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Executive Compensation and Employee Benefits and Capital Markets Client Alert: SEC Issues Additional Guidance on Compliance with Pay Ratio Rule

On September 21, 2017, the Securities and Exchange Commission (the “SEC”) released additional guidance on the pay ratio rule mandated under Section 953(b) of the Dodd-Frank Wall Street Reform and Consumer Protection Act, which rule was adopted in August 2015 (the “pay ratio rule”). The SEC’s new guidance includes an interpretive release and additional guidance from the Division of Corporation Finance, as well as updates to the compliance and disclosure interpretations related to the pay ratio rule. To the disappointment of many registrants, in connection with its new guidance, the SEC confirmed that the pay ratio rule will take effect on schedule.

Key highlights from the SEC’s interpretive guidance can be summarized as follows:

Use of Reasonable Estimates, Assumptions, Methodologies and Statistical Sampling: Perhaps most notably, the new guidance clearly states that there would be no basis for enforcement action against registrants who use reasonable assumptions, estimates or methodologies, so long as those assumptions, estimates and methodologies are provided in good faith. The SEC’s guidance reflects commentators’ concerns about potential liability given the fact that complying with the pay ratio rule may involve a degree of imprecision.

Independent Contractors: In October 2016, the SEC issued a C&DI that many commentators interpreted to suggest that independent contractors should only be excluded from the rule if an unaffiliated 3rd party determined the individual’s compensation. In connection with its new guidance, the staff withdrew this C&DI. The new interpretive guidance provides that registrants can rely on a widely recognized test used under another area of law to determine whether an individual should be considered an “employee” for purposes of the pay ratio rule. This should make it easier for registrants to determine which individuals to include as “employees” for purposes of identifying a median employee, since it allows registrants to look to more

commonly-used tests, such as those under tax or employment law, to make this determination.

Use of Internal Records: The SEC clarified that registrants may use appropriate existing internal records, such as tax or payroll records, to determine whether and to what extent it can exclude certain non-U.S. employees as provided for under the 5% de minimis exemption. The SEC also clarified that registrants can use tax or payroll records as a “consistently applied compensation measure” to identify the median employee, even if such records do not include every element of compensation (such as equity awards widely distributed to employees), so long as those records reasonably reflect the annual compensation of the registrant’s employee population.

In addition to the SEC’s guidance, the staff of the Division of Corporate Finance issued fairly descriptive guidance on the use of reasonable estimates and statistical sampling to determine the median employee.

Key highlights from the Division of Corporate Finance’s guidance are summarized below:

- The staff provided specific examples of sampling methods that registrants may use, which include simple random sampling, stratified sampling, cluster sampling and systematic sampling, and confirmed that registrants may use a combination of sampling methods.
- The staff provided examples of situations where registrants may use reasonable estimates, which include analyzing the composition of the registrant’s workforce, using the mid-point of a compensation range to estimate compensation, and characterizing a statistical distribution of compensation of the registrant’s employees and its parameters.
- To illustrate the use of combining reasonable estimates with statistical sampling or other reasonable methodologies, the staff confirmed that, for example, a registrant with multinational operations may be permitted to use sampling for some geographic/business units and a combination of other methodologies and reasonable estimates for other geographic/business units.

Practical Considerations

Though the SEC’s new guidance certainly provides clarification with respect to certain aspects of the pay ratio rule, this new guidance also has the effect of providing registrants with even more flexibility in the methodologies and assumptions that may be used to identify the median employee and comply with the pay ratio rule. It is possible that, as a result of this new guidance, we will see more registrants using statistical sampling to identify their median employee, given that certain sampling

methods are likely to ease the costs and administrative burdens to the registrant. The overall tone of the SEC's guidance seems clear: registrants are given wide latitude in employing reasonable estimates, assumptions or methodologies, but these estimates, assumptions and methodologies must be reasonable in light of the registrant's particular facts and circumstances and be designed to result in good faith compliance with the pay ratio rules. Registrants should take comfort in the statement that, so long as the registrant's estimates, assumptions and/or methodologies are reasonable and not made other than in good faith, the resulting pay ratio and related disclosure would not provide a basis for SEC enforcement.

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