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Anticipating SEC's Final Exec Compensation Disclosure Rule

By **Jake Downing, Elizabeth Morgan and Jessica Stricklin**
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On Feb. 2, the U.S. Securities and Exchange Commission officially reopened the comment period for its proposed rule on so-called pay versus performance disclosures, which was originally published on May 7, 2015, but never finalized. The comment period reopened following the SEC's move to refloat the proposed rule on Jan. 27.

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The proposed rule is intended to implement the pay versus performance disclosures required under Section 953(a) of the Dodd-Frank Wall Street Reform and Consumer Protection Act. The original proposed rule would require tabular disclosure focusing on the relationship between compensation actually paid to executives and the cumulative total shareholder return of the issuer and a peer group.

Elizabeth Morgan

In reopening the comment period, the SEC sought comments on potentially broadening the original proposed rule to require disclosure of three additional financial performance metrics in addition to total shareholder return: pretax net income, net income and a company-selected measure.

The 30-day comment period for the proposed rule expires at midnight on March 4.[1]

This article provides an overview of the pay versus performance proposed rule and next steps for issuers in considering how to plan if the rule will become final more than a decade after the Dodd-Frank Act originally introduced the requirements.

Jessica Stricklin

Section 953(a) of the Dodd-Frank Act requires the SEC to issue regulations that require issuers to disclose in their annual proxy statement 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.

Accordingly, the law provides the SEC wide latitude on how to implement the requirement through regulation. Given the limited direction provided by the Dodd-Frank Act, the SEC's only clear mandate is to require issuers to disclose compensation actually paid compared to the "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 SEC is left to prescribe, among other things:

- How to value the compensation actually paid;
- When and how often to value the compensation actually paid;
- What method or methods are appropriate for determining the change in value of the issuer's shares; and
- What method or methods are appropriate for comparing the value of the compensation actually paid to the change in value of the issuer's shares.

The proposed rule attempts to address each of these open questions by prescribing a tabular disclosure to be included in the issuer's annual proxy statement. This tabular disclosure would require:

- Summary compensation total for the principal executive officer;
- Compensation actually paid to the principal executive officer;
- Average compensation actually paid to named executive officers who are not the principal executive officer;
- Total shareholder return; and
- Peer group total shareholder return.

The proposed rule requires the above information for the issuer's previous five fiscal years — three in the case of small reporting companies.

Much of the information in the newly required table will come from the existing summary compensation table already included in the annual proxy.

One key distinction includes a requirement that the compensation actually paid to the principal executive officer and other named executive officers have different valuation principles — most importantly, that the value of equity grants are determined on the vesting date instead of the grant date, and the compensation actually paid to named executive officers who are not the principal executive officer are averaged across these executives.

In addition, the actual compensation figures would exclude the actuarial present value of benefits under defined benefit and actuarial pension plans that are not attributable to the applicable year of service. Put another way, the disclosure of compensation actually paid will largely come from existing compensation-related disclosures but will be valued and presented in a different manner.

The key change from existing disclosures then is the requirement to compare these compensation calculations to the issuer's total shareholder return and the total shareholder return of the issuer's peer group. Small reporting companies are currently excluded from disclosing the total shareholder return of their peer group.

For issuers using actual and relative total shareholder return performance metrics, this additional disclosure may align with the issuer's pay practices and be a relatively benign additional disclosure step.

For those using different metrics to measure performance, a tabular comparison of compensation actually paid to a total shareholder return benchmark may understate or overstate how the compensation correlated to the performance benchmarks that the issuer independently determined to be the most important for purposes of measuring issuer performance and paying its executives.

To potentially address the concern of tabular disclosures of pay versus performance that do not align with how the issuer believes performance is best measured, the SEC requested comment in the reopened comment period on whether the following three additional financial performance measures should be included in the table:

- Pretax net income;
- Post-tax net income; and
- An issuer-selected measure that is the most important performance measure used to link compensation actually paid to performance not already included in the table.

If finalized, the tabular disclosure could have as many as five performance measures for issuers to compare actual compensation paid to the principal executive officer and other named executive officers — i.e., actual total shareholder return, relative total shareholder return, pretax net income, post-tax net income and an issuer-selected measure.

The SEC further requested comment on whether to require issuers to provide a separate table ranking their top five performance measures used to link compensation actually paid to issuer performance.

While all of these measures could be reasonably debated as useful comparative figures when reviewing compensation actually paid to the principal executive officer and other named executive officers, requiring the inclusion of all of these in a single table will be costly to prepare.

Also, it is unclear that institutional investors have been requesting this additional detail, and the contemplated presentation could be confusing to investors in terms of showing how executive pay actually related to performance during the covered period.

An area of concern in the request for comments is the SEC's request for feedback on what would be appropriate for issuers to include when disclosing any issuer-specific performance measure. Of particular concern is the SEC's suggestion to potentially require issuers to separately list the five most important performance measures when determining executive compensation.

Requiring this level of detail when disclosing pay versus performance will lead to significant time and expense for the issuer to evaluate how to comply with this disclosure requirement and introduce additional disclosures that go beyond the mandate provided in the Dodd-Frank Act. Issuers would be forced to rank their performance measures for the purpose of completing the newly required table, which is not a common practice.

As we wait for the SEC to react to public comment on the proposed rule, the hope is that the SEC will

reconsider how both the original proposed rule and the newly suggested updates are implemented, and will issue a final rule that is less prescriptive and provide issuers more flexibility in disclosing how compensation actually paid correlates to issuer performance.

This would be consistent with — rather than a departure from — the existing principles-based approach in the compensation disclosure and analysis section of the annual proxy statement, where issuers are expected to provide a customized narrative disclosure explaining key elements of their compensation program.

Given the language of Section 953(a) of the Dodd-Frank Act, the SEC has the flexibility to simplify the disclosure obligation and provide more generalized guidance.

For example, it would be consistent with the language of the Dodd-Frank Act to compare compensation actually paid to actual total shareholder return and then permit the issuer to include a column or columns comparing actual compensation paid to the performance measure or performance measures the issuer viewed as most important when setting its executive compensation targets.

In the meantime, issuers may find it worthwhile to prepare mock disclosures based both on the original proposed rule and the updated proposed rule inclusive of the additional financial performance measures.

As part of this exercise, issuers should consider which performance measures they use when determining compensation for named executive officers, whether any refinements might be warranted in light of the proposed rule, and how the narrative around those measures ties with the issuer's investor relations messaging, both in earnings disclosures and engagement.

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[1] https://www.federalregister.gov/documents/2022/02/02/2022-02024/reopening-of-comment-period-for-pay-versus-performance.