Korn Ferry Hay Group Top 300 CEO Compensation Study

CEO pay continues to track performance

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| HayGroup

CEO pay loses steam in light of overall company financial performance and investor caution

Agenda

Presentation overview

1 **OVERVIEW OF FINDINGS**
WHAT DID ANOTHER YEAR MEAN FOR CEO PAY IN 2015?

2 **PAYING FOR PERFORMANCE**
WAS THERE A STRONG RELATIONSHIP BETWEEN CEO PAY AND COMPANY PERFORMANCE IN 2015?

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HOW DID COMPANIES RESPOND TO SAY-ON-PAY VOTES AND SHAREHOLDER OUTREACH?

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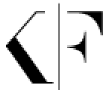
WHAT WILL BE 2015'S LASTING IMPACT ON EXECUTIVE PAY IN THE UNITED STATES? WHAT WILL WE SEE IN 2016 & 2017?



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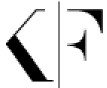
Overview of Findings

Overview of findings

About this study

- Korn Ferry Hay Group's ninth CEO pay study
- 300 U.S. public companies:
  - Median FY 2015 revenues of $18.0 billion
- Proxy filings between May 1, 2015 – April 30, 2016
- CEO pay for FY 2015



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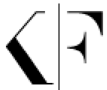
Overview of findings

Components of compensation in the study

	Base Salary
+	Annual Incentives
=	**Total Cash Compensation**
+	Long-Term Incentives
=	**Total Direct Compensation**
+	All Other Compensation + Change in Pension Value + Non-Qualified Deferred Compensation Earnings
=	**Total Compensation**



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Overview of findings

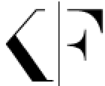
Snapshot – CEO pay and revenue by industry

- Our sample shows that larger company CEOs generally make more than that of smaller companies, but industry may influence pay levels too

Oil & Gas
Health Care
Consumer Goods
Financials
Industrials
Basic Materials
Utilities
Consumer Services
Full Sample

Total Compensation ($000)
$20,000
$18,000
$16,000
$14,000
$12,000
$10,000
$8,000
$6,000

$10,000 $12,000 $14,000 $16,000 $18,000 $20,000 $22,000 $24,000
Total Revenue ($MM)



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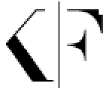
Overview of findings

Median CEO compensation increases and values

- Weaker financial performance begins to temper pay as bonuses and cash compensation remained flat while modest LTI increases drove a slight median total direct compensation increase of 2.7% over 2014 pay levels

Base Salary	Annual Incentive	Total Annual	LTI	Total Direct
$1,250,000	$2,300,000	$3,468,167	$8,350,236	$11,700,344

	Base	Annual Incentive	Total Annual	LTI	Total Direct
Increase	2.3%	0.0%	0.0%	5.1%	2.7%



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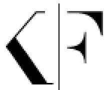
Overview of findings

Realized long-term incentive income by industry

- The recent bear market has slowed the momentum on gains from historically high LTI grants. However, median realized ('take home') LTI values rose a solid ~18% to ~$9.4 million

Industry	Median Realized LTI ($000)
Median CEO	$9,353
Basic Materials	$4,130
Consumer Goods	$10,991
Consumer Services	$13,017
Financials	$13,878
Health Care	$12,980
Industrials	$7,440
Oil & Gas	$4,220
Technology	$14,853
Telecom	$11,370
Utilities	$6,652



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Overview of findings

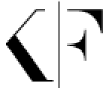
Snapshot – median CEO total compensation

- Total compensation comes in at $12.9 million

$14,000,000
$12,000,000
$10,000,000
$8,000,000
$6,000,000
$4,000,000
$2,000,000
$0

$747,348
$232,419
$8,350,236
$2,300,000
$1,250,000

Pension Value Chg
All Other Comp
LTI
STI
Salary



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Overview of findings

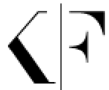
Change in CEO pay mix – 2014 vs. 2015

- Companies continue to slightly shift pay toward long-term incentives

	Salary	STI	LTI
2014 TDC	11%	23%	66%
2015 TDC	12%	20%	68%

0% 20% 40% 60% 80% 100%

Percentage of Total Direct Compensation



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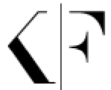
Overview of findings
Incentives as a % of base

- Annual payout percentages declined while long-term incentive payout percentages exhibited a modest increase

	2014	2015
STI %	208%	198%
LTI %	641%	658%



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Overview of findings

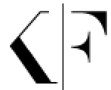
Mix of elements – industry CEOs (total direct compensation)

- All sectors emphasize long-term incentives, with modest differences in overall mix. Sectors operating on longer time horizons to execute their business strategy may tend to weight LTI more heavily than others

	Salary	STI	LTI
Median CEO	12%	20%	68%
Basic Materials	13%	22%	65%
Consumer Goods	13%	25%	62%
Consumer Services	13%	22%	65%
Financials	10%	26%	64%
Health Care	11%	19%	70%
Industrials	12%	18%	70%
Oil & Gas	12%	15%	73%
Technology	10%	19%	71%
Telecom	9%	21%	70%
Utilities	13%	20%	67%

Axis: 0% 20% 40% 60% 80% 100%

Percentage of Total Direct Compensation



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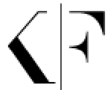
Overview of findings

Change in CEO long-term incentive mix – 2014 vs. 2015

- The emphasis on performance awards increased to their highest levels ever, as emphasis on stock options continues to slowly decline over time

	Stock Options/SARs	Restricted Stock	Performance Awards
2013 LTI	29%	25%	46%
2014 LTI	26%	25%	49%
2015 LTI	25%	25%	50%

Percentage of LTI (axis: 0%, 20%, 40%, 60%, 80%, 100%)



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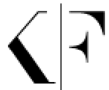
Overview of findings

Mix of long-term elements – industry CEOs

- Almost every sector continues to emphasize performance plans over any other vehicle

	Opt	RS	Perf
Median CEO	25%	25%	50%
Basic Materials	31%	12%	57%
Consumer Goods	30%	23%	47%
Consumer Services	30%	29%	41%
Financials	18%	29%	53%
Health Care	27%	19%	54%
Industrials	31%	20%	49%
Oil & Gas	21%	42%	37%
Technology	16%	30%	54%
Telecom		41%	59%
Utilities	7%	23%	70%

Percentage of Long-Term Incentives (axis: 0%, 20%, 40%, 60%, 80%, 100%)



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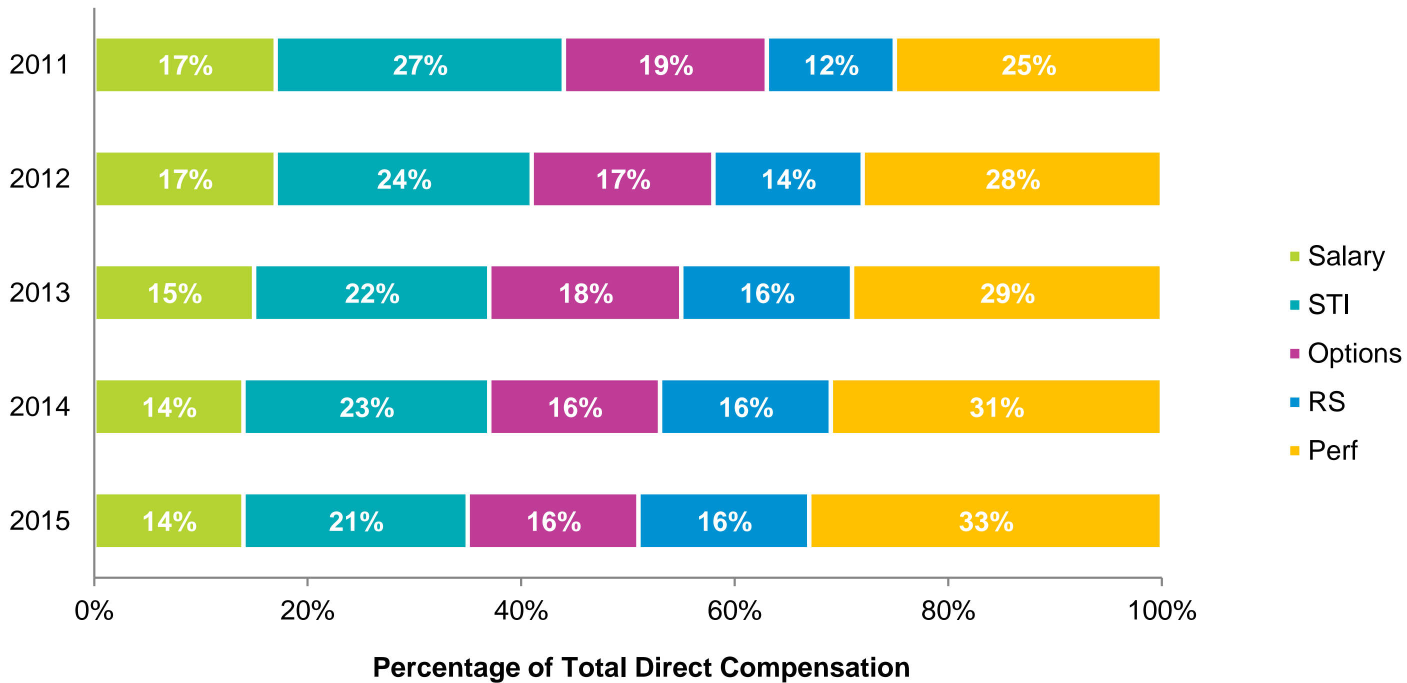
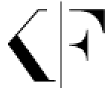
Overview of findings

