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When "Compensation Actually Paid" is Not Compensation Actually Paid and "Company Financial Performance" May be Unrelated to Company Financial Performance

On April 29, 2015, the SEC voted to propose rules requiring public companies to disclose the relationship between compensation actually paid and company financial performance. The proposal comes almost five years after the Dodd-Frank Wall Street Reform and Consumer Protection Act imposed on the SEC the obligation to craft these rules through Section 14(i) of the Securities Exchange Act of 1934.

"Pay for performance" has long been the *cri de coeur* of governance activists, institutional investors, compensation consultants and proxy advisors, but the methodologies for measuring compensation and financial performance have not been embraced on a uniform basis. Currently, many companies voluntarily provide information that could fit these disclosure imperatives, but there is little consistency in definitions, time period or manner of calculation. Dodd-Frank did not define "compensation actually paid" or "financial performance" and instead directed the SEC to do so through rulemaking. Imposition of standardized requirements as a result of this rulemaking is intended by the SEC to help investors better evaluate executive pay and make comparisons among companies. However, the proposed new definition of "compensation actually paid" employs accounting measures that may not even approximate amounts actually paid, and the stock price metric designed to measure "company financial performance" might reflect the vagaries of the stock market as much or more than it does changes in a company's actual financial performance. As a result, we may find that the SEC's rulemaking, if adopted as proposed, not only compounds the complexity of proxy disclosure, but also fails to provide the insights or analysis necessary to satisfy investors.

Although this rulemaking is certainly less controversial than the pay-ratio rules that the SEC proposed in 2013 but has yet to finalize, it nevertheless drew the ire of two dissenting Commissioners. The almost five-year delay in proposing rules to implement Section 953 of Dodd-Frank notwithstanding, Commissioners Daniel Gallagher and Michael Piwowar still rejected the notion that time devoted to crafting and considering the proposal was well spent. In their view, the SEC should have put this rulemaking aside and focused its attention on rules meant to address problems associated with the financial crisis.

The proposed new disclosure, which would be set forth in new Item 402(v) of Regulation S-K, would be required in any proxy or information statement for which disclosure under Item 402 of Regulation S-K is required and would be subject to the advisory say-on-pay vote. However, the new disclosure would not be deemed to be incorporated by reference into any filing under the Securities Act or the Exchange Act, except to the extent that a company specifically incorporated it by reference.

The disclosure would not be required for foreign private issuers, registered investment companies or emerging growth companies, and smaller reporting companies would be subject to scaled reporting requirements.

The proposed rules are subject to public comment until July 6, 2015. Although it is not known whether and when the proposed rules might be adopted, it is possible, if the SEC acts promptly, that they might be in effect for the 2016 proxy season. The proposed new disclosure will be required in the first applicable filing after the rules become effective.

The proposed rules are discussed in more detail below.

The pay-versus-performance table

The proposed new rules would require tabular disclosure of "total compensation" as shown in the company's Summary Compensation Table (SCT), as well as a new measure of "compensation actually paid," for a phased-in five-year period. The company would be required to show these data separately for the principal executive officer (PEO) and as an average for the other named executive officers (NEOs). As discussed in more detail below, compensation actually paid uses the total compensation measure included in the SCT, with adjustments to the amounts disclosed for pension benefits and equity awards. The SEC believes that providing both calculations of compensation in one table would facilitate comparisons of the two measures. The company would also be required to disclose in the table the company's cumulative total shareholder return (TSR) and the cumulative TSR for a selected peer group.

Companies would be permitted to supplement the required disclosure by providing measures of "realized pay," "realizable pay" or other appropriate measures of compensation paid, as well as supplemental measures of financial performance, so long as any additional disclosure is clearly identified, not misleading and not presented with greater prominence than the required disclosure.

The format of the required table is illustrated below:

Pay versus performance

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

Observations and commentary

Interestingly, the proposing release itself notes that a "report by the Senate Committee on Banking, Housing and Urban Affairs indicated that the rules mandated by Section 953(a) of the Dodd-Frank Act were not intended to be overly-prescriptive and that Congress recognized that there could be many ways to disclose the relationship between executive compensation and financial performance of the registrant." That language seems to support the key objection to the proposal advanced by the two dissenting Commissioners, both of whom rejected the proposal largely because they viewed it as too prescriptive, and particularly because of its prescription to use TSR as the financial performance metric. Both dissenting Commissioners would have much preferred a principles-based version of the rule. Commissioner Gallagher's preferred alternative, as expressed at the open meeting to consider the proposal, was "to admit that we have not solved the very difficult question of how to align executive pay with performance. Perhaps because we shouldn't be involved in that determination in the first place. But if we are forced to take it on, then we should give issuers the flexibility to determine how best to communicate their compensation story to investors, provided they meet the general principles set out in the statute."

