Pearl Meyer

CLIENT ALERT

CEO Pay Ratio Disclosure Requirement Now Imminent: SEC Releases Additional Guidance

While the rules promulgated by the Securities and Exchange Commission ("SEC") under the Dodd-Frank CEO Pay Ratio Rule ("Pay Ratio Rule") have been final for more than two years, most anticipated that they would be either materially amended or that implementation would be delayed under the new administration. However, on September 15, 2017, most of us gave up that last vestige of hope when, at the American Bar Association's Business Law Section Annual Meeting, William Hinman, Director of the Division of Corporation Finance, indicated that the SEC had no current plans to delay implementation of the Pay Ratio Rule, which has been scheduled for proxies filed in 2018. Given these remarks and the fact that it is now highly unlikely Congress will take any steps to repeal the Pay Ratio Rule prior to the compliance deadline, companies should begin assessing their pay ratio strategy *now* and anticipate that it could take months to prepare the disclosure.

On the coattails of this relatively bad news, however, came some relief from the SEC in the form of additional guidance that appears to be intended to mitigate the pain of compliance. On September 21, the SEC Division of Corporate Finance unleashed a flurry of new guidance on the Pay Ratio Rule, including an Interpretive Release (the "Release"), detailed Corporate Finance Guidance (the "CorpFin Memo") and updated Compliance and Disclosure Interpretations ("CDIs")[1].

- **Relaxed SEC Liability:** Because pay ratio computations involve a degree of imprecision, the Release states that if a company uses reasonable estimates, assumptions, or methodologies, the pay ratio and related disclosure would not provide a basis for SEC enforcement action *unless* the disclosure was made or reaffirmed without a reasonable basis or was provided in bad faith. So, if you get started early and do your due diligence by documenting all assumptions and methodologies, the risk of an SEC enforcement action is very low (although it is unclear whether this guidance would impact private litigation). In addition, a new CDI (128C.06) suggests that companies may want to specifically state that the pay ratio is a reasonable estimate calculated in a manner consistent with the rules.

[1] For reference, a marked copy of the CDIs is attached as Appendix A, which shows updates from previously-released CDIs in October 2016.

- **Relaxed Independent Contractor Exception:** In October 2016, the SEC issued guidance to help companies understand which individuals qualified as independent contractors that could be excluded from the ratio calculation. At that time, the test turned on whether or not the individual's compensation was determined by the contractor (or contractor's agency), or the company. If the latter, the individual would need to be included in the calculation. The Release has retracted from this position (and also withdrew a previously issued CDI on this point). Instead, the Release now confirms that whether or not an individual is exempt from the calculation turns on whether the individual would be considered an employee under any ***"widely recognized test under another area of law that the company uses to determine whether its workers are employees."*** The entity that determines the individual's compensation may be an element of that test, but it is not the exclusive basis on which to make the determination for reason of inclusion in the pay ratio. For example, common law and the IRS typically focus on who has the right to control what the worker does and how the worker does his or her job, who provides tools/supplies, whether employee benefits and insurance are available, etc.

  Pearl Meyer Observation: Expansion of the independent contractor definition should provide much needed relief to those companies having difficulty determining whether or not pay was set by them. In our experience to date, those companies struggling to find data on individuals deemed to be independent contractors can more comfortably exclude these individuals under the new guidance. In other words, if a company was finding it nearly impossible to track down information about all of its contracts with individuals not typically considered "employees," chances are such individuals would not be categorized as ones intended to be included in the pay ratio calculation. However, we would still recommend due diligence and proper documentation that any information available was reviewed to make this determination.