Historical view: total direct compensation mix

- Over the last five years, emphasis on performance awards has gradually increased, while emphasis on cash compensation has declined





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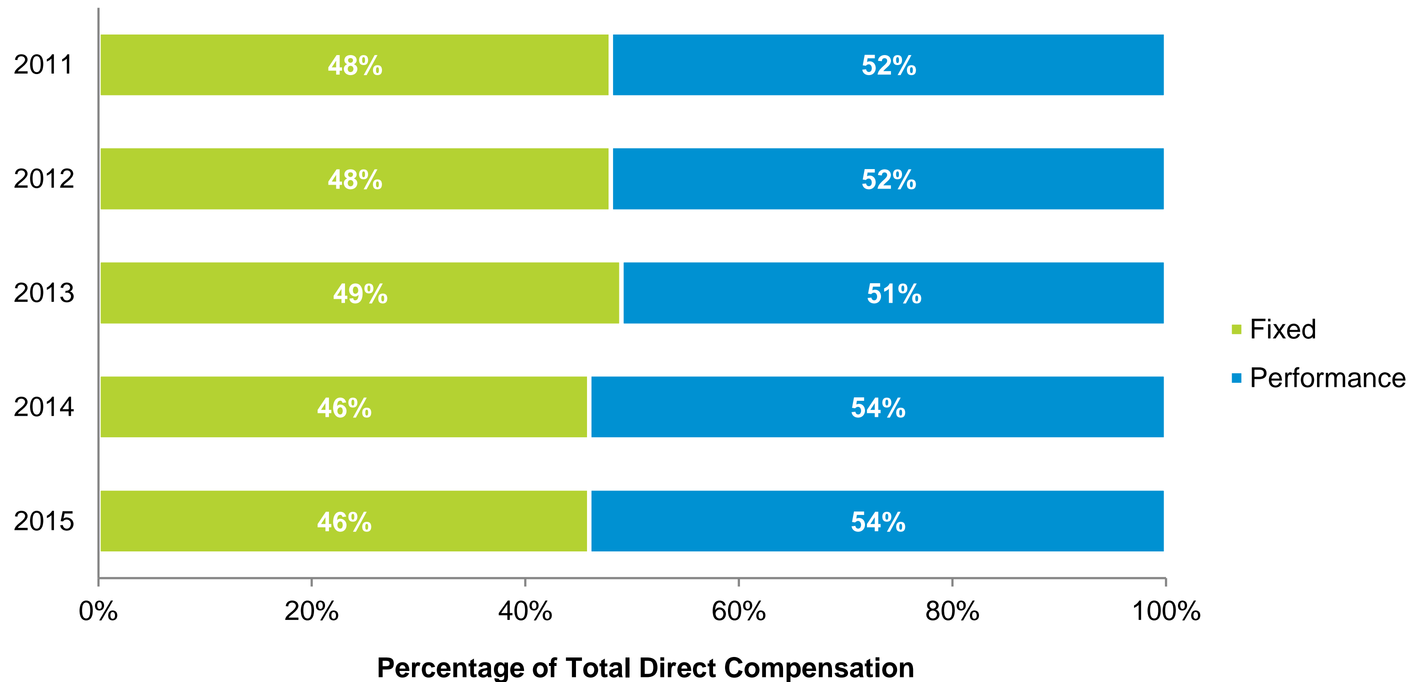
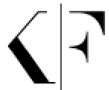
Overview of findings

Historical view: “fixed” vs. performance pay

- Over time, the balance continues to shift from 'fixed' or 'time-vested' (base + options + restricted stock) to performance-oriented (annual incentive plans + performance-vested LTI) elements, but appears to have begun to steady





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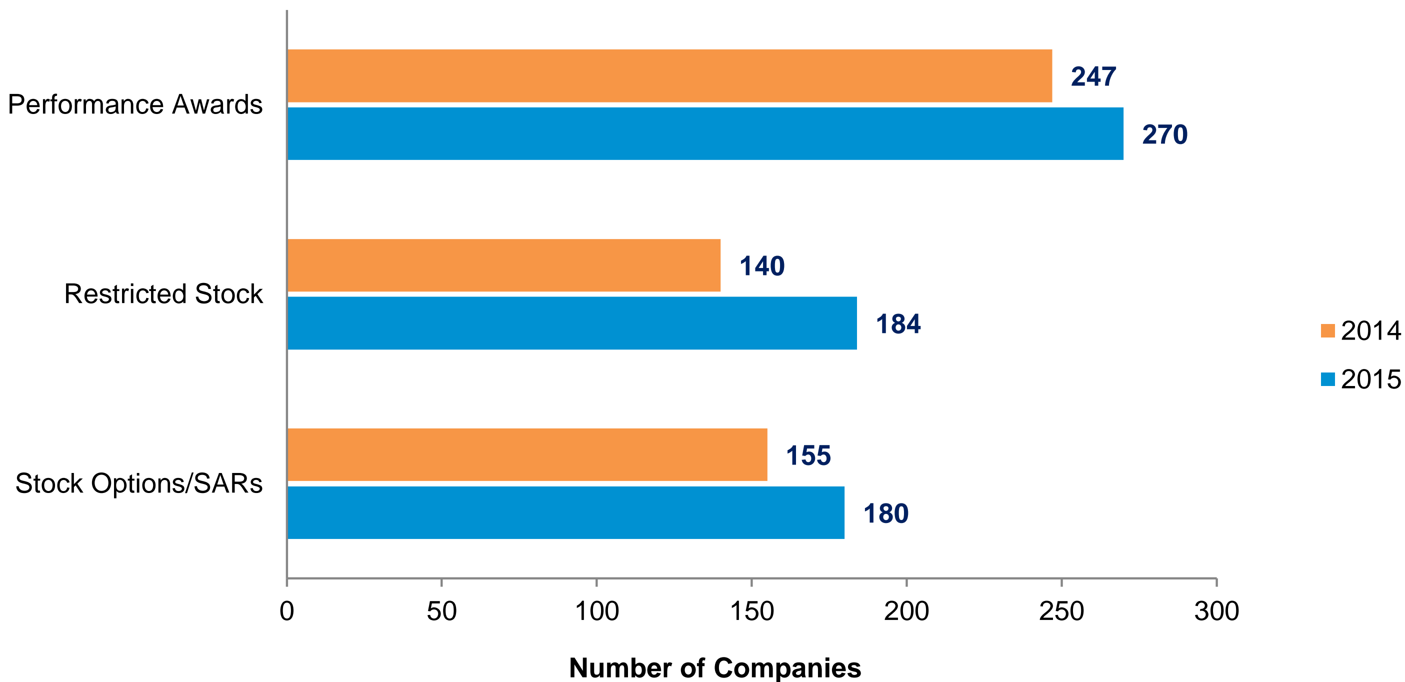
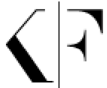
Overview of findings

Change in CEO long-term incentive prevalence – all incumbents

- Performance awards continue to reign as the most widely-used vehicle. While every equity vehicle increased in prevalence, restricted stock exhibited the biggest jump as companies may want to begin reintroducing retention into their pay program





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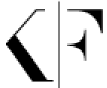
Overview of findings

Use of LTI portfolios

- The most widely-used 'portfolio' includes use of all three LTI vehicles, with over 80% using more than one vehicle. Over a four-year period, the biggest increase has been seen in RS + performance awards, while the biggest drop has been in options + performance awards

	2011	2015
All three	86	91
Opt + Perf	82	60
RS + Perf	35	65
Perf Only	27	30
Opt + RS	32	16
RS Only	14	13
No Usage	13	11
Opt Only	12	14



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Overview of findings

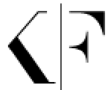
CEO LTI portfolio mix

- Companies taking a 'portfolio' approach emphasize performance plans over the other vehicles, while stock options have the least emphasis within the portfolio

	Stock Options	Restricted Stock	Performance Awards
Options, Restricted Stock & Performance Awards	26%	24%	50%
Options & Performance Awards	33%		67%
Restricted Stock & Performance Awards		33%	67%
Options & Restricted Stock	50%	50%	

0% 20% 40% 60% 80% 100%

Percentage of LTI



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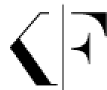
Overview of findings

Top 10 – 2014 vs. 2015

- Top 10 CEOs' pay has declined 14% (at median), but appears more tightly clustered
- Five CEOs appeared in the top 10 in both 2014 and 2015 – all of whom run media companies that now routinely sit at the top of the list in pay levels. Their pay positioning is in large part due to their size, scale, operating complexity, talent profile, and pay volatility in the sector

