Harvard Law School Forum on
Corporate Governance and Financial Regulation

SEC Releases Proposed Rules on Dodd-Frank Pay vs. Performance Disclosure Rule

Posted by Michael J. Segal, on Monday, May 4, 2015

Editor's Note: Michael J. Segal is partner in the Executive Compensation and Benefits Department of Wachtell, Lipton, Rosen & Katz. This post is based on a Wachtell Lipton memorandum by Mr. Segal, Andrea K. Wahlquist, and David E. Kahan.

On April 29, 2015, the SEC released proposed rules under Section 953(a) of the Dodd-Frank Act, regarding required proxy and other information statement disclosure of the relationship between executive compensation actually paid by a company, and the company's financial performance. The proposed rules are subject to public comments for 60 days following their publication in the Federal Register. The new requirements could become effective as early as the 2016 proxy season.

The proposed rules would require the inclusion in the proxy of a new table, titled "Pay versus Performance," requiring disclosure of information in the following columns:

a. **Year**. The most recent three fiscal years must be included for the first year the rule is effective; for the second year, the most recent four fiscal years, and thereafter the most recent five fiscal years. Thus, once fully implemented, the table would cover two years of historical information in addition to those covered by the other compensation disclosures in the proxy.
b. **Summary Compensation Table Total for PEO**. If more than one person was the principal executive officer (PEO) during the applicable year, their compensation (as shown in the proxy's summary compensation table) must be aggregated for this column and column (c).
c. **Compensation Actually Paid to PEO**. This column would reflect the column (b) compensation, *reduced by* the reported value of pension accruals and stock awards (which are generally reported in the year granted based on grant-date fair value), and *increased by* the vesting-date fair value of stock awards which vest during the year, and the service cost of pension accruals for the year. These deductions and additions must be explained in footnotes.
d. **Average Summary Compensation Table Total for non-PEO Named Executive Officers**. This column would reflect the average compensation for all non-PEO named executive officers, based on the compensation shown in the proxy's summary compensation table. Note that the aggregation requirement of column (b) for PEOs does not appear to apply with respect to the principal financial officer position, even though all individuals who held that position during the year must be classified as named executive officers.

e. **Average Compensation Actually Paid to non-PEO Named Executive Officers**. The disclosure in this column would be subject to the same rules as column (c).
f. **Total Shareholder Return**. The TSR of the registrant for the applicable fiscal year would be disclosed in this column, computed in the same manner as for the performance graph currently required to be included in the proxy.
g. **Peer Group Total Shareholder Return**. The TSR for either the peer group used for the performance graph referenced above or, if different, the peer group reported in the CD&A, would be utilized to compute the TSR disclosed in this column.

Also required would be a graphic or narrative description of the relationship between (i) pay and company TSR, and (ii) company TSR and peer group TSR, with respect to the years covered by the table. Additionally, the data in the table would be required to be tagged in interactive data form, in order to facilitate comparisons between companies.

We hope that in finalizing these rules, the SEC will reconsider the prescriptive and burdensome approach proposed on Wednesday. The SEC could have proposed implementing the Dodd-Frank mandate by allowing companies to include in their proxies and information statements a description of how financial performance actually influenced pay decisions rather than introducing a new “actual pay” metric that adds to the already cluttered compensation disclosure tables in the proxy. Instead, it chose to pursue a uniform, but rigid, system of backwards-looking reporting, leaving on the defensive companies whose pay decisions in one year based on performance at that time (which may have been perfectly reasonable decisions) result in “actual payment” of compensation in a subsequent year in which its TSR may not appear to support the amount paid, and companies whose pay decisions are not based solely on TSR (a useful but not universally employed metric, particularly in measuring the contribution of specific individuals below the PEO level). Although the focus on TSR is no doubt intended to implement the statute, the exclusive use of that metric through a rigid tabular framework, as well as the required peer group comparison (which is not mandated by the statute), illustrate the degree to which the proposed rules objectify compensation decisions which would be better explained through customized and flexible disclosure by each individual company. A more restrained approach by the SEC in the final rules would better promote coherent disclosure and sensitivity to the significant burdens imposed on companies in preparing proxy disclosures.

We agree with Commissioner Gallagher’s dissenting statement to the proposing release, which asserts that “…the more appropriate path forward would be to admit that we have not solved the very difficult question of how to align executive pay with performance…[B]ut, 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.”