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What Does 'Reasonable' Mean Under the SEC's New Pay Ratio Disclosure Rules?

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U.S. public companies, other than emerging growth and smaller reporting companies, are tackling their first pay ratio disclosures. The SEC's pay ratio rule, mandated by Section 953(b) of the Dodd-Frank Wall Street Reform and Consumer Protection Act, and adopted as Item 402(u) of the SEC's Regulation S-K, is applicable for the first fiscal year beginning on or after Jan. 1, 2017. This means that calendar year-end companies will be making the disclosures in their 2018 proxy statements.

The pay ratio rule requires disclosure of:

- The median of the annual total compensation of all employees of the company, except the principal executive officer (PEO);
- The annual total compensation of the PEO; and
- The ratio of these two amounts.

A company must select a specific date within the last three months of the fiscal year (by Dec. 31) for determining the employee population from which the median employee will be identified.

The SEC doesn't define "median." Rather, the SEC's adopting Release (Release Nos. 33-9877 and 34-75610) states that "median" has the same meaning used in statistics and probability theory, and quotes the Random House Webster's Dictionary definition of "median": "the middle number in a sequence, or the average of the two middle numbers when the sequence has an even number of numbers."

Once the population of employees from which the median employee must be selected is determined, the next step is for the company to identify the specific median employee. The median employee must be a real person. While the name of the median employee should not be disclosed, the nature of the position held by the median employee is required to be disclosed in the proxy statement.

A company must use either "annual total compensation" calculated using Item 402(c)(2)(x) of Regulation S-K or another consistently applied compensation measure, or "CACM," in calculating annual total compensation and identifying the median employee. As it would be very burdensome for most companies to calculate annual total compensation for each employee in accordance with the complex provisions of Item 402(c)(2)(x) of Regulation S-K, companies must select a CACM.

The SEC's September 2017 guidance includes the following:

"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. Required disclosure may be based on a registrant's reasonable belief; use of reasonable estimates, assumptions, and methodologies; and reasonable efforts to prepare the disclosures. Specifically, the rule permits registrants to use reasonable estimates to identify the median employee, including by using statistical sampling and a consistently applied compensation measure (such as payroll or tax records). The rule also allows registrants to use reasonable estimates in calculating the annual total compensation or any elements of annual total compensation for employees." (See pages 2 and 3 of the Commission Guidance on Pay Ratio Disclosure, Release No. 33-10415; 34-81673; footnotes omitted.)

In addition: "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 … 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." (See the SEC's Division of Corporation Finance Compliance and Disclosure Interpretations, or CD&Is, Question 128C.01.)

The SEC uses the term "reasonable" repeatedly, but does not define it. How will a company know if it is using a measure that "reasonably reflects annual compensation"?

As the SEC has specifically mentioned only tax and payroll records as an acceptable basis for determining annual compensation, a company cannot know for certain what other measuring techniques the SEC will find reasonable. As internal tax and payroll information is typically available, companies would be wise to use this information to identify the median employee.

Is a company with a large employee population required to review tax and payroll information for all of its employees? No. The SEC has stated that "reasonable estimates" and statistical sampling may be used. While the SEC has not elaborated on what makes an estimate reasonable, recent SEC guidance provides some examples of "sampling methods that could be appropriate to use (alone or in combination), depending on the registrant's particular facts and circumstances," including but not limited to:

- "Simple random sampling (drawing at random a certain number or proportion of employees from the entire employee population);
- Stratified sampling (dividing the employee population into strata, e.g., based on location, business unit, type of employee, collective bargaining agreement, or functional role and sampling within each strata);
- Cluster sampling (dividing the employee population into clusters based on some criterion, drawing a subset of clusters, and sampling observations within appropriately selected clusters; cluster sampling may be conducted in one stage or multiple stages); and
- Systematic sampling (the sample is drawn according to a random starting point and a fixed sampling interval, every nth employee is drawn from a listing of employees sorted on the basis of some criterion)." (SEC's Division of Corporation Finance Guidance, Sept. 21, 2017.)

Once the median employee is determined, the median employee's annual compensation must be re-calculated in accordance with the detailed requirements of Item 402(c)(2)(x) of Regulation S-K, and then compared with the CEO's annual compensation, also calculated in accordance with Item 402(c)(2)(x) of Regulation S-K. This means that a company's flexibility to use a reasonable methodology and reasonable estimates in developing its pay ratio disclosures is limited to determining the median employee and calculating the total compensation of the various employees from whom the median employee will be identified.

A company's pay ratio disclosure in the proxy statement should include a description of the assumptions, estimates and methodologies used in determining the median employee and in calculating the median employee's compensation and the pay ratio. It is by clearly describing a process, and the reasons behind it, that a company will be able to support the "reasonableness" of its pay ratio methodology. A company should focus on documenting its decisions and the reasons for them as it goes through the process of complying with the SEC's new rule.

Until the SEC provides further guidance, which may not occur until after the 2018 proxy season, a company should not be too creative in its methodology or disclosure. To comply with the SEC guidance provided to date, a company should:

- Use internal payroll and/or tax records for determining the median employee;
- Use one of the sampling methodologies described in the SEC's guidance if a large employee population makes it impractical to review payroll and/or tax information for all employees; and
- Explain the processes used, and the reasons for the decisions made, in making the required pay ratio disclosures.

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