SULLIVAN & CROMWELL LLP

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UPDATE: SEC Publishes Text of Proposed Pay-Versus-Performance Disclosure Rule

Focuses on Relationship of Executive Compensation Actually Paid Versus Annual Total Shareholder Return; Two Commissioners Dissent, Citing Lack of Flexibility and Concerns over Short-Termism

SUMMARY

On Wednesday, the SEC proposed a rule that would require SEC registrants to disclose the relationship between named executive officers' "actual" pay and the registrant's and its peers' total shareholder return, over each of the registrants' five most recently completed fiscal years. This proposed rule would implement Section 953(a) of the Dodd-Frank Wall Street Reform and Consumer Protection Act and would require new disclosure in proxy statements and information statements in which executive compensation disclosure is currently required pursuant to Item 402 of Regulation S-K. The rule would apply to SEC registrants, other than foreign private issuers, registered investment companies and emerging growth companies.

The proposal was approved by a 3-to-2 vote, with Chair White being joined by Commissioners Aguilar and Stein in voting for the measure while Commissioners Gallagher and Piwowar voted against the proposal. The dissenting Commissioners raised concerns regarding the overly prescriptive nature of the required metrics, which do not allow for a principles-based analysis based on how the company views pay and performance, as well as concerns over the impact of focusing corporate and investor attention on stock price movements over short-term periods.

Comments are due 60 days after publication of the proposal in the Federal Register. The proposing release does not indicate when the disclosure would take effect, if adopted.

BACKGROUND

Section 953(a) of Dodd-Frank added a new Section 14(i) to the Securities Exchange Act of 1934 that directs the SEC to adopt rules requiring SEC registrants to disclose in any proxy or consent solicitation materials for an annual meeting of shareholders a clear description of any compensation required to be disclosed by the registrant under Item 402 of Regulation S-K, including information showing the relationship between executive compensation actually paid and the financial performance of the registrant, taking into account any alteration in the value of shares of stock and dividends of the registrant.

PROPOSED RULE

The proposed rule would add a new paragraph (v) to Item 402 of Regulation S-K requiring that a registrant disclose, in its proxy or information statement, the relationship between named executive officers' (NEOs') "actual" pay and the registrant's and its peers' total shareholder return (or TSR). The requirements and details of the proposed rule are discussed in more detail below.[1]

New Required Table and Narrative/Graphic Disclosure

The proposed rule would require covered registrants to disclose the following in a new table for *each* of the most recent five years (subject to the transition periods discussed below):

- The CEO's total compensation and the average of the other NEOs' total compensation as reported in the Summary Compensation Table.
- The CEO's "actual" pay (described below) and the average of the other NEOs' "actual" pay.
- The registrant's and its peers' annual TSR, using the definition of total shareholder return from Item 201(e) of Regulation S-K (providing for a performance graph to be included in the annual report) and using either the peer group used in the Item 201(e) performance graph or the peer group reported in the compensation discussion and analysis (although smaller reporting companies would not be required to present a peer group total shareholder return at all).
    - If a peer group is used that is not a published industry or line-of-business index, the identity of the issuers comprising the group must be disclosed, and the returns of each component issuer of the group must be weighted according to their respective market capitalization at the beginning of each period for which a return is indicated.
    - The disclosed TSR for each year would be the cumulative TSR from the beginning of the earliest year in the table through the end of that year.

Furthermore, the registrant would be required to "provide a clear description," through narrative description, graphic presentation or a combination of the two, of the relationship of "actual" pay to its TSR and of its TSR to that of its peers.

[1] The proposing release, *Pay Versus Performance* (SEC Release No. 34-74835), is available at http://www.sec.gov/rules/proposed/2015/34-74835.pdf.

As noted below, the two dissenting Commissioners expressed concerns over the focus on TSR and whether it incentivizes short-term thinking to the detriment of companies and investors. The SEC requested comment on, among other things, whether they should require *aggregate* TSR over the period, rather than for each year within the period.

The SEC proposal does not specify a desired location within the proxy statement or information statement for the proposed disclosure. However, the proposing release expresses an expectation that registrants would disclose the required information with Item 402 executive compensation disclosure.

