SEC's Proposed "Pay versus Performance" Disclosure Rules Likely to Present Numerous Challenges

In April, the SEC proposed amendments to its rules to implement Section 953(a) of the Dodd-Frank Wall Street Reform and Consumer Protection Act, the provision requiring public companies to disclose the relationship between their named executive officer compensation and their financial performance. The proposed amendments, which contemplate a combination of tabular and narrative (or graphic) disclosure, raise numerous issues that are likely to create several compliance challenges. Further, it's not clear that the resulting disclosure will advance the statute's stated purpose – to provide shareholders with information that will help them assess a company's executive compensation relative to its actual performance as measured by total shareholder return.

This Thoughtful Pay Alert identifies several of these issues, which no doubt will be the subject of public comment and debate in the coming months as the SEC moves to adopting final rules later this year.

Background

Section 953(a) of the Dodd-Frank Act 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 financial performance of the company.

The SEC has proposed to satisfy this directive by requiring public companies to include in their proxy statements in which executive compensation disclosure is required a new "pay versus performance" table containing the following information for each of the last five fiscal years:

- 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 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 either the companies in the peer group identified by the company in its stock performance graph or the compensation peer group disclosed in its Compensation Discussion and Analysis.

In addition, 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 cumulative TSR and to describe the relationship between their cumulative TSR and the cumulative TSR of the peer group included in the table. This disclosure may be in narrative form, presented as a graphic (or series of graphics), or a combination of the two.

Compliance Issues

As proposed, the new disclosure raises several compliance issues, including the following:

Treating "Underwater" Options as "Compensation Actually Paid"

The proposed rules introduce a new formulation of executive pay – 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, subject to two adjustments, one for pension benefits and the other for equity awards.

The proposed adjustment for equity awards, which would be considered "actually paid" on the date of vesting based on their accounting fair value on that date, is problematic, particularly when applied to stock options. As proposed,

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even if an option is "underwater" (that is, the exercise price exceeds its fair market value) on the date of vesting, the fair value of that award would have to be calculated (using an option pricing model with updated assumptions) and added to total compensation. Consequently, this amount would be considered compensation actually paid even if the executive never exercises the option.

Disclosure by Companies with Multiple CEOs

The new "pay versus performance" table singles out a company's Chief Executive Officer for individual disclosure of his or her reported pay and "compensation actually paid" for each of the table's five covered fiscal years. Where a company hires a new Chief Executive Officer, or has its current CEO leave, during a covered fiscal year, the proposed rules provide that the aggregate compensation reported and actually paid to each of these individuals must be disclosed in the table.

Given an average CEO tenure of approximately eight years, this means that many companies will face the challenge of having to disclose the compensation of multiple Chief Executive Officers in at least one of the years covered by the table. Factoring in "new hire" awards (which may include an "on-boarding" equity award with vesting conditions that differ significantly from typical annual awards) and potential severance payments (which may have been negotiated at the time of hire), this may create a potentially misleading profile of the company's executive compensation program necessitating a detailed breakdown of the compensation figures and explanation of their purpose. In situations where (as described below) the company's executive pay decisions are not tethered to total shareholder return, which is almost always the case in CEO transitions, analyzing the relationship between pay and performance will be difficult.

Correlating Pay and Performance

The proposed rules would require companies to disclose executive compensation and cumulative TSR year-over-year for each of the fiscal years covered by the new table and, using this information, describe the relationship between the compensation actually paid to their named executive officers and their cumulative TSR for each of the last five completed fiscal years.

This approach assumes that a meaningful correlation between pay and performance can be intuited by comparing the compensation actually paid during a fiscal year and the TSR for that year. Further, it assumes that trends can be identified over the multi-year period that is covered by the new table.

