Proposed Pay Versus Performance Rules Preliminary Observations

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Overview

On April 29, the Securities and Exchange Commission (SEC) voted in favor of issuing **proposed** rules for the Pay Versus Performance disclosure that Congress included under Section 953(a) of the Dodd-Frank Wall Street Reform and Consumer Protection Act. The proposed rules can be viewed at the following link:

Federal Register: http://www.gpo.gov/fdsys/pkg/FR-2015-05-07/pdf/2015-10429.pdf

As the 60 day comment period ends July 6, there is ample time for the SEC to issue final rules by year's end and require application of the final rules for the 2016 proxy season, which covers fiscal years ending December 31, 2015.

The proposed disclosure reflects the SEC's attempt to help shareholders gain a better understanding of how executive pay compares to company performance by:

(1) Comparing Named Executive Officers' (NEOs) total compensation as described in the Summary Compensation Table (SCT) to what the SEC is now defining as compensation "actually paid,"

(2) Using Total Shareholder Return (TSR) as the performance measure comparing performance to compensation "actually paid," and

(3) Using TSR of a company's peer group (likely the one listed in the Compensation Discussion and Analysis for compensation or performance purposes) to provide additional context for the company's performance.

The proposed Pay Versus Performance disclosure, in addition to the proposed Pay Ratio Disclosure, is intended to provide the investor with additional information when voting on a company's Say on Pay vote.

Required Disclosures

If the proposed rules become final without changes, registrants will need to add **a new table**, as shown below, to the proxy statement disclosing:

- The total compensation of the Principal Executive Officer (PEO) reported in the SCT for the current year, and each of the prior four years (see Note 1);
- The total compensation "actually paid" to the PEO in each of those years;
- The average total compensation of the other NEOs reported in the SCT for the current year and each of the prior four years (a total of five years);
- The average total compensation "actually paid" to the other NEOs in each of those years;

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- For each year, the cumulative TSR of the company measured as of the end of the year; and
- For each year, the cumulative TSR of a peer group selected by the company.

PAY VERSUS PERFORMANCE

Year	Summary compensation table total for PEO	Compensation actually paid to PEO	Average summary compensation table total for non-PEO named executive officers	Average compensation actually paid to non-PEO named executive officers	Total shareholder return	Peer group total shareholder return
(a)	(b)	(c)	(d)	(e)	(f)	(g)

In addition, companies will be required to provide a clear description of the relationship between the compensation actually paid and cumulative TSR for each of the last five completed fiscal years. Required disclosures must be electronically formatted and tagged using XBRL.

As proposed, compensation "actually paid" equals:

- Base salary for the fiscal year (same as SCT);
- Non-equity incentives and/or bonus earned for the fiscal year (same as SCT);
- Equity vested during the fiscal year valued at the fair value as of vesting date (differs from SCT which includes equity fair value *when granted*):
  - Full value equity fair value will generally be priced at vesting date for restricted stock (units) and performance shares earned (however, post-vesting retention restrictions may need to be considered in determining fair value under ASC Topic 718); stock option fair value at the vesting date must follow valuation guidance under ASC Topic 718, and disclosure is required if assumptions used differ materially from those previously reported (A company's prior selection of a Black-Scholes or lattice model for grant date valuations would normally continue to apply when measuring fair value at the vesting date.);
- "Service cost" attributable to services for the year (differs from SCT which is based on the "change in pension value");
  - The service cost is the measure of the present value of benefits actually earned during the year. As such, it is either positive (benefits were earned) or zero, if no new benefits were earned. The change in pension value includes that, but also reflects changes in the interest/discount rate, the mortality table used to value the benefits, and other adjustments made to the present value of the accumulated benefits earned to date (not just in the past year, but over their career), and can therefore be positive or negative, and generally reflects a much larger value.
- Above market earnings (if any; same as SCT); and
- All other compensation items (same as SCT).

Initial Reactions to the Proposed Rules

We agree with the SEC's position that a higher degree of standardization of compensation "actually paid" will be helpful to shareholders in understanding pay-to-performance alignment. Based on research by McLagan and Aon Hewitt, there continues to be great variance among companies (a minority as of last year) that present alternative definitions of "actually paid" compensation and how that compensation is compared to

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performance. The great degree of difference makes it harder for shareholders to gain understanding across potential alternative investments.

While the SEC's proposed definition of compensation "actually paid" and the related treatment of equity awards and pensions is better than using SCT total compensation in terms of understanding the alignment of executive pay to performance, the definition could be improved. The SEC also recognizes that the proposed solution may be improved upon and is seeking input on a number of issues. The ones that we