ALERT

October 4, 2017

# SEC ISSUES SIGNIFICANT GUIDANCE ON PAY RATIO DISCLOSURE RULES

On September 21 the SEC released several documents interpreting the pay ratio disclosure rules required under the Dodd-Frank Wall Street Reform and Consumer Protection Act ("Dodd-Frank"). In addition to implicitly confirming the widespread perception that the SEC plans to take no steps to modify the final regulations or delay implementation of the rule, the guidance provided some liberalization with respect to the procedures companies could use to compute the pay ratio. Notably, the SEC reversed its controversial position that, at least in some circumstances, independent contractors and leased workers had to be counted in computing the pay ratio.

## Background

Starting with proxy statements for fiscal years ending on or after December 31, 2017, Dodd-Frank requires a company to publish the ratio of its CEO pay to that of the median employee. Pay is computed using the complex rules applicable to calculating compensation in the Summary Compensation Table ("SCT"). While computing pay for one more employee is not a particularly daunting task, identifying the median employee in a company's worldwide population is much more of a challenge. The final SEC regulations in 2015 and supplemental guidance issued since then in the form of SEC Compliance and Disclosure Interpretations ("Pay Ratio CDIs") have done some good, but many companies have encountered numerous challenges as they have started to compute the ratio.

On September 21 the SEC took four actions with respect to the pay ratio rule, publishing a press release, a document entitled "Commission Guidance on Pay Ratio Disclosure" (the "Commission Guidance"), a document entitled "Division of Corporate Finance Guidance on Calculation of Pay Ratio Disclosure" (the "Corporate Finance Guidance"), and revising a portion of the Pay Ratio CDIs. These disclosures make it clear that the SEC has no intent to delay implementation of the pay ratio disclosure rules. The SEC also took several steps intended to make compliance less onerous.

This Alert will focus on what we consider the key components of the new guidance:

- Elimination of the requirement to count some independent contractors and leased workers
- Guidance regarding expanded use of existing internal records
- The SEC's announcement that enforcement actions would occur only in limited circumstances
- Additional SEC guidance with respect to use of estimates and sampling

We conclude with some practical observations drawn from our experience that companies may find helpful as they ramp up their efforts to compute the CEO pay ratio.

## Companies Are Not Required to Consider Whether Some Independent Contractors and Leased Workers Need to Be Treated as Employees

To the surprise of almost everybody, the SEC's final regulations and the subsequent Pay Ratio CDIs required independent contractors and leased workers to be counted as employees unless their pay was "determined" by "an unaffiliated third party." This position was extremely problematic because of difficulties in determining who was an independent contractor (the HR department may not even have the relevant records) and which entity was "determining" pay.

In its recent Commission Guidance the SEC effectively overruled its initial position by saying a company can determine its employees by electing to "apply a widely recognized test under another area of law that the registrant uses to determine whether its workers are employees." (Pay Ratio CDI 128C.05, which took a contrary position, was withdrawn.) In other words, a company can comply with the pay ratio rules by just looking at the individuals that it treats as employees for payroll tax purposes.

## Use of Existing Internal Records

Calculating the median employee's pay generally uses the complex SEC rules applicable to computing pay in the SCT. A company has much more flexibility, however, in defining compensation used to determine who the median employee is. Once the employee census has been determined (which can be determined as of any "determination date" within three months of the end of the fiscal year), choosing the median employee from among that population may be determined by using any "consistently applied compensation measure" ("CACM"). Previous SEC guidance had given several examples of what might or might not constitute a CACM.

While the previous Pay Ratio CDIs blessed the use of any measure that "reasonably reflected" annual compensation, they had suggested some limitations, in particular noting that total cash compensation could not be used if equity awards were widely distributed and that Social Security tax withholding could not be used unless all employees earned less than the Social Security wage base. In contrast, the recent Commission Guidance broadly states that "internal records that reasonably reflect annual compensation" can be used, "even if those records do not include every element of compensation, such as equity awards widely distributed to employees." Pay Ratio CDI 128C.01 was simultaneously amended to remove these exclusions. This change should be quite beneficial to companies that widely distribute equity awards since otherwise capturing the value of those awards involves potential issues in integrating the payroll system with the equity award recordkeeping system and determining the individual accounting values for those awards.

