Center On Executive Compensation
A Principled Voice on Pay Practices

Policy Brief

SEC-Proposed Pay for Performance Rules Would Compare Modified Summary Compensation Table Pay With Cumulative TSR

Drive to Enhance Understanding of Pay for Performance Link Superseded by Emphasis on Comparability, Standardization

On April 29, 2015, the U.S. Securities and Exchange Commission voted 3-2 along party lines to propose rules implementing the Dodd-Frank Act pay for performance disclosure requirement. Section 953(a) of the Act instructed the SEC to implement a disclosure requirement showing "the relationship between executive compensation actually paid and the financial performance of the issuer taking into account any change in the value of the shares of stock and dividends of the issuer and any distributions." Section 953(a) was added to Dodd-Frank in an effort to more clearly explain the link between company pay and performance as well as to provide additional transparency with regard to executive pay. Many companies have recognized the inadequacy of the Summary Compensation Table in explaining the link between pay and performance and thus have been providing supplemental executive pay disclosures in the proxy statement to better explain the connection. These approaches, though varied in nature, reflect the wide variety of corporate structures, methods of pay design, and measures of firm performance. Unfortunately, rather than take a principles-based approach, which permits flexibility in describing the pay for performance link, the proposed pay for performance rule takes a prescriptive approach which forces companies to compare cumulative total shareholder return (TSR) to a modified calculation of Summary Compensation Table pay that values equity at vesting date. By choosing standardization over clarity, TSR as the universal performance measure, and valuing all equity at the vesting date, the proposed rule creates the potential for a litany of unintended consequences.

Proposed Rule Favors Standardized Table Over Principles-Based Approach

The proposed rule would require companies to disclose pay for performance in the following standardized table ("Pay Actually Received) in the proxy accompanied by additional narrative and/or graphical disclosure explaining the connection between the various data points in the table, each of which is explained in more detail below. Each element of the table will need to be provided for three years

Pay Versus Performance

Year (a)	Summary Compensation Table Total for PEO (b)	Compensation Actually Paid to PEO (c)	Average Summary Compensation Table Total for non-PEO named executive officers (d)	Average Compensation Actually Paid to non-PEO named executive officers (e)	Total Shareholder Return (f)	Peer Group Total Shareholder Return (g)
2014					Cumulative TSR for 2010- 2014	Cumulative TSR for 2010- 2014
2013					Cumulative TSR for 2010 – 2013	Cumulative TSR for 2010 – 2013
2012					Cumulative TSR for 2010 – 2012	Cumulative TSR for 2010 – 2012
2011					Cumulative TSR for 2010 – 2011	Cumulative TSR for 2010 – 2011
2010					Cumulative TSR for 2010	Cumulative TSR for 2010

initially, which will expand to *five* fiscal years in the third year after the disclosure takes effect.

"Compensation Actually Paid" Includes Equity Valued at Vesting Date, Revised Pension Value The proposed rule would require companies to disclose the total Summary Compensation Table pay as well as "compensation actually paid" for both the company's "Principal Executive Officer" or "PEO" (typically the CEO) in column (c) of the table as well as the average compensation "actually paid" for the other NEOs listed in the Summary Compensation Table in column (e).

Equity Valued as of Vesting Date. "Compensation actually paid" is defined by modifying Summary Compensation Table pay to reflect the recalculated accounting expense of options as of the vesting date (*i.e.*, the recalculated Black-Scholes value with updated assumptions as of the vesting date) plus the value of other equity awards that vest in the current year in lieu of using the grant date value.

Actuarial Increase in Pension Removed, But Annual Service Cost Added. Pension value must also be included in the definition of "compensation actually paid." For the purpose of calculating pension value, companies can exclude the changes in actuarial present value generated by reductions in the discount rate or mortality table changes, but are required to include actuarially determined "service costs" for services rendered by an executive during the applicable year.

Comparison to Summary Compensation Table Total Pay. As noted, "compensation actually paid" is required to be disclosed in column (c) and (e) of the tabular disclosure. Each value will appear next to the corresponding total compensation amount reported in the Summary Compensation Table in columns (b) and (d) to facilitate comparison of the two values. Companies must include footnotes to the disclosure which detail the assumptions and calculations made to Summary Compensation Table pay to calculate "compensation actually paid".

The proposed rule's calculation of compensation "actually paid" is problematic for two reasons. First, the inclusion of any pension value is illogical because pensions are not received, even constructively, until an executive hits retirement age and satisfies other vesting conditions such as age and service requirements. Until those conditions are met, an executive is not eligible to receive pension amounts, and for nonqualified deferred compensation, the amounts are at risk if a company goes into bankruptcy or insolvency. Additionally, an executive's pension value is not subject to fluctuations in company TSR and therefore the disclosure does not help in assessing pay for performance.

