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SEC Proposes Long-Awaited Pay for Performance Rules

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On April 29, 2015, in a 3-2 vote of commissioners cast along party lines, the Securities and Exchange Commission (the "SEC") proposed rules to implement Section 953(a) of the Dodd-Frank Wall Street Reform and Consumer Protection Act of 2010 ("Dodd-Frank").[1] Section 953(a) directs the SEC to promulgate rules to require public companies to provide a clear description of any compensation required to be disclosed under Regulation S-K, Item 402, including information that shows the relationship between executive compensation actually paid and the registrant's financial performance, taking into account any change in the value of the shares of stock and dividends and any distributions.

The SEC has proposed adding a new paragraph (v) to Item 402 of Regulation S-K, which would require tabular disclosure of compensation "actually paid" to the principal executive officer ("PEO") and an average of the compensation "actually paid" to the other named executive officers (each, a "NEO")[2] and the corresponding "total compensation" amount as shown in the summary compensation table.[3] In addition, disclosure of the

1 Release No. 34-74835; File No. S7-07-15. SEC Chair Mary Jo White and Commissioners Luis A. Aguilar and Kara M. Stein voted in favor of the proposal. Commissioners Michael S. Piwowar and Daniel M. Gallagher voted against it.

2 See Item 402(a)(3) of Regulation S-K.

3 See Item 402(c) of Regulation S-K.

relationship between (1) compensation "actually paid" and the registrant's total shareholder return ("TSR") on an annual basis and (2) the registrant's TSR and a peer group TSR on an annual basis, would be required.

The SEC reports having received numerous comment letters on Section 953(a), even before announcing its proposed rules, and, in the proposing release, solicits public comment on a wide range of topics. Depending on the nature and extent of the comments received, it is possible that the SEC could consider final rules later this year with the final rules going into effect for the 2016 proxy season.

Background

There has been long-standing debate on the merits of helpful and clear pay for performance disclosure. Although the SEC acknowledged an increasing trend to include "realizable pay" and "realized pay" disclosure in proxy statements as a means of comparing pay and performance, it observed that no uniform practice or presentation of that information has emerged. Consequently, supporters of pay for performance disclosure hope that the formulaic and machine-readable presentation of data prescribed by the new proposed rule will provide useful and comparable data to shareholders. In cases where a registrant believes that the requirements risk presenting a skewed or misleading picture, supporters maintain that registrants have the flexibility to opt to supplement the new required disclosure. Critics counter that pay for performance disclosure is overly simplistic (specifically its use of the single metric of TSR), could be misleading to investors, may lead to unintended effects on equity program design and exacerbates "the current overemphasis on short-term performance at the expense of long-term shareholder value creation."[4] In the proposing release, the SEC noted its attempt to address the concerns of commenters and cites to letters it received.

Summary of Proposed Pay for Performance Rules

The proposed pay for performance rules would add a new paragraph (v) to Item 402 of Regulation S-K, which would require tabular disclosure of (1) compensation "actually paid" to the PEO and an average of the compensation "actually paid" to the other NEOs, in each case to be phased-in over a transition period and (2) the corresponding "total compensation" amount as shown in the summary compensation table, with footnote disclosure explaining the amounts included or deducted to arrive at amounts "actually paid," as well as any other materially different assumptions. The new paragraph (v) to Item 402 of Regulation S-K would also require disclosure of the relationship between (1) compensation "actually paid" and the registrant's financial performance as reflected by its TSR on an annual basis and (2) the registrant's TSR and a peer group TSR on an annual basis, in a narrative, graphical format or a combination of the two. Registrants would be required to tag the disclosure in an interactive data format using eXtensible Business Reporting Language ("XBRL"), which is the first time XBRL would be used for a proxy filing.

[4] Commissioner Daniel M. Gallagher during his dissenting statement at the open meeting on April 29, 2015.

Covered Executives

The proposed rules require disclosure for those executive officers for whom, under the current rules, compensation disclosure is required in the summary compensation table (i.e., the NEOs)[5]. The proposed rules would require that the compensation information be presented separately for the PEO and as an average for the remaining NEOs. The SEC indicated an average may enhance comparability and will, therefore, be more meaningful to shareholders than individual or aggregate NEO compensation in part due to the significant variability in the identity of NEOs over time.

In the event that more than one person served as the PEO during the covered period, the proposal would have registrants aggregate the amounts for all persons who served in the role of PEO in an effort to reflect the total amount paid for the services of a PEO in the relevant year. If adopted, this would skew the compensation for the PEO role in the transition year and, in our view, would impair comparability of that registrant with peers for any transition year.

