Client Alert

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Pay-Versus-Performance: SEC Proposes Rules to Expand Executive Compensation Disclosure in Proxy Materials

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Nearly five years after the Dodd-Frank Wall Street Reform and Consumer Protection Act (the "Act") was enacted in July 2010, the SEC narrowly approved proposed rules required under Section 953(a) of the Act. Section 953(a) of the Act added Section 14(i) to the Securities Exchange Act of 1934 (the "Exchange Act"), which directs the SEC to adopt rules requiring companies to disclose in a clear manner the relationship between executive compensation actually paid and the financial performance of the company, as measured by share price appreciation and dividends or distributions. In proposing these rules, SEC Chair White commented that the disclosure contemplated by the rules would "better inform shareholders and give them a new metric for assessing a company's executive compensation relative to its financial performance."

While the Act is principally focused on changes to the financial regulatory system, Title IX of the Act includes corporate governance, compensation and disclosure provisions that apply to public companies, regardless of industry. This latest rule proposal follows the SEC's previous rulemaking efforts on these topics, notably "say-on-pay" (final rules adopted 2010), compensation committee and adviser independence (final rules adopted January 2013), enhanced incentive compensation restrictions and disclosure for covered financial institutions (rules proposed March 2011), proxy access (rules adopted in August 2010 and invalidated by a court ruling in July 2011), CEO pay ratio (rules proposed September 2013), and employee and director hedging (rules proposed February 2015). In addition, the national securities exchanges have taken action to implement the Act's compensation committee and adviser independence requirements.

The proposed pay-versus-performance rules are subject to a 60-day comment period following publication in the *Federal Register*.

OPERATION OF THE PROPOSED RULES

The proposed rules would add new Item 402(v) of Regulation S-K, which would require a company to provide a clear description of (1) the relationship between executive compensation actually paid to the company's named executive officers and the cumulative total shareholder return ("TSR") of the company, and (2) the relationship between the company's TSR and the TSR of a peer group chosen by the company, over each of the company's five most recently completed fiscal years.

The proposed disclosure would be required in proxy or information statements for annual meetings of shareholders in which executive compensation disclosure is required. Such executive compensation disclosure is required if any action is to be taken at the annual meeting of shareholders with regard to (1) the election of directors; (2) any bonus, profit sharing or other contract or arrangement in which any director, nominee or executive officer of the company will participate; (3) any pension or retirement plan in which any director, nominee or executive officer of the company will participate; or (4) the granting or extension of options, warrants or rights to purchase securities on a pro rata basis to any director, nominee or executive officer of the company.

General Content of Proposed Disclosure

Currently, no requirement exists under the federal securities laws to disclose specific information showing the relationship between executive compensation actually paid and the financial performance of a company.

The proposed disclosure would require companies to add a new table to their proxy materials with the following information:

- Executive compensation actually paid for the principal executive officer and the average compensation actually paid to the remaining named executive officers;
- The total executive compensation reported in the Summary Compensation Table included under Item 402(c) of Regulation S-K for the principal executive officer and the average of the reported amounts for the remaining executive officers;
- The company's TSR on an annual basis, using the definition of TSR in Item 201(e) of Regulation S-K, which sets forth an existing requirement for a stock performance graph; and
- The TSR on an annual basis of the companies in a peer group.

The SEC designed this tabular disclosure so that it may be compared across companies. In addition, the proposed rules allow companies to supplement their disclosure about pay-versus-performance with a narrative discussion to provide additional information that reflects the specific situation of the company and its industry.

Executives Included in the Disclosure of "Executive Compensation Actually Paid"

The new table prescribed by the proposed rules would include executive compensation "actually paid" to named executive officers, as defined in Item 402(a)(3) of Regulation S-K (or Item 402(m) for smaller reporting companies). However, while the proposed rules would require companies to disclose the executive compensation actually paid to the principal executive officer, the compensation amounts disclosed for the remaining named executive officers would be the average compensation actually paid to those executives.

If more than one person served as principal executive officer during the fiscal year covered by the proxy materials, the proposed compensation to be disclosed for the persons who served as principal executive officer of the company would be aggregated for the years in which more than one person served as the principal executive officer.

Executive Compensation "Actually Paid"

Under the proposed rules, executive compensation "actually paid" would be calculated using compensation that companies already report in the proxy statement as a starting point. Specifically, compensation "actually paid" pursuant to the proposed rules would equal total compensation, as reported in the Summary Compensation Table, with certain adjustments relating to pension amounts and equity awards.

