Client Alert

A Closer Look at the SEC's Proposed Pay Versus Performance Disclosure Rules

EXEQUITY
Independent Board and Management Advisors

On April 29, 2015, the U.S. Securities and Exchange Commission (SEC) approved the issuance of proposed rules to implement Section 953(a) of the Dodd-Frank Act[1] regarding the disclosure of pay versus performance by a 3-2 margin along party lines. Exequity issued a Client Alert[2] that day alerting our clients and friends to the general nature of the proposed rules. This Client Alert takes a closer look at the proposed rules as set out in the proposing release.[3]

Introduction

The SEC has proposed adding these new pay versus performance disclosure requirements to Regulation S-K as new Item 402(v). The disclosures would be required in any proxy statement or information statement that is required to include executive compensation disclosures under Item 402 of Regulation S-K. Consequently, the proposed disclosures will be subject to the say-on-pay advisory vote under Exchange Act Rule 14a-21(a).

New Tabular Disclosure

The proposed rules will require a new tabular disclosure. The SEC does not propose a specific location for the new table and related disclosure to appear in the proxy statement or information statement. Thus, it does not have to be included in the Compensation Discussion and Analysis (CD&A) section, which would imply that the Compensation Committee considered the information in setting pay. We expect very few companies will include the new disclosure in the CD&A.

The new table will set forth:

- The total executive compensation reported in the Summary Compensation Table (SCT) for the Principal Executive Officer (PEO/CEO) and an average of the reported amounts for the other Named Executive Officers (NEOs);
- "Compensation actually paid" (*see discussion starting on page 3 on how this is to be calculated)* to the CEO and an average of the compensation actually paid to the NEOs other than the CEO(s) for the year;

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[1] Dodd-Frank Wall Street Reform and Consumer Protection Act, available at: https://www.sec.gov/about/laws/wallstreetreform-cpa.pdf.
[2] Exequity's Client Alert, *SEC Proposes Pay Versus Performance Disclosure Rules* (April 29, 2015), available at: https://www.exqty.com/Media/Publications/SEC%20Pay%20vs%20Perf%20Rules_20150429.pdf.
[3] Pay Versus Performance, SEC Release No. 34-74835; File No. S7-07-15, available at: http://www.sec.gov/rules/proposed/2015/34-74835.pdf (SEC Release).

- The company's annual total shareholder return (TSR); and
- The annual TSR of the peer group companies identified in the stock performance graph or the CD&A on a market capitalization weighted basis.

The proposed table looks like this:

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)
Year 1						
Year 2						
Year 3						
Year 4						
Year 5						

After the phase-in period, the disclosure will cover the last 5 fiscal years, but smaller reporting companies will only be required to show the last 3 fiscal years.

SEC Questions: The SEC Release asks, among other questions, (1) in which filings the proposed new disclosure should be included, (2) whether the format should be further prescribed to promote comparability across companies, (3) whether merely disclosing the values of executive compensation covered and TSR without additional information about the relationship between these items is sufficient, and (4) whether the information regarding TSR should be deemed filed as proposed.

Exequity Comments*: Overall, the tabular disclosure implies that there is a relationship between the information disclosed in each of the columns and that investors can compare the compensation in the SCT to the "compensation actually paid" to TSR and to the peer group TSR and draw some conclusions about the relationship of pay to performance. This is not the case. The SCT compensation is not comparable to the "compensation actually paid" because the equity awards vesting are not the same awards disclosed in the SCT. The "compensation actually paid" cannot be compared to TSR for reasons discussed more fully below, and neither SCT pay nor "compensation actually paid" can be compared to peer group TSR because there is no context for peer group compensation. The SEC already requires the comparison of TSR to peer group TSR and thus, it is duplicative to include that comparison in the pay versus performance disclosure.*

In addition, this prescriptive requirement represents a departure from the principles-based disclosure focus of the CD&A. The compensation of the peer group is not required to be disclosed. As a result, companies will be able to produce this disclosure before they file their proxy/information statements. Additionally, the TSR that is disclosed will be expressed as a dollar amount ($) following the requirements of Item 201(e) of Regulation S-K, not as a percentage as many companies and proxy advisory firms currently use for disclosure of TSR. We believe the requirement to disclose 5 years of data is too long, particularly when the SCT is limited to 3 years of data.