One question we have puzzled over is what the SEC means when it requires that the relevant internal records "reasonably reflect annual compensation." Our concern has two components. When compensation is computed under the SEC rules for the SCT, it is referred to in the Commission Guidance and the CDIs as "annual total compensation." The Commission Guidance (as well as the CDIs) use both the terms "annual total compensation" and "annual compensation" in different places, suggesting that the SEC may have something different in mind when it refers to "annual compensation." But we cannot find a definition. This is more than a dispute in semantics. For example, excluding equity awards for a senior executive can obviously produce a compensation number significantly lower than the number that would be produced under the SCT. But it is clearly permissible to exclude equity awards. Does this mean that "annual compensation" is a concept that excludes equity?

Until we can find more guidance, we think one potential interpretation of the "reasonably reflects annual compensation" language is that the company must reasonably conclude that using the relevant internal records will result in the selection of a median employee with compensation reasonably close to what would have occurred if the calculation had computed each employee's compensation in accordance with the SCT rules. So, for example, while ignoring equity awards for an individual will in many cases produce a compensation figure for an individual that is not reasonably close to the number produced by including the equity awards, a company can still reasonably conclude that the resulting median employee will be reasonably close to the employee that would have been selected if equity awards had been included.

## SEC Disinterest in Enforcement Actions

While it may be obvious that the overworked SEC has little interest in assigning staff to police pay ratio calculation, the SEC took pains in the Commission Guidance to reemphasize that fact. Specifically, the SEC stated that, no enforcement actions would be taken unless the disclosure was "made or reaffirmed without a reasonable basis or was provided other than in good faith."

The SEC's lack of enforcement interest is not paralleled by the plaintiffs' bar, however, which over the last decade has become increasingly resourceful in converting the proxy compensation disclosure rules into a revenue source. The instructions to the final regulations state that:

> "The registrant shall briefly describe the methodology it used to identify the median employee. It shall also briefly describe any material assumptions, adjustments (including any cost-of-living adjustments), or estimates it used to identify the median employee or to determine total compensation or any elements of total compensation, which shall be consistently applied. The registrant shall clearly identify any estimates used. The required descriptions should be a brief overview; it is not necessary for the registrant to provide technical analyses or formulas."

Regardless of the reasonableness of any estimates, companies should carefully draft their pay ratio disclosures to avoid potential lawsuits based on a failure-to-adequately-disclose theory.

## The Corporate Finance Guidance

Despite its four-page length, on balance it is not clear how much the Corporate Finance Guidance adds to what companies already understood to be the applicable rules with respect to using estimates and statistical sampling in computing the pay ratio rule. In fact, it may be argued that, to the extent a company thought it could use sampling techniques without investigating the characteristics of its own employee population, the Corporate Finance Guidance is restrictive.

Its general message is that companies may combine reasonable estimates with the use of statistical sampling or other reasonable methodologies (Q&A 1). Since the instructions to the final regulations had already referred to “statistical sampling and/or other reasonable methods,” it would seem that the authority to combine methods had already been announced. The guidance does, however, note that different methods can be used for different business units and geographies and perhaps that can be regarded as expansive.

