Expert Q&A: Preparing for Pay Ratio Disclosure

An Expert Q&A with Nyron Persaud of Winston & Strawn LLP on complying with the pay ratio disclosure requirement of the Dodd-Frank Act. This Expert Q&A has been updated to reflect interpretive guidance issued by the SEC on September 21, 2017.

In 2015, the Securities and Exchange Commission (SEC) adopted a rule requiring reporting companies to disclose the median annual total compensation of all company employees other than the chief executive officer (CEO), the CEO's total compensation, and the ratio between these two numbers. The rule is complex and offers companies flexibility in determining and disclosing their pay ratios. We asked Nyron Persaud, partner at Winston & Strawn LLP, to share some insights on complying with the rule.

The CEO pay ratio rule is currently scheduled to go into effect for disclosure in 2018 SEC filings (either their Form 10-K reports or proxy statements). Earlier this year the SEC acknowledged companies' compliance difficulties and said it was considering whether additional guidance or relief may be appropriate. Should companies assume that they will be required to comply with the rule for 2018?

On February 6, 2017, the acting chairman of the SEC invited the public to comment on unexpected challenges experienced in preparing to comply with the CEO pay ratio rule. At the time, many practitioners were hopeful that a delay in implementation of the rule would be forthcoming. However, the SEC has not taken any subsequent action to delay implementation and additional guidance released on September 21, 2017 essentially confirms that the SEC will not be granting a reprieve. Companies should be very proactive about preparing for this additional disclosure if they have not already begun.

A complicated part of complying with the rule is identifying the "median employee." What methodologies can companies use to identify their median employee?

The first step in determining the median employee is selecting a date within the last three months of the applicable fiscal year on which to identify the employee population. As a practical matter, for companies with a calendar year fiscal year, it probably makes sense to start with October 1 as the determination date, especially for 2017, to get a head start on the disclosure in the first year.

In determining its median employee, a company generally must consider all of its employees and those of its consolidated subsidiaries. This includes US and non-US employees as well as part-time, seasonal, or temporary employees. The SEC clarified that companies may apply a widely recognized test under another area of law (such as under guidance issued by the Internal Revenue Service) for purposes of determining whether an individual is an employee. For example, a company may treat a US worker as an employee if he or she receives a Form W-2 from the company. To the extent a company already maintains employee classification records for other legal purposes, using a widely recognized test under another area of law may help the company expedite the process of identifying the median employee.

One caveat with respect to seasonal or temporary employees is that because the median employee must be determined within the last three months of the applicable fiscal year, companies that employ seasonal or temporary employees only in the early part of the year are not required to include those employees if they are not otherwise employed with the company on the determination date. This potentially presents strategic alternatives for companies that are able to exclude seasonal or temporary employees because they are not employed during the last three months of the fiscal year may find that their pay ratios are lower due to the exclusion of these employees. As a practical matter, however, companies in certain industries, such as retail and logistics, which tend to employ seasonal workers during the year-end holiday season, may find the ability to exclude seasonal workers to be of little utility if they also have calendar year fiscal years.
The rule also permits companies to use statistical sampling or other reasonable methods in determining the employee population from which the median employee will be identified. The rule does not prescribe or advocate any particular method and the SEC’s Division of Corporation Finance (the SEC staff) indicated that companies may use a combination of statistical sampling and other reasonable methods. Each company’s methodology will depend on the facts and circumstances surrounding its workforce. On the one hand, a company with global operations and employees in many jurisdictions may decide on random sampling of the employees in each jurisdiction to narrow its employee population. On the other hand, a company with only domestic employees in various pay bands may choose to eliminate employees in the upper and lower pay bands and focus solely on the middle pay bands as its preferred methodology. In the additional guidance issued on September 21, 2017, the SEC staff provided examples of:

- Statistical sampling methods.
- Other reasonable methods.
- Situations where use of reasonable estimates may be appropriate.

Companies should review the additional guidance with the assistance of legal counsel before deciding on a particular methodology or combination of methodologies. Whatever the methodology, companies should ensure that the selected approach is defensible in light of their overall employee population and pay distribution among employees.

