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Defining Issues®

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SEC Proposes Rules for Pay-for-Performance

The SEC recently proposed rules that would require companies to disclose in a clear manner the relationship between executive compensation paid and the companies' financial performance.[1]

The proposed disclosures would be required in proxy or information statements that require executive compensation disclosures. They would not be required for emerging growth companies, foreign private issuers, and registered investment companies.[2] However, they would apply to smaller reporting companies.

Key Facts

- Disclosures would need to be made in a tabular format for each of the five most recently completed fiscal years (three fiscal years for smaller reporting companies).
- A clear, concise description in narrative or graphical format would be required. These disclosures would need to show the relationship between the executive compensation actually paid and the total shareholder return as well as companies' peer groups.

Key Impacts

- For each disclosure date, companies would need to determine the executive compensation that is actually paid. This would require companies to calculate the pension benefits representing the service costs for services rendered by the principal executive officer (PEO) and non-PEO named executive officers (NEOs), and the fair value of equity awards on their vesting dates.
- Companies would need to update their systems to capture the new information required under this proposed rule.

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[1] SEC Release No. 34-74835, Pay versus Performance, available at www.sec.gov. The disclosures are required by Section 953(a) of the Dodd-Frank Wall Street Reform and Consumer Protection Act (Dodd-Frank Act). The rules would apply to SEC registrants.

[2] Emerging growth companies are exempt under the requirements of the Jumpstart Our Business Startups Act, which was passed in 2012 to help smaller businesses raise funds in the public capital markets.

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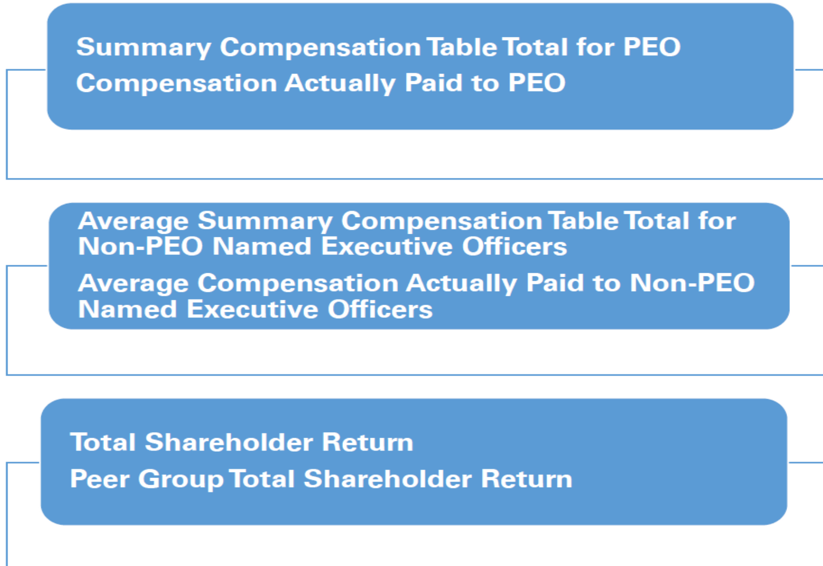

Companies would need to provide the information listed above in a tabular format for each of the five most recently completed fiscal years (three fiscal years for smaller reporting companies).[3]

Item 402 of Regulation S-K currently contains detailed disclosure requirements for executive compensation and Compensation Discussion and Analysis that describe the relationship between pay and performance. The SEC believes that these additional disclosures would give shareholders a new metric for assessing executive compensation relative to the company's financial performance.

Executive Compensation Actually Paid

The proposed rule uses the phrase "actually paid," which differs from current disclosures of "compensation awarded to, earned by or paid." The executive compensation actually paid would be total compensation that is currently reported in the Summary Compensation Table under Item 402(c) of Regulation S-K that has been *modified* to include the amounts paid for pension benefits and equity awards.

Pension Benefits

Companies may have either defined benefit or defined contribution retirement plans, and this proposed change is intended to provide a more meaningful comparison between the amounts actually paid under both plan types.

Under defined benefit and actuarial pension plans, the changes in actuarial present value of benefits would be deducted from the reported total compensation. The actuarially determined service cost for services rendered by the executive would be added.

[3] The proposed rules would amend Item 402 of Regulation S-K to implement Section 14(i) of the Securities Exchange Act of 1934. This section was added by Section 953(a) of the Dodd-Frank Act.

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For awards of stock and options that have vested, the fair value at vesting date would be computed under the fair value guidance for stock compensation awards.

Therefore, the executive compensation actually paid would include only the pension costs for benefits *earned during the year* and would exclude the portion of the total change in actuarial pension value reported in the Summary Compensation Table that results solely from changes in interest rates, mortality assumptions, age, and other actuarial inputs and assumptions.

For defined contribution plans, the Summary Compensation Table currently requires disclosure of contributions or other allocations to vested and unvested defined contribution plans for the applicable fiscal year. These amounts would also be included in computing compensation actually paid.

Equity Awards

Equity awards would be considered actually paid on the date of vesting (even if, in the case of stock options, they have yet to be exercised) and valued at their fair value on the vesting date under current GAAP methodology.[4] This would contrast with the Summary Compensation Table where equity awards are reported at their fair value on the grant date.

Footnote disclosure would be required for all adjustments, as well as valuation adjustments used to determine any equity award adjustments that are materially different from those disclosed in the financial statements.

Using vesting-date valuations would result in a compensation measure that includes the grant-date value of equity awards plus or minus any change in the value of equity awards between the grant and vesting date. The SEC believes that the change in the value of equity grants after the grant date represents one of the primary means through which pay is linked to company performance.

An award requiring exercise would be considered actually paid upon its vesting, because once the award is vested the NEOs can control how and when the award is monetized. This means that the NEOs could influence pay-versus-performance disclosure by controlling the fiscal year in which compensation is received. According to the SEC, changes in the fair value of the award after vesting generally reflect investment decisions made by the NEOs rather than companies' compensation decisions.

Currently, the fair value of stock awards upon vesting is disclosed in the Option Exercises and Stock Vested Table. The fair value of option awards upon vesting is not required to be reported if the option awards are not exercised. Companies would be able to apply existing models and methodologies to compute the fair values.

For purposes of the proposed rule, the amounts reported in the Summary Compensation Table for awards of stock and options at their fair value at grant date would be subtracted from total compensation. The fair values at the vesting date for the respective awards determined using U.S. GAAP would be used instead.

[4] FASB ASC Topic 718, Compensation – Stock Compensation, available at www.fasb.org.

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The requirement to apply XBRL tags would be the first time that the SEC has required companies to tag proxy statement disclosures.

Measurement of Performance

Total Shareholder Return is the same measure of performance, without any adjustments, for purposes of pay-versus-performance that is defined in Item 201(e) of Regulation S-K and used in other required disclosures.

Transition Rule and Exceptions

Under the proposed transition rule, all companies, other than smaller reporting companies, would be required to provide the proposed disclosures for three fiscal years, rather than five, in the first filing after the rules become effective. Companies would need to disclose an additional year in each of the two subsequent annual proxy filings. Existing smaller reporting companies initially would be required to provide the disclosures for only the last two fiscal years, and would subsequently provide disclosures for the prior three fiscal years.

Tagging in XBRL

The proposed rule would require that the disclosures in each column of the proposed table, including footnotes, be provided in interactive data format using eXtensible Business Reporting Language (XBRL).

Next Steps

Comments on the proposed rules are due by July 6, 2015. The SEC will review the comments and determine whether to adopt the proposed rules.

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