Corporate and Privacy and Information Governance Practices

## Final Pay Ratio Rule Doubles Down on Latitude for Companies; Requires Cross Border Privacy Analysis for Data of Foreign Employees

On August 5, 2015, the Securities and Exchange Commission voted 3 to 2 to issue a final rule which requires certain public companies to disclose the following CEO-to-worker pay multiples ("pay ratio"):

- annual total compensation for the median employee, out of all employees, excluding the CEO (or equivalent),
- annual total compensation of the CEO, and
- ratio of the annual total compensation of the median employee to the annual total compensation of the CEO.

The disclosure is first required with respect to a company's fiscal year beginning on or after January 1, 2017. The final rule affords companies many options for determining their pay ratios. However, the final rule also requires companies to disclose nearly all choices with respect to the pay ratio. Generally, the types of information the final rule requires companies to disclose relate to methodology, assumptions, rationale for certain changes, reliance on available exemptions and the impact of the foregoing.

The final rule, which implements Section 953(b) of the Dodd Frank Wall Street Reform and Consumer Protection Act, came following intensive commenting both before and after the initial proposal of the rule in September 2013. Key changes from the proposed rule include:

- companies are only required to select the median employee once every 3 years, except in the event of certain changes to the company's employee population or employee compensation;
- companies may identify a median employee as of any date in the 3-month period prior to the applicable fiscal year end;
- companies may exclude certain employees, including, after taking certain measures and with a legal opinion, international employees where obtaining or processing information would conflict with applicable foreign privacy rules;
- companies must not disclose any personally identifiable information about that median employee other than compensation; and
- the compensation of certain foreign employees may be adjusted for cost of living.

### I. The Final Rule

#### What does "all employees" mean?

An "employee" is any employee of the company or any consolidated subsidiary of the company employed as of a measurement date. The measurement date is selected by the company and must fall within the last 3 months of the company's last completed fiscal year. A company need only identify a median employee once every 3 years, so long as there has been no change in the company's employee population or employee compensation arrangements that the company reasonably believes would result in a significant change to its pay ratio disclosure. Full-time, foreign, seasonal, part-time and temporary employees are included in the "all employee" pool. Independent contractors are explicitly excluded. Several additional exemptions are available for employees who would otherwise be included in the "all employee" pool:

### Data Privacy Exemption

Employees may be excluded from the "all employees" pool if they are employed in a foreign jurisdiction with data privacy laws or regulations that would be violated if the company were to obtain or process the information needed to comply with the pay ratio rule ("data privacy exemption"). However, in order to rely on the data privacy exemption, the company must comply with an onerous process, including, at a minimum, seeking an exemption under the applicable foreign law and obtaining (and filing as an exhibit) a legal opinion from counsel opining that obtaining or processing the information necessary to comply with the final rule would violate foreign law. Given the substantial burden and expense of obtaining the data privacy exemption, we expect companies will prefer, to the extent possible, to (i) exempt impacted employees under the de minimis exemption discussed below or (ii) seek out methods for including foreign employees in the "all employee" pool while complying with any applicable foreign privacy laws. The privacy laws of some foreign jurisdictions contain their own exemptions in respect of certain required disclosures. Companies and their counsel will need to analyze the interaction between the privacy laws of applicable foreign jurisdictions and the required pay ratio calculation and disclosure, including any dueling exemptions. A company relying on the data privacy exemption must disclose the excluded jurisdictions and the foreign data privacy law at issue and explain how complying with the pay ratio rule violates the foreign law. The disclosure must include the efforts made by the company to obtain an exemption and provide the approximate number of employees exempted from each jurisdiction under the data privacy exemption.

### De Minimis Exemption

If a company's foreign employees make up 5% or less of the company's world-wide employees, the company may choose to either exclude or include all foreign employees from the "all employees" pool. Additionally, if a company's foreign employees make up more than 5% of the company's world-wide employees, the company may exclude foreign employees representing up to 5% of the company's world-wide employees from the "all employees" pool. If a company excludes any employee in a particular foreign jurisdiction, the company must exclude all employees in such foreign jurisdiction. Accordingly, no company may exclude an employee in a jurisdiction in which more than 5% of the company's world-wide employees are employed. Any exclusions under the data privacy exemption count against the 5% available for this "de minimis exemption." For instance, if 2% of the company's world-wide employees are excluded under the data privacy exemption, only up to 3% may be excluded under the de minimis exemption. A company using the de minimis exemption must name the jurisdiction(s) from which employees are being excluded and indicate (approximately) how many employees are being excluded from each such jurisdiction. The company must also disclose the total number of US and non-US employees without regard to the data privacy or de minimis exemptions and the total number of US and non-US employees used for its de minimis calculation.

### Acquisition Exemption

Employees who became employed by a company as a result of an acquisition or business combination may be excluded from the "all employee" pool in the fiscal year in which the transaction was completed. Similarly, for the purposes of determining whether a new median employee needs to be identified, companies are not required to evaluate whether the transaction was a significant change to employee population or compensation until the fiscal year after the fiscal year in which the transaction was completed. The company must disclose the approximate number of employees omitted and identify the acquired business.

## What methods may be used to identify the median employee?

Annual total annual compensation need only be calculated for the median employee (not for each employee), making selection of the median employee a crucial element of the process. Companies may elect to identify the median employee from the full employee population's actual annual total annual compensation as calculated pursuant to Regulation S-K Item 402(c)(2)(x), but the final rule also allows use of statistical sampling, consistently applied compensation measures (such as payroll or tax records) and reasonable assumptions or estimates regarding compensation (or any element of compensation) in order to identify the

median employee. Companies may, but are not required to, annualize compensation of permanent employees employed for less than the full fiscal year. However, companies are prohibited from annualizing or making a full-time equivalent adjustment to the compensation of seasonal or part-time employees. In determining the median employee, a company is permitted to adjust the cost of living of employees residing in a jurisdiction other than the jurisdiction in which the CEO lives. (However, a company electing this approach must also disclose the median employee's annual total compensation and pay ratio without the cost of living adjustment.)

