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GMS Flash Alert

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United States - New Implementation Guidance from SEC on CEO Pay Ratio Disclosure

The wishful hopes of many public companies were possibly dashed on September 21, 2017, as the U.S. Securities and Exchange Commission (SEC) issued interpretive implementation guidance, thereby acknowledging that CEO Pay Ratio disclosure will most likely neither be delayed nor repealed.[1]

From a global perspective, the new U.S. disclosure rules are similar to other countries' efforts, particularly in Europe, to move towards more transparency related to pay equity and executive compensation, in general.

WHY THIS MATTERS

The requirements will impose new disclosure burdens on companies and will heighten scrutiny of executive compensation policies by employees, shareholders, government, and the public.

With the proxy season approaching, now is a good time for companies to be getting their pay ratio ready and coordinating with the Compensation Committee in consideration of preparing internal and external communication plans (including proxy disclosure).

Background

In August 2015, the SEC adopted the CEO Pay Ratio rule that requires public companies to disclose (i) CEO compensation; (ii) median employee total annual compensation; and (iii) the ratio of CEO pay compared to median employee pay as required under the Dodd-Frank Act.

On September 21, 2017, the SEC issued an interpretive release[2] on the new rule, while the Division of Corporate Finance provided guidance[3] that reinforced the perceived implementation flexibility, including the setting of parameters for statistical sampling methods.

Highlights of the New Guidance

Reasonable Estimates Are Allowed: Required disclosures that are constructed using reasonable estimates, assumptions, and methodologies to develop the pay ratio and related disclosures, "…would not provide the basis for Commission enforcement action unless the disclosure was made or reaffirmed without a reasonable basis or was provided other than in good faith."[4]

Existing Internal Records Are Sufficient: Tax, payroll and other existing 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"[5] can be used to identify the median employee.

"Leased" Workers Are Just One Example of Independent Contractors: The guidance reaffirms that independent contractors are excluded from the pay ratio analysis and provides that "independent contractors" may include more than just "leased" workers. The new guidance allows any, "widely recognized test under another area of law that the company uses to determine whether its workers are employees"[6] to be used to define independent contractors for purposes of calculating the CEO pay ratio.

Statistical Sampling Is Acceptable: The Division of Corporate Finance specifically indicated that statistical sampling is acceptable.[7] It was also noted that various methods can be used alone or in combination with one another. Four specific methods were cited as potentially appropriate, with an indication that such a list is not intended to be all-inclusive:

- Simple random sampling – random selection of a certain number of employees from the entire employee population;
- Stratified sampling – sampling employees within specific strata (considering business unit, location, job grade);
- Cluster sampling – Grouping employees into clusters based on selected criteria and sampling employee observations within the clusters;
- Systematic sampling – sampling employees according to a random starting point and then applying a fixed sampling interval, for example, every *nth* employee is drawn from a list.

KPMG NOTE

In our experience, the full universe of data approach has been the widely preferred approach for determining the draft CEO Pay Ratios. In an effort to explore alternatives, many companies have used one or more sampling approaches as an additional validation of their calculated ratio using the full universe approach. Since the recently issued guidance provides detailed discussion on estimates and sampling methodologies, companies may begin to explore statistical sampling as the primary approach.

Employers: Timeline and Steps to Consider

Companies are required to provide the new pay ratio disclosures for the first fiscal year commencing on or after January 1, 2017; and as a result, companies with a fiscal year ending December 31, 2017, will need to disclose the pay ratio information (reflecting 2017 compensation) in their 2018 proxy statements.

As the proxy season approaches, management teams should have their pay ratio ready and be coordinating with the Compensation Committee when preparing internal and external communication plans (including proxy disclosure) to address their CEO pay, median employee compensation, and overall methodology.

KPMG NOTE

The CEO Pay Ratio rule provides companies with significant flexibility to determine the "median" employee. This flexibility recognizes the inherent differences in business and workforce operations while satisfying the filing requirements. While there are broad guidelines, it is up to each company to determine their assumptions and methodology and not rely on any industry estimates that may not directly reflect the company's compensation distribution.

FOOTNOTES:

1 See: https://www.sec.gov/rules/interp/2017/33-10415.pdf.

2 See: https://www.sec.gov/rules/interp/2017/33-10415.pdf .

3 See: https://www.sec.gov/corpfin/announcement/guidance-calculation-pay-ratio-disclosure .

4 SEC, "Commission Guidance on Pay Ratio Disclosure," p. 3.

5 SEC, "Commission Guidance on Pay Ratio Disclosure," p. 5.

6 SEC, "Commission Guidance on Pay Ratio Disclosure," p. 7.

7 "Division of Corporation Finance Guidance on Calculation of Pay Ratio Disclosure," pp. 1 and 3.

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