Milbank

May 7, 2015

CONTACTS:

Joel I. Krasnow
Partner
+1-212-530-5681
jkrasnow@milbank.com

Manan (Mike) Shah
Partner
+1-212-530-5501
mdshah@milbank.com

Nicholas DeLuca
Associate
+1-212-530-5391
ndeluca@milbank.com

# Executive Compensation and Employee Benefits Group Client Alert:

## New SEC Proposed Pay-Versus-Performance Rules

On April 29, 2015, the United States Securities and Exchange Commission (the "SEC") proposed new rules intended to address the required measure of "executive compensation actually paid" under Section 953(a) of the Dodd-Frank Wall Street Reform and Consumer Protection Act (the "Dodd-Frank Act").

### PROPOSED PAY-VERSUS-PERFORMANCE RULES

The proposed rules would add a new Item 402(v) to SEC Regulation S-K. Under proposed Item 402(v), additional executive compensation disclosures would be required in proxy solicitation materials or other applicable information statements that are required to contain executive compensation disclosure. The proposed new disclosures would not apply to emerging growth companies, foreign private issuers, or registered investment companies (other than business development companies). Similar to other disclosures required under Item 402, these disclosure obligations would be scaled and somewhat less onerous for smaller reporting companies.

*Milbank observations*:

- This new disclosure could be placed in the Compensation Discussion and Analysis (the "CD&A") for context. However, inclusion in the CD&A could implicitly suggest that these new pay-versus-performance disclosures were considered in making executive compensation decisions.

- As the new disclosures are contained in SEC Regulation S-K Item 402, they would be subject to ordinary say-on-pay advisory votes along with the other executive compensation information disclosed under Item 402.

### TABULAR DISCLOSURE OF COMPENSATION ACTUALLY PAID

The proposal requires the new disclosures to be contained in a prescribed table. Subject to a proposed phase-in period, the new table would be required to include the following information for each of the company's five most recently completed fiscal years:

- executive compensation "actually paid" to the company's principal executive officer (the "PEO") and the average of executive compensation "actually paid" to the company's other named executive officers, as listed in the Summary Compensation Table for the applicable year (the "Other NEOs);
- total compensation of the PEO and the average total compensation of the Other NEOs, as is already required to be disclosed in the Summary Compensation Table;
- the company's cumulative total shareholder return ("TSR"), determined as already prescribed under existing SEC rules; and
- the TSR of the company's designated peer group of companies (the "Peer Group").

If more than one person serves as the PEO in any year, the compensation for those people would be aggregated into a single PEO entry for the applicable year.

*Milbank observation:*

Disclosure of average compensation for the Other NEOs potentially makes this information more comparable from year to year, regardless of the fact that the number and identity of the Other NEOs may vary from year to year during the comparison period.

### DETERMINATION OF EXECUTIVE COMPENSATION ACTUALLY PAID

The amount of executive compensation "actually paid" to an individual during an applicable year begins as total compensation set forth in the Summary Compensation Table, but is then adjusted by (i) removing changes in pension value that are not attributable to the applicable year of service and (ii) utilizing the vesting date value of equity awards that vested during the applicable year, rather than awards granted during the year. Equity award fair values would be determined using FASB ASC Topic 718. Itemized numerical footnote disclosure would be required to accompany the new table for each entry in order to explain the applicable differences between executive compensation "actually paid" and total compensation as determined for purposes of the Summary Compensation Table. In addition, in the case of stock options and stock

appreciation rights ("SARs"), vesting date valuation assumptions must be disclosed if they are materially different from those disclosed in the financial statements as of the grant date. To the extent that equity awards were repriced or otherwise modified during the applicable year, the incremental fair value changes are also required to be disclosed (including on a pro-rata basis for awards with multiple vesting dates).

*Milbank observations:*

- The net effect of the pension adjustment is to remove the portion of change in pension value that results solely from changes in interest rates, age, and other actuarial inputs and assumptions, instead capturing only the value attributable to the incremental service during the applicable year.