Time period covered

To provide a meaningful period over which a relationship between annual measures of pay and performance could be evaluated, the SEC proposed that disclosure be required for each of the five most recently completed fiscal years (three years for smaller reporting companies). Reporting would be phased in starting with three years of disclosure, increasing annually to five years and, for smaller reporting companies, starting with two years, increasing to three. For example, if the rules were effective for the 2016 proxy season, the table in the 2016 proxy statement (for a company other than a smaller reporting company) would include three years of compensation data, with each year presented separately, and three years of TSR information, presented cumulatively. For newly reporting companies, disclosure would start with one year and annually phase in the remaining years.

Executives covered

Under the proposed rules, the compensation actually paid and total compensation would be required to be shown separately for the PEO and as an average for the other NEOs. If more than one person served as PEO in any year, their compensation would be aggregated for that year. The SEC believes that using an average for the NEOs would be most appropriate, particularly because of the possible variability in the number and composition of the NEOs over the period.

Observations and commentary

Aggregating compensation for multiple PEOs could be quite misleading. First, the rules regarding SCT disclosure provide that, if an individual served in the capacity of PEO during any part of a covered fiscal year, information about the individual's compensation for the full fiscal year is required to be disclosed, even if that compensation does not relate to the individual's service as PEO. Moreover, total compensation will include amounts paid or accrued in connection with a termination of employment and potentially could include all payments triggered by the termination, even if those termination payments will be deferred or paid in subsequent years. As a result, the amounts shown for PEO compensation in any year when a PEO has departed could be substantially inflated. In that event, companies will certainly want to add explanatory footnotes or narrative.

Calculation of "compensation actually paid"

Compensation actually paid, as calculated under the proposed rules, relies on the measure of total compensation in the SCT, but with two adjustments to the amounts included for pension benefits and equity awards. Those adjustments must be disclosed in footnotes to the two columns showing compensation actually paid.

Pension benefits adjustment. The SCT discloses the aggregate year-over-year change in the actuarial present value of an NEO's pension benefits. For purposes of the calculation of pension benefits actually paid, only the actuarial present value of benefits attributable to services rendered during the applicable fiscal year would be included. Accordingly, companies would be required to deduct from the value reported in the SCT the positive change in the actuarial present value of all defined benefit and actuarial pension plans that resulted solely from changes in interest rates, the executive's age and other actuarial inputs and assumptions regarding benefits accrued in previous years. As a result, the amount included in computing compensation actually paid would be comparable to disclosure in the SCT for a defined contribution plan such as a 401(k) plan.

Equity awards adjustment. The SCT discloses the aggregate fair value of equity awards at the date of grant calculated in accordance with the fair value guidance in FASB ASC Topic 718. For purposes of the calculation of compensation actually paid, equity awards would be considered actually paid on the date of vesting and would be valued at fair value as of that date. Accordingly, companies would be required to deduct from total compensation as reported in the SCT the amounts reflected in the Stock Awards and Option Awards columns and instead include, for awards of stock or options that vested in the applicable year, the fair value at the vesting date regardless of when such equity awards were granted. If there were multiple vesting dates within the applicable year, the pro rata incremental fair value would be determined at each vesting date and included in compensation actually paid.

Footnotes to the table. Companies would be required to disclose in the footnotes the individual adjustments to the amounts reported in the SCT to arrive at compensation actually paid, and, for NEOs other than the PEO, those adjustments would be disclosed as averages. Companies would also be required to disclose vesting date valuation assumptions, but only if they are materially different from those disclosed in the financial statements with regard to the grant date valuation.

