CONSULTING Client Alert

# The SEC Proposes Pay-versus-Performance Disclosure Rules. Now What?

By: *Dave Sugar, Partner; with special commentary for Radford clients from Ram Kumar, Director*
Team: Aon Hewitt
Published: May 2015

## Introduction

On April 29, the Securities and Exchange Commission (SEC) voted in favor of issuing proposed rules for the "pay-versus-performance" disclosure that Congress included under the Dodd-Frank Wall Street Reform and Consumer Protection Act. Interested parties will have 60 days to provide the SEC with comments. With the comment period ending in mid-summer, there is ample time for the SEC to issue final rules by year's end and require application of the final rules for the first quarter of the 2016 proxy season.

The proposed disclosure reflects the SEC's attempt to help shareholders gain a better understanding of how executive pay compares to company performance by: (1) comparing Named Executive Officers' (NEOs) compensation as described in the Summary Compensation Table (SCT) to what the SEC is calling compensation "actually paid," (2) using Total Shareholder Return (TSR) as the performance measure comparing performance to compensation "actually paid," and (3) using TSR of a company's peer group, likely the one listed in the Compensation Discussion and Analysis (CD&A) for compensation or performance purposes, to provide additional context for the company's performance.

## Required Disclosures

If the proposed rules become final without changes, registrants will need to add a new table to the proxy statement disclosing:

- The total compensation of the Principal Executive Officer reported in the SCT for the current year, and each of the prior four years (see Note 1);
- The total compensation "actually paid" to the Principal Executive Officer in each of those years;
- The average total compensation of the other NEOs reported in the SCT for the current year and each of the prior four years;
- The average total compensation "actually paid" to the other NEOs in each of those years;



Radford An Aon Hewitt Company

- For each year, the cumulative TSR of the company measured as of the end of the year; and
- For each year, the cumulative total shareholder return of a peer group selected by the company.

In addition, companies will be required to provide a clear description of the relationship between the compensation actually paid and cumulative TSR for each of the last five completed fiscal years. Required disclosures must be electronically formatted and tagged using XBRL.

As proposed, compensation actually paid equals:

- Base salary for the fiscal year (same as SCT);
- Non-equity incentives and/or bonus earned for the fiscal year (same as SCT);
- Equity vested during the fiscal year valued at the fair value as of vesting date (differs from SCT, which includes equity fair value when granted). Fair value will generally be priced at vesting date for restricted stock (units) and performance shares earned. Stock options will use a Black-Scholes value as of the vesting date taking into account changes in share price since grant;
- "Service cost" attributable to services for the year (differs from SCT which is based on the "change in pension value");
- Above market earnings (if any; same as SCT); and
- All other compensation items (same as SCT).

## Initial Reactions

We agree with the SEC's position that a higher degree of standardization of compensation "actually paid" will be helpful to shareholders in understanding pay-to-performance alignment. Based on Aon Hewitt's research, there continues to be great variance among companies (a minority as of last year) that present alternative definitions of "actually paid" compensation and how that compensation is compared to performance. The great degree of variance makes it harder for shareholders to gain understanding across potential alternative investments.

While the SEC's proposed definition of compensation "actually paid" and the related treatment of equity awards and pensions is better than using SCT total compensation in terms of understanding the alignment of executive pay to performance, the definition could be improved. The SEC also recognizes that the proposed solution may be improved upon and is seeking input on a number of issues. The ones that we have initially identified as in need of greater debate are:

- The disconnect between measuring equity fair value at the vesting date versus TSR at the end of the reporting period; for some companies, the share price could be materially different;
- The disconnect between the TSR measurement periods and the multiple measurement periods used for various long-term performance awards;
- The proposed mandate for a peer group comparison of TSR even though "actually paid" compensation for the peer group is not compared and some companies do not use a specified peer group of companies for making pay decisions. (Additionally, the Dodd-Frank Act does not require the disclosure of peer group TSR. See Note 2); and

- Finally, for companies that change CEOs during a fiscal year, the proposed rules include special treatment in years where there are multiple Principal Executive Officers. In such situations, the SEC has proposed that companies should report the aggregate compensation paid to both. (There are no special rules if there are additional NEOs; presumably, the registrant will still report the average compensation paid for all NEOs other than the Principal Executive Officer.)

All of this will make providing a clear description of the relationship between the compensation "actually paid" and the company's financial performance more challenging.

## Radford Commentary: Assessing the Impact to Technology and Life Sciences Firms

The SEC's decision to measure corporate performance through TSR has a disproportionate impact on high-growth sectors like technology and life sciences. Per the illustrative case study below, it is not uncommon to see the following scenario play out in some form in our consulting engagements:

### Case Study

*A pre-commercial biotechnology company awards short- and long-term incentives to its executives based on internal operational metrics as opposed to, or in addition to, total shareholder return (TSR)—such as migration of new drugs in the pipeline and other R&D initiatives. The company's most promising drug suffers an enrollment set back during clinical trials that leads to a delay; this delay results in a major drop in the company's stock price. While proxy advisory firms may then claim a "misalignment" between executive pay and performance at the close of the fiscal year, the Compensation Committee disagrees. Other operational metrics suggest the company is still well-positioned to go to market with commercially-viable products, and in another 18 months the promising drug is expected to complete the final milestones for product approval.*

*In this case, the Board has information about the company's operations that is not publicly available. TSR may be the appropriate metric for measuring the performance of a company over a long period of time—but for many innovation-based companies, the stock market can take much longer to capture the overall health and performance of an organization.*

This is the type of volatile pay analysis that can occur when TSR is the only metric upon which performance is measured—particularly for companies that experience large fluctuations in stock price based on measurements that can be out of executives' control and that do not necessarily correlate with long-term value creation. Case in point, look at the exceptionally high levels of volatility observed in the life sciences sector, and biotechnology in particular, in just the past month. While proxy advisory firms already measure corporate performance based upon TSR, Radford is concerned that this one-size-fits all analysis will become even more widespread if mandated in a separate table in the proxy statement under the SEC's proposed rules.

For this reason, we would recommend that if the rule is adopted as proposed, development stage life sciences and technology firms consider the pros and cons of providing supplemental information that can help provide context to the mandated TSR-based analysis. This may include an assessment of compensation "actually" paid among the peer group being referenced for the TSR comparison, as well as additional measures of corporate performance—although we acknowledge the challenge of finding performance metrics that can be applied effectively across the peer group.

Separately, we note that the proposed rules exempt emerging growth companies—those with "total annual gross revenues" of less than $1 billion. While many technology and life sciences IPOs in the past couple of years have been valued well above $1 billion, often these companies' revenues fall well beneath this threshold. This exemption would allow newly public companies time to adjust to other mandatory disclosure requirements when they are required to file a CD&A before they need to worry about disclosing actual pay and performance data.

Additionally, smaller reporting companies—those with a market cap under $75 million—would receive a slight reprieve under the proposed rules with a more generous phase-in schedule. These companies would be required to disclose two years' worth of pay data the first year the rule is in place, adding an additional year of information in the following proxy statement. All other companies would be required to include three years of compensation history in the first year of mandatory disclosure and then add an additional year of disclosure for each two subsequent proxy filings.

## Things to Consider

The questions we believe that compensation professionals and Compensation Committees should be asking today are:

- Should we be trying to replicate the proposed disclosure now?
- Should we provide comments to the SEC?
- Does the SEC's proposed methodology for evaluating pay versus performance replace the internal realizable pay-to-performance analyses used to assess the pay-to-performance relationship?

We think it is likely that the pay-versus-performance rules will be finalized in the near future, but that the disclosure requirements could change in some material aspects before they are finalized. Therefore, relative to these three questions, Aon Hewitt and Radford suggest:

- Begin to consider the data sources needed to prepare the proposed tabular disclosure. For those companies that have not voluntarily provided alternative pay and/or pay-for-performance disclosures, consider the messages that will accompany the tables. For companies that have provided alternative pay and/or pay-for-performance decisions, consider how the proposal and the messaging may differ from what has been provided to shareholders;
- Consider providing comments directly to the SEC or indirectly through third parties. We will be formulating our own detailed comments and would certainly like to hear your thoughts; and
- Aon Hewitt and Radford believe the analysis required by the SEC should not replace the realizable pay-to-performance analyses used to internally assess a company's degree of pay-to-performance alignment. We believe realizable pay-to-performance analyses to be a better approach to comparing "earned" pay to target pay and for comparing pay and performance to peers.

To learn more about Radford's executive compensation, broad-based compensation and compensation governance consulting services, please visit: [radford.com/home/consulting/](radford.com/home/consulting/)

**Endnotes:**

1. If desired, large filers can choose to show only three years of data in the first year of the new disclosure increasing the number of years disclosed in each succeeding year until five years are displayed. Smaller reporting companies will only be required to disclose three years of data.

2. Section 953(a) of the Dodd-Frank Act includes the following: “DISCLOSURE OF PAY-VERSUS-PERFORMANCE.— The Commission shall, by rule, require each issuer to disclose in any proxy or consent solicitation material for an annual meeting of the shareholders of the issuer a clear description of any compensation required to be disclosed by the issuer under section 229.402 of title 17, Code of Federal Regulations (or any successor thereto), including information that shows 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. The disclosure under this subsection may include a graphic representation of the information required to be disclosed.”

## Contact Our Team

To start a conversation with Radford's consulting team, please contact one of our colleagues below:


### Boston

**Ted Buyniski**, *Partner*
+1 (781) 906-2389
tbuyniski@radford.com

**Ram Kumar**, *Director*
+1 (781) 906-2395
rkumar@radford.com

**Ed Speidel**, *Partner*
+1 (781) 906-2377
espeidel@radford.com

**Rob Surdel**, *Partner*
+1 (781) 906-2394
rsurdel@radford.com

### San Francisco

**Linda Amuso**, *President Radford*
+1 (415) 486-7255
lamuso@radford.com

**Brooke Green**, *Associate Partner*
+1 (415) 486-6911
brooke.green@radford.com

**Kyle Holm**, *Associate Partner*
+1 (415) 486-7717
kyle.g.holm@radford.com

**David Knopping**, *Partner*
+1 (415) 486-7122
dknopping@radford.com

**Scott Barton**, *Associate Partner*
+1 (415) 279-6494
scott.barton@radford.com

### San Jose

**Brett Harsen**, *Partner*
+1 (408) 321-2547
bharsen@radford.com

### So. California

**Ken Wechsler**, *Associate Partner*
+1 (760) 633-0057
ken.wechsler@radford.com


## About Radford

Radford provides compensation data and advice to technology and life sciences companies. We support firms at every stage of development, from emerging start-ups to established multi-nationals. Today, our surveys deliver in-depth compensation insights in more than 80 countries to over 2,650 participating organizations, and our consultants work with hundreds of firms annually to design rewards programs for boards of directors, executive officers, broad-based employees and sales professionals. Radford is part of Aon Hewitt, a business unit of Aon plc (NYSE: AON). For more information, please visit radford.com.