Compensation Actually Paid

Compensation actually paid will be determined using compensation that companies report in the SCT with adjustments relating to pension amounts and equity awards. Companies will be required to disclose the nature of the actual adjustments in a footnote.

Consequently, compensation actually paid equals:

- **Total compensation** for the fiscal year, as reported in the **SCT**,
- *Less* (-) the **aggregate change in the actuarial present value** of the NEO's accumulated benefit under all defined benefit and actuarial pension plans reported in the SCT,
- *Plus* (+) the **service cost** under all defined benefit and actuarial pension plans reported in the SCT calculated as the **actuarial present value** of each NEO's benefit under all such plans **attributable to services rendered during the covered fiscal year**, consistent with "service cost" as defined in FASB ASC Topic 715 (this is intended to exclude the portion of the total change in actuarial pension value that results solely from changes in interest rates, executive's age, and other actuarial inputs and assumptions regarding benefits accrued in previous years),
- *Less* (-) the **amounts** reported in the **Stock Awards and Option Awards columns** in the SCT,
- *Plus* (+) the **"fair value" on the vesting date** of all stock awards and option awards, for which all applicable vesting conditions were satisfied during the covered fiscal year.

The following table compares the existing SCT pay disclosures with those proposed for purposes of disclosing pay-for-performance relationships:

Pay Components	Typical Forms of Pay	SCT Disclosure	Proposed Pay-for-Performance Disclosure
Salary	Base salary	Base salary earned during year	Same as SCT (base salary earned during year)
Bonus	Short-term payments not tied to performance criteria or determined pursuant to one or more preestablished performance measures (e.g., discretionary awards)	Amounts earned during the year	Same as SCT (amounts earned during the year)
Stock Awards	Equity-based awards which do not have option-like features and which fall within the scope of FASB ASC Topic 718 (e.g., restricted stock, restricted stock units, and performance shares)	Grant-date fair value of awards **granted** during the year, as determined under FASB ASC Topic 718	Fair value of awards **vested** during the year
Option Awards	Nonqualified stock options and incentive stock options	Grant-date fair value of options **granted** during the year, as determined under FASB ASC Topic 718	Fair value of options **vested** during the year; likely requires new valuation of all options at time of vesting

Pay Components	Typical Forms of Pay	SCT Disclosure	Proposed Pay-for-Performance Disclosure
Non-Equity Incentive Plan Compensation	Annual and long-term incentives tied to achievement of performance conditions and which are not equity incentives (e.g., annual incentives and performance units)	Values earned during the year, based on degree of achievement of performance conditions	Values earned during the year, based on degree of achievement of performance conditions
Change in Pension Value and Nonqualified Deferred Compensation Earnings	Pensions	**Total change** in actuarial present value of defined benefit and actuarial pension plans	Service cost of defined benefit and actuarial pension plans, measured as actuarial present value of NEOs' benefits attributable to services **during the year**
	Nonqualified deferral programs	Above-market interest on deferrals during the year	Same as SCT (above-market interest on deferrals during the year)
All Other Compensation	Variety of compensation vehicles (e.g., contributions to defined contribution plans, severance, perquisites)	Generally, amounts paid or accrued, although perquisites and other personal benefits are valued based on the aggregate incremental cost	Same as SCT

The proposed disclosure rules would require a company to disclose in a footnote each of the amounts added or subtracted, using averages for the non-PEO disclosures. With respect to the "fair values" of stock awards that are added, companies must disclose any assumptions (expected life, volatility, interest rate, dividend rate, stock price, etc.) made in the valuation that differ materially from those disclosed in the SCT. If a company reprices or materially modifies a stock or option award, the proposed rules require that executive compensation actually paid include the incremental fair value paid at each vesting date.

SEC Questions: The SEC Release asks (1) whether the definition of executive compensation actually paid is appropriate, (2) whether it will enhance comparability across companies, (3) whether the required disclosure should require that companies address the disconnect between years and pay in supplemental disclosure, (4) whether the amounts to be used make sense or if there are better amounts or methods to calculate them, (5) whether stock awards should be valued using fair value on the vesting date, (6) whether the definition of executive compensation actually paid leaves anything out that should be included, and (7) whether treating stock awards that require exercise as actually paid upon vesting is appropriate.