Observations and commentary

- For equity awards, the SEC selected the date of vesting rather than the date of exercise or sale as the date of "payment" by the company because it believes that, once the award is vested, the executive can control when to exercise and sell, and changes in its fair value "generally reflect investment decisions made by the executive rather than compensation decisions" made by the company. In addition, the SEC believes that shareholders may be interested in vesting date valuation assumptions to the extent they believe that changes in the value of equity grants after the grant date reflect performance and, therefore, represent a mechanism through which pay is linked to company performance.
- SCT pay is a mix of some elements of compensation actually paid and some elements that reflect accounting estimates of potential future pay. While disclosing compensation actually paid may serve to better show the alignment between pay and performance, the new definition of "compensation actually paid" is not compensation actually paid. Under the proposed rules, equity awards are still valued in accordance with the accounting guidance, but they are valued as of the vesting date instead of the grant date. The accounting value on the vesting date may be higher or lower than the spread between the exercise price and the price of the stock on the stock market as of the vesting date or, in other words, the amount that the individual would actually receive if he exercised and sold his shares on the vesting date. Further, while the SEC notes that equity awards should be valued on the vesting date instead of the exercise or sale date because deciding to exercise or sell is an investment decision, an NEO does not realize any actual compensation until a stock option is exercised. An alternative view was suggested in the discussion regarding realized compensation by The Conference Board Working Group on Supplemental Pay Disclosure, which argued that options should not be included until exercised, at which point the gains could be compared to the corresponding return to shareholders over the period the options were outstanding: "[v]aluing stock options at the vesting date," the working group contended, "would add a lone hypothetical number to the realized pay disclosure, which is inconsistent with pay actually received."

Measure of performance

As proposed, companies would be required to use TSR to reflect their financial performance over a phased-in five-year period (three years for smaller reporting companies). Companies, other than smaller reporting companies, would also be required to disclose peer group TSR, weighted according to market cap and using the same index or peer group used for purposes of the "performance graph" under Regulation S-K, Item 201(e), or, if applicable, the companies disclosed in the CD&A for purposes of disclosing the company's compensation "benchmarking" practices. If the peer group were not a published industry or line-of-business index, the composition of the peer group would need to be disclosed or incorporated by reference from prior filings. TSR would be calculated in the same way that it is calculated for the performance graph, which assumes dividend reinvestment. For each fiscal year in the table, the amount included for the company and its peer group would be the cumulative TSR as of the end of that year, which means that the measurement period would begin with the market close on the last trading day before the earliest fiscal year in the table, through and including the end of the company's last completed fiscal year.

Observations and commentary

- The SEC contends that using TSR as a measure of financial performance is advantageous because it is objectively determinable from share prices. Moreover, the SEC maintains, using TSR should increase the comparability across companies and reduce burdens on companies and shareholders because companies are already required to determine TSR and shareholders are already familiar with it. However, both Commissioners Gallagher and Piwowar were dubious that TSR would be an appropriate measure for all companies, and, in her public statement, even SEC Chair Mary Jo White requested comment on whether TSR was the optimal measure to use here. The two dissenters viewed a stock price metric as potentially inaccurate, insufficiently nuanced and subject to potential "gaming" by management through conducting stock buybacks, cutting research and development spending to inflate profits and other timing strategies, resulting in an overemphasis on short-term performance to the detriment of long-term performance.
- Those views have been largely echoed by critics of reliance on TSR from both ends of the political spectrum. In addition to concerns regarding possible manipulation of stock price, some critics have argued that TSR is not an appropriate measure because it varies for reasons that are well beyond the control or influence of the company's executives, including factors such as central bank policies, macroeconomics and global politics. In addition, critics suggest that stock price-based metrics can mask a decline in a company's economic value. A more accurate performance measure, some critics contend, would be economic profit, *i.e.*, net operating profit minus a capital

charge for invested capital. A letter from Public Citizen cited in the SEC's release recommended the use of four performance measures: total shareholder return, return on assets, return on equity, and the growth in earnings per share. Notwithstanding these criticisms, however, the SEC might feel hamstrung in selecting a significantly different measure from TSR in light of the Dodd-Frank mandate to take into account, in presenting company performance, changes in the stock value and any distributions, and it may view multiple or combined measures as too complex for shareholders to understand or too burdensome to impose on companies. Nevertheless, we would not be surprised to see the SEC receive substantial pushback on this aspect of the rule proposal in particular.

