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## Corporate Practice

# SEC Balances Comparability Against Flexibility in Proposed Pay-Versus-Performance Rule

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On April 29, 2015, the Securities and Exchange Commission (the SEC) voted 3 to 2 to issue a long-awaited proposed rule on pay-versus-performance disclosure mandated by the Dodd-Frank Wall Street Reform and Consumer Protection Act (Dodd-Frank). The proposed rule seeks to provide investors with standardized information that can be compared across companies while preserving companies' flexibility to tell their own stories regarding the relationship between executive compensation and company performance. The comment period will be open for 60 days. Given the ease of computing the required disclosure, if the comment process and rule adoption move forward smoothly, we may see pay-versus-performance disclosure begin to be phased-in for the next proxy season.

**I. The Proposed Disclosure – Overview**

The proposed rule would require proxy and information statements[i] bearing executive compensation disclosure to include a table with the following new items covering the previous five fiscal years:

- *Total compensation actually paid to the CEO or other principal executive officer*

  This metric is derived by modifying the total for the officer in the current summary compensation table, as described more fully below. Where there is more than one CEO in a year, compensation for the CEOs will be aggregated.

- *Average of the total compensation actually paid to the other named executive officers (NEOs)*

  By using an average figure, the SEC hopes to smooth out the variability associated with changes in the identity and number of NEOs over a five-year period and standardize the figure for cross-company comparisons.

- T*otal shareholder return (TSR) of the company*

  This metric ties to the current shareholder return calculations, used for the performance graph required by Item 201(e) of Regulation S-K, which are calculated based on dividends and changes in share price.

- *TSR for the company's self-determined peer group*

  The peer group would be that used for comparison in the current performance graph or the current benchmarking in the CD&A.[ii]

The new table would also include amounts from the summary compensation table, for comparison purposes. In addition to the tabular disclosure, companies would be required to describe the relationship between pay and performance using the data points in the new table. Companies would have broad flexibility to determine the format for describing the relationship (as a narrative, graphically or both) and what additional measures or data points to include in the description.

**II. Background**

Section 953(a) of Dodd-Frank added Section 14(i) to the Securities Exchange Act of 1934 (the ’34 Act) and provides significant latitude to the SEC to implement a pay-versus-performance rule. Information on executive compensation and financial performance is already required by existing items in Regulation S-K. The proposed rule would layer the new pay-versus-performance disclosure into those existing Regulation S-K disclosure requirements by adding a new Item 402(v). The release anticipates that the pay-versus-performance disclosure will be especially helpful for say-on-pay advisory votes and has sought to structure the disclosure in order to “enable [shareholders] to better determine whether their companies are appropriately and responsibly setting executive pay.”[iii]

**III. New Disclosure Requirements**

*What Executive Compensation is “Actually Paid?"*

The SEC proposes to use a “cost for services rendered” concept to capture executive compensation “actually paid.” Executive compensation actually paid would be based on the current summary compensation table required by Item 402 of Regulation S-K, with the following adjustments:

- deduct changes in the actuarial present value of defined benefit and pension plans, and
- value equity awards at the vesting date instead of the grant date.

A company would have discretion to supplement the required disclosure with additional pay measures the company believed to be useful in understanding the relationship between pay and performance, so long as any supplemental measures were not misleading or more prominent than the required disclosure.

*What Performance Counts?*

Under the proposed rule, “performance” is defined as TSR. While companies must disclose TSR, they would also have latitude to determine how best to describe the relationship of pay to performance for their executives and industry, using the data points from the new chart. The SEC suggests that companies might choose to describe the relationship with a graph relating executive compensation to total shareholder return[iv] and/or by showing the percentage change year over year for executive compensation and total shareholder return, along with a brief discussion. The graph and percentage increase disclosure are only examples of options available to issuers and are not intended to be exclusive. Companies would also be permitted to provide performance measures in addition to TSR, so long as those measures were not misleading or more prominent than the required disclosure.

*How would the Disclosure be Phased-In?*

Companies would initially be required to provide pay-versus-performance disclosure only for the three most recently completed fiscal years. Each subsequent year, an additional year of disclosure would be added. Thus, companies would provide pay-versus-performance disclosure for the full five-year period in their third proxy statement requiring the disclosure. A company would not be required to provide pay-versus-performance disclosure for any years in which it was not a reporting company pursuant to Section 13(a) or Section 15(d) of the ’34 Act, and some additional phase-ins would apply in special circumstances.

*How would XBRL be Used?*

In a move that may signal a coming trend, the proposed rule would require the new disclosure to be tagged in eXtensible Business Reporting Language (XBRL). This data will be the first in the proxy statement to use XBRL tagging, which proponents argue will “unlock far greater value from the information”[v] and allow for information to be easily compared across companies.

*Who Must Disclose?*

Generally, public companies filing a proxy or consent solicitation that requires compensation disclosure under Item 402 of Regulation S-K must include the pay-versus-performance disclosure. The proposed rule would not require disclosure by foreign private issuers, registered investment companies or emerging growth companies.

*What About Smaller Reporting Companies?*

The proposed rule provides for scaled disclosure for smaller reporting companies. Smaller reporting companies would only be required to present information for the past three years instead of five, with the smaller reporting company phase-in requiring only two years of disclosure in the first year in which pay-versus-performance disclosure is required. Because smaller reporting companies' current compensation disclosure requirements do not include pension plans, those companies would not be required to include pension plan amounts in their calculation of executive compensation actually paid. Additionally, smaller reporting companies would not need to present peer group performance figures.

**IV. Consequences for Companies**

Companies should consider pay-versus-performance disclosure together with the existing disclosure requirements and the proposed CEO pay ratio disclosure when drafting their say-on-pay message. While the basic information required for the new disclosure should be fairly easy to compile based on information required for current disclosure, the hard work will be in communicating a company's complex pay-versus-performance story in the face of the simplistic TSR data point. We may see companies elect to incorporate into their disclosure pieces of some of the more complex models proxy advisors are already using to evaluate pay for performance. Cynics have suggested the proposed disclosure does a disservice to shareholders by incentivizing companies to emphasize short-term returns over long-term growth strategies.[vi] Total average compensation actually paid to NEOs may be subject to manipulation at the margins as well, to the extent of the discretion permitted to companies in determining which executives are NEOs.

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[i] Under the proposed rule, the disclosure would not be required for Forms 10-K.

[ii] The proposed rule would not require any new disclosure of compensation information for the peer group, so use of the peer group currently used for benchmarking would round out the current disclosure particularly well.

[iii] Improving Transparency for Executive Pay Practices, Commissioner Luis A. Aguilar.

[iv] If a company feels its performance cannot be reduced to TSR, it might elect a narrative discussion and avoid the discretionary chart plotting compensation and shareholder return.

[v] Recommendations of the Investor Advisory Committee Regarding the SEC and the Need for the Cost Effective Retrieval of Information by Investors (adopted July 25, 2013).

[vi] See, e.g., Dissenting Statement at an Open Meeting Proposing Mandated Pay Versus Performance Disclosures, Commissioner Daniel M. Gallagher.

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