

Memorandum

SEC Proposes Pay-Versus-Performance Rule

May 13, 2015

On April 29, 2015, the Securities and Exchange Commission (“SEC”) issued proposed rules to implement the Dodd-Frank Act requirement that issuers disclose in any annual proxy or consent solicitation 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 registrant and any distributions.”¹ In the SEC’s view, this disclosure requirement² is “intended to provide shareholders with information that will help them assess a registrant’s executive compensation when they are exercising their rights to cast advisory votes on executive compensation.” The proposed rule would require registrants to:

- present, in a prescribed table:
 - “total compensation” as disclosed in the Summary Compensation Table, presented separately for the company’s principal executive officer (“PEO”) and as an average for the other named executive officers (“NEOs”) listed in the Summary Compensation Table;
 - executive compensation “actually paid” (as calculated in accordance with the proposed rule), presented separately for the company’s PEO and as an average for the other NEOs listed in the Summary Compensation Table;

¹ [Pay Versus Performance](#), Release No. 34-74835; File No. S7-07-15 (Apr. 29, 2015), at 4 (citing §14(i) of the Securities Exchange Act of 1934) (hereinafter “Release”); *see also* Dodd-Frank Wall Street Reform and Consumer Protection Act § 953(a). Commissioners Daniel Gallagher and Michael Piwowar voted against the proposal.

² Dodd-Frank Added this requirement as Section 14(i) of the Securities Exchange Act of 1934, as amended (the “Exchange Act”).

- the registrant’s cumulative total shareholder return (“TSR”) over the “measurement period”³; and
- the cumulative TSR of the registrant’s peer group over the same “measurement period”; and
- describe the relationship between:
 - executive compensation actually paid and the registrant’s TSR; and
 - the registrant’s TSR and its peer group’s TSR.

Proposed new Item 402(v) of Regulation S-K would codify the disclosure requirement.

- **Registrants Not Subject to the Disclosure.** The proposed pay-versus-performance rule would not apply to:
 - emerging growth companies;
 - foreign private issuers; or
 - registered investment companies.
- **Location of the Disclosure.** The SEC proposes requiring the pay-versus-performance disclosure to be included “in any proxy or information statement for which disclosure under Item 402 of Regulation S-K is required.” The SEC reasons that this would make pay-versus-performance information available to shareholders, “along with all other executive compensation disclosures called for by Item 402, in circumstances in which shareholder action is to be taken with regard to an election of directors or executive compensation.” The SEC does not propose a specific location within the proxy or information statement for the pay-versus-performance disclosure, but “generally expect[s] registrants would disclose it with the Item 402 executive compensation disclosure.” While the proposed disclosure would be provided pursuant to Item 402 and would, therefore, be subject to the say-on-pay advisory vote, it would not need to be included in registration statements or Annual Reports on Form 10-K. Accordingly, a company that does not file a proxy or information statement (*e.g.*, a debt filer) would not be subject to the proposed pay-versus-performance disclosure.
- **Format and Content of the Disclosure.**
 - **Prescribed Table.** As noted above, proposed Item 402(v) would require registrants to provide a table with the following headings:

³ The proposed rule defines “measurement period” as “the period beginning at the “measurement point” established by the market close on the last trading day before the registrant’s earliest fiscal year in the table, through and including the end of the registrant’s last completed fiscal year.” Release at 132.

Pay Versus Performance

Year	Summary Compensation Table Total for PEO	Compensation Actually Paid to PEO	Average Summary Compensation Table Total for non-PEO Named Executive Officers	Average Compensation Actually Paid to non-PEO Named Executive Officers	Total Shareholder Return	Peer Group Total Shareholder Return
(a)	(b)	(c)	(d)	(e)	(f)	(g)

With regard to executive compensation actually paid, disclosed in columns (c) and (e), the proposed rule would require “footnote disclosure for both principal executive officer compensation and average NEO compensation of each amount deducted from, and added to the total compensation amount as provided in the Summary Compensation Table.” According to the SEC, requiring the disclosure of Summary Compensation Table totals in columns (b) and (d) in addition to executive compensation actually paid “would facilitate comparisons of the two measures of a registrant’s executive compensation to the registrant’s performance.”

- The proposed rule would require the disclosure in each column, including any footnote disclosure, to be provided in interactive data format using eXtensible Business Reporting Language (“XBRL”). “The interactive data would have to be provided as an exhibit to the definitive proxy or information statement filed with the Commission, in addition to appearing with and in the same format as the rest of the disclosure provided pursuant to proposed Item 402(v) of Regulation S-K (e.g., in ASCII or HTML).”
- **Disclosure of Relationship Between Executive Compensation and Issuer’s Performance.** In addition to providing the required table, registrants would need to use the values included in the table to describe:
 - the relationship between the executive compensation actually paid and the registrant’s TSR; and
 - the relationship between the TSR of the registrant and that of its peer group.

