

## SEC PROPOSES PAY VERSUS PERFORMANCE RULES

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On April 29, the Securities and Exchange Commission (SEC) issued a release<sup>1</sup> that includes proposed rules to implement requirements imposed on the SEC under Section 953(a) of the Dodd-Frank Wall Street Reform and Consumer Protection Act (the Dodd-Frank Act). Section 953(a) added Section 14(i) to the Securities Exchange Act, which directs the SEC to adopt rules requiring public companies to disclose in any proxy or consent solicitation material a “clear description” of compensation required to be disclosed under Item 402 of Regulation S-K (the provision of Regulation S-K addressing executive compensation disclosures). Section 14(i) further requires that the description include information that shows “the relationship between executive compensation actually paid and the financial performance of the issuer, taking into account any change in the value of the shares of stock and dividends of the issuer and any distributions.”

In its proposed rules, the SEC's response to the Dodd-Frank Act mandate reflects the following themes:

- Disclosure with regard to “compensation actually paid” and “financial performance” should be provided in a manner that will enable comparisons among public companies.
- The disclosure should address compensation actually paid to the principal executive officer (PEO) and the average of compensation actually paid to the other named executive officers.
- “Compensation actually paid” should be based on total compensation set forth in the Summary Compensation Table, subject to certain modifications with regard to equity awards and pension benefits.
- The measure of “financial performance” to be used is total shareholder return (TSR), computed in the same manner as in the stock performance graph.
- For most companies, the disclosure should cover a five-year period, subject to a transitional phase-in provision.
- The “clear description of the relationship between pay and performance” should address the relationship of PEO and average non-PEO named executive officer compensation actually paid to company TSR, as well as a comparison of company TSR to peer group TSR.
- The data provided under the proposed rules should be presented both in conventional form and in eXtensible Business Reporting Language (XBRL).

The manner in which the proposed rules apply these themes is described below. The proposed required disclosures would be included in a company's proxy and information statements in which executive compensation disclosures are required.<sup>2</sup> Accommodations for smaller reporting companies are described below, following the general discussion of the proposed rules. Emerging growth companies are among the entities, listed below, that would not be subject to the proposed rules.

## **THE PAY VERSUS PERFORMANCE TABLE**

The proposed rules would require inclusion of a Pay Versus Performance table in the following tabular format:

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1. Pay Versus Performance, Release No. 34-74835 (April 29, 2015).

2. However, as noted below, the disclosures would not be incorporated by reference in the company's Securities Act or other Exchange Act filings, except to the extent that the company specifically incorporates it by reference.

## Pay Versus Performance

Year (a)	Summary Compensation Table Total for PEO (b)	Compensation Actually Paid to PEO (c)	Average Summary Compensation Table Total for non-PEO Named Executive Officers (d)	Average Compensation Actually Paid to non-PEO Named Executive Officers (e)	Total Shareholder Return (f)	Peer Group Total Shareholder Return (g)

The disclosure requirements related to each column in the table are described below.

### Year

The proposed rules require information for each of the company's last five completed fiscal years. However, the proposed rules provide a transition period under which the company would be required to provide information for only the preceding three fiscal years in the first filing providing the tabular disclosure and the preceding four years in the subsequent annual filing. In addition, a company that has not been subject to the reporting requirements under Sections 13(a) or 15(d) of the Exchange Act during the entire period otherwise subject to the disclosure requirement need only provide information for any completed fiscal year in which it was subject to the reporting requirements, including the fiscal year during which it first became subject to the reporting requirements.

### Summary Compensation Table Total for PEO

This column would require insertion of the "Total" amount shown in the Summary Compensation Table for the PEO. If more than one person served as the PEO during any year, the amounts for all persons serving as PEO would be aggregated. Since the disclosure ultimately would cover the five previous fiscal years, the information for the earliest two fiscal years would not be reflected in the Summary Compensation Table included in the current year proxy statement and would be derived from information in earlier filings.

### Compensation Actually Paid to PEO

Based on its belief that "Congress intended executive compensation 'actually paid' to be an amount distinct from the total compensation" reported under current executive compensation disclosure requirements, the SEC added a specific requirement to address compensation "actually paid." To arrive at this amount, a company is required to make adjustments to the total compensation reported in the Summary Compensation Table for the relevant year with respect to equity awards and pension benefits as follows:

#### Equity Awards

- Deduct the amounts reported in the Stock Awards and Option Awards columns of the Summary Compensation Table.
- Add the fair value on the vesting date of all stock awards and option awards for which all vesting conditions were satisfied during the applicable fiscal year.
- If, during the last completed fiscal year, the company adjusted the exercise price of an already vested option or stock appreciation right, or otherwise materially modified the award, add the excess fair value of the modified award over the fair value of the original award.

