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SEC Issues New and Revised Guidance to Clarify Its CEO Pay Ratio Rule

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Background

On August 5, 2015, the SEC issued a final rule[1] on chief executive officer (CEO) pay ratio disclosure (the "CEO pay ratio rule" or the "final rule") in response to a mandate in Section 953(b) of the Dodd-Frank Wall Street Reform and Consumer Protection Act. Registrants must adopt the CEO pay ratio rule for their first fiscal year beginning on or after January 1, 2017.

In the two years since the release of the final rule, stakeholders have raised concerns about the rule's implementation. In response to those concerns and to clarify the final rule as well as revise some of the interpretations the SEC previously issued on October 16, 2016, the SEC issued *Commission Guidance on Pay Ratio Disclosure* (the "interpretive release"), a revised set of Compliance and Disclosure Interpretations on the final rule (the "C&DIs"), and Staff Guidance on Calculation of Pay Ratio Disclosure (the "SEC staff guidance") on September 21, 2017.

This *Heads Up* summarizes the key components of the SEC's CEO pay ratio rule as clarified by the interpretive release, C&DIs, and SEC staff guidance.

[1] SEC Release No. 33-9877, *Pay Ratio Disclosure*.

Scope and Exemptions

Under the final rule, a registrant must annually disclose (1) the median of the annual total compensation of all its employees (excluding the individual that the SEC describes as the principal executive officer (PEO) and that is referred to herein as the CEO, (2) the annual total compensation of its CEO, and (3) the ratio of the median of the annual total compensation of all its employees to the annual total compensation of its CEO.

Example

If the median annual total compensation of a registrant's employees is $50,000 and the annual total compensation of its CEO is $2,500,000, the CEO's compensation is 50 times larger than the median employee's compensation.

The pay ratio may be described numerically (as either 50 to 1 or 50:1) or narratively (e.g., "the CEO's annual total compensation is 50 times the median employee's annual total compensation").

In accordance with paragraph (u) of SEC Regulation S-K, Item 402,[2] registrants are required to disclose their pay ratio in any filing described in paragraph (a) of SEC Regulation S-K, Item 10,[3] for which executive compensation disclosure is required under SEC Regulation S-K, Item 402 (e.g., an annual report on Form 10-K, registration statement under the Securities Act of 1933 (the "Securities Act") and Securities Exchange Act of 1934 (the "Exchange Act"), proxy and information statement).[4] However, the disclosure requirement does not apply to emerging growth companies, smaller reporting companies, foreign private issuers, or U.S.-Canadian multijurisdictional disclosure system filers.

Definition of "Employee" Under the Rule

The final rule's definition of "employee" encompasses all "full-time, part-time, seasonal, and temporary employees of the registrant or any of its consolidated subsidiaries." Independent contractors or "leased" workers that provide services to a registrant or its consolidated subsidiaries, and whose compensation is determined by an unaffiliated third party, are not considered employees and must be excluded from a registrant's identification of its median employee.

In the interpretive release, the SEC clarified that existing characterizations of workers as employees or independent contractors may be relied on provided that such characterizations are based on "a widely recognized test under another area of law that the registrant otherwise uses to determine whether its workers are employees."

Connecting the Dots

Probably the most welcome news of the interpretive release is the broadening of the exclusion of independent contractors from the CEO pay ratio calculation. Under the final rule, an independent contractor is excluded from the calculation if he or she worked for an unaffiliated party and the registrant did not set the individual worker's compensation. The SEC tried to clarify this exception with a C&DI issued in October 2016 (specifically, C&DI Question 128C.05, which was withdrawn on September 21, 2017). However, questions persisted, and the burden of identifying every contractor to evaluate whether the individual could be excluded from the employee base created a significant administrative burden for a number of registrants.

[2] SEC Regulation S-K, Item 402, "Executive Compensation."

[3] SEC Regulation S-K, Item 10, "General."

[4] In a manner consistent with the treatment of other SEC Regulation S-K, Item 402, information, the final rule treats the pay ratio disclosure as "filed" for purposes of the Securities Act and Exchange Act. Therefore, a registrant making the disclosure is subject to potential liability (e.g., for making misleading statements under Section 18 of the Exchange Act).

The expanded flexibility and broadening of the SEC's exclusion for independent contractors should simplify registrants' compliance with the CEO pay ratio disclosure requirement.

The final rule defines an "employee" as an individual employed on any date of the registrant's choosing within the last three months of the registrant's last completed fiscal year. Registrants must disclose the date used to identify the median employee but not the rationale for selecting that particular date.

