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SEC Substantially Eases Burden of Pay Ratio Disclosure

New Guidance Allows Use of Widely Recognized Tests to Determine Who Is Included as an Employee, Reinforces Flexibility to Use Reasonable Estimates and Existing Internal Records to Identify the Median Employee and Allows Ratio to be Described as an Estimate

SUMMARY

The SEC's Division of Corporation Finance yesterday issued [interpretive guidance](#) substantially easing the burden of CEO pay ratio disclosure, which will be required for most U.S. public companies beginning with the upcoming 2018 proxy season. In particular:

- The guidance allows the use of widely recognized tests used in other legal and regulatory contexts, such as for employment law or tax purposes, to determine who is an “employee” for purposes of the rule. The treatment of independent contractors in calculating the ratio had been a significant source of confusion and expense for many companies.
- The guidance clarifies that a registrant may use existing internal records, such as tax and payroll records, with respect to:
 - determining whether the 5% de minimis exemption is available to exclude non-U.S. employees; and
 - identifying the median employee using internal records that reasonably reflect annual compensation, even if those records do not include every element of compensation.
- The guidance reinforces the flexibility to use reasonable estimates and assumptions and determine reasonable methodologies and statistical sampling to identify the median employee and calculate the median employee's annual total compensation.
- In light of the preceding, the guidance allows the ratio to be described as an “estimate.”

The SEC also updated the Compliance and Disclosure Interpretations regarding the CEO pay ratio disclosure that were initially posted on October 18, 2016. The changes to the interpretations (which are

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set out in the attached Annex) reflect the new interpretive guidance. In addition, the SEC provided separate guidance regarding the use of statistical sampling by registrants to determine their median employee for purposes of the pay ratio disclosure, which is available at <https://www.sec.gov/corpfin/announcement/guidance-calculation-pay-ratio-disclosure>.

The new interpretive guidance was published “[i]n light of the approaching compliance date and concerns raised about the implementation of the disclosure requirement” and focuses on providing flexibility for registrants in their compliance with the pay ratio rule.

BACKGROUND

As directed by Section 953(b) of the Dodd-Frank Wall Street Reform and Consumer Protection Act, on August 5, 2015, the SEC adopted the final pay ratio disclosure rule as Item 402(u) of Regulation S-K.¹ The rule requires that U.S. public companies disclose:

- the median of the annual total compensation of all employees of the registrant, except the registrant’s CEO;
- the annual compensation of the registrant’s CEO; and
- the ratio of those two amounts.

Disclosure is required with respect to the first fiscal year beginning on or after January 1, 2017; accordingly, the rule becomes effective beginning with the upcoming 2018 proxy season. The pay ratio disclosure rule does not apply to emerging growth companies, smaller reporting companies, foreign private issuers, filers under the U.S.-Canadian Multijurisdictional Disclosure System and registered investment companies.

HIGHLIGHTS FROM THE PAY RATIO GUIDANCE

Determining the Relevant Employee Population: Independent Contractors

The rule permits a registrant to exclude workers who provide services to the registrant as independent contractors and “leased” workers as long as they are employed, and their compensation is determined, by an unaffiliated third party. The Compliance and Disclosure Interpretations posted on October 18, 2016 emphasized that a key factor in determining whether a worker such as an independent contractor was an “employee” for purposes of the rule was whether the registrant or one of its consolidated subsidiaries determined the compensation of the worker, regardless of whether such worker would be considered an “employee” for tax or employment law purposes or under other common tests. The new guidance

¹ See Pay Ratio Disclosure, Rel. Nos. 33-9877; 34-75610 (August 6, 2015), *available at* <https://www.sec.gov/rules/final/2015/33-9877.pdf>. The pay ratio rule is discussed in our memo to clients entitled *SEC Adopts CEO Pay Ratio Rule: New Rule Will Not Be Effective Until 2018 Proxy Season* (August 7, 2015), *available at* https://sullcrom.com/siteFiles/Publications/SC_Publication_SEC_Adopts_CEO_Pay_Ratio_Rule.pdf.