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(Fair value is to be computed in accordance with FASB ASC Topic 718.)

## **Pension Benefits**

- Deduct the aggregate change in the actuarial present value of the named executive officer's accumulated benefit under all defined benefit and actuarial pension plans reported in the Change in Pension Value and Nonqualified Deferred Compensation Earnings column of the Summary Compensation Table.
- Add back the service cost under all defined benefit and actuarial pension plans reported in the Change in Pension Value and Nonqualified Deferred Compensation Earnings column of the Summary Compensation Table, calculated as the actuarial present value of each named executive officer's benefit under the plans that are attributable to services rendered during the covered fiscal year, consistent with "service cost" as defined in FASB ASC Topic 715.

In addition, the proposed rules require that the company disclose by footnote to the table each of the amounts deducted and added to determine the "compensation actually paid." With respect to the value of equity awards, the company also would be required to disclose any assumption made in the valuation that differs materially from those disclosed with respect to Summary Compensation Table disclosure of the stock and option awards. (The Summary Compensation Table disclosures typically refer to grant date value assumptions in the company's financial statements.)

In explaining its rationale for substituting vesting date information for grant date information relating to stock and option awards, the SEC stated that because an executive does not have an unconditional right to an equity award prior to vesting, it does not believe a stock or option award should be considered "actually paid" before vesting. The SEC also noted that the adjustments related to pension benefits were appropriate because they would result in inclusion of only the service cost for services rendered by the executive during the relevant year, which is limited to pension costs for benefits earned during that year (in contrast to changes in actuarial present value resulting from changes in interest rates, executive age, and other actuarial inputs and assumptions that are reflected in the Summary Compensation Table amounts).

If more than one person served as PEO during the relevant year, the amounts shown in the column must be aggregated for all persons who served as PEO during that year. In some circumstances, such as a promotion during the year, the "compensation actually paid" will include compensation paid during the portion of the year that the PEO was not a named executive officer. This is consistent with the treatment of named executive officer compensation in the Summary Compensation Table, but the aggregation of PEO compensation in the context of the Pay Versus Performance table may lead to amounts that overstate PEO-focused compensation and distort the relationship of pay to performance. A footnote explanation as accompanying narrative disclosure likely would be required; hopefully, the SEC will address this issue in connection with the final rulemaking.

## **Average Summary Compensation Table Total for non-PEO Named Executive Officers**

A company also would be required to include the average of the executive compensation paid to all executives other than the PEO, by reference to the Total column of the Summary Compensation Table.

The SEC noted that, in determining to require average compensation for the non-PEO named executive officers, there can be significant variability in the persons who constitute the non-PEO named executive officers, as well as changes in the number of named executive officers from year to year. The SEC stated that "requiring disclosure of average compensation would help make the information about these [named executive officers] more comparable from year to year in spite of the variability in the composition and number of [named executive officers] who are not the PEO over the years for which disclosure is

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required.” This may be a dubious assertion, especially with regard to those years in which one or two additional executives are included in the Summary Compensation Table because the executives' compensation was great enough to otherwise have required their inclusion as named executive officers had they remained with the company until the end of the fiscal year. Under these circumstances, particularly with respect to higher paid executives such as chief financial or chief operating officers, their inclusion might distort the average amounts, resulting in defects in comparability.

## **Average Compensation Actually Paid to non-PEO Named Executive Officers**

The adjustments for determining “compensation actually paid” are the same as discussed above with respect to the PEO. Considerations relating to potential variations in average compensation discussed above also are applicable here.

## **Total Shareholder Return**

The SEC determined to use TSR as the measure of financial performance for purposes of the pay versus performance disclosure. Although the SEC recognized that “financial performance of the registrant is a broad term and can mean different things to different registrants,” it apparently relied on the requirement in Section 14(i) that information showing the relationship between executive compensation actually paid and the financial performance of a company should take into account “any change in the value of the shares of stock and dividends of the [company] and any distributions.”

For purposes of the table, TSR would be calculated for each year covered by the table, in the same manner, and over the same measurement period, as the stock performance graph required by Item 201(e) of Regulation S-K.

## **Peer Group Total Shareholder Return**

In addition to including the company's TSR, the table also would reflect “Peer Group” TSR. For this purpose, Peer Group TSR would be calculated using the same methodology as is used to calculate the company's TSR. The peer group would be the same published industry index, line of business index, or peer group used by the company in its stock performance graph; alternatively, the company could use the companies included in the peer group referenced in the company's compensation discussion and analysis.

