

Meridian Client Update

SEC Issues New Guidance on CEO Pay Ratio Disclosure Rule

Last Thursday, the Securities and Exchange Commission (SEC) and the Division of Corporation Finance issued new guidance on the CEO pay ratio disclosure rule. The issuance of the new guidance lays to rest any remaining hope that the SEC will delay or significantly modify the CEO pay ratio disclosure requirement.

Public companies and practitioners who were hoping for a comprehensive set of new guidance to address many of the vexing issues underlying the pay ratio rule generally will be disappointed by the limited nature of the guidance. However, the guidance does include a number of important elements that should help to facilitate registrants' implementation of the pay ratio disclosure requirement.

SEC Guidance on Pay Ratio Disclosure

The SEC's interpretative guidance, which carries the weight of law, covers the following four areas – each of which is discussed below: (i) use of reasonable estimates, assumptions, methodologies and statistical sampling, (ii) 5% de minimis exception, (iii) consistently applied compensation measures and (iv) "employee" status.

- **Use of Reasonable Estimates, Assumptions, Methodologies and Statistical Sampling.** The pay ratio rule affords registrants significant flexibility in determining appropriate methodologies to identify the median employee and to calculate the median employee's annual total compensation. In particular, the rule allows registrants to develop the pay ratio disclosure based on reasonable estimates, assumptions and methodologies, including the use of statistical sampling techniques. This flexibility is intended to facilitate the implementation of the pay ratio disclosure; however, registrants are left to determine whether any chosen estimate, assumption or methodology is "reasonable."

The SEC's interpretative guidance indirectly addresses registrants' concerns about reasonableness by implementing a relatively high bar for enforcement action. The interpretive guidance provides the following:

"if a registrant uses reasonable estimates, assumptions or methodologies, the pay ratio and related disclosure that results from such use would not provide the basis for Commission enforcement action unless the disclosure was made or reaffirmed without a reasonable basis or was provided other than in good faith."

Put another way, this means that a registrant would be subject to a potential SEC enforcement action only if its use of reasonable estimates, assumptions or methodologies were made on an unreasonable basis or in bad faith.

- **5% De Minimis Exemption.** The pay ratio rule defines the term "employee" to include U.S. employees and employees located in a jurisdiction outside the United States ("non-U.S. employees"). The pay ratio rule permits registrants to exempt non-U.S. employees where these employees account for 5% or less of

the registrant's total global employee population, with certain limitations. The SEC's interpretive guidance provides 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.

- **Consistently Applied Compensation Measures.** The pay ratio rule permits a registrant to identify from its covered employee population its median employee using a consistently applied compensation measure ("CACM"). The SEC's interpretive guidance provides that a registrant 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 widely distributed to employees.

This represents a significant departure from the SEC staff guidance issued in October 2016, which suggested that a CACM must include any widely distributed compensation element. By way of example, the staff guidance noted that a registrant may use total cash compensation as a CACM, *unless* the registrant also distributed annual equity awards widely among its employees. The SEC's interpretive guidance flatly rejects this notion that a CACM must include every widely distributed pay component.

For example, the SEC's interpretive guidance paves the way for registrants to use base salary as a CACM, regardless of whether annual incentive compensation and/or long-term incentive compensation is widely distributed to employees.

- **"Employee" Status.** The pay ratio rule requires a registrant to identify the median employee from its worldwide employee workforce, subject to applicable exclusions. The pay ratio rule defines the term "employee" as "an individual employed by the registrant or any of its consolidated subsidiaries." Excluded from this definition are those 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. Some registrants have found the definition of who is not an employee problematic in application.

To address these concerns, the SEC's interpretive guidance provides that the pay ratio rule definitions of who is and who is not an employee were "not intended to serve as an exclusive basis for determining whether a worker is an employee of a registrant." The interpretive guidance will allow a registrant "to apply any widely recognized test under another area of law that the registrant otherwise uses to determine whether its workers are employees." For example, the interpretive guidance permits a registrant to determine employee/independent contractor status based on the definitions under federal tax laws or U.S. federal employment laws.

Division of Corporation Finance Guidance on Calculation of Pay Ratio

The SEC Division of Corporation Finance guidance covers the use of statistical sampling methodologies and other reasonable methods for determining the pay ratio disclosure. This guidance, which does not carry the weight of law, is summarized below.

- **Combination of reasonable estimates and statistical sampling.** A registrant may combine the use of reasonable estimates with the use of statistical sampling or other reasonable methodologies for purposes of determining the covered employee population from which to identify the median employee.
- **Combination of sampling methods.** A registrant is permitted to use a combination of sampling methods (e.g., simple random sampling, stratified sampling, cluster sampling, systemic sampling).

- **Use of reasonable estimates.** A registrant may use reasonable estimates under the appropriate facts and circumstances that include, but are not limited to:
 - analyzing the composition of the registrant's workforce (by geographic unit, business unit, employee type),
 - characterizing the statistical distribution of compensation of the registrant's employees and its parameters (e.g., a lognormal, beta, gamma or another distribution, or a mixture of distributions—for example a mixture of two normal or lognormal distributions yielding a bimodal distribution),
 - calculating a consistent measure of compensation and annual total compensation or elements of the annual total compensation of the median employee,
 - evaluating the likelihood of significant changes in employee compensation from year to year,
 - identifying the median employee,
 - identifying multiple employees around the middle of the compensation spectrum, and
 - using the mid-point of a compensation range to estimate compensation.

- **Use of statistical techniques and methodologies.** Common statistical techniques and methodologies a registrant may consider include, but are not limited to:
 - making one or more distributional assumptions, such as assuming a lognormal or another distribution provided that the registrant has determined that the use of the assumption is appropriate given its own compensation distributions,
 - reasonable methods of imputing or correcting missing values, and
 - reasonable methods of addressing extreme observations, such as outliers.

The Division of Corporation Finance also issued a new Compliance & Disclosure Interpretations (C&DI) 128C.06 which allows a registrant to state that its pay ratio disclosure is a reasonable estimate calculated in a manner consistent with SEC Item 402(u) of Regulation S-K.

Lastly, to conform with the SEC's interpretative guidance, the Division of Corporation Finance revised its previously issued guidance on the use of consistently applied compensation measure (i.e., C&DI 128C.01) and withdrew its guidance on the determination of whether a worker is an employee of a registrant (C&DI 128C.05).

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