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Meridian Client Update

SEC Issues Proposed Rule on Relationship Between Pay and Performance

On April 29, 2015, the Securities and Exchange Commission (SEC) approved (by a 3 to 2 vote) a proposed rule that would require a public company to disclose the relationship between executive compensation actually paid and the financial performance of the company.

At today's hearing, the SEC staff disclosed that the proposed rule would require an issuer to disclose and discuss in its annual meeting proxy statement the five-year relationship between (i) annual compensation "actually paid" to its CEO and (ii) cumulative Total Shareholder Return (TSR) of the issuer and of an issuer developed custom peer group (or alternatively, an issuer selected industry group or index). The same disclosure would be required with respect to the annual average compensation actually paid to an issuer's other named executive officers.

The SEC staff also disclosed the following details on the proposed rule:

- **Placement of proposed pay and performance disclosure**: An issuer would be required to place the proposed pay and performance disclosure in the Compensation Discussion and Analysis section of its annual proxy.
- **Covered executives**: An issuer's proxy-disclosed officers (i.e., CEO, CFO and the three highest paid executive officers other than the CEO and CFO) would be subject to the pay and performance disclosure.
- **Covered time period**: The pay and performance disclosure would cover the five-year period through the end of the fiscal year covered by the applicable proxy statement.
- **Definition of "actually paid"**: The "pay" portion of the disclosure would relate to the annual compensation "actually paid" to the CEO during each year of the covered time period and the annual average compensation actually paid to the other named executive officers during each year of the covered time period. Under the proposed rule, a named executive officer's actually paid compensation for a fiscal year would be determined under the following formula:

Total Compensation as reported in the Summary Compensation Table (SCT)

less

Changes in Pension Value and Value of Stock Awards and Options as reported in the SCT

plus

"Fair Value" of Stock Awards and Options that vested during the fiscal year

plus

Annual Accrual of Pension Benefits during the fiscal year

The fair value of stock awards and stock options that vest during a fiscal year would be determined in accordance with applicable accounting standards. The fair value of stock awards (e.g., restricted stock, restricted stock units and performance shares) would be equal to an issuer's share price on the date of vesting multiplied by the number of shares that vested. The fair value of stock options would be equal to the Black-Scholes value of a single option (determined as of the date of vesting) multiplied by the number of options that vested.

- **TSR disclosure**: The pay and performance disclosure would include cumulative TSR over the applicable five-year period for the issuer and for an issuer developed custom peer group or selected industry group or index.
- **Nature of disclosure**: Registrants would have the flexibility in determining whether to make the required pay-for-performance disclosure in narrative and/or graphical form. An issuer may provide supplemental narrative or graphical disclosures to provide additional context on the required disclosure.
- **Exempt registrants and smaller reporting companies**: The following registrants would be exempt from the proposed rule: foreign private issuers, emerging companies and investment companies. However, smaller reporting companies would be subject to a scaled back version of the proposed rule.
- **Transition period**: The proposed rule would be phased in over a three-year period. Initially, an issuer would be required to disclose compensation and cumulative TSR performance for a three-year period. Over the next two fiscal years, the covered disclosure period would increase to four years and five years, respectively.
- **Comment Period and Effective Date**: Once published, the proposed rule will set forth a 60-day comment period during which interested parties may submit comments to the SEC. After considering submitted comments, the SEC will issue a final rule. However, the SEC is under no deadline by which to issue a final rule (note that a final rule on the CEO pay ratio has yet to be issued despite the fact the proposed rule was approved by the SEC during September 2013). Therefore, at this point, it is not clear when the likely effective date will be of any final rule.

Meridian comment. The proposed rule includes a number of surprises. Many commentators thought (and hoped) that the pay and performance disclosure would solely apply to an issuer's CEO rather than all named executive officers as is the case under the proposed rule. In addition, the SEC which could have defined compensation "actually paid" (which was undefined in Dodd-Frank) as total compensation disclosed in an issuer's summary compensation table chose to introduce a new definition of compensation that is only partially based on proxy disclosed compensation. This proposed definition of actually paid compensation would require registrants to make additional calculations to determine the value of stock option awards on the date of vesting and the value of annual pension accruals.

We will have more to say on this topic after the SEC has published the text of the proposed rule.

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The ***Client Update*** is prepared by Meridian Compensation Partners' Technical Team led by Donald Kalfen. Questions regarding this Client Update or executive compensation technical issues may be directed to Donald Kalfen at 847-235-3605 or dkalfen@meridiancp.com.