- As in the case of total compensation for purposes of the Summary Compensation Table, executive compensation "actually paid" would include preferential earnings on non-qualified deferred compensation.

- One implication of using the fair value of awards vesting during the relevant year, rather than the fair value of awards granted or exercised during the relevant year, is that different vesting schedules (i.e., cliff versus time vesting) could have a big year to year impact on these disclosures.

- One-day vesting date differences at the end of a year (i.e., on December 31 versus January 1) could similarly have a significant impact on the executive compensation "actually paid" during a given year, in particular if the fair value of the equity award vesting represents a substantial portion of the executive's total compensation for that year.

- Under the SEC's proposal, it appears that equity awards are included in the computation of executive compensation "actually paid" only to the extent that all vesting conditions applicable to the award (or portion thereof) are fully satisfied. If an equity award is subject to both time and performance conditions, it seems that both would need to be satisfied before the applicable portion of the award is included in the calculation of executive compensation "actually paid."

- The required disclosure of stock option and SAR valuation assumption differences would require revisiting the assumptions used at each applicable grant date to ensure conformity.

### DISCLOSURE OF PAY-VERSUS-PERFORMANCE RELATIONSHIPS

With respect to the information disclosed in the new table, the proposed rules would also require disclosure regarding the relationship between (i) executive compensation "actually paid" and the company's TSR, and (ii) the company's TSR and the Peer Group's TSR. The proposed rules do not prescribe any particular method for presenting this relationship disclosure, instead indicating that the relationship disclosure could be in the form of a narrative, a graph, a chart, or some combination thereof. Similarly, the proposed rules specify that this new information would not be required to be disclosed in any particular location within the proxy or information statement.

### ADDITIONAL TECHNICAL REQUIREMENTS

As with executive compensation disclosures in general, the SEC's plain English principles would apply to these new disclosures. In addition, as proposed, these new disclosures must be provided in tagged data format using eXtensible Business Reporting Language (XBRL).

### PROCESS AND IMPACT

The proposed rules are subject to a 60-day public comment period. If the proposed rules are adopted in their current form following the public comment period, they would apply to the first proxy or other applicable filing after the rules become effective. However, a phase-in is currently proposed that would initially require disclosure for only the company's three most recently completed fiscal years (with one additional year of historical disclosure being added during each subsequent year until five years are disclosed).

*Milbank observations:*

- If the SEC adopts final rules by the end of 2015, they would likely apply with respect to the 2016 proxy filing season.
- The phase-in reduction is permissive and not mandatory, meaning that companies can still disclose data for five years if they prefer.
- As with compensation disclosure generally, these new historical disclosures are only required with respect to years when the company was a reporting company.

### COORDINATION WITH PAY RATIO RULES

These proposed pay-versus-performance rules are distinct from the chief executive officer ("CEO") pay ratio disclosure rules that the SEC previously proposed on October 1, 2013 under Section 953(b) of the Dodd-Frank Act. Those proposed rules would require disclosure regarding the ratio of the CEO's annual total compensation to the median annual total compensation of company employees. However, the SEC has not yet adopted final CEO pay ratio rules.

EXECUTIVE COMPENSATION AND EMPLOYEE BENEFITS GROUP

Please feel free to discuss any aspects of this Client Alert with your regular Milbank contacts or any of the members of our Executive Compensation and Employee Benefits Group.

If you would like copies of our other Client Alerts, please visit our website at www.milbank.com and choose "Client Alerts" under "News."

This Client Alert is a source of general information for clients and friends of Milbank, Tweed, Hadley & McCloy LLP. Its content should not be construed as legal advice, and readers should not act upon the information in this Client Alert without consulting counsel.

©2015 Milbank, Tweed, Hadley & McCloy LLP.

All rights reserved.

**NEW YORK**
28 Liberty Street, New York, NY 10005

| | | |
|---|---|---|
| Joel I. Krasnow | jkrasnow@milbank.com | +1-212-530-5681 |
| Manan (Mike) Shah | mdshah@milbank.com | +1-212-530-5501 |
| Nicholas DeLuca | ndeluca@milbank.com | +1-212-530-5391 |