
September 28, 2017

SEC Issues Pay Ratio Guidance

On September 21, the Securities and Exchange Commission (“SEC”) and its Division of Corporation Finance issued interpretative guidance on the calculation of CEO pay ratio disclosure for public companies. Among other things, the guidance provides companies with significant flexibility in using estimates and statistical sampling to identify the median employee and calculate his or her total compensation, with the core message being that any one or combination of methods is acceptable so long as it is “reasonable.”

As a reminder, the pay ratio rules require the disclosure of the ratio of the annual total compensation of a registrant’s median employee to the annual total compensation of its principal executive officer and take effect with respect to compensation paid by companies in their first full fiscal year beginning on or after January 1, 2017. This will require proxy disclosure in 2018 for most companies. The pay ratio rules do not apply to foreign private issuers.

This guidance was provided in interpretive guidance from the SEC (available [here](#)), an interpretive release from the Division of Corporation Finance (available [here](#)), and related Compliance & Disclosure Interpretations (available [here](#)).

Background

In August 2015, as mandated by the Dodd-Frank Act, the SEC approved final rules to require U.S. public companies to disclose the ratio of their principal executive officer compensation to the compensation of the median employee. Facing intense pressure both supporting and criticizing the pay-ratio requirement, the SEC implemented rules that, in the words of former Chair Mary Jo White, provide companies with “substantial flexibility in determining the pay ratio, while remaining true to the statutory mandate.” Nonetheless, numerous questions remained as to how to perform the pay ratio calculation (including identifying the median employee).

Following the election of President Trump and a Republican-controlled Congress, various efforts ensued to suspend or repeal the pay ratio rules; however, in a speech on September 15, Corporation Finance Director Bill Hinman stated that the SEC would not be delaying the implementation of the pay ratio disclosure rules.

SEC Interpretive Guidance

The SEC's interpretive guidance clarified several points with respect to the pay ratio rules:

- ***Use of Reasonable Estimates, Assumptions, Methodologies and Statistical Sampling.*** The SEC acknowledged that in light of the use of estimates, assumptions, adjustments, and statistical sampling permitted by the rule, pay ratio disclosures may involve a degree of imprecision. The SEC clarified that, in its view, if a registrant uses reasonable estimates, assumptions or methodologies, “the pay ratio and related disclosure that results from such use 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.”
- ***Use of Internal Records.*** To address concerns about compliance costs, the pay ratio rules permit registrants to exempt non-U.S. employees where these employees account for 5% or less of the registrant's total U.S. and non-U.S. employees, with certain limitations. The SEC guidance clarifies that a registrant may use appropriate existing internal records, such as tax or payroll records, in determining whether the 5% *de minimis* exception is available.

In addition, the guidance states that a registrant may use consistently applied 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. If there are anomalous characteristics of the identified median employee's compensation that have a significant impact on the pay ratio calculation, the registrant may substitute another employee with substantially similar compensation to the original identified median employee based on the compensation measure it used to select the median employee.

- ***Independent Contractors.*** In the adopting release, the SEC indicated that excluding certain types of workers such as independent contractors or “leased” workers can be appropriate because registrants generally do not control the level of compensation that these workers are paid. The SEC's interpretive guidance clarifies that the definition of “employee” or “employee of the registrant” as set forth in Item 402(u) of Regulation S-K was not intended to serve as an exclusive basis for determining whether a worker is an employee of the registrant, and that it would also be consistent with Item 402(u) for a registrant to apply a widely recognized test under another area of law (such as employment or tax law) that the registrant otherwise uses to determine whether its workers are employees.

Division of Corporation Finance Interpretive Release

In its interpretive release, the Division of Corporation Finance reiterated that Item 402(u) of Regulation S-K allows registrants substantial flexibility to determine the pay ratio. Instruction 4.1 to Item 402(u)

provides that registrants may use reasonable estimates 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. Additionally, Instruction 4.2 permits a registrant to use its employee population or statistical sampling or other reasonable methods in determining the median employee. In the adopting release, the SEC explained that registrants may make determinations based on their particular facts and circumstances and declined to specify requirements for statistical sampling, such as appropriate sample sizes, confidence levels, or other requirements, to avoid unduly constraining registrants from developing the most appropriate methodology. While providing broad flexibility, however, the SEC was clear that registrants must determine their own median and may not use industry estimates.