Under proposed Item 402(v), this disclosure “could be described as a narrative, graphically, or a combination of the two” and would also be required to be provided in XBRL format.

- **Executives Covered by the Disclosure.** Proposed Item 402(v) disclosure would be required for “named executive officers” as defined in Item 402(a)(3) of Regulation S-K, except that smaller reporting companies would use their “named executive officers” required to be disclosed under Item 402(m). The disclosure would not include the issuer’s broader group of executive officers. The SEC reasons that the “named executive officers” are the executive officers for whom compensation disclosure is currently required in the Summary Compensation Table and the SEC’s other executive compensation disclosure

requirements. The SEC also proposes “that, for each year, the compensation information be presented separately for the principal executive officer and as an average for the remaining NEOs identified in the Summary Compensation Table.” For any year in which more than one person served as the PEO of the registrant, the proposed rule would require the disclosure regarding those persons to be aggregated, since this would reflect the total amount the company had paid that year for the services of a PEO.

- **Definition and Calculation of “Executive Compensation Actually Paid”.** The SEC believes that the Dodd-Frank Act’s use of the term “actually paid” signifies Congress’ intention to refer to “an amount distinct from the total compensation as reported under Item 402.” Accordingly, the SEC proposes that for purposes of proposed Item 402(v), “executive compensation actually paid” would be “total compensation as reported in the Summary Compensation Table, modified to adjust the amounts included for pension benefits and equity awards.”
 - **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 Summary Compensation Table.” Accordingly, for purposes of proposed Item 402(v), for each applicable year the registrant would subtract the grant date fair values of the equity awards from the amounts reported in the Summary Compensation Table, and would add in their place the fair values of the equity awards at the vesting date. While the proposed rule does not specify a particular valuation method to be used, “[a]s proposed, a registrant would be required to disclose vesting date valuation assumptions if they are materially different from those disclosed in its financial statements as of the grant date.”
 - **Actuarial Pension Value.** Under the proposed rule, for each applicable year changes in actuarial present value of all defined benefit and pension plans would be deducted from the Summary Compensation Table total. However, “the actuarially determined service cost for services rendered by the executive during the applicable year [would] be added back.” According to the SEC, the resulting amount “may be viewed to approximate the value that would be set aside currently by the registrant to fund the pension benefits payable upon retirement for the service provided during the applicable year.”
 - **Earnings on Non-Qualified Deferred Compensation.** As with the current disclosure requirements of the Summary Compensation Table, “the compensation calculation under proposed Item 402(v) would include above-market or preferential earnings on deferred compensation that is not tax-qualified because these amounts represent compensation accrued during the relevant year.”

The proposed rule would allow registrants to supplement the mandated disclosure “by providing pay-versus-performance disclosure based on a measure of ‘realized pay,’ ‘realizable pay,’ or other appropriate measure if they believe it provides useful information about the relationship between compensation and registrant performance, provided that the supplemental disclosure is not misleading and not presented more prominently than the required disclosure.”

- **Measure of Registrants' Financial Performance.** Under the proposed rule, registrants would be obligated to use TSR as the measure of their financial performance for purposes of pay-versus-performance disclosure. The SEC believes that using this “consistently calculated measure” would “increase the comparability of pay-versus-performance disclosure across registrants,” provide an objectively determinable measure based on the registrant’s share price, and reduce the burden placed on registrants as a result of the disclosure given that TSR is a measure that they are already required to determine and disclose. The proposed rule would allow registrants to include supplemental measures of financial performance in their disclosures “so long as any additional disclosure is clearly identified, not misleading and not presented with greater prominence than the required disclosure.” With regard to calculating peer group TSR, the proposed rule requires that the returns of each issuer in the group be weighted in accordance with its respective market capitalization “at the beginning of each period for which a return is indicated.”
- **Determination of Peer Group.** For purposes of disclosing peer group TSR, registrants can either use:
 - the peer group they use for purposes of Item 201(e) of Regulation S-K; or
 - a peer group they use in the Compensation Discussion and Analysis (“CD&A”) for purposes of disclosing their compensation benchmarking practices.

Under the proposed rule, “[i]f the peer group is not a published industry or line-of-business index, the registrant would be required to disclose the identity of the issuers”; issuers would, however, be permitted to comply with this requirement through incorporation by reference to earlier filings that contain this information.

