“It all sounds very reasonable...”
New SEC Guidance Emphasizes Reasonableness and Flexibility in CEO Pay Ratio Disclosure

By Michael Dunn, Jon Karelitz, and Peter Varney

On September 21, 2017, the Securities and Exchange Commission (the “SEC”) published an interpretative release and related compliance and disclosure interpretations (“C&DIs”) for registrants regarding the CEO pay ratio disclosure rule, one of the widely publicized (and much maligned) requirements of the Dodd-Frank Wall Street Reform and Consumer Protection Act (“Dodd-Frank”). The SEC’s overarching message in this interpretive guidance and staff guidance is “Be reasonable,” accompanied by the acknowledgment of some “degree of imprecision” in ascertaining pay ratios.

The pay ratio disclosure rule, which was added to Item 402(u) of Regulation S-K by Section 953(b) of Dodd-Frank, requires a registrant to disclose the ratio of its principal executive officer’s compensation to its median employee’s compensation. Expounding on its August 2015 instructions and release accompanying the final pay ratio disclosure rule, the SEC’s recently published interpretive release, C&DIs, and staff guidance underscores registrants’ flexibility in identifying the median employee and calculating that employee’s compensation for the year, so long as any assumptions are based on reasonable foundations consistent with the final rule and made in good faith.

Specifically, registrants can use reasonable beliefs, estimates, assumptions, methodologies and statistical sampling in determining median employee compensation, including:

- Using existing internal records that are reasonably reflective of annual compensation, such as payroll or tax records, to determine median compensation (even if the records do not account for all aspects of compensation), as well as to determine if its non-US population is de minimis (5% or less of total employees) and thus excludable.

- Ascertaining whether an individual is an independent contractor according to another “widely recognized test” (e.g., the 20-factor test commonly used by the IRS)—despite the fact that Item 402(u) contains its own definition of “employees” who must be taken into account for purposes of determining the median employee.

In its staff guidance released at the same time as the interpretive guidance, the SEC’s Division of Corporation Finance offers questions and examples to illustrate how a registrant can use estimates, statistical sampling and other reasonable methodologies (alone or in combination) to identify its median employee and to calculate that employee’s annual total compensation for purposes of determining the ratio to be disclosed. The SEC notes that the pay ratio disclosure rule does
not mandate any particular technique to determine the population of employees from which a registrant must identify the median employee. For example, a registrant may consider statistical methods such as making distributional assumptions (e.g., assuming a lognormal distribution), as well as methods to impute or adjust for missing data and to account for outlying data points. The new guidance emphasizes that if a company does not use annual total compensation to identify its median employee, that any alternative measure must be consistently applied and reasonably reflect the annual compensation of employees.

Note that the CEO pay ratio disclosure is required in proxies for fiscal years beginning on or after January 1, 2017. Despite a commitment by the SEC to revisit prior guidance related to this disclosure requirement, as well as ongoing Congressional attempts to repeal the associated section of Dodd-Frank, registrants should now be strategizing on how to comply with the new requirement, including the options for navigating disclosure challenges.

Michael Dunn is a partner in Seyfarth’s Houston office, Jon Karelitz is a partner in Seyfarth’s Chicago office, and Peter Varney is counsel in Seyfarth’s Atlanta office. If you would like further information, please contact Michael Dunn at mdunn@seyfarth.com, Jon Karelitz at jkarelitz@seyfarth.com, or Peter Varney at pvarney@seyfarth.com.