Exequity Comments*: The value for equity awards included in compensation actually paid generally will not match to the awards granted and disclosed in the SCT for each respective year in the new table because the equity awards in compensation actually paid generally will have been granted in prior fiscal years.*

We believe determining a fair value for equity awards (stock options and stock appreciation rights in particular) as of the date of vesting will require the use of assumptions that differ from the grant date of such awards, which will cause most companies to provide the additional disclosure about the assumptions used (e.g., expected life, volatility, interest rate, dividend rate, stock price). Fair value valuation methodologies often "break down" when the stock price and exercise price are sufficiently divergent, i.e., the methodologies tend to undervalue or overvalue deeply in-the-money or out-of-the-

money stock options. This will almost certainly cause the "compensation actually paid" to fail to tie to an actual value that the NEOs will receive. Finally, most companies establish vesting dates in terms of the anniversary of the date of grant of equity awards. Most annual equity grants are made during the first half of the year after the results for the prior fiscal year are known and considered by the Board/Compensation Committee when approving equity grants. Consequently, most vesting dates do not correspond to the beginning or end of a company's fiscal year. Thus, fair values on the date of vesting may be substantially different than at year-end when TSR is measured. Early vesting due to retirement eligibility further complicates this issue.

The SEC disregarded the concepts of "realizable pay" and "realized pay" (already in use by most companies that include supplemental disclosures regarding the relationship between pay and performance as well as by proxy advisory firms like ISS and Glass Lewis) because there has not been broad agreement upon any particular formula. Yet, the SEC's definition of "compensation actually paid" is rarely (if ever) used in practice by companies. Realizable pay is best correlated to SCT total compensation because it tracks the same grants as disclosed in the SCT. Realizable pay is best correlated to TSR because it corresponds to the same time period. Finally, realizable pay is best measured over a cumulative time period. The focus of the proposed disclosure rules looks at each year within the period separately and does nothing to address the potential pay that an executive holds and the impact of changes in stock price over the period on such potential pay. Investors and proxy advisory firms for some time have suggested that Boards should consider the outstanding equity awards of an executive when deciding upon new equity grants. Investors and proxy advisory firms place weight on potential pay, and companies have responded by providing supplemental disclosure that helps to address this. These proposed disclosure rules do nothing to address the relationship between potential/realizable pay and performance, which investors have already signaled is important to them and is something that Boards should be considering.

TSR

Under the new disclosures, TSR must be calculated in the same manner as for the stock performance graph required under Item 201(e) of Regulation S-K (which is required to be included in the Annual Report to Shareholders). Consequently, TSR must be disclosed as a **dollar amount** in the new table (as opposed to the more conventional portrayal of TSR in percentage terms), with the dollar amount reflecting the then current value at year-end assuming $100 invested at the beginning of the period.

For purposes of peer group TSR disclosed in the new table, companies must use (1) the same index or (2) companies used for purposes of the stock performance graph disclosure, or (3) the companies used for benchmarking purposes, as identified in the CD&A. If the peer group is not a published industry or line-of-business index, the identity of the companies in the group must be disclosed. Finally, the TSR of all peer group companies must be **weighted** according to each company's stock **market capitalization** at the beginning of each period for which TSR is calculated.

Exequity Comments*: There is no logical relationship between the SCT's total compensation, "compensation actually paid," and TSR. Compensation actually paid is based on when equity awards vest. However, vesting of the awards generally will not align with the period used to calculate TSR. The TSR measurement period is annual, but awards typically vest on a multi-year basis. Typical vesting schedules for stock options and restricted stock vest over a 3- to 5-year period, which does not align with 1-year TSR. Another example relates to long-term performance awards. Many companies use 3-year performance periods for long-term performance-based equity awards, which will not align with 1-year*

TSR; a company could have excellent TSR in the first 2 years with a decline in the 3rd year of a 3-year performance period and the proposed disclosure will indicate nonalignment, i.e., payout for the long-term incentive award in a year when TSR is down.

