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View From McDermott: SEC Proposes New Pay Versus Performance Disclosure Rules

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On April 29, 2015, the Securities and Exchange Commission (SEC), by a three-to-two vote, proposed new rules that would prescribe new mandatory pay-versus-performance disclosure.[1] The proposed rule would include specific information showing the relationship between executive compensation ''actually paid'' and financial performance of the registrant. The proposed rule, issued under Section 953(a) of the Dodd-Frank Wall Street Reform and Consumer Protection Act (Dodd-Frank Act), would add a new Item 402(v) to Regulation S-K.

The key take-away is that covered issuers would not be allowed to use their existing pay for performance disclosure approaches to meet the requirements under the proposed rule. Instead, if the proposed rule is finalized in its current form, covered issuers would be required to include a new ''Pay Versus Performance'' table.[2] Covered issuers would also be required to provide a ''clear description'' of the relationship between certain data elements included in the new table.

The proposed rule is ''designed, in part, to enhance comparability across registrants. . . .'' perhaps in connection with shareholders' ''Say on Pay'' votes. However, the commissioners differed on the usefulness of the information that would be provided by the proposed rule, and the final vote was divided along political lines—similar to how the commissioners voted on the CEO Pay Ratio proposal.

New Tabular Disclosure

The following new table would be required for all covered issuers (essentially all public companies other than emerging growth companies, foreign private issuers and registered investment companies; as discussed below, smaller reporting companies would be subject to these reporting requirements on a modified basis):

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)
Year 1						
Year 2						
Year 3						
Year 4	*One year phase-in for this row (see below)*					
Year						

[1] *See* SEC Release No. 34-74835 (April 29, 2015); ''SEC Proposes Pay-for-Performance Rule, Uses Total Shareholder Return as Key Metric'' (83 PBD, 4/30/15).

[2] Proposed Item 402(v)(1).

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5	*Two year phase-in for this row (see below)*

In completing the table above:

■ *Computing ''pay.''* The SEC noted that many public companies have used different definitions of ''realizable pay'' and ''realized pay.'' It appears that the new definition of ''compensation actually paid'' is intended to provide a more uniform way to compare pay and performance. Specifically, ''Pay'' under the Pay Versus Performance table would be reported *both* as the total from the Summary Compensation Table (SCT) *and* as ''executive compensation actually paid,'' which is defined as the SCT total compensation with adjustments to *exclude* certain pension costs and the unvested amounts reported in the ''Stock Awards'' and ''Option Awards'' columns of the SCT, and to *include* the fair value of equity awards *on the vesting date — as opposed to when granted.*

— Treating equity awards as ''paid'' at vesting based on their fair value (*e.g.*, using a binomial pricing model such as Black-Scholes for stock options) could create a perceived pay for performance misalignment as there could be significant stock price movements between the time of grant, when the compensation committee granted the equity award, and vesting.

— Pension amounts would be adjusted by first deducting the change in pension value reflected in the SCT and then adding back the actuarially determined service cost for the current year. Footnote disclosure would be required with respect to each amount deducted from, and added to the total compensation amount set forth in the SCT. The SEC noted that many public companies have used different definitions of ''realizable pay'' and ''realized pay.'' It appears that the new definition of ''compensation actually paid'' is intended to provide a more uniform way to compare pay and performance.

— We anticipate that in most cases it will not be overly difficult to calculate the required pay elements for the new Pay Versus Performance table. However, there are some technical issues that hopefully will be addressed as part of finalizing the proposed rules. There is no definition of ''vesting'' in the proposed rules, which can raise interpretation issues. For example, what happens if an executive can ''retire'' under the terms of an award but has not done so? Is that award ''vested'' even though the executive remains employed and the award remains subject to forfeiture in the event of a for cause termination?

Pay would be reported separately for both 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. The proposed rule, if adopted in its current form, will highlight significant differences in pay between the principal executive officer and other NEOs and require covered entities to address any significant disparities. It will not be sufficient to simply state that the compensation committee considers this information in setting compensation. Some investors and rating services have claimed that a large disparity in the pay between the principal executive officer and the other NEOs is a key indicator of corporate governance problems ranging from poor pay for performance, to a weak executive team to succession planning issues. One potential consequence of the proposed rule is that it may cause some covered entities to consider adopting an internal pay policy.

The proposed rule also provides that if more than one person served as the CEO of the registrant, then the amounts paid to both CEOs should be aggregated because, according to the SEC, ''this reflects the total amount that was paid by the registrant for the services of a PEO.'' However, this aggregation approach can skew the disclosure — perhaps significantly — in years where a necessary CEO transition requires payment of severance amounts to the departing CEO and signing bonuses, etc., for the new CEO.

■ *Computing ''performance.''* ''Performance'' under the Pay Versus Performance table would be reported using cumulative total shareholder return (TSR) using the same rules that apply when preparing stock performance graphs disclosed in annual reports. While not entirely clear from the proposed rule, it appears that TSR is to be calculated on a *cumulative basis for each year* required to be included in the Pay Versus Performance Table. For example, if the proposed rule is in effect in 2016 and TSR is being disclosed for 2015 in the table, the 2015 TSR figure would be based on the period from Jan. 1, 2011, to Dec. 31, 2015 (for a covered issuer on the calendar year). 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 is unclear how a stockholder will be able to readily assess the pay for performance relationship when annual pay for a particular year is being compared to TSR for as many as five years. It is likely that a covered issuer will need to provide narrative disclosure in order to provide an appropriate description of the pay for performance relationship.

