CAPflash
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Pay and Performance Disclosure – Proposed Rules Adopted by SEC

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On Wednesday April 29, the SEC held an open meeting and approved by a vote of 3-2 a staff proposal to amend Section 14(i) of the Securities Exchange Act of 1934 to expand disclosure requirements for executive compensation. The proposed amendment was added by Section 953(a) of the Dodd-Frank Wall Street Reform and Consumer Protection Act of 2010. The proposed rules will require clear disclosure of the relationship between executive compensation *actually paid* and company financial performance.

The SEC's objectives – enhanced disclosure, more transparency, alignment of pay and performance – are praiseworthy, but some of the new rules are complex. CAP predicts that compliance will prove to be burdensome for most companies.

HIGHLIGHTS OF THE PROPOSED RULES

Publication of a New Table: The proposed rules add a new table to the current disclosure on executive compensation. This new table will include:

- Executive compensation actually paid for the principal executive officer and the average amount actually paid to the remaining named executive officers. For purposes of the table, compensation actually paid is total compensation as disclosed in the summary compensation table with adjustments to the amounts included for pensions and equity awards.
- The total executive compensation reported in the summary compensation table for the principal executive officer and an average of the reported amounts for the remaining named executive officers.
- The company's total shareholder return (TSR) on an annual basis as presented in the existing stock performance graph. The definition of TSR is provided for the stock performance graph in Item 201(e) of Regulation S-K.
- The TSR of the companies in a peer group or index, using either the peer group identified by the company in its stock performance graph or in its compensation discussion and analysis.

CAP predicts that graphic representations, similar to the Stock Performance Graph, will be a popular approach.

Additional Disclosure: In addition to the new table, companies will be required to provide a clear explanation for the relationship between compensation actually paid and the company's TSR performance. An explanation of the company's TSR performance and the TSR performance of the peer group or index is also

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required. Companies will have the flexibility to provide this explanation as a narrative, in a graph or by using both.

Adjustments to Calculate Compensation Actually Paid: Companies will need to make two adjustments to total compensation reported in the summary compensation table to calculate compensation *actually paid*. The adjustments relate to equity award values and pension values. Companies will be required to disclose the adjustments to the compensation reported in the summary compensation table in a footnote.

First, the reported grant date value of equity will be subtracted from reported total compensation and the fair value of equity vesting in that year and re-valued on the date of vesting will be added to calculate compensation *actually paid*. Companies will need to disclose the vesting date valuation assumptions if they differ materially from the assumptions used for financial statements as of the grant date.

In the second adjustment, the reported change in pension value will be subtracted from reported total compensation and the change in pension value attributable to the actuarially determined service cost for services rendered by the executive during the applicable year will be added.

Time Period Covered: The disclosure will be required for the last five fiscal years, provided a company was subject to disclosure rules during this period.

Interactive Data Format Required: Companies will be required to tag the disclosure in an interactive data format using eXtensible Business Reporting Language, or XBRL.

Covered Companies: The proposed rules apply to all reporting companies, except that foreign private issuers, registered investment companies and emerging growth companies are exempt.

Transition Period: The proposed rules provide a phase-in for all companies. In the first year, companies will be required to provide the information for three years. The fourth and fifth years of disclosure will be added in each subsequent year's annual proxy filing that requires this disclosure.

Rules for Smaller Reporting Companies: These companies are required to provide disclosure for only the last three fiscal years, rather than for five fiscal years. Smaller reporting companies will not be required to include peer group TSR, since they do not disclose either a stock performance graph or a compensation discussion and analysis. In addition, smaller reporting companies will not be required to make adjustments to pension amounts because they are subject to scaled compensation disclosure requirements that do not include disclosure of pension plans. The requirement to tag disclosure in an interactive data format will also be phased-in for smaller reporting companies, so that they will not be required to comply with the tagging requirement until the third annual filing in which the pay-versus-performance disclosure is provided. Initially, smaller reporting companies will provide the information for two years, adding an additional year in the next annual proxy or information statement.

