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Meridian Client Update

SEC Issues Proposed Rule on Relationship Between Pay and Performance

In our Client Update of April 29, 2015, we reported on testimony provided at a hearing of the Securities and Exchange Commission (SEC) during which it approved a proposed rule that would require a public company to disclose the relationship between executive compensation "actually paid" and the financial performance of the company. This Client Update summarizes the release of the proposed rule ("Release") that was published following the SEC hearing.

Under the proposed rule, an issuer would be required to make two disclosures: (i) a tabular disclosure showing prescribed compensation information for its CEO and other named executive officers (NEOs), issuer cumulative total shareholder return (TSR) and cumulative TSR of an issuer selected peer group and (ii) an explanatory disclosure describing the relationship between compensation actually paid and the issuer's TSR and the relationship between an issuer's TSR and the TSR of its peer group. These disclosures are highlighted below.

Required Tabular Disclosure

Under the proposed rule, an issuer would be required to make the following tabular disclosure:

(a)	(b)	(c)	(d)	(e)	(f)	(g)
Year	Summary Compensation Table Total Compensation For CEO	Compensation **Actually Paid** to CEO	Average Summary Compensation Table Total Compensation for Other NEOs	Average Compensation **Actually Paid** to Other NEOs	Cumulative Total Shareholder Return	Peer Group Cumulative Total Shareholder Return
1						
2						
3						
(Initial disclosure would cover a 3 fiscal year period that would be expanded to include an additional fiscal year for each of the next 2 fiscal years.)						

Compensation "actually paid" for a fiscal year would equal an NEO's total compensation from the SCT:

- Less the change in the actuarial present value of pension benefits reported in the SCT for the fiscal year
- Plus the actuarial present value of pension benefits attributed to services rendered by the executive officer during the fiscal year
- Less the grant-date fair value of any stock and option awards granted during the fiscal year
- Plus the "fair value" at vesting of stock awards and option awards that vested during the fiscal year

Required Explanatory Disclosure

Following the tabular disclosure, an issuer would be required to explain the relationship between compensation actually paid and the issuer's TSR and the relationship between the issuer's TSR and peer group TSR. Under the proposed rule, an issuer would have discretion to determine the content of this explanatory disclosure and the form of disclosure (e.g., narrative and/or graphic).

Background

The SEC is mandated under Section 953(a) of the Dodd-Frank Wall Street Reform and Consumer Protection Act ("Dodd-Frank") to adopt rules that would require an issuer to disclose in a "clear manner the relationship between executive compensation actually paid and the financial performance of the registrant." Set forth below are the precise requirements of Section 953(a):

> "The Commission shall, by rule, require each issuer to disclose in any proxy or consent solicitation material for annual meeting of the shareholders of the issuer ***a clear description of any compensation required to be disclosed by the issuer under [Item 402 of Regulation S-K] (or any successor thereto), including 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. The disclosure under [Section 953(a)] may include a graphic representation of the information required to be disclosed."

In accordance with this Dodd-Frank mandate, the SEC approved the proposed rule on the disclosure of pay-versus-performance. In the Release, the SEC noted that the proposed rule would provide shareholders information relevant to how they cast their vote on management say on pay proposals and on director elections. In regard to director elections, the SEC noted that the proposed disclosure might help shareholders evaluate the directors' oversight of executive compensation.

In the Release, the SEC also noted that it designed the proposed rule to enhance comparability of pay-versus-performance disclosures across issuers.

Details of the Proposed Rule

The following describes the key elements of the proposed rule.

- **Placement of proposed pay-versus-performance disclosure**. The proposed disclosure would be included in any proxy or information statement for which disclosure under Item 402 of Regulation S-K is required (e.g., annual meeting proxy). However, the proposed rule does not mandate where the pay-versus-performance disclosure must be placed within an issuer's proxy or information statement. Rather, an issuer would have discretion to determine the placement of the proposed disclosure. The SEC observes, and we agree, that most issuers are likely to place the proposed disclosure within their disclosure on executive compensation (e.g., within the Compensation Discussion and Analysis).

