McDermott Will & Emery

Bloomberg BNA Presentation
SEC Proposal on
New Pay versus Performance Disclosure Rules

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Agenda

- Background on Proposed Rule
- What would the new Pay versus Performance table look like?
- How is “pay” determined?
- Who are the covered executives?
- How is “performance” measured?
- What is the applicable peer group?
- What else must and may go into the proxy?
- Open issues
- Next steps

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Background on Proposed Rule

- Issued on April 29, 2015 in a 3-2 vote
- Implements the pay-for-performance disclosure rule requirement under §953(a) of the Dodd-Frank Act:
  - "The Commission shall, by rule, require each issuer to disclose in any proxy or consent solicitation material for an annual meeting of the shareholders of the issuer a clear description of any compensation required to be disclosed by the issuer under section 229.402 of title 17, Code of Federal Regulations (or any successor thereto), including 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.* The disclosure under this subsection may include a graphic representation of the information required to be disclosed."
- Mandates a new prescribed table in addition to the existing Summary Compensation Table (SCT)
- Requires five years' worth of pay and total shareholder return (TSR) data subject to a phase-in
- Introduces a new definition of "executive compensation actually paid"
- Requires a "clear description" of the relationship between certain data elements included in the new table
- Many had hoped for principles-based rules instead of prescriptive rules
- Does not apply to emerging growth companies or foreign private issuers – smaller reporting companies are subject to reduced disclosure requirements

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What would the new Pay versus Performance table look like?

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)
Year 1						
Year 2						
Year 3						
Year 4	One year phase-in for this row					
Year 5	Two year phase-in for this row					

What would the new Pay versus Performance table look like?

- A transition period would apply so that, in the first year, only three years' worth of data would be required to be reflected in the Pay versus Performance table, with an additional year of pay and performance data being added in each of the following two years.
- Smaller reporting companies would be subject to these reporting requirements on a modified basis:
  - Three-year cumulative reporting (two years during transition period),
  - no peer group TSR, and
  - no reporting of pension amounts
- All data elements in the Pay versus Performance table (including footnotes) would be required to be tagged using XBRL format (eXtensible Business Reporting Language) to facilitate investor analysis of reported data.
  - The SEC believes that using XBRL format "would permit data to be analyzed more quickly by investors and other end-users[,] would facilitate comparisons among public companies. . . . [and] would facilitate analysis of how information related to a single issuer changes over time."

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How is pay determined?

- "Pay" under the Pay versus Performance table would be reported ***both*** as the total from the SCT and "executive compensation actually paid"
- Executive compensation actually paid is defined as SCT total compensation:
  - ***Less***: the fair value of equity awards granted during the fiscal year
  - ***Plus***: the fair value of equity awards that vest during the fiscal year
  - ***Less***: the change in actuarial present value of all defined benefit pension plans (derived from the Pension Table)
  - ***Plus***: the actuarial pension service cost for services rendered during the fiscal year
- This new definition is intended to provide a more uniform way to compare pay and performance.
- Treating equity awards as "paid" at vesting causes compliance burdens and potential distortions:
  - Significant work to compute new Black-Scholes values for stock options with multiple vesting dates
  - Actual benefit from stock options can be very different from the Black-Scholes value of an option at vesting
- Proposed rules do not define vesting – consider:
  - retirement eligible executives
  - covenants not to compete,
  - timing issues for performance shares

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Who are the covered executives?

- Pay would be reported separately for:
  - the principal executive officer (*i.e.*, the chief executive officer), individually, and
  - as an average for the remaining named executive officers (NEOs) listed in the SCT.
- Requires aggregation of amounts paid to more than one CEO
  - Severance pay for departing CEO
  - Signing bonus and initial equity grants for incoming CEO
- The other NEOs who are compared to the CEO may vary over the five-year period.
  - Changes in the number and identity of the other NEOs may cause distortions
- Disclosure will highlight differences in pay between the CEO and other NEOs
  - Increased focus on internal pay equity?

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How is performance measured?

