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SEC Proposes Pay-for-Performance Disclosure Rules

On April 29, 2015, nearly five years after the Dodd-Frank Wall Street Reform and Consumer Protection Act of 2010 (the "Act") was enacted, the Securities Exchange Commission ("SEC") issued proposed rules as the next step in implementing Section 953(a) of the Act, the pay-for-performance disclosure requirement. The vote among the Commissioners was split 3-2, reflecting divided opinions on the proposed rule.

The proposal would generally mandate that a company disclose in its proxy or information statement: the "actual pay" of its principal executive officer ("PEO"), average "actual pay" for its other named executive officers ("NEOs"), the company's total shareholder return ("TSR") and TSR for the company's peers (which may include a standardized index), each on an annual basis, over the five most recently completed fiscal years, subject to a phase-in period. The information would be presented in a prescribed table, with a subsequent description of the reported relationships. Supplemental disclosure is permitted, but not required. The proposed disclosure requirements would not apply to emerging growth companies or foreign private issuers, and smaller reporting companies would be subject to scaled disclosure requirements. There is a 60-day comment period, following which the SEC will vote on it a second time before it can take effect.

Background

Executive pay has attracted a great deal of attention over the past decade, with heightened focus on the linkage between pay and performance. While this linkage is critical to shareholders, there are differing views on how to measure both pay and performance for purposes of any meaningful single illustration or comparison across companies. In order to provide useful information to investors, the proposed rules attempt to accomplish this ambitious goal of defining in a clear manner both pay and performance.

Section 953(a)(i) of Dodd-Frank states that: "the Commission shall, by rule, require each issuer to disclose…information that shows the relationship between executive compensation actually paid and the financial performance of the issuer, taking into account any change in the value of the shares of stock and dividends of the issuer and any distributions." Since the statutory language was drafted quite broadly, and left much room for interpretation on several key factors essential to any disclosure, the market has long been awaiting the SEC's guidance on the matter.

As proposed, the rules mandate specific calculations of the SEC's formalized definitions of pay and performance (each described in more detail below), but leave some room for companies to supplement the disclosure with additional performance measures and/or explanatory text or graphics. While compliance costs are likely to vary among companies depending on the particular compensation structures, and in almost all cases companies will

need to collect new data, the SEC stated that it hopes the rules will increase transparency and promote accountability.

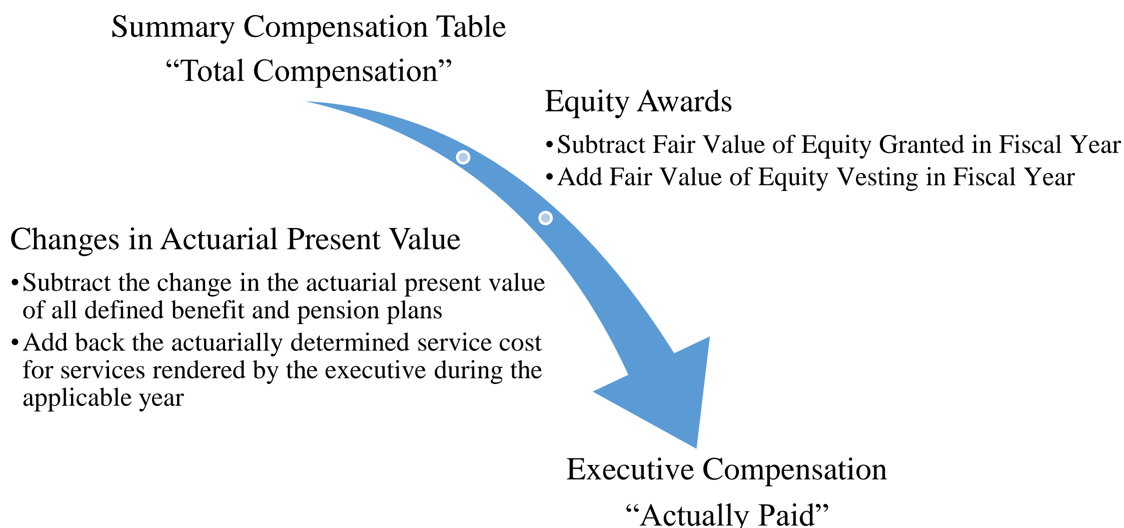
Following is a copy of the required table under the proposed rules, as context for the discussion below:

PAY VERSUS PERFORMANCE

Year (a)	Summary Compensation Table Total for PEO (b)	Compensation Actually Paid to PEO (c)	Average Summary Compensation Table Total for non-PEO Named Executive Officers (d)	Average Compensation Actually Paid to non-PEO Named Executive Officers (e)	Total Shareholder Return (f)	Peer Group Total Shareholder Return (g)

What Constitutes "Executive Compensation Actually Paid"?

The proposed rules would require that "executive compensation actually paid" be total compensation as disclosed in the Summary Compensation Table, modified to exclude changes in actuarial present value of benefits under defined benefit and actuarial pension plans that are not attributable to the applicable year of service, and to include the value of equity awards at vesting rather than when granted.



With respect to pension plan payments, the proposed rule excludes the portion of the total change in actuarial pension value that results solely from changes in interest rates, executive's age, and other actuarial inputs and assumptions regarding benefits accrued in previous years due to the significant volatility that may be attributable to these factors.

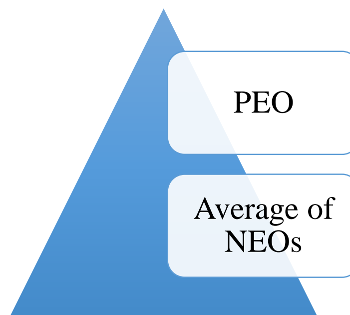
As for the new equity valuation, the value of stock awards upon vesting is already disclosed in the Option Exercises and Stock Vested Table, and thus is, in part, a repackaging of already calculated amounts. By contrast, companies are not currently required to report the value of option awards upon vesting if they are not exercised, and will now be required to compute these amounts on a "fair value" basis. Moreover, as proposed, a company would be required to disclose in a footnote to the table the vesting date valuation assumptions, such as expected

term and volatility, if they are materially different from those disclosed in its financial statements as of the grant date.

Overall, we note that calculating executive compensation "actually paid" will necessitate computing historical values for equity and pension benefits that were not previously required for proxy statement disclosure.

Who are the Executives Covered?

The executives covered would consist of (i) the company's PEO; and (ii) the company's other NEOs as identified in the Summary Compensation Table (reported based on average pay). The rule proposes that if more than one person served as the PEO during the fiscal year, then the disclosure for the persons who served as PEO will be aggregated for such year, noting this is appropriate because it reflects the total amount that was paid by the company for those services.

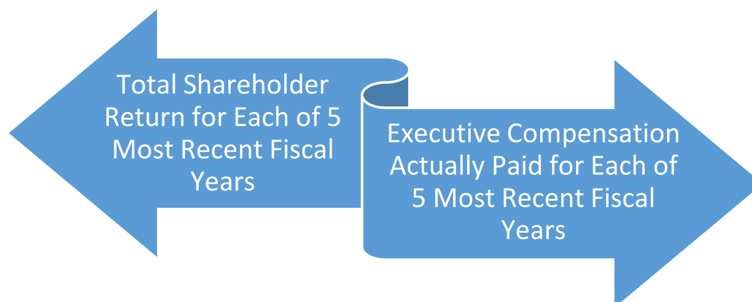


The SEC further states that requiring disclosure of the average compensation of the remaining NEOs would help make the information about these NEOs more comparable from year to year in spite of the variability in the composition and number of NEOs over the years for which disclosure is required. Nevertheless, this may raise questions as to how companies will depict and explain fluctuation in compensation due to changes in the composition of the NEO group over the reporting period, as severance and new hire packages may appear to skew results when compared to the normal, ongoing pay program.

