

SEC Proposes Rules to Implement Pay versus Performance Disclosure Requirement

The Securities and Exchange Commission has taken action on another significant executive compensation-related provision of the Dodd-Frank Wall Street Reform and Consumer Protection Act, proposing rules to implement Section 953(a) of the Act, which requires public companies to disclose the relationship between their named executive officer compensation and their financial performance.

On April 29, 2015, the SEC proposed rules to implement this requirement. Comments by the public on the proposed rules must be submitted to the Commission within 60 days of their publication in the Federal Register, which we expect will take place shortly. Accordingly, comments will be due by early July.

This Thoughtful Pay Alert summarizes the key aspects of the proposed rules and provides our initial observations about the likely impact of the rules on technology and life sciences companies.

Background

To enhance the mix of compensation information available to investors, Section 953(a) of the Dodd-Frank Act added new Section 14(i) to the Securities Exchange Act of 1934. This provision directs the SEC to amend its rules to require:

- A clear description of the compensation required to be disclosed under its executive compensation disclosure rules, including
 - ▶ information that shows the relationship between executive compensation actually paid and the

Four Things Technology and Life Sciences Companies Should Know about the SEC's Proposed Pay Versus Performance Rules

- **New Disclosure Table.** Companies would be required to include a new “pay versus performance” table in their proxy statements. This table would include, for each of the past five fiscal years, the total compensation (as reported in the Summary Compensation Table) and compensation actually paid to the Chief Executive Officer and the average of these amounts for the other named executive officers. The table would also include, on an annual basis, the company’s total shareholder return and the TSR for a group of peer companies.
- **Additional Disclosure.** Companies would be required to describe the relationship between the compensation actually paid to their named executive officers and their TSR. In addition, companies would be required to describe the relationship between their TSR and the TSR of the peer group included in the new table. This disclosure may be in narrative or graphic form, or a combination of the two.
- **Compensation Actually Paid.** “Compensation actually paid” would be calculated by taking the total compensation as reported in the Summary Compensation Table, with the amounts reported in the “Stock Awards” and “Option Awards” columns replaced with the accounting fair value of such awards as of their vesting date. As a result, “underwater” stock options would reflect a positive value, even though the named executive officers would not realize any economic benefit from exercising such options on their vesting date.
- **Effective Date.** The comment period on the proposed rules is expected to run until early July. Depending on the volume and complexity of the public comments, the SEC may consider final rules as early as September. If final rules are adopted at that time, it is possible that the new disclosure requirement could be effective in time for the 2016 proxy season.

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financial performance of the company (taking into account any change in the value of the shares of stock and dividends of the company and any distributions).

Largely as a result of its other rulemaking projects under the Dodd-Frank Act and the Jumpstart Our Business Start-ups (“JOBS”) Act, it has taken nearly four years for the SEC to formally propose rules to implement this disclosure requirement.

Proposed Rules

On April 29, 2015, the SEC proposed amendments to its rules to implement the “pay versus performance” disclosure requirement. The key aspects of the proposed rules are summarized below.

New Disclosure Table

The centerpiece of the required disclosure would be a new “pay versus performance” table containing the following information for each of the last five fiscal years (subject to a phase-in period):

- The amount reported in the “Total Compensation” column of the Summary Compensation Table for the Chief Executive Officer and the average of the amounts reported in the “Total Compensation” column for the remaining named executive officers;
- The compensation “actually paid” to the Chief Executive Officer (calculated as described below) and the average compensation actually paid to the remaining named executive officers;
- The company’s cumulative total shareholder return (“TSR”) on an annual basis; and
- The cumulative TSR on an annual basis of the companies in a peer group (using either the peer group identified by the company in its stock performance graph or the compensation peer group in its Compensation Discussion and Analysis).

Smaller reporting companies would only be required to provide disclosure for the last three fiscal years. In addition, such companies would not be required to present a peer group TSR since currently they are not required to provide either a stock performance graph or prepare a CD&A.

