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BENEFITS BRIEF

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SEC Proposes "Pay for Performance" Rules under Dodd-Frank Act

On April 29, 2015, the Securities and Exchange Commission ("SEC") released a proposed rule that would require a public company to disclose the relationship between the compensation of its top executives and the company's financial performance. This so-called "pay for performance" rule is the latest in a line of executive compensation rules issued or proposed by the SEC under the Dodd-Frank Wall Street Reform and Consumer Protection Act (the "Dodd-Frank Act"). Like the "CEO pay ratio" disclosure rule proposed on September 18, 2013, the SEC proposed the "pay for performance" rule following a 3-2 vote.

The proposed rule would generally apply to all reporting companies other than foreign private issuers, registered investment companies and emerging growth companies. There are special rules for smaller reporting companies, including that they are required to provide only three (as opposed to five) years of data in the new table, and are not required to include peer group information. We summarize key features of the proposed rule below.

New Pay vs. Performance Table

Under the proposed rule, public companies would be required to include in their annual proxy statements a new table setting forth the following information for each of the last five fiscal years:

- The principal executive officer's ("PEO's") total compensation reported in the summary compensation table (in the company's annual proxy statement);
- The compensation "actually paid" to the PEO;
- The average total compensation reported in the summary compensation table of all other named executive officers ("NEOs");
- The average compensation "actually paid" to these other NEOs;
- The company's annual total shareholder return ("TSR"); and
- The annual TSR of the company's peer group members.

The table must also include footnotes describing the compensation "actually paid" to the PEO and other NEOs. As a form of transitional relief, the proposed rule requires only three years of data in a company's first table, and allows companies to "grow into" the full requirement by adding an additional year of data in each subsequent annual filing.

Clear Description Comparing Pay with Performance

In addition to the required table, the proposed rule would require a clear description of the relationship between the company's TSR and the compensation actually paid to the company's PEO and other NEOs, as well as a clear description of the relationship between the company's own TSR and the TSR of its peer group members. These descriptions can be presented in narrative or graphical format.

Compensation "Actually Paid"

Perhaps the most significant aspect of the proposed rule is the required disclosure of compensation "actually paid" to an NEO in a year, which differs from the "total compensation" for the NEO currently required to be reported in the annual proxy summary compensation table. Section 953(a) the Dodd-Frank Act requires disclosure of the relationship between compensation "actually paid" and the company's performance. The SEC noted that the term "total compensation," as used in the current summary compensation table rules, reflects compensation "awarded to, earned by or paid to" an NEO rather than compensation "actually paid" to the NEO. The SEC therefore believes Congress intended that compensation "actually paid" would be distinct from "total compensation" disclosed in the summary compensation table.

However, the SEC also noted that it believes "total compensation" is an appropriate starting point for determining compensation "actually paid." Therefore, the proposed rule defines compensation "actually paid" as total compensation reported in the summary compensation table, with the following adjustments:

- Compensation "actually paid" includes only the pension service cost attributable to the NEO's service for the year, rather than the full change in present value of the NEO's pension benefits for the year as reported in the summary compensation table. The SEC noted that this figure is intended to approximate the value a company would set aside to fund an NEO's pension benefits at retirement for the service provided in the year. The SEC also noted that this new measure would be less volatile than the number reported in the summary compensation table each year, which is impacted by, among other things, changes in interest rates.

- Compensation "actually paid" includes the fair value of equity awards (including options and SARs) as of the award's vesting date. In contrast, the summary compensation table includes the fair value of equity awards as of the grant date. The SEC noted that it believes looking at the vesting date (rather than the grant date) more accurately reflects the amount of compensation "actually paid" pursuant to the equity awards. Notably, companies are not currently required to disclose the vesting date value of options and SARs. While companies are currently required to disclose the vesting date value of stock awards (such as restricted stock and RSUs) in the "option exercises and stock vested" table of the proxy statement, this table requires only the value of options and SARs actually *exercised* by an NEO.

Other Key Points for Comments

Several other features of the proposed rule are likely to draw the attention of commenters, including:

- Covered executives: The proposed rule requires disclosure for the NEOs with compensation information presented separately for the PEO and an average for the remaining NEOs. The SEC indicated that covering only the NEOs should help to reduce the costs associated with this disclosure because companies are already required to track compensation information for NEOs.

- Five-year time period: Although the summary compensation table only requires three years of data, the proposed rule requires disclosure for the five most recently completed fiscal years. Pointing to the stock performance graph that also requires disclosure for the previous five years (which will remain a separate required disclosure), the SEC indicated that the longer period provides a meaningful period over which a comparison between pay and performance can be evaluated.

- Measure of Performance: Section 953(a) of the Dodd-Frank Act requires a performance measure which takes into account "any change in the value of the shares of stock and dividends [of the company] and any distributions." The SEC noted that using TSR, which companies are already required to determine and disclose in the stock performance graph, would reduce the burden placed on companies by the proposed rule while still satisfying the Dodd-Frank Act's requirements.

- Peer Group: The proposed rule would require a public company to compare its own TSR to the TSR of its peer group members. For purposes of the proposed rule, a company may use the same peer group that it uses for comparison in its stock performance graph. Alternatively, the proposed rule would allow the company to use the TSR of a peer group it describes in the compensation discussion and analysis portion of the company's proxy statement. In either case, the returns for each member of the peer group must be weighted based on the member's stock market capitalization at the beginning of the relevant measurement period. The proposed rule would require a company to disclose the members of its selected peer group (except where the peer group is a published industry or line-of-business index). However, the proposed rule would not specifically require the company to discuss its rationale for choosing which peer group it uses, though the SEC requested comment on whether such a requirement should be included in the final rule.

Next Steps

The SEC will accept comments on the proposed rule through the 60th day following the rule's publication in the Federal Register. Although it is unclear when the rule will be finalized, companies should begin to collect data in anticipation of the final rule. It is possible that a final rule will be adopted later this year, and that public companies will need to be begin including this "pay for performance" disclosure in their proxies as early as next year. However, the fact that the "CEO pay ratio" rule was proposed in September 2013 and has not yet been finalized suggests that this is unlikely.