Center On Executive Compensation

Policy Brief

Forthcoming SEC Rules to Require Comparison of Executive Compensation "Actually Paid" to Company Financial Performance

Section 953(a) of Dodd-Frank Provides SEC an Opportunity to Urge Greater Standardization of Supplemental Pay Disclosures

Section 953(a) of the Dodd-Frank Act directs the SEC to draft rules requiring companies to provide a disclosure of pay versus performance. As is common with other provisions of the Dodd-Frank executive compensation rules, Section 953(a) states that the comparison must entail "a clear description" of "the relationship between executive compensation actually paid and the financial performance of the company," but does not provide clear guidance as to the meaning of the terms. Thus, the SEC is left to craft a disclosure based on the vague legislative language. Meanwhile, over the past four years, more companies have begun to use supplemental disclosures, such as realizable and realized pay, in their Compensation Discussions and Analyses for the purpose of explaining the linkage between pay and performance. However, one of the drawbacks of the considerable experimentation occurring is that in many cases neither terms nor disclosures are comparable among companies, making it more confusing for investors and making it difficult to compare pay for performance across companies. It is in this context that the SEC will engage rulemaking on Section 953(a). There is no statutory deadline for the SEC to propose regulations implementing Section 953(a). However, SEC staff has recently characterized the rulemaking status as "seeing the light at the end of the tunnel," signifying that rules are likely to come sooner rather than later. The Center believes that the SEC should use the rulemaking to bring greater consistency to supplemental pay disclosures.

The Language of Section 953(a) and Insight into Potential SEC Rulemaking As noted above, the text of 953(a) leaves considerable discretion to the SEC in defining the pay for performance disclosure. The text of Section 953(a) reads as follows:

> 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 [by Item 402 of Regulation SK], 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.
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> The disclosure under this subsection may include a graphic representation of the information required to be disclosed.

How the SEC approaches its proposed rules will determine whether the disclosure requirements will provide greater standardization to supplemental pay for performance disclosures, even while allowing flexibility, or merely apply a loose framework of principles that companies will be required to address in their disclosures. The text of 953(a), while lacking in detail, does include some significant terms and concepts which the SEC will need to address in a rulemaking.

- "Clear description of any compensation required by [Item 402 of Regulation SK]" – Suggests that companies will be required to provide a description of the varying elements of executive compensation. The final sentence of Section 953(a) notes that this description can be presented using a graphic in addition to or as a substitute for typical narrative disclosures.
- "Including information that shows the relationship between executive compensation actually paid" – The statute states that the disclosure must describe compensation "actually paid." The phrase "actually paid" is undefined in the statute, and the question is whether and how the SEC will define the term. One approach is to consider "compensation actually paid" as compensation that the executive realizes at the end of an incentive period, such as when performance shares pay

out, restricted stock vests and stock options are exercised. Another possible interpretation is when compensation is granted, although that would seem to be redundant given the existing disclosures in the Summary Compensation Table. A third approach is that the SEC may take a flexible interpretation and require companies to define "actually paid" in their disclosures. This would allow companies to use realized pay, realizable pay or another formulation of pay for performance. Unfortunately, this approach would not help clear up confusion by promoting greater standardization of supplemental forms of pay disclosure such as realized or realizable pay.

- "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." – Companies will be required to discuss executive compensation "actually paid" in the context of the company's financial performance. This is likely to be construed to mean stock price appreciation, and in particular, total shareholder return, which takes into account dividends. However, the proposal may also my require companies to describe financial performance in terms of the metrics that apply to the company's annual and long-term incentive plans.

Regardless of the approach that the SEC takes in its proposed rules, the Center will encourage the development of greater standardization among supplemental disclosures while preserving flexibility to accommodate individual company circumstances.

Center Comments on 953(a) Implementation Focus on Preserving Flexibility for Companies The Center believes that the Commission should interpret Section 953(a) by taking an approach consistent with principles-based disclosure that recognizes the need for flexibility in properly portraying the unique aspects of individual company pay philosophies, programs and decisions and the focus should be on allowing companies the flexibility to explain the Compensation Committee's decision in the context of its overall pay philosophies. The Center's approach to disclosure is consistent with the recent *Conceptual Framework on Supplemental Pay Disclosure* developed by a Working Group co-led by The Conference Board Governance Center, the Center and the Society of Corporate Secretaries and Governance Professionals.

Definition of Actually Paid: The Center believes that the determination of "actually paid" may vary based on how the Compensation Committee and the Board structured the performance basis of incentive compensation granted to executives. For example, where incentive grants represent an incentive for future performance, that may suggest "actually paid" should be defined consistent with "realized pay." By contrast, in some companies, incentive grants are made as rewards for past performance. In such cases compensation "actually paid" may be the grant date fair value of the awards or the realizable value of the awards as of the reporting date, because realizable pay shows the value of awards based on the intrinsic value of stock-based grants.

Definition of Financial Performance Should be Company-Specific: The Center believes it makes the most sense that the definition of "financial performance" reflect the financial metrics the Compensation Committee and Board have incorporated into a company's incentive plans. Companies choose these financial measures to begin with because they believe they represent the short and long term financial objectives that will best drive shareholder value, which will ultimately be reflected in share price. Moreover, using the same financial metrics for all companies would fail to recognize that different metrics are more applicable to certain industries.

Conclusion Forthcoming SEC rules are likely to provide companies with a loose, principles-based framework to utilize to develop their pay for performance disclosures. The Center believes that the SEC should use this opportunity to encourage greater standardization of supplemental disclosures while providing sufficient flexibility to allow companies to explain their specific circumstances.