It is much more likely that this disclosure will highlight the timing differences between the stock prices on the vesting dates when equity award values must be calculated and the year-end stock price used by a company to determine its annual TSR. The timing of equity award grants, as well as vesting practices, will also have a significant impact on the relationship between pay and performance – factors that have not typically influenced compensation decisions. In addition, most performance-based equity awards are earned based on performance measured over a multi-year period, which may not correlate solely to the TSR for the year of payout. As a result, companies may struggle to identify a meaningful relationship between the compensation amounts being disclosed and each year's financial performance – or need to explain why no such relationship exists.

Finally, most executives receive equity awards annually and each award typically has a three to five-year vesting period. As such, in any given year a named executive officer's compensation actually paid will include increments from equity awards granted anywhere from three to five years earlier that happen to vest in the current fiscal year. These vesting patterns are unlikely to reflect the compensation committee's philosophy or approach to setting executive pay in any single year or lend themselves to insights on how overall pay aligns with the company's performance. To minimize confusion, companies may seek to truncate their vesting schedules or coordinate vesting dates with their reporting cycle, practices which run counter to the recent move towards long-term performance-based incentives.

Focus on Total Shareholder Return

While TSR is a widely-understood performance measure, it is not necessarily reflective of current incentive compensation design at many companies, which, instead, may use other financial or operational measures that are more closely tied to their annual and long-term financial and strategic objectives to set executive pay. These companies will need to provide a second explanation of pay and performance which corresponds to their choice of the drivers of

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corporate performance, adding complexity and length to their disclosures.

Selecting a Comparator Peer Group

The proposed rules give companies two choices when selecting a peer group for purposes of establishing the total shareholder return against which their cumulative TSR is to be compared and analyzed: the index or peer group used for purposes of the stock performance graph required under SEC rules or the compensation peer group disclosed in the company's Compensation Discussion and Analysis. It is not clear whether this latter peer group is supposed to be the one disclosed in the most recent CD&A or may be the peer group that the company is currently using.

Further, the proposed rules appear to overlook the fact that most companies update their compensation peer group each year, thereby making its use to compare TSR over a multi-year period difficult, if not impractical. As a result, most companies are likely to use the index or peer group from their stock performance graph to satisfy this disclosure requirement, even though it may not be directly relevant to their executive pay decisions.

Reconciling Disparate Disclosure among Companies

The proposed rules would permit companies to "phase-in" the new disclosure. Regular reporting companies would be permitted 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.

A newly-public company that qualifies as an "emerging growth company" (that is, a company with annual revenues of less than $1 billion as of the end of the last completed fiscal year) would be exempt from the disclosure requirement until it relinquishes EGC status. If a newly-public company did not otherwise qualify for EGC relief, it must comply with the new rules but need not provide the disclosure for fiscal years prior to the fiscal year of its initial public offering.

As a result, at any given point in time, many companies would be providing the "pay versus performance" table covering a different number of fiscal years, hindering comparability and, in all likelihood, necessitating an explanation of the table's coverage.

Final Observations

As proposed, the computations required to populate the new "pay versus performance" table are likely to present challenges for most companies. Calculating the fair value of equity awards, especially stock options, as of each vesting date will be a time-consuming and tedious process. This burden is magnified by the fact that, to come up with "compensation actually paid," these calculations will have to be made for between four to six executive officers (in addition to the CEO) and will require producing historical values for equity awards granted in several prior fiscal years.

Moreover, it remains to be seen whether this disclosure will replace the current "pay for performance" analysis that many companies provide in their Compensation Discussion and Analysis. Given the novel means for calculating compensation "actually paid" and the mandate to compare this amount to TSR, companies that are already addressing "pay for performance" using different analytics are unlikely to abandon their existing disclosure – particularly if it reflects the compensation committee's philosophy and approach to setting pay. Further, companies that have yet to go down this path may be reluctant to rely on the new disclosure to present their "pay for performance" message, particularly in view of its potential limitations. As a result, companies may need to say more about pay just to maintain their current level of transparency.

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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