

# Client Update

## Apples to Oranges: SEC Proposes Rules to Show “Relationship” Between CEO Pay and Company Performance

### NEW YORK

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As part of a broader effort designed to address shareholder rights and executive compensation, the U.S. Securities and Exchange Commission (“SEC”) has finally proposed the long-awaited “pay-versus-performance” rule required by the Dodd-Frank Act, which is intended to shed light on the relationship between executive compensation and the financial performance of registrants.

The rule, if adopted, would require registrants to provide a clear description of the relationship between “executive compensation actually paid” and the registrant’s “financial performance,” measured by the registrant’s cumulative total shareholder return (“TSR”, which is described below), and the relationship between the registrant’s TSR and the TSR of a peer group. The disclosure would consist of a required table displaying the total compensation as reflected in the Summary Compensation Table and the total compensation “actually paid” to the chief executive officer(s) and the average of each such measure of compensation for the registrant’s other named executive officers (“NEOs”), as well as TSR for the issuer and, for registrants other than smaller reporting companies, a peer group, in each case for the five prior fiscal years. The table is to be supplemented by various footnotes and a description of the *relationship* between executive compensation and the registrant’s financial performance, presented either as a narrative or graphically, or as a combination of the two.

Emerging growth companies, foreign private issuers and registered investment companies would not be subject to the new rules. As discussed below, “smaller reporting companies” would be subject to the rule, but with somewhat reduced disclosure obligations.

### DETERMINATION OF "EXECUTIVE COMPENSATION ACTUALLY PAID"

Compensation "*actually paid*," which is distinct from total compensation as reported on the Summary Compensation Table, is calculated by adjusting the amounts reflected there for pension benefits and equity awards.

- *Equity Awards.* For purposes of calculating compensation actually paid, equity awards, such as restricted stock, SARs and options, would be considered actually paid on the date of vesting and valued at the fair value of the equity on the vesting date using the same principles used to determine grant date fair value under FASB Topic 718. In the case of options and SARs, this means that vesting date option value, rather than spread value, would be included in the reported figure. The value of unvested equity and changes in the value of equity securities after vesting would not generally be reflected in "actual payment." However, if the registrant adjusts or amends the exercise price of previously vested options or SARs during the fiscal year, the proposed rule would require the registrant to include any additional incremental fair value, computed as the excess fair value of the modified award over the fair value of the original award upon vesting, in the actually paid amount.
- *Changes in Actuarial Pension Value.* For purposes of calculating compensation actually paid with respect to pensions, only the actuarially determined additional service cost for the fiscal year would be included. In contrast to the Summary Compensation Table, changes in the actuarial present value of an executive's benefit under defined benefit pension plans arising from changes in interest rates, the executive's age and other actuarial inputs and assumptions regarding benefits accrued in previous years would be excluded. Above-market or preferential earnings on deferred compensation would continue to be included. Smaller reporting companies would not be required to disclose amounts related to pensions in total actual compensation.

Finally, the SEC recognized that certain registrants already disclose "realized pay" or "realizable pay," both of which present different measures of alignment between an NEO's pay and performance. Registrants may continue to do so provided that the supplemental disclosure is not misleading and not presented more prominently than the disclosure required by the proposed rule.

### MEASURE OF PERFORMANCE: TOTAL SHAREHOLDER RETURN

The Dodd-Frank Act requires disclosure of information that shows the relationship between "executive compensation actually paid" and "financial performance . . . taking into account any change in the value of the shares of stock and dividends . . . and any distributions." Although there is considerable

debate over whether TSR is an accurate measure of “financial performance,” the SEC has proposed the use of TSR as a yardstick against which to measure financial performance for purposes of administrative convenience, cost reduction, objectivity and uniformity. TSR is calculated using the same methodology as is used for the stock performance graph required to be included in the registrant’s annual report. Recognizing that TSR may not be a perfect proxy for financial performance, the SEC is inviting comments about what other measures of financial performance might provide meaningful information to shareholders while satisfying the statutory requirement that any measure of financial performance take into account the change in stock price, dividends and distributions paid in stock.

In response to comments in the pre-proposal stages indicating that stand-alone company performance may be insufficient for evaluating pay versus performance, the SEC is also proposing to require registrants, other than smaller reporting companies, to disclose peer group TSR using either the peer group included in the stock performance graph or the Compensation Discussion and Analysis peer group used for compensation benchmarking purposes. Thus, a registrant may have some discretion over what peer group to use for the disclosure.

### EXECUTIVES COVERED

The SEC has proposed that the rule cover only a registrant’s NEOs. This group typically includes the CEO, CFO and the registrant’s three most highly compensated officers other than the CEO and CFO, although additional or former officers may be required to be included in certain circumstances. For smaller reporting companies, the NEOs are typically the CEO and the registrant’s two most highly compensated officers other than the CEO.

Compensation figures for the registrant’s CEO would need to be disclosed on an individual basis, while compensation figures for the registrant’s other NEOs would be presented as an arithmetic mean. This approach is meant to reduce the variability in reported compensation over a range of years for non-CEO executives due to factors such as variations in performance-based bonuses or executive turnover, while providing a “clear and meaningful disclosure to interested shareholders.” Where more than one person acts as CEO in a given year, the compensation for all CEOs would be aggregated.

### FORMAT AND LOCATION OF PROPOSED DISCLOSURE

Disclosure under the proposed rule would be required only in a registrant’s proxy or information statement. As currently proposed, it would not be required in a

Form 10-K or registration statement, and would not be automatically incorporated into other SEC filings. The disclosure table must be provided in interactive data format using XBRL for easier analysis. Smaller reporting companies would not be subject to the XBRL requirement until the third year in which the disclosure is required.

In an effort to provide registrants with flexibility, the SEC did not propose specific requirements regarding where to locate the new disclosure within the proxy or information statement. Nevertheless, the SEC expects that registrants will generally make the disclosure with the other required executive compensation disclosures. Registrants may, however, want to segregate this pay-versus-performance information so that it is not inadvertently incorporated into other filings.

#### TIME PERIOD COVERED AND TRANSITIONAL RELIEF

For registrants other than smaller reporting companies, the SEC is proposing to require registrants to provide pay-versus-performance disclosure for the **five** most recently completed fiscal years. In contrast, smaller reporting companies would be required to provide the disclosure for the **three** most recently completed fiscal years. The SEC has proposed a transition period during which the disclosure requirements will be phased in for all companies – with the first year including three years, rather than five years.

Finally, the SEC has proposed that disclosure under the proposed rule be required only for years that a registrant is required to report compensation. Accordingly, disclosure under the proposed rule would be subject to a phase-in period that is consistent with the phase-in period for new reporting companies in their Summary Compensation Table disclosure.

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The SEC has asked for comments on all aspects of the proposal. The comment period for the proposed rule is 60 days beginning on the date on which it is published in the Federal Register. We expect a final rule to be in effect by the 2016 proxy season.

Please do not hesitate to contact us with any questions.