to many companies. It came in three parts:

- The **Commission's interpretative guidance** that clarifies:
 - A basis for excluding independent contractors, by allowing companies to use a widely recognized test that they otherwise use under other laws and regulations to determine whether their workers are "employees;"
 - The ability to use appropriate existing internal records, such as tax or payroll records, in identifying the median employee and in determinations about the inclusion of non-U.S. employees; and
 - The significant flexibility in methodologies available to identify a company's median employee and in calculating his or her annual compensation.
- **Staff guidance** that includes detailed examples illustrating how reasonable estimates and statistical methodologies may be used; and
- **Updated Compliance and Disclosure Interpretations (C&DIs)**, which, among other things, withdraws the prior C&DI on independent contractors.

The issuance of this guidance underscores the need for calendar-year companies to continue their preparations to comply with the pay ratio rule during the 2018 proxy season.

Background

Section 953(b) of the Dodd-Frank Act directed the SEC to amend Item 402 of Regulation S-K to require each company, with limited exceptions,¹ to disclose:

- the median of the annual total compensation of all employees of the company, except the chief executive officer (or any equivalent position) of the company determined in accordance with Item 402(c) of Regulation S-K;
- the annual total compensation of the chief executive officer (or any equivalent position) of the company; and
- the ratio of these two amounts.

In August 2015, the SEC adopted its **final rule** implementing the Dodd-Frank provision by adding a new Item 402(u). Under the final rule, companies are required to disclose their pay ratio in proxy statements or Form 10-Ks filed starting in 2018.²

¹ Under the final rule, emerging growth companies, smaller reporting companies, foreign private issuers (even those filing on Form 10-K), MJDS filers and registered investment companies are exempt from the pay ratio disclosure requirement.

In February 2017, then-Acting SEC Chairman, Michael S. Piowar issued a request for public comments on the implementation of the pay ratio rule in response to “unanticipated compliance difficulties” encountered by some companies “that may hinder them in meeting the reporting deadline.” In response to Mr. Piowar’s request, the SEC received a number of comment letters³ that addressed, among other things, the rule’s expansion of the definition of “employee” to capture independent contractors and the resulting administrative burdens and complexities.

On September 15, 2017, at a meeting of the American Bar Association, William Hinman, Director of the SEC Division of Corporation Finance, indicated that the implementation of the pay ratio rule would not be delayed. However, he further indicated that the SEC would issue additional guidance to provide flexibility and to reduce the cost of compliance.

Below, we have set forth the SEC’s guidance in Q&A format.

Independent Contractors

Q: May a company apply a widely recognized test under another area of law that it otherwise uses to determine whether its workers are “employees?”

A: Yes.

In what may be perceived as a major shift for the SEC, the SEC stressed that Item 402(u) makes clear that an “employee” is an individual employed by the company. The exception from employee status for workers who are employed, and whose compensation is determined, by an unaffiliated third party was intended only to describe one category of workers who are excluded from the definition of “employee,” but was not intended to serve as an exclusive basis for exemption.

The SEC’s latest guidance clarifies that a company may apply a widely recognized test under another area of law that the company otherwise uses to determine whether its workers are employees. In furtherance of this, the SEC withdrew old C&DI 128C.05, which previously provided that, in determining when a worker is an “employee,” a company “must consider the composition of its workforce and its overall employment and compensation practices” and that a company “should include those workers whose compensation it . . . determines regardless of whether these workers would be considered ‘employees’ for tax or employment law purposes or under other definitions of that term.”

Q: Did the SEC provide any examples as to what such a widely recognized test might be?

A: Yes.

While the SEC did not specifically bless any particular test, it suggested that such a test might, for example, be drawn from guidance published by the Internal Revenue Service with respect to independent contractors. A company may also rely upon another widely recognized test that it already uses to determine whether a worker is an employee or independent contractor in other legal and regulatory contexts, such as for employment law or tax purposes.

Significant Flexibility

Q: What level of flexibility is afforded to companies in determining appropriate methodologies to identify the median employee and in calculating the median employee’s annual compensation?

A: *Significant flexibility.*

(cont.)

² For our client memorandum regarding the final rule, please see [here](#).

³ For our comment letter in response to Mr. Piowar’s request, please see [here](#).