- **Covered executives**. The proposed rule would apply to an issuer's proxy-disclosed officers (i.e., CEO, CFO and the three highest paid executive officers other than the CEO and CFO). If more than one person served as the CEO of the issuer during a covered fiscal year, then the compensation for all persons who served as the CEO of the issuer for that year shall be aggregated.

- **Covered time period and transition rule**. Under the proposed rule, the pay-versus-performance disclosure would be required to cover the five most recently completed fiscal years of the issuer. In the Release, the SEC noted that this time period should provide a meaningful period over which a relationship between annual measures of pay and performance can be evaluated by investors.

  The proposed rule would be phased in over a three-year period. The initial year disclosure would cover three fiscal years and then would be expanded to cover one additional fiscal year for each of the next two fiscal years.

  For a newly public company, the proposed disclosure would only cover those fiscal years during which the company was public.

- **Required tabular disclosure.** Under the proposed rule, an issuer would be required to make the pay-versus-performance disclosure in the following the tabular format:

(a)	(b)	(c)	(d)	(e)	(f)	(g)
Year	Summary Compensation Table Total Compensation For CEO	Compensation **Actually Paid** to CEO	Average Summary Compensation Table Total Compensation for Other NEOs	Average Compensation **Actually Paid** to Other NEOs	Cumulative Total Shareholder Return	Peer Group Cumulative Total Shareholder Return
1						
2						
3						
(Initial disclosure would cover a 3 fiscal year period that would be expanded to include an additional fiscal year for each of the next 2 fiscal years.)						

— **Determination of compensation actually paid to the CEO**. Compensation actually paid to an issuer's CEO would be determined for each fiscal year covered by the above tabular disclosure. Fiscal year compensation actually paid the CEO would be equal to the CEO's Total Compensation as disclosed in the Summary Compensation Table (SCT):

- Less the change in the actuarial present value of pension benefits reported in the SCT for the fiscal year
- Plus the actuarial present value of pension benefits attributed to services rendered by the executive officer during the fiscal year
- Less the grant-date fair value of any stock awards and option awards granted during the fiscal year reported in the SCT for the fiscal year
- Plus the "fair value" at vesting of stock awards and option awards that vested during the fiscal year

— **Determination of compensation actually paid to the other NEOs**. Compensation actually paid to an issuer's other NEOs would be determined in the same fashion as compensation actually paid to an issuer's CEO. However, the amount disclosed in the above table would represent the average compensation actually paid to such NEOs during each fiscal year covered by the table.

— **Selection of peer group**. The proposed rule would require an issuer to use as its peer group either (i) the peer group used in its performance graph (that typically is disclosed in Form 10-K) or (ii) the peer group used for benchmarking compensation and disclosed in its CD&A. If the peer group is not a published industry or line-of-business index, the issuer would be required to disclose the identity of each component company of the peer group. An issuer that has previously disclosed the composition of its peer group in prior filings with the SEC would be permitted to comply with the proposed requirement by incorporation by reference to those filings.

— **Determination of cumulative TSR**. Cumulative TSR would be determined for each "measurement period" shown in the table and would be calculated in accordance with the following formula:

$$\frac{\text{Ending Stock Price} - \text{Beginning Stock Price} + \text{Cumulative Dividends Assuming Reinvestment}}{\text{Beginning Stock Price}}$$

Measurement period refers to the fiscal year(s) over which cumulative TSR is being determined. For example, in year 1 of the table the measurement period would be the first fiscal year and in year 3 of the table the measurement period would be three fiscal years beginning with the first day of the first fiscal year.

Cumulative TSR for an issuer's peer group must be weighted according to the respective peer companies' stock market capitalization at the beginning of each measurement period for which TSR is calculated.

— **Required footnote disclosure**. An issuer would be required to disclose in a footnote to the table: (i) amounts deducted from, and added, to the SCT total compensation of the CEO and the average SCT total compensation of the other NEOs and (ii) the assumptions used to calculate the vesting date fair value of option awards if such assumptions materially differ from the assumptions used to calculate grant date fair value of such option awards.