2014			2015		
Company	Executive	TDC	Company	Executive	TDC
Liberty Global	Michael T. Fries	$110,607,895	CBS	Leslie Moonves	$55,199,918
Microsoft	Satya Nadella	$84,296,026	Viacom	Philippe P. Dauman	$53,876,984
Qualcomm	Steven M. Mollenkopf	$60,619,442	Oracle	Mark V. Hurd	$53,222,875
CBS	Leslie Moonves	$53,013,427	Oracle	Safra A. Catz	$53,222,875
Viacom	Philippe P. Dauman	$43,788,679	Disney	Robert A. Iger	$42,170,641
Disney	Robert A. Iger	$42,592,600	Honeywell	David M. Cote	$32,178,000
Time Warner Cable	Robert D. Marcus	$34,195,763	Time Warner	Jeffrey L. Bewkes	$31,242,578
Time Warner	Jeffrey L. Bewkes	$32,469,657	AON	Gregory C. Case	$29,002,082
Aramark	Eric J. Foss	$31,299,343	General Motors	Mary T. Barra	$27,979,533
Target	Brian C. Cornell	$27,998,277	Liberty Global	Michael T. Fries	$26,451,649
	Median	$43,190,640		Median	$37,174,321
	Average	$52,088,111		Average	$40,454,714



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Paying for performance

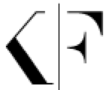
Paying for performance
Highlights

How much did annual and long-term performance drive pay outcomes in 2015

Weaker performance drove lower bonuses, but strong performance didn't necessarily translate into meaningful increases to cash compensation

- While similar pay disparity was observed in 2014 between top and bottom performing CEOs, significant increases in profitability for top-performing CEOs only translated into a 5.2% rise in cash compensation levels
- To a lesser degree, companies that lost money did not necessarily see a proportional drop in cash compensation levels

Considering 2015 was the most challenging year in the post-recession era, long-term performance remained robust and continued to drive the clearest pay differentiation between the various levels of performers



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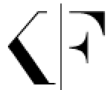
Paying for performance

Change in CEO TCC vs. change in net income

- While bottom-third performers were somewhat penalized, top-third performers weren't necessarily rewarded for strong performance as companies remain cautious about paying executives for short-term results

	% Change in Net Income	% Change in TCC
Top Third	40.3%	5.2%
Middle Third	1.8%	2.0%
Bottom Third	-33.4%	-10.6%



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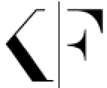
Paying for performance

Realized CEO long-term incentive income vs. 2013-2015 annualized total shareholder return

- Looking at long-term performance, however, we saw stronger alignment between long-term TSR performance and realized LTI in 2015

	Realized LTI ($000)	3 Yr TSR
Top Third	$15,846	28.4%
Middle Third	$12,853	17.0%
Bottom Third	$4,096	1.2%



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Examples of changing programs

Examples of changing programs

Companies respond to Say-on-Pay votes

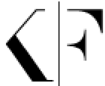
In 2015, shareholder outreach continued as companies engaged investors throughout the year to discuss pay issues within the context of the economic climate

- Following those meetings, companies often listened to the expressed concerns and recommendations of shareholders, with many continuing to adopt changes to their pay programs
- Companies that have held-out on performance awards and a TSR metric over the last several years have felt the shareholder pressure to finally adopt these pay practices

The most common types of changes seen in 2015 involved the following three areas:

- Continued enhancement of performance-based equity vehicles at the expense of time vested equity vehicles
- Redesigned STI and LTI programs with new performance metrics
- Extension of LTI performance periods to better align with the time horizon to execute on the intended business strategy

We have seen pay mix evolve over the past 5+ years, but as shareholders continue to step up their involvement in the wake of depressed share prices, companies will continue to face more pressure to align longer-term pay with performance



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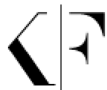
Examples of changing programs

Companies respond to Say-on-Pay votes *cont'd*

- Most pay program changes in response to shareholders observed within our sample included refined performance metrics, performance period extensions, and other incentive program design modifications that strengthen alignment with the business strategy

Company	New LTI Vehicle	Increased Emphasis on Perf-Based LTI	New / Revised Perf Metrics	Perf Period / Goal-Setting Adjustment	STI / LTI Redesign
Leucadia National		✓	✓	✓	✓
Carnival	✓				
Freeport-McMoRan			✓		
Anadarko Petroleum				✓	
CVS Health	✓	✓			✓
Ford			✓	✓	
Target					✓
Aflac			✓	✓	



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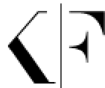
Examples of changing programs

Companies respond to Say-on-Pay votes cont'd

Company	Historical SOP Support	Pay Program Change	Shareholder Engagement?
Leucadia National	2015: 93.0% 2014: 62.4%	• **Shifted bonus opportunity** to performance-based equity • Agreed to **multi-year performance vesting with additional three years holding** requirement • **Added TSR** as a performance metric	✓
Carnival	2015: 85.5% 2014: 58.4%	• All NEO compensation other than base salary **converted to 100% at-risk and performance-based**	✓
Freeport-McMoRan	2015: 89.2% 2014: 62.7%	• **Incorporated financial and operational metrics** into the incentive program – in addition to TSR, other goals included debt reduction, capital expenditures, and consolidated net unit cash costs per lb of copper	✓
Anadarko Petroleum	2015: 86.9% 2014: 61.9%	• **Eliminated two-year performance unit program** so that all awards will be granted subject to a three-year performance period	✓
CVS Health	2015: 94.7% 2014: 70.6%	• **Shift to 100% stock-settled LTI awards** • **Rebalanced CEO's LTI mix**	✓
Ford	2015: 97.2% 2014: 75.1%	• **LTI performance period extended** from one to three years • **Incorporated TSR metric** for 2015 performance unit grants	✓



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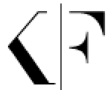
Examples of changing programs

Companies respond to Say-on-Pay votes *cont'd*

Company	Historical SOP Support	Pay Program Change	Shareholder Engagement?
Target	2015: 96.6% 2014: 77.9%	• **Replaced personal performance component** with a team scorecard to encourage alignment with strategy, collective goals, and greater objectivity • **Increased financial performance weighting** from 67% to 80%	✓
Aflac	2015: 87.0% 2014: 73.6%	• **Incorporated an average risk-based capital ratio over a 3-year period** rather than annual measurements • **Eliminated overlap in performance metrics** used between the AIP and LTIP	✓



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What's next?

What’s next?

Looking back at 2015/2016

Most companies continue to receive strong shareholder support for their pay programs, but more effort was likely required

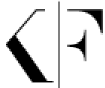
- Shareholders spoke and companies listened
- Pay mix continues to evolve as companies enhance their pay for performance reinforcement
- Performance share plans continue to be the enabler for the new, more shareholder friendly, compensation mix. But, time-vested equity remains an important retentive element in the wake of uncertain economic conditions

Shareholder outreach continued to pick up steam

- Outreach activity continues to intensify and should carry into 2016/2017 as companies rationalize pay decisions that balance performance alignment and retention

Companies are working hard at improving pay program disclosures

- More explanation, rationale, and clarity on pay decisions and structure are becoming the norm within the CD&A
- More depth can be found today with respect to annual incentive and performance-based LTI disclosures to educate shareholders and score points with proxy advisors



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What's next?

Staying ahead of Say-on-Pay

So far, shareholder outreach seems to be working in optimizing pay program support

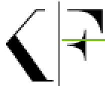
- This has been much easier to do with shareholders during strong TSR years in 2013 and 2014, but it'll likely become a harder sell as shareholders begin to realize little or no gains

The poor TSR year is potentially happening for the first time in the era of mandatory SOP

- Strengthening relationships now with your largest shareholders can help make the conversation easier even as the market takes a downward turn
- The effectiveness of shareholder outreach efforts will really be tested this year

Aligning pay and performance that supports a longer-term business strategy within the context of economic uncertainty may require some tough decisions as not all of these pay program changes may fare well with shareholders and proxy advisory groups

- Companies have listened to shareholders and gave them a nod with respect to making pay programs more about performance over the last two years
- However, aligning the pay program with the intended business strategy will require some trust on the part of shareholders – companies need to be cautious about making pay program changes that are all about 'checking the box' in a down market



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Questions?

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SEC ADOPTS PAY RATIO DISCLOSURE RULE

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OVERVIEW OF THE PAY RATIO RULE

The Basic Rule

Reporting companies subject to the rule (Subject Companies) must disclose the ratio (pay ratio) for the most recent fiscal year of (a) the median of total compensation of all employees of the Subject Company other than the principal executive officer (PEO) to (b) the compensation of the PEO.

- For purposes of this requirement, either (i) the ratio must present the amount in (a) as equal to one, or (ii) the ratio may be expressed narratively as the multiple that the amount in (b) bears to the amount in (a).
- Under the rule, Subject Companies must identify a "median employee" whose compensation will represent "the median of total compensation of all employees" for purposes of the rule.

Identification of the Median Employee

The median employee generally need be identified only once every three years; however, the total compensation of the median employee for purposes of the pay ratio disclosure must be recomputed annually.

- If the Subject Company reasonably believes a change in its employee population would significantly impact the pay ratio disclosure, the median employee must be re-identified for the fiscal year in which the change occurred.

