The CEO Pay Ratio Rule: The Foreign Employee Exemptions

Starting in 2018, public companies will be required to disclose in their annual report on Form 10-K and definitive proxy statement the ratio of the median of the annual total compensation of their employees (other than the Chief Executive Officer) and the annual total compensation of their Chief Executive Officer (the "Pay Ratio Rule"). This initial disclosure will be based on the compensation paid for the first fiscal year beginning on or after January 1, 2017.

To assist you in understanding and complying with this new disclosure requirement, we have put together a guide, ***Complying with the CEO Pay Ratio Disclosure Requirement***.

To determine the "median of the annual total compensation of their employees," companies subject to this new disclosure requirement must first identify the "median employee" whose pay is to be compared to that of their CEO. For this purpose, the "median employee" is to be selected from all of a company's employees. While, as a general matter, non-U.S. employees are to be included in a company's employee population when identifying the "median employee," the Pay Ratio Rule contains two specific exemptions that permit companies to exclude non-U.S. employees from their employee population under the following conditions:

- The employee is employed in a foreign country in which the laws or regulations governing data privacy are such that the company is unable to do so without violating such laws or regulations (the "Data Privacy Exemption"); and
- The company's non-U.S. employees account for 5% or less of its total employees (the "De Minimis Exemption").

This article summarizes the requirements of these two exemptions.

The Data Privacy Exemption

In adopting the Pay Ratio Rule, the Securities and Exchange Commission noted that a country's data privacy laws or regulations may prohibit the transfer of compensation data outside the country's borders, making it impossible to obtain the information necessary to include that country's employees in the population used to identify the "median employee" without violating those laws or regulations. Consequently, the Pay Ratio Rule permits a company to exclude employees located in such a country if the company:

1. As part of the narrative disclosure that must accompany the CEO pay ratio:
   a. discloses each of the excluded countries;
   b. identifies the specific governing data privacy law or regulation;
   c. explains how complying with the Pay Ratio Rule violates such law or regulation;
   d. Describes the efforts it made to comply with such law or regulation (including, at a minimum, using or seeking an exemption or other relief under such law or regulation); and
   e. discloses the approximate number of employees exempted from each country based on this exemption.
2. Obtains a legal opinion from counsel that opines on the company's inability to obtain or process the information necessary to comply with the Pay Ratio Rule without violating such laws or regulations, including its inability to obtain an exemption or other relief under such laws or regulations; and
3. Files the legal opinion as an exhibit to the filing in which the CEO pay ratio disclosure is included.

Compliance Tip No. 1: To evaluate the utility of this exemption, you should determine the number of workers who performed services for your company in each country where you operated or maintained a business presence for the last completed fiscal year. This will enable you to ascertain whether any of these countries has laws or regulations that prevent you from obtaining the compensation data for your workers in each of these countries. If so, it will also enable you to determine whether, based on the number and status of the workers in each such country, it is worth pursuing the exemption.

Compliance Tip No. 2: If you decide to take advantage of the exemption in one or more countries, you should allow sufficient time to seek the required legal opinion (or opinions) that must be included with the filing containing your CEO pay ratio disclosure. Since it may take time to identify and retain appropriate counsel and, in addition, may require that you first seek an exemption or other relief from the applicable laws or regulations, it is important to start the process well in advance of the completion of your annual report on Form 10-K or definitive proxy statement.

Compliance Tip No. 3: The Pay Ratio Rule provides that where a company excludes any non-U.S. employees in a particular country, it must exclude all non-U.S. employees in that country. Note that this requirement may impact the availability of the De Minimis Exemption (as described below).

The De Minimis Exemption

In response to criticism that the inclusion of non-U.S. employees in the employee population for purposes of identifying the "median employee" would be unduly burdensome, the Pay Ratio Rule permits a company whose non-U.S. employees constitute 5% or less of its total employees to exclude all of these non-U.S. employees if the company:

1. As part of the narrative disclosure that must accompany the CEO pay ratio discloses:
    a. Each of the excluded countries;
    b. the approximate number of employees excluded from each such country;
    c. the total number of U.S. employees and non-U.S. employees irrespective of the exemption; and
    d. the total number of U.S. employees and non-U.S. employees used for its de minimis calculation.

Compliance Tip No. 1: If the aggregate number of non-U.S. employees in your company is less than 5% of your total employees, it behooves you to consider making use of this exemption as it should greatly simplify the process required for identifying the "median employee." In this situation, it is likely that you will be able to gather the necessary compensation data for your U.S. employees from a single payroll or HRIS system (or from multiple systems that are readily accessible) and to more readily select a "consistently-applied compensation measure" to identify the "median employee."

Compliance Tip No. 2: Even if the aggregate number of non-U.S. employees in your company is greater than 5% of your total employees, you may still exclude up to 5% of your total employees who are non-U.S. employees subject to the following conditions:

- if a company elects to take advantage of this exemption with respect to a specific country, it must exclude all of the employees of the selected country (in other words, it may not pick and choose which non-U.S. employees to exclude in any particular country);
- in the aggregate, the excluded non-U.S. employees from all of the countries selected must be 5% or less of your total employees; and
- any non-U.S. employees excluded pursuant to the Data Privacy Exemption must be counted against the 5% limit of the De Minimis Exemption for purposes of calculating the number of non-U.S. employees that may be excluded for purposes of the De Minimis Exemption.

Need Assistance?

Compensia can assist companies in preparing their CEO pay ratio disclosure, including developing a process for identifying their "median employee." If you would like assistance in understanding how the CEO pay ratio disclosure requirement will affect your company, preparing your initial CEO pay ratio disclosure, or if you have any questions on the subjects addressed in this Thoughtful Disclosure Alert, please contact Mark A. Borges. ■

The CEO Pay Ratio Requirement: The Foreign Employee Exemptions (continued)

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