

## Chaos is a Ladder: SEC Releases New Pay Ratio Guidance

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Yesterday, the Securities and Exchange Commission (SEC) published an [interpretive release](#) and the Division of Corporation Finance issued a [press release](#) and new [Compliance and Disclosure Interpretations \(C&DIs\)](#) related to the CEO pay ratio disclosure that will be required for the upcoming 2018 proxy season. This new guidance should provide valuable assistance and welcome clarification to issuers that are continuing to aggregate employment and compensation data, calculate their CEO pay ratios, and determine how best to present the related disclosures in their 2018 proxy statements. In addition, the release of this guidance seemingly confirms that the SEC is moving ahead full-steam with the effectiveness of the CEO pay ratio rule for the 2018 proxy season. Below is a summary of the important highlights from the additional guidance.

### Enforcement Guidance

The SEC acknowledges in the interpretive release that some imprecision is inherent in the preparation of pay ratio disclosures given that the data-gathering process and performance of the calculations involve several layers of estimation, adjustments, and statistical sampling. Accordingly, so long as issuers use reasonable estimates, assumptions, or methodologies, the pay ratio itself and the corresponding disclosure will 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.

#### Key Takeaway

Based on the newly issued C&DI Q/A 128C.06, issuers should specifically describe their pay ratios as estimates in their disclosures, assuming that such a statement can be made in good faith.

### Employee Determinations

Previously, the SEC guidance on “employee” determinations for purposes of the pay ratio rule under Item 402(u)(3) of Regulation S-K was fairly narrow. Under that item, the only category of individuals that could be excluded from the

definition of “employee” was the subset of workers who are employed, and whose compensation is determined, by an unaffiliated third party. In addition, C&DI Q/A 128C.05 (now withdrawn) required an issuer to include workers whose compensation it determined, regardless of any classification made under tax or employment laws. However, based on this new guidance, an issuer may, in the process of determining who is an “employee” for purposes of the pay ratio rule, apply a widely recognized test under another area of law (e.g., tax or employment laws) that the issuer otherwise uses to determine whether its workers are employees.

### **Key Takeaway**

In order to simplify the process, issuers should consider using a widely recognized test under another area of law to determine who is an employee for purposes of determining their employee populations from which the median employee will be identified (e.g., for a U.S. worker, whether a Form 1099 or Form W-2 is issued).

## **Median Employee Determinations**

Issuers 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. Previously, C&DI Q/A 128C.01 indicated that total cash compensation could be a consistently applied compensation measure (CACM), unless the issuer widely distributed equity awards.

### **Key Takeaway**

Issuers may want to consider updating or reassessing their CACM determinations based on this more flexible guidance.

## **Combining Methods**

The additional guidance clarifies that issuers may use a combination of statistical sampling and other reasonable methods in order to identify the median employee.

### **Key Takeaway**

The previously issued guidance appeared to allow for this approach, but now it is expressly permitted by the SEC.

## **Certain Examples**

A selection of examples from the guidance of potentially appropriate statistical sampling methods and situations where other reasonable methods may be appropriate is summarized below.

### **Examples of Statistical Sampling Methods:**

- 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 strata, e.g., based on location, business unit, type of employee, collective bargaining agreement, or functional role and sampling within each strata)

### **Examples of Other Reasonable Methods:**

- Reasonable methods of imputing or correcting missing values
- Reasonable methods of addressing extreme observations, such as outliers

## Examples of Situations Where Other Reasonable Methods May Be Appropriate:

- Analyzing the composition of the company's workforce (by geographic unit, business unit, and employee type)
- Calculating a consistent measure of compensation and annual total compensation or elements of the annual total compensation of the median employee
- Using the mid-point of a compensation range to estimate compensation

### Key Takeaway

Issuers should evaluate the methods they are using or contemplating using against the methods that the additional guidance indicates are appropriate and determine whether a combination of any of the foregoing will be useful or suitable for them.

We are continuing to monitor developments on this front and will provide updates to the extent additional guidance is issued. For additional background on the CEO pay ratio, our previously published client alert on this topic can be found [here](#).

3 Min Read

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