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SEC Guidance on Pay Ratio Disclosure

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On September 21, 2017, the U.S. Securities and Exchange Commission (SEC) adopted interpretive guidance to assist domestic reporting companies in their efforts to comply with the pay ratio disclosure required by item 402 of Regulation S-K under the *Securities Act of 1933*, as amended. On the same day, the SEC staff provided separate guidance on calculating the pay ratio disclosure. Domestic reporting companies must begin providing pay ratio disclosure for the first time in early 2018 for the fiscal year beginning on or after January 1, 2017.

Background

The pay ratio disclosure rule, which was adopted by the SEC in August 2015, requires domestic registrants (other than smaller reporting companies and emerging growth companies) to disclose the following: (i) the annual total compensation of the chief executive officer; (ii) the median of the annual total compensation of all other employees, which is calculated by identifying a registrant's "median employee"; and (iii) the ratio of the figures in (i) and (ii) expressed either as a ratio in which the median compensation of all other employees equals one or, narratively, as the multiple that the chief executive officer compensation bears to the median compensation of all other employees. Foreign private issuers, Canadian multijurisdictional disclosure system (MJDS) filers, smaller reporting companies and emerging growth companies are exempt from providing pay ratio disclosure.

Use of Reasonable Estimates, Assumptions and Methodologies, and Statistical Sampling

The pay ratio disclosure rule requires a registrant to identify its "median employee." Registrants have significant flexibility in determining the appropriate methodology to identify the median employee and calculating the median employee's annual total compensation. Registrants may choose a method based on their own facts and circumstances, including statistical sampling, but must disclose the method they use in identifying the median employee, as well as any material assumptions, adjustments and estimates used.

The SEC interpretive guidance clarifies that, so long as a registrant uses reasonable estimates, assumptions, statistical sampling or other methodologies, or a combination thereof, to identify the median employee and calculate the median employee's annual total compensation, the pay ratio disclosure that results from such use would not provide the basis for SEC enforcement action unless the disclosure was made or reaffirmed without a reasonable basis or was provided other than in good faith.

In addition, depending on the registrant's particular facts and circumstances, registrants may use sampling methods. Some examples of sampling methods that could be appropriate include (i) simple random sampling (i.e., drawing at random a certain number or proportion of employees from the entire employee population); (ii) stratified sampling (i.e., dividing the employee population into strata, based on location, business unit, type of employee, collective bargaining agreement or functional role and sampling within each strata); (iii) cluster sampling (i.e., dividing the employee population into clusters based on some criterion, drawing a subset of clusters, and sampling observations within appropriately selected clusters); and (iv) systematic sampling (i.e., having the sample drawn according to a random starting point and a fixed sampling interval, every nth employee is drawn from a listing of employees sorted on the basis of some criterion).

Use of Internal Records

The rule requires a registrant to disclose the median of the annual total compensation of all its employees (excluding its principal executive officer). All employees of a registrant and its consolidated subsidiaries worldwide must be taken into account in calculating such median, except that a registrant may exclude all employees outside the United States so long as the total number of excluded non-U.S. employees does not exceed 5% of the total number of employees worldwide.

The SEC interpretive guidance clarifies that

- a registrant may use appropriate existing internal records, such as tax or payroll records, in determining whether the 5% de minimis exemption is available;
- a registrant may use existing internal records in identifying its median employee even if such internal records do not include every element of compensation (such as equity awards widely distributed to employees) so long as such internal records reasonably reflect annual compensation to identify the median employee; and
- when a registrant determines that using a consistently applied compensation measure based on internal records results in anomalous characteristics of the identified median employee's compensation that have a significant higher or lower impact on the pay ratio, the registrant may, in lieu of concluding that such consistently applied compensation measure was unsuitable to identify its median employee, substitute another employee with substantially similar compensation to the original identified median employee based on the compensation measure such registrant used to select the median employee.

Determining Whether an Individual Is an "Employee"

An individual employed by the registrant or any of its consolidated subsidiaries is considered an "employee" under the rule. Workers who are employed, and whose compensation is determined, by an unaffiliated third party but who provide services to the registrant or its consolidated subsidiaries as independent contractors or "leased" workers are excluded. The SEC's guidance clarifies that, in determining whether a worker is an employee or independent contractor, a registrant may apply a widely recognized test under another area of law, such as employment or tax law, which the registrant uses to determine whether its workers are employees.

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