The Commission's interpretative guidance makes clear that companies have "significant" flexibility in this regard. Required disclosure may be based upon a company's reasonable belief; use of reasonable estimates, assumptions and methodologies; and reasonable efforts to prepare its disclosure. Specifically, the pay ratio rule:

- Permits 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);
- Permits companies to use reasonable estimates in calculating the annual total compensation or any elements of annual total compensation for employees; and
- Provides that, after a company's first disclosure, it may change its methodology or its material assumptions, adjustments or estimates, as long as the company briefly describes the change and the reasons for the change if its effects are significant.

Q: May a company described its pay ratio as an "estimate"?

A: Yes.

New C&DI 128C.06 specifically provides that, "due to the use of estimates, assumptions, adjustments, and statistical sampling permitted by the rule, pay ratio disclosures may involve a degree of imprecision. Therefore, the staff would not object if a [company] states in any required disclosure that the pay ratio is a reasonable estimate calculated in a manner consistent with Item 402(u)."

Median Employee

Q: Is the use of existing internal records appropriate in identifying a company's median employee?

A: Yes, in most circumstances.

Instruction 4 to Item 402(u) permits a company to identify its median employee using a consistently applied compensation measure (CACM), such as information derived from the company's tax or payroll records. The SEC has clarified that a company 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 this connection, the SEC revised C&DI 128C.01 by deleting references that previously provided that total cash compensation might not be an adequate CACM for a company that distributed annual equity awards widely among its employees and that withheld Social Security taxes would likely not be an appropriate CACM unless all employees earned less than the Social Security wage base.

Q: Once a median employee is identified, if the company then determines that his or her actual total compensation has anomalous characteristics that have an impact on the pay ratio, can the company replace the median employee with a another median employee?

A: Yes, the company may substitute another employee with substantially similar compensation to the original identified median employee.

In such a circumstance, instead of concluding that the CACM that the company used was unsuitable to identify its median employee, the company may substitute another employee with substantially similar compensation to the original identified median employee based on the CACM it used to select the median employee. This means that if, for example, the original identified median employee earns a higher or lower than typical bonus, the company can select a new median employee, as long as he or she has substantially similar compensation to the original employee based on the CACM it used to select the median employee.

Non-U.S. Employees

Q: Can a company use existing internal records, such as tax or payroll records, in determining whether the 5% *de minimis* exemption is available in connection with its non-U.S. employees?

A: Yes.

The pay ratio rule permits a company to exempt non-U.S. employees where these employees account for 5% or less of its total U.S. and non-U.S. employees, with certain limitations (often referred to as the “*de minimis* exception”). In the guidance, the SEC has clarified that a company may use appropriate existing internal records, such as tax or payroll records, in determining whether the *de minimis* exemption is available.

Use of Reasonable Estimates, Assumptions and Methodologies, and Statistical Sampling

Q: May companies combine the use of reasonable estimates with the use of statistical sampling or other reasonable methodologies? For instance, is a company with multinational operations or multiple business lines permitted to use sampling for some geographic/business units and a combination of other methodologies and reasonable estimates for other geographic/business units?

A: Yes.

The Staff guidance specifically points out that Instruction 4.2 to Item 402(u) provides that “[i]n determining the employees from which the median employee is identified, a [company] may use its employee population or statistical sampling and/or other reasonable methods.” Focusing on the use of the “and/or,” the Staff guidance indicates that a company is permitted to use statistical sampling, other reasonable methods or a combination of statistical sampling and other reasonable methods. Further, the Staff guidance notes that the SEC deliberately did not specify “other reasonable methods” that may be appropriate to allow each company the flexibility to determine the method that best suits its own facts and circumstances.

Q: Are companies permitted to use a combination of sampling methods?

A: Yes.

The Staff guidance points out that Instruction 4 to Item 402(u) does not set forth specific limitations regarding the methods of sampling that are permissible and that, rather, it provides that companies must use reasonable methods and make reasonable estimates. For example, “reasonable estimates of the median for [companies] with multiple business lines or geographical units may be determined using more than one statistical sampling approach. Additionally, all statistical sampling approaches should draw observations from each business or geographical unit with a reasonable assumption on each unit’s compensation distribution and infer the [company’s] overall median based on the observations drawn.”

Q: What are some examples of sampling methods that companies may use?

A: *The Staff guidance provides a non-exhaustive list of sampling methods that could be appropriate to use (alone or in combination), depending on the company’s particular facts and circumstances.*

These sampling methods include:

- simple random sampling (drawing at random a certain number or proportion of employees from the entire employee population);
- stratified sampling (dividing the employee population into segments, e.g., based on location, business unit, type of employee, collective bargaining agreement, or functional role and sampling within each segment);

- cluster sampling (dividing the employee population into clusters based on some criterion, drawing a subset of clusters, and sampling observations within appropriately selected clusters; cluster sampling may be conducted in one stage or multiple stages); and
- systematic sampling (the sample is drawn according to a random starting point and a fixed sampling interval, every n^{th} employee is drawn from a listing of employees sorted on the basis of some criterion).