The rule provides some flexibility for a Subject Company in identifying the median employee:

- The median employee may be determined as of any date that is within the last three months of the fiscal year.
- The company can identify the median employee using annual total compensation or any other measure (e.g., salary and incentive bonuses) consistently applied among all employees.
  - The company may apply cost-of-living adjustments to compensation for jurisdictions other than the jurisdiction where the PEO resides.
- The company need not compute the compensation of every employee; it may use statistical sampling and/or other reasonable methods to determine the median employee.
- The company may use reasonable estimates in the methodology used to identify the median employee and in the calculation of compensation used to determine the median employee.
- The company may annualize total compensation for permanent employees first employed during the subject fiscal year; however, it may not annualize compensation for temporary or seasonal employees and may not make full-time equivalent adjustments.

The rule provides for the exclusion of certain non-U.S. employees in determining the median employee:

- Data Privacy Exception—allows for the exclusion of foreign employees where the laws of the foreign jurisdiction governing data privacy render the company unable to obtain necessary information for compliance with the pay ratio rule without violating the laws, subject to specified conditions.
- *De Minimis* Exception—
  - Allows for exclusion of all non-U.S. employees if such employees constitute less than 5% of all U.S. employees.
  - Otherwise, Subject Companies are permitted to exclude up to 5% of all employees (minus the percentage of employees subject to the data privacy exclusion), provided that all employees in any particular jurisdiction must be excluded. If more than 5%

(or the net percentage after giving effect to the data privacy exception) of all employees are in a particular jurisdiction, none may be excluded under the *de minimis* exclusion.

Computing Total Compensation

Once the median employee is identified, total annual compensation for the PEO and the median employee generally must be based on the same methodology as is used to determine total compensation in the Summary Compensation Table typically included in a company's annual meeting proxy statement.

- However, personal benefits aggregating less than $10,000 and compensation under non-discriminatory benefit plans (which generally are excluded from the Summary Compensation Table) may be included in calculating the median employee's compensation (in which case, they also must be included in PEO compensation for this purpose).

Disclosures, Excluded Entities, Effective Date, Transition Provisions

- Extensive disclosure requirements apply, particularly where the Subject Company opts to take advantage of accommodations under the rule (e.g., use of data-sampling or other methodologies in lieu of calculating the compensation of each employee, cost-of-living adjustments, and data privacy or *de minimis* exceptions).
- The pay ratio rule does not apply to foreign private issuers, emerging growth companies, smaller reporting companies, Canadian issuers reporting under the U.S. Securities and Exchange Commission's (SEC's) Multijurisdictional Disclosure System, or registered investment companies.
- The rule applies to any fiscal year beginning on or after January 1, 2017.
    - For calendar year companies, the first pay ratio disclosure generally will cover 2017 and be included in the proxy statement for the 2018 annual meeting.
- Transition provisions apply with respect to newly public companies and companies that lose smaller reporting company or emerging growth company status.
- Other transition provisions apply in the context of mergers and acquisitions.

BACKGROUND

The pay ratio rule, which was adopted on August 5, 2015,[1] closely tracks the initial 2013 rule proposal,[2] subject to limited exceptions. The rule, which is discussed in further detail below, is the culmination of a somewhat contentious rulemaking process.

Numerous publications have reported the dramatic growth of chief executive officer (CEO)[3] pay over the past several decades, highlighting studies that show an increasing range in CEO-to-worker pay, with some studies and reports asserting that CEOs are paid 300, 500, or even 1,000 times more than average worker pay.[4] There have been ongoing debates about the meaning and significance of CEO-to-worker pay ratio information.

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[1] *See* Securities Act Release No. 9877, "Pay Ratio Disclosure," August 5, 2015, available at sec.gov/rules/final/2015/33-9877.pdf (Adopting Release).

[2] Securities Act Release No. 9452, "Pay Ratio Disclosure," available at sec.gov/rules/proposed/2013/33-9452.pdf.

[3] Because the pay ratio rule refers to the "principal executive officer" (PEO) rather than the chief executive officer, our discussion of the provisions of the rule uses the term "PEO."

[4] *See*, e.g., "Despite Federal Regulation, C.E.O.-Worker Pay Gap Data Remains Hidden," New York Times, (April 10, 2015), available at nytimes.com/2015/04/12/business/despite-federal-regulation-ceo-worker-pay-gap-data-remains-hidden.html.

The Dodd-Frank Wall Street Reform and Consumer Protection Act (Dodd-Frank Act),[5] enacted in July 2010, provided a point of focus on the debate. Section 953(b) of the Dodd-Frank Act directs the SEC to amend Item 402 of Regulation S-K to require "each issuer" to disclose the following:

- the median of the annual total compensation of all [emphasis added] employees of the issuer, except the chief executive officer (or any equivalent position) of the issuer;
- the annual total compensation of the chief executive officer (or any equivalent position) of the issuer; and
- the ratio of the median of the total compensation of all employees of the issuer to the annual total compensation of the chief executive officer of the issuer.

Section 953(b) also requires that the total compensation of an employee of an issuer "shall be" determined using the highly prescriptive definition of "total compensation" in Item 402(c)(2)(x) of Regulation S-K.[6]

In September 2013, the SEC proposed amendments to Item 402 of Regulation S-K to implement Section 953(b) of the Dodd-Frank Act. More than 287,000 comments were submitted regarding the rule proposal. Many commenters contended that the rule, as proposed, would impose substantial costs and burdens on companies without any corresponding benefit to investors. In particular, these commenters argued that requiring the ratio to be based on "all" employees would be overly burdensome and unfairly skew the resulting ratio.[7] At the open meeting of the SEC on August 5, 2015 held for the Commissioners to consider and vote on finalizing the pay ratio rules, Chair White stated that "[t]o say that the views on the pay ratio disclosure requirement are divided is an obvious understatement."[8] The disparity of views on the pay ratio rule was underscored by the dissents of two of the five Commissioners on the vote to approve the rule.[9] Nevertheless, on August 5, 2015, the SEC adopted its pay ratio rule as required by the Dodd-Frank Act.

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[5] Public Law No. 111-203, sec. 953(b), 124 Stat. 1376, 1904 (2010), as amended by Public Law No. 112-106,126 Stat. 306 (2012).

[6] Although Section 953(b) refers to Item 402(c)(2)(x) as in effect on the day before the date of enactment of the Dodd-Frank Act, the SEC explained that it did not include the reference in the rule because no changes had been made to Item 402(c)(2)(x) since the enactment of the Dodd-Frank Act and it will address the "as in effect" requirement in Section 953(b) if it amends Item 402(c)(2)(x) in the future.

[7] A number of these commenters suggested that the SEC should consider allowing companies to exclude from the proposed pay ratio calculations certain categories of employees, such as non-U.S. workers and part-time, temporary, and seasonal workers that would, in their view, distort the calculation. In contrast, many other commenters contended that the pay ratio information was needed to provide important transparency on executive compensation and enable investors to make more informed decisions when voting on the election of directors responsible for CEO compensation and on say-on-pay.

On June 4, 2015, to assist the SEC in developing final rules regarding pay ratio disclosure, the SEC's Division of Economic and Risk Analysis (DERA) issued a memorandum providing a technical analysis on the potential effects on the proposed pay ratio calculation of the exclusion of different percentages of employees. DERA concluded that, depending on the percentage of employees excluded from the calculation, whether the excluded employees were paid above or below the median pay and other technical factors, the pay ratio figure could vary considerably, with the variance increasing with the percentage of employees excluded. Specifically, DERA's analysis stated that the exclusion of 5% of employees could cause the pay ratio estimate to decrease by up to 3.4% or increase by up to 3.5%, resulting in a deviation range of 6.9%, whereas the exclusion of 20% of employees could cause the pay ratio estimate to decrease by up to 13% or increase by up to 15%, resulting in a deviation range of 28%. The SEC made the analysis available for public comment and extended the comment period for the proposed rules until July 6, 2015. On June 30, 2015, DERA extended its technical analysis in another memorandum, noting that its extended analysis was in line with the original analysis.

[8] Chair Mary Jo White, Statement at Open Meeting on Security-based Swap Rules Under Title VII and on Pay Ratio Disclosure Rule, August 5, 2015, available at sec.gov/news/statement/statement-at-open-meeting-on-sbs-and-pay-ratio-disclosure.html.

[9] *See* Commissioner Michael S. Piwowar's Statement at Open Meeting Regarding Municipal Advisors and Pay Ratio Disclosure (Sept. 18, 2013), available at sec.gov/News/PublicStmt/Detail/PublicStmt/1370542565153. *See also* Dissenting Statement of Commissioner Daniel M. Gallagher Concerning the Proposal of Rules to Implement the Section 953(b) Pay Ratio Disclosure Provision of the Dodd-Frank Act (Sept. 18, 2013), available at sec.gov/News/PublicStmt/Detail/PublicStmt/1370542558873.

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THE PAY RATIO RULE

The pay ratio rule reflects the SEC's effort to address the Congressional mandate of Section 953(b) of the Dodd-Frank Act while providing flexibility "in a manner that we expect will reduce costs and burdens for registrants."[10] However, the rule is complex, and it remains to be seen if the objectives articulated by the SEC are, in fact, realized.