- **Relaxed Methodologies for Selecting a Consistently Applied Compensation Methodology ("CACM")**: It appears that the SEC is giving even more flexibility to companies both in determining the CACM and in statistical sampling. The Release states that companies can use "existing internal records" both with respect to figuring out the 5% carve-out for non-US employees and also for determining the median employee. While the Release does not define "existing internal record," it does state that companies may use records even if they don't include every element of compensation, such as equity awards widely distributed to employees. In turn, the CDI that addressed CACMs (128C.01) has been modified. The original CDI confused most companies by giving examples. It stated that "total cash compensation could be a CACM unless the registrant also distributed annual equity awards widely among its employees. Social Security taxes withheld would likely not be a CACM unless all employees earned less than the Social Security wage base," leading us to question what elements could be used if a company's employees didn't fit in those fact patterns. The updated CDI deletes these examples, and simply defers to the Release, which states that "a registrant 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."

- **Increased Flexibility on Statistical Sampling Methodologies and Reasonable Estimates:** The CorpFin Memo provides further guidance, which is more technical in nature, as to reasonable estimates and valid statistical sampling methodologies. It clarified that companies may use a combination of statistical sampling and other reasonable methods in order to identify the median employee, and provided examples of reasonable methodologies.

  - Examples of ***statistical sampling*** may 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 strata [e.g., based on location, business unit, type of employee, collective bargaining agreement, or functional role] and sampling within each strata);
    - Cluster sampling (dividing the employee population into clusters based on some criterion, drawing a subset of clusters, and sampling observations within appropriately selected clusters, with sampling 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* employee is drawn from a listing of employees sorted on the basis of some criterion).

  - Examples of situations where ***reasonable estimates*** may be made include:

    - 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 consistent measure of compensation 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;
    - Using the mid-point of a compensation range to estimate compensation;
    - 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;
    - Imputing or correcting missing values; and
    - Addressing extreme observations, such as outliers.

The CorpFin Memo also provided three hypothetical fact patterns as illustrative examples of how statistical sampling and/or other reasonable methods may be applied in particular fact patterns.

Conclusions

While not the repeal or delay of the Pay Ratio Rule we had all hoped for, the SEC did provide some limited relief in the form of additional flexibility (and perhaps relaxation of liability) with the new guidance. Nonetheless, it is now even more urgent that companies begin the process of data collection and communication planning if they have not already started. While there is some additional flexibility, it is imperative that companies do their due diligence and take their time to make reasonable estimates and assumptions. Tracking all assumptions and considerations will be perhaps the most important facet in the early stages of the process.

Appendix A
CEO Pay Ratio CDIs
As of 9/21/17 (MARKED TO SHOW CHANGES)

Section 128C — Item 402(u) Pay Ratio Disclosure

Question 128C.01

Question: If a registrant does not use annual total compensation calculated using Item 402(c)(2)(x) of Regulation S-K ("annual total compensation") to identify the median employee, how should a registrant select another consistently applied compensation measure ("CACM") to identify the median employee?

Answer: Item 402(u) requires registrants to identify the median employee using annual total compensation or another CACM, such as information derived from the registrant's tax and/or payroll records. Because of concerns about the expected compliance costs if registrants had been required to calculate annual total compensation for all employees, the Commission permitted registrants to use a CACM other than annual total compensation as a reasonable alternative to identifying the median employee. Any measure that reasonably reflects the annual compensation of employees could serve as a CACM. The appropriateness of any measure will depend on the registrant's particular facts and circumstances. ~~For example, total cash compensation could be a CACM unless~~ As the Commission stated in the interpretive release, "a registrant ~~also distributed annual equity awards widely among its employees. Social Security taxes withheld would likely not be a CACM unless all employees earned less than the Social Security wage base. The registrant must also briefly disclose the compensation measure used. Although the CACM must~~ may use internal records that reasonably reflect annual compensation~~, it is not expected that the CACM would necessarily~~ to identify the ~~same~~ median employee, even if those records do not include every element of compensation, such as ~~if the registrant were to use annual total compensation.~~ equity awards widely distributed to employees." [October 18, 2016; updated September 21, 2017]

Question 128C.02

Question: May a registrant exclusively use hourly or annual ***rates*** of pay as its CACM?

