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Regulatory Spotlight on Excessive Compensation

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Executive compensation, and in particular excessive executive compensation, has been a major topic of conversation in recent years both on Wall Street and Main Street. The Dodd-Frank Wall Street Reform and Consumer Protection Act, enacted in 2011 in response to the economic recession and general public mistrust of Wall Street, has once again brought the topic of executive compensation front and center. With this background in mind, we have addressed two topics in this article that remain the focus of the Securities and Exchange Commission rule-making: "golden parachutes" and CEO-to-employee pay-ratio disclosures.

GOLDEN-PARACHUTE PAYMENTS

Golden parachutes are compensation arrangements with executives relating to any type of compensation payable in connection with a change in control transaction, such as an acquisition, merger, disposition or similar transaction. The principle behind golden parachutes is to protect an executive who engages in a transaction that may be in the best interest of shareholders but which may result in the executive losing his or her job.

Golden parachutes have been a significant focus of regulatory activity since 2006, when the SEC overhauled its executive compensation disclosure requirements and required public companies to begin disclosing their golden-parachute arrangements with executives. Under Item 402(t) of Regulation S-K, a public company must provide narrative disclosure of compensation arrangements that provide for payments to its most highly compensated officers, referred to as the named executive officers (NEOs), which are triggered by a change in control of the company. The narrative disclosure must include, among others, the estimated payment that would be due to the NEO upon a change in control. Because the circumstances leading to change-in-control payments are usually uncertain, companies must make reasonable estimates of the payment amounts and disclose the material assumptions on which they rely to provide such an estimate.

More recently, on January 25, 2011, the SEC adopted rules implementing Section 951 of the Dodd-Frank Act, which, in addition to requiring public companies to conduct an advisory shareholder vote on executive compensation at least once every three years (the say-on-pay vote), provide that public companies seeking shareholder approval of an acquisition, merger, disposition or other similar transaction must provide their shareholders with the opportunity to vote, on an advisory basis, on the golden-parachute arrangements of NEOs. The say-on-parachute vote, as it is ?commonly known, is not required if the company previously disclosed its golden-parachute arrangements in executive compensation disclosures subject to a prior say-on-pay vote.

In conducting a say-on-parachute vote, a company must disclose any golden-parachute arrangements with the NEOs of the target or acquiring company, whether present, deferred or contingent compensation.

The disclosure must be presented clearly and in simple form in both tabular and narrative format. The company must provide detailed disclosure regarding each separate form of compensation, whether such compensation is paid on a single- or double-trigger basis, material conditions or obligations applicable to receipt of payment, the specific circumstances that trigger payment, timing and duration of payment (e.g., lump sum or periodic), and the party making such payment (e.g., target or acquiring company).

Disclosure would not be required for bona fide post-transaction employment agreements to be entered into in connection with the proposed transaction.

ISS Proxy Advisory Services, an influential proxy advisory firm, has also voiced its opinion on golden-parachute arrangements. ISS policies have historically focused on new golden-parachute arrangements with NEOs as opposed to existing golden-parachute arrangements. However, for the first time, in its November 2012 governance policy updates, ISS shifted that focus. Currently, ISS's recommendations on golden parachutes, while conducted on a case-by-case basis, factor in existing golden-parachute arrangements when assessing compensation practices. Factors relating to golden-parachute arrangements that could lead to a negative vote recommendation include (1) single- or modified single-trigger cash severance; (2) single-trigger acceleration of unvested equity awards; (3) excessive cash severance; (4) excise tax gross-ups triggered and payable; (5) excessive golden-parachute payments; (6) recent amendments that incorporate any such problematic features or recent actions (e.g., equity grants) that make post-employment packages so attractive as to lead to transactions that may not be in the best interests of shareholders; or (7) any assertion that a proposed transaction is conditioned upon a positive say-on-parachute vote. Of these factors, ISS has stated that recent ?amendments that incorporate problematic features should carry more weight.

The SEC rules and current ISS policies have begun to have an impact on shareholder voting. For example, seven companies failed their say-on-parachute vote between April 2012 and April 2013. In each of those instances, it appears that the company modified existing golden-parachute arrangements simultaneously or following the announcement of the proposed transaction. Such modifications reportedly included changing double-trigger to single-trigger or modified single-trigger arrangements, granting additional equity to the NEOs, accelerating the vesting of performance shares and/or vesting such shares at maximum levels.

While a say-on-parachute vote is not binding on a company or its board of directors and a company may choose to continue to proceed with a proposed transaction, a failed say-on-parachute vote may be viewed negatively by the investing community. Golden parachutes are facts of life in most public companies and remain commonplace. As a result of heightened shareholder scrutiny, however, public companies should consider shareholder perceptions and the current regulatory environment when structuring their golden-parachute arrangements or choosing to modify them in connection with a proposed transaction.

PAY-RATIO DISCLOSURE PROPOSAL

On September 18, the SEC, by a 3-2 vote, released a proposed rule intended to implement Section 953(b) of the Dodd-Frank Act, commonly known as the pay-ratio disclosure. The proposed rule would add a new Subsection (u) to Item 402 of Regulation S-K, which would require public companies to report the ratio of the median of annual total compensation of all employees to the CEO's annual total compensation. The definition of employees includes full-time, part-time, temporary, seasonal and non-U.S. employees of the company or any of its subsidiaries employed as of the last day of the company's prior fiscal year. If a permanent employee was not employed for the full year, a company may annualize the total compensation.

To attempt to address the criticism of the pay-ratio disclosure, which includes the complexity and costs associated with such disclosure, the proposed rule avoids a one-size-fits-all approach. The proposed rule provides a public company with flexibility in choosing a methodology to calculate the pay ratio that is appropriate based on the size and structure of the company's business and its compensation practices. For instance, a company could calculate the median by using its full employee population, a statistical sample of that population or another reasonable method. While existing executive compensation rules require extensive disclosure on NEO compensation, including CEO pay, such information is not typically provided for all employees. Therefore, a company could calculate the median using annual total compensation under existing executive compensation rules or any consistently used compensation measure, such as compensation amounts reported in its payroll or tax records. The company could also use reasonable estimates in its calculations of annual total compensation and any element of total compensation.

A company would be required to disclose the methodology, any material assumptions, adjustments or estimates used to calculate the pay ratio. Narrative disclosure is permitted but not required. The pay-ratio disclosure would be required in registration statements, proxy and information statements and annual reports that already include executive compensation disclosure.

While some applaud the flexible approach of the proposed rule for its practical considerations, others view this as preventing a true company-to-company comparison, a result the SEC has acknowledged in its release of the proposed rule. The proposed rule also faces criticism from within the SEC. SEC Commissioner Daniel Gallagher has stated that the proposed rule has nothing to do with the SEC's mission, "costs a lot and teaches little," and serves only to "name and shame" public companies and executives. While the proposed rule is intended to avoid unduly burdening companies while complying with the mandate of the Dodd-Frank Act, as SEC Commissioner Kara Stein stated, whether the SEC has "gotten that balance right remains to be seen."

Under the proposed rule, a public company will be required to comply with the pay-ratio disclosure for its first fiscal year beginning on or following the effective date of the final rule. Emerging growth companies, smaller reporting companies and foreign private issuers would be exempt from the pay-ratio disclosure. The proposed rule is subject to a 60-day public comment period. Where the rule will end up, only time will tell. In the meantime, public companies should begin to consider the implications of the rule that will be sure to come in some form.

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