



May 2015

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Pay Versus Performance: SEC Proposal Will Keep Executive Compensation Hot

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On April 29, 2015, the SEC followed through on Section 953(a) of the Dodd-Frank Act by releasing its proposed “pay versus performance” disclosure rule. In short, the SEC’s 137-page [proposal](#) requires that U.S. public companies use a new table in their proxy statements that will disclose information on executive compensation and include a related discussion. That table must present data, for the most recently completed five fiscal years, covering:

- (1) the relationship between the executive compensation of the company’s named executive officers (NEOs) and its total shareholder return (TSR); and
- (2) the relationship between the company’s TSR and that of a peer group that the company chooses.

A phase-in would require three years of data in the first year, four years in the second, and five in future years. Smaller reporting companies would only need to provide three years of data and would be exempt from peer group comparisons. The proposed rule also exempts foreign private issuers, registered investment companies, and emerging growth companies.

The SEC split 3-2 in voting to release the proposal, with the majority asserting that the disclosure provides shareholders with “a new metric for assessing a company’s executive compensation relative to its financial performance” (quoting SEC Chair Mary Jo White in the SEC’s [press release](#) announcing the proposed rules).

The dissenting Commissioners expressed numerous concerns with the SEC proposal. Their key concern centered on whether TSR should serve as the sole corporate performance measure for all companies. The [majority of companies](#) that analyze pay-for-performance use methods that may not align with those in the SEC proposal. It will be interesting to see if the SEC backs away from mandating the use of TSR, as the Commission has solicited public comment as to whether TSR is the optimal measure.

Highlights of the SEC’s Proposal

If adopted as proposed, the SEC’s rule would add Item 402(v) to Regulation S-K. According to the SEC, disclosure under Item 402 will enable shareholders to factor pay-versus-performance information into their voting with respect to say on pay, proposed stock plans, and the election of directors.



- **“Actual Pay”**

S-K Item 402(v) will require disclosure of “actual pay” based on what is reported in the summary compensation table with specified adjustments in order to:

- (1) value equity awards based on their value when vesting occurs, rather than based on their grant date value; and
- (2) replace the change in pension value with an actuarially determined service cost.

The latter adjustment would not apply to smaller reporting companies.

- **The New Table**

Set forth below is the general format that the SEC has prescribed for its proposed pay-versus-performance table:

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)

Note that companies will need to include a footnote to explain the adjustments made in order to calculate compensation “actually paid.” Also, for the first time, the SEC is requiring issuers to tag their tabular information, in XBRL format, in order to facilitate comparisons between companies.

- **Peer Groups**

For peer group comparisons, a company may use the peer group identified in its stock performance graph or one of the groups discussed in its compensation discussion and analysis (CD&A). The constituent peer companies must be identified, unless they are listed in a published industry or line-of-business index. For TSR calculations, the SEC proposes that “[t]he returns of each component issuer of the group must be weighted according to the respective issuers’ stock market capitalization at the beginning of each period for which a return is indicated.”

- **Placement of the Disclosure**

The SEC proposal defers to companies on where to present pay-versus-performance disclosures. The SEC notes that inclusion within the CD&A makes sense if such information influenced compensation decisions.



Pay-for-Performance – Accountability

The new tabular disclosure is to be followed by a discussion concerning the relationship between pay and corporate and peer group performance. Those relationships can be discussed using narratives, graphs, or a combination of the two. As with executive compensation disclosures generally, this will introduce an additional challenge as companies justify their pay decisions in order to defuse any sense of misalignment. It is worth noting that even companies that espoused a pay-for-performance philosophy have suffered from shareholder derivative litigation alleging breaches of fiduciary duty and misleading disclosures in past proxy statements.

Conclusion

As indicated by the SEC commissioners' split vote, reasonable minds will differ as to the relative costs and benefits of pay-versus-performance disclosures. There is little doubt, however, that the SEC's proposal further burdens public companies in crafting their compensation disclosures. They will need to devote significant thought and resources to making the nuanced calculations and pay-for-performance explanations required by the proposed rules.

In anticipation of a final rule, compensation committees would be well-advised to use 2015 to consider the impending disclosure requirements as they seek to demonstrate the alignment of their executive pay with corporate performance often demanded by the investment community. Many of the companies that have failed say on pay votes in past years either went it alone or disconnected pay and performance. Professional insights are likely needed to refine existing practices, navigate peer selection, and consider better styles of disclosure and analysis, such as alternative measures of compensation (e.g. realized versus realizable pay).

Finally, public companies should consider participating in efforts to submit comments to the SEC. Since adoption of final pay-versus-performance rules appears likely, comments aimed at easing the compliance burden on public companies and making the rules more sensible would be of benefit to public companies. Public comment along these lines has resulted in varying degrees of success in connection with past executive compensation related rule-making.



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