PUBLICATION

CEO Pay Ratio Disclosure: Comparing CEO and Employee Compensation

Authors: Christopher Murray Douse
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In August 2015, the Securities and Exchange Commission (the SEC) adopted a final rule implementing Section 953(b) of the Dodd-Frank Act. The final rule requires U.S. public reporting companies to disclose the ratio of their principal executive officer's (the PEO) compensation to the compensation of their "median" employee. The final rule added Item 402(u) to Regulation S-K, so the new disclosure will appear in the executive compensation section of a company's Form 10-K or definitive proxy statement.

The instructions to Item 402(u) require certain registrants[1] to identify a "median" employee based on a "consistently applied compensation measurement," such as information derived from payroll or tax records. Then, a registrant must determine the annual total compensation of both the median employee and the PEO and disclose both amounts and report the ratio of the two amounts. A registrant may use a number of methodologies, including statistical sampling and consistently applied compensation measurements, to identify the median employee. A registrant also may rely on reasonable estimates to determine annual total compensation. A registrant must disclose any methodologies or estimates that it relies upon when identifying the median employee or calculating annual total compensation.

Non-exempt companies must comply with the pay ratio disclosure in their Form 10-K or definitive proxy statement for fiscal years beginning on or after January 1, 2017 (i.e., the 2018 proxy season). In anticipation of the effective date of the pay ratio rule, the SEC recently issued guidance to assist companies in their efforts to comply with Item 402(u). The SEC's guidance came in three parts: (1) interpretive guidance from the SEC, (2) staff guidance from the Division of Corporation Finance, and (3) updated Compliance and Disclosure Interpretations (C&DIs). Overall, the guidance explains key parts of the new pay ratio rule and is intended to potentially reduce the cost of compliance. Some important takeaways from the guidance are discussed below.

Reasonable Estimates and Methodologies

The SEC reiterated that the pay ratio rule affords companies significant flexibility when identifying the median employee and when calculating that employee's annual total compensation. The guidance, for example, indicates that a company may calculate its pay ratio using statistical sampling, reasonable estimates, or other reasonable methods. Because of this flexibility, the SEC will allow companies to describe their pay ratio as an "estimate" in their filings.

Further, the new guidance highlights that the SEC will not prescribe which methodologies a company should rely on when calculating its pay ratio. Instead, the SEC will allow companies to select a given method of calculating compensation based on the company's particular facts and circumstances. For instance, a company with global operations and numerous business units might choose a different approach to identifying its median employee than a company with only U.S. operations and a few business units.

Moreover, the new guidance provides useful examples of both statistical sampling and "reasonable estimates," which companies may use as a starting-place when calculating their pay ratio. For example, the SEC staff indicated that companies may rely on the following forms of statistical sampling:

- simple random sampling (drawing at random a certain number or proportion of employees from the entire employee population);
- stratified sampling (dividing employees into strata, e.g., based on location, business unit, or functional role and sampling within each strata);
- cluster sampling (dividing employees into clusters, drawing a subset of clusters, and sampling observations within appropriately selected clusters); and
- systematic sampling (drawing a sample according to a random starting point and a fixed sampling interval, e.g., every n^{th} employee is drawn from a listing of employees sorted on the basis of some criterion).

Further, the new guidance lists circumstances where a company may rely on reasonable estimates under the appropriate facts and circumstances, such as:

- analyzing the composition of the company's workforce (by geographic unit, business unit, or employee type);
- calculating a consistent measure of compensation and annual total compensation or elements of the annual total compensation of the median employee;
- identifying the median employee;
- identifying multiple employees around the middle of the compensation spectrum; and/or
- using the mid-point of a compensation range to estimate compensation.

Additionally, the final rule allows companies to rely on "other reasonable methods," besides statistical sampling and reasonable estimates, when determining the median employee. Similar to the other categories, the SEC purposefully left open the definition of "other reasonable methods" and opted to allow each company to customize an approach that best suits its own facts and circumstances.

Use of Internal Records

The instructions to Item 402(u) allow companies to rely on existing internal records, such as tax and payroll records, to identify their median employee. Many companies were reluctant to rely on such records because these records often do not reflect every element of a person's compensation. The SEC's new guidance, however, indicates that companies 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.

The SEC also changed C&DI 128C.01 to reflect its position on a company's reliance on internal records to identify its median employee. Specifically, the SEC deleted language that did not allow a company to use total cash compensation as a compensation measurement if it distributed equity awards among its employees. The SEC also removed language that warned against using withheld Social Security taxes as a compensation measurement unless all employees earned less than the Social Security wage base.

Lastly, the pay ratio rule defines the term "employee" to include U.S. employees and employees located in a jurisdiction outside the United States. The SEC acknowledged in the rule's release that the inclusion of non-U.S. employees would raise compliance costs for multinational companies. To address these concerns, the rule permits companies to exempt non-U.S. employees where the employees account for five percent or less of the registrant's total number of employees, with certain limits. In its recent guidance, the SEC clarified that its position on internal records also applies to this exemption. Therefore, companies may use "appropriate existing internal records, such as tax or payroll records," to determine if the five percent de minimis exception is available to them.

Substituting Employees

The new guidance reiterated that a company may substitute another employee with substantially similar compensation to an originally identified median employee if the latter's compensation has anomalous characteristics. For example, a company might identify a person as the "median employee" who has received an above-average bonus in that year due to exceptional performance. In that situation, the final rule allows a company to substitute another employee with substantially similar compensation based on the compensation measure it used to originally select the median employee.

Independent Contractors

The SEC's new guidance also clarifies the status of independent contractors. The final rule instructed companies to exclude independent contractors from the definition of "employee," because companies generally do not control the level of compensation that these workers receive. Many commenters expressed concern about identifying which workers were independent contractors instead of employees. Those commenters suggested allowing "widely-recognized tests" from other areas of the law, such as tax or employment law, to govern this determination.

The SEC adopted the position that a registrant may apply a "widely-recognized test" under another area of law to determine if a worker is an independent contractor. Previously, the SEC instructed companies to disregard whether a worker was classified as an employee under other areas of the law. The SEC made clear, however, in its recent guidance that it is abandoning that approach. Although the SEC did not explicitly adopt any test as controlling, it suggested the Internal Revenue Service's test as a potential candidate for determining if someone is an employee or independent contractor.

Enforcement

The SEC's new guidance acknowledges that calculating a company's pay ratio may involve a degree of imprecision because companies may use a variety of estimates and assumptions in the calculation. Significantly, the new guidance clarifies that this imprecision will not form the basis of an enforcement action unless a company discloses or affirms its pay ratio in bad faith or without a reasonable basis in fact.

In sum, companies should begin to prepare, if they have not done so already, to comply with the new pay ratio disclosure on their Form 10-K or definitive proxy statement covering the fiscal year beginning on or after January 1, 2017. The SEC's recent guidance gives companies significant flexibility in designing the appropriate methodology for calculating their pay ratio. If your company needs assistance understanding its obligations under the new pay ratio disclosure, or under any other aspect of the federal securities laws, please contact a member of Baker Donelson's Corporate Finance & Securities Group.

[1] The final rule and Item 402(u) exempt emerging growth companies, smaller reporting companies, and foreign private issuers. Also, registered investment companies are excluded from compliance with the pay ratio disclosure requirements.