Simpson Thacher

Memorandum

SEC Issues Updated Guidance on Pay Ratio Disclosure

September 22, 2017

On September 21, 2017, the Securities and Exchange Commission (the "SEC") released updated interpretive guidance with respect to the pay ratio disclosure requirement codified in Item 402(u) of Regulation S-K, while the staff of the SEC's Division of Corporation Finance issued revised Compliance and Disclosure Interpretations ("C&DIs") related to the pay ratio requirement.[1] In addition, the SEC staff separately issued new guidance with respect to use of statistical sampling and other methods in determining a company's "median employee" under the pay ratio rule.[2] On the whole, the updated guidance suggests that the SEC, concerned with companies' cost of compliance, is eager to provide registrants additional flexibility in determining how to comply with the pay ratio requirement.

In particular, the SEC's new guidance:

1. States the SEC's views on the use of reasonable estimates, assumptions, methodologies and statistical sampling permitted by the rule;

2. Clarifies that a company may use appropriate existing internal records, such as tax and payroll records, in evaluating the inclusion of non-employees and identifying the median employee; and

3. Indicates that companies may use widely recognized tests, such as for employment law or for tax purposes, in order to determine whether workers are "employees" for purposes of the pay ratio rule.

[1] *See* Commission Guidance on Pay Ratio Disclosure (Sept. 21, 2017) and Compliance and Disclosure Interpretations on Regulation S-K, Section 128C. *See* also Annex A, which reflects changes to the SEC staff's prior pay ratio C&DIs. For a summary of the SEC's final rule on pay ratio disclosure and the SEC's earlier interpretative guidance, *see* Simpson Thacher & Bartlett LLP, "SEC Issues Rule on Pay Ratio Disclosure" (Aug. 25, 2015) and "SEC Issues Guidance on Pay Ratio Disclosure" (Oct. 24, 2016).

[2] *See* Division of Corporation Finance Guidance on Calculation of Pay Ratio Disclosure (Sept. 21, 2017).

I. Use of Reasonable Estimates, Assumptions, Methodologies and Statistical Sampling

The SEC's new guidance underscores that the pay ratio rule affords "significant flexibility to registrants in determining appropriate methodologies to identify the median employee and calculating the median employee's annual total compensation." In response to concerns that the imprecision associated with the preparation of pay ratio disclosure may lead to potential liability, the new guidance states that, in the view of the SEC, "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 unless the disclosure was made or reaffirmed without a reasonable basis or was provided other than in good faith." One of the new C&DIs further states that "the staff would not object if a registrant states in any required disclosure that the pay ratio is a reasonable estimate calculated in a manner consistent with Item 402(u)."

II. Use of Internal Records

Item 402(u) of Regulation S-K requires registrants to identify the company's median employee using annual total compensation or another consistently applied compensation measure ("CACM"). The SEC's new guidance clarifies that, instead of having to implement new systems to capture the relevant data to determine the median employee, registrants may use appropriate existing internal records, such as tax or payroll records, to help make this determination. For example, Item 402(u)(4)(ii) of Regulation S-K currently provides that registrants may exempt from the definition of "employees" those non-U.S. employees that account for 5% or less of the registrant's total U.S. and non-U.S. employees, with certain limitations. According to the SEC's new guidance, "a registrant may use appropriate existing internal records, such as tax or payroll records, in determining whether the 5% *de minimis* exemption is available."

The SEC's new guidance also provides that, when determining the median employee, "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 guidance represents a shift in thinking by the SEC staff, which previously suggested that the use of total cash compensation could not be used as a CACM to determine the median employee if the registrant distributed annual equity awards widely among its employees.

According to the SEC's new guidance, this updated approach may lead to the identification of a median employee that has anomalous compensation characteristics but that, consistent with the adopting release, registrants "may substitute another employee with substantially similar compensation to the original identified median employee based on the compensation measure it used to select the median employee."

III. Independent Contractors

Pursuant to Item 402(u)(3) of Regulation S-K, the universe of employees from which the median employee must be identified under the pay ratio rule excludes 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". In a previous C&DI interpreting this provision, the SEC staff had stated that "a registrant should include those workers whose compensation it or one of its consolidated subsidiaries determines regardless of whether these workers would be considered 'employees' for tax or employment law purposes or under other definitions of that term."

The SEC's new guidance reverses the initial guidance and now indicates that the provision in Item 402(u)(3) "was not intended to serve as an exclusive basis for determining whether a worker is an employee of the registrant" and that it would be consistent with the rule for "a registrant to apply a widely recognized test under another area of law that the registrant otherwise uses to determine whether its workers are employees," e.g., for employment law or tax purposes. In light of this updated guidance, the SEC staff has withdrawn the previous C&DI.

Discussion

While many companies' processes for complying with the pay ratio disclosure requirement are already well underway, the SEC's new guidance should be well received by issuers, as it suggests that the SEC staff will be reasonable in assessing compliance with the rule's requirements, as long as a company makes a good faith and reasonable effort.

If you have any questions or would like additional information, please do not hesitate to contact **Karen Hsu Kelley** at +1-212-455-2408 or kkelley@stblaw.com, or any other member of the Firm's Public Company Advisory Practice.

Annex A

Question 128C.01

Question: If a registrant does not use annual total compensation calculated using Item 402(c)(2)(x) of Regulation S-K ("annual total compensation") to identify the median employee, how should a registrant select another consistently applied compensation measure ("CACM") to identify the median employee?