Adjustments to Pension Amounts. Companies would be required to disclose the adjustments to the compensation as reported in the Summary Compensation Table. Pension amounts would be adjusted by deducting the change in pension value reflected in that table and adding back the actuarially determined service cost for services rendered by the executive during the applicable year. Smaller reporting companies would not be required to make adjustments in pension amounts because they are subject to scaled compensation disclosure requirements that do not include disclosure of pension plans.

Adjustments to Equity Awards. Under the proposal, equity awards would be considered actually paid on the date of vesting and at fair value on that date, rather than fair value on the grant date as required in the Summary Compensation Table. Both amounts would be disclosed in the new pay-versus-performance table. A company would be required to disclose the vesting date valuation assumptions if they are materially different from those disclosed in its financial statements as of the grant date.

Any deviation of compensation “actually paid” from the total compensation amount as reported in the Summary Compensation Table may be explained in footnote disclosure to the pay-versus-performance table.

Measure of Company Performance

The proposed rules would require that companies use TSR (as defined in Item 201(e) of Regulation S-K) as the measure of financial performance of the company for purposes of pay-versus-performance disclosure.

TSR is an objectively determinable measurement, and not open to subjective determinations of performance. The SEC set forth a standard unit of measure for the proposed disclosure—instead of allowing companies to choose a measure best suited to their company—in order to increase the comparability of pay-versus-performance disclosure across companies.

To supplement the required disclosure, the proposed rules would permit companies to provide supplemental measures of financial performance, as long as any such additional disclosure is clearly identified, not misleading and not presented with greater prominence than the required disclosure.

Peer Group

Pursuant to the proposed rules, companies would be required to disclose the relationship between company TSR and peer group TSR, in each case over the company’s five most recently completed fiscal years, using the peer group identified by the company in its stock performance graph or in its compensation discussion and analysis discussion (“CD&A”) included in Item 402(b) of Regulation S-K.

Smaller reporting companies would not be required to present a peer group TSR because they are not required to include an Item 201(e) performance graph or a CD&A.

Disclosure Period Covered

Companies would be required to provide the disclosure contemplated by proposed rules for the last five fiscal years, except that smaller reporting companies would be required to provide disclosure for only the last three fiscal years.

For companies that are new to Exchange Act reporting obligations, the pay-versus-performance disclosure would be required for only the years in which the company was an Exchange Act reporting company.

Location of Proposed Disclosure

Proxy Materials—Not Annual Reports or Registration Statements. The SEC contemplates that the proposed disclosure would be provided along with the Item 402 executive compensation disclosures; however, the proposed rules provide flexibility to companies in determining where in the proxy or information statement to provide the disclosure contemplated.

The CD&A disclosure required by Item 402(b) of Regulation S-K must provide an explanation of "all material elements of the company's compensation of the named executive officers." While not encompassed by the CD&A—because the company may not have considered the pay-versus-performance relationship in its compensation decisions—the proposed disclosure can supplement the discussion in the CD&A as part of the shareholder's evaluation of the company's executive compensation practices and policies.

The language of Section 14(i) of the Exchange Act calls for the proposed disclosure to be provided in solicitation materials for an annual meeting of shareholders. As a result, the proposed disclosure would not be required in any Form 10-K or any registration statement that also requires Item 402 disclosure.

XBRL. In addition to providing the tabular and narrative disclosure contemplated by the proposed rules, companies would also be required to tag the disclosure in an interactive data format using eXtensible Business Reporting Language, or XBRL. Notable for being the first instance in which disclosures in proxy materials would be tagged in XBRL, this requirement would be phased-in for smaller reporting companies, so that they would not be required to comply with the tagging requirement until the third annual filing in which the pay-versus-performance disclosure is provided.

Covered Companies

The proposed rules would apply to all Exchange Act reporting companies, except for foreign private issuers, registered investment companies and emerging growth companies (which are exempt from the statutory requirement under the JOBS Act).

Transition Period

The proposed rules would provide a phase-in for all companies. Companies—other than smaller reporting companies—would be required to provide the information for the three most recent fiscal years in the first proxy or information statement in which they provide the disclosure, adding an additional year of disclosure in each of the two subsequent annual proxy or information statements that require this disclosure. Smaller reporting companies would initially provide the information for two years, adding an additional year in the subsequent annual proxy or information statement that requires this disclosure.

DISSENTING VIEWS

At the Open Commission Meeting at which the SEC Commissioners voted on the pay-versus-performance rules, Commissioners Gallagher and Piwowar each issued dissenting statements indicating that they did not support—and would not vote in favor of—the proposed rules. Among their concerns with the proposal were: (1) tabular disclosure is unnecessary, as the statutory directive only required narrative disclosure of pay-versus-performance; (2) compensation for named executive officers other than the principal executive officer is unnecessary because the tone of named executive officers' compensation is set by the compensation paid to the principal executive officer; (3) requiring the singular measure of TSR to compute a company's performance will lead to corporate strategies designed to inflate stock price in the short term; (4) smaller reporting companies are not excluded from the requirements of the proposed rules; and (5) the rulemaking was inappropriately prioritized over other important Dodd-Frank Act rulemakings.