For purposes of the new table, companies would use the definition of TSR as provided for the stock performance graph which must be included in the glossy annual report to shareholders.

Observations

While the new disclosure table must be included in a company’s proxy statement, it need not be part of its Compensation Discussion and Analysis – or even its executive compensation disclosure. Nonetheless, companies will be faced with the question of where to include the new table in their proxy statement. Given the attention that has been given to explaining the relationship between executive pay and corporate performance in the CD&A, we expect that many companies will seek to integrate the required disclosure into their “pay for performance” analysis or to otherwise present the table in a way that harmonizes the disclosure with their current compensation messaging strategy.

It is also noteworthy that the new disclosure table requires companies to include the amounts reported in the “Total Compensation” column of the Summary Compensation Table (for the Chief Executive Officer and, based on the average amount, for the other named executive officers). This suggests that the SEC does not expect that the table will necessarily accompany the other required compensation tables and, therefore, wants to be sure that shareholders can easily compare the amounts reported for the named executive officers in the Summary Compensation Table with the compensation actually paid during the same fiscal year. This is a curious comparison, however, since (i) the majority of most executive officers’ total direct compensation consists of long-term incentive pay (typically in the form of equity awards) and (ii) most (if not all) of the equity awards that will be included in the compensation actually paid amount will have been granted in prior years, rather than in the last completed fiscal year.

Finally, by requiring a comparison between a company’s cumulative TSR with the cumulative TSR of a peer group, in some ways the proposed rules will be reintroducing some of the information required in the stock performance graph into the proxy statement. Since the overhaul of the executive compensation disclosure rules in 2006, this graph has not been required in the proxy statement. It will be interesting to see whether companies opt to return this graph to their proxy statements to help them comply with the new rules.

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Additional Disclosure Required

Using the information presented in the new table, companies would be required to provide a clear description of the relationship between the compensation actually paid to their named executive officers and their TSR. In addition, companies also would be required to describe the relationship between their TSR and the TSR of the peer group selected for inclusion in the new table. This disclosure could be in narrative form, presented as a graphic (or series of graphics), or a combination of the two.

Observations

Section 955 of the Dodd-Frank Act requires that companies provide a clear description of any compensation required to be disclosed pursuant to the SEC's executive compensation disclosure rules. The SEC has interpreted this mandate to apply to the relationship between the compensation actually paid to its named executive officers and its TSR, as well as to the relationship between its TSR and its peer group TSR. For companies that don't necessarily use TSR as a performance measure for their incentive compensation arrangements, this may result in additional analysis beyond what they are currently providing. In addition, the focus in the required disclosure is on one-year TSR, a measure that the proxy advisory firms recently elected to minimize in their analyses of company performance. Companies may be compelled to expand their TSR discussion to cover longer periods to present a balanced perspective of their relative performance.

Calculation of "Compensation Actually Paid"

As proposed, "compensation actually paid" would be calculated using the amount disclosed in the "Total Compensation" column of the Summary Compensation Table, with two adjustments:

- **Pension amounts.** Pension amounts disclosed in the Summary Compensation Table (if any) would be adjusted by:
 - ▶ deducting the change in pension value reported in the SCT; and
 - ▶ adding back the actuarially-determined service cost for services rendered by the executive during the applicable year.
- **Equity awards.** Stock and option awards disclosed in the Summary Compensation Table would be

- adjusted by:
 - ▶ deducting the amounts reported in the "Stock Awards" and "Option Awards" columns; and
 - ▶ adding in the fair value (as calculated under FASB ASC Topic 718) of stock awards and option awards that actually vested during the applicable year.

Companies would be required to disclose the vesting date valuation assumptions if they are materially different from those disclosed in its financial statements as of the grant date.

Observations

The proposed adjustment for pension amounts will likely have little impact on technology and life sciences companies since most do not offer defined benefit or other retirement plans to their employees. Far more significant is the adjustment for equity awards.