A key consideration with respect to statistical sampling, as noted in the Commission Guidance, is whether the population being sampled has a normal distribution (the familiar bell-shaped curve) versus more exotic distributions, such as a lognormal, bimodal, beta, gamma or other distribution. The guidance also states that use of any distribution requires the company to determine that “the use of the assumption is appropriate given its own compensation distributions.” These references suggest that the SEC expects companies to have a detailed understanding of how compensation data variables are distributed at their companies if they rely on statistical sampling. For companies where the entire population for a compensation data variable is known, analysis can be performed, albeit it is a fairly complex process, to develop reasonable estimates for use in the statistical sampling process. However, when the characteristics of a population for a compensation data variable are not fully known, like in the case of some large, complex, global companies, it becomes much more difficult to make reasonable estimates because there needs to be factual basis for any basic assumptions or estimates. Thus, ironically, companies that need to use statistical sampling the most, need to know virtually as much about their compensation data as companies with full information.

For these reasons, statistical sampling may not ease the burden in the way many may have first hoped and may be why so few companies plan on using statistical sampling (the one exception is in situations where difficulties in obtaining payroll data leave no alternative to sampling). In hindsight, the better approach, from proposed rules to final implementation, may have been to solve any data issues caused by multiple payroll systems and to avoid sampling altogether. The widespread avoidance of sampling reminds us that, while the SEC has endorsed sampling as a technique starting with the proposed regulations in 2013, the SEC always acknowledged that sampling was not for everybody. The Economic Analysis of the proposed regulations acknowledged that only roughly half of companies covered by the pay ratio rule have an organizational structure characterized by “a compensation distribution that falls into a tractable statistical distribution category,” so we should not be surprised if the majority of our clients and other larger companies have “intractable” problems with sampling.

## Next Steps

Just in case anyone has not yet started computing their pay ratio, it is time to get going. Our experience suggests five principles companies may want to consider as a starting point. The following discussion assumes some familiarity with the final regulations and uses the dates applicable to a calendar year corporation. Of course, all rules have exceptions, so a different approach may be necessary for some companies. But we still think the principles are a good starting point for many companies, i.e., they should start with these principles and see whether their circumstances require modification.

- ***Principle One***—As our prior discussion indicates, the SEC intends to be forgiving in this first year of compliance. There are lots of gray areas in the regulations. As long as a company picks an interpretation that makes some sense (and explains it clearly in the proxy), we do not think there will be a problem. If there are various ways to interpret the SEC guidance and one is more reasonable than the other, that does not mean you cannot use the other one.

- ***Principle Two***—Does a company want the median employee to have high or low pay? Initially everyone assumed that the goal was to implement the rules in a way that resulted in choosing a median employee with the highest possible pay so as to hopefully lessen negative public reaction to a high pay ratio. We are finding the opposite in many cases: some employers worry about employees discovering they are paid below median. Unlike the children in Lake Wobegon, not all employees can be above average. An employer needs to decide at the outset what is more important, as there is flexibility under the SEC rules.

- ***Principle Three***—Apply the KISS ("keep it simple stupid") rule, the design rule coined at the Lockheed Skunk Works to remind engineers that simple systems work best. Follow this in the first year unless circumstances require otherwise. Do not use statistical sampling, do not make COLA adjustments, do not annualize pay, and do not use the 5% exclusion (unless the simplification gain is very clear cut). If nothing else, you will save time and money.

- ***Principle Four***—Use October 1 as your determination date and make it work. The rules permit a company to select its employees by looking at employees on the payroll on any date from October 1 through December 31, 2017. Why wait to December 31? Take October 1 data and get to work. This gives a company the most time to get the computation right. We realize this suggestion may significantly change the ratio for some companies with seasonal employees, but, before deciding on a later date, those companies should decide if it really matters (a December 31 date will lead to a lower ratio, so this inquiry involves the question of whether the company cares about a higher or lower ratio).

- ***Principle Five***—Pick a simple CACM to compute the compensation of your employees. We think the simplest periods over which to compute compensation are the nine months ending September 30 or calendar 2016. We think the simplest measures are W-2 compensation or cash compensation. Pick one of these combinations (the foreign rule does not have to be the same as the domestic rule). Ignore equity compensation.

While nothing is going to make computing the pay ratio fun, we think following these principles (with exceptions as appropriate) may help ease the pain.

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