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Proxy Season Is Almost Here – Are You Ready?

As preparations begin for the 2018 proxy season, attention is being drawn to the pay ratio disclosure requirement that will make its first appearance in the proxy statement. This *For Your Information* addresses recently issued SEC interpretive guidance intended to help companies comply with the new disclosure requirement.

Background

In 2015, as mandated by the Dodd-Frank Act, the SEC adopted a rule that requires public companies to disclose the ratio of CEO pay to the median employee pay in registration statements, proxy information statements, and annual reports that call for executive compensation disclosure. The pay ratio rule is intended to increase transparency and assist shareholders in evaluating executive pay practices at major U.S. companies. Companies have been actively gathering the information required to provide the required disclosure for the 2018 proxy season. Our August 21, 2015 *For Your Information* covers the details of the final rule. The rule provides flexibility to determine the pay ratio – reasonable estimates may be used in both the methodology used to identify the median employee and in calculating compensation. Also, statistical sampling or other reasonable methods may be used in determining the median employee. The flexibility is intended to reduce the costs and burdens associated with the disclosure.

Interpretive Guidance

On September 21, the SEC issued interpretive guidance to assist issuers in preparing the disclosure and address some concerns. At the same time, the SEC's Division of Corporate Finance issued separate guidance and examples on how to apply statistical sampling. In addition, they updated related Compliance & Disclosure Interpretations (CDIs).

The interpretive guidance addressed three main areas:

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

The SEC allays the fear of issuers – the imprecise nature of estimates and other methodologies will not result in enforcement action, if the methodologies are applied in good faith. A new CDI 128C.06 provides that the staff will not object if a registrant describes the pay ratio as an estimate.

Use of Internal Records

Registrants can use internal records, such as tax or payroll records, to determine the median compensation of all employees, even where those records don't include every element of compensation. The internal records can be used to determine whether the 5% non-U.S. employee exemption from inclusion is available. A Revised CDI 128C.01 reflects the ability to use internal records to reasonably reflect annual compensation; previously it indicated that cash compensation alone would not be sufficient if equity awards were widely distributed to employees.

What's pay?

Compensation included in the pay ratio is the same as that reported as CEO compensation in the annual proxy statement's Summary Compensation Table. This includes cash and stock compensation, stock and option awards, nonequity incentive plan compensation, and retirement or change of control accruals in qualified and nonqualified plans.

Independent Contractors

In determining whether an individual is an employee, a leased employee or independent contractor, companies can use widely recognized tests that are applied for other legal purposes. CDI 128C.05 – which provided that all workers must be included unless employed by an unaffiliated third party – was withdrawn.

Corporate Finance Guidance

The SEC's Division of Corporate Finance provided guidance and hypothetical examples to assist registrants in determining how to use statistical sampling methodologies and other reasonable methods to determine the median employee, including examples of:

- Sampling methods
- Situations where registrants may use reasonable estimates
- Common statistical techniques and methodologies registrants may consider

Corporate Finance stated that a registrant is permitted to use statistical sampling, other reasonable methods or a combination of statistical sampling and other reasonable methods. Furthermore, whether or not a method is appropriate depends on the registrant's facts and circumstances.

It's only one employee, but …

It's difficult to calculate! It must be calculated and presented in accordance with U.S. Generally Accepted Accounting Principles (GAAP), which differs from the tax and accounting standards that companies use to determine employee compensation.

In Closing

Since most companies have already started the process of identifying the median employee and calculating annual total compensation, one might think the SEC's interpretive guidance is too little too late. However, it should help allay some fears and reiterates that if the issuer carefully considers the methodologies used and makes a good faith effort to comply, it should avoid any SEC enforcement action.

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