Framework of the Rule

The pay ratio rule is set forth in new paragraph (u) to Regulation S-K Item 402, which is accompanied by 11 substantive instructions. The rule tracks Section 953(b) of the Dodd-Frank Act, although it provides several accommodations not addressed in Section 953(b), particularly with respect to the gathering of information regarding "all" employees, and requires several significant disclosures that supplement the disclosed pay ratio and are not required by Section 953(b). The disclosure provisions of the rule are largely consistent with the rule as proposed.

Subject Companies and Initial Compliance Date

The rule does not apply to foreign private issuers, smaller reporting companies, emerging growth companies, registered investment companies, or Canadian issuers that file reports under the SEC's Multijurisdictional Disclosure System.

All other companies (Subject Companies) will be required to comply with the rule and provide disclosure of their pay ratios for their first full fiscal year beginning on or after January 1, 2017. This means that a calendar-year-end Subject Company will be required to make its first pay ratio disclosures in 2018. A newly public Subject Company will be required to provide pay ratio disclosure for the first fiscal year following the year in which it becomes an Exchange Act reporting company, but not for any fiscal year commencing before January 1, 2017. Once an emerging growth company or a smaller reporting company ceases to qualify as such, the company will be required to provide pay ratio disclosure for the first fiscal year, commencing on or after January 1, 2017, following the year in which the company ceased to be an emerging growth company or smaller reporting company, as applicable.

The pay ratio disclosures are required in any SEC filing that mandates the inclusion of executive compensation disclosure under Regulation S-K Item 402, that is, proxy statements, annual reports, and registration statements under the Securities Act and the Exchange Act. However, a registration statement need not include the pay ratio disclosure for the most recent fiscal year if it is filed prior to the filing of the Subject Company's Form 10-K or, if later, its annual meeting proxy statement, unless more than 120 days have elapsed since the end of the most recent fiscal year, in which case the pay ratio disclosure for such fiscal year must be provided.

Covered Employees

The rule requires a Subject Company to determine the median of the annual total compensation of all of its employees and the employees of its "consolidated subsidiaries." The Adopting Release explains that the requirement to consider all "employees" of "consolidated subsidiaries" "generally will result in a smaller pool of employees" than would be the case if, as proposed, the rule had covered employees of every "subsidiary," as that term is defined under Securities Act Rule 405. Interestingly, the SEC bases this conclusion on its understanding that the term "subsidiary" could include a company in which a Subject Company owns "as little as a 10% stake" due to the view held by "many practitioners" in the Section 16 context that a person can be an affiliate or a control person of an entity in which it owns a 10% voting interest.[11]

The SEC stated that defining "employees" with reference to "consolidated subsidiaries" would be less burdensome for Subject Companies "because most registrants consolidate based on their ownership of

[10] Adopting Release, page 13.

[11] Adopting Release, page 85.

over 50% of the outstanding voting shares of their subsidiaries and more guidance is readily available on when consolidating subsidiaries is appropriate than when an entity should be considered a 'subsidiary' based on the concept of control."[12] The Adopting Release notes, however, that consolidation may be required when "[t]he power to control [thus triggering a consolidation requirement] exist[s] with a lesser [than 50%] percentage of ownership, for example, by contract, lease, agreement with other stockholders, or by court decree."[13] For some Subject Companies, we believe that consolidation determinations can be very complex precisely because of contractual arrangements and other factors unrelated to voting control. In addition, the Financial Accounting Standards Board's most recent standard on consolidation requirements, Financial Accounting Standards Update No. 2015-02 (Feb. 2015), will require companies to reassess their consolidation decisions relating to partnership interests and variable interest entities.

The rule requires that all employees of a Subject Company and its consolidated subsidiaries—including full-time, part-time, temporary, seasonal, and non-U.S. employees—be treated as covered employees.[14]

Date of Determination of Employee Pool

The rule allows a Subject Company to define its "employee" pool using any date within the last three months of the Subject Company's last completed fiscal year. A Subject Company must disclose the date used and, if the date changes year to year, the reasons for the change.[15]

Exceptions Related to Non-U.S. Employees

The rule also provides exceptions for non-U.S. employees from the definition of "employee" in two instances, as follows.

Data Privacy Exception

The data privacy exception contemplates the exclusion from the definition of "employee" of all (but not less than all) non-U.S. employees employed in a jurisdiction where data privacy laws would prevent the Subject Company's access to the information needed to comply with the pay ratio rule, provided that:

- The Subject Company makes "reasonable efforts" to obtain the non-U.S. employees' compensation information, with "reasonable efforts" including, "at a minimum, using or seeking an exemption or other relief under any governing data privacy laws or regulations."[16]
- The Subject Company obtains an opinion of legal counsel "opining on the inability of the [Subject Company] to obtain or process the information necessary" for compliance with the pay ratio rule, including the company's "inability to obtain an exemption or other relief under any governing laws or regulations."[17]

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[12] Adopting Release, page 86.

[13] Adopting Release, footnote 222, citing FASB Accounting Standards Codification, Paragraph 810-10-15-8.

[14] Regulation S-K Item 402(u)(3). The rule further states that covered employees do not include "workers who are employed, and whose compensation is determined, by an unaffiliated party but who provides services to the registrant or its consolidated subsidiaries as independent contractors or 'leased' workers." Commissioner Piwowar, in his additional dissenting comments on the rule, stated that this exclusion's focus on an unaffiliated party would have the following effect:

"Employees of unconsolidated subsidiaries would be swept back into the definition of employee to the extent that they provide services to the company or its consolidated subsidiaries because they are not employed by an unaffiliated third party."

Commissioner Michael S. Piwowar, Additional Dissenting Comments on Pay Ratio, August 7, 2015, available at sec.gov/news/statement/additional-dissenting-statement-on-pay-ratio-disclosure.html. We are hopeful the SEC staff will clarify the scope of the exclusion in an interpretive statement.

[15] Regulation S-K Item 402(u), Instruction 1. This represents a change from the rule as proposed, which would have defined the term "employee" as those employees employed as of the last day of the issuer's fiscal year.

[16] Regulation S-K Item 402(u)(4)(i).

[17] *Id.*

- The Subject Company files the legal opinion as an exhibit to the SEC filing that includes the pay ratio disclosure and provides disclosure about its use of the data privacy exception.

There is no limit on the number of non-U.S. employees who can be excluded from the pay ratio definition of "employee" under the data privacy exception.

Some data privacy laws outside the United States are rigorous. As a practical matter, the conditions for excluding non-U.S. employees in these countries from the pay ratio definition of "employee" are formidable and likely will impose significant additional costs on Subject Companies that intend to use this exception. We believe that these conditions to the exception will raise significant issues for Subject Companies with non-U.S. employees in countries that have meaningful data privacy laws, and that such companies should begin a process to address these issues well in advance of the time that pay ratio disclosures are first required to be made.

De Minimis Exception

The rule also includes the following two-prong "*de minimis*" exception that allows a Subject Company to exclude up to 5% of its non-U.S. employee population:

- Where non-U.S. employees account for 5% or less of a Subject Company's total employees, the Subject Company may exclude all, but not less than all, of those non-U.S. employees.
- Where non-U.S. employees exceed 5% of a Subject Company's total employee population, the Subject Company may exclude up to 5% of its total employees who are non-U.S. employees.[18]

If a Subject Company excludes any non-U.S. employees in a particular jurisdiction, it must exclude all non-U.S. employees in that jurisdiction. Accordingly, if more than 5% of a Subject Company's employees are located in any one non-U.S. jurisdiction, the Subject Company may not exclude any employees in that jurisdiction.

Moreover, any employees excluded from the definition of "employee" under the data privacy exception must be counted towards the 5% limit of the *de minimis* exception. Therefore, if more than 5% of a Subject Company's total employees are excluded under the data privacy exception, the Subject Company may not rely on the *de minimis* exception.

If a Subject Company relies on the *de minimis* exception, it must provide detailed disclosure relating to its reliance on the exception, including the jurisdiction(s) from which employees are excluded and the approximate number of employees excluded.

Business Combinations

The rule permits a Subject Company to omit any employees who became its employees as a result of a business combination or acquisition of a business for the fiscal year in which the transaction becomes effective. If the Subject Company excludes such employees, it must identify the acquired business and disclose the approximate number of employees it is omitting.[19]

Determination of the "Median Employee"

After identifying its "employee" pool, a Subject Company must then identify from that pool the "median employee," that is, "the employee in the middle of the compensation spectrum."[20] In a helpful change from the rule as initially proposed, Subject Companies are required under the rule to identify their "median employee" only once every three years, provided that during the last completed fiscal year there was no change to the employee population or compensation arrangements that the Subject Company

[18] Regulation S-K Item 402(u)(4)(ii).

[19] Regulation S-K Item 402(u), Instruction 7, paragraph 2.

[20] Adopting Release, page 119

"reasonably believes" would result in a significant change to its pay ratio disclosure.[21] If there has been a change, the Subject Company would have to identify a new median employee for the affected fiscal year.[22] A Subject Company that retains the same median employee under the three-year provision must disclose that it is using the same median employee and that there has been no change in its employee population or employee compensation arrangements that it reasonably believes would result in a significant change to its pay ratio disclosure, and the basis for such reasonable belief. In this regard, the rule states: "For example, the registrant could disclose that there has been no change in the employee population or employee compensation arrangements that it believes would significantly impact the pay ratio disclosure."[23] This is a curious example, as it essentially parrots the "reasonable belief" requirement without articulating a basis for that belief.

