SEC Proposes New Pay-for-Performance Disclosure Rules

Says Total Shareholder Return (TSR) is Defining Measure of Performance To Be Compared To All Named Executive Officers’ Pay

The SEC has issued proposed rules (Proposed Rules or the Proposal)\(^1\) that mandate specific proxy statement disclosures on the link between pay and performance. The Proposal is designed to fulfill one of the SEC’s mandates from the Dodd-Frank Act of 2010. Highlights of the Proposal include:

- **All Named Executives Officers (NEOs) Are Covered**: Pay will be reported separately for the Chief Executive Officer (CEO), and as an average for the remaining NEOs listed in the Summary Compensation Table (SCT).
- **Actual Pay**: Pay to be compared includes NEO compensation actually paid (Actual Pay) which modifies SCT Total Pay by including equity values when vested instead of when granted and current year pension service costs.
- **TSR Performance**: Performance to be compared includes the company’s cumulative total shareholder return (TSR), as well as those of its peers (peer TSR).
- **Mandatory Tabular Disclosure with Clear Explanations**: A new Pay-Versus-Performance (PVP) table containing specific amounts for NEO Total Pay, Actual Pay, company TSR and peer TSR will generally be required for the past five years. A clear discussion must be provided to explain the relationship between Actual Pay and company TSR, and also between company TSR and peer TSR.
- **Exemptions**: Emerging growth companies, foreign private issuers and registered investment companies are not subject to the new pay-for-performance mandate.
- **Smaller Reporting Companies (SRCs)**: SRCs are not exempt from the disclosure mandate, but will be subject to curtailed reporting requirements.
- **Transition**: The most recent three fiscal years must be included for the first year the rule is effective; for the second year, the most recent four fiscal years; and thereafter the most recent five fiscal years.
- **Interactive Data Tagging**: All data elements in the PVP table (including footnotes) must be tagged using eXtensible Business Reporting Language (XBRL) to facilitate investor analysis by providing instant and interactive data access.

Background

Section 953(a)(i) of the Dodd-Frank Wall Street Reform and Consumer Protection Act of 2010 (DFA) directed the SEC to require companies to disclose information that shows “the relationship between executive compensation actually paid and the financial performance of the company, taking into account any change in value of the shares of stock and dividends of the company and any distributions”. In the five years since the DFA was enacted, the issue of pay-for-performance has been a hot topic among companies, investors and proxy advisors, all of whom have a different formulation or opinion as to how to demonstrate and best disclose this relationship. As a result, pay-for-performance disclosure has run the gamut in recent proxy seasons, with many companies following Institutional Shareholder Services’ methodology of describing the CEO’s pay in relation to a company’s three- and five-year TSR.

The SEC could have proposed rules allowing for significant company discretion in determining how to disclose the relationship between pay and performance, and continue to allow companies to describe the relationship as they deemed most relevant to their pay decisions. However, the Commission decided to provide specificity in the directive to encourage consistency and comparability across companies. In turn, it believes that better information will be available to shareholders to vote on say-on-pay and the election of Directors. As a result, the Proposal specifically prescribes “pay” and “performance”, but allows companies continued flexibility to provide supplemental information and formats to support their views on the linkage between pay and performance.

The Proposal provides for a 60-day comment period from the date of publication in the Federal Register (with the comment period likely ending sometime in July).

Pearl Meyer Observation: The DFA does not mandate a deadline for Final Rules and implementation, but based on the current timeline the new disclosure could be effective as early as the 2016 proxy season (although given recent historical time gaps between Proposed and Final rules, it could be delayed until 2017). As such, it is critical for companies to understand the Proposal and make a plan for gathering and computing new data, as well as modifying their pay-for-performance narratives based on the new directive.

Which Companies Are Subject to the New Disclosure Rule?

Public companies (excluding emerging growth companies, foreign private issuers and registered investment companies) that file information and proxy statements will be required to include the new pay-for-performance disclosure, with SRCs providing the information on a scaled basis as discussed below.
What is the Time Period Covered?

Disclosure is required for the five most recently completed fiscal years. Transition rules provide for companies to initially report only three years of data for the first year in which the requirement is effective, increasing by one year each subsequent year until all five years are being reported in the third year after the effective date. In addition, newer public companies are required to report data only for the years in which they have been public and subject to the SEC’s reporting requirements.

**Pearl Meyer Observation:** Once fully implemented, this table will cover an additional two years of historical pay data in addition to those covered in the SCT, providing investors with five years of pay data in each proxy statement versus the current three years. In addition, the historical pay data will be of a different nature than presented in the SCT (discussed in more detail below), potentially furthering data overload and confusion on the part of investors.