Connecting the Dots

The three-month rule may make it easier for employers to identify the median employee by eliminating part-time and seasonal employees hired in the fourth quarter of the fiscal year.

Although the final rule defines "employee" as a registrant's U.S. and non-U.S. employees, the SEC provides two exemptions from this definition to alleviate potential difficulties associated with collecting global compensation data.

Data Privacy Exemption

The final rule's definition of "employee" does not apply to workers in foreign jurisdictions in which a registrant cannot obtain the compensation data it needs to comply with the rule without violating local data privacy laws.

To qualify for this exemption, a registrant must first make "reasonable efforts" to collect the required compensation data. The final rule states that such efforts would entail seeking an exemption under the applicable jurisdiction's data privacy laws and using that exemption if it is granted. Registrants that use the data privacy exemption also must:

- Disclose each jurisdiction that was excluded.
- Identify the specific data privacy laws or regulations for each jurisdiction and explain how complying with the final rule violates such laws or regulations.
- Note any efforts to obtain an exemption under the data privacy laws.
- Exclude all non-U.S. employees in any jurisdiction in which the exemption is used (i.e., registrants cannot choose to exclude only a subset of that jurisdiction's employees from the definition of employee).
- Disclose the estimated number of employees from each jurisdiction that have been exempted as a result of data privacy laws.
- Obtain and file as an exhibit a legal opinion on the registrant's inability to collect the compensation data necessary to comply with the final rule without violating the jurisdiction's data privacy laws.

De Minimis Exemption

The final rule also contains a de minimis exemption for non-U.S. employees. To apply this exemption, a registrant must have a non-U.S. employee workforce that makes up 5 percent or less of the total employee population. Such a registrant may choose to exclude all of those non-U.S. employees when determining the median employee but is not permitted to exclude only a portion of its non-U.S. workforce. If more than 5 percent of a registrant's workforce is composed of non-U.S. employees, the registrant may exclude non-U.S. employees up to 5 percent of the registrant's total employees; however, it must exclude all employees located in a particular jurisdiction (i.e., it cannot exclude a subset of employees from one jurisdiction and employees from other jurisdictions to arrive at the 5 percent threshold).

A registrant using the de minimis exemption must disclose:

- The jurisdiction(s) of the excluded employees.
- The approximate number of employees excluded from each jurisdiction.
- The total number of its U.S. and non-U.S. employees before any exemption (data privacy or de minimis) is used.
- The total number of U.S. and non-U.S. employees used for its de minimis calculation.

Non-U.S. employees excluded from the determination of the median employee under the data privacy exemption count against the 5 percent de minimis threshold. Although a registrant may exclude any non-U.S. employee that meets the data privacy exemption, if the number of excluded employees under the data privacy exemption equals or exceeds 5 percent of total employees, the registrant may not use the de minimis exemption to exclude additional employees.

Connecting the Dots

Although registrants can exclude non-U.S. employees up to 5 percent of total employees, they are still required to track and disclose the number of total employees that reside outside the United States.

Further, if more than 5 percent of a registrant's total workforce is located in a single foreign country, the registrant would not be able to exclude *any* of these employees from its median employee determination. This is because the final rule states that registrants must exclude all employees from the same jurisdiction, and excluding all of the employees from that country would violate the 5 percent de minimis cap.

Identifying the Median Employee and Calculating Annual Total Compensation

Identifying the Median Employee

The final rule requires a registrant to identify the median employee whose compensation will be used for the annual CEO pay ratio calculation only once every three years unless there has been a change in the registrant's employee population or compensation arrangements that the registrant reasonably believes would result in a significant change to its CEO pay ratio disclosure. If the registrant believes that there have been no such changes, it must disclose that it is using the same median employee in its CEO pay ratio calculation and briefly describe the basis for its reasonable belief. The rule states that if significant changes in the median employee's circumstances have occurred (e.g., the employee is no longer employed in year 2 or 3 or is promoted to a much higher-paying job), "the registrant may use another employee whose compensation is substantially similar to the original median employee based on the compensation measure used to select the original median employee."

Connecting the Dots

It is important for registrants to thoroughly document all of the steps taken and assumptions made in identifying the median employee so that they can (1) clearly describe their method in the pay ratio disclosure (2) repeat the process in the future, and (3) demonstrate that the method and all material assumptions were reasonable.