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reverses this prior guidance and clarifies that registrants may indeed use widely recognized tests from other legal and regulatory contexts to determine who is an “employee” for purposes of the pay ratio disclosure. For example, a registrant may use guidance published by the Internal Revenue Service or another widely recognized test used for employment law or tax purposes. The updated Compliance and Disclosure Interpretations have incorporated this clarification by withdrawing fully the previous Q&A on this topic.

Using Internal Records

Median Employee. The rule permits a registrant to use annual total compensation, as determined under existing executive compensation rules, or any other consistently applied compensation measure (CACM), such as compensation reported in payroll or tax records, to identify the median employee. The Compliance and Disclosure Interpretations posted on October 18, 2016 provided that the CACM may be any measure that reasonably reflects the annual compensation of employees depending on the facts and circumstances, but that it would not be permissible to use cash compensation as a measure when employees widely receive equity awards, as the cash compensation would not reasonably reflect annual compensation. The new guidance clarifies that the 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, including equity awards widely distributed to employees.

The new guidance also confirms that, if the registrant identifies a median employee as a result of using a CACM based on internal records and determines that the identified median employee’s compensation includes anomalous characteristics, such that the compensation may have a significant impact on the pay ratio, the registrant may substitute another employee with substantially similar compensation.

Non-U.S. Employees. Due to the potential for increased costs for multinational companies of including both U.S. and non-U.S. employees as “employees,” the rule generally exempts registrants from including non-U.S. employees where they account for 5% or less of the total employees. The guidance clarifies that a registrant may use appropriate internal records, including tax records or payroll records, to determine whether this de minimus exemption is available.

Using Reasonable Estimates, Assumptions and Methodologies

The rule permits a registrant flexibility to use reasonable beliefs, estimates and efforts to both identify the median employee (including by using statistical sampling and a CACM) and to calculate annual total compensation or any elements of annual total compensation. Consistent with the rule, the guidance clarifies that, if the registrant uses reasonable estimates, assumptions or methodologies, so long as provided in good faith and not made without a reasonable basis, the resulting disclosure will not provide the basis for SEC enforcement action.

The updated Compliance and Disclosure Interpretations also clarify that the SEC would not object if a registrant, in any required disclosure, describes the pay ratio as a reasonable “estimate.”

Using Statistical Sampling

The separate SEC guidance regarding the calculation of pay ratio disclosure by registrants clarifies and provides flexibility in how registrants may use statistical sampling and other reasonable methodologies to identify the median employee. This guidance provides that registrants may combine the use of reasonable estimates with statistical sampling or other reasonable methodologies. For example, registrants with multiple business lines are permitted to use statistical sampling for some business units and use other methodologies and reasonable estimates for other business units. The guidance includes a non-exclusive list of sampling methods that registrants may choose to employ, including simple random sampling, stratified sampling, cluster sampling and systematic sampling. The SEC also clarifies here that registrants have flexibility to use reasonable estimates in the methodology implemented to identify the median employee and in the calculation of annual total compensation for employees. Finally, this guidance includes hypothetical examples of the use of reasonable estimates, statistical sampling and other methodologies, or a combination thereof, including in the context of companies with global workforces.

IMPLICATIONS

Companies should be aware that, while the SEC has afforded reasonably broad flexibility to implement the pay ratio rule—and the new guidance reinforces such flexibility—the rule requires disclosure of the methodology chosen to determine the median employee and any material assumptions, adjustments or estimates used to identify the median employee or to determine total compensation. As a result of such flexibility, there will likely be a wide range of methodologies used, and companies will need to be mindful of how their methodology, and not only the ultimate pay ratio that results, is communicated to their shareholders.

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ANNEX

Section 128C — Item 402(u) Pay Ratio Disclosure

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. As the Commission stated in the interpretive release, “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.” [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

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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

[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

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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]