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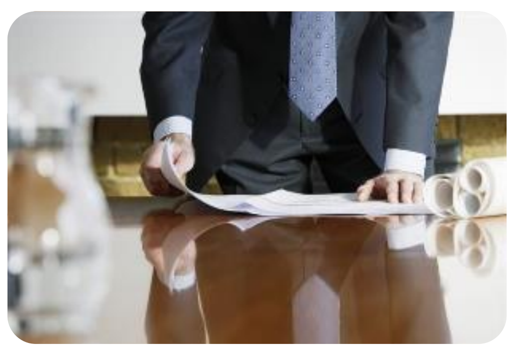
SEC Proposes Pay Versus Performance Disclosures

On May 7, the Securities and Exchange Commission issued a proposed rule that would require public companies to disclose the relationship between compensation actually paid to executives and the company's financial performance. The "pay versus performance" rule, which implements Section 953(a) of the Dodd-Frank Act, would require disclosure of the chief executive's actual pay, the average pay of other named executive officers, total shareholder return, and peer group comparisons. The proposed changes would be phased in over a three-year period. The SEC has invited comments by July 6, 2015.

Background

The *Dodd-Frank Wall Street Reform and Consumer Protection Act* (Dodd-Frank), which took effect in 2010, contains, among other things, provisions that affect executive compensation and the governance of public companies. The Securities and Exchange Commission (SEC), which is primarily responsible for enforcing federal securities laws, has already adopted a number of these provisions. However, four executive compensation rules remain to be finalized — including the pay-versus-performance disclosure rule.

The Securities Act of 1933, which governs the initial issuance and registration of securities (including stocks, bonds and debentures), requires the disclosure of financial information in registration statements and prospectuses to enable investors to make informed investment decisions. The Securities Exchange Act of 1934 (Exchange Act) governs the financial reporting and secondary trading of these securities.



Regulation S-K lays out reporting and disclosure requirements for various SEC filings by public companies under the Securities Act and the Exchange Act. Item 402 of Regulation S-K addresses executive compensation disclosures. It generally requires disclosure of all plan and non-plan (cash and non-cash) compensation awarded to, earned by, or paid during the last completed fiscal year to the company's named executive officers (NEOs) — the principal executive officer (PEO), principal financial officer (PFO), and the other three most highly compensated executive officers based on total compensation in the Summary Compensation Table (other than change in pension value). It does not, however, currently require disclosure of information on the relationship between executive pay and the company's financial performance.

Section 953(a) of Dodd-Frank added a new Section 14(i) to the Exchange Act, directing the SEC to issue rules requiring public companies to clearly describe in their proxy or consent solicitation material any compensation that is required to be disclosed under Item 402. Importantly, the new disclosure rules require public companies to compare executive compensation actually paid with the company's stock performance over the five most recently completed fiscal years — including any change in the value of the company's shares, dividends and distributions.

Proposed Pay-Versus-Performance Rule

In a 3-2 vote on April 29, the SEC approved a proposed pay-versus-performance rule that would require companies to disclose executive compensation as compared with corporate performance. Under the proposed rule, public companies would have to disclose the PEO's actual pay, average actual pay for other NEOs, and total shareholder return (TSR) in proxy and other information statements in which executive compensation disclosures are currently required under Item 402 of Regulation S-K. The proposed rule would also require disclosure of the TSR of those companies in the peer group identified by the company in its stock performance graph or in its Compensation Discussion and Analysis (CD&A) section.

The proposed rule would generally apply to all US reporting companies, but smaller reporting companies would have less burdensome disclosure obligations. Emerging growth companies, registered investment companies and foreign private issuers would be excepted from the new requirements.

Pay Versus Performance Table

The SEC proposal would require public companies to include a new Item 402(v) Pay Versus Performance Table in their annual proxy statements. Information for each of the last five fiscal years would have to be set forth in the following format:

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)

As shown above, the new table would require separate disclosures for PEO and average NEO compensation.

In addition to the new Pay Versus Performance Table, reporting companies would also be required to provide in narrative or graphical format for each of the last five completed fiscal years (subject to the transition rule) clear descriptions of the relationship between:

- The company's TSR and the compensation actually paid to the company's PEO and other NEOs
- The company's TSR and that of its peer group members

Companies would have the flexibility to add supplemental disclosure and performance measures, but would not be required to do so.

Disclosure Period

With certain limited exceptions, disclosures by securities issuers would be required for the five most recently completed fiscal years, but the requirement would be phased in over a three-year transition period. Companies covered by the new rule would have to provide three years of data in the first year, four years in the second and five in the third and future years.