### How is annual total compensation to be determined?

Once the median employee is identified, actual total annual compensation for the fiscal year for both the median employee and the CEO would be determined pursuant to Regulation S-K Item 402(c)(2)(x). Item 402(c)(2)(x) requires disclosure of the total sum of all compensation, including salary, bonus, stock awards, option awards, non-equity incentive plan compensation, change in the pension value and non-qualified deferred compensation earnings and all other compensation. Reasonable estimates may be used in respect of any element of the median employee's annual total compensation, but may not be used in respect of CEO annual total compensation. Companies with more than one CEO in a fiscal year may elect to combine the compensation of all the CEOs during their time as CEO in the fiscal year or annualize the compensation of the CEO serving as of the measurement date.

Given that Item 402 was drafted to communicate the compensation of executives, companies may face challenges adapting the requirements for the median employee. For non-salaried employees, references to salary may be deemed to refer to wages plus overtime. Some employees, particularly abroad, may receive unique benefits, such as housing, which may be difficult to quantify. Benefits under $10,000 (which often includes healthcare) may be excluded from the total annual total compensation calculation. However, companies may prefer to include such benefits in total compensation as those amounts may represent a significant portion of the median employee's annual total compensation. Companies must take a consistent approach in respect of the items included for calculations of the compensation of the CEO and the median employee. Employer contributions to a government-mandated pension plan, which the SEC likens to a tax, may not be included in an employee's annual total compensation.

Any cost of living adjustment made for the purpose of identifying the median employee must be used to calculate such employee's annual total compensation.

### What disclosure is required in addition to the pay ratio?

The final rule requires companies to briefly describe the methodology used to identify the median employee and any material assumptions, adjustments (including any cost-of-living adjustments), or estimates used to identify the median or to determine total compensation or any elements of total compensation. Such methodologies must be consistently applied throughout all calculations. The final rule also requires a company to clearly identify any estimates used. The adopting release notes, for example, that a company using statistical sampling must describe the sample size, the estimated whole population, any material assumptions used and the sampling method(s) used. Additionally, although the required descriptions must provide sufficient information for readers to evaluate the appropriateness of the methodologies used, companies are not required to include any technical analyses, formulas, confidence levels, or the steps used in data analysis. The final rule requires companies to disclose any change in methodology, significant assumption, adjustment, or estimate from the prior year if the effects of any such change are significant. Companies must also disclose if they changed from using the cost-of-living adjustment to not using that adjustment and if they changed from not using the cost-of-living adjustment to using it.

### How must the pay ratio be expressed?

The pay ratio may be expressed as a ratio in which the median employee's annual total compensation equals one or, alternatively, in a narrative format indicating the multiple that the CEO compensation bears to the median employee's compensation.

### When and where must pay ratio disclosure be made?

Pay ratio disclosure will first be required in respect of fiscal years beginning on or after January 1, 2017. The

disclosure will be required in the later filed of a company's annual report on Form 10-K or definitive proxy or information statement for an annual meeting, so long as the pay ratio disclosure is made within 120 days after the end of the fiscal year; for calendar year-end companies, these filings will be in 2018.

### Which public companies must disclose pay ratios?

The disclosure requirements do not apply to emerging growth companies, smaller reporting companies, foreign private registrants filing on Form 20-F or Canadian companies that file their annual report on Form 40-F.

### What if CEO compensation cannot be calculated?

Pursuant to Instruction 1 to Items 402(c)(2)(iii) and (iv) of Regulation S-K, companies may omit salary or bonus compensation of an executive officer from the summary compensation table if the information is not calculable as of the latest practicable date and then provide the information under Item 5.02(f) of Form 8-K, once it becomes available. Under the final rule, a company relying on Instruction 1 to omit the compensation of the CEO would also delay disclosure of the pay ratio until the CEO's compensation information could be calculated. Companies would be required to disclose when the CEO's compensation is expected to become calculable in its entirety. Once the information is available, the pay ratio would be disclosed along with the CEO's annual total compensation in the Form 8-K.

### How should employees' personally identifiable information be treated in the disclosure?

Pursuant to the final rule, companies must not disclose any personally identifiable information about an employee other than compensation. However, for data privacy purposes, companies may look to use reasonable estimates for elements of the median employee total compensation, in order to avoid uniquely identifying the median employee and his or her total compensation. The final rule permits general disclosure of an employee's position to provide context to his or her compensation, but only to the extent the information could not identify a specific individual.

## II. Next Steps for Companies

- Start early. Preparing the pay ratio disclosure may require collection and analysis of voluminous data as well as a series of strategic decisions by management teams. The process will take time.
- Determine whether the company employs employees in foreign jurisdictions with data privacy laws applicable to obtaining and processing information required to comply with the final rule. If so, determine whether such employees can be excluded from the "all employees" pool (pursuant to the data privacy or de minimis exemptions) or whether such employees' data can be obtained and processed without violating applicable law. In this regard, explore whether counsel will provide an opinion.
- Consider whether to elect to exclude eligible foreign employees pursuant to the de minimis exemption.
- Determine the best method for identifying the median employee based on the company's circumstances.
- Consider whether cost of living adjustments are appropriate.
- Carefully craft a description to provide context for the pay ratio. In addition to the ample required disclosure, consider whether to take advantage of the option of including supplemental ratios. Investors are likely to consider messaging regarding the pay ratio when making their say on pay votes.
- Establish controls to protect the privacy of employees' data.

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