It is important to note that the three-year provision regarding the frequency of median employee identification does not apply to the frequency of computing the compensation of the median employee for purposes of pay ratio disclosure. A Subject Company that uses the same median employee for two or three years would still be required to calculate that employee's total annual compensation and disclose the pay ratio each year.

The rule does not specify a required methodology for identifying a median employee. Instead, the rule "permits [Subject Companies] the flexibility to choose a method to identify the median employee based on their own facts and circumstances."[24] The SEC states that among the factors a Subject Company could consider in determining the methodology to use are the size and nature of its workforce, the complexity of its organization, the "stratification of pay levels across the workforce," the types of compensation its employees receive, the number of payroll systems it has (and any integration challenges between such systems), the number of tax and accounting regimes to which it is subject, and the extent to which different currencies are involved.[25] A Subject Company may use "reasonable estimates" in the methodology used to identify the median employee and in calculating the annual total compensation or any elements of total compensation for employees other than the PEO.[26]

In identifying its "median employee," the rule would allow a Subject Company to develop a methodology that does the following:

- Uses the entire employee population, a statistical sampling, or other "reasonable methods."[27] Regarding use of statistical sampling, the Adopting Release states that "a relatively small sample size may be appropriate in certain situations" and that Subject Companies may use more than one statistical sampling approach where, for example, a Subject Company has multiple business lines or geographical units.[28]
- Uses the annual "total compensation" paid to those employees or, instead, any consistently applied compensation measures, such as information derived from tax and/or payroll records.[29] The flexibility permitted in applying compensation measures is underscored by the SEC's favorable reference to a commenter's observation:

> As one commenter noted, while a consistently applied compensation measure may exclude benefits, perquisites, and other allowances, it will still capture

[21] Regulation S-K Item 402(u), Instruction 2.

[22] *Id.* In accordance with the rule, the three-year period prior to another identification of the median employee will recommence with the fiscal year in which the new identification is made.

[23] Adopting Release, page 113.

[24] *Id.*

[25] Adopting Release, page 115.

[26] Regulation S-K Item 402(u), Instruction 4, paragraph 1.

[27] Regulation S-K Item 402(u), Instruction 4, paragraph 2.

[28] Adopting Release, page 118.

[29] Regulation S-K Item 402(u), Instruction 4, paragraph 3; Adopting Release, page 121.

salary, incentive cash earned, and stock awards, which will encompass "the substantial majority of compensation and [should] not lead to distortion of the median."[30]

The Adopting Release also states that "[f]or purposes of calculating the annual total compensation amounts when using a consistently applied compensation measure," a Subject Company may use a measure "that is defined differently across jurisdictions and may include different annual periods as long as within each jurisdiction, the measure is consistently applied." In this regard, the SEC cited an example of a compensation measure suggested by a commenter ("taxable wages") and noted that the measure may be defined differently across jurisdictions and may include different annual periods.[31] However, the SEC noted that a Subject Company "would not be permitted to use an entirely different type of measure across jurisdictions that would not be consistently applied."[32]

- Uses a cost-of-living adjustment, as discussed below.

In addition, the rule permits Subject Companies to annualize the total compensation for full-time and part-time employees employed by the Subject Company for less than the full fiscal year. However, annualizing adjustments may not be made for temporary or seasonal positions, and full-time equivalent adjustments also are not permitted.[33] The impact of the prohibition on annualizing adjustments may be mitigated by the Subject Company's ability to define its employee pool as of any date within the last three months of its fiscal year.

Whatever methodology a Subject Company determines to use to identify its median employee, the Subject Company must briefly describe the methodology. In addition, it must briefly describe any material assumptions, adjustments (including any cost-of-living adjustments) or estimates used to identify the median employee or determine total compensation or any elements of total compensation.[34]

Cost-of-Living Adjustments

In response to several comments, the Adopting Release acknowledged that "requiring registrants to determine their median employees and calculate the pay ratio without permitting them to adjust for different underlying economic conditions [in the countries in which the Subject Company operates] could result in what some would consider a statistic that does not appropriately reflect the value of the compensation paid to individuals in those countries."[35] Therefore, the rule permits a Subject Company, when identifying its median employee—whether using "total compensation" or another consistently applied compensation measure—to make cost-of-living adjustments to the compensation of employees employed in jurisdictions other than the one where the Subject Company's PEO resides (which, the SEC notes, typically will be the United States).[36]

A Subject Company seeking to make cost-of-living adjustments may only do so if the adjustments are made as prescribed by Paragraph 4 of Instruction 4 to Regulation S-K Item 402(u). However, the instruction is not entirely clear as to whether the cost-of-living adjustment provisions of the rule allow Subject Companies with employees in multiple non-U.S. jurisdictions (assuming their PEOs reside in the United States) to use cost-of-living adjustments in only certain of those non-U.S. jurisdictions, or would require that cost-of-living adjustments, if made in any non-U.S. jurisdiction, must be made in all non-U.S. jurisdictions. In the Adopting Release, the SEC acknowledged that Subject Companies

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[30] Adopting Release, page 120.

[31] Adopting Release, pages 120-121.

[32] Adopting Release, page 121.

[33] Regulation S-K Item 402(u), Instruction 5.

[34] Regulation S-K Item 402(u), Instruction 4, paragraph 5.

[35] Adopting Release, page 79.

[36] Adopting Release, page 80.

> could alter the reported ratio to achieve a particular objective with the ratio disclosure. [Footnote omitted.] Registrants with a significant number of employees in countries with a higher cost of living than the jurisdiction in which the PEO resides may be unlikely to adjust those compensation figures downward, while registrants with a sizeable work force in countries with a lower cost of living may be likely to adjust the compensation figures upward.[37]

The SEC did not state, however, that a Subject Company with employees in both higher and lower cost-of-living jurisdictions could choose among the jurisdictions to select, which might be read to imply that if a Subject Company chooses to apply a cost-of-living adjustment, it must do so with respect to all jurisdictions other than the jurisdiction in which the PEO resides. However, absent more definitive guidance from the SEC staff, the scope of a Subject Company's discretion in the application of cost-of-living adjustments is uncertain.

The rule specifically provides that if a Subject Company "uses a cost-of-living adjustment to identify the median employee, and the median employee identified is in a jurisdiction other than where the PEO resides, the [Subject Company] must use the same cost-of-living adjustment in calculating the median employee's annual total compensation and disclose the median employee's jurisdiction."[38]

The rule also provides that where a Subject Company calculates its median employee using a cost-of-living adjustment, the company must also disclose the median employee's annual total compensation without the cost-of-living adjustment.[39] The final sentence of the instruction states that "[a Subject Company] electing to present the pay ratio in this manner [with a cost-of-living adjustment] also shall disclose the median employee's annual total compensation and pay ratio without the cost-of-living adjustment. To calculate this pay ratio, the [Subject Company] will need to identify the median employee without using any cost-of-living adjustments." It appears that the rule could be calling for a Subject Company to identify its median employee without using any cost-of-living adjustments, and the re-identified median employee could be different from the median employee identified through use of the cost-of-living adjustment. We anticipate that the SEC staff will provide an interpretive clarification on this point.

Finally, if a Subject Company identifies its median employee without using any cost-of-living adjustment and finds that the median employee resides in a jurisdiction other than the one where the PEO lives, the Subject Company may not then make a cost-of-living adjustment to the median employee's compensation for purposes of the pay ratio disclosure.

Determination of Total Compensation for Purposes of the Pay Ratio Disclosure

The rule requires a Subject Company to calculate the "total compensation" for both its PEO and median employee using the requirements in Regulation S-K Item 402(c)(2)(x), which governs the calculation of "total compensation" of a public company's "named executive officers" for purposes of the Summary Compensation Table typically included in an annual meeting proxy statement. However, because the item relates to "named executive officers," as defined in Item 402(a) of Regulation S-K, the rule provides the following guidance regarding the application of certain terminology in Item 402(c)(2)(x) to non-executive employees under the pay ratio rule:

- All references to "named executive officer" in Item 402 may be deemed to refer instead, as applicable, to "employee."

[37] Adopting Release, page 81.

[38] Regulation S-K Item 402(u), Instruction 4, paragraph 4.

[39] *Id.*

- For non-salaried employees, references to "base salary" and "salary" in item 402 may be deemed to refer instead, as applicable, to "wages plus overtime."[40]

As a result of the SEC's acknowledgment that "the application of the definition of total compensation under Item 402(c)(2)(x) to employees who are not executive officers could understate the overall compensation paid to such employee,[41] the rule permits the Subject Company to include the following items (which otherwise would be excluded under Item 402) in calculating the median employee's total compensation, provided that the items also are included in the PEO's compensation:

- Personal benefits that aggregate less than $10,000.
- Compensation under non-discriminatory benefit plans.[42]

LOOKING AHEAD

The SEC adopted the rule in a split vote, with Chair White and Commissioners Aguilar and Stein voting in favor and Commissioners Gallagher and Piwowar voting against. The split vote is consistent with the votes of the Chair and Commissioners on issuing the rule proposal and representative of intense interest and conflicting views of commenters that were expressed during the rulemaking process.