With respect to non-US employees, there are several exceptions that may be available. Non-US employees in jurisdictions with stringent data privacy laws may be excluded if the data privacy laws would prevent the company from complying with the rule. The company must make reasonable efforts to comply with the rule, including seeking an exemption or other relief under the applicable data privacy laws. If the company is ultimately unable to comply with the rule, then it must obtain an opinion of counsel to that effect and file the opinion with its proxy statement (or Form 10-K report, as applicable). There are also additional disclosures required if the company relies on this exception, including disclosing:

- The approximate number of employees excluded.
- The applicable data privacy laws and jurisdictions.
- How compliance with the pay ratio rule would violate those laws.
- What efforts were made to seek relief under the laws.

In addition, companies may exclude some or all of their non-US employee population under the de minimis exception. The de minimis exception permits the exclusion of all non-US employees if they account for 5% or less of the company’s total employee population. If non-US employees account for more than 5% of employees, the company may exclude up to 5% of the total employees who are non-US employees. However, if any employees in a particular jurisdiction are excluded, then all employees in that jurisdiction must be excluded. As a practical matter, a company will not be able to use this exception to exclude employees in a jurisdiction if the total number of employees in that jurisdiction exceeds 5% of all non-US employees. The SEC clarified that companies may use internal records such as tax or payroll records to determine whether the de minimis exception is available. Companies relying on the de minimis exception must also disclose the excluded jurisdictions and the approximate number of employees excluded from those jurisdictions.

To the extent that employees are excluded under the data privacy exception, these employees are counted against the 5% total that may be excluded under the de minimis exception. Therefore, a company that excludes 5% or more of its employees under the data privacy exception will not be able to rely on the de minimis exception to exclude an additional 5% of employees.

There is also an exception for employees acquired as part of a merger or acquisition that occurred during the fiscal year. Acquirors may exclude employees of the seller for the fiscal year in which the transaction occurred. The acquiror must identify in its disclosure the business acquired and the number of employees involved.

**How should the company calculate the annual total compensation of the median employee and the CEO? What if the CEO was replaced during the year?**

There is quite a bit of flexibility in the rule regarding calculating total annual compensation. A company may use total annual compensation as calculated in accordance with the rules for the Summary Compensation Table. Alternatively, a company may use any other consistently applied compensation measure (CACM) that reasonably reflects the annual compensation of employees, including:

- Base pay only.
- Total cash compensation: base pay plus cash bonus.
- Total cash compensation plus the value of equity awards.
- Compensation as reported for tax purposes: W-2 wages or the equivalent.

The SEC clarified that companies may use internal records that reasonably reflect annual compensation even if those records do not include every element of compensation. For example, a company that widely distributes equity awards may use internal records that include only cash compensation as its CACM so long as those records reasonably reflect annual compensation.

A company may also use total annual compensation for the prior fiscal year so long as there has not been a change in the employee population or in employee compensation arrangements that would result in a significant change of its pay distribution to its workforce.

With respect to employees who have not been employed for the entire fiscal year, a company may, but is not required to, annualize compensation of full and part-time employees hired during the applicable year. However, a company may not annualize compensation paid to temporary or seasonal employees.

If a company has had more than one person serving as CEO during the applicable fiscal year, the company may either:
Calculate the compensation provided to each such person during the year and combine those figures.

Look to the person serving as CEO on the date it selects to identify the median employee and annualize that person’s compensation.

**Strategically is any particular methodology for calculating either the median employee or annual compensation likely to yield a more desirable result?**

A lot of companies have been trying to reverse engineer the process in order to put forth the most favorable disclosure. Unfortunately, there is no way of knowing which methodology will work best for a particular company. Companies with the resources to run multiple calculations may wish to do so and ultimately use the methodology that yields the most favorable result. What is considered the most favorable result may also vary by company. Some companies may be concerned that a higher ratio due to lower median compensation may inflame the public. Others may be more concerned about the morale of their workforce and employees feeling negatively about their own compensation if it is below the median. These companies may prefer a lower median compensation number and therefore a higher ratio.

