



## The SEC Provides Flexibility for Issuers as it Affirms the Pay Ratio Rule Will go into Effect in 2018

On Thursday, September 21<sup>st</sup>, the U.S. Securities and Exchange Commission (SEC) issued [guidance](#) on the implementation of the Pay Ratio disclosure requirement as well as [separate guidance](#) from SEC staff concerning the use of sampling and other methodologies. Concurrently, the staff of the SEC's Division of Corporation Finance issued revised [Compliance and Disclosure Interpretations](#) ("C&DIs") related to implementing the new requirement.

While many issuers have been preparing to disclose a pay ratio in 2018, these documents put to rest any questions regarding whether the SEC may take action to materially delay or discard the requirement before the coming proxy season. This new guidance provides important flexibility and direction for issuers around the types of estimates, assumptions sampling and methodologies that can be used to implement the disclosure.

In addition to beginning or continuing to compile compensation data for compliance with the rule and guidance, public companies should be preparing proxy disclosure and considering how to provide context for investors who may be planning to use pay ratio information when voting their proxy. As previously [discussed](#) by CamberView, this new disclosure is likely to have important, and possibly unforeseen, implications for shareholder engagement regarding compensation as well as the potential to impact proxy voting decisions. Issuers should continue to account for the investor perspective as they frame their narrative around the pay ratio, and ensure that the totality of company efforts to build, invest and compensate their entire workforce is effectively communicated.

### Commission Guidance on Pay Ratio Disclosure

The SEC's new [guidance](#) on pay ratio disclosure focuses on three central elements: (1) the use of reasonable estimates, assumptions, and methodologies and statistical sampling; (2) the use of internal records; and (3) the treatment of independent contractors.

- I. The SEC's guidance around the use of reasonable estimates, assumptions as well as methodologies and statistical sampling centers on the concept of reasonableness. Issuers may make 'reasonable estimates to identify the median employee, including by using statistical sampling and a consistently applied compensation measure (such as payroll or tax records).' In light of the imprecise nature of calculating the pay ratio, the SEC stated that it will not initiate enforcement actions against companies if disclosures that are made or reaffirmed have a reasonable basis and are provided in good faith.
- II. The SEC's guidance around the use of internal records for calculating the pay ratio similarly provides flexibility to issuers in how they calculate their disclosure.
  - a. Companies may use existing internal records to determine whether they can exclude their non-U.S.-based workforce when that group comprises less than 5% of the total workforce, with certain exclusions.
  - b. Companies may use internal tax or payroll records to identify the median employee, 'even if those records do not include every element of compensation, such as equity awards widely distributed to employees'.
- III. Companies that intend to exclude independent contractors from the pay ratio calculation may use widely recognized tests of who is an employee, such as Internal Revenue Service guidance or other employment law, to determine whether an individual is an employee or independent contractor.

## Use of Sampling and other Methodologies and Compliance and Disclosure Interpretations

Given the flexibility around the methodology and elements that issuers may use to determine the median employee, SEC staff provided [further guidance](#) and examples around the use of sampling, assumptions and other methodologies. The guidance document highlights how issuers can use the above criteria in their calculation and provides insightful examples to illustrate how the SEC would view different paths forward. Issuers may also find it helpful to review the updated [Compliance & Disclosure Interpretations](#) published last week which provide further insight into how the SEC may view actions taken by issuers regarding the new disclosure.

### Takeaways for Issuers

In an investor context, the relative flexibility around pay ratio estimates, assumptions and methodologies granted by the SEC may be a double-edged sword. While the new guidelines provide a helpful measure of administrative relief to companies dealing with the complexity, costs, and burdens of the new calculation, it may also increase scrutiny from certain investors on the estimates, assumptions, and methodologies that companies use to create its pay ratio disclosure. Certain investors, particularly public pension funds and labor-backed asset owners, are likely to be wary of companies that provide unclear disclosure, include different elements in the pay ratio calculation than in other compensation-related disclosures, or rely on estimates, assumptions, or methodologies that are not explained in detail.

One of the key shifts in the newly-published guidance centers on the exclusion of independent contractors from the pay ratio calculation and the exclusion of offshore workers for certain issuers. Many companies, particularly in the technology and retail sectors, increasingly rely on independent contractors to fill positions in their workforce. Investors may place additional scrutiny on those companies with large numbers of such workers and are likely to be vigilant about the final ratio figure including asking specific questions about the calculations underlying that figure. This investor scrutiny may be magnified if a company discloses a ratio that is out of step with peers.

As pressure builds on investors to scrutinize executive compensation at issuers where pay is misaligned with performance, the pay ratio disclosure will be a new, and notable, addition to that broader discussion. As we have stated in previous [guidance](#), the pay ratio may introduce significant 'disclosure noise' for issuers in 2018. Data from the recently published [ISS 2017-2018 Benchmark Voting Policy Survey](#) indicates that nearly three-quarters of investor survey respondents intend to compare ratios across companies/industry sectors or assess the ratio on a year-over-year basis or both. Certain portions of the investor community, such as asset owners with significant labor representation, may use their analysis of the pay ratio to take other actions, such as identify targets for 2019 shareholder proposals.

Given this new guidance and the compressed time-frame around which issuers and investors alike will need to prepare for and understand this new disclosure, it is important for companies to engage in dialogue with stakeholders around the rule this fall. To the extent companies foresee additional attention to methodologies and assumptions, or are unsure whether their ultimate ratio figure will be problematic, highly-focused engagement and disclosure can help get ahead of any issues. The combination of thoughtful, clear disclosure and engagement with investors can mitigate and minimize potential negative consequences in 2018 and beyond from the first publication of the pay ratio.

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