Compensation

Bracing for a New Disclosure Rule on Executive Pay for Performance

By Bob Romanchek and Katherine Beall

A new and mandatory executive pay proxy disclosure requirement is about to hit. A remnant of the 2010 Dodd-Frank Wall Street Reform and Consumer Protection Act, this pay-for-performance disclosure rule will become effective for most public companies shortly after the US Securities and Exchange Commission (SEC) officially posts the final rules and a related comment period expires.

For the first time since 2010, this published item has been formally entered onto the SEC's "to-do list" agenda—meaning that it is now a top priority. Although finalization likely won't occur until 2021, we may see these rules before 2020 ends.

This pay-for-performance rule is meant to show the relationship between actual executive pay, as disclosed in the proxy (with certain adjustments), and company performance, as represented by company stock price performance plus dividends, or total shareholder return (TSR).

Although conceptually understandable, the proposed rules were released by the SEC in 2015 but never finalized, raising a host of definitional issues along with a mandated disclosure approach that resulted in little more than a lot of head-scratching.

The effect is that the curious, soon-to-be required disclosure may necessitate a new definition of "pay" and create a means of reporting performance that could result in the entire disclosure being of little or no value. Here are some of the more material issues that public companies may soon need to address, thanks to this upcoming disclosure rule.

- The proposed rules would require a tabular disclosure, supplemented by a narrative explanation, that contains a line of pay data and TSR performance for the CEO for each year of a five-year period (a three-year transition rule would apply up front), even though the Summary Compensation Table only goes back three years.

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- A second line of tabular pay and TSR data would combine and average the compensation of all other executives included in the proxy into one line, which means that pay for performance for each executive will not be determinable.
- The pay used in the new table would not match the pay contained in the Summary Compensation Table. Rather, pension values would be calculated on a present-value basis (instead of on an annual accrual basis), and stock options would need to be revalued using a "fair-value" methodology that differs from the "grant date" valuation rules used in the Summary Compensation Table.
- The company-disclosed TSR performance contained in the table would also need to be compared to the TSR of a select group of peer companies. Although there could be choice in selecting the peer group, some companies may end up with three different disclosed peer groups, i.e., one for benchmarking executive pay levels, a second for the long-term incentive performance share relative to TSR comparison, and a third for this new pay-for-performance tabular disclosure.
- Although there would be a comparison of TSR between the issuing company and the selected peer group, there would be no comparison of CEO and other executives' average pay to the pay of comparable executives at the chosen peer companies. Thus, a key element of the peer pay-for-performance comparison would appear to be missing.
- The one-year period used in the new table for TSR measurement would not match the three-year, long-term incentive–relative TSR cycle, typically the standard design with performance share vehicles.

The bottom line is that a new executive pay-for-performance disclosure is likely coming our way soon, via SEC rules under the Dodd-Frank statute. These rules will require significant effort for companies to be in compliance, but likely will result in not telling investors anything meaningful.

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