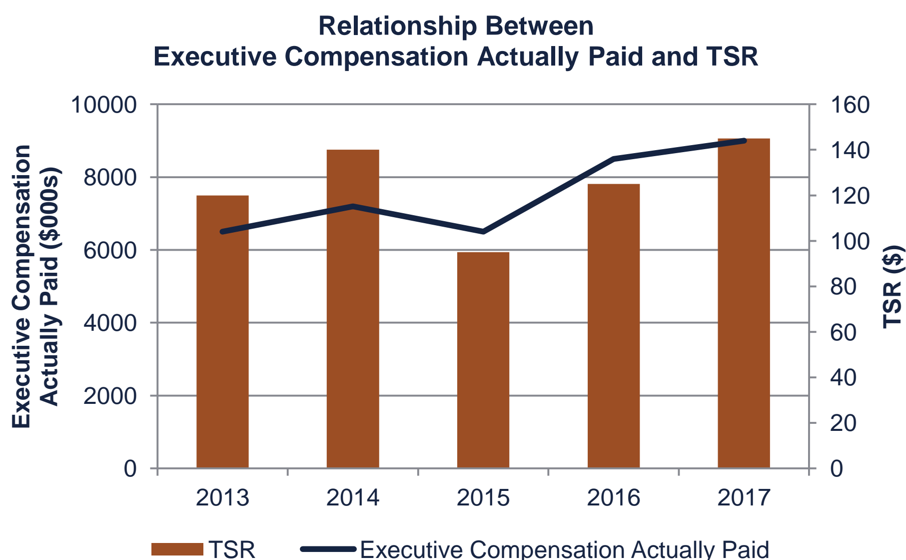
Our understanding of the proposed rules is that relative TSR must be calculated using one of the peer groups disclosed in the CD&A or the performance graph for the year covered by the proxy statement or information statement that will include the new table. Using one of the peer groups in the CD&A or the performance graph will exacerbate comparability because peer groups often change from year to year.

Peer group relative TSR disclosure should not be required because it places too much emphasis on relative TSR performance which may or may not be relevant to the assessment of executive compensation depending on the comparability of the peer group. Compensation peer group selection is based on factors other than TSR performance (e.g., sources of talent, availability of compensation data, etc.) and is not necessarily the same group that would be used to compare performance; likewise, the published line-of-business or industry index used in the stock performance graph may not be appropriate because it is not used for compensation purposes.

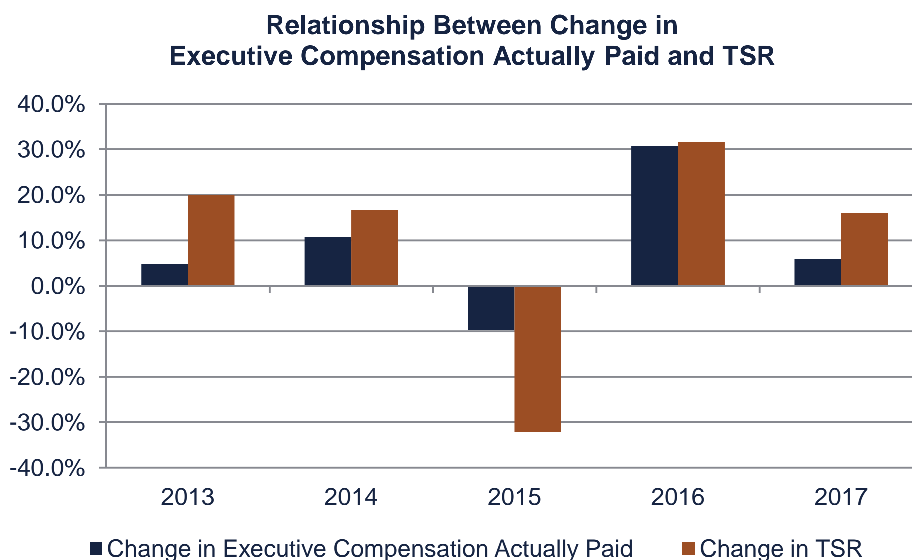
Additional Disclosure Following New Table

The new table will not stand alone. Using the information identified in the new table, companies will have to describe the relationship between executive compensation actually paid and the company's TSR, and the relationship between the company's TSR and the TSR of its selected peer group. The proposed rules will permit this disclosure to be accomplished using narrative or graphical disclosure, or a combination of the two. The SEC Release mentions two possible charts/graphs that could be used to disclose this relationship:

- A graph providing executive compensation actually paid and change in TSR on parallel axes and plotting compensation and TSR over the required time period.



- A graph showing the percentage change over each year of the required time period in both executive compensation actually paid and TSR together with a brief discussion of that relationship.



> ***Exequity Comment:*** *The percentage change chart uses the same underlying data used in the chart above showing the relationship between executive compensation actually paid and TSR over the period (using bars and a line). According to the SEC Release, the chart would need to be supplemented with additional narrative.*

The proposed rules also require that the company provide disclosure comparing the company's TSR to that of the peer group's TSR over the period. This disclosure can also be accomplished through a narrative description, a graph, or a combination of the two.