Since the SEC is proposing to use the "fair value," rather than the "intrinsic value," of the awards on their vesting date, some anomalous outcomes may result. For example, an "underwater" stock option will still result in "compensation actually paid" since its fair value will be added to the other amounts reported in the Summary Compensation Table. This differs significantly from the typical formulation of "realized pay" that, until now, has been used by many companies in analyzing their "pay for performance" correlation.

On one level, this approach is consistent with the way equity awards are reported in the Summary Compensation Table; simply focusing on the accounting value of those awards once they have been earned by a named executive officer and can be converted to cash. It also avoids the "winner or loser" phenomenon that can arise when an intrinsic value is used in the case of stock options. As a practical matter, this vesting date approach only affects stock options since, under FASB ASC Topic 718, the fair value of full value equity awards is generally equal to the fair market value of the company's stock on the valuation date. As a result, companies will likely need to recalculate the fair value of their stock options as each increment vests to generate the required compensation figure.

Executives Subject to Disclosure Requirement

The proposed rules would require disclosure about a company's named executive officers. These are the individuals for whom disclosure is currently required in the Sum-

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mary Compensation Table. As noted above, for each year in which disclosure would be required, companies would present the information separately for the Chief Executive Officer, and as an average for the remaining named executive officers.

Filings Subject to Disclosure Requirement

The proposed rules require companies to include the “pay versus performance” disclosure in any proxy or information statement in which the executive compensation disclosure specified in Item 402 of Regulation S-K is required.

Companies Subject to Disclosure Requirement

The proposed rules apply to companies subject to the reporting requirements of the Exchange Act, including smaller reporting companies. They do not apply to “emerging growth companies” (that is, companies with annual revenues of less than \$1 billion as of the end of their last completed fiscal year), foreign private issuers, or registered investment companies.

Transition Period

The proposed rules provide a “phase-in” for all companies. Companies, other than smaller reporting companies, would be required to provide the “pay versus performance” information for three years in the first proxy statement in which the disclosure is required. They would then add another year of disclosure in each of their two subsequent proxy statements. Smaller reporting companies would initially provide the “pay versus performance” information for two years, then add an additional year in their next proxy statement.

Comment Period

The SEC is soliciting comments from the public on the proposed rules for 60 days from the date that they are published in the Federal Register. Assuming such publication by early next week, the comment period is likely to run until early July.

Disclosure to be provided in Interactive Form

Companies would be required to tag the new disclosure in an interactive data format using eXtensible Business Reporting Language (“XBRL”). This requirement would be phased-in for smaller reporting companies, so that they would not be required to comply with the tagging require-

ment until the third annual filing containing the “pay versus performance” disclosure.

Final Observations

Since the introduction of the shareholder advisory vote on named executive officer compensation (the so-called “Say-on-Pay” vote) in 2011, many companies now include a “pay-for-performance” analysis in their Compensation Discussion and Analysis, often in the Executive Summary. For many companies, this analysis has become a key disclosure in determining the outcome of their Say-on-Pay vote.

Companies that have used an alternative pay formulation (such as “realized” or “realizable” pay) in this analysis will now have to decide whether to maintain their current approach – along with the new “pay versus performance” disclosure – or to incorporate the new disclosure into their “pay for performance” discussion. Companies that have, so far, not provided a “pay for performance” discussion in their CD&A will now need to consider how to include the new information in their executive compensation disclosure. While the information can be provided on a stand-alone basis, given its connection to the Say-on-Pay vote we expect to see it become part of the CD&A or, at a minimum, added to the supporting statement for the Say-on-Pay proposal.

Need Assistance?

Compensia has extensive experience in helping companies understand how the corporate governance and executive compensation-related disclosure provisions of the Dodd-Frank Act will affect the design, operation, and disclosure of their executive compensation program. If you would like assistance in analyzing how the proposed rules are likely to impact your executive compensation disclosure, or if you have any questions on the subjects addressed in this Thoughtful Pay Alert, please feel free to contact Mark A. Borges. ■

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