

Corporate Governance Commentary

[Latham & Watkins Benefits, Compensation & Employment Practice](#)

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New SEC Proposed Rules on Pay versus Performance

As early as the 2016 proxy season, most U.S. public companies may need to include new disclosures, and should start thinking about them now.

On April 29, 2015, the Securities and Exchange Commission (the SEC) proposed rules that would require companies to include a new Pay versus Performance (PvP) table in proxy and information statements. The table will show the amount of compensation paid to the company's principal executive officer (PEO) (typically the CEO) and its other named executive officers (NEOs), cumulative total shareholder return (TSR) and TSR of a peer group over each of the five most recent fiscal years (three years for smaller reporting companies). The rules would also require companies to use the values presented in the table to describe the relationship between executive compensation and the company's performance, and between the company's performance and its peer group's performance. The rules would add a new Item 402(v) (the Proposed Rules) to Regulation S-K and would implement Section 14(i) of the Securities Exchange Act of 1934, as amended (the Exchange Act), as added by Section 953(a) of the Dodd-Frank Wall Street Reform and Consumer Protection Act. The Proposed Rules will be subject to comment for 60 days after publication in the Federal Register (likely this week), and may be effective as early as the 2016 proxy season.

Overview of Proposed Rules

- **Required Table:** The Proposed Rules require the following table:

Pay Versus Performance

Year	Summary Compensation Table Total	Compensation Actually Paid to PEO	Average Summary Compensation Table Total for non-PEO Named Executive Officers	Average Compensation Actually Paid to non-PEO Named Executive Officers	Total Shareholder Return	Peer Group Total Shareholder Return
(a)	For PEO	(c)	(d)	(e)	(f)	(g)

There is no specific mandated location for the PvP table in proxy or information statements.

- **Individuals Covered:** The compensation of the PEO must be provided on an individual basis, while only the average compensation of the other NEOs is required. If more than one PEO served during the year, the compensation of all such PEOs must be aggregated.

- Compensation Covered: In addition to the Summary Compensation Table (SCT) totals for the NEOs, the PvP Table is required to include the compensation “actually paid,” which is determined by modifying the SCT totals as follows:
 - For all companies other than smaller reporting companies (which are not required to report pension benefits in the SCT), subtract any portion of the change in the actuarial present value of the NEO’s accumulated defined benefit pension benefits reported in the SCT that is not specifically attributable to services rendered during the covered fiscal year (the amount attributable to services is the amount commonly referred to as either the “normal cost” or “service cost”) and
 - Replace the grant-date fair values of equity awards granted in the applicable year reported in the SCT with the vesting-date fair values of any awards that vested in the applicable year (plus the incremental fair value of any vested awards that were materially modified in such year)

The release adopting the Proposed Rules (Release No. 34-74835) (the Release) states that these adjustments are required in order to accurately capture compensation “actually paid” to the NEOs, as required by Section 14(i) of the Exchange Act, as compared to the compensation “awarded to, earned by or paid to” the NEOs, which is covered by the SCT.

Companies are required to include a footnote to the table that describes these adjustments to the SCT totals.

- Determining TSR: TSR (both of a company and its peer group) must be calculated in the same manner as for the stock performance graph required by Item 201(e) of Regulation S-K to be included in annual reports. Item 201(e) provides that TSR for a year equals (i) the sum of (a) the cumulative amount of dividends for such year, assuming dividend reinvestment, and (b) the difference between the company’s share price at the end and the beginning of the year, divided by (ii) the share price at the beginning of the year.
- Determining Peer Group: A company may use either the peer group that it uses for purposes of the stock performance graph in Item 201(e) or the peer group it uses for purposes of its Compensation Discussion and Analysis (CD&A). The names of the companies in the peer group must be disclosed if the peer group is not a published industry or line-of-business index. The returns of each company in the peer group must be weighted according to the company’s stock market capitalization at the beginning of the relevant period. Smaller reporting companies are not required to disclose peer group TSR.
- Required Additional Disclosure: The Proposed Rules require companies to use the information provided in the PvP Table to provide a clear description of the relationship between:
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 - (i) The executive compensation actually paid to the CEO (column (c)) and the average of the executive compensation actually paid to the other NEOs (column (e)) and
 - (ii) The TSR (column (f))

This description must include a comparison of the TSR (column (f)) and the TSR of the peer group (column (g)) (smaller reporting companies do not need to address this comparison).

There is no mandated format for this additional disclosure. It can be in tabular, graphical or narrative form.

- Filings Covered: The Proposed Rules and related disclosure are required to be included in proxy and information statements in which executive compensation disclosure pursuant to Item 402 of Regulation S-K is required. The disclosure is not required in registration statements or annual reports, even if such documents otherwise include Item 402 disclosure. The table will be subject to the “Say on Pay” shareholder advisory vote.
- Electronic Formatting: The disclosure must be electronically formatted using eXtensible Business Reporting Language (XBRL), and each amount required to be disclosed must be tagged separately, in order to better enable shareholders to compare different companies’ disclosures. The data must be provided as an exhibit to the proxy or information statement. This would be the first time these electronic formatting requirements have been applied to tables in proxy statements.
- Transition Relief:
 - If the Proposed Rules are adopted, companies — other than smaller reporting companies — may provide the new disclosure for three years, rather than five, in the first filing subject to the rules, and then provide disclosure for an additional year in each of the two subsequent filings.
 - Smaller reporting companies may provide the new disclosure for two years, rather than three years, in the first filing subject to the rules.
 - Like the initial public offering transition rules for the SCT, information for fiscal years prior to the last completed fiscal year is not required if the company was not required to report such information at any time during that year.
 - Smaller reporting companies are not required to comply with the electronic formatting requirements until the third filing in which they are required to comply with the rules.
- Exempted Companies: Emerging growth companies, registered investment companies and foreign private issuers are exempt from the PvP disclosure requirements.

