

## Background

In its most recent action dealing with the controversial topic of executive pay, on Wednesday, April 29, 2015, the Securities and Exchange Commission (SEC) voted 3 - 2 to approve proposed rules regarding pay-for-performance in the wake of the Dodd-Frank Act.<sup>1</sup> The proposed rule is intended to require companies to show, typically in their annual proxy statement, the relationship between the amount of executive compensation actually paid and the company's financial performance. This proposal is separate from the pay ratio disclosure rule proposed by the SEC in September 2013 that would require companies to disclose the pay gap between CEOs and ordinary employees,<sup>2</sup> and we are not expecting that proposed rule to be re-addressed by the SEC until at least the second half of 2015.

SEC Chair Mary Jo White stated, "These proposed rules would better inform shareholders and give them a new metric for assessing a company's executive compensation relative to its financial performance . . . The proposal would require enhanced disclosure that can be compared across companies."<sup>3</sup> Chair White also opined that the proposed new disclosures could help guide investors with say-on-pay votes as well as in director elections, helping shareholders to evaluate directors' oversight of this area.<sup>4</sup>

## Proposed Rule

### Required Tabular Disclosure.

The SEC proposes a template pay-versus-performance table which uses cumulative total shareholder return (TSR) as the measure of company financial performance, showing the relationship between executive compensation paid to its named executive officers (NEOs) and its TSR and the relationship between the company's TSR and the TSR of a peer group chosen by the company. The proposed rule has somewhat less burdensome requirements for smaller reporting companies.

### Specifically:

- In calculating **executive compensation**, companies can use the figures contained in the summary compensation table as presented in the proxy statement. Such information must be modified, however, to exclude changes in actuarial present value of benefits under defined benefit and actuarial pension plans that are not attributable to the applicable year of service, and to include the value of equity awards at vesting rather than when granted. These modifications are intended to present a clear picture of "actual" executive pay.
- **TSR** is measured by dividing the sum of the cumulative amount of dividends for the measurement period, assuming dividend reinvestment, and the difference between the company's share price at the end and the beginning of the measurement period, by the share price at the beginning of the measurement period (as per Item 201(e) of Regulation S-K).
- In selecting its **peer group** for purposes of this disclosure, a company may either use its peer group utilized in its stock performance graph, or its peer group used in the Compensation Discussion and Analysis (CD&A) for benchmarking compensation practices.

For a company's chief executive officer (CEO), information must be presented separately, whereas for the remaining NEOs, the amount disclosed need only be the average compensation paid to those executives.

Generally, companies would provide the disclosure for three fiscal years, instead of five, in their first applicable filing, and would then provide disclosure for an additional year in each of the two subsequent annual proxy filings.

### Practical Implications:

- If adopted, the proposed rules could make it easier for investors to determine whether NEO compensation is in lock-step with a company's financial performance. Conversely, however, applying the same metric to all companies imposes a "one-size-fits-all" standard of calculating a company's performance that may not fairly present the link between performance and compensation for all companies.
- For those companies that have historically used TSR as a compensation metric for performance, this disclosure will likely not be overly onerous. However, establishing pay-for-performance metrics could pressure companies who lag behind their peers in this area to change their practices. Also, companies who may already use performance share programs but do not use TSR as a metric may be swayed to change their metrics to include TSR for ease of disclosure.

1 The SEC's pay-for-performance rule release can be found at <http://www.sec.gov/news/pressrelease/2015-78.html>. The full text of the proposed rule(s) can be found at: <http://www.sec.gov/rules/proposed/2015/34-74835.pdf>.

2 The SEC's rule release on pay ratio disclosure can be found at <http://www.sec.gov/News/PressRelease/Detail/PressRelease/1370539817895>. The full text of the proposed rule(s) can be found at <http://www.sec.gov/rules/proposed/2013/33-9452.pdf>.

3 SEC's pay-for-performance rule release, supra n. 1.

4 SEC Votes 3-2 to Propose Executive Compensation Rules, April 29, 2015, Dow Jones, <http://news.morningstar.com/all/dow-jones/the-economy/2015042912742/sec-votes-3-2-to-propose-executive-compensation-rules.aspx>.

This new proposed mandate will likely add to the cost and time of preparing disclosures, which should be taken into account. In particular, companies that do not already utilize TSR as a performance metric in relation to its compensation will want to review its potential disclosure ramifications. All companies will want to consider their peer group compositions and which group will be best for this disclosure, and any appropriate adjustments to be made. Further, companies should consider whether this disclosure should be a part of their internal compensation discussions and decisions in the future.

For additional information about the proposal, please contact your principal Squire Patton Boggs lawyer or any of the lawyers listed in this Alert.

## Contacts

**Daniel G. Berick**

Americas Chair  
+1 216 479 8374  
daniel.berick@squirepb.com

**Abby E. Brown**

+1 202 457 5668  
abby.brown@squirepb.com

**Wendy K. LaDuca**

+1 202 457 5686  
wendy.laduca@squirepb.com

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