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Pay Ratio Is Still Here—The Relief Is New SEC Guidance That Offers Latitude

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Pay ratio is still here. If you thought pay ratio was out the door when the new presidential administration came through in January of this year, you are not alone. However, the pay ratio rule has not been repealed by Congress. Instead, the Securities and Exchange Commission (SEC) has provided some new guidance that may provide relief for companies that have been preparing for the pay ratio disclosures for more than a year now.

Under Item 402(u) of Regulation S-K, the pay ratio rule, beginning early 2018, public companies must disclose the median of the annual total compensation of all employees (other than the CEO), the CEO's annual total compensation, and the ratio between the two, referred to in this article as the pay ratio.

In February 2017, then acting chairman of the SEC, Michael S. Piwowar, asked the public to provide feedback on unexpected challenges posed in calculating the pay ratio. As a result of the feedback, on Sept. 21, the SEC issued helpful direction in the form of an interpretive guidance, staff guidance (which includes hypothetical examples), a modification of an existing compliance and a disclosure interpretation (C&DI), the withdrawal of an existing C&DI and the addition of a new C&DI, collectively referred to in this article as the new guidance. The new guidance should assist public companies to comply with the pay ratio rule and reduce the cost of disclosure. In particular, the new guidance covers areas including the use of reasonable estimates, assumptions and methodologies and statistical sampling, the use of internal records, and the use of widely recognized tests for determination of who is the employee. Collectively, the new guidance offers significant latitude in providing the required pay ratio disclosure.

USE OF REASONABLE ESTIMATES, ASSUMPTIONS, AND METHODOLOGIES AND STATISTICAL SAMPLING

The SEC designed the pay ratio rule to provide public companies with flexibility in calculating the pay ratio. A company may calculate the pay ratio based on the use of reasonable estimates, assumptions, and methodologies and reasonable efforts. Nevertheless, there remained uncertainty about whether methods used would be compliant with the pay ratio rule. With the new guidance, the SEC provides that if a company uses reasonable estimates, assumptions or methodologies, the SEC would not seek enforcement action with respect to the resulting pay ratio disclosure unless the disclosure was made or reaffirmed without a reasonable basis or the disclosure was not provided in good faith. While not binding on any court, the SEC's position should provide some relief to companies given the high threshold for potential liability.

The guidance also indicates that a company may combine the use of reasonable estimates with the use of statistical sampling or other reasonable methodologies. For example, a company with international operations or multiple business lines may use sampling for some geographic or business units and combine other methods and reasonable estimates for other geographic or business units. The SEC also offered a nonexclusive list of acceptable types of sampling methods, which can also be combined. Such acceptable methods included simple random sampling, stratified sampling, cluster sampling and systematic sampling. The SEC further acknowledged that the use of estimates, assumptions, adjustments and statistical sampling involves a degree of "imprecision" and indicated that it would not object if a company characterizes the pay ratio as a "reasonable estimate." We expect that the SEC's expansive view on statistical sampling, in particular, will lead to more companies using statistical sampling than originally anticipated.

USE OF INTERNAL RECORDS

The pay ratio rule allows a company to determine its "median employee" using a consistently applied compensation measure (CACM), such as compensation information found in payroll or tax records. The new guidance provides that a company may use internal records that reasonably reflect annual compensation to identify the median employee, whether or not those records include every element of compensation, such as equity awards. This means that a company that uses equity awards to compensate employees may nonetheless use cash compensation from its internal records if the records reasonably reflect annual compensation. This position is contrary to the previous SEC guidance which had stated that cash compensation could not be a CACM if equity awards were widely distributed.

Significantly, the new guidance also gives companies the ability to substitute another employee with substantially similar compensation to the originally identified median employee based on the same CACM if the company determines that there are anomalous characteristics of the originally identified median employee's compensation that could significantly impact the pay ratio. For instance, if the originally identified median employee earns a higher than usual bonus, rather than determining that the CACM that was used was inappropriate and using an alternative CACM, the company may substitute the employee with a new median employee who has substantially similar compensation based on the CACM that was used.

USE OF WIDELY RECOGNIZED TESTS FOR DETERMINATION OF EMPLOYEE

The pay ratio rule excludes from the definition of "employee" individuals whose compensation is determined by an unaffiliated third party but who provide services to a company as independent contractors or leased workers. In contrast to prior guidance, the new guidance confirms that this provision is not the exclusive basis for determining whether an individual is an "employee" and that companies may apply a widely recognized test under another area of law, such as IRS guidelines or employment law, to make the determination.

THE ROAD AHEAD

While the new guidance from the SEC should alleviate compliance concerns, some hurdles and uncertainties still remain with respect to the pay ratio disclosure. Interestingly, a recent Willis Towers Watson poll found that what most companies find most challenging is not how to determine the pay ratio, but rather how to deal with employee reactions to the pay ratio disclosure. Companies should be prepared to address potential negative reactions from their employees, other stakeholders and the media. In light of potential negative reactions, companies are cautioned to develop a communication plan ahead of disclosure. Companies should carefully consider the level of disclosure and explanation around the pay ratio to thwart some of these negative reactions without being misleading. With the inaugural disclosure of the pay ratio due this upcoming 2018 proxy season, companies, their stakeholders and practitioners alike will be monitoring and analyzing the disclosure practices and trends that will emerge.

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