SEC PROPOSES NEW PAY-VERSUS-PERFORMANCE DISCLOSURE RULES

On April 29, 2015, the Securities and Exchange Commission (the "SEC") proposed new rules that would require most publicly traded companies to describe in detail the relationship between their financial performance and their executive compensation actually paid, taking into account changes in the value of the stock and dividends of the company and any distributions.

Specifically, proposed Item 402(v) of Regulation S-K would require affected securities issuers to publish a new table in certain proxy and information statements for disclosure of:

- Executive compensation actually paid to the principal executive officer (the "PEO"), as well as the average compensation paid to other named executive officers (the "NEOs") as defined in Item 402 of Regulation S-K, with specified adjustments for pension benefits and equity awards;
- Total shareholder return ("TSR") as defined in Item 201(e) of Regulation S-K, which is a function of annual dividends and share price appreciation; and
- TSR for similar securities issuers in a peer group that each disclosing registrant must identify.

Using the table, each registrant would also need to describe the relationship between TSR and executive compensation, as well as the relationship between its own TSR and that of its peer group, using narrative text and/or graphic measures.

All securities issuers would have to include such disclosures in any proxy or information statements in which executive compensation disclosure is mandated, including proxies for director elections or annual meetings, Form 10-K annual reports and all registration statements.

"These proposed rules would better inform shareholders and give them a new metric for assessing a company's executive compensation relative to its financial performance," said SEC Chair Mary Jo White, adding that the resulting disclosures could assist shareholders "when voting in an election of directors and in connection with a shareholder's advisory vote on executive compensation." While much of this information is already required to be disclosed in other contexts, the SEC stated that the new rules would make it easier for stockholders to analyze the information, given that the information would be presented more directly and in a standardized format.

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The SEC issued the proposed rules for comment in order to comply with Section 14(i) of the Securities Exchange Act of 1934 (the "Exchange Act") as added by Section 953(a) of the Dodd-Frank Wall Street Reform and Consumer Protection Act (the "Dodd-Frank Act") which we previously summarized in our July 2010 Securities Law Update entitled, "Summary of Corporate Governance Changes in the Dodd-Frank U.S. Financial Regulatory Reform Act," available at: http://www.burnslev.com/apps/uploads/publications/Securities_Update_Dodd-Frank_July2010.pdf.

This update provides an overview of the proposed changes and some of the supporting rationale for those changes cited by the SEC. For a more detailed examination of the proposed "pay versus performance" regulations, see the 137-page SEC Release no. 34-74835 at http://www.sec.gov/rules/proposed/2015/34-74835.pdf.

The SEC has invited public comment on its proposals, requiring that all comments must be received on or before July 6, 2015. It is therefore possible that final rules could be adopted by the SEC in time for the 2016 proxy season.

APPLICATION AND OPERATION OF PROPOSED ITEM 402(v)

As proposed, the rules would apply to all reporting companies, except for foreign private issuers (which ordinarily are not subject to the proxy rules), registered investment companies and emerging growth companies (an emerging growth company, as defined in the JOBS Act of 2012, is a company that had total annual gross revenues of less than $1 billion during its most recently completed fiscal year, other than an issuer that completed an IPO on or before December 8, 2011).

The SEC also proposed that the disclosures called for under new item 402(v) of Regulation S-K should be included in any proxy or information statement for which Item 402 disclosures are required. Currently, this would necessitate disclosure in any proxy or information statements relating to: elections of directors; bonus, profit sharing or other arrangements in which directors, nominees or executive officers will participate; pension or retirement plans in which they will participate; or the granting of options, warrants or rights to purchase securities on a pro rata basis.

These disclosures would be required in connection with either an annual or a special meeting where the foregoing agenda items are considered. They would also be required, pursuant to Item 402, in a registrant's Form 10-K annual report and in certain registration statements for the offering of securities.

DISCLOSURE FORMAT

Section 14(i) of the Exchange Act does not specify the format or location for required disclosures within a proxy or information statement, and the SEC specifically declined to mandate the location for the proposed disclosures.

