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Client**Alert**

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SEC Proposes Rules on Pay-versus-Performance Disclosure

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On April 29, 2015, the Securities and Exchange Commission (the "SEC") approved by a three-to-two vote proposed rules (the "Proposed Rules") implementing Section 953(a) of the Dodd-Frank Wall Street Reform and Consumer Protection Act (the "Dodd-Frank Act"). The Proposed Rules would require disclosure of the relationship between executive compensation actually paid and the financial performance of the issuer. The disclosure would be required in any annual report, proxy statement or registration statement that would otherwise require executive compensation disclosure under Item 402 of Regulation S-K. Foreign private issuers, registered investment companies and emerging growth companies are exempt from the proposed disclosure requirements. The Proposed Rules draw meaningful distinctions between the disclosure requirements applicable to smaller reporting companies[1] and all other reporting companies. Public comments on the Proposed Rules must be received within the 60-day period following the Proposed Rules' publication in the *Federal Register*. This Client Alert summarizes the material features of the Proposed Rules and the key considerations for the public companies to which the Proposed Rules would apply.

Requirements of the Proposed Rules

Overview

Section 953(a) of the Dodd-Frank Act instructs the SEC to adopt rules requiring public companies to include in their annual proxy statements information that shows the relationship between the executive compensation paid to named executive officers ("NEOs") and the financial performance of the company, taking into account any change in the value of the shares of stock and dividends of the company and any dividends and distributions ("pay-versus-performance"). The Proposed Rules would require disclosure under a new Item 402(v) of Regulation S-K. The following table summarizes the new disclosure requirements and their applicability to smaller reporting companies and to all other reporting companies:

1 A "smaller reporting company" is an issuer that is not an investment company, an issuer of asset-backed securities, or a majority-owned subsidiary of a parent that is not a smaller reporting company and that had a public float of less than US$75 million. If an issuer has no common equity public float or market price, then the following revenue test applies: a company would be considered a smaller reporting company if its annual revenues are less than US$50 million.

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<table>
<tr><th></th><th>New Disclosure Requirement Regarding Relationship of TSR to Executive Compensation</th><th>Definition of NEO for Each Type of Issuer[2]</th><th>Measurement Period</th><th>Phase-In of Measurement Period</th><th>New Disclosure Requirement Regarding Performance Compared to Peer Group</th></tr>
<tr><td>Smaller reporting company</td><td rowspan="2">The relationship between “executive compensation actually paid” to the issuer’s NEOs and the cumulative total shareholder return (“TSR”) of the issuer calculated in accordance with Item 201(e) of Regulation S-K</td><td>Principal executive officer (“PEO”) + two most highly compensated executive officers</td><td>Three most recent fiscal years</td><td>Two most recent fiscal years in first year after rule adoption; three most recent fiscal years thereafter</td><td>Not applicable</td></tr>
<tr><td>All other reporting companies</td><td>PEO + principal financial officer + three mostly highly compensated executive officers</td><td>Five most recent fiscal years</td><td>Three most recent fiscal years in first year after rule adoption and one additional year in each subsequent year of reporting</td><td>The relationship between the issuer’s TSR and the TSR of a peer group (which may be any peer group chosen by the issuer, such as the peer group used for the purposes of Item 201(e) of Regulation S-K or the peer group used in the Compensation Discussion and Analysis (“CD&A”)</td></tr>
</table>

Prescribed Tabular Format and Accompanying Narrative/Graphical Disclosure

The required information would be presented in a prescribed table, as reproduced below, followed by additional narrative/graphical disclosure.

Pay Versus Performance Table

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)

2 NEOs also include up to two additional individuals for whom compensation disclosure would have been provided but for the fact that the individual was not serving as an executive officer of the issuer at the end of the most recently completed fiscal year.

The SEC specifically indicates that because the Dodd-Frank Act requires disclosure of the relationship between the executive compensation paid and the company's performance, simply disclosing the amount of the "executive compensation actually paid" and the financial performance measure in the above table would not satisfy the statutory requirement. Therefore, the Proposed Rules require issuers to describe the relationship between the "executive compensation actually paid" and TSR, as well as the relationship between the issuer's TSR and its peer group's TSR. The disclosure about the TSR relationship would follow the table and could be presented as a narrative, graphically, or as a combination of the two. The Proposed Rules contain several suggestions for disclosing the relationship, including a graph illustrating the "executive compensation actually paid" and change in TSR on parallel axes and plotting compensation and TSR over the required time period. Alternatively, the relationship could be presented by showing the percentage change over each year of the required time period of both "executive compensation actually paid" and TSR together with a brief discussion of that relationship.

