

SIDLEY UPDATE

SEC Provides Further Guidance on Pay Ratio Disclosure Rule Companies Are Strongly Encouraged to Take Advantage of the Rule's Flexibility to Reduce Compliance Costs

Yesterday, the Securities and Exchange Commission (SEC) published guidance to assist companies as they prepare for compliance with the CEO pay ratio disclosure rule. Taken as a whole, the guidance makes clear that companies have substantial flexibility in developing their response to the new disclosure requirement. For calendar year-end companies, the first pay ratio disclosure will be required in their 2018 annual meeting proxy statements and will be based on 2017 compensation.

The new guidance on the pay ratio rule took three different forms. First, the SEC released [interpretive guidance](#), which SEC Chair Jay Clayton noted “reflects the feedback the SEC has received and encourages companies to use the flexibility incorporated in [the rule] to reduce costs of compliance.” Separately, the Staff of the SEC’s Division of Corporation Finance (the Division Staff) published [guidance](#) (including hypothetical examples) on the use of statistical sampling and other reasonable methods to assist companies in determining the median employee for purposes of calculating the pay ratio. Finally, the Division Staff modified the pay ratio disclosure Compliance & Disclosure Interpretations (C&DIs) in light of the interpretive guidance and added one new C&DI. The full text of the C&DIs is available [here](#).

The new guidance underscores that companies have broad latitude in complying with the disclosure requirement. The proposed sampling techniques and hypothetical examples will be particularly helpful to companies as they devise strategies for identifying the median employee’s total compensation. The key takeaways from the new guidance are summarized below. For a detailed description of the rule and previous guidance issued by the Division Staff, see our [August 2015 Sidley Update](#) and our [October 2016 Sidley Update](#).

SEC Interpretive Guidance

- *High Bar for Potential Liability.* The SEC confirmed that, if a company uses reasonable estimates, assumptions or methodologies to calculate the pay ratio, then the pay ratio and related disclosure would not form the basis for an SEC enforcement action unless the company provides or reaffirms the disclosure without a reasonable basis or the disclosure was provided other than in good faith.
- *Use of Internal Records.* The SEC made the following clarifications with respect to the use of appropriate existing internal records (e.g., tax or payroll records) to determine the annual total compensation of the median employee:
 - A company may use internal records that reasonably reflect annual compensation to identify the median employee even if such records do not include every element of compensation (e.g., equity awards widely distributed to employees). (Previous guidance had indicated that total cash compensation could be a consistently applied compensation measure unless the company also distributed annual equity awards widely among its employees.)

- If a company identifies a median employee using a consistently applied compensation measure based on internal records and determines that there are anomalous characteristics of the identified median employee's compensation that have a significant impact on the pay ratio, then the company may substitute another employee with substantially similar compensation to the originally identified median employee based on the compensation measure it used to select the median employee.
- A company may use internal records when determining whether it can rely on the rule's 5% *de minimis* exemption for non-U.S. employees.
- *Use of Widely Recognized Tests.* Contrary to previous guidance, the SEC confirmed that, for purposes of the pay ratio rule, a company may apply a widely recognized test that it uses to determine whether its workers are employees under another area of law such as for tax or employment law purposes (e.g., IRS guidance with respect to independent contractors).

Guidance from the Division Staff

- *Combining Statistical Sampling and Other Reasonable Methods.* The pay ratio rule permits a company to use its employee population or a statistical sampling and/or other reasonable methods in determining the median employee. The Division Staff clarified that companies are permitted to use a combination of statistical sampling and other reasonable methods to determine the median employee.

Example of Combining Statistical Sampling and Other Reasonable Methods	
A company with multinational operations or multiple business lines may use sampling for some geographic/business units and a combination of other methodologies and reasonable estimates for other geographic/business units.	

- *Statistical Sampling Techniques.* The Division Staff clarified that companies are permitted to use a combination of statistical sampling approaches to determine the median employee and provided the following non-exhaustive list of examples.

Examples of Statistical Sampling Techniques	
Simple Random Sampling	Drawing at random a certain number or proportion of employees from the entire employee population
Stratified Sampling	Dividing the employee population into strata (e.g., based on location, business unit, type of employee, collective bargaining agreement or functional role) and sampling within each strata
Cluster Sampling	Dividing the employee population into clusters based on some criterion, drawing a subset of clusters, and sampling observations within appropriately selected clusters; may be conducted in one or multiple stages
Systematic Sampling	The sample is drawn according to a random starting point and a fixed sampling interval, every n th employee is drawn from a listing of employees sorted on the basis of some criterion

- *Use of Reasonable Estimates.* The Division Staff reiterated that the rule permits companies to use reasonable estimates both in the methodology used to identify the median employee and in calculating the annual total compensation (or any elements thereof) for employees. It provided the following non-exhaustive list of examples of situations in which a company may use reasonable estimates.

Examples of Situations in Which a Company May Use Reasonable Estimates	
Analyzing the composition of the company's workforce (e.g., by geographic unit, business unit or employee type)	
Characterizing the statistical distribution of compensation of the company's employees and its parameters (e.g., a lognormal, beta, gamma or another distribution, or a mixture of	

distributions such as 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
Using the mid-point of a compensation range to estimate compensation

- *Other Reasonable Methods.* The Division Staff clarified that companies are permitted to use other reasonable methods in determining the employees from which the median employee is identified. It provided the following non-exhaustive list of examples of common statistical techniques and methodologies companies may consider.

Examples of Reasonable Methods
Making one or more distributional assumptions (e.g., assuming a lognormal or another distribution provided that the company has determined that the use of the assumption is appropriate given its own compensation distributions)
Reasonable methods of imputing or correcting missing values
Reasonable methods of addressing extreme observations (e.g., outliers)

The Division Staff's guidance also includes three helpful hypothetical examples that illustrate how a company with employees outside of the U.S. and/or multiple business units may use reasonable estimates, statistical sampling and other reasonable methods to identify its median employee.

Pay Ratio Disclosure C&DIs

The Division Staff modified its C&DIs relating to the pay ratio rule in light of the SEC's new interpretive guidance. Specifically, the Division Staff revised Question 128C.01 to reflect the interpretive guidance and withdrew Question 128C.05, which has been superseded. Importantly, acknowledging that "pay ratio disclosures may involve a degree of imprecision," the Division Staff added new Question 128C.06 indicating that it will not object if a company describes its pay ratio as "a reasonable estimate calculated in a manner consistent with Item 402(u)."

If you have any questions regarding this Sidley Update, please contact the Sidley lawyer with whom you usually work, or

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