- Proxy advisory firms have been measuring pay for performance since before Dodd Frank mandated say-on-pay votes. Institutional Shareholder Services (ISS) uses TSR as the sole measure of company performance in its quantitative screens, while, for most companies, Glass Lewis currently uses change in operating cash flow, EPS growth, return on equity and return on assets in addition to TSR in its quantitative pay-for-performance model. Each firm selects its own peer group to compare a company's relative pay and performance and each firm has its own methodology for calculating realizable pay. The proxy advisory firms' one-size-fits-all calculations have long been subject to criticism, and it remains to be seen whether they will modify their policies with regard to the new pay-versus-performance disclosure.
- Interestingly, Dodd Frank did not mandate the peer group TSR disclosure required by the proposed rules. In its release, the SEC said it believes disclosure about a company's TSR and its peer group TSR would provide information that investors can use to compare a company's performance with that of its peers and "may provide a useful point of comparison to assess the relationship between the registrant's executive compensation actually paid and its financial performance compared to the performance of its peers during the same time period." This requirement could lead companies that do not technically benchmark, but rather use peer groups for general market check purposes, to spend additional time refining a peer group more often than they otherwise would for purposes of assisting with executive compensation decisions. Nevertheless, companies and investors may welcome disclosure of peer group TSR, which may help to moderate the impact of stock price movement that is outside a company's control or that affects the industry or market generally.

Description of relationship of compensation to performance

Following the table, the new rules would also require a description, in narrative or graphic form or both, of the relationship of compensation actually paid to executives as shown in the table compared to the company's financial performance as reflected in its TSR, as well as a description of the relationship of the company's TSR to the TSR of the peer group. The SEC does not discuss the elements of any potential narrative presentation, other than that it should be in "plain English." However, the SEC does provide two examples of possible graphic presentations: first, a presentation showing executive compensation actually paid and change in TSR on parallel axes, plotting compensation and TSR over the required time period; and second, a presentation showing the percentage change over each year of the required time period in both executive compensation actually paid and TSR, together with a brief discussion of that relationship.

Observations and commentary

Although the SEC offers some suggestions for potential graphic presentations, it provides no direction with regard to the nature of any narrative disclosure. However, we anticipate that, in most circumstances, companies will want to provide some narrative explaining any issues or assumptions, the reasons underlying changes reflected in the table over time and the reasons why TSR may or may not reflect actual financial performance.

Data tagging using XBRL

The SEC is also proposing that the disclosure provided in each column of the proposed table, including any footnote disclosure, be data-tagged using XBRL, marking the first time that data-tagging would be required for companies outside the financial statements. Companies would need to tag the values disclosed in the required table separately, and to separately block-text tag the disclosure of the relationship among the measures, along with the required footnote disclosure of adjustments to total compensation and disclosure regarding vesting date valuation assumptions.

Smaller reporting companies would be allowed a phase-in and would not be required to provide the data in XBRL until the third filing in which they provide pay-versus-performance disclosure.

Observations and commentary

There appeared to be a lot of enthusiasm among the Commissioners for mandating data-tagging with XBRL. The SEC opined that requiring data-tagging would lower the cost to investors to collect data and facilitate analysis and comparison across multiple companies. However, not all subscribe to that perspective. Many companies have viewed XBRL as expensive and time-consuming, cutting into time needed for internal analysis, especially in light of the abbreviated time frames for filing periodic reports. What's more, a study from Columbia Business School showed that analysts and investors—the intended beneficiaries of XBRL—remain skeptical about XBRL, have many concerns about its utility and accuracy and, most significant of all, are apparently not using it.

Scaled disclosure for smaller reporting companies

In addition to reduced reporting periods (discussed above), smaller reporting companies would also be subject to scaled disclosure. Because they do not disclose pension amounts in the SCT, smaller reporting companies would not be required to disclose amounts related to pensions for purposes of calculating compensation actually

paid. Similarly, because they are not required to present a performance graph or a CD&A, they would not be required to include peer group TSR in the pay-versus-performance table.

Location of disclosure

Although the SEC is not proposing a specific location for the new disclosure other than that it be included with the other executive compensation information, the release suggests that the disclosure would be appropriate as a supplement to CD&A in that it would "provide a useful point of comparison for the analysis provided in the CD&A about a compensation committee's approach to linking pay and performance" and enhance the ability of shareholders to evaluate compensation practices and policies, particularly for purposes of voting on say-on-pay proposals and in connection with elections of directors. However, companies have the flexibility to locate the disclosure outside of the CD&A if, for example, they viewed the location in CD&A to incorrectly suggest that they considered the disclosed pay-versus-performance relationship in making their compensation decisions.

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Key Contacts

Kenneth Guernsey **San Francisco**	**kguernsey@cooley.com** **+1 415 693 2091**
Cydney Posner San Francisco	cposner@cooley.com +1 415 693 2132
Sam Livermore San Francisco	slivermore@cooley.com +1 415 693 2113
Thomas Welk San Diego	twelk@cooley.com +1 858 550 6016

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