Determining Compensation "Actually Paid"

Although Dodd Frank Section 953(a) directs the SEC to promulgate rules requiring registrants to disclose the relationship between compensation actually paid to their executives and their financial performance, the statute provides no guidance as to what "actually paid" is intended to mean. The proposed rules would require registrants to determine compensation "actually paid" by reference to the "total compensation" measure included in the summary compensation table, with certain modifications. Specifically, the "total compensation" measure should be modified with respect to:

- Changes in Actuarial Pension Value: only the actuarial present value of benefits attributable to services rendered during the applicable fiscal year, or the service cost (rather than the total change in actuarial pension value), is proposed to be included. This would exclude the portion of the total change that results from changes in interest rates, age and other actuarial inputs and assumptions with respect to benefits accrued in previous years. The SEC believes its proposed disclosure will result in improved comparability across registrants and reduce the volatility caused by changes in interest rates and other actuarial assumptions.

- Equity Awards: equity award values in this table would reflect the fair value on the vesting date (rather than the grant date), computed in accordance with the fair value guidance in FASB ASC Topic 718, with footnote disclosure addressing the vesting date valuation assumptions to the extent they are materially different than those disclosed as of the grant date.

  In the SEC's view, this will be of value to shareholders to the extent they believe that changes in the value of equity grants after the grant date are a primary channel through which pay is linked to performance. However, the SEC acknowledges that the variation in time-based vesting schedules or the use of cliff-vesting may result in a sharp increase in compensation in any year during which significant equity awards vest that will create a degree of volatility and affect the comparability of data across registrants. The SEC also concedes that the proposed rule may have the unintended effect of influencing equity award design.

  We note that, if adopted as proposed, Item 402(v) would require a revaluation of equity awards in each vesting year, which would be more burdensome than existing requirements. We observe that presenting the valuation of equity awards at the time of vesting rather than at the time of actual delivery or settlement will have a significant impact on comparability, especially with respect to certain industries or for particular forms of equity awards.

[5] See Item 402(a)(3) of Regulation S-K or, for smaller reporting companies, see Item 402(m) of Regulation S-K.

In addition to compensation "actually paid," the new tabular disclosure would also include the "total compensation" amount as shown in the summary compensation table presented separately for the PEO and as an average for the remaining NEOs, with footnote disclosures explaining any modifications.

Determining Measure of Performance (TSR)

The new paragraph (v) to Item 402 of Regulation S-K would further require disclosure of the relationship between (1) compensation "actually paid" and the registrant's financial performance as reflected by its TSR (as defined in Item 201(e) of Regulation S-K) on an annual basis and (2) the registrant's TSR and a peer group TSR on an annual basis, in a narrative, graphical format or a combination of the two. Under the proposed rule, registrants are permitted to use the same index or peer group used for purposes of the "performance graph" under Item 201(e) Regulation S-K, or, if applicable, the peer group used for the purposes of the CD&A on compensation benchmarking practices under Item 402(b) of Regulation S-K. If the peer group is not a published industry or line-of-business index, the registrant must identify the companies comprising the group. The proposed rules do not require smaller reporting companies to present a peer group TSR as they are not subject to Item 201(e) of Regulation S-K.

The SEC notes that it opted to require registrants to use one consistently calculated measure, rather than permitting registrants the flexibility to select what they view as the best suited performance metric, in an effort to ensure comparability and provide a measure that is objectively determinable using share price, which is not open to subjective determinations of performance. The SEC further observed that using a measure that registrants are already required to determine and disclose under Item 201(e) Regulation S-K, and with which shareholders are already familiar, would reduce the compliance burden. The SEC has requested comment on whether TSR is an optimal measure of financial performance.

Registrants would be permitted, as they currently are with other mandated disclosures, to disclose other measures of financial performance as long as that additional disclosure is clearly identified, not misleading and not presented with greater prominence than the required disclosure.

In the proposed rule, as TSR is measured at fiscal year-end, but equity award values are determined as of their respective vesting dates, there will be a mismatch in stock prices used in the disclosure.

Where Pay for Performance Disclosure is Required

The disclosure would be required in any proxy statement filed on Schedule 14A or information statement filed on Schedule 14C that mandates executive compensation disclosure under Item 402 of Regulation S-K, which would not include annual reports on Form 10-K or Form S-1 registration statements to the extent that disclosure under Item 402 of Regulation S-K is required therein. Although Section 953(a) of Dodd-Frank could be read more broadly, the SEC focused on the language calling for the new disclosure to be provided in solicitation material for an annual meeting of shareholders and shared their belief that the proposed disclosure would be most useful to shareholders when deciding whether to approve the compensation of the NEOs through the say-on-pay advisory vote, the vote on a compensation plan in which NEOs participate and make decisions pertaining to the election of directors. In addition, as proposed, the disclosure would not be deemed to be incorporated by reference into any filing under the Securities Act of 1933 (the "Securities Act") or the Securities Exchange Act of 1934 (the "Exchange Act"), except to the extent that a registrant specifically incorporates it by reference. The proposal does not specify where in the proxy or information statement the new Item 402(v) disclosure must appear but rather affords registrants full flexibility to determine its location. We expect that registrants will include this information with the remainder of their Item 402 executive compensation disclosure – although perhaps not in the CD&A.