Transition Periods

For registrants other than smaller reporting companies, the proposed rule would be phased in over three years with three years of disclosure initially required and five years of disclosure eventually required. Smaller reporting companies would initially be required to disclose two years of information and three years of information thereafter. Companies are not required to include periods prior to becoming an SEC-reporting company.

Executives Covered

The proposed disclosure would relate to the NEOs included in the Summary Compensation Table and would be presented separately for the CEO and as an average for the remaining NEOs. Although it is not clear from the text of the proposed rule itself, the proposing release makes clear that this means to capture the average compensation for the NEOs who were actually included in the Summary Compensation Table in prior years, whether or not they are NEOs for the most recent year. The proposing release states that "requiring disclosure of the average compensation 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 who are not the [CEO] over the years for which disclosure is required."

For any year in which there were multiple CEOs reported in the summary compensation table, the data would be based on an aggregation of the compensation of those individuals.

Determination of "Actual" Pay

"Actual" pay would start with the total amount reported in the Summary Compensation Table with the following adjustments:

- Equity awards would be considered actually paid on the date of vesting and at fair value on that date, rather than fair value on the grant date as required in the Summary Compensation Table. The SEC reasons that, prior to vesting, an executive does not have an "unconditional right to an equity award" and so it is not appropriate to consider unvested awards "actually" paid.
- Change in pension value would be excluded and replaced with an actuarially determined service cost (although this would not be required for smaller reporting companies). The SEC notes that this would result in exclusion of 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, which the SEC believes would remove significant volatility from the measure.

In determining how to define “actual” pay, the SEC states that it is aware of the various concepts of “realized” and “realizable” pay that have been increasingly used in proxy statement in recent years, but that it is not aware that there has been broad agreement on any particular formula. Companies could supplement the required disclosure with other appropriate measures that they think provide useful information on pay-for-performance alignment, “provided that the supplemental disclosure is not misleading and not presented more prominently than the required disclosure."

Exempted Companies

Foreign private issuers, registered investment companies and emerging growth companies would be exempted from the proposed disclosure.

Say-on-Pay Implications and Form Requirements

Because the proposed disclosure would be provided pursuant to Item 402 of Regulation S-K, it would be subject to a say-on-pay advisory vote under Exchange Act Rule 14a-21(a).

The SEC proposal requires the new disclosure in proxy statements on Schedule 14A and information statements on Schedule 14C (whether or not for an “annual meeting,” despite the use of that phrase in the statute), to the extent that executive compensation disclosure is currently required. The SEC reasoned that such disclosure would be most useful to shareholders in instances regarding (i) approval of executive compensation through a say-on-pay advisory vote, (ii) voting decisions on a compensation plan in which executive officers participate and (iii) decisions pertaining to the election of directors.

The proposed disclosure would not need to be included in registration statements, Form 10-Ks or other reports under the Exchange Act or the Securities Act, nor would it be deemed incorporated by reference into any other SEC filing except to the extent that the registrant specifically incorporates it by reference.

XBRL Requirement

Registrants would be required to tag, using eXtensible Business Reporting Language (“XBRL”), (i) the values disclosed in the required table, (ii) the narrative or graphic disclosure of the relationship among the measures, (iii) the footnote disclosure of deductions/additions used to determine compensation actually paid and (iv) the footnote regarding vesting date valuation assumptions. This would be the first table in proxy statements to be required to be in XBRL format.

Concerns of Dissenting Commissioners

As noted above, Commissioners Gallagher and Piwowar dissented from the proposal of the rule. As an initial matter, they each expressed the view that, while this is a required rule-making under Dodd-Frank, they did not think it needed to be a focus of SEC resources at the moment, given other competing demands. On the substance of the proposal, each expressed the view that an overly prescriptive approach, while enhancing comparability, does not take sufficient account of the variation in companies and in appropriate metrics. Further, each had concerns regarding an undue focus on a short-term TSR metric, with Commissioner Gallagher stating that "the Commission's chosen metric risks exacerbating the current overemphasis on short-term performance at the expense of long-term shareholder value creation."

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