The Legal Intelligencer

SEC Addresses Rulemaking Mandates on Compensation

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October 13, 2015

The past year has seen its fair share of U.S. Securities and Exchange Commission rulemaking initiatives, in particular with respect to rules relating to compensation matters. During 2015, the SEC issued rules on three significant and highly anticipated compensation-related matters. The rules, two of which are proposed and one of which is final, address pay-for-performance disclosure, the clawback of erroneously awarded incentive-based compensation, and, perhaps most significantly, pay-ratio disclosure. Each of these rules was issued pursuant to outstanding rulemaking mandates imposed by the Dodd-Frank Wall Street Reform and Consumer Protection Act of 2010. Such rulemaking mandates were enacted in response to the economic recession in order to address excessive executive compensation. The rules require public companies to provide additional disclosure in their securities filings and to implement a new written clawback policy. Some of the underlying requirements of the rules have been met with fierce criticism. This article reviews the SEC's rules on these major compensation matters and summarizes their likely impact on public companies.

Pay-Ratio Disclosure

The most controversial of the SEC's compensation rules from 2015 was clearly the rule on pay-ratio disclosure. The final pay-ratio rule was adopted Aug. 5 by a 3-2 vote. The rule requires disclosure under new Item 402(u) of Regulation S-K of: the median of annual total compensation of all employees (other than the CEO); the annual total compensation of the CEO; and the ratio of these two amounts. The rule specifies how to determine the median employee and the annual total compensation. Disclosure of the ratio must be included in a public company's annual reports, proxy and information statements and registration statements filed for its first full fiscal year commencing on or after Jan. 1, 2017. Accordingly, calendar year companies must provide the disclosure in their annual reports and proxy statements beginning in 2018 for their 2017 fiscal year. Emerging growth companies, smaller reporting companies and foreign private issuers are exempt from pay-ratio disclosure.

The SEC received over 287,000 comments in response to its proposed pay-ratio rule issued in 2013. Despite the comments, which were received from a wide variety of groups, professionals, business and other market participants, the SEC elected to largely adopt the pay-ratio rule as proposed. The inclusion of only minimal revisions in the final rule reflects the SEC's unwillingness to compromise on the controversial issues posed by the rule. Industry and market professionals continue to express concerns regarding the pay-ratio rule, which essentially requires companies to explain large compensation discrepancies between the CEO and employees to their shareholders. Employees will also be able to see how they compare to the median employee and the median employees at competitors.

While the rule is intended to enable shareholders to challenge executive pay practices, there has been much discussion regarding how it will actually affect companies' practices. In particular, there is concern that requiring disclosure will shame companies into modifying their pay practices. Companies and other market participants argue that the rule distills CEO pay practices down to one ratio. This is especially troubling since the ratio is not generally accepted as providing meaningful information to shareholders. Instead, the ratio merely highlights the disparity between CEO compensation and the employee base.

In addition to these concerns, opponents argue the rule will impose significant costs on public companies. The SEC recognized the burdens of complying with pay-ratio disclosure and adopted certain changes to alleviate potential high costs in the final rule. For example, the final rule permits companies to exclude non-U.S. employees who represent less than 5 percent of a company's total employee base. Notwithstanding the accommodations in the final rule, the initial costs of compliance have been estimated to be as high as $1.3 billion.

Companies have at least two years to comply with the pay-ratio rule. Since most companies lack an easy way to accumulate the data needed to complete the calculations required by the rules, it is likely that compliance will be difficult. Companies should therefore start to consider how to prepare for compliance. That being said, because compliance is more than two years away and in light of the controversial nature of the rule, there are likely to be legal challenges to the rule. Some commentators have even suggested that the rule could be addressed on the 2016 campaign trail and result in legislative efforts to undo it.

Pay for Performance

The other significant compensation disclosure rule from 2015 was the pay-for-performance rule. The SEC proposed the rule in late April. The proposed rule would require inclusion of a new pay-for-performance table in a company's proxy statement. The table would require disclosure of the total compensation of a company's principal executive officer and the average of the total compensation of the company's other named executive officers. Compensation disclosed in the table would consist of the total compensation amount from the summary compensation table and

a new amount based on compensation "actually paid." The table would also disclose the cumulative total shareholder return of the company and its peer group. The table must cover five years of compensation or three years for smaller reporting companies. In addition to the tabular disclosure, companies would have to provide narrative disclosure of the relationship between compensation actually paid and the total shareholder return of the company and its peer group.

The rule is designed to provide additional transparency so shareholders may better evaluate executive compensation. Pay-for-performance disclosure aims to capture whether executives are being paid in light of market performance. The tabular disclosure contrasting compensation with total shareholder return is intended to provide shareholders with effective information on executive performance versus the market.

Although the proposed pay-for-performance rule is not as controversial as the pay-ratio rule, there have still been many criticisms. The primary criticism leveled against the rule is that, while it may provide meaningful information in some cases, there are many instances where total shareholder return will not be an appropriate metric for comparison. For instance, the rule may adversely impact technology and life sciences companies that provide compensation for achieving internal objectives, such as completion of successful research and development goals, the achievement of which may not be reflected by the market until some later time. There would therefore be a disconnect in the analysis of tying CEO compensation to total shareholder return.

In light of these concerns, as well as others, the final rule, which is anticipated soon—possibly by the end of 2015—could be adopted with changes. Companies and their compensation committees are therefore advised to begin preparing for this new disclosure requirement.

Clawback

Finally, in July, the SEC proposed a rule providing for the return, or clawback, of incentive-based compensation received by executives as the result of materially noncompliant financial statements. The rule would force stock exchanges to implement listing rules requiring companies to adopt and comply with a written clawback policy providing for the recovery of excess incentive-based compensation (including stock option awards) received by a company's executives in circumstances that resulted in a financial restatement. Current and former executives would be subject to clawback. The proposal also requires companies to file a copy of the clawback policy and, in the event of a restatement, to disclose certain information concerning the restatement.

On its face, the clawback rule appears appropriately crafted to protect shareholder interests. A company and its shareholders should be entitled to recover compensation that may have resulted from material noncompliance with financial statement requirements. On the other hand, there are several concerns with the rule as proposed. For example, it is difficult to estimate the impact of

the misstatement on the company's stock price. In addition, the lack of a tax adjustment for unrecovered taxes paid by executives could be problematic since it may be difficult for executives to recoup such amounts. Ultimately, if these concerns prove burdensome enough, companies may elect to transition away from incentive-based compensation based on financial performance.

The rule remains subject to comment, and as such may be changed prior to its adoption. Whether the rule is adopted as proposed or with changes, companies should expect to implement a written clawback policy and should benefit from planning ahead. It is true that many companies currently have clawback provisions within incentive plans. More robust policies, however, may come into play.

Prepare Early

Although there is still time before any of the rules become effective, compliance will require extensive time and resource commitments of companies. Companies will therefore likely benefit by considering and preparing for implementation of the rules early. Companies should consider briefing their compensation committees on the rules, including potential ramifications of implementing such rules. Companies should also develop plans for collecting the extensive amount of information that is needed to comply with the new disclosure requirements. Finally, companies should review their incentive plans in anticipation of the final clawback provisions. These actions may assist when it comes time to apply the rules.

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