Covered Registrants

The proposed rules would apply to all companies that are registered under Section 12 of the Exchange Act (including smaller reporting companies), which are, therefore, subject to the federal proxy rules, other than emerging growth companies.[6] The SEC would also exempt foreign private issuers or companies with reporting obligations only under Section 15(d) of the Exchange Act on the theory that these companies are not subject to the proxy statement requirements of the Exchange Act, as well as registered investment companies due to their differentiated management structure and their not having NEOs within the meaning of Item 402 of Regulation S-K, which also exempts them from the requirement to conduct shareholder advisory votes. In addition, for some Section 12(g) registrants, such as limited partnerships, the disclosure requirement might not apply in some or all years because these registrants might not file either proxy or information statements every year. As proposed, business development companies would be treated in the same manner as issuers other than registered investment companies and, therefore, would be subject to the new disclosure requirements.

Covered Time Period

Subject to the transition rules described below, the proposed rules would require registrants, other than smaller reporting companies, to provide the pay for performance disclosure for the five most recently completed fiscal years. The proposing release states this provides a meaningful period over which a relationship between annual measures of pay and performance can be evaluated, although the five year requirement exceeds the three year look back provided in the summary compensation table. Smaller reporting companies would be only required to provide the disclosure for the three most recently completed fiscal years.

Note that a registrant is required to provide this disclosure only for those years that it was a reporting company pursuant to Section 13(a) or Section 15(d) of the Exchange Act. Accordingly, a new reporting company would be required to provide disclosure for only the most recently ended fiscal year in any proxy statement or information statement in which executive compensation disclosure pursuant to Item 402 of Regulation S-K is required in its first year as a reporting company, and in the two most recently completed fiscal years in any proxy statement or information statement in which executive compensation disclosure pursuant to Item 402 of Regulation S-K is required in its second year as a reporting company.

Transition Period

All registrants, other than smaller reporting companies, would be required to provide the proposed disclosure for three fiscal years, instead of five, in the first applicable filing after the rules become effective, and provide disclosure for an additional year in each of the two subsequent annual proxy filings where disclosure is required. Existing smaller reporting companies initially would be required to provide the disclosure for only the last two fiscal years, and would subsequently provide disclosure for the prior three fiscal years.

Disclosure to be Deemed "Filed"

The proposed rules provide that the pay for performance disclosure will be considered "filed" for purposes of liability under the Securities Act of 1933 and the Exchange Act and the content is, therefore, subject to the certification requirements of Sections 13(a) and 15(d) of the Exchange Act.[7]

[6] The Jumpstart Our Business Startups Act of 2012 (the "JOBS Act") specifically exempts emerging growth companies from Section 953(a). See JOBS Act Section 102(a)(3). Our related publications on the JOBS Act are available at http://www.shearman.com/jobs-act-signed-into-law/.

eXtensible Business Reporting Language (XBRL) Format

The proposed rules would require that the disclosure, including any footnote disclosure, be provided in interactive data format using XBRL. Registrants would be required to separately tag the values disclosed in the required table, and to separately block-text tag (1) the disclosure of the relationship among the measures, (2) the footnote disclosure of deductions and additions used to determine executive compensation actually paid and (3) the footnote disclosure regarding vesting date valuation assumptions. Smaller reporting companies would benefit from a phase-in period and would be required to provide the data in XBRL beginning with the third filing in which it provides pay for performance disclosure.

Ultimately, the SEC notes that data tagging will aid in lowering the cost of collecting this information to investors, permitting data to be analyzed more quickly and facilitating comparisons among public companies over time.

What's Next?

The comment period for the proposed rules will be 60 days after publication in the Federal Register, which occurred on April 29, 2015.

Conclusion

New Item 402(v) as proposed by the SEC would require registrants to compare executive compensation against a single performance metric in standardized, machine-readable format. The proposal does allow registrants some, arguably limited, flexibility in how the relationship of pay for performance is presented and whether any supplemental disclosure is included. Whether on balance the disclosure will increase comparability and produce useful information to shareholders remains to be seen. No action is required, however, until the SEC adopts final rules.

7 Section 18 of the Exchange Act imposes liability for material misstatements or omissions for "filed" disclosure. "Furnished" disclosure under Regulation FD, such as the disclosure of certain market information made to institutional investors, does not attract liability under Section 18.

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