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New SEC Guidance Will Make Calculating Your CEO Pay Ratio Easier, But Don't Relax Yet

The SEC's new guidance provides a measure of relief for companies, but the same big challenge remains: putting your CEO ratio into proper context.

For much of 2017, corporate issuers hoped the Securities and Exchange Commission (SEC) might scrap or delay its CEO pay ratio disclosure rule. It's now clear that won't happen and companies are swinging into action to get ready ahead of proxy season. However, the SEC provided a measure of relief on September 21 when it issued additional guidance on how to interpret and implement the rule.

This long-awaited guidance, taking the form of an **interpretive release**, a **press release** and **new and revised Compliance and Disclosure Interpretations** (C&DIs) arrived just nine days before many calendar year filers intended to calculate their median employee and only a few short weeks after many issuers had begun to prepare for this new disclosure requirement. After a careful review of the SEC's new release, several points stand out to us, which we discuss in more detail below.

Reasonable Estimates Are Allowed

One C&DI clarifies that the pay ratio may be presented as an estimate. While this does not impact the actual process of identifying the median employee, it is an apparent nod to imprecision built into the median identification. Companies had raised concerns about how to make reasonable estimates in calculating elements of the median employee's compensation (e.g., change in pension value).

This guidance says companies may rely on reasonable estimates, though the use of such estimates must be disclosed. Additionally, any "reasonable estimates, assumptions or methodologies" used will not provide the basis for enforcement action unless the disclosure was "made or reaffirmed without a reasonable basis or was provided other than in good faith."

▶ **Our Advice –** If you plan to use estimates, consider whether their use is necessary, and consider how such estimates will be viewed by investors and other outside audiences.

Identifying Employees vs. Independent Contractors

In this area, the SEC staff withdrew and expanded upon its prior guidance, which said that contractors whose compensation is determined by an unaffiliated third party are not employees for purposes of calculating CEO pay ratios. In its place, the new interpretive release indicates that the “unaffiliated third party” test is not intended to be an exclusive means used to determine whether a contractor is an employee.

The staff says a company can apply “a widely recognized test under another area of law.” One example the agency provided is IRS Publication 15-A, which adopts a test to determine independent contractors based on “control” rather than “power” to set the contractor’s rate. While all of this may sound rather technical, the implication of the new guidance is that you may be able to consider more workers as general contractors then previously guidance suggested.

▶ **Our Advice –** If an employer has correctly determined that an individual’s compensation should be reported on Form 1099 rather than Form W-2, then we would expect that individual to not be included as an employee. The same type of decision making may also apply in non-U.S. situations.

Statistical Sampling

Earlier guidance left open the ability for companies to engage in sampling and/or other reasonable methodologies, but lacked specifics on how to do this. The new guidance provides clarifications concerning sampling, details of other reasonable methods, and some examples of both.

First, the SEC reaffirmed that if a company uses sampling and/or other reasonable methods to complete their pay ratio, the sampling needs to be based on the registrant’s facts and circumstances— not on broad or industry averages. However, exact compensation information does not need to be available to perform the pay ratio analysis. In cases where issuers do not wish to rely on the exact compensation data for a given business unit, a distribution assumption could be employed instead. This means companies can make an informed assumption about the distribution of their specific underlying compensation data.

▶ **Our Advice –** Gathering input on compensation data from regional managers might be particularly useful for registrant companies with multiple global HRIS systems— either with or without a statistical sampling methodology. In fact, the updated guidance approves using different methods for different units. Companies should not feel wedded to one approach for their entire employee population.

Next Steps

The SEC’s new guidance will be helpful as companies begin calculating their median worker compensation, but it does have limitations. While this guidance addresses the mechanics of calculating the ratio, it does not address the “softer” elements accompanying the rule— that is, how companies should disclose the ratio in a wider context and to a wider stakeholder audience.

At Radford, we recommend companies disclose the different factors that can influence the ratio, including size of your global workforce, composition of your workforce (e.g., heavy manufacturing component vs. higher proportion of knowledge workers, etc.) and how it relates to industry standards. For more information on putting ratios into context by industry, see our alert ***In Calculating Your CEO Pay Ratio, Relativity to Peers is the New Math***.

The case for thoughtful disclosure got a boost recently when Institutional Shareholder Services (ISS) released the results of its policy survey. The results indicate that, despite many institutional investors not being ardent supporters of the rule (with the exception of groups like pension funds), a majority of them do plan to track CEO pay ratio disclosures. Sixty-three percent of investors responding to ISS' 2018 policy formulation **survey** said they plan to compare companies' ratios and also review a company's ratio over time. Only 16% of investors said they do not intend to use the ratio. In contrast, 44% of companies said they do not plan to use the information, expressing skepticism about its usefulness.

To learn more about our approach to tackling the calculation and disclosure of your CEO pay ratio, visit our CEO pay ratio website or write to consulting@radford.com.

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