SEC Commissioners Gallagher and Piwowar each made strong dissenting statements against the rule. Commissioner Gallagher stated that the rule would result in "low quality data," and that due to the SEC's failure to opt for a "less expensive rule" and his assertion that the benefits of the rule, as adjusted, "do not justify the costs," he concluded that "there is no reasoned basis for the Commission's action."[43] He also suggested that the rule may not be constitutional.

Commissioner Piwowar's dissenting remarks were similarly critical as to the costs and benefits of the rule, and asserted that the pay ratio rules were politically driven. Moreover, on August 7, 2015, Commissioner Piwowar released additional dissenting comments on the rule,[44] including several legal arguments that certain of the procedures followed (or not followed) by the SEC in proposing and adopting the pay ratio rules violated the Administrative Procedures Act. The specificity of the criticism levied by the dissenting Commissioners—and particularly the content and form of Commissioner Piwowar's second dissent—signal the possibility that the pay ratio rules may be challenged in court using arguments similar to prior challenges of SEC rules.[45] Of course, whether any legal challenge will result or succeed cannot be predicted, and Subject Companies should assume that the rule will take effect as scheduled.

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[40] Regulation S-K Item 402(u)(2)(i).

[41] Adopting Release, pages 132-133.

[42] Regulation S-K Item 402(u), Instruction 4, paragraph 6. The following example illustrates the potential understatement that the instruction is designed to address. Assume that the PEO's total annual compensation calculated in accordance with Item 402(c)(2)(x) was $3,000,000 and the median employee's compensation was $50,000. The ratio of the median employee's compensation to the PEO in this instance is 1:60. However, assume further that the median employee received $5,000 in personal benefits, while the PEO's benefits already exceeded the $10,000 threshold for disclosure under Item 402(c)(2)(ix)(A) (i.e., the PEO's total annual compensation would already have included all personal benefits). Moreover, both the PEO and the median employee received $15,000 in medical coverage for their families under a non-discriminatory health plan. Finally, under the Subject Company's tax-qualified Section 423(b) plan, the median employee purchased $10,000 in company stock at a 15% discount from the market price, realizing a $1,500 benefit; the PEO, having meaningful equity benefits under other plans, did not participate. In calculating total annual compensation including these items, the median employee's total annual compensation is $71,500 while the PEO's compensation is $3,015,000, resulting in a ratio of approximately 1:40.

[43] Commissioner Daniel M. Gallagher, Dissenting Statement at an Open Meeting to Adopt the "Pay Ratio" Rule, August 5, 2015, available at sec.gov/news/statement/dissenting-statement-at-open-meeting-to-adopt-the-pay-ratio-rule.html.

[44] Commissioner Michael S. Piwowar, Additional Dissenting Comments on Pay Ratio, August 7, 2015, available at sec.gov/news/statements/additional-dissenting-statement-on-pay-ratio-disclosure.html.

[45] Indeed, one commenter addressed the form and content of Commissioner Piwowar's second dissenting comments as follows:

While the initial pay ratio disclosures will not be required until 2018, the complexity involved in the rule's requirements, particularly for multinational Subject Companies, underscores the need for Subject Companies to begin analyzing how they can comply with the rule and begin to establish reasonable and efficient methodologies and systems to enable timely compliance when required. Specifically:

- A Subject Company should consider whether its payroll and related systems accommodate a cost-efficient method of computing total compensation (or key elements of total compensation) in identifying a median employee. If this is not feasible, a Subject Company should determine whether new systems should be established and provide for appropriate testing mechanisms. In this regard, the Subject Company should consider whether existing or new systems could or should accommodate statistical sampling or some other reasonable methodology.
- A multinational Subject Company should additionally consider the following:
    - A determination of the scope of applicable data privacy laws is essential. If permitted under the applicable statute, the company should consider a strategy for seeking an exemption from the data privacy provisions (to establish that it took reasonable efforts to obtain or process the necessary information for compliance with the rule).
    - If the *de minimis* exemption is available (based on the employee population and extent of reliance on the data privacy exclusion), identify any jurisdictions in which pay practices are such that they may unduly distort the pay ratio and make the employee population of that jurisdiction an appropriate candidate for exclusion.
    - Consider the practicality and effect of applying cost-of-living adjustments to employees in jurisdictions other than the PEO's jurisdiction.
- If feasible, annualize compensation for all permanent full-time and part-time employees that were employed for less than the full fiscal year for which pay ratio disclosure will be provided.
- If the Subject Company hires employees in seasonal positions, consider using a date, within the last three months of the fiscal year, when seasonal employees (or a significant number of seasonal employees) are not engaged.
- Finally, the Subject Company should take steps to develop appropriate disclosure controls and procedures to enable the effective gathering and review of information regarding identification of the median employee and computation and disclosure of the pay ratio, in accordance with the rule.

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> The second dissent could be a blueprint for how a complaint would look if this rulemaking is challenged in court. It claims the SEC violated the Administrative Procedure Act in adopting the rule and similar legal mumbo jumbo (e.g., the SEC acted in an "arbitrary & capricious" manner, a phrase that describes a standard of review used when a government agency's actions are challenged under administrative law). This is interesting because Piwowar is not a lawyer, he's an economist.

Broc Romanek, Pay Ratio: SEC Commissioner Piwowar Doubles Down (On His "No"), August 10, 2015, available at compensationstandards.com/member/Blogs/consultant/2015/08/pay-ratio-sec-commissioner-piwowar-doubles-down-on-his-no.html.

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Morgan Lewis | White Paper

SEC PROPOSES PAY VERSUS PERFORMANCE RULES

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On April 29, the Securities and Exchange Commission (SEC) issued a release[1] that includes proposed rules to implement requirements imposed on the SEC under Section 953(a) of the Dodd-Frank Wall Street Reform and Consumer Protection Act (the Dodd-Frank Act). Section 953(a) added Section 14(i) to the Securities Exchange Act, which directs the SEC to adopt rules requiring public companies to disclose in any proxy or consent solicitation material a "clear description" of compensation required to be disclosed under Item 402 of Regulation S-K (the provision of Regulation S-K addressing executive compensation disclosures). Section 14(i) further requires that the description include 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."

In its proposed rules, the SEC's response to the Dodd-Frank Act mandate reflects the following themes:

- Disclosure with regard to "compensation actually paid" and "financial performance" should be provided in a manner that will enable comparisons among public companies.
- The disclosure should address compensation actually paid to the principal executive officer (PEO) and the average of compensation actually paid to the other named executive officers.
- "Compensation actually paid" should be based on total compensation set forth in the Summary Compensation Table, subject to certain modifications with regard to equity awards and pension benefits.
- The measure of "financial performance" to be used is total shareholder return (TSR), computed in the same manner as in the stock performance graph.
- For most companies, the disclosure should cover a five-year period, subject to a transitional phase-in provision.
- The "clear description of the relationship between pay and performance" should address the relationship of PEO and average non-PEO named executive officer compensation actually paid to company TSR, as well as a comparison of company TSR to peer group TSR.
- The data provided under the proposed rules should be presented both in conventional form and in eXtensible Business Reporting Language (XBRL).

The manner in which the proposed rules apply these themes is described below. The proposed required disclosures would be included in a company's proxy and information statements in which executive compensation disclosures are required.[2] Accommodations for smaller reporting companies are described below, following the general discussion of the proposed rules. Emerging growth companies are among the entities, listed below, that would not be subject to the proposed rules.

THE PAY VERSUS PERFORMANCE TABLE

The proposed rules would require inclusion of a Pay Versus Performance table in the following tabular format:

1. Pay Versus Performance, Release No. 34-74835 (April 29, 2015).
2. However, as noted below, the disclosures would not be incorporated by reference in the company's Securities Act or other Exchange Act filings, except to the extent that the company specifically incorporates it by reference.

Pay Versus Performance

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)

The disclosure requirements related to each column in the table are described below.

Year

The proposed rules require information for each of the company's last five completed fiscal years. However, the proposed rules provide a transition period under which the company would be required to provide information for only the preceding three fiscal years in the first filing providing the tabular disclosure and the preceding four years in the subsequent annual filing. In addition, a company that has not been subject to the reporting requirements under Sections 13(a) or 15(d) of the Exchange Act during the entire period otherwise subject to the disclosure requirement need only provide information for any completed fiscal year in which it was subject to the reporting requirements, including the fiscal year during which it first became subject to the reporting requirements.

Summary Compensation Table Total for PEO

This column would require insertion of the "Total" amount shown in the Summary Compensation Table for the PEO. If more than one person served as the PEO during any year, the amounts for all persons serving as PEO would be aggregated. Since the disclosure ultimately would cover the five previous fiscal years, the information for the earliest two fiscal years would not be reflected in the Summary Compensation Table included in the current year proxy statement and would be derived from information in earlier filings.

