

Client Alert

SEC Issues CEO Pay Ratio Guidance

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On September 21, 2017, the Securities and Exchange Commission (SEC) released several items providing additional guidance regarding the CEO Pay Ratio. The SEC issued a press release¹ announcing an interpretative release,² guidance from the Division of Corporation Finance,³ modified and withdrew existing Compliance and Disclosure Interpretations (C&DIs), and released a new C&DI.⁴

Interpretative Release

The guidance in the Interpretative Release basically boils down to, “We meant what we said in the final rule, primarily that the ratio is not intended to be compared to the ratios of other companies and the Commission intends to provide significant flexibility to reduce the costs and administrative burden.” The release provides guidance on:

- The use of reasonable estimates, assumptions, and methodologies and statistical sampling and clarifies that the pay ratio and related disclosure from such use would not be a basis for Commission enforcement action unless the disclosure was made or reaffirmed without a reasonable basis or was provided other than in good faith. Although this is good news, it may not address the liability issue that may arise from potential shareholder lawsuits.
- The use of internal records:
 - Companies may use internal records to identify the median employee, even if those internal records do not include every element of compensation.
 - Companies can use internal records to determine whether the 5% *de minimis* non-U.S. employee exemption is available.
- How companies can identify who is an employee for purposes of applying the CEO Pay Ratio Disclosure rule, i.e., can apply a widely recognized test under another area of law that the company otherwise uses, e.g., for employment law or tax purposes, to determine whether its workers are employees. The withdrawn C&DI had indicated a more narrow standard.

¹ SEC Adopts Interpretative Guidance on Pay Ratio Rule, 2017-172 (September 21, 2017), available at: <https://www.sec.gov/news/press-release/2017-172>.

² SEC Release, Commission Guidance on Pay Ratio Disclosure, SEC Release No. 33-10415; 34-81673; File No. S7-07-13 (September 21, 2017), available at: <https://www.sec.gov/rules/interp/2017/33-10415.pdf> (Interpretive Release).

³ Division of Corporation Finance Guidance on Calculation of Pay Ratio Disclosure, September 21, 2017, available at: <https://www.sec.gov/corpfin/announcement/guidance-calculation-pay-ratio-disclosure>.

⁴ See Questions 128C.01 (modified), 128C.05 (withdrawn), and 128C.06 (new), Section 128C-Item 402(u) Pay Ratio Disclosure, Compliance & Disclosure Interpretations, September 21, 2017, available at: <https://www.sec.gov/divisions/corpfin/guidance/regs-kinterp.htm#128c.01>.

Division of Corporation Finance Guidance

The guidance released by the Division of Corporation Finance focuses on the use of sampling and other reasonable methodologies to identify the median employee. The primary message in this guidance release is “we understand the need for flexibility and we are permitting broad flexibility.” Specifically, the guidance:

- Clarifies that companies may combine the use of reasonable estimates with the use of statistical sampling or other reasonable methodologies;
- Provides examples of sampling methods that companies may use;
- Provides examples of situations where companies may use reasonable estimates;
- Provides examples of other reasonable methodologies companies may use and indicates that a combination of reasonable methodologies may be employed; and
- Provides examples of the use of reasonable estimates, statistical sampling, and other reasonable methods.

C&DIs

As for the C&DIs, the SEC modified one C&DI, issued a new C&DI, and withdrew an existing C&DI.

The modified C&DI, Question 128C.01, makes clear that if a company does not use annual total compensation under the proxy disclosure rules to identify the median employee, it can select another consistently applied compensation measure (CACM) to identify the median employee. Any measure that reasonably reflects the annual compensation of employees could serve as a CACM, even if it does not include every element of compensation.

The new C&DI, Question 128C.06, permits companies to describe the pay ratio as a reasonable estimate calculated in a manner consistent with Item 402(u) of Regulation S-K in their disclosures without fear that the SEC would object to such a characterization.

The withdrawn C&DI, Question 128C.05, provided that a company was required to include workers whose compensation it determined, regardless of any classification determination under employment or tax rules. This retraction was necessary given the new guidance in the Interpretative Release regarding how companies can identify employees for purposes of the CEO Pay Ratio rule.



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