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Updated SEC Guidance Emphasizes Flexibility in Complying with Pay Ratio Disclosure Rule

Sep 29, 2017

Reading Time : **2 min**

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The Securities and Exchange Commission (SEC) and the staff of the SEC's Division of Corporation Finance (the "Staff") recently published updated guidance on the pay ratio rule. This new guidance emphasizes that this rule is intended to be flexible and give companies certain latitude in calculating the pay ratio.

In this spirit, the guidance provides for the following:

- The use of estimates to determine the median employee and the annual total compensation of employees would not provide a basis for an SEC enforcement action, unless the resulting disclosure was made without a reasonable basis and was not provided in good faith.
- The median employee can be identified using internal records that reasonably reflect annual compensation and that do not necessarily include every element of compensation, such as equity awards that are widely distributed to employees. Likewise, the availability of the 5 percent exemption can be determined using appropriate existing internal records.
- Reasonable estimates used may be based on a combination of statistical sampling and/or other reasonable methodologies:
    - Sampling methodology that may be appropriate to use alone or in combination includes, but is not limited to, (i) drawing at random a certain number or proportion of employees from the entire employee population; (ii) dividing the employee population into strata based on location, business unit, employee type, collective bargaining agreement or functional role, and

sampling within each strata; (iii) dividing the employee population into clusters based on some criterion, drawing a subset of clusters and sampling observations within appropriately selected clusters; and (iv) drawing a sample according to a random starting point and a fixed sampling interval, and then drawing every “n^{th}” employee from a listing of employees sorted on the basis of some criterion.
    - Other reasonable methodologies include, but are not limited to, (i) making one or more distributional assumptions, such as 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; (ii) reasonable methods of imputing or correcting missing values; and (iii) reasonable methods of addressing extreme observations, such as outliers.
- Classification of independent contractors and “leased” workers may be based on flexible criteria. The new SEC guidance provides that a company may apply a widely recognized test under another area of law that the company otherwise uses to determine whether its workers are employees, in contrast with the Staff’s guidance in the October 2016 Compliance & Disclosure Interpretation (C&DI) 128C.05 that a registrant should include those workers whose compensation it determines, regardless of whether these workers would be considered “employees” for tax or employment law purposes or under other definitions of that term. Consistent with this updated SEC view, that C&DI has been withdrawn.

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