With respect to selecting a methodology for calculating annual compensation, however, it is unlikely that any given methodology will lead to a significantly different outcome than any other methodology. Each compensation element tends to correspond in some manner to other compensation elements. For example, an employee’s annual cash bonus opportunity tends to be a function of the employee’s base pay and a company’s use of base pay as its CACM may ultimately result in the selection of a median employee with total compensation that is very similar to the total compensation of the median employee that would have been selected if the company instead used base pay plus annual cash bonus as the CACM.

Some companies voluntarily elected to comply with the rule in 2017. What have you learned from their disclosures?

Not much. These were voluntary disclosures and therefore they were not required to comply with the final rule. For the most part, the disclosures did not appear to be fully compliant with the rule. For example, certain companies did not indicate the date on which the employee population was determined, and others did not disclose the methodology used to measure compensation or identify the median employee. However, it is apparent from the voluntary disclosures that most of the companies elected to calculate compensation in accordance with the Summary Compensation Table rules.

**How should companies prepare for reaction to their disclosure, both from the media and from their own employees?**

Companies should anticipate and prepare for potentially negative reaction from various stakeholders, including, among others, employees, competitors, media, union leaders, and customers. Coping with this potentially inflammatory response involves getting out in front of the disclosure, developing a plan of action to soften the blow prior to the disclosure and addressing any adverse responses following the disclosure. With respect to employees in particular, companies may wish to consider holding town hall meetings in advance of the disclosure being made public as a means to explain how elements of compensation are determined and to reinforce the “total rewards” concept of compensation programs. In addition, direct managers and supervisors should be prepared to respond to questions and backlash from employees.

**Can you discuss any unexpected issues encountered by companies that have already begun implementing procedures to identify the median employee?**

We have heard from several companies with significant overseas operations that their computer systems are not set up in a way that allows payroll data to be aggregated. In other words, payroll data is segregated on a jurisdiction by jurisdiction basis. This presents a great deal of complexity in identifying the median employee, particularly for companies with a large and diverse employee population. Companies facing this challenge may wish to start by narrowing their employee populations from which the median employee will be identified by using statistical sampling or another reasonable methodology. As the goal is to identify the median employee, companies should focus their efforts on the subset of employees in which the median employee is likely to be found.

**Can you identify any tips for companies that are beginning their compliance process now?**

Companies that are beginning the process now should start by reviewing the additional guidance issued by the SEC and the SEC staff on September 21, 2017, including a review of hypotheticals provided by the SEC staff that illustrate use of a combination of statistical sampling, reasonable estimates and other reasonable methods. This may help to get the ball rolling and provide ideas as to the appropriate methodology or combination of methodologies in light of a company’s workforce composition.

Companies should do one or more dry runs with respect to the various determinations. Because the rules provide a great deal of flexibility in identifying the median employee and determining total compensation, there are several decision points involved in the process. As an aside, although the rule does not require disclosure of every individual decision point, it is important to record key decisions and the methodology used in the event that the SEC audits the disclosure. Performing dry runs will not only help to ensure that a company has the resources to comply with the rule but practice may also help in putting forth the most favorable disclosure. Ensuring that computer systems are capable of aggregating the payroll data across jurisdictions is also a critical gating item.

It is also important to remember that, in most cases, the ultimate disclosure will be imprecise but will still fit within the parameters of the rule. Unless a company intends to calculate total annual compensation for all of its employees in accordance with the Summary Compensation Table rules, the identification of the median employee using a CACM will merely be an estimate. Accordingly, companies should keep the process and methodology simple and
focus on gathering data on the subset of employees from which the median employee is likely to be identified.

**Should companies be concerned with potential liability in light of the imprecision and uncertainty involved in pay ratio calculations?**

The SEC acknowledged in the additional guidance issued on September 21, 2017 that the process of determining the pay ratio inherently involves some degree of imprecision. The SEC indicated that so long as companies use reasonable estimates, assumptions or methodologies, the pay ratio and related disclosure will not provide the basis for SEC enforcement action unless the disclosure is made or reaffirmed without a reasonable basis or is provided other than in good faith.

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