- **Additional requirements for determining compensation actually paid**. As noted above, the proposed rule would require an issuer to determine compensation actually paid to an NEO by adjusting the NEO's total compensation as disclosed in the SCT. The adjustments are discussed below.

  — **Adjustment for changes in actuarial pension value**. An issuer is required to disclose in the SCT the aggregate year-over-year change in the actuarial present value of an NEO's accumulated benefit under all defined benefit plans (both tax-qualified and nonqualified plans). This reported change in pension value would be deducted from an executive officer's total compensation under the proposed rule. However, the actuarially determined service cost for services rendered by an executive officer during the applicable fiscal year would be added to the executive officer's total compensation. The SEC noted that service cost is a more appropriate measure for determining compensation "actually paid" than changes in pension value because it reflects pension benefits earned during the applicable fiscal year. The SEC further noted that the adjustment is intended to provide a more meaningful comparison across issuers of the amounts "actually paid" under both defined benefit and defined contribution plans.

  — **Adjustment for equity awards**. Under the proposed rule, equity awards would be considered actually paid on the date of vesting and valued at fair value on that date, rather than fair value on the date of grant as required in the SCT. In the Release, the SEC noted that prior to vesting an executive officer does not have an unconditional right to an equity award and, therefore, non-vested awards would not be appropriate to include in compensation actually paid to an executive officer. In contrast, the SEC observed that the satisfaction of vesting conditions "can be viewed as representing payment" of an equity award by an issuer. Based on these views, the proposed rule would require the following adjustments to an executive officer's Total Compensation for a fiscal year:

    - The ***aggregate grant date fair value*** of stock awards and option awards disclosed in the SCT for the fiscal year ***would be deducted*** from the executive officer's Total Compensation.

    - The ***aggregate vesting date fair value*** of stock awards and option awards which vest during the fiscal year ***would be added*** to the executive officer's Total Compensation. Fair value would be determined in accordance with the fair value guidance under ASC Topic 718. In accordance with this guidance, the vesting date fair value of stock awards would be equal to the number of stock awards (e.g., restricted stock, restricted stock units and performance shares) that vested during the fiscal year multiplied by the issuer's share price on the date of vesting. The vesting date fair value of stock options would be equal to the Black-Scholes value of a single option determined as of the date of vesting multiplied by the number of options that vested.

      Any "incremental fair value" resulting from the modification of an equity award would also be added to an executive officer's Total Compensation.

- **Required explanatory disclosure**. Following the tabular disclosure, an issuer would be required to make a disclosure explaining the relationship between compensation actually paid and issuer TSR and the relationship between issuer TSR and peer group TSR. Under the proposed rule, an issuer would have discretion to determine the content of this disclosure and the form of disclosure (e.g., narrative and/or graphical).

- **Supplemental disclosure**. The proposed rule would permit an issuer to supplement the required disclosure by providing pay-versus-performance disclosure based on other measures of pay and/or performance if the issuer believes such supplemental disclosure would provide useful information about the relationship between compensation and issuer performance. For example, an issuer could measure pay based on “realized pay” or “realizable pay” and could measure performance based on financial metrics. In addition, an issuer could provide supplemental pay-versus-performance disclosures over a time period greater than five years (or three years in the initial year of disclosure). However, any supplemental disclosure could not be misleading or presented more prominently than the required disclosure.

- **Exempt registrants and smaller reporting companies**. Foreign private issuers and investment companies would be exempt from the proposed rule. Emerging companies are exempt from the propose rule by virtue of the JOBS Act. However, smaller reporting companies would be subject to a scaled back version of the proposed rule.

- **Comment Period and Effective Date**. Interested parties may submit to the SEC comments on the proposed rule on or before July 6, 2015. After considering submitted comments, the SEC will issue a final rule. However, the SEC is under no deadline by which to issue a final rule (note that a final rule on the CEO pay ratio has yet to be issued despite the fact the proposed rule was approved by the SEC during September 2013). However, if the SEC acts with unusual speed with regard to adopting a final rule on the pay-versus-performance disclosure, then the disclosure rule could be effective as early as the 2016 proxy season.

Meridian comment. The central question raised by the proposed disclosure is whether it will, in fact, provide investors with meaningful information on the relationship between executive officer compensation and corporate performance. The required tabular disclosure alone simply will not. This proposed disclosure is a hodgepodge of disconnected information that is unlikely to enlighten major institutional investors.

The primary focus of the tabular disclosure is showing CEO (and average NEO) compensation actually paid for each covered fiscal year and cumulative TSR of the issuer (measured from the first day of the first fiscal year through the end of each covered fiscal year). Inclusion of cumulative TSR is just one of many alternative methods used for evaluating pay-versus-performance. The SEC has not provided an explanation as to why comparison of pay and cumulative TSR would yield meaningful information on the relationship between pay-versus-performance.

The proposed rule leaves to issuers the task to make the tabular disclosure understandable and meaningful to investors. Specifically, the proposed rule would require issuers to explain the relationship between pay-versus-performance and the relationship between issuer TSR and peer group TSR. We expect issuers to make both graphical and narrative disclosures to help explain the relationship between executive officer pay-versus-performance. We believe the scope and nature of these disclosures will not be uniform among issuers and, therefore, will make comparisons of such disclosures among and between issuers problematic.

Finally, the scope and mechanics of the proposed rule raises numerous additional issues some of which are highlighted below.

- **Scope of covered employees**. The SEC claims that the statutory language indicates that the pay-versus-performance disclosure should relate to all NEOs. However, the statute does not necessarily call for such an expansive reading. We believe that statute may be reasonably construed solely to cover an issuer's CEO and CFO. This would facilitate comparability of the pay-versus-performance disclosure across issuers. In contrast, the inclusion of disparate NEO positions (both on an annual basis and over the measurement period) is likely to undermine comparability.

- **SCT total compensation included in required tabular disclosure**. Further complicating the required tabular disclosure is the gratuitous requirement that the table include SCT total compensation. In the Release, the SEC stated that the "disclosure of the [SCT] measure of total compensation together with our proposed measure of executive compensation actually paid would provide shareholders with disclosure of two measures in one single table and, we believe, would facilitate comparisons of the two measures of a registrant's executive compensation to the registrant's performance." However, Dodd-Frank does not call for such a dual comparison. Rather, the disclosure required under Dodd-Frank is clearly limited to compensation actually paid, which the SEC has interpreted to mean an adjusted form of SCT total compensation. This begs the question as to why SCT total compensation should be included in the tabular disclosure, especially when such compensation information is disclosed elsewhere in an issuer's proxy statement (or prior proxy statements for years 4 and 5 covered by the tabular disclosure).

- **Peer group TSR**. Unexpectedly, the SEC proposed rule would require an issuer to include peer group cumulative TSR in the required tabular disclosure. Neither the language of Section 953(a) of the Dodd-Frank nor the legislative history requires or suggests that the pay-versus-performance disclosure should include information about peer group TSR and an explanation as to the relationship between issuer TSR and peer group TSR. In the Release, the SEC explained that the requirement for such disclosure was in response to several commenters that "indicated that absolute company performance may not be a sufficient basis for comparison and advocated disclosure of [issuer] performance relative to that of a peer group." To some, promulgating a rule solely based on publicly-submitted comments (rather than statutory language or history) might seem to be a thin legal reed upon which to support such rulemaking.

- **Average of compensation actually paid to NEOs (exclusive of the CEO)**. Neither Dodd-Frank nor typical business practices directly supports the SEC's proposal to require an issuer to compare and discuss the relationship between ***average*** annual compensation actually paid to NEOs (exclusive of the CEO) and corporate performance. The SEC provides no explanation as to why such a comparison is appropriate or will provide meaningful information to investors.

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