The SEC noted that the proposed disclosures are generally related to the currently required Compensation Discussion and Analysis ("CD&A") in proxy and information statements, but added that "including this disclosure as part of CD&A might suggest that the registrant considered the pay-versus-performance relationship, as disclosed, in its compensation decisions, which may not be the case." Thus, inclusion of the required disclosures in CD&A could constitute an implied statement regarding pay for performance in the eyes of the SEC.

Addressing the format, the SEC explained in its release that proposed Item 402(v) would require a table containing: "the values of the prescribed measures of executive compensation actually paid; TSR for the registrant; and TSR for the [registrant's] selected peer group."

The following information would be provided under each of seven specified columns:

- The year for which each required disclosure is being made;
- The total PEO compensation reported in the currently required Summary Compensation Table;
- The compensation "actually paid" to the PEO;
- The average Summary Compensation Table total for NEOs other than the PEO;
- The average compensation "actually paid" to NEOs other than the PEO;
- The registrant's TSR; and
- The TSR of the registrant's peer group.

Because the Dodd-Frank Act requires disclosure of the relationship between executive compensation and registrant

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performance, the SEC also proposed that companies should use the values presented in the table to specifically describe, for each year covered: the relationship between executive compensation actually paid and the company's TSR, as well as the relationship between company TSR and peer group TSR. This disclosure would be permitted in either narrative or graphic format, or some combination of both.

All disclosure data, including any footnote disclosures, would also have to be coded in eXtensible Business Reporting Language ("XBRL") interactive data format and the interactive data would have to be provided as an exhibit to the proxy or information statement filed with the SEC. XBRL formatting allows the data to be easily compared over time and across companies.

COVERED EXECUTIVES

Noting that Exchange Act Section 14(i) does not specify the executives for whom compensation disclosures must be made, the SEC made its case for extending the disclosure mandates to all NEOs as defined in Item 402(a)(3) of Regulation S-K.

This would mean that executive compensation disclosure should be provided for:

- All individuals serving as the registrant's PEO during the period in question;
- All individuals serving as the registrant's principal financial officer ("PFO") or the equivalent thereof during the period in question;
- The registrant's three most highly compensated executive officers other than the PEO or PFO; and
- Up to two additional individuals for whom Item 402 disclosure would have been provided but for the fact that the individuals were not serving as an executive officer during the relevant period.

The SEC provided for separate and more specific disclosure for the PEO compensation because of the interest level in that element of executive compensation among investors and commenters, noting that "we believe requiring disclosure of the average compensation [of other NEOs] would help make the information about these NEOs more comparable from year to year in spite of the variability in the composition and number of NEOs."

DETERMINATION OF EXECUTIVE COMPENSATION "ACTUALLY PAID"

Exchange Act Section 14(i) requires disclosure of executive compensation "actually paid," so the SEC proposed that registrants must make disclosures of total compensation, as already reported in the Summary Compensation Table pursuant to Item 402(c) of Regulation S-K, but with modifications for pension benefit and equity award compensation, which can be calculated in different ways and therefore can be difficult to compare.

"We believe that Congress intended executive compensation 'actually paid' to be an amount distinct from the total compensation reported under Item 402 because it used a term not otherwise referenced in Item 402," the SEC explained.

In order to give registrants a uniform measuring stick for compensation "actually paid," the SEC delineated specific rules for measurement of actuarial pension value, earnings on non-qualified deferred compensation and equity awards.

1. Actuarial Pension Values

The SEC proposed that registrants should include in their pension compensation disclosures only "the service cost for services rendered by the executive during the applicable year" in determining total compensation actually paid because the service cost "is limited to pension costs for those benefits earned during that year."

Service cost is defined by the Financial Accounting Standards Board ("FASB") as the "actuarial present value of benefits attributed by the pension plan's benefit formula to services rendered by the employee during the [reporting] period."

This would exclude from calculation of pension compensation any changes in pension value solely due to interest rate or market fluctuations, the executive's age and inputs or assumptions that are a function of benefits accrued in previous years.

Noting that some registrants use defined benefit plans and others use defined contribution plans for executive compensation, the SEC asserted that its proposed methodology would result in "a more meaningful comparison across registrants of the amounts 'actually paid' under both types of plans."

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2. Earnings on Non-qualified Deferred Compensation

The SEC specified that under the proposed disclosure rules, the executive compensation calculation would also include "above-market or preferential earnings on deferred compensation that is not tax-qualified because these amounts represent compensation accrued during the relevant year."

Under the proposed disclosure rules, it would not be necessary for the PEO or NEO to withdraw or take a distribution from a deferred compensation plan in order for the compensation to be "actually paid."

3. Equity Awards

The SEC proposed that equity awards be considered as "actually paid" on the date of vesting. As proposed, the fair value on the date of vesting would be relevant to calculation of compensation actually paid, rather than the fair value on the date of grant as specified in the current Summary Compensation Table.

Because an executive does not have an unconditional right to an equity award until vesting, the date of vesting should be used in valuation of option or equity awards, the SEC asserted, adding that this approach "will result in a compensation measure that includes, upon the vesting date, the grant-date value of equity awards plus or minus any changes in the value of equity awards between the grant and vesting date."

"We believe shareholders may be interested in vesting date valuation assumptions to the extent they believe that changes in the value of equity grants after the grant date are a primary channel through which pay is linked to performance," the SEC concluded.

THE MEASURE OF A REGISTRANT'S FINANCIAL PERFORMANCE

Under the proposed rules, registrants would have to use TSR as the measure of their financial performance, as defined in Item 201(e) of Regulation S-K.

That disclosure item provides that cumulative TSR is calculated by "dividing (i) the sum of (A) the cumulative amount of dividends for the measurement period, assuming dividend reinvestment, and (B) the difference between the registrant's share price at the end and the beginning of the measurement period by (ii) the share price at the beginning of the measurement period."

Because company performance alone may not be a sufficient basis to support pay versus performance assessments, the SEC also proposed a requirement for performance disclosures relative to a satisfactory peer group. Under this approach, registrants would be allowed to use either the same peer group used for purposes of Item 201(e) disclosure or a peer group used in the CD&A for purposes of disclosing compensation benchmarking practices.

TIME PERIODS TO BE COVERED BY DISCLOSURES

Section 14(i) of the Exchange Act does not specify the time period for which pay-versus-performance disclosure is required, but the SEC noted that commenters have expressed support for varying time periods.

"We believe that requiring disclosure of the relationship between executive compensation and registrant performance over the five most recently completed fiscal years is appropriate because it provides a meaningful period over which a relationship between annual measures of pay and performance over time can be evaluated," the SEC said.

Smaller reporting companies would be required to provide the required disclosures only for the three most recently completed fiscal years because of the greater proportional burden placed on them in order to comply.

The SEC also provided a transition period for compliance for all registrants. Existing smaller reporting companies would be required to provide required disclosures for only the last two fiscal years in their first applicable filing. In subsequent years, such companies would be required to provide disclosure for the last three fiscal years.

All other existing registrants would be required to provide Item 402(v) disclosures for three fiscal years in their first applicable filing, and they would have to provide disclosure for an additional year in each of their two subsequent proxy filings for which disclosure is required.

Furthermore, the SEC proposed that a registrant only have to provide pay-versus-performance disclosure for years when it was a reporting company under Section 13(a) or Section 15(d) of the Exchange Act.

FOR SMALLER REPORTING COMPANIES

The SEC acknowledged that it is harder for smaller reporting companies to comply with these rules. Such companies, as

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defined in Item 10(f)(1) of Regulation S-K, have a public float – a total equity amount held by non-management and non-control group persons – of less than $75 million, or annual revenues of less than $50 million if there is no public float at all.

In an effort to minimize the disproportionate burdens of compliance on smaller reporting companies, the SEC proposed the following special considerations for such registrants:

- They would not be required to calculate and disclose amounts related to pensions for purposes of executive compensation disclosure;
- They would not be required to present a peer group TSR;
- They would be required to present Item 402(v) disclosures only for the three most recently completed fiscal years, instead of the five most recently completed years;
- They would be permitted in the first required filing after the effective date of the rules to include only two years of relevant disclosure; and
- They would have a phase-in period for XBRL format compliance, allowing them to do XBRL tagging only as of their third pay-versus-performance filing.

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