- Total shareholder return (TSR) is used as the performance measure for the Pay versus Performance table.
  - Objective, consistent and well-known
- TSR is reported annually over a five-year period using the performance graph rules for annual reports.
- It is unclear how TSR is to be calculated for each year required to be reported in the table.
  - If the Proposed Rule is in effective for 2017 and TSR is being disclosed for 2016 in the table, it appears that the 2016 TSR is based on the period from January 1, 2012 to December 31, 2016.
  - The cumulative TSR amount for a particular year in the table would then be disclosed in the same row as the annual pay for that year.
- It will be challenging to assess the Pay versus Performance relationship when annual pay for a particular year is being compared to TSR for as many as five prior fiscal years.

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What is the applicable peer group?

- The Proposed Rule would require TSR to be reported for both the covered issuer and a "peer group."
- The peer group may be:
  - the same peer group used for the stock performance graph, or
  - "if applicable", the peer group reported in the issuer's Compensation Discussion and 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 also be weighted according to the respective issuers' stock market capitalization at the beginning of each period for which a return is indicated.
  - This method of computing peer group TSR may be very different than the methodology used by an issuer in its CD&A disclosure.
- It is unclear what adjustments, if any, will be required, if the covered issuer changes its selected peer group from one year to the next.

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What else must and may go in the proxy

- Based on the information in the Pay versus Performance table, companies would then be required to provide “a clear description” of:
  - the relationship of the executive compensation actually paid and the company’s TSR, and
  - the relationship between the company’s TSR and the TSR of its selected peer group.
- The disclosure may be in a narrative and/or tabular format – examples include:
  - having a graph providing executive compensation actually paid and change in TSR on parallel axes and plotting compensation and TSR over the required time period, and
  - showing the percentage change over each year of the required time period in both executive compensation actually paid and TSR together with a brief discussion of that relationship
- It could become quite confusing to have three (or more) charts (*e.g.*, SCT, Pay versus Performance Table and Realizable Pay table).
- It is permissible to include supplemental Pay versus Performance disclosure, so long as it is not misleading or presented more “prominently” than the required disclosure.
  - Companies will consider other ways to tell the company’s Pay versus Performance stock when TSR information suggests a misalignment of interests.

What else must and may go in the proxy

- The SEC did not propose a specific location within the proxy for this new disclosure
- The SEC noted that the proposed disclosure item “is related to the CD&A because it would show the historical relationship between executive pay and registrant financial performance, and may provide a useful point of comparison for the analysis provided in the CD&A”
  - The narrative discussion appears to require a discussion of historical pay over a five-year period
- Assuming that flexibility as to the location of the new proposed disclosure is retained in final rules, it is likely that many covered issuers will want to include this new disclosure outside of the CD&A
  - Doing otherwise might be confusing and suggest that the compensation committee considered TSR in its decisions, which may not be the case.

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Open issues

- SEC sought comments on 64 questions.
- Several comments requested a principles-based approach (including alternative performance measures to TSR) and that compensation actually paid for stock options be limited to the intrinsic value on vesting.
- It remains unclear how the SEC will address changes in peer groups in the final rules.
- Will companies disclose that there is no relationship between the reported pay and TSR data, particularly if there is no correlation between TSR and compensation actually received?
  - timing differences between TSR measuring period and performance periods for incentive awards
  - significant elements of compensation often have no relationship to TSR
- Will there be a move towards greater use of TSR in incentive awards?
  - ISS impact? Clawback impact?

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Next steps

- No action is required until final rules are issued.
- It's likely that the SEC will issue final rules at some point during 2016.
- SEC may issue final rules even if with only three sitting commissioners.
- It is questionable whether there will be significant structural changes to the Proposed Rules.
- If final rules are issued in 2016, it appears likely that they will be effective for the 2017 proxy season

Next steps

- Companies should consider what type of recordkeeping will be required to calculate "compensation actually paid" and whether it would be appropriate to make changes to vesting schedules.
- Who within the company should be involved in evaluating the company's TSR as compared to TSR of other peer group companies?
- Consider how the existing executive compensation proxy disclosure would need to change if the Proposed Rules had been in effect for 2015 and what types of supplemental disclosure would be most appropriate:
  - Realizable pay vs. executive compensation actually received vs. ISS Pay versus Performance.
  - TSR vs. other financial performance measures
  - Consider how to explain relationship of TSR to compensation actually received when other factors resulted in pay decisions

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Joseph S. Adams is a partner in the law firm of McDermott Will & Emery LLP based in the Firm's Chicago office. Joe focuses his practice exclusively on employee benefits and executive compensation matters for both public and private entities and for certain executives.