Second, although the valuation of equity at the vesting date is much better for comparing pay with performance than Summary Compensation Table pay, especially with respect to restricted stock and performance shares, the valuation of stock options using the recalculated accounting expense as of the vesting date repeats the problems with the Summary Compensation Table. The approach combines pay actually realized (e.g., restricted stock and performance shares) with estimates of future potential pay (options) creating further confusion. The executive may exercise options after the vesting date and thus receive significantly higher or lower compensation than the estimate produces, years after it will be disclosed in the new table. For this reason, the Center has advocated the valuation of options when they are exercised because the actual compensation received by an individual can be ascertained and used for a comparison with actual performance. It appears that the SEC staff relied on valuation under the accounting rules as the primary guide to pay for performance comparisons.

Proposed Rule Uses Cumulative TSR to Measure Performance, But Pay and Performance Periods Do Not Necessarily Match The proposed pay for performance disclosure will require companies to use cumulative TSR for both the company and a peer group as the universal performance measures for the pay for performance disclosure. The company and peer group TSR, required in columns (f) and (g) respectively will be required to be calculated for each of the five fiscal years required to be included in the disclosure. Companies can use the same peer group otherwise used in the CD&A for compensation benchmarking or the peer group used to construct the stock performance graph in their 10-K (in compliance with Section 201(e) of Regulation S-K).

The formulation of TSR in the proposed regulatory text is complex and has resulted in varying interpretations stemming from language in the proposing release which appeared contradictory.

However, the SEC Staff has since clarified that the proposed regulatory language requires TSR to be aggregated over each year in the five-year period reported in the table. Under this approach, compensation actually paid for the most recent fiscal year (*e.g*., 2014 if the table were included in the proxy for the 2014 fiscal year) would be compared to five-year cumulative TSR over 2010-2014, while 2010 would be compared to cumulative TSR just for 2010. The SEC likely adopted this approach because the same methodology is already used in the stock performance graph disclosed in the 10-K. However, the approach is likely to create substantial confusion when used in a table comparing pay and performance.

Equity awards are designed to reward long-term performance with plans vesting over a number of years with the goal of rewarding multiple years of sustained performance so long as the performance conditions are met. Under the proposed rule, companies will compare compensation actually paid, which includes salary, annual incentives and the annual total of vested equity, which may include equity vehicles that have vested over one year *and* multiple years, to a TSR performance period ranging from one to five years. The reported cumulative TSR for the company or its peer group is not linked to the vesting period of any equity vehicle (over which the pay is earned), but rather to the year reported in the table. The comparison fails to match the intended performance period with the period over which pay is earned communicated by the TSR disclosure. In addition, because the options valuation is based on an accounting estimate of future potential pay, the comparison to the prior one-year TSR, or even the cumulative TSR over two to five years further confuses the pay for performance link. This approach to pay for performance could also create unintended consequences, including potentially encouraging short-term thinking in incentive plan design or in financial management, as companies come under pressure to ensure pay data is aligned with one-year TSR. Indeed, ISS dropped a comparison of long-term pay to one-year TSR as part of its quantitative analysis starting in 2014 for this reason.

Narrative, Graphical Disclosure Intended to Supplement Mandated Table In contrast to the tabular disclosure, the additional explanatory disclosure which is required to accompany the completed table is not provided with a prescribed format. Instead, the proposed rule states that companies can choose to provide a narrative and/or graphical disclosure so long as it explains the connection among the data points in the table, with an emphasis on the connection between compensation "actually paid" and company TSR and how company TSR compared to Peer Group TSR. The disclosure will be required in any proxy statement which includes an election of directors or a say on pay vote and is not required to be located in a specific place in a company's proxy.

In the proposed rule, the SEC makes it clear that it chose to utilize a standardized tabular approach in effort to enhance the ability of investors to compare the disclosure across companies. The addition of the narrative disclosure accompanying the standardized table was likely the agency's attempt at allaying concerns that the rigidness of the table will result in force companies to adopt a one-sized-fits-all approach to the disclosure as well as a nod to commentators, like the Center, which called for a principles-based and flexible disclosure.

Disclosure Requires XBRL Tagging, Underscoring SEC Emphasis on Standardization, Comparability, and Data Gathering For the first time for a corporate governance disclosure, the proposed rule will require companies to format the disclosure using eXtensible Business Reporting Language (XBRL). XBRL is a business reporting standard which allows the data to be tagged and machine processed for comparative analyses.

Conclusion The proposed pay for performance disclosure rules represent a missed opportunity. Although the valuation of equity at the vesting date has its shortcomings, the most alarming element of the proposal is that companies compare compensation that vests over multiple years be compared to a measure of total shareholder return not linked to the vesting period. This approach will not highlight pay for performance disconnects, is likely to have unintended consequences, and is likely to encourage companies to include additional supplemental disclosure beyond the new requirements.