> **Comment.** While the Summary Compensation Table currently requires disclosures for a three-year period, the stock performance graph requires disclosure for the prior five years. By adopting the same measurement period the graph uses, the SEC's proposed pay versus performance rule seeks to facilitate the comparison between pay and performance.

Smaller Reporting Companies. Smaller reporting companies would only be required to provide three — rather than five — years of data, phased in over a two year transition period. Two years of data would have to be provided in the first year, and three in the second and future years. As discussed more fully below, these companies would also be exempt from providing peer group comparisons.

Newly Reporting Companies. A company that is newly covered by the disclosure requirement, but not for the entire reporting period, would only be required to provide information for a completed fiscal year in which it was subject to the reporting requirements.

Compensation "Actually Paid"

In a significant shift from current reporting requirements, the SEC's proposed rule would require companies to disclose separately the compensation "actually paid" to the PEO for each covered fiscal year. The rules would also require companies to disclose the average compensation actually paid to the other NEOs in a year, which differs from the current requirement to report "total compensation" in the annual proxy Summary Compensation Table.

For these purposes, compensation actually paid would be based on the total compensation reported in the Summary Compensation Table — currently required in the proxy statement — with certain modifications for equity awards and pension benefits.

Equity Awards. While the Summary Compensation Table requires equity awards to be shown based on the fair value on the grant date, the proposed rule would require awards to be based on their value when vesting occurs, with certain adjustments for awards that vested during the applicable year.

> **Comment.** Currently companies are not required to disclose the value of options or stock appreciation rights (SARs) as of the vesting date, but they do have to disclose the value of stock awards (including restricted stock) as of the vesting date in the proxy statement's Option Exercises and Stock Vested table. While stock award values will not require additional calculations, companies will now be required to compute the value of vested but unexercised options on a fair value basis for this disclosure.

Pension Benefits. Defined benefit and pension plan amounts shown in the Summary Compensation Table would be replaced by an actuarially determined service cost that is intended to represent the amount "actually paid."

Under the SEC proposal, companies would be required to disclose in footnotes adjustments made to calculate the compensation actually paid. Any assumption made in valuing equity awards that materially differs from those disclosed in the Summary Compensation Table would also have to be disclosed.

Total Shareholder Return

Section 14(i) of the Exchange Act requires a company's financial performance to take into account changes in the value of the company's shares of stock and dividends and any distributions, but it does not specify how to measure performance. Under the proposed rule, financial performance would be measured by TSR.

Smaller Company Exemption

Because the compensation disclosure requirements for smaller reporting companies do not include pension plan disclosures, those companies would not have to make adjustments in pension amounts.

TSR of Reporting Company. For these purposes, TSR would be defined as in Item 201(e) of Regulation S-K and computed in the same way as the stock performance graph required in annual reports or proxy statements.

TSR of Peer Group. A public company would also be required to compare its TSR to that of its peer group members. Under the proposed rule, a company may opt to use either the same peer group it used in its stock performance graph or the peer group reported in the CD&A portion of its proxy statement. Either way, the TSR for each peer group company must be weighted based on the company's stock market capitalization at the beginning of each relevant measurement period. If the peer group is not a published industry or line-of-business index, the reporting company will be required to disclose the members of the peer group it has selected. However, it will not be required to explain the selection.

New Electronic Format

In the first-of-its-kind requirement for compensation-related or other proxy statement information, the SEC proposal would require the new disclosure to be electronically formatted using eXtensible Business Reporting Language (XBRL) and filed with the SEC as an exhibit to the definitive proxy or information statement. Each amount disclosed in the new Pay Versus Performance Table would be tagged, while footnote and other disclosures would be block tagged. Smaller reporting companies would have some transition relief and would not be required to comply with this requirement until the third annual filing in which the pay versus performance disclosure is provided.

In Closing.

The SEC included with the release of its proposal a general request for comments and 64 specific requests for comments by July 6. Among other things, the SEC asks whether its proposed rule strikes the right balance between satisfying the statutory requirements of Section 14(i) and giving issuers enough flexibility to provide useful information to their shareholders. The SEC also asks whether it should allow a principles-based approach to executive compensation disclosures. Although it is not yet clear whether new disclosure requirements will be in effect for the 2016 proxy season, compensation committees should begin to consider whether they will need to rethink how they measure their executive pay and align it with corporate performance as the SEC moves forward.

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