Capital Markets Alert
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Pay Versus Performance Disclosure — Have you Started Preparing?

The Securities and Exchange Commission (SEC) on Aug. 25 adopted changes to its executive compensation disclosure rules to require that reporting companies provide a direct comparison of their financial performance versus how their executives are being compensated in filings related to a vote of its stockholders. This new disclosure requirement will apply to most reporting companies other than emerging growth companies, foreign private issuers or registered investment companies. Smaller reporting companies (SRCs) do need to comply with the new rules but may do so on a scaled basis (similar to the existing scaled executive compensation disclosure requirements applicable to SRCs).

While on its face the requirement is simply the addition of a new Pay Versus Performance table to the existing executive compensation disclosures along with related explanatory narrative disclosure, as with any new requirement, the devil is in the details, and we urge reporting companies to begin the preparation now.

What Must Be Disclosed?

Like the Summary Compensation Table, the format of the Pay Versus Performance table is set forth in Item 402 of Regulation S-K. Reporting companies must disclose for their principal executive officer (PEO) and an average of the other named executive officers (NEOs) included in the Summary Compensation Table both compensation as reported on the Summary Compensation Table and compensation actually paid, which will reflect both positive and negative adjustments in equity compensation to more closely match the year in which the value of the equity award is realized. Regulation S-K requires that the grant date fair value of equity awards be reported in the Summary Compensation Table in the year the grant is made regardless of any vesting schedule attached to the award. Compensation actually paid will reflect both positive and negative adjustments for pension plan income as well.

The "performance" columns require disclosure of the total shareholder return (TSR) on $100 invested both for the company and for a peer group selected by the reporting company. The TSR is calculated on a cumulative basis beginning with the first year required to be shown in the table. SRCs are exempt from the peer group disclosure requirement. The last two columns consist of net income for the year and a company-selected measure that is meant to be the most important performance measure (not otherwise disclosed in the table) used by the company to link pay and performance.

The table will ultimately contain five years of these comparisons, although applicable transition provisions allow registrants to initially include three years of data followed by four years in the second year of compliance and five years thereafter. SRCs may include only two years of data in the first year and then three years thereafter, and are exempt from the peer group TSR and "company-selected measure" requirements.

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Accompanying the table must be a "clear description" of the relationships between each of the figures included in the table regarding company performance to the compensation "actually paid" to the PEO and the average compensation "actually paid" to the non-PEO NEOs (who must be named in the footnotes to the table for all relevant periods), as well as the relationship between company TSR and peer group TSR (in cases where peer group TSR is required). Registrants may convey such "clear description" in the form of graphs, tabular disclosure or a narrative, provided that in each case the combined description is "clear."

An additional requirement is an unranked tabular list of three to seven "most important" performance measures used by a non-SRC registrant to link compensation "actually paid" to the NEOs to the company's performance; this list must include the registrant's three most important financial measures (or fewer than three, in the event the registrant uses fewer than three financial measures). The company-selected measure included in the Pay Versus Performance table must appear in the tabular list.

What Should You Be Doing Now?

Most reporting companies will have to comply with this new requirement beginning with the proxy statement for their annual meeting in the spring. However, there are several preparatory items that can and should be addressed now, including:

Calculate Compensation Actually Paid in Prior Two Years. Reporting companies should begin the process now of calculating compensation actually paid in the past two fiscal years. Particularly for companies that make frequent equity grants, this could be a complex and time-consuming process, as it requires an analysis of each grant's initial value, vesting schedule, subsequent year-end value, any forfeitures and any dividends. Pension plan adjustments can be complicated as well.

Identify Any Unusual Situations. If there have been management changes in the past three years, the preparation of the table may be more complex. In the event of more than one individual serving as a PEO during a particular fiscal year, a column will have to be added to the table to reflect the amount for each additional PEO. In addition, the average of non-PEO NEO compensation must include all principal financial officers (PFOs) who served during the relevant fiscal year (in the event of multiple PFOs) and up to two additional NEOs if they would have been an NEO were they serving as such at the end of that fiscal year, based on the total compensation reported in the Summary Compensation Table.

Identify Company-Specific Information. Registrants should start selecting a peer group as well as preparing a list of key financial metrics used to link compensation with performance and their company-selected measure, if they are required to provide that disclosure.

Be Prepared to Explain Differences Between Pay and Performance. The SEC expects that companies may need to provide additional narrative disclosure to explain significant "misalignments" between compensation and a company's TSR. Reporting companies should begin to analyze whether this may be needed, as this disclosure should not be left to the last minute.

Decide Where the Disclosure Will Be in the Proxy Statement. Registrants have discretion regarding the location in the proxy or information statement of the Pay Versus Performance table, although the SEC has noted that inclusion of the table in the context of the Compensation Disclosure and Analysis section may be confusing to the reader if there are discrepancies between the performance measures discussed in the Compensation Discussion and Analysis (CD&A) and the Pay Versus Performance table.

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