- **Time Period Covered by the Disclosure.** Under the proposed rule, registrants would be required to provide pay-versus-performance disclosure for the five most recently completed fiscal years, except that smaller reporting companies could use only the three most recently completed fiscal years.
 - **Transition Period.** In the first proxy or information statement filed after the rule becomes effective, registrants would be required to provide the proposed Item 402(v) disclosure for three fiscal years (or two years for smaller reporting companies); they would then be required to “provide disclosure for an additional year in each of the two subsequent annual proxy filings where disclosure is required.” In addition, under the proposed rule, a company need only provide pay-versus-performance disclosure for years that it was a reporting company pursuant to Section 13(a) or Section 15(d) of the Exchange Act. Accordingly, a newly-reporting registrant would be required to provide the disclosure for only the most recently completed fiscal year in any applicable filing in its first year as a reporting company, and would be required to provide the disclosure for the two most recently completed fiscal years in any applicable filing in its second year as a reporting company.
- **Smaller Reporting Companies.** In addition to being required to provide Item 402(v) disclosure only for the three most recently completed fiscal years, smaller reporting companies:

- would not need to “disclose amounts related to pensions for purposes of disclosing executive compensation actually paid because they are subject to scaled compensation disclosure that does not include pension plans”;
- would not be required to provide a peer group TSR; and
- would not need to provide pay-versus-performance disclosure in XBRL format until the third filing in which it provides such disclosure

Takeaways from the Proposed Rule

- **Prepare Draft Disclosure.** Companies should consider drafting a mock-up of their pay-versus-performance disclosure. Since the proposed rule would allow issuers flexibility in deciding which peer group they want to use for purposes of the rule, issuers may want to prepare separate draft disclosures using the peer group included in their CD&A and the same index or issuers they use for purposes of Item 201(e) of Regulation S-K.
- **Review Peer Group.** This is a good time for registrants to review their peer group. In light of the proposed rule, as part of this review, companies should take into account the market capitalizations of the companies in their peer group.
- **Revise Timeline.** Registrants should be mindful that they may need to build in extra time in their timelines to allow for formatting the disclosure using XBRL.
- **Update Compensation Committee.** Consider updating the compensation committee on the proposed rule. The compensation committee may request that management begin to engage in dialogue with the company’s compensation consultants regarding what additional information they plan to present to the committee as a result of the pay-versus-performance disclosure requirement, as well as the format and content of the company’s proxy disclosure management should consider.

The SEC set a 60-day period for public comment on its proposed rule. Issuers will be required to include pay-versus-performance disclosure in the first proxy or information statement they file after the final rule becomes effective. Although it is unknown when the rule will be finalized, it is possible that disclosure will be required for the 2016 proxy season.

If you have any questions or would like additional information, please do not hesitate to contact **Yafit Cohn** at +1-212-455-3815 or yafit.cohn@stblaw.com, any other member of the Firm's Public Company Advisory Practice or any of the following members of the firm's Executive Compensation and Employee Benefits Practice:

NEW YORK CITY

Greg Grogan

+1-212-455-2477
ggrogan@stblaw.com

Larry Moss

+1-212-455-2280
larry.moss@stblaw.com

Brian D. Robbins

+1-212-455-3090
brobbins@stblaw.com

David Rubinsky

+1-212-455-2493
drubinsky@stblaw.com

PALO ALTO

Tristan M. Brown

+1-650-251-5140
tbrown@stblaw.com

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UNITED STATES

New York
425 Lexington Avenue
New York, NY 10017
+1-212-455-2000

Houston
600 Travis Street, Suite 5400
Houston, TX 77002
+1-713-821-5650

Los Angeles
1999 Avenue of the Stars
Los Angeles, CA 90067
+1-310-407-7500

Palo Alto
2475 Hanover Street
Palo Alto, CA 94304
+1-650-251-5000

Washington, D.C.
1155 F Street, N.W.
Washington, D.C. 20004
+1-202-636-5500

EUROPE

London
CityPoint
One Ropemaker Street
London EC2Y 9HU
England
+44-(0)20-7275-6500

ASIA

Beijing
3919 China World Tower
1 Jian Guo Men Wai Avenue
Beijing 100004
China
+86-10-5965-2999

Hong Kong
ICBC Tower
3 Garden Road, Central
Hong Kong
+852-2514-7600

Seoul
West Tower, Mirae Asset Center 1
26 Eulji-ro 5-gil, Jung-gu
Seoul 100-210
Korea
+82-2-6030-3800

Tokyo
Ark Hills Sengokuyama Mori
Tower
9-10, Roppongi 1-Chome
Minato-Ku, Tokyo 106-0032
Japan
+81-3-5562-6200

SOUTH AMERICA

São Paulo
Av. Presidente Juscelino
Kubitschek, 1455
São Paulo, SP 04543-011
Brazil
+55-11-3546-1000