Who is Covered?

The Proposal covers all NEOs in the SCT for each year, with pay data presented separately for the CEO and as an average for the remaining NEOs. The average NEO data would contain average compensation for NEOs who were actually included in SCTs for prior years, whether or not they are NEOs for the most recent year. The SEC believes averaging other NEO data in this manner would smooth out the variability in the composition and number of NEOs over the five years. For years in which there were multiple CEOs reported in the SCT, the data will be based on an aggregation of the compensation of all CEOs in that year.

**Pearl Meyer Observation:** While many companies were hopeful the pay-for-performance disclosure would focus on the CEO (as do many of the proxy advisors), the SEC took the position that the DFA language required it to cover all NEOs. Consequently, pay data will not only include more years than previously required, but it will capture, at least on an aggregate basis, the compensation of more NEOs over time. Contrary to the SEC’s belief that averaging NEO data would “smooth” variability, it is likely outlier data from severance payments and other unusual events will result in a need to provide more information to explain the variances. Such an outcome will also be true for years in which there is a change in CEOs, which often results in higher than average pay for the incoming CEO as well as higher than average pay for the outgoing CEO as programs reach final settlement upon the termination of employment.
What Does the New PVP Table Look Like?

The Proposal adds Item 402(v) to the proxy reporting rules, which requires the following new table, along with specific narrative disclosures.

Pay Versus Performance

<table>
<thead>
<tr>
<th>Year</th>
<th>Summary Compensation Table Total Compensation CEO</th>
<th>Compensation Actually Paid CEO</th>
<th>Average Summary Compensation Table Total for non-CEO Named Executive Officers</th>
<th>Average Compensation Actually Paid to non-CEO Named Executive Officers</th>
<th>Total Shareholder Return</th>
<th>Peer Group Total Shareholder Return</th>
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</table>

How Does the SEC Define “Pay” for Purposes of Pay-for-Performance?

There are two measures of pay that must be disclosed in the new PVP table – Total Pay and Actual Pay, the latter of which is the focus of the narrative discussion that follows the table. Total Pay is simply the last column of the SCT for the CEO (and an average of the last columns for each NEO in the respective years).

Actual Pay starts with the Total Pay number, but is adjusted as follows:

- **Equity Awards Count When Vested**: Rather than including value of equity awards at grant date based on fair value, they are included at fair value in the year they vest. For stock awards, this amount is already presented in the Option Exercises and Stock Vested Table in the year the stock vests. However, stock option vesting values are not readily available from that table. Thus, companies will now be required to compute a new valuation for all stock options vesting in each of the past five years. If previously vested options or stock appreciation rights are repriced during the year, the disclosure must also include the incremental fair value resulting from the repricing (i.e., the excess fair value of the modified award over the fair value of the original award upon vesting of the modified award).

**Pearl Meyer Observation**: Companies will now be required to make and disclose new valuation assumptions for vested options that have varying expected lives – a potentially confusing and burdensome exercise not to be alleviated by reference to the appropriate footnote in the Form 10K.
**Pension Values Focus on Service Cost for Applicable Year:** Rather than including changes in actuarial present value of benefits under defined benefit and actuarial pension plans, only *the actuarial present value of benefits attributable by the pension plan’s benefit formula to services rendered by the employee during the year (Service Cost)* will be included in Actual Pay. The SEC believes this change will eliminate volatility by excluding values solely attributable to changes in interest rates, NEO age and other actuarial inputs and assumptions regarding benefits accrued in previous years.

Footnote disclosure to the Actual Pay columns of the PVP table must discuss the above adjustments to Total Pay, as well as valuation assumptions used in determining any equity award fair values that are materially different from those disclosed in the company’s financial statements (e.g., any changes to expected term and volatility of options).

**Pearl Meyer Observation:** While these modifications seem minor at first reading, they will require new calculations to complete historical valuations for equity and pension plan benefits that were not previously recorded or readily available. In addition, footnote disclosure of the changes to equity and pension values may also lead to another table to fully document the changes taking place for five NEOs in each year of a five-year period, analogous to the supplemental charts many companies insert in the footnotes to the SCT to document the Other Compensation column.

**How Does the SEC Define “Performance” for Purposes of Pay-for-Performance?**

While the DFA did not dictate the performance measure to be used, the Proposal indicates SEC belief that TSR is the most appropriate measure as it is an objective and consistent measure, and not based on subjective determinations of performance. TSR would be calculated in the same way as required for purposes of the performance graph required in a company’s annual report.