Joe has substantial experience advising clients regarding executive and incentive compensation programs including:

- Drafting employment/separation agreements, incentive/equity compensation arrangements and nonqualified retirement plans, and then analyzing how those arrangements are impacted by SEC requirements and IRS rules including Code Sections 162(m) ($1 million limit on compensation), 280G (change in control) and 409A (nonqualified deferred compensation) .
- Advising clients on the design, drafting and ongoing operation of 401(k) plans, employee stock ownership plans (ESOPs), cash balance plans and other qualified retirement plans, nonqualified retirement arrangements and welfare/fringe benefit plans.

Joe regularly writes and speaks about employee benefits and executive compensation topics including:

- Writing for leading employee benefits and executive compensation publications such as the *Pension Plan Fix-It Handbook*, *Guide to Assigning and Loaning Benefit Plan Money, Executive Compensation Strategies*, *Beyond Stock Options/Equity Alternatives*, and *Domestic Partner Benefits: An Employer's Guide*.
- Contributing to national publications such as *The New York Times*, *The Wall Street Journal*, *Forbes*, *Business Week*, *The Chicago Tribune*, *Bloomberg*, *Kiplinger*, *CFO.com* and *Investment News*.

Joe has been recognized repeatedly as a leading lawyer in the area of employee benefits and executive compensation by:

- *Chambers USA*, which called him "responsive and thorough" and "a phenomenal attorney";
- *The Legal 500 United States*, which recognized Joe as "outstanding" in employee benefits and executive compensation; and
- *The Best Lawyers in America*, which named him the Best Lawyers' 2013 Chicago Employee Benefits (ERISA) Law "Lawyer of the Year."

Joe is a Fellow of The American College of Employee Benefits Counsel (ACEBC).

Joe originally joined McDermott upon graduating from Cornell Law School where he served as an editor of the *Cornell Law Review*. From 2001 until his return to McDermott in 2004, Joe was with one of the "Big Four" accounting firms, where he served in a variety of roles including as the tax partner in charge of the Chicago Employee Benefits Tax group.

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Andrew C. Liazos is a partner in the law firm of McDermott Will & Emery LLP based in the Firm's Boston office and co-chairs the Firm's Executive Compensation Group.

Andrew has over twenty-five years experience represents public companies, large closely held businesses and compensation committees on all aspects of executive compensation, ERISA fiduciary and compensation plan governance, employee benefits in business transactions, initial public offerings and bankruptcy, international compensation planning and related litigation matters. He also counsels executives in employment agreement and joint venture negotiations.

Andrew has been recognized for several years as a national leader in the executive compensation and employee benefits field by Chambers USA, The Best Lawyers in America, Legal 500 and Corporate Counsel. BTI Consulting Group has recognized Andrew as Law Firm Client Service All-Star for superior client service in its surveys of Fortune 1000 clients. He is a Fellow of the American College of Employee Benefits Counsel, which recognizes lawyers who have made outstanding contributions to the field of employee benefits.

Andrew is co-chair of the National Institute on Executive Compensation for the American Bar Association (ABA) Joint Committee on Employee Benefits and a Vice Chair of the Employee Benefits Committee of the ABA's Section of Taxation. He is a past chair of the ABA Foreign and International Subcommittee on Employee Benefits and Executive Compensation, ABA Joint Split-Dollar Life Insurance Task Force and ERISA Committee of the Boston Bar Association. He is a faculty member of the American Law Institute.

Andrew regularly contributes to publications such as *The Tax Lawyer, Tax Notes, BNA Tax Management Memorandum, the Benefits Law Journal, the Journal of Pension Planning and Compliance* and *CFO.com*. Andrew is board member of the Pension Action Center, which strives to improve standard of living in retirement through issue analysis and reform of public policy.

Any questions?

Thank you.