SEC Questions: Among other questions regarding the proposed new disclosure rules, the SEC Release asks (1) whether the filings in which it proposes to include these new disclosures are sufficient, (2) whether other filings that include executive compensation disclosures should also include the new pay versus performance disclosures, (3) whether the stock performance graph required by Item 201(e) of Regulation S-K should be modified to include a line representing executive compensation actually paid, and (4) whether it should be required to be disclosed in the proxy or information statement as well as or instead of in the annual report.

Supplemental Disclosures Permitted

Companies can also provide supplemental disclosures to explain the relationship between pay and performance so long as such supplemental disclosures are not misleading and not presented more prominently than the required disclosure.

Exequity Comments*: Given how the proposed pay versus performance disclosures will focus on TSR as the sole performance metric with which to compare executive compensation, we expect companies that utilize more strategic company performance metrics will want to provide supplemental disclosure showing the relationship between pay and the more relevant performance metric. Additionally, given that the proposed disclosures will produce many false negatives showing misalignment of pay and performance,*

we expect companies to provide supplemental disclosures demonstrating how pay does align with performance, which could take the form of realized/realizable pay disclosures or disclosures exploring company pay and performance relative to peers (if a rebuttal of the new disclosure table is needed) using something like Exequity's ROX analysis.[4]

Companies Covered by Proposed Rules

The proposed rules will apply to all public companies except foreign private issuers, registered investment companies, and emerging growth companies.

Smaller reporting companies will be subject to scaled disclosure:

- No peer group TSR;
- Disclosure for 3 years (2 years initially during the phase-in period);
- Not required to make adjustments for pensions; and
- Transition period for the XBRL tagging requirements, i.e., not required until the third annual filing under the rules.

Executives Covered

The proposed new disclosures apply to the PEO (which is usually the CEO) and the other NEOs, with the NEOs' information presented on an average basis. The other NEOs would include any executive other than those who served as CEO during the year and are included in the SCT, i.e., anyone serving as CFO during the year, the top 3 highest-paid executives employed at the end of the year, and up to 2 additional executives that would have been included in the table but for the fact that they were not employed as of the last day of the year.

Anyone who served as CEO (PEO) during the applicable year would be included when determining the compensation for the PEO in the new table. The amounts of all such individuals are to be aggregated for purposes of the new disclosure requirements.

<u>SEC Questions</u>: Among other questions, the SEC Release asks (1) whether the rule should require use of the aggregate amounts for the non-PEO NEOs or stick with the average as proposed, (2) whether the amounts for different CEOs in the same year should be aggregated, and (3) whether the disclosure should only be required with respect to the CEO.

Exequity Comments*: If a company has a CEO retire and a new CEO start in the same year, the pay reported for the SCT amounts for the PEO in the new table may be higher than normal and the executive compensation actually paid may also be higher depending on the treatment of compensation upon retirement, e.g., if it vests upon the CEO's retirement.*

Inclusion of all NEOs may not be justifiable from a cost-benefit perspective because numerous additional calculations for fair value will likely be required to cover different vesting tranches for all the non-PEO executives over a 5-year period. In addition, since the primary focus for most investors is on the CEO, the relationship of pay to performance for the CEO should be sufficient. In addition, for executives who join or

[4] More information on Exequity's ROX analysis can be found in Exequity's Client Briefing, *Benchmarking Pay for Performance* (February 11, 2014), available at: https://www.exqty.com/Media/Publications/Benchmarking%20P4P_20140211.pdf.

leave the company during the period, their sign-on and termination-related compensation (e.g., severance) will distort the depiction of the relationship between the regular pay program and TSR.

Interactive Data Requirement (XBRL Tagging)

The SEC Release also proposes that all the data provided in each column of the new table, including any footnote disclosure, be provided in interactive data format using XBRL. This will require companies to separately tag the values disclosed in the table, and to separately block-text tag the disclosure of the relationship among the measures, the footnote disclosure of deductions and additions used to determine executive compensation actually paid, and the footnote disclosure regarding vesting date valuation assumptions. This interactive data would need to be presented as an exhibit to the definitive proxy statement or information statement in which such disclosure is provided and also appear in the same format as the rest of the disclosure provided pursuant to proposed Item 402(v) of Regulation S-K.

