SEC Proposes "Pay versus Performance" Disclosure Rules

hugheshubbard.com eALERT

On April 29, the SEC proposed the long-awaited "pay versus performance" disclosure rules mandated by the 2010 Dodd-Frank Wall Street Reform and Consumer Protection Act. The new disclosure would be added to Item 402 of Regulation S-K as new paragraph (v), and would be required in proxy and information statements in which Item 402 executive compensation information is required, but would not be required in registration statements or Form 10-K. The new disclosures would not be required for foreign issuers or emerging growth companies, but would be required on a scaled-down basis for other smaller reporting companies.

Although the timing and content of the final rule is unclear, pending the public comment process, the proposed rule reflects the SEC's view that such disclosure will assist shareholders in determining how to vote on "say on pay" proposals.

Content of the Disclosure

The proposed rule calls for both a required "Pay Versus Performance" table and a description of the relationship between pay and performance based on the information in the table.

Tabular Disclosure. The table is required to contain the following information for each of the five years (three years for smaller reporting companies) ending with the last-completed fiscal year:

- **CEO "total compensation"** for the year, as reported in the Summary Compensation Table. If the company had more than one CEO in any year, amounts for the various CEOs for that year must be aggregated.
- **Compensation "actually paid" to the CEO** (or CEOs) for the year, determined as described below.
- **Average NEO "total compensation**" for the year, for the named executive officers (other than the CEO(s)), as reported in the Summary Compensation Table for the applicable year. The NEOs whose compensation would be included in the average for a given year would be all NEOs (other than the CEO(s)) listed in the Summary Compensation Table for that year, including those who left before the end of the year.
- **Average compensation "actually paid" to the NEOs other than the CEO** for the applicable year.
- **Cumulative Total Shareholder Return (TSR) for the company.** TSR would be defined in the same way as it is for purposes of the stock performance graph required to be included in the company's annual report pursuant to Item 201(e) of Regulation S-K (generally, the sum of (i)

cumulative dividends for the period, assuming dividend reinvestment, and (ii) the change in share price over the period, divided by the share price at the beginning of the period). For each year, the applicable period for measuring TSR would start the day before the earliest year covered in the table and run through the end of the applicable year.

- **Cumulative TSR for the company's peer group.** The peer group used for this purpose may be either the peer group used in the stock performance graph or the peer group used for compensation benchmarking purposes as described in the Compensation Discussion and Analysis (CD&A). If the peer group is not a published industry or line of business index, the company would need to identify the companies comprising the peer group. (Smaller reporting companies would not be required to include this column in the Pay Versus Performance table since they are not otherwise required to present peer group TSR.)

Compensation "actually paid," whether for the CEO or the average for the other NEOs, is required to be calculated by adjusting "total compensation" as reported in the Summary Compensation Table to make the following changes to amounts included for pension benefits and equity awards:

- **Pension Benefits** -- Deduct the change in actuarial present value of defined benefit pension plans, but add back the actuarial present value of benefits for services rendered by the executive during the applicable year (i.e., the "service cost" as defined for purposes of the company's financial statements, reflecting the increase in benefits attributable to an additional year of service). The net effect of these two adjustments is that compensation "actually paid" would exclude the portion of the change in actuarial present value of pension benefits reported in "total compensation" that results from changes in interest rates, the executive's age, and other actuarial inputs and assumptions. (Smaller reporting companies would not be required to make these adjustments because they do not report pension benefits in the Summary Compensation Table.)

- **Equity Awards** -- Instead of reporting the grant date fair value of equity awards in the year of grant, as required in the Summary Compensation Table, the compensation "actually paid" amount would only include equity awards that vested during the year in question, and would value them using the fair value on the vesting date. The disclosure would include stock options that vested in the year, even if they were not exercised. The company would be required to disclose the assumptions used in calculating vesting date fair value if they differed materially from the assumptions used to calculate grant date fair value (which are required to be disclosed in the company's financial statements). If the company repriced or otherwise amended an equity award, the "actually paid" amount would also be required to include the incremental fair value attributable to the amendment on the later of the date of the amendment or the date of vesting.

Footnote disclosure would be required to reconcile the two measures of compensation, showing the amount of each element added to or deducted from "total compensation" in order to arrive at compensation "actually paid."

The proposing release recognizes that a number of companies have used the concepts of "realizable pay" and "realized pay" as a means of comparing pay to performance, but the SEC declined to use either concept in the new rule in the belief that there is as yet no broad consensus as to how to determine these measures. The release states that companies may choose to supplement the required disclosures with disclosures based on these or other measures so long as the supplemental disclosure is not misleading and is not presented more prominently than the required disclosure. Similarly, companies may choose to provide measures of financial performance other than cumulative TSR so long as the supplemental disclosure is not misleading and is not presented more prominently than the required disclosure.

Description of Relationship between Pay and Performance. The proposed rule also calls for a description of (1) the relationship between the executive compensation "actually paid" and the company's TSR, and (2) the relationship between the company's TSR and that of its peer group. This disclosure must be based on the data contained in the Pay Versus Performance table, and may be provided in narrative form, graphical form, or as a combination of the two. However, in its request for comments, the proposing release asks whether the format of this part of the disclosure should be prescribed in order to promote greater comparability.

Time Period Covered

Most companies would be required to provide the pay versus performance disclosure for the five most recently completed fiscal years, but smaller reporting companies would be required to provide information for only the last three years. These requirements would be phased in, so that smaller reporting companies would only need to provide two years of disclosure in the first filing to which the rules apply, with an additional year in the next annual proxy filing; and all other companies would need to provide three years of disclosure in the first filing to which the rules apply, with an additional year in each of the next two annual proxy filings. Emerging growth companies are exempt from this disclosure requirement by statute. All other newly reporting companies would be required to provide pay versus performance disclosure only for years that they were Exchange Act reporting companies.

Location of the Disclosure

The proposed rules do not specify a particular place in the proxy statement for the new pay versus performance disclosures. Instead, companies would have flexibility to determine where in the proxy statement to provide the information. The proposing release notes that some companies may choose to include the disclosure in the CD&A, but companies that do not use this information in their compensation decisions may find it more appropriate to provide the disclosure elsewhere in the executive compensation section of the proxy statement.

Interactive Data Requirement

The proposed rule would require that all data in the Pay Versus Performance table, as well as the related footnote disclosure and the description of the relationship between pay and performance, be also provided in interactive data format using eXtensible Business Reporting Language (XBRL). The interactive data would need to be provided as an exhibit to the proxy or information statement in which pay versus performance disclosure is included. Smaller reporting companies would also be required to provide the XBRL exhibit, but not until the third proxy or information statement filing in which pay versus performance disclosure is included.

For further information, please contact:

Gary Simon, *Partner*
(212) 837-6770
gary.simon@hugheshubbard.com

Sarah Downie, *Partner*
(212) 837-6590
sarah.downie@hugheshubbard.com

Gloria Nusbacher, *Counsel*
(212) 837-6719
gloria.nusbacher@hugheshubbard.com

Ellen Friedenberg, *Partner*
(212) 837-6465
ellen.friedenberg@hugheshubbard.com

Spencer Harrison, *Partner*
(212) 837-6858
spencer.harrison@hugheshubbard.com

Erin DeCecchis, *Counsel*
(212) 837-6450
erin.dececchis@hugheshubbard.com

Employee Benefits & Executive Compensation Practice

Corporate Governance Practice

May 2015

Hughes Hubbard & Reed LLP
One Battery Park Plaza | New York, New York 10004-1482 | 212-837-6000