Q: What are some examples of situations where companies may use reasonable estimates?

A: Per Instruction 4.1 to Item 402(u), reasonable estimates may be used 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 principal executive officer.

The Staff guidance provides a non-exhaustive list of examples of situations where companies may use reasonable estimates under the appropriate facts and circumstances:

- analyzing the composition of the company's workforce (by geographic unit, business unit, employee type);
- characterizing the statistical distribution of compensation of the company's employees and its parameters (e.g., a lognormal, beta, gamma or another distribution, or a mixture of distributions – for example a mixture of two normal or lognormal distributions yielding a bimodal distribution);
- calculating a CACM 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.

Q: May companies use a combination of other reasonable methodologies?

A: Yes.

The Staff guidance notes that Item 402(u) does not specify any required methodology and permits companies flexibility to choose a method or combination of methods based on their facts and circumstances. Any method or combination of methods used would need to be reasonable.

Q: What are some examples of other reasonable methodologies that companies may use?

A: The Staff guidance provides a non-exhaustive list of examples of common statistical techniques and methodologies that companies may consider.

These techniques and methodologies include:

- making one or more distributional assumptions, such as assuming a lognormal or another distribution, provided that the company has determined that the use of the assumption is appropriate given its own compensation distributions;
- reasonable methods of imputing or correcting missing values; and
- reasonable methods of addressing extreme observations, such as outliers.

Q: Does the SEC provide hypothetical examples of the use of reasonable estimates, statistical sampling and other reasonable methods?

A: Yes, the Staff guidance provides of examples of three hypothetical scenarios:

- *A company that has employees in and outside the United States, within three business units and 21 geographic units, covered by multiple payroll systems;*
- *A company that has a global workforce with employees concentrated in the following geographic units: North America, China, Europe and Latin America; and*
- *A company that has employees in the United States and Asia.*

The Staff's examples are intended to illustrate the principles that a company may consider when using reasonable estimates, statistical sampling and other reasonable methods to identify its median employee. The Staff guidance also states that the application of the principles should be tailored to a specific company's facts and circumstances and that, in addition, the use of estimates, statistical sampling and other methods must be reasonable. The Staff guidance notes that some of the techniques referenced in the examples may be more suitable for larger companies with more complex workforces, and also reminds companies that the examples are not meant to suggest that they follow any particular approach and that, in many cases, simpler approaches may be appropriate in determining the pay ratio.

Enforcement

Q: Under what circumstances might the SEC bring an enforcement action with respect to a company's pay ratio disclosure?

A: If the company does not have a reasonable basis for the disclosure or the disclosure was provided other than in good faith.

The SEC acknowledges that, in light of the use of estimates, assumptions, adjustments and statistical sampling permitted by the pay ratio rule, disclosures may involve "a degree of imprecision." In its view, if a company uses reasonable estimates, assumptions or methodologies, then the pay ratio and related disclosure that results from such use would not provide the basis for the SEC to bring an enforcement action, unless the disclosure was made or reaffirmed "without a reasonable basis or was provided other than in good faith."

Implications and Observations

The SEC repeatedly reiterated the significant flexibility afforded by the pay ratio disclosure rule in this most recent guidance from the Commission and the Staff. This latest guidance, such as the clarification related to independent contractors, should alleviate some compliance costs and administrative burdens of companies.

That said, the core rule remains in place and, at this point, there is little chance that it will go away altogether, unless Congress intervenes (which seems highly unlikely in the short term, at least). The benefit of this disclosure to shareholders may be questionable at best and the costs may be high. In addition to the administrative costs of compliance, companies may have to deal with employee relations issues and broader scrutiny and criticism from the public and the media as a result of their disclosure. Aside from the pay ratio number itself, the disclosure of the methodology chosen to determine the median employee and any material assumptions, adjustments or estimates may also be subject to scrutiny and questions.

Given this, companies are advised to carefully think through the methodology they employ to identify the median employee and how they will calculate the pay ratio, how this information will be disclosed in their proxy statement and what communications, if any, they will want to prepare to address the concerns that their shareholders and broader stakeholders may have.

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

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