Client Update
Additional Flexibility for Upcoming CEO Pay Ratio Compliance

The Securities and Exchange Commission (the "SEC") recently issued additional guidance on its rules requiring a public company to disclose the ratio of the CEO's compensation to that of the company's median employee beginning in 2018,[1] including an interpretive release, SEC staff guidance on the pay ratio calculation, and revisions to the staff's Compliance & Disclosure Interpretations.[2] Although many had hoped that these rules would be rescinded by year end, rescission no longer seems likely, and issuers should now calculate and prepare to disclose their pay ratio. The new guidance affords companies flexibility that should make it easier to comply with this obligation.

HIGHLIGHTS OF THE NEW GUIDANCE

Notable elements of the SEC's interpretive release include:

- ***No SEC enforcement if the estimates, assumptions and methodologies underlying disclosure have a reasonable basis and are provided in good faith***. If a company uses reasonable estimates, assumptions and methodologies in accordance with the rules, the SEC will not challenge the resulting pay ratio and disclosure except where the disclosure was not provided in good faith. In addition, acknowledging that pay ratio compliance "may involve a degree of imprecision," the SEC will not object if a company discloses that the pay ratio is a reasonable estimate calculated in a manner consistent with the rules.

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[1] For an overview of the pay ratio rules, see our prior client update "Minding the Gap: SEC Hands Down Final CEO Pay Ratio Rule," Aug. 11, 2015, *available at* http://www.debevoise.com/insights/publications/2015/08/minding-the-gap.

[2] *See* Commission Guidance on Pay Ratio Disclosure, Release No. 33-10415; 34-81673 (Sept. 21, 2017), *available at* https://www.sec.gov/rules/interp/2017/33-10415.pdf; Division of Corporation Finance Guidance on Calculation of Pay Ratio Disclosure, Sept. 21, 2017, *available at* https://www.sec.gov/corpfin/announcement/guidance-calculation-pay-ratio-disclosure; C&DI 128C.01 (Oct. 18, 2016; updated Sept. 21, 2017); C&DI 128C.05 (Withdrawn, Sept. 21, 2017); C&DI 128.06 (Sept. 21, 2017).

- ***Additional flexibility to identify the median employee and calculate annual total compensation and elements of total compensation:***
  - A company may use reasonable estimates combined with statistical sampling and other reasonable methodologies. For example, a company with global operations or multiple business lines can use statistical sampling for some geographic/business units and a combination of other methodologies and reasonable estimates for other geographic/business units.
  - A company may use any reasonable sampling method or combination thereof, such as simple random, stratified, cluster and systematic sampling.
  - Reasonable estimates are appropriate in making many determinations under the rules, such as analyzing the composition of the company's workforce (by geography, business unit or employee type); calculating a consistent measure or elements of compensation; and identifying the median employee.
  - Other permitted reasonable methods to determine the employees from which the median employee is identified include making one or more distributional assumptions; reasonable methods of imputing or correcting missing values; and reasonable methods of addressing extreme observations, such as outliers.
- ***Internal records used to identify the median employee must reasonably reflect annual compensation but need not include every compensation element***. A company can use 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.
- ***Expanded permitted use of internal company records, such as tax or payroll records***. The use of internal records is not limited to identification of the median employee. A company can also use appropriate existing internal records, such as tax or payroll records, to determine whether it can exclude non-U.S. employees from the pay ratio calculation where those employees account for 5% or less of the total U.S. and non-U.S. employee population. This can make a meaningful difference for global issuers based in the United States.
- ***There are more grounds to exclude independent contractors and other nonemployee workers***. The pay ratio rules exclude workers whose compensation is determined by an unaffiliated third party. The new guidance clarifies that this provision is not an exclusive basis for determining employee status. A company can also apply a "widely recognized test under another area of law" that it uses to determine whether workers are employees in other contexts, such as IRS guidance. If an issuer otherwise considers a service provider to be an independent contractor for tax purposes, the issuer can exclude that worker from the pay ratio calculation.

WHAT'S NEXT?

Companies are required to make their pay ratio disclosures for the first fiscal year beginning on or after January 1, 2017, which means that the first pay ratio disclosures will be made in proxies or Form 10-Ks in early 2018. The new SEC guidance gives issuers additional flexibility in complying with these rules. It also serves as a timely reminder that proxy season is right around the corner, so issuers should determine now the methodology and assumptions they will use for their pay ratio disclosure.

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Please do not hesitate to contact us with any questions.

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