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Client Alert

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SEC Proposes "Pay Versus Performance" Disclosure Rules

On April 29, 2015, the Securities and Exchange Commission (the "SEC") proposed rules to enact the "pay versus performance" disclosure requirement under Section 953(a) of the Dodd-Frank Act. The proposed rules would require certain US public companies to disclose the relationship between executive compensation actually paid and the company's financial performance. The proposed rules will be open for public comment for 60 days following the publication of the proposing release in the Federal Register.

Overview

The SEC is proposing to add a new paragraph (v) to Item 402 of Regulation S-K. The new disclosure would provide additional information about the relationship between executive compensation actually paid to a reporting company's named executive officers and the cumulative total shareholder return (TSR) of the company, as well as the relationship between the company's TSR and its peer group. The proposed disclosure is intended to provide additional information to investors for when they make the say-on-pay advisory vote and other voting decisions regarding executive compensation.

Item 402(v) would require companies to provide a table containing six columns: (a) Year, (b) Summary Compensation Table Total for PEO,[1] (c) Compensation Actually Paid to PEO, (d) Average Summary Compensation Table Total for non-PEO Named Executive Officers, (e) Average Compensation Actually Paid to non-PEO Named Executive Officers, (f) Total Shareholder Return, and (g) Peer Group Total Shareholder Return. The disclosure provided in each column of the table, including any footnotes, would have to be provided in interactive data format using eXtensible Business Reporting Language (XBRL). The proposal also requires disclosure about the relationship between executive compensation and company performance, which could be described narratively, graphically, or using a combination of the two. Plain English principles would be applicable to the pay versus performance disclosure.

The proposed disclosure under the new Item 402(v) would be included in any proxy statement or information statement that requires disclosure under Item 402. Disclosure would not be required in registration statements or annual reports on Form 10-K, even if these forms otherwise require Item 402 compensation disclosure. Nor would the new disclosures be incorporated by reference into any other SEC filings.

Companies Covered

The proposed rules would apply to all public companies that file proxy statements or information statements with the SEC other than (i) emerging growth companies, (ii) foreign private issuers, and (iii) registered investment companies. Consistent with current Item 402, smaller reporting companies would be permitted to provide scaled disclosures under the proposed rules.

[1] Principal Executive Officer

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Executives Covered

Consistent with current executive compensation disclosure rules, the proposed disclosure would cover the “named executive officers” as defined in Item 402. Compensation information would be presented separately for the principal executive officer (PEO), and be aggregated for the years in which more than one person served as the PEO. Compensation information would be presented as an average for the remaining named executive officers identified in the Summary Compensation Table.

Determination of “Executive Compensation Actually Paid”

“Executive compensation actually paid” would be total compensation as reported in the Summary Compensation Table, adjusted for amounts included for pension benefits and equity awards. First, the change in the actuarial present value of all defined benefit and pension plans would be deducted, but the actuarial present value of benefits attributable to services rendered by the executive during the applicable year would be added back. Second, the above-market or preferential earnings on deferred compensation that is not tax-qualified would be included in the compensation calculation. Third, the grant-date value of any stock and option awards granted during the year that are subject to vesting would be subtracted. Finally, the fair value at vesting date of equity awards that vested in the applicable year would be added. Equity awards would be considered actually paid on the date of vesting, regardless of whether or not they are exercised, and valued at fair value on the vesting date, rather than fair value on the grant date. Additionally, if the exercise price of previously vested options or stock appreciation rights was adjusted or amended during the last completed fiscal year, the company’s compensation calculation must include the incremental fair value. For modified awards that are subject to multiple vesting dates, the pro rata incremental fair value would be included in compensation actually paid at each vesting date.

Measure of Performance

Reporting companies would use TSR as defined in Item 201(e) of Regulation S-K as the measure of financial performance. Companies other than smaller reporting companies would also be required to disclose peer group TSR, using either the same peer group used for Item 201(e) of Regulation S-K or a peer group used in the compensation discussion and analysis for purposes of disclosing the company’s compensation benchmarking practices. If the peer group is not a published industry or line-of-business index, the identity of the companies in the peer group would be required to be disclosed. Supplemental measures of financial performance would be permitted, provided that the additional disclosure is clearly identified, not misleading, and not presented with greater prominence than the required disclosure.

Time Period Covered

Reporting companies other than smaller reporting companies would be required to provide the Item 402(v) disclosure for the five most recently completed fiscal years. Smaller reporting companies would make the disclosure for the three most recently completed fiscal years. In any event, pay versus performance data would only be required for the years that a reporting company was required to file reports with the SEC.

Transition Period

Under the proposal, there would be a transition period that would allow larger reporting companies 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. Smaller reporting companies would be allowed to provide two years of data in the first applicable filing after the rules become effective and three years of data in subsequent filings. Additionally, smaller reporting companies would have until the third filing in which they provide pay versus performance disclosure to provide the prescribed disclosure in XBRL format.

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Conclusion

Given the timeline for a typical SEC rulemaking, it is possible that the SEC could adopt final rules in time for the 2016 proxy season. The proposing release seeks public comment on all facets of the proposed rules, including whether the proposal would impose significant transition costs on registrants, whether the proposal strikes the appropriate balance between satisfying the requirements of Dodd-Frank and allowing pay versus performance information that is most relevant to shareholders, and whether there are alternative proposals the SEC should consider. Although the proposed rules, if adopted in their current form, would be disclosure rules only and would not require a company to amend its internal policies, public companies subject to the rules may wish to assess their executive compensation policies and performance relative to their peers to assess where they would stand in light of the proposed disclosure requirement.

As with other Dodd-Frank rulemakings, the SEC permitted interested parties to submit comments to the agency before proposal of this new rule. Commenters were split between favoring a rigid quantitative approach to the disclosure (like the proposed rules) and a more qualitative discussion that provided reporting companies with greater flexibility to determine the substance of disclosure. We expect that commenters on the proposed rules will be similarly divided.

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