SEC Proposes Dodd-Frank Pay-Versus-Performance Disclosure Rules

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Overview

On April 29, 2015, the Securities and Exchange Commission (SEC) voted 3-2 to propose new rules requiring companies to disclose the relationship between executive compensation “actually paid” and the company’s “financial performance.” The proposed rules implement Section 14(i) of the Securities Exchange Act of 1934, as added by Section 953(a) of the Dodd-Frank Wall Street Reform and Consumer Protection Act. These disclosures would be required to be included in proxy or information statements in which executive compensation disclosure is currently required pursuant to Item 402 of Regulation S-K.

The pay-versus-performance rules are one of four governance and executive compensation-related provisions applicable to public companies under the Dodd-Frank Act that remain to be adopted by the SEC. Three of the four (pay-versus-performance, hedging policy and pay ratio) have now been proposed, leaving only the clawbacks rulemaking to be proposed. While not as controversial as the pay ratio rulemaking, pay-versus-performance nonetheless will bring with it challenges for companies subject to the new disclosure requirements, not to mention contribute to the ever-expanding length of proxy statements.

The two key questions in the pay-versus-performance disclosure mandate are what is compensation “actually paid” and what is “performance.” The SEC took the approach in the proposal that compensation “actually paid” is the total compensation that companies report in the summary compensation table with adjustments for pension benefits and equity awards, while “performance” must be measured by total shareholder return (TSR). In addition to disclosing information about the company’s compensation and TSR, certain companies subject to the new requirements also will be required to provide disclosure of their peer companies’ TSR.

Companies Subject to the New Disclosure Requirements

The proposed rules would apply to all reporting companies except for foreign private issuers (which are not generally subject to the proxy rules), registered investment companies and emerging growth companies (which were exempted from the statutory requirement by Section 102(a)(2) of the JOBS Act). Smaller reporting companies would be subject to the new requirements, but would receive certain accommodations under the proposal.

Covered Executives

The proposed rules would require disclosure about the company's named executive officers (NEOs) for each covered fiscal year. Information for the principal executive officer (PEO) would be presented separately, while an average would be provided for the remaining NEOs. If multiple PEOs serve during a covered fiscal year, the reported data would be an aggregation of those individuals' compensation. Any other former executives who are included in the summary compensation table as NEOs would be included in the average reported for the remaining NEOs. In discussing the proposal, the SEC noted its belief that requiring average compensation for the non-PEO NEOs would make the information more comparable year-to-year in light of the likely variability in the composition and number of non-PEO NEOs over the years for which disclosure is required.

Summary of New Disclosures

The proposed rules would add new paragraph (v) to Item 402 of Regulation S-K, which would require the following tabular disclosure for each of the company's last five completed fiscal years (or three years in the case of smaller reporting companies) in any proxy or information statement in which disclosure under Item 402 is required:

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)

As reflected above, the required table must disclose the following for each covered fiscal year:

- the PEO's total compensation, as reported in the summary compensation table in the proxy statement (presented on an aggregate basis if there was more than one PEO during the year);

- the compensation “actually paid” to the PEO (the summary compensation table total compensation as adjusted for pension benefits and equity awards) (presented on an aggregate basis if there was more than one PEO during the year);
- the average total compensation for the non-PEO NEOs (including any former executive officers required to be included in the summary compensation table);
- the average compensation “actually paid” to non-PEO NEOs (including any former executive officers required to be included in the summary compensation table);
- the company’s cumulative TSR, using the definition of TSR included in Item 201(e) of Regulation S-K, which sets forth an existing requirement for a stock performance graph; and
- the TSR of the companies identified in the peer group identified by the company in its stock performance graph or in its compensation discussion and analysis (CD&A).

Companies also would be required (using the information provided in the table) to provide 1) a clear description of the relationship between executive compensation actually paid to the company’s PEO and other NEOs and the cumulative TSR of the company for the period covered in the table and 2) a comparison of the company’s TSR and the TSR of the company’s peer group.

In addition to being allowed to present three rather than five years of information, smaller reporting companies also would not be required to provide disclosure about peer group TSR because they are not required to disclose an Item 201(e) performance graph or CD&A.

Companies would be required to tag the disclosure in eXtensible Business Reporting Language, or XBRL, which represents the first time information in proxy or information statements would be required to be tagged. 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.

Calculating Executive Compensation “Actually Paid”

The SEC stated that it recognizes companies currently follow different concepts for “realized” and “realizable” pay and that companies have not broadly accepted one conceptual approach over another. To provide comparability across issuers, the SEC’s proposed rule sets forth a calculation for amounts “actually paid.” Executive compensation “actually paid” would be calculated using the total compensation amount that companies report in the summary compensation table already required in the proxy statement as a starting point, with adjustments relating to pension benefits and equity awards. Companies would be required to disclose the adjustments to the compensation as reported in the summary compensation table.

Under the proposal:

- Pension amounts would be adjusted by deducting the change in pension value reflected in the summary compensation 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.

- 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. 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.

Measure of Financial Performance

While Section 14(i) of the Exchange Act does not specify how a company's financial performance is to be measured, it requires financial performance to take into account any change in the value of the shares of stock and dividends of the company and any distributions of the company. To meet this statutory requirement, the SEC has proposed to use TSR, as defined in Item 201(e) of Regulation S-K, which is calculated by dividing (i) the sum of (A) the cumulative amount of dividends for the measurement period, assuming dividend reinvestment, and (B) the difference between the registrant's share price at the end and the beginning of the measurement period; by (ii) the share price at the beginning of the measurement period. Issuers, other than smaller reporting companies, must present comparative TSR information for the same peer group used for purposes of Item 201(e) of Regulation S-K, or, a peer group used in the CD&A for purposes of disclosing the issuer's compensation benchmarking practices. For many companies, TSR is not the way financial performance is generally measured. While the proposal would require use of TSR, companies may supplement the required disclosure under the proposed rule with other measures that they feel are better suited to the company, so long as such measures are clearly identified, not misleading, and not presented with greater prominence than the required disclosure.

Subject to Say-on-Pay Vote

Because the proposed new disclosures would be provided under Item 402, the disclosures would be subject to the say-on-pay advisory vote required under Rule 14a-21(a). In proposing the new disclosure requirements, the SEC noted its belief that both the pay-versus-performance and pay ratio provisions under the Dodd-Frank Act were intended to provide shareholders with information to help assess a company's executive compensation when exercising their rights to cast say-on-pay votes, and that the new pay-versus-performance disclosures will provide shareholders a new metric for assessing a company's executive compensation relative to its financial performance.

Phase-In of New Disclosure Requirements

The proposed rules would be phased in for all companies subject to the new disclosure requirements. Companies other than smaller reporting companies would be required to provide information on the prior three years the first time the new disclosure is provided, with an additional year of information provided in each of the two subsequent annual proxy or information statements. Smaller reporting companies would initially provide the information for two years, with the third year to be added in their next annual proxy or information statement. The timing of adoption of the final rules will determine when the disclosure is first required, which could be as early as the 2016 proxy season.

Comment Period

Comments on the rule proposal should be received by the SEC on or before July 6, 2015. The proposing release includes 54 specific requests for comment, as well as a general request for comment. In addition to requesting comment on the various specific details of the rule proposal, the SEC more generally requests comment on whether the proposed rule strikes the appropriate balance between prescribing rules to meet the statutory requirements of Section 14(i) while also allowing issuers sufficient flexibility to provide the most useful information to shareholders, and whether the SEC should permit a principles-based approach to the disclosures.

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