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SEC Issues New Guidance to Help Companies Prepare CEO Pay Ratio Disclosures

The Securities and Exchange Commission recently issued new guidance to help companies prepare their pay ratio disclosures that provides some relief for companies—and further validates that these rules are highly unlikely to be deferred or reversed prior to the 2018 proxy season.

The pay ratio rules generally require U.S. public companies to disclose the following information:

- The median of the annual total compensation of all employees, excluding the chief executive officer;
- The annual total compensation of the CEO; and
- The ratio of these two totals.

In August 2015, the SEC adopted its final [rules](#) implementing Section 953(b) of the Dodd-Frank Act by adding a new Item 402(u) to Regulation S-K. Under these rules, public companies must first disclose their CEO pay ratio based on compensation paid for a company's first full fiscal year that begins on or after January 1, 2017, which means that calendar year-end companies will generally be required to include this disclosure in proxy statements (or annual reports on Form 10-K) starting in 2018.

The new guidance came primarily in a seven-page SEC [interpretive release](#) providing several needed clarifications, supplemented by five pages of SEC [staff guidance](#) and examples on calculation methodologies, and updated Compliance and Disclosure Interpretations ([C&DIs](#)) to conform to the new guidance.

This update highlights key points of the new guidance and offers practical advice.

Helpful New Guidance Clarifies Independent Contractor Exception

Pay Ratio Rules' Definition of "Employee" Not Exclusive. Recognizing the concern many companies and commenters have expressed about the rules' definition of "employee," especially as it relates to independent contractors, the SEC issued helpful new guidance that should ease compliance. Under the pay ratio rules, the term "employee" is defined as "an individual employed by the registrant or any of its consolidated subsidiaries" and excludes from the definition workers (such as independent contractors or "leased" workers) who are employed, and whose compensation is determined by, an unaffiliated third party. In its interpretive release, the SEC clarified that this provision was not intended to serve as an exclusive basis for determining whether a worker is an employee.

- **Companies Can Use Tax or Employment Law Definition of "Employee."** Noting that companies already make determinations about whether a worker is an employee or independent contractor in other legal and regulatory contexts, the SEC advised that a company can apply a widely recognized test under another area of law, such as employment or tax laws, that the company otherwise uses to determine whether its workers are employees. The SEC suggested that, as an example, companies could use guidance published by the Internal Revenue Service with respect to independent contractors, citing [IRS Publication 15-A, Employer's Supplemental Tax Guide \(2017\)](#).

Companies May Use Existing Internal Records to Identify Median Employee

The SEC's interpretive release also clarified how a company may use existing internal records to identify its median employee using a consistently applied compensation measure. The SEC clarified that companies may use existing internal records, such as tax or payroll records, in determining whether the 5% *de minimis*

exemption for non-U.S. employees is available. The SEC also clarified that companies may use existing internal records, such as tax or payroll 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).

- **Companies May Substitute if Median Employee Has Anomalous Compensation.** Recognizing that this method may result in the identification of a median employee whose compensation has anomalous characteristics, the SEC reinforced its guidance in the adopting release that companies may substitute another employee with substantially similar compensation based on the compensation measure used to select the median employee. Disclosure of this substitution must be included in the company's discussion of the methodology used to identify the median employee.

SEC Encourages Companies to Use Reasonable Estimates, Assumptions and Methodologies

As noted above, the pay ratio rules give companies the flexibility to use reasonable estimates to identify the median employee (including using statistical sampling and a consistently applied compensation measure, such as payroll or tax records). Companies are also allowed to use reasonable estimates in calculating the annual total compensation for employees. In its interpretive release, the SEC recognized that this ability to use estimates, assumptions and statistical sampling has raised some concern about potential liability due to the imprecision of the results. The SEC encouraged companies to take advantage of the flexibility provided in the rule by offering its view that use of reasonable estimates, assumptions or methodologies in its pay ratio calculations and disclosures would not provide the basis for an enforcement action by the SEC, unless the disclosure was made without a reasonable basis or other than in good faith.

- **SEC Staff Q&A Includes Illustrations and Hypothetical Examples.** To supplement the SEC's interpretive release, the SEC staff also released guidance in Q&A format, showcasing the broad flexibility under the rules on using statistical sampling methodologies and other reasonable methods (or a combination of both), including illustrations and hypothetical examples for companies with more complex workforces.

SEC Staff Updates C&DIs to Conform to New Guidance

The SEC staff further supplemented the SEC's guidance by updating the Regulation S-K C&DIs, including by:

- updating an existing C&DI (128C.01) by deleting references that previously indicated that total cash compensation might not be an adequate consistently applied compensation measure for a company that distributed annual equity awards widely,
- adding a new C&DI (128C.06) to provide that a company may describe its pay ratio as a "reasonable estimate," and
- withdrawing a prior C&DI (128C.05) on independent contractors.

Practical Tips

Companies Should Document Independent Contractor Determinations. Companies should document their assessments of independent contractor determinations, especially with respect to workers in foreign countries, to facilitate consistently replicating this analysis for future pay ratio calculations, as well as for internal backup purposes.

Companies Should Revisit Method for Identifying Median Employee. Companies that may have structured their process for identifying the median employee based on the prior guidance should revisit their process and

consider whether to make changes based on the new guidance. For example, a company may want to consider using "total cash compensation" as its consistently applied compensation measure, even if the company widely distributes annual equity awards.

Companies Should Strive to Streamline Pay Ratio Processes Where Practicable. Although the SEC's new pay ratio guidance encourages companies to take advantage of the various alternatives for flexibility in using reasonable estimates, assumptions and methodologies, companies should keep in mind that they will have to describe their process in SEC filings. Companies should consider whether their process can be simplified for purposes of reducing the length and complexity of their disclosure, and also considering the message that this disclosure sends to shareholders, advisory groups and employees.

Additional Information

For additional information on the SEC's pay ratio rules, please reference the following resources:

- The [SEC release adopting the final pay ratio rules](#)
- The [SEC's pay ratio interpretive release](#)
- The [SEC staff guidance](#) on pay ratio and examples of calculation methodologies
- Updated pay ratio [Compliance and Disclosure Interpretations](#) (C&DIs)

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