



## Insights



### PROXY NAMED EXECUTIVE OFFICERS: SHOULD BUSINESS UNIT HEADS BE INCLUDED?

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#### Introduction

To include business unit heads or not to include business unit heads; that is the question.

Each year, public companies must determine which executives are named executive officers ("NEOs") under the proxy disclosure rules. This determination is important, as public companies are required to disclose in their annual meeting proxies the compensation paid to each NEO (i.e., a company's chief executive officer, chief financial officer and the three most highly compensated executive officers other than the CEO and CFO). In identifying the three most highly compensated executive officers, companies often face the issue of whether a business unit head should be considered an "executive officer". The intent of this article is to provide guidance on this issue based on a review of law and current market prevalence.

#### Definition of Proxy NEO

The rules for determining whether a business unit head is an executive officer are set forth in the regulations under Securities Act of 1933 and Securities Exchange Act of 1934 ("Securities Exchange Act").

Item 402(a) of Regulation S-K (prescribed legislation under the Securities Act of 1933) defines NEOs to be:

- Each chief executive officer employed during a registrant's fiscal year;
- Each chief financial officer employed during a registrant's fiscal year; and
- The three other most highly compensated "executive officers" (other than the CEO and CFO) serving at the end of the last completed fiscal year of the registrant whose total compensation exceeded \$100,000.

The term "executive officer" means a registrant's president, any vice president of the registrant in charge of a principal business unit, division or function (such as sales, administration or finance), any other **officer** who performs a policy making function or **any other person** who performs similar policy making functions for the registrant (Rule 3b-7 of Securities Exchange Act).

An executive officer of a subsidiary corporation of a registrant **may be deemed an executive officer if the executive officer serves in a policymaking role for the registrant** (Rule 3b-7 of Securities Exchange Act).

#### Application of Definition of Executive Officer to Business Unit Heads

The definition of executive officer expressly covers the head of an unincorporated business unit or division **of a registrant**. The single qualifier is that the business unit or division must be a "principal" business unit or division. The proxy rules do not define the term principal. However, the term principal suggests that a business unit or division is material to the overall operation of a registrant in terms of revenue, assets or other key financial metrics. What constitutes "material" is a subjective determination.

The determination of whether the head of an incorporated business unit is an executive officer of the registrant appears to differ from whether the head of an unincorporated business unit is an executive officer of the registrant. In the former case, Rule 3b-7 requires that such business unit head serve in a "policymaking role" for the registrant in order to be deemed an executive officer. In contrast, the policymaking role requirement appears not to be applicable in the determination of whether the head of an unincorporated business

unit or division of a registrant is an executive officer. In practice, this distinction may not be meaningful. For some registrants, the head of a major business unit (whether or not incorporated) will necessarily play a policymaking role for the registrant. Since such a policymaking role often arises by virtue of the size of the business unit, registrants are likely to focus primarily on the relative size of a business unit (whether or not incorporated) in determining whether the head of the business unit is an executive officer.

It is important to note that designation of a business unit head as an executive officer alone is not sufficient for such business unit head to be considered a named executive officer. The business unit head must also be among the three most highly compensated executive officers (without regard to the CEO and CFO).

### Market Prevalence of Companies Disclosing Business Unit Heads as NEOs

To determine the market prevalence of public companies disclosing one or more business unit heads as an NEO, we surveyed the most recently filed proxy statements of the component companies of the Standard & Poor's 1500 index. The survey results show that 58% of companies disclosed one or more business unit heads as an NEO. Below is a summary of the survey results:

Revenue Size	n	% of Companies That Did Report BU Heads in Proxy	% of Companies That Did Not Report BU Heads in Proxy	Median # of Disclosed BU Heads (for those disclosing)
<b>All companies</b>	<b>1,500</b>	<b>58%</b>	<b>42%</b>	<b>2</b>
Under \$1 billion	510	47%	53%	1
\$1.0B – \$5.0B	569	52%	48%	2
\$5.0B – \$10B	172	65%	35%	2
\$10B – \$20B	123	64%	36%	2
Over \$20B	123	76%	24%	3

*Survey data provided by Equilar*

It is important to recognize that, although 42% of all companies comprising the Standard & Poor's 1500 **do not** disclose a business unit head, this statistic is a function of such companies determining that:

- Business unit heads do not meet the definition of executive officer, or
- Business unit heads meet the definition of executive officer but are not among the top-three paid executive officers (exclusive of the CEO and CFO)

Alternatively, business unit heads may not be disclosed as NEOs due to a potential misapplication of the disclosure rules.

The survey results show that the number of business unit heads designated as NEOs is strongly correlated with revenue size. This correlation likely reflects differences in organizational structure and policy-making role, coupled with the relative pay levels of business unit heads. High revenue companies are commonly organized around large business lines headed by relatively high-paid officers with broad policy-making responsibilities. In contrast, small revenue companies are often organized around a single business line headed by executives with limited company policy-making responsibilities.

### Conclusion

Ultimately, there is not a bright line rule that determines whether a business unit head should be considered an executive officer, and therefore potentially an NEO. If a business unit head is one of the three highest paid executives beyond the CEO and CFO, the decision will hinge on whether the business unit head engages in policy-making responsibility *for the company*. Market data shows that small companies are less likely to designate business unit heads as NEOs than larger organizations.