What is the Financial Performance Measure?

While countless performance measures are used by companies in annual and long-term incentive plans, the SEC selected TSR as the measure to evaluate company performance due in part to TSR's objective nature, consistency in calculation, and lack of subjective determination. Also mentioned was shareholder familiarity with the measure and the ease in which to apply it across industries and over various time frames.

A company may provide additional disclosure using any other measures it believe to be appropriate so long as any additional disclosure is clearly identified, not misleading and not presented with greater prominence than the required disclosure. This flexibility in approach may be helpful if a company believes that TSR does not accurately present a holistic view of total performance or other factors are necessary to tell the company's individual story.



The disclosure calls for the reporting company's TSR on an annual basis over the prior five years, as well as the TSR of the company's peer group. As proposed, the rules require companies to use either the same peer group they use for the SEC's already required "stock performance graph" (which may include a published industry or line-of-business index) or, a peer group reported in the Compensation Discussion & Analysis ("CD&A").

If the peer group is not a published industry or line-of-business index, the identity of the issuers comprising the group must be disclosed. The returns of each component issuer of the group must be weighted according to the respective issuers' stock market capitalization at the beginning of each period for which a return is indicated. Note that the weighted average TSR computation in the proposed rules is different from the typical simple average or percentile comparisons included in many companies' CD&As as well as those used by proxy advisory firms.

What is the Performance Period?

The proposed disclosure would ultimately look back five years, subject to a phase-in period whereby a three-year look-back is required in the first year of disclosure, a four-year look-back in the second year of disclosure, and finally the full five-year look-back beginning in the third year of disclosure. In addition, a company need only provide pay-for-performance disclosure for years that it was a reporting company, such as a newly public company that does not otherwise qualify for emerging growth company relief.

What is the Form of Disclosure?

Under the proposed rules, the form of disclosure would be a standardized table and a corresponding explanation. Specifically, the rules would require companies to provide (i) total compensation as disclosed in the Summary Compensation Table, (ii) the executive compensation actually paid, (iii) company TSR, and (iv) peer group TSR, all in the prescribed table. The executive compensation disclosure would be presented separately for the PEO, and as an average for the remaining NEOs.

The SEC stated that requiring disclosure of the Summary Compensation Table measure of total compensation together with the new proposed measure of executive compensation actually paid would provide shareholders with disclosure of two measures in one single table, and thus facilitate comparisons of the two measures of a company's executive compensation to its performance.

For each amount disclosed as executive compensation actually paid in the prescribed table, the proposed rule would also require footnote disclosure for both PEO compensation and average NEO compensation of each amount deducted from, and added to the total compensation amount as provided in the Summary Compensation Table.

Using the values presented in the table, the proposed rule would then require the company to describe the relationship between the executive compensation "actually paid" and company TSR, and the relationship between company TSR and peer group TSR. The disclosure about the relationship would follow the table and could be described as a narrative, in a graph, or a combination of the two.

Disclosure Details

The pay for performance disclosure would be included in any proxy or information statement for which regular executive compensation disclosure is required. As described above, additional graphic or tabular depictions, as well as the use of additional performance measures, are permitted but not required. In addition, companies would have flexibility regarding the location of the new disclosure in the proxy or information statement; it would not be required to be included in the CD&A.

Smaller reporting companies would only have to report for the three most recent years (with a modified phase-in period), could exclude pension amounts from the calculation of compensation, and would not have to provide the peer group TSR information. Foreign private issuers, registered investment companies and emerging growth companies would be exempt from the disclosure requirements.

The SEC would also require that the disclosure be provided in tagged data format using eXtensible Business Reporting Language (XBRL).

Next Steps

Comments on the proposed rules may be submitted to the SEC within 60 days after publication of the rules in the Federal Register.

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General questions about this summary can be addressed to:

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Specific questions should be referred to company counsel. Copies of this summary and other published materials are available on our website at www.fwcook.com.