Adjustment to equity award values adds complexity and creates disconnects. By revaluing equity on the date of vesting, timing differences between the TSR calculation and the date(s) of vesting will occur. In addition, compensation actually paid will include tranches of different awards that happen to vest in a particular year so Board decision-making on pay and performance in the year of grant will be unclear.

Process: The proposed rules will be published on the SEC's website and in the Federal Register. The comment period for the proposed rules will last for 60 days after publication in the Federal Register.

CAP'S INITIAL ASSESSMENT OF THE PROPOSED RULES

We applaud the SEC's attempt to improve disclosure and we agree that pay and performance alignment is critical to good governance and effective executive compensation programs. We also agree that some standardization is necessary. Our research indicates that approximately 15% to 20% of S&P 250 companies provide supplemental disclosure of either realized or realizable pay. Currently, there is no standard definition for either formulation of total compensation.

Supplemental pay disclosure is frequently compared to TSR performance, but a consistent approach that can be compared across companies does not exist. The proposed rules impose a standard approach, but at what cost?

We are concerned that the proposed rules are too prescriptive and overly complex. Implementation will burden many companies. The proposed definition of compensation actually paid stands out as our biggest concern. The SEC proposal requires companies to re-value equity awards that vest in each year as of the date of vesting. This approach instantly creates timing differences between the stock prices used in the TSR calculation and the stock prices on the date(s) of equity award vesting. Vesting dates occur throughout the year, but occur most frequently in February – April for calendar year companies. As a result, the proposed approach allows for a re-valuation of equity awards at a more current stock price, but that stock price will likely not correlate with the fiscal year end stock price used in the TSR calculation. This is an obvious disconnect.

In addition, the re-valuation of equity awards for most companies will be composed of tranches of different awards that were granted in different years – likely spanning a three to five year period – that happen to vest in a single year. This approach contributes to confusion around the Board's thinking on pay and performance alignment, rather than increasing clarity. Instead of focusing on the date of vesting, a better approach would be to re-value equity awards *granted* in a single year using a year-end stock price consistent with the TSR calculations.

Finally, to the extent that a company uses stock options, updating the assumptions used in option pricing models, such as Black-Scholes, to reflect the date of vesting will be time-consuming at best. This means that stock options will not only be re-valued at a new stock price, but that other assumptions, such as expected life, volatility, dividend yield and risk-free rates, must also be updated.

Two other aspects of the proposed rules contribute greatly to the compliance burden. First, the requirement to include compensation of the average of the remaining named executive officers in the new table in addition to the compensation of the CEO will be very complicated for companies to work through. Publication of this average based on equity grants made over a three to five year span to at least four executives for five years potentially requires dozens of calculations. The SEC should have limited the new disclosure to the CEO since that would greatly reduce the compliance burden and arguably allow for a simpler and more targeted explanation of the Board's thinking. After all, the CEO normally sets the tone for the entire organization!

The second aspect of the proposed rules that increase the compliance burden is the decision to publish five years of information, rather than three years. Arguably longer time frames are positive when assessing TSR performance, but the summary compensation table shows three years of compensation. Most supplemental disclosure of realized and realizable pay out there today incorporates only three years of compensation and performance data. Even though the SEC provides transition relief, building out the new table to cover five years will be burdensome.

Adjustment to change in pension value is appropriate since it eliminates the impact of changes in assumptions for mortality and discount rates.

We will refine our initial assessment and provide more finely tuned comments back to the SEC during the public comment period. We would not be surprised if the SEC backs off on the date of vesting re-valuation of equity in favor of date of grant re-evaluation. Many will recall that when the proxy disclosure rules were initially proposed, equity award values reflected the amounts recognized for financial reporting purposes. After much public discussion and pushback, the SEC amended the disclosure rules in 2009 to incorporate the grant date fair value of equity awards.

More to come on these points in the next few months! We hope that the SEC achieves consensus on effective pay and performance disclosure before the 2016 proxy season begins.

Please contact us at (212) 921-9350 if you have any questions about the issues discussed above or would like to discuss your own executive compensation issues. You can access our website at www.capartners.com for more information on executive compensation.