Calculating "Executive Compensation Actually Paid"

The SEC's current rules regarding executive compensation require disclosure of compensation "awarded to, earned by or paid to" an executive officer with respect to a particular fiscal year. As a result, the compensation disclosed in an issuer's "Summary Compensation Table" can be substantially different from the actual compensation paid to an executive in a particular fiscal year. The Dodd-Frank Act does not define "executive compensation actually paid." Rather than create a new definition, the SEC has proposed applying adjustments to the total compensation presented in the Summary Compensation Table to satisfy the new disclosure requirements. The compensation considered for purposes of the new disclosure requirements consists of all compensation actually paid to the executive. Two adjustments are necessary to achieve this result:

- First, equity awards would only be considered actually paid on the date of vesting and valued at fair value on such date, rather than at fair value on the date of grant as required for purposes of disclosure in the Summary Compensation Table. For example, any unvested stock options would be subtracted from total compensation as presented in the Summary Compensation Table because such awards are not yet "actually paid" and would be replaced with the fair value on the vesting date of such options. Issuers would also be required to disclose vesting date valuation assumptions if they are materially different from those disclosed in the financial statements as of the grant date.
- Second, any change in actuarial pension value that results from changes in interest rates, an executive's age and other actuarial inputs and assumptions regarding benefits accrued in previous years, which are included in the Summary Compensation Table, would be excluded. The effect of these changes is expected to reduce the volatility of the actuarial pension value compensation from year to year.

The Proposed Rules require footnote disclosure to the new table for both PEO compensation and average remaining NEOs compensation, itemizing each amount deducted from, or added to, the total compensation amount as provided in the Summary Compensation Table. We expect that some issuers may choose to include these required reconciliations as a separate table similar to tabular reconciliations frequently presented to describe and quantify perquisite information disclosed in the Summary Compensation Table.

In this context, the SEC specifically referenced the concepts of "realized pay" (the amount that the executive actually earns during the measurement period) and "realizable pay" (the amount that the executive expects to realize in the near future) as a means of comparing pay and performance used by some issuers and proxy advisors. A table included in Annex A provides a brief overview and highlights major differences among the various concepts used in this context.

Applicable Executive Officers

The executive officers for whom pay-versus-performance disclosure is required mirror the NEOs for whom smaller reporting issuers and all other reporting companies, respectively, are required to disclose compensation information in the Summary Compensation Table. All issuers are required to provide compensation information for an issuer's PEO separately. If more than one person served as PEO during any given year, then the compensation for the persons who served as PEO would be aggregated for such year to show the total amount that was paid by the issuer for the services of its PEOs. All issuers are required to provide the average compensation of the remaining NEOs identified in the Summary Compensation Table.

Measure of Performance

The Proposed Rules use TSR as the measure of performance. This is calculated by dividing the sum of (x) the difference between the issuer's share price at the end and the beginning of the measurement period plus the cumulative amount of dividends during that period, assuming dividend reinvestment, by (y) the share price at the beginning of the measurement period.

Issuers, other than smaller reporting companies, would also be required to disclose the TSR of a peer group to show the performance of the issuer relative to such peer group. If the peer group is not a published industry or line-of-business index, the issuer would have to disclose the identity of each peer issuer.

Issuers are permitted to disclose additional measures of financial performance so long as any additional disclosure is clearly identified. The flexibility to discuss other measures is intended to provide investors with a more comprehensive understanding of the relationship between an issuer's compensation practices and its financial performance. Disclosure of additional measures may also be particularly useful for issuers that do not use TSR as a metric in measuring financial performance. The SEC is requesting comment on whether any other measures of financial performance take into account any change in the share price and dividends and distributions of an issuer, and whether such metrics would be more useful than TSR for the purpose of the Proposed Rules.

Time Period Covered

Issuers, other than smaller reporting companies, would be required to provide the pay-versus-performance disclosure for the five most recently completed fiscal years. Smaller reporting companies would be required to provide this information for the three most recently completed fiscal years.

Initially, however, the rules provide for a phase-in period whereby issuers, other than smaller reporting companies, would be able to provide three years of disclosure in the first year of reporting, and provide information for an additional year in each of the two subsequent annual filings. Smaller reporting companies would be required to provide two years of information in their initial filings and three years of information thereafter.

Disclosure for newly-reporting issuers would follow a phase-in period consistent with the Summary Compensation Table phase-in period for such companies, whereby a newly-public company would be required to provide pay-versus-performance disclosure for only the most recently completed fiscal year in any proxy statement or information statement in which executive compensation disclosure pursuant to Item 402 of Regulation S-K is required in its first year as a reporting company, and for the two most recently completed fiscal years in any proxy statement or information statement in which executive compensation disclosure pursuant to Item 402 of Regulation S-K is required in its second year as a reporting company.

While the Proposed Rules indicate the SEC's belief that the covered time periods would allow for a meaningful time horizon to observe trends, the SEC is specifically requesting comment on whether the required time period should be shorter, including whether only three years of disclosure should be required (instead of five) for issuers other than smaller reporting companies, consistent with the existing Summary Compensation Table disclosure requirements.

Determining the Location and Presentation Format of the Pay-versus-Performance Disclosure

The new disclosure would not be required in a specific location within the proxy statement or information statement. While it may seem reasonable to include the required disclosure in the CD&A, the SEC specifically notes that presenting this information as part of the CD&A may suggest to an investor that the issuer considered the pay-versus-performance relationship in its compensation decisions, which is a factual question that may vary among issuers. We therefore expect that issuers will present this information as part of the narrative discussion following the executive compensation tables.