■ *Peer group disclosure.* The proposed rule would require TSR to be reported for both the covered issuer and a ''peer group.'' The peer group may be (1) the same peer group used for the stock performance graph, or, ''if applicable,'' (2) the peer group reported in the issuer's Compensation Discussion and Analysis (CD&A). It is not entirely clear whether a covered issuer with a peer group within its CD&A could choose to use the peer group required for the stock performance graph. 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. One question that is not addressed in the proposed rule is what happens if the covered issuer changes its selected peer group from one year to the next. This is a fairly common occurrence – a change may result from an acquisition, a company no longer being viewed as comparable due to a change in its business size or model or the selection of a new compensation consultant. If a peer group changes during a fiscal year, presumably disclosure will be required for both the new and prior peer group. It remains to be seen what disclosure will be required for peer groups from prior years.

■ *Other points to note regarding the new table.* A transition period would apply so that, in the first year,

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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. There is no requirement to use the transition rule, and including additional years immediately might be to the covered issuer's advantage.

Smaller reporting companies would be subject to these reporting requirements on a modified basis (*e.g.*, 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.'' It is reasonable to expect that pay for performance data reported in XBLR format will be widely used by economists and academics to assess executive compensation practices.

Proxy Discussion

Based on the information in the Pay Versus Performance table, companies would then be required to provide ''a clear description'' of (1) the relationship of the named executive officer compensation actually paid and the covered issuer's TSR, and (2) the relationship between the covered issuer's TSR and the TSR of its selected peer group. According to the SEC, this discussion was required because simply disclosing the amount of executive compensation actually paid and the financial performance measure would not satisfy the Dodd-Frank Act requirement to disclose ''the *relationship* between executive compensation and registrant performance.''

Fortunately, the proposed rule does not require a specific format for this disclosure. According to the proposed rule:

> The disclosure about the relationship would follow the table and could be described as a narrative, graphically, or a combination of the two. . . . Disclosure of the relationship could include, for example, a graph providing executive compensation actually paid and change in TSR on parallel axes and plotting compensation and TSR over the required time period. Alternatively, disclosure of the relationship could include 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.

Covered issuers will want to consider whether their existing approaches for describing the relationship between pay for performance could be adopted in some manner when preparing the required Pay Versus Performance table.

Location of the Proposed Disclosure

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.'' Assuming that flexibility as to the location of the new proposed disclosure is retained in final rules, it is unclear whether covered issuers will want to include this new disclosure as part of the CD&A. As noted by the SEC in the preamble to the proposed rule, doing so ''might suggest that the registrant considered the pay-versus-performance relationship, as disclosed, in its compensation decisions, which may not be the case.'' This is particularly likely to be the case when a covered issuer uses a different methodology for assessing pay for performance when making compensation decisions.

Additional Information Possible

Covered issuers would be permitted to present supplemental pay for performance information to stockholders, so long as it is not misleading or presented more ''prominently'' than the required disclosure. Covered issuers that currently use performance benchmarks other than TSR when measuring pay for performance will likely want to address any pay for performance misalignment that might be indicated by the new pay for performance disclosure. How difficult that will be to accomplish is likely to depend upon the facts and circumstances. For example, consider a pre-revenue pharmaceutical company that provides incentive compensation based on achieving operational performance goals related to drug development and regulatory approval. Assuming that there is not an internal pay equity issue, it should be relatively straightforward to address why the compensation paid to the NEOs in relation to operational performance was appropriate and that TSR is not a fair way to assess that pay versus performance. On the other hand, a well-seasoned, covered issuer in a mature market may face more challenges explaining why performance goals using financial measures other than TSR were appropriate used to set compensation when its TSR is substantially less than members of its peer group and its NEO compensation is significantly higher than NEO compensation at its peer group member.

Comments Sought

As with other Dodd-Frank Act rulemakings, the SEC had sought comment from the public prior to the issuance of the proposed rule. Notwithstanding those advance comments, the proposed rule raises many questions. The SEC itself requested comments on 64 questions spanning 17 pages, including among other things:

- should the SEC further prescribe the format of the proposed disclosure to promote comparability across registrants;

- should the SEC require the disclosure as part of the CD&A; and

- should the SEC permit a principles-based approach like that used with the CD&A that would allow registrants to determine which elements of compensation to include, so long as they clearly disclosed how the amount was calculated.

The comment period ends on July 6, 2015.

Implications

In light of the strong dissents by Commissioners Gallagher and Piwowar, it is reasonable to expect that there will be comments on the proposed rule focusing on:

- the added complexity resulting from the new disclosure approach, which will likely necessitate many supplemental disclosures and potentially cause stockholder confusion;
- the value of comparability of pay for performance disclosures across covered issuers in light of those disadvantages. For instance, the vesting of equity awards will not be the same across peer group companies (and vesting periods frequently will not match the annual TSR computation period), and such slight differences could produce wildly divergent results; and
- the possibilities for unintended consequences, particularly in terms of how this disclosure might impact the design of compensation packages (e.g., tying performance-based incentives to TSR) and how this disclosure might impact internal pay equity between the principal executive officer and the other NEOs.

Given the language of Section 953(a) of the Dodd-Frank Act, the comments that the SEC solicited prior to the issuance of the proposed rule and the ability for covered issuers to provide supplemental disclosures, it is questionable whether there will be significant structural changes to the proposed rules.

The new disclosure requirement could apply as soon as the 2016 proxy season. (We note that the SEC recently pushed back its deadline to issue final CEO Pay Ratio rules, final hedging disclosure rules, and proposed compensation recovery (''clawback'') rules from October 2015 to April 2016.) It is appropriate for covered issuers to start considering what the new Pay Versus Performance table would look like for prior years and what disclosure approaches to describe the pay for performance relationship might work best if the proposed rule is finalized in its current form.

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