Compensation Actually Paid to PEO

Based on its belief that "Congress intended executive compensation 'actually paid' to be an amount distinct from the total compensation" reported under current executive compensation disclosure requirements, the SEC added a specific requirement to address compensation "actually paid." To arrive at this amount, a company is required to make adjustments to the total compensation reported in the Summary Compensation Table for the relevant year with respect to equity awards and pension benefits as follows:

Equity Awards

- Deduct the amounts reported in the Stock Awards and Option Awards columns of the Summary Compensation Table.
- Add the fair value on the vesting date of all stock awards and option awards for which all vesting conditions were satisfied during the applicable fiscal year.
- If, during the last completed fiscal year, the company adjusted the exercise price of an already vested option or stock appreciation right, or otherwise materially modified the award, add the excess fair value of the modified award over the fair value of the original award.

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(Fair value is to be computed in accordance with FASB ASC Topic 718.)

Pension Benefits

- Deduct the aggregate change in the actuarial present value of the named executive officer's accumulated benefit under all defined benefit and actuarial pension plans reported in the Change in Pension Value and Nonqualified Deferred Compensation Earnings column of the Summary Compensation Table.
- Add back the service cost under all defined benefit and actuarial pension plans reported in the Change in Pension Value and Nonqualified Deferred Compensation Earnings column of the Summary Compensation Table, calculated as the actuarial present value of each named executive officer's benefit under the plans that are attributable to services rendered during the covered fiscal year, consistent with "service cost" as defined in FASB ASC Topic 715.

In addition, the proposed rules require that the company disclose by footnote to the table each of the amounts deducted and added to determine the "compensation actually paid." With respect to the value of equity awards, the company also would be required to disclose any assumption made in the valuation that differs materially from those disclosed with respect to Summary Compensation Table disclosure of the stock and option awards. (The Summary Compensation Table disclosures typically refer to grant date value assumptions in the company's financial statements.)

In explaining its rationale for substituting vesting date information for grant date information relating to stock and option awards, the SEC stated that because an executive does not have an unconditional right to an equity award prior to vesting, it does not believe a stock or option award should be considered "actually paid" before vesting. The SEC also noted that the adjustments related to pension benefits were appropriate because they would result in inclusion of only the service cost for services rendered by the executive during the relevant year, which is limited to pension costs for benefits earned during that year (in contrast to changes in actuarial present value resulting from changes in interest rates, executive age, and other actuarial inputs and assumptions that are reflected in the Summary Compensation Table amounts).

If more than one person served as PEO during the relevant year, the amounts shown in the column must be aggregated for all persons who served as PEO during that year. In some circumstances, such as a promotion during the year, the "compensation actually paid" will include compensation paid during the portion of the year that the PEO was not a named executive officer. This is consistent with the treatment of named executive officer compensation in the Summary Compensation Table, but the aggregation of PEO compensation in the context of the Pay Versus Performance table may lead to amounts that overstate PEO-focused compensation and distort the relationship of pay to performance. A footnote explanation as accompanying narrative disclosure likely would be required; hopefully, the SEC will address this issue in connection with the final rulemaking.

Average Summary Compensation Table Total for non-PEO Named Executive Officers

A company also would be required to include the average of the executive compensation paid to all executives other than the PEO, by reference to the Total column of the Summary Compensation Table.

The SEC noted that, in determining to require average compensation for the non-PEO named executive officers, there can be significant variability in the persons who constitute the non-PEO named executive officers, as well as changes in the number of named executive officers from year to year. The SEC stated that "requiring disclosure of average compensation would help make the information about these [named executive officers] more comparable from year to year in spite of the variability in the composition and number of [named executive officers] who are not the PEO over the years for which disclosure is

required." This may be a dubious assertion, especially with regard to those years in which one or two additional executives are included in the Summary Compensation Table because the executives' compensation was great enough to otherwise have required their inclusion as named executive officers had they remained with the company until the end of the fiscal year. Under these circumstances, particularly with respect to higher paid executives such as chief financial or chief operating officers, their inclusion might distort the average amounts, resulting in defects in comparability.

Average Compensation Actually Paid to non-PEO Named Executive Officers

The adjustments for determining "compensation actually paid" are the same as discussed above with respect to the PEO. Considerations relating to potential variations in average compensation discussed above also are applicable here.

Total Shareholder Return

The SEC determined to use TSR as the measure of financial performance for purposes of the pay versus performance disclosure. Although the SEC recognized that "financial performance of the registrant is a broad term and can mean different things to different registrants," it apparently relied on the requirement in Section 14(i) that information showing the relationship between executive compensation actually paid and the financial performance of a company should take into account "any change in the value of the shares of stock and dividends of the [company] and any distributions."

For purposes of the table, TSR would be calculated for each year covered by the table, in the same manner, and over the same measurement period, as the stock performance graph required by Item 201(e) of Regulation S-K.

Peer Group Total Shareholder Return

In addition to including the company's TSR, the table also would reflect "Peer Group" TSR. For this purpose, Peer Group TSR would be calculated using the same methodology as is used to calculate the company's TSR. The peer group would be the same published industry index, line of business index, or peer group used by the company in its stock performance graph; alternatively, the company could use the companies included in the peer group referenced in the company's compensation discussion and analysis.

If the company uses a peer group rather than a published industry or line of business index, the companies in the peer group must be identified, and the returns of each component company must be weighted based on market capitalization at the beginning of each period for which a return is computed.

ADDITIONAL DISCLOSURE REQUIREMENTS

In addition to the tabular disclosure requirements, the proposed rule would require companies to provide, using the information in the Pay Versus Performance table, a clear description of the relationship between the compensation actually paid by the company to the PEO and the cumulative TSR of the company for each of the last five completed fiscal years (subject to the transition period accommodation described above). Similar disclosure would be required with respect to the relationship between average compensation actually paid to the named executive officers other than the PEO and the company's cumulative TSR. In addition, the description must also include a comparison of the cumulative TSR of the company and of the peer group used in the Pay Versus Performance table over the same period. The SEC stated that the disclosure could be provided as a narrative, graphically, or through a combination of the two.

The emphasis on TSR may not reflect company policies or procedures regarding executive compensation, which might be focused on more direct financial measures of performance, such as revenues, operating profit, or net income, and might encourage an emphasis on short-term performance that could be

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deemed undesirable. The SEC, in addressing the suggestion of some commenters that the company should be permitted to choose the performance measure best suited to the company, noted that companies could provide supplemental measures of financial performance, such as "realized pay" or "realizable pay," if they believe it provides useful information about the relationship between compensation and company performance. Such additional disclosure must be "clearly identified, not misleading and not presented with greater prominence than the required disclosure."

XBRL FORMATTING

The proposed rules would require that, in addition to its inclusion in the proxy or information statement, the required disclosure must be electronically formatted using XBRL and filed as an exhibit to the definitive Schedule 14A. Each amount included in the Pay Versus Performance table would be separately tagged; footnote disclosure regarding amounts used to adjust Summary Compensation Table amounts to "compensation actually paid" amounts, and disclosure regarding the relationship of PEO and average non-PEO named executive officer compensation to the company's TSR, and the comparison of the company's TSR and peer group TSR, would be block tagged.

This would mark the first time that XBRL tagging is used in the context of executive compensation disclosures. The SEC supported this proposed development by stating that "the data to be tagged would lower the cost to investors of collecting this information, would permit data to be analyzed more quickly by investors and other end-users . . . and would facilitate comparisons among companies." While this may be true, XBRL tagging will add time and expense to the proxy statement preparation process. It is not clear if the actual usage of XBRL data justifies this time and expense. In this regard, empirical data indicating how many investors and other end users actually use this information may be instructive.

NO INCORPORATION BY REFERENCE OF PAY VERSUS PERFORMANCE INFORMATION IN SECURITIES ACT AND EXCHANGE ACT FILINGS

Because the provisions of Section 14(i) call for Pay Versus Performance disclosure only in solicitation materials for an annual meeting of shareholders,[3] the SEC concluded that the disclosure was intended to be provided only in conjunction with a shareholder vote. Therefore, the proposed rule provides that pay versus performance information would not be incorporated by reference in any Securities Act or Exchange Act filing, except to the extent that the company specifically incorporates the information by reference.

ACCOMMODATIONS FOR SMALLER REPORTING COMPANIES

The proposed rules provide the following accommodations for smaller reporting companies:

- Information is required for the last three completed fiscal years rather than five years.
- The initial filing would be required to cover only two completed fiscal years.
- Adjustments and footnote disclosure would not be required with respect to pension benefits (a logical accommodation, in light of the fact that the Summary Compensation Table for smaller reporting companies does not require information on actuarial changes in pension value).

3. Despite the reference to an annual meeting of shareholders in Section 14(i), the proposed rules would call for the disclosures to be included in any proxy or information statement in which executive compensation disclosures under Item 402 of Regulation S-K are required to be included.

- Peer group TSR is not required to be disclosed in the Pay Versus Performance table or accompanying disclosure.
- The XBRL requirements would not apply until the third filing in which the smaller reporting company provides pay versus performance disclosure.

ENTITIES PROPOSED TO BE EXCLUDED

The following entities would not be subject to the proposed rules:

- Emerging growth companies (their exclusion is mandated by the Jumpstart Our Business - Business Startups Act (JOBS));
- Foreign private issuers; and
- Investment companies registered under the Investment Company Act of 1940.

COMMENT PERIOD

The comment period ends 60 days after publication of the proposed rules in the *Federal Register*.

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