Answer: No. Although an hourly or annual pay rate may be a component used to determine an employee's overall compensation, the use of the pay rate alone generally is not an appropriate CACM to identify the median employee. Using an hourly rate without taking into account the number of hours actually worked would be similar to making a full-time equivalent adjustment for part-time employees, which is not permitted. Similarly, using an annual ***rate*** only, without regard to whether the employees worked the entire year and were actually paid that amount during the year, would be similar to annualizing pay, which

the rule only permits in limited circumstances. [October 18, 2016]

Question 128C.03

Question: When a registrant uses a CACM to identify the median employee, what time period may it use? Must the period include the date on which the employee population is determined? Must it always be for an annual period? May it use the prior fiscal year?

Answer: To calculate the required pay ratio, a registrant must first select a date, which must be within three months of the end of its fiscal year, to determine the population of its employees from which to identify the median. Once the employee population is determined, the registrant must then identify the median employee from that population using either annual total compensation or another CACM. In applying the CACM to identify the median employee, a registrant is not required to use a period that includes the date on which the employee population is determined nor is it required to use a full annual period. A CACM may also consist of annual total compensation from the registrant's prior fiscal year so long as there has not been a change in the registrant's employee population or employee compensation arrangements that would result in a significant change of its pay distribution to its workforce. [October 18, 2016]

Question 128C.04

Question: When someone is furloughed on the date that the registrant uses to determine the population of its employees from which it is required to identify the median, must the registrant include the furloughed person in the employee population used to identify the median employee, and, if included in the population, how should the furloughed employee's compensation be calculated?

Answer: Item 402(u) does not define or even address furloughed employees. Because a furlough could have different meanings for different employers, registrants will need to determine whether furloughed workers should be included as employees based on the facts and circumstances. If the furloughed worker is determined to be an employee of the registrant on the date the employee population is determined, his or her compensation should be determined by the same method as for a non-furloughed employee. Item 402(u)(3) of Regulation S-K identifies four classes of employees: full-time, part-time, temporary and seasonal. The registrant must determine in which class the employee belongs on that date and determine that individual's compensation using annual total compensation or another CACM in accordance with Instruction 5 of Item 402(u). That instruction states that a registrant may annualize the total compensation for all permanent employees (full-time or part-time) that were employed by the registrant for less than the full fiscal year or who were on an unpaid leave of absence during the period. In contrast, a registrant may not annualize the total compensation for employees in temporary or seasonal positions. A registrant may not make a full-time equivalent adjustment for any employee. [October 18, 2016]

Question 128C.05

~~**Question:** Under what circumstances is a worker employed and his or her compensation determined by an unaffiliated third party such that the worker is considered an independent contractor or leased worker under the rule? When is a registrant considered to be determining the compensation of a worker?~~

~~**Answer:** In the release, the Commission noted its belief that the primary benefit of the pay ratio disclosure is to provide shareholders with a company-specific metric that they can use to evaluate the compensation paid to the PEO within the context of their company. Therefore, in determining when a worker is an "employee" of the registrant under the rule, the registrant must consider the composition of its workforce and its overall employment and compensation practices. In furtherance of this, a registrant should include those workers whose compensation it or one of its consolidated subsidiaries determines regardless of whether these workers would be considered "employees" for tax or employment law purposes or under other definitions of that term. Frequently, a registrant will obtain the services of workers by contracting with an unaffiliated third party that employs the workers. When a registrant obtains services in this way, we do not believe it is determining the workers' compensation for purposes of the rule if, for example, the registrant only specifies that those workers receive a minimum level of compensation. Further, an individual who is an independent contractor may be the "unaffiliated third party" who determines his or her own compensation. [October 18, 2016]~~

[Withdrawn, September 21, 2017]

Question: Given the significant flexibility provided to registrants in Item 402(u) to identify the median employee, would the staff object if a registrant describes the pay ratio as an estimate?

Answer: No. As the Commission stated in the interpretive release, 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 registrant states in any required disclosure that the pay ratio is a reasonable estimate calculated in a manner consistent with Item 402(u). [September 21, 2017]

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