The Division of Corporation Finance provided additional guidance and hypothetical examples of the use of sampling and other reasonable methodologies, as set forth below:

- ***A registrant may use any one or combination of statistical sampling and other reasonable methodologies to identify the median employee.*** In adopting the “other reasonable methods” language, the Staff indicated that it did not specify “other reasonable methods” that may be appropriate in order to allow each registrant the flexibility to determine the method that best suits its own facts and circumstances.
- ***Registrants may use a combination of sampling methods provided that they use reasonable methods and make reasonable estimates.*** The SEC expressly stated in the adopting release “that reasonable estimates of the median for registrants 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 registrant’s overall median based on the observations drawn.” The interpretive release notes a nonexclusive list of examples that could be appropriate to use, depending on the registrant’s particular facts and circumstances:
 - 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; cluster sampling may be conducted in one stage or multiple stages); and

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- systematic sampling (the sample is drawn according to a random starting point and a fixed sampling interval, with each sampled employee drawn from a listing of employees sorted on the basis of some criterion).
 - **Examples of situations where registrants may use reasonable estimates.** Item 402(u) of Regulation S-K provides that registrants may use reasonable estimates 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. Examples of situations in which reasonable estimates may be appropriate include but are not limited to:
 - 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; and
 - using the mid-point of a compensation range to estimate compensation.
 - **Other reasonable methodologies a registrant may use.** Item 402(u) of Regulation S-K permits registrants to use other reasonable methods in determining the employees from which the median employee is identified and does not specify any required methodology so long as the method or combination of methods chosen is reasonable. Examples of statistical techniques and methodologies that a registrant may consider include but are not limited to:
 - 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.
- ***Hypothetical examples of the use of reasonable estimates, statistical sampling and other reasonable methods.*** The interpretive release also provides illustrative examples of the principles that a registrant may consider when using reasonable estimates, statistical sampling and other reasonable methods to identify its median employee, particularly larger registrants with more complex workforces. For example:
 - *A company with employees in the U.S. and outside the U.S. within three business units and 21 geographic units, covered by multiple payroll systems.* One approach would be for the company to perform sampling from each of the three business units. In obtaining samples of compensation data from each of the three business units, the company could select samples from the geographic locations whose employee pay is generally representative of employee pay within the entire business unit.
 - *A company with a global workforce with employees concentrated in North America, China, Europe and Latin America.* The interpretive release provides detailed guidance, noting that a combination of statistical sampling and other methods may be used to identify the median depending on the characteristics and distribution of the workforce across jurisdictions, so long as they are reasonable. Because of the varying nature of the workforce in each of the company's jurisdictions, a different statistical or sampling method could be used for purposes of identifying the median employee in each jurisdiction.
 - *A company with employees in the U.S. and Asia.* In an example where the company reasonably believes that the distribution of employee compensation is multimodal and approximately characterized as a mixture of lognormal distributions, weighted based on estimated workforce distribution, the median may be identified based on the resulting distribution mixture. In a company with four main cohorts of workers, for instance, distribution assumptions and parameters could be based on data and reasonable estimates regarding the pay levels of each individual cohort.

Compliance and Disclosure Interpretations

The Division of Corporation Finance concurrently updated three Compliance and Disclosure Interpretations in light of the new guidance. Question 128C.01 was amended to reflect the Staff's clarification 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. Question 128C.05, regarding the determination of an "employee" of the registrant, was superseded by the interpretive guidance and withdrawn. New question

128C.06 clarifies that the Staff would not object if a registrant describes the pay ratio as a reasonable estimate calculated in a manner consistent with Item 402 of Regulation S-K.

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This memorandum is not intended to provide legal advice, and no legal or business decision should be based on its content. Questions concerning issues addressed in this memorandum should be directed to:

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