Answer: Item 402(u) requires registrants to identify the median employee using annual total compensation or another CACM, such as information derived from the registrant's tax and/or payroll records. Because of concerns about the expected compliance costs if registrants had been required to calculate annual total compensation for all employees, the Commission permitted registrants to use a CACM other than annual total compensation as a reasonable alternative to identifying the median employee. Any measure that reasonably reflects the annual compensation of employees could serve as a CACM. The appropriateness of any measure will depend on the registrant's particular facts and circumstances. ~~For example, total cash compensation could be a CACM unless the registrant also distributed annual equity awards widely among its employees. Social Security taxes withheld would likely not be a CACM unless all employees earned less than the Social Security wage base. The registrant must also briefly disclose the compensation measure used. Although the CACM must~~As the Commission stated in the interpretive release, "a registrant may use internal records that reasonably reflect annual compensation~~, it is not expected that the CACM would necessarily~~ to identify the median employee~~ as if the registrant were to use annual total~~, even if those records do not include every element of compensation~~,~~ such as equity awards widely distributed to employees." [October 18, 2016; updated September 21, 2017]

Question 128C.02

Question: May a registrant exclusively use hourly or annual rates of pay as its CACM?

Answer: No. Although an hourly or annual pay rate may be a component used to determine an employee's overall compensation, the use of the pay rate alone generally is not an appropriate CACM to identify the median employee. Using an hourly rate without taking into account the number of hours actually worked would be similar to making a full-time equivalent adjustment for part-time employees, which is not permitted. Similarly, using an annual rate only, without regard to whether the employees worked the entire year and were actually paid that amount during the year, would be similar to annualizing pay, which the rule only permits in limited circumstances. [October 18, 2016]

Question 128C.03

Question: When a registrant uses a CACM to identify the median employee, what time period may it use? Must the period include the date on which the employee population is determined? Must it always be for an annual period? May it use the prior fiscal year?

Answer: To calculate the required pay ratio, a registrant must first select a date, which must be within three months of the end of its fiscal year, to determine the population of its employees from which to identify the median. Once the employee population is determined, the registrant must then identify the median employee from that population using either annual total compensation or another CACM. In applying the CACM to identify the median employee, a registrant is not required to use a period that includes the date on which the employee population is determined nor is it required to use a full annual period. A CACM may also consist of annual total compensation from the registrant's prior fiscal year so long as there has not been a change in the registrant's employee population or employee compensation arrangements that would result in a significant change of its pay distribution to its workforce. [October 18, 2016]

Question 128C.04

Question: When someone is furloughed on the date that the registrant uses to determine the population of its employees from which it is required to identify the median, must the registrant include the furloughed person in the employee population used to identify the median employee, and, if included in the population, how should the furloughed employee's compensation be calculated?

Answer: Item 402(u) does not define or even address furloughed employees. Because a furlough could have different meanings for different employers, registrants will need to determine whether furloughed workers should be included as employees based on the facts and circumstances. If the furloughed worker is determined to be an employee of the registrant on the date the employee population is determined, his or her compensation should be determined by the same method as for a non-furloughed employee. Item 402(u)(3) of Regulation S-K identifies four classes of employees: full-time, part-time, temporary and seasonal. The registrant must determine in which class the employee belongs on that date and determine that individual's compensation using annual total compensation or another CACM in accordance with Instruction 5 of Item 402(u). That instruction states that a registrant may annualize the total compensation for all permanent employees (full-time or part-time) that were employed by the registrant for less than the full fiscal year or who were on an unpaid leave of absence during the period. In contrast, a registrant may not annualize the total compensation for employees in temporary or seasonal positions. A registrant may not make a full-time equivalent adjustment for any employee. [October 18, 2016]

Question 128C.05

~~**Question:** Under what circumstances is a worker employed and his or her compensation determined by an unaffiliated third party such that the worker is considered an independent contractor or leased worker under the rule? When is a registrant considered to be determining the compensation of a worker?~~

~~**Answer:** In the release, the Commission noted its belief that the primary benefit of the pay ratio disclosure is to provide shareholders with a company-specific metric that they can use to evaluate the compensation paid to the PEO within the context of their company. Therefore, in determining when a worker is an "employee" of the registrant under the rule, the registrant must consider the composition of its workforce~~

~~and its overall employment and compensation practices. In furtherance of this, a registrant should include those workers whose compensation it or one of its consolidated subsidiaries determines regardless of whether these workers would be considered "employees" for tax or employment law purposes or under other definitions of that term. Frequently, a registrant will obtain the services of workers by contracting with an unaffiliated third party that employs the workers. When a registrant obtains services in this way, we do not believe it is determining the workers' compensation for purposes of the rule if, for example, the registrant only specifies that those workers receive a minimum level of compensation. Further, an individual who is an independent contractor may be the "unaffiliated third party" who determines his or her own compensation.[October 18, 2016]~~

[Withdrawn, September 21, 2017]

Question 128C.06

Question: Given the significant flexibility provided to registrants in Item 402(u) to identify the median employee, would the staff object if a registrant describes the pay ratio as an estimate?

Answer: No. As the Commission stated in the interpretive release, due to the use of estimates, assumptions, adjustments, and statistical sampling permitted by the rule, pay ratio disclosures may involve a degree of imprecision. Therefore, the staff would not object if a registrant states in any required disclosure that the pay ratio is a reasonable estimate calculated in a manner consistent with Item 402(u). [September 21, 2017]

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