Key Determinations and Actions Required

The SEC emphasized in the Release that the Proposed Rules would not require much more information than companies already must provide or prepare, and therefore would not impose much of a burden on companies. However, several aspects of the Proposed Rules would require companies to devote additional resources, either to gathering information or to determining the optimal way to present the required disclosure. We suggest that companies begin to consider these areas — which are described in more detail below — now to prepare for if and when the rules become effective.

- Placement of PvP Table and Related Disclosure: Although the SEC has not mandated any particular location in the proxy or information statement where the PvP disclosure should be placed, it did note in the Release that it generally expects companies to include the disclosure with the Item 402 executive compensation disclosure. The SEC suggested including the disclosure within the CD&A, but noted that companies may be hesitant to place the disclosure in that section, if the compensation

committee did not consider the information in making its pay decisions. If companies have this concern, they may wish to include the PVP disclosure immediately following the CD&A so that it is not covered by the Compensation Committee Report. This is a common location for Item 402(s) disclosure regarding the relationship between compensation policies and practices and risk management. Another potential location is within the “Say on Pay” shareholder advisory vote proposal. The SEC noted that the PVP disclosure is intended to provide shareholders with information that will help them assess a company’s executive compensation for purposes of such advisory votes. Therefore, for companies that hold an annual “Say on Pay” advisory vote, that proposal seems like a logical place to include the PVP disclosure.

- Determining Format of Disclosure Describing Relationships Between Pay and Performance: Companies should begin thinking about the format that will work best based on their particular circumstances for describing the relationship between the compensation actually paid and the company’s TSR, as well as between the company’s TSR and the TSR of the peer group. There is no mandated format for this disclosure. Formats suggested in the Release include: (i) 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 (ii) disclosing 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.
- Additional Voluntary Disclosure: Companies are permitted to supplement the disclosure required by the Proposed Rules with additional information, provided that the supplemental disclosure is clearly identified, not misleading and not presented more prominently than the required disclosure. Companies should consider whether to provide any supplemental voluntary disclosure, such as (i) information about a company’s performance with respect to metrics other than TSR that the company may believe are better indicators of overall performance and (ii) total compensation figures calculated in a manner different from that required by the Proposed Rules. Companies that disclose other measures of pay for performance in the CD&A should consider whether such other disclosure could be considered “presented more prominently” than the PVP disclosure, depending upon where the PVP disclosure is placed in the proxy.
- Calculating Vesting-Date Fair Values: Companies should take the time now to decide upon the methodology and assumptions they will use for determining the fair value of equity awards, especially option awards, at vesting, and any necessary processes for tracking such amounts. This would be the first time that vesting date fair values must be calculated and disclosed for options. The Option Exercises and Stock Vested Table required by Item 402 shows only option spread values at the time of exercise. The SEC noted that companies can apply existing models and methodologies to compute vesting-date fair values of options, and that many of the inputs are already required to be disclosed. The SEC did acknowledge, however, that the translation of such inputs into fair values at vesting requires the choice of a valuation methodology and certain assumptions. Companies are not required to use the same assumptions as used for grant-date valuations in the SCT, but must describe any differences in a footnote. With respect to stock awards, the market values of stock awards at vesting are already required to be disclosed in the Option Exercises and Stock Vested Table for companies other than smaller reporting companies. Accordingly, the Proposed Rules do not add any further information gathering requirements for those awards.

- **Calculating Pension Service Cost:** The Proposed Rules require companies with defined benefit pension plans to determine and report separately the service cost for each year. The service cost can be calculated based on the assumptions reported in the footnotes to the currently required Pension Benefits Table. As an individual's service cost is not an item that a company would normally calculate annually, we recommend that companies ensure that their actuaries are advised of the new requirements, so that each NEO's service cost can be computed efficiently if and when the Proposed Rules become effective.
- **Determining Peer Group:** Since companies are permitted to use either the same peer group used for purposes of Item 201(e) of Regulation S-K or the peer group used in the CD&A for purposes of disclosing benchmarking practices, companies may want to calculate the TSR of both peer groups for the prior four years in order to help assess which group to use for PvP purposes.
- **Preparing for Electronic Formatting Requirements:** Companies should make sure they are familiar with the required interactive data format and should set up systems to ensure that they can comply quickly, if and when the Proposed Rules become effective.

In addition to focusing on the specific aspects of the Proposed Rules described above, we recommend that companies draft sample disclosure based on the Proposed Rules so that any difficulties in compliance can be identified and resolved and in order to assess the relationship between pay and performance that the disclosure will highlight.

If you have questions about this *Client Alert*, please contact one of the authors listed below or the Latham lawyer with whom you normally consult:

[James D. C. Barrall](#)

jim.barrall@lw.com
+1.213.891.8342
Los Angeles

[Robin L. Struve](#)

robin.struve@lw.com
+1.312.876.7632
Chicago

[Lori D. Goodman](#)

lori.goodman@lw.com
+1.212.906.4533
New York

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