If the company uses a peer group rather than a published industry or line of business index, the companies in the peer group must be identified, and the returns of each component company must be weighted based on market capitalization at the beginning of each period for which a return is computed.

## **ADDITIONAL DISCLOSURE REQUIREMENTS**

In addition to the tabular disclosure requirements, the proposed rule would require companies to provide, using the information in the Pay Versus Performance table, a clear description of the relationship between the compensation actually paid by the company to the PEO and the cumulative TSR of the company for each of the last five completed fiscal years (subject to the transition period accommodation described above). Similar disclosure would be required with respect to the relationship between average compensation actually paid to the named executive officers other than the PEO and the company's cumulative TSR. In addition, the description must also include a comparison of the cumulative TSR of the company and of the peer group used in the Pay Versus Performance table over the same period. The SEC stated that the disclosure could be provided as a narrative, graphically, or through a combination of the two.

The emphasis on TSR may not reflect company policies or procedures regarding executive compensation, which might be focused on more direct financial measures of performance, such as revenues, operating profit, or net income, and might encourage an emphasis on short-term performance that could be

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deemed undesirable. The SEC, in addressing the suggestion of some commenters that the company should be permitted to choose the performance measure best suited to the company, noted that companies could provide supplemental measures of financial performance, such as “realized pay” or “realizable pay,” if they believe it provides useful information about the relationship between compensation and company performance. Such additional disclosure must be “clearly identified, not misleading and not presented with greater prominence than the required disclosure.”

## **XBRL FORMATTING**

The proposed rules would require that, in addition to its inclusion in the proxy or information statement, the required disclosure must be electronically formatted using XBRL and filed as an exhibit to the definitive Schedule 14A. Each amount included in the Pay Versus Performance table would be separately tagged; footnote disclosure regarding amounts used to adjust Summary Compensation Table amounts to “compensation actually paid” amounts, and disclosure regarding the relationship of PEO and average non-PEO named executive officer compensation to the company's TSR, and the comparison of the company's TSR and peer group TSR, would be block tagged.

This would mark the first time that XBRL tagging is used in the context of executive compensation disclosures. The SEC supported this proposed development by stating that “the data to be tagged would lower the cost to investors of collecting this information, would permit data to be analyzed more quickly by investors and other end-users . . . and would facilitate comparisons among companies.” While this may be true, XBRL tagging will add time and expense to the proxy statement preparation process. It is not clear if the actual usage of XBRL data justifies this time and expense. In this regard, empirical data indicating how many investors and other end users actually use this information may be instructive.

## **NO INCORPORATION BY REFERENCE OF PAY VERSUS PERFORMANCE INFORMATION IN SECURITIES ACT AND EXCHANGE ACT FILINGS**

Because the provisions of Section 14(i) call for Pay Versus Performance disclosure only in solicitation materials for an annual meeting of shareholders,<sup>3</sup> the SEC concluded that the disclosure was intended to be provided only in conjunction with a shareholder vote. Therefore, the proposed rule provides that pay versus performance information would not be incorporated by reference in any Securities Act or Exchange Act filing, except to the extent that the company specifically incorporates the information by reference.

## **ACCOMMODATIONS FOR SMALLER REPORTING COMPANIES**

The proposed rules provide the following accommodations for smaller reporting companies:

- Information is required for the last three completed fiscal years rather than five years.
- The initial filing would be required to cover only two completed fiscal years.
- Adjustments and footnote disclosure would not be required with respect to pension benefits (a logical accommodation, in light of the fact that the Summary Compensation Table for smaller reporting companies does not require information on actuarial changes in pension value).

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3. Despite the reference to an annual meeting of shareholders in Section 14(i), the proposed rules would call for the disclosures to be included in any proxy or information statement in which executive compensation disclosures under Item 402 of Regulation S-K are required to be included.

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- Peer group TSR is not required to be disclosed in the Pay Versus Performance table or accompanying disclosure.
- The XBRL requirements would not apply until the third filing in which the smaller reporting company provides pay versus performance disclosure.

## ENTITIES PROPOSED TO BE EXCLUDED

The following entities would not be subject to the proposed rules:

- Emerging growth companies (their exclusion is mandated by the Jumpstart Our Business - Business Startups Act (JOBS));
- Foreign private issuers; and
- Investment companies registered under the Investment Company Act of 1940.

## COMMENT PERIOD

The comment period ends 60 days after publication of the proposed rules in the *Federal Register*.

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## **About Morgan, Lewis & Bockius LLP**

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