HOW WILL PAY-VERSUS-PERFORMANCE DISCLOSURE INFLUENCE ENGAGEMENT WITH SHAREHOLDERS?

With respect to the all-important shareholder engagement efforts that have been implemented in response to say-on-pay, the relationship of compensation to company performance has become a central part of the ongoing dialogue. The strong interest of shareholders in the portion of executive compensation tied to a company's performance is already reflected in most proxy statements, which often utilize a variety of methodologies and visual aids to demonstrate the relationship between pay and performance for the company's CEO and other named executive officers.

In addition, when developing voting recommendations for say-on-pay proposals, each of the major proxy advisory firms—ISS and Glass Lewis—evaluates a company's executive compensation program using both quantitative and qualitative components. Both firms use the quantitative alignment between pay and performance as the foundation of their analyses. ISS focuses solely on the CEO and measures performance based only on TSR. Glass Lewis focuses on all of the named executive officers, and measures performance based on a multifaceted proprietary model, including GAAP financial measures and TSR. We note that proxy advisory services have also begun to take into account some version of "realizable pay" or "realized pay" when making say-on-pay voting recommendations. Companies with strong alignment usually receive a "for" vote recommendation from the proxy advisory firms, unless the absolute magnitude of CEO pay is deemed to be excessive or the company maintains problematic pay practices. Companies with "improper" alignment are subject to a higher degree of qualitative scrutiny and are more likely to receive an "against" vote recommendation, especially if there are problematic pay practices or other policies that are deemed to be inconsistent with a pay-versus-performance compensation philosophy.

Given the extent to which pay-versus-performance disclosure and analysis has already evolved since the implementation of say-on-pay votes, it appears likely that any new disclosures to be required by the SEC will serve to supplement, rather than replace, the disclosure practices that have developed. One of the criticisms of current disclosure practices concerning pay-versus-performance is that the measures used by companies and the ways in which they compare compensation and performance are not uniform, creating a lack of comparability across companies. The SEC seeks to address this concern in its rulemaking by mandating a more standardized approach to determine compensation actually paid and mandating a comparison to TSR.

WHAT'S LEFT FOR RULEMAKING UNDER THE ACT?

The future of some rulemaking under the Act remains uncertain. Various bills are pending in Congress that would seek to correct, clarify or scale back provisions of the Act. For example, the "Burdensome Data Collection Relief Act" (HR 414) was introduced to repeal the CEO pay ratio disclosure requirement, which would require companies to disclose, with Item 402 executive compensation discussion, the ratio of the median of the annual total compensation of all employees to the annual total compensation of the chief executive officer. This same bill was introduced in 2013 but was not ultimately enacted.

The SEC has not yet proposed rules with regard to Section 954 of Dodd-Frank—"Recovery of Erroneously Awarded Compensation." Section 954 added Section 10D to the Exchange Act and requires that stock exchange listing standards be amended to require that companies adopt a "clawback" policy. Under Section 954, these "clawback" policies would be required to provide that, if a company is required to prepare an accounting restatement due to material noncompliance with any financial reporting requirement under the securities laws, the company will recover from any current or former executive officer the amount of incentive-based compensation received during the three-year period preceding the date on which the company is required to prepare an accounting restatement that is in excess of what would have been paid under the restatement. Additional disclosure will also be required of a company's policy on incentive-based compensation that is based on financial information required to be reported under the securities laws. There is no available timeline for release by the SEC of proposed rules implementing Section 954 of the Act, although we note that many companies have implemented clawback practices voluntarily for the purposes of demonstrating their commitment to good corporate governance practices.

In February 2015, the SEC proposed rules that would implement Section 955 of the Act, which would require disclosure of whether employees or members of the board of directors are permitted to engage in transactions to hedge or offset any decrease in the market value of equity securities granted to the employee or director as compensation, or held directly or indirectly by the employee or board member. The comment period for this rulemaking has closed, and no indication has been provided as to when the final rules will be adopted.

In March 2011, the SEC and several other federal agencies proposed rules to implement Section 956 of the Act, which would provide for restrictions and disclosure concerning certain incentive-based compensation arrangements of certain financial institutions. The comment period for this rulemaking has closed, and no indication has been provided as to when the final rules will be adopted.

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