Phase-In Period

A phase-in of the requirements is proposed. Companies that are not smaller reporting companies will have to provide the tabular disclosure for 3 years in the first proxy or information statement in which they provide this disclosure, adding another year of disclosure in each of the 2 subsequent years until the new table covers a full 5-year period.

Smaller reporting companies will initially provide 2 years of information in the new table and add 1 year in their subsequent annual filings until the new table covers a full 3-year period.

Assuming the SEC publishes the final Pay Versus Performance disclosure rules before the end of 2015 and the requirements apply to proxies filed starting in 2016, the phase-in would cause the following years to be covered in the new table and associated disclosure each year until 5 full years are disclosed:

Years Included in New Table	2016 Proxy	2017 Proxy	2018 Proxy
2013	●	●	●
2014	●	●	●
2015	●	●	●
2016		●	●
2017			●

"●" indicates the year is included in the new pay versus performance table for the proxy year indicated.

Next Steps

The SEC approved the proposed rules at the April 29, 2015 meeting. The proposed rules were published in the *Federal Register* on May 7, 2015 and are subject to a 60-day comment period. The comment period for the proposed rules will run until July 6, 2015. The SEC will then consider the comments and finalize the new disclosure rules. It is entirely possible that these rules will be in place for the 2016 proxy season.

Companies may want to do some initial modeling of the new proposed table, determine how to best describe the relationship between compensation actually paid and TSR, and the relationship between the company's TSR and that of the peer group, as well as review the various possible peer groups that could be used (published index, line-of-business index or specific group of companies from the stock

performance graph and the peer group(s) used for compensation purposes that will be disclosed in the 2016 proxy). Finally, companies may want to explore supplemental disclosures that would best describe the alignment between pay and corporate performance using the most relevant performance metrics, as well as analyze what a realized/realizable pay disclosure might look like for possible inclusion.

Exequity Comments*: Shareholders are likely to be confused with the new disclosures. Due to the unusual and confusing way in which the rules seek to compare pay and company performance, we expect many issuers to include supplemental disclosures. The SEC's proposed disclosure requirements do not relate pay and performance in a logical manner, and companies will seek to explain that relationship and why the required disclosure does not adequately demonstrate alignment. We expect some companies to disclose alternative measures of performance which are directly connected to their strategic and operating objectives rather than exclusively TSR. Of course, both ISS and Glass Lewis (proxy advisory firms) use concepts of "realizable pay" which will differ from these proposed new disclosures and this will cause further confusion for institutional shareholders as they will be confronted with a multitude of alternative pay versus performance disclosures and summaries.*

If you have any questions about this ***Client Alert***, please contact Ed Hauder ((847) 996-3990 or Edward.Hauder@exqty.com) or any of the following:

Ben Burney	(847) 996-3970	Ben.Burney@exqty.com
David Cahn	(847) 232-4066	David.Cahn@exqty.com
Robbi Fox	(847) 948-8655	Robbi.Fox@exqty.com
Mark Gordon	(925) 478-8294	Mark.Gordon@exqty.com
Jeff Hyman	(203) 210-7046	Jeff.Hyman@exqty.com
Lynn Joy	(847) 996-3963	Lynn.Joy@exqty.com
Stacey Joy	(847) 996-3969	Stacey.Joy@exqty.com
Chad Mitchell	(949) 748-6169	Chad.Mitchell@exqty.com
Jeff Pullen	(847) 996-3967	Jeff.Pullen@exqty.com
Dianna Purcell	(718) 273-7444	Dianna.Purcell@exqty.com
Bob Reilley	(856) 206-9852	Bob.Reilley@exqty.com
Mike Sorensen	(847) 996-3996	Mike.Sorensen@exqty.com
Ross Zimmerman	(847) 996-3999	Ross.Zimmerman@exqty.com

Illinois Office (Headquarters) – 1870 West Winchester Road, Suite 141 ● Libertyville, IL 60048
California Offices – 650 Town Center Drive, Suite 830 ● Costa Mesa, CA 92626
– 2840 Comistas Drive ● Walnut Creek, CA 94598
Connecticut Office – 108 Pine Ridge Road ● Wilton, CT 06897
New Jersey Office – 309 Fellowship Road, Suite 200 ● Mt. Laurel, NJ 08054
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