Under the final rule, registrants may make cost-of-living adjustments to the compensation of employees that reside in a jurisdiction different from that of the CEO provided that these adjustments are applied to all such employees included in the calculation. If the median employee does not reside in the CEO's jurisdiction, any cost-of-living adjustments applied to identify the median employee also must be applied to the median employee's annual total compensation.

The final rule requires registrants to describe the cost-of-living adjustments used to identify the median employee and to calculate the median employee's annual total compensation. Registrants must also disclose (1) the measure used as the basis for the cost-of-living adjustment (e.g., a purchasing power parity conversion factor), (2) the jurisdiction in which the median employee resides, and (3) the median employee's annual total compensation and pay ratio without any cost-of-living adjustments.

Connecting the Dots

Registrants that choose to apply cost-of-living adjustments will substantially increase the effort they need to make to determine the "median employee." This disclosure requirement precludes a registrant from assuming that the same individual would represent the "median employee" in both adjusted and unadjusted terms. Rather, the registrant must identify two separate median employees — one by using cost-of-living adjustments, the other by using unadjusted compensation.

Although a registrant must disclose both the adjusted and unadjusted pay ratios in its filings, the SEC will consider the cost-of-living-adjusted ratio the "official" pay ratio.

Flexibility in Choice of Method

The final rule grants a registrant flexibility to choose a method of identifying the median employee on the basis of its own facts and circumstances. The registrant must describe the method it chooses, including any material assumptions, adjustments (such as cost-of-living or foreign exchange rates), or estimates.

Use of Reasonable Estimates and Assumptions

The interpretive release confirms that the SEC views "reasonable belief; use of reasonable estimates, assumptions, and methodologies; and reasonable efforts to prepare the disclosures" as acceptable means by which to "identify the median employee" or calculate "annual total compensation or any elements of annual total compensation." The release also indicates that given the inherent lack of precision resulting from the use of estimates and assumptions in the preparation of the pay ratio disclosure, the SEC will not pursue enforcement action "unless the disclosure was made or reaffirmed without a reasonable basis or was provided other than in good faith." In addition, C&DI Question 128C.06 notes that the SEC staff "would not object if a registrant states in any required disclosure that the pay ratio is a reasonable estimate."

Connecting the Dots

Although the SEC has indicated that it does not intend to pursue enforcement action against a registrant if the registrant has made reasonable assumptions and a good-faith attempt to comply with the final rule, some registrants may want to communicate to shareholders that their CEO pay ratio disclosure is based on a reasonable estimate.

Use of Internal Records

In its interpretive release, the SEC reiterated its prior guidance that a registrant may use internal records, such as tax or payroll records, to determine the registrant's employee population and identify the median employee. For example, when applying the 5 percent de minimis test for non-U.S. employees, the registrant may rely on internal records to identify the total employee population and the number of employees in each non-U.S. jurisdiction.

The SEC also acknowledged that when internal records are used to identify the median employee, information derived from payroll or tax records may not include all elements of compensation, and the identified median employee sometimes may not be representative of the "true" median employee (e.g., the individual could have deferred a substantial portion of his or her compensation, which would not be reflected in the payroll tax records).

The SEC provides that the internal records can still be relied on as a "consistently applied compensation measure" in such cases and recommends that the registrant substitute another employee with compensation substantially similar to that of the original identified median employee on the basis of the internal records.

Connecting the Dots

In situations in which a registrant's selection of a consistently applied compensation measure resulted in the identification of an employee with anomalous compensation, the final rule was unclear about whether the registrant would be required to identify another, consistently applied compensation measure or increase its sample size (or both) to identify a more appropriate median employee. The additional guidance in the interpretive release gives a registrant much needed latitude to select an employee that the registrant believes accurately reflects the median employee.

Use of Statistical Sampling

The final rule allows registrants to use statistical sampling when identifying the median employee. The SEC believes that each registrant must determine which method is appropriate on the basis of its facts and circumstances. Hence, the final rule does not provide specific parameters, such as sample size and confidence intervals. However, the final rule cites an analysis discussed in the proposed rule that indicated that:

- Under the assumptions used in the analysis, the appropriate sample size for a registrant with a single business line or geographical unit varied between 81 and 1,065 employees, with an average of 560, depending on the industry.
- More than one statistical sampling approach may be used for businesses with multiple business lines or geographical units.
- In identifying the median employee, a registrant does not need to calculate the exact compensation amounts for every employee. For example, the registrant may not need to determine exact compensation for employees that have extremely high or low compensation that would clearly fall above or below the median employee compensation.

For many registrants, determining an appropriate random sample of employees will be the most challenging aspect of complying with the final rule. In the initial year of adoption, the determination is likely to be an iterative process.