XBRL Requirement

The Proposed Rules provide that the new disclosure, including any footnote disclosure, be provided in tagged data format using eXtensible Business Reporting Language ("XBRL"). If implemented, issuers would be required to tag separately the values disclosed in the required table. Issuers would also be required to block-text tag separately the disclosure of the relationship among the measures, the footnote disclosure of deductions and additions used to determine "executive compensation actually paid," and the footnote disclosure regarding vesting date valuation assumptions. The SEC reasons that requiring XBRL tagging would promote comparability across issuers. In this context, Commissioner Aguilar called the proposal "an important step forward in the usability and comparability of pay disclosure." The XBRL data would have to be provided as an exhibit to the definitive proxy or information statement filed with the SEC. This requirement would be phased in for smaller reporting companies, whereby such companies would not be required to comply with the tagging requirement until the third annual filing in which they would provide pay-versus-performance disclosure. The SEC is seeking comment as to whether a requirement to include XBRL exhibits should extend to preliminary proxy statements.

Practical Considerations

- Disclosure required under the Proposed Rules will serve as additional context for issuers to support advisory "say on pay" votes. The SEC also expects this disclosure to serve as additional context in director elections, as it would enable shareholders to evaluate the effectiveness of the directors' oversight function in this area. In this context, in line with the overall trend of increasingly utilizing graphs and charts in compensation disclosures, relying on such visual means to present information regarding the relationship between pay-versus-performance as permitted under the Proposed Rules may allow issuers to present a more clear picture of their compensation practices in support of both say-on-pay and director election votes.

- Once effective, issuers will have to carefully review the compensation disclosure required to be presented and provide clarifying remarks to forestall potential shareholder confusion. For example, the proposed new disclosure may not capture the economic relationship between an issuer's performance and an NEO's individual contribution to the company. Similarly, in a scenario where a PEO's or average NEOs' compensation increased, while TSR dropped, shareholders may focus on this particular correlation in isolation, in the absence of further clarifying context to put this information in perspective.

- Because under the Proposed Rules unvested equity would be excluded from "executive compensation actually paid," issuers may have to explain the relationship between this figure and the amount reported in the Summary Compensation Table. For example, issuers that compensate NEOs largely in equity should be aware that the pay-versus-performance information may appear particularly volatile in a cliff-vesting scenario or when vesting dates are less frequent, making the proposed disclosure potentially confusing for shareholders, or leading shareholders to draw incorrect inferences about the relationship between pay and performance. Similarly, because equity would not be included in "executive compensation actually paid" until the relevant vesting date, it may reduce the comparability across peer issuers.

- The Proposed Rules contain 64 specific requests for comments. Issuers that expect to be significantly impacted by the new disclosure requirements, particularly issuers with complex compensation structures and issuers that are small enough that the cost involved in making the new disclosures would be relatively more consequential in comparison to their size, should consider submitting detailed and data-intensive comment letters describing their observations and estimating compliance costs. In particular, smaller reporting companies are not currently required to comply with Item 201(e) requiring TSR disclosure, as part of the required performance graph, so such companies may face a significantly enhanced burden in calculating their own TSR for the purpose of the proposed disclosure requirement.

- While the Proposed Rules are currently subject to comment and the requirements will not become effective until the final rules are adopted, it is possible that issuers will have to include pay-versus-performance information in their filings for the 2016 annual reporting season.

Annex A

Element of Compensation	SEC Summary Compensation Table ("SCT")	Proposed Rules "Executive Compensation Actually Paid"	ISS "Realizable Pay"
Salary	Included	SCT value included	SCT value reported for all years in the measurement period (i.e., typically three years)
Bonus	Included	SCT value included	SCT value reported for all years in the measurement period
Stock Awards	Aggregate grant date fair value computed in accordance with Financial Accounting Standards Board Accounting Standards Codification Topic 718 ("ASC 718")	Fair value on the date of vesting	Value (based on stock price as of the end of the measurement period) of awards made during the period (less any shares/ units forfeited due to failure to meet performance criteria based on complete and clear disclosure); or, if performance awards remain ongoing, the target level of such awards
Option Awards	Aggregate grant date fair value computed in accordance with ASC 718	Fair value on the date of vesting	Net value realized with respect to such granted options which were also exercised during the period; for options granted but not exercised during the measurement period, ISS will recalculate the option value, using the Black-Scholes option pricing model, as of the end of the measurement period
Non-Equity Incentive Plan Compensation	Included	SCT value included	SCT value reported for all years in the measurement period[3]
Change in Pension Value and Nonqualified Deferred Compensation Earnings	Included	Change in the actuarial present value of all defined benefit and pension plans excluded Above-market or preferential earnings on deferred compensation that is not tax-qualified included consistent with SCT value	SCT value reported for all years in the measurement period
All Other Compensation	Included	SCT value included	SCT value reported for all years in the measurement period

3 For all prospective long-term cash awards made during the measurement period, consists of the earned value of the award (if earned during the same measurement period) or its target value in the case of ongoing award cycles.