The Proposal not only requires reporting the company’s TSR on an annual basis over the past five years, but it also calls for the TSR of the company’s peer group over the same period. The peer group can either be the same peer group used in the stock performance graph (which may include a published industry or line-of-business index) or may include the peer group reported in the company’s Compensation Discussion & Analysis (CD&A). If the peer group is not a published industry or line-of-business index, the identity of the companies in the peer group must be disclosed, and the returns of each component company in the group must be weighted according to their respective market capitalization at the beginning of each period for which a company performs return calculations.
Pearl Meyer Observation: Once again, the Proposal contains an additional computation requirement. Specifically, weighted average TSR is not a measure that had been historically required or used by companies or proxy advisors, who have typically looked at average or rank placement.

What Narrative Must Accompany the PVP Table?

Following the PVP Table, the disclosure must provide a clear description of two relationships:

- Actual Pay to Company TSR; and
- Company TSR to Peer TSR.

The SEC offers flexibility in the presentation of these relationships – it suggests the disclosure may be narrative (but in Plain English), graphic or a combination of the two.

In addition, the SEC notes it is aware of the various concepts companies have relied on to show the relationship between pay and performance, such as “realized” and “realizable” pay. While the Proposal mandates disclosure of Actual Pay (which has elements of both realized and realizable pay in it, but is neither) and TSR performance as defined by the SEC, the Proposal expressly permits companies to supplement the required disclosure with other measures which illustrate the pay-for-performance alignment so long as it is not misleading and is not presented more prominently than the required disclosure.

Pearl Meyer Observation: The one size fits all approach of using TSR as a controlling performance measure for compensation comparison may have the unintended consequence of changing compensation programs to enhance or support the disclosure. We do not believe Committees should be beholden to one particular measure of performance to gauge pay, but should continue to design programs that are most appropriate to unique business strategy and goals, which will ultimately drive long-term shareholder value. However, if Committees stick with their tailored programs, proxy disclosure will be more challenging. Not only will the proxy contain the mandated pay-for-performance disclosure, but it will also contain a discussion of measures the company actually used to support its pay-for-performance program. This will likely necessitate an explanation regarding why TSR is not appropriate as the sole or primary driver for the company’s compensation program. As a result, we anticipate the executive compensation disclosure section of the proxy will become even more bloated and laborious for investors to digest than ever.
Where is the New Disclosure Located and Is It Part of the Say-On-Pay Vote?

The Proposal does not specify where in the proxy statement the additional disclosures should be located, but the SEC believes most companies will include it with the rest of the company’s tabular executive compensation disclosures. While companies have the flexibility to incorporate the disclosure into the body of the CD&A (before the tables), it should not be located there unless the company actually considered the information in making its compensation decisions for that year. Regardless of its placement within the proxy statement, the new disclosure is considered for purposes of the say-on-pay advisory vote for the year.

How Does XBRL Formatting Apply?

The PVP Table, footnotes and narratives must be tagged and electronically formatted using XBRL. The SEC believes tagging in this way will facilitate analysis over time and comparison across companies and will lower costs to investors and other end-users. Notably, this is the first time the SEC has proposed requiring XBRL formatting in the context of corporate governance matters.

How do the Rules Apply to Smaller Reporting Companies?

SRCs are subject to curtailed pay-for-performance reporting requirements as follows:

- Tabular disclosure is only required for three (vs. five) fiscal years, with only two years reported in the first year of disclosure and the full three years in the second year of disclosure;
- Peer TSR information is not required;
- Pension amounts are not included in Actual Pay;
- Reporting is only required for three executives (the CEO and next two highest paid NEOs); and
- XBRL tagging is not required until the third year of reporting.

When Will the New Rules Become Effective?

The comment period will likely run through some point in July, after which the SEC will issue Final Rules and determine the initial year of effectiveness. The DFA does not mandate a deadline for Final Rules and implementation, but based on the current timeline, the rules could be effective as early as the 2016 proxy season.

What’s Next?

The Proposal seeks to strike a middle ground between mandating specific tabular disclosure and allowing companies the flexibility to supplement with their own pay-for-performance story. Nonetheless, providing the heightened statistical data and narratives around the mandate will require increased compliance time and expense. While there is
some time delay before Final Rules may be promulgated, companies should act now to collect the additional data and populate the new PVP table. Doing so will allow companies to get a jump start on the mandated narratives describing the various relationships, and also provide time to determine if additional performance measures and/or explanatory texts or graphics will be necessary to give shareholders a better understanding of the performance measures most important to the company.

One certain result of the new rules will be yet a longer proxy statement as companies meet the new requirements and simultaneously provide the actual pay-for-performance story particular to their business strategy and goals. As a consequence, executive compensation proxy drafting will take on yet another layer of complexity in upcoming years.

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