Connecting the Dots

A statistically valid random sample of the workforce should take into account various factors, including the distribution of compensation data throughout the organization (e.g., a registrant with a wider distribution is likely to need a larger sample size than an organization with a narrower distribution). Registrants should also consider other factors, including:

- Number of employees (full-time, part-time, seasonal, and temporary).
- Geographies.
- Lines of business.
- Payroll systems.
- Stratification of pay levels across the workforce.
- Types of compensation the employees receive.

The population should include all U.S.-based and non-U.S.-based full-time, part-time, seasonal, and temporary employees who were employed on the date chosen by the registrant. Presumably, most registrants will want to simplify the process by taking full advantage of the data privacy and de minimis exemptions before defining the population to be sampled. Independent contractors and temporary workers employed by a third party should not be included in the population.

The SEC staff guidance includes a series of Q&As on reasonable estimates, methods, and statistical sampling. Key takeaways from the Q&As include the following:

- A registrant may use statistical sampling and reasonable estimates to identify the median employee provided that the method is reasonable (e.g., a registrant reasonably believes that the median employee is in grade levels 16–18 and draws a sample of employees from those grades).
- Different statistical sampling techniques may be used for different populations. For example, a registrant might use a random sample of U.S. employees and a stratified or cluster sample for non-U.S. employees because of the wide variation in pay outside the United States.
- A registrant may use reasonable estimates to identify the median employee or annual total compensation, and the SEC provides a nonexclusive list of situations in which reasonable estimates are permissible (e.g., focusing on employees in the middle of the compensation spectrum).

Determining Annual Total Compensation to Identify the Median Employee

The final rule allows a registrant, when determining the median employee, to use any compensation measure that is consistently applied to all employees in the calculation as long as the chosen measure is disclosed. The SEC makes it clear that this flexibility in choosing a compensation measure is only for *identifying* the median employee. The actual value disclosed in the proxy must be calculated in accordance with SEC Regulation S-K, Item 402(c)(2)(x) (i.e., the "summary compensation table" value).

For many registrants that do not extend incentive compensation throughout the organization, base salary or wages plus overtime may be the most appropriate measure of compensation to use to identify the median employee. For registrants whose annual cash incentives do extend throughout the organization, annual total cash compensation might be the most representative measure of compensation.

Total compensation used to identify the median employee does not have to coincide with the end of the registrant's fiscal year. Therefore, an alternative approach might be to use tax or payroll information (e.g., a W-2 or non-U.S. equivalent).

Calculating Annual Total Compensation Used in the Pay Ratio

Once the median employee has been identified, registrants must gather relevant compensation data and make necessary assumptions to calculate the annual total compensation for the median employee and CEO in accordance with SEC Regulation S-K, Item 402(c)(2)(x) (i.e., the "summary compensation table" values). If the registrant provides benefits such as health care, bus passes, housing, and employee discounts, it may include these elements in the median employee's annual total compensation. Each registrant will need to determine whether to include such "personal benefits" and perquisites in the calculation of the median employee's annual income (e.g., a registrant may want to include them because their inclusion should improve the pay ratio). However, if they are included in the median employee's annual total compensation, the registrant would also be required to include these items in the calculation of the CEO's annual total compensation.

Connecting the Dots

Adding health care benefits to the median employee's and CEO's total annual compensation could have a fairly meaningful impact on the pay ratio, as shown in the following table:

	CEO	Median Employee	Pay Ratio
Total annual compensation	$ 4,200,000	$ 42,000	100:1
Employer-paid health care	12,000	12,000	—
Total annual compensation + employer-paid health care	$ 4,212,000	$ 54,000	78:1

The final rule and interpretive release permit a registrant to use reasonable assumptions (e.g., in calculating the change in the actuarial present value of an employee's defined pension benefit under a multiemployer pension plan) in estimating the annual total compensation. In addition, the final rule excludes government-mandated pensions and other benefits from annual total compensation, even if the employer funds those benefits through social taxes.

Under the final rule, there are two methods of calculating annual total compensation when a CEO is hired mid-year:

- Combining the total compensation of each person who served as CEO during the year.[5]
- Annualizing the compensation of the CEO in place on the date the registrant selects to identify the median employee.

In either case, the registrant must disclose the method it used to calculate the CEO's annual total compensation.

Disclosure of Methods, Assumptions, and Estimates

As noted previously, the final rule does not prescribe the method a registrant must use to identify the median employee or calculate annual total compensation; however, registrants must apply the methods they choose consistently and explain them in a brief disclosure. This disclosure must sufficiently explain the appropriateness of the methods, as well as the

[5] Calculated in accordance with SEC Regulation S-K, Item 402(c)(2)(x), and reflected in the summary compensation table that is also required by that regulation.

estimates, material assumptions, and adjustments used, but it need not include technical details, such as formulas, confidence intervals, or exact steps followed.

Under the final rule, registrants must also disclose any significant changes in their methods, assumptions, adjustments, or estimates from one year to the next.

Connecting the Dots

We expect that during the first year or two after adoption, some registrants may change their methods of computing the pay ratio as they find more efficient and accurate ways to identify the median employee and calculate annual total compensation. The interpretive release reiterates that "if a registrant changes its methodology or its material assumptions, adjustments, or estimates, and the effects are significant, the registrant must briefly describe the change and the reasons for the change."

Once registrants find a method that works for them, they are advised to stick with it. Some shareholders, analysts, or other parties may view frequent method changes as a red flag, thereby drawing unwarranted attention to a registrant's pay ratio disclosure.

Meaning of "Annual"

Under the final rule, annual total compensation for the median employee and CEO is total compensation for the registrant's last completed fiscal year. The use of any other annual periods, such as the year before the registrant's last completed fiscal year or the period used for tax or payroll records, is not allowed.

Connecting the Dots

Although the final rule allows registrants to choose the compensation measure and time frame used to identify the median employee, the annual total compensation amount to be used in the pay ratio disclosure is well defined and is determined in a manner consistent with that specified in the rules governing the preparation of the summary compensation table disclosure required by SEC Regulation S-K.

Timing and Transition

Updating Pay Ratio Disclosure for the Last Completed Fiscal Year

Registrants are not required to disclose the pay ratio for the last completed fiscal year until they file their Form 10-K or proxy statement, whichever is later. In either case, registrants must disclose their pay ratio no later than 120 days after the end of the fiscal year.[6]

Initial Compliance Date and Transition Periods

The final rule indicates that registrants' first reporting period under the final rule is their first full fiscal year beginning on or after January 1, 2017.

As with the transition period for existing registrants, a new registrant's initial pay ratio disclosure must follow its first full fiscal year beginning after the registrant has (1) been subject to the requirements of Section 13(a) or 15(d) of the Exchange Act (i.e., it is a "reporting company") for a period of at least 12 calendar months beginning on or after January 1, 2017, and (2) filed at least one proxy statement that does not contain the pay ratio disclosure. The

[6] Under the final rule, when a registrant is relying on Instruction 1 of Item 402(c)(2)(iii) and (iv) of SEC Regulation S-K to omit the salary or bonus of the CEO because it is not calculable until a later date, the registrant may also omit the pay ratio disclosure until the salary or bonus component of its CEO's total compensation is determined. In such cases, the registrant must disclose (1) that the pay ratio is not calculable until the CEO's salary or bonus is determined and (2) the date on which the CEO's actual total compensation is expected to be determined.

final rule does not require registrants to disclose the pay ratio in a registration statement for an initial public offering.

A registrant that ceases to be a smaller reporting company or an emerging growth company will not be required to provide the pay ratio disclosure until its first full fiscal year that begins after exiting such status; however, no disclosure is required for any fiscal year commencing before January 1, 2017.

Registrants that merge with or acquire another company are not required to include the employees of the acquired entity in the calculation of the median employee until the first full fiscal year after the combination.

Connecting the Dots

A registrant with a fiscal year that ends on December 31 must provide its initial pay ratio disclosure (computed on the basis of 2017 compensation totals) in its 2018 proxy statement.

Permissibility of Providing Additional Information

Registrants may present additional ratios or other information to supplement the required ratio. For example, some registrants may want to disclose the pay ratio based solely on U.S. employees or salaried employees in addition to the required pay ratio. However, the final rule states that registrants that choose to provide such additional information must ensure that it is "clearly identified, not misleading, and not presented with greater prominence than the required ratio."

Connecting the Dots

Registrants may determine that disclosing additional pay ratios (e.g., based on the U.S. employee population only or full-time employees only) provides valuable additional context to their shareholders. We suggest that registrants disclose additional pay ratios only if they expect to continue to disclose the additional information in the future. Further, we recommend that registrants, before providing such disclosures, consider whether the supplemental pay ratios help explain their pay decisions to shareholders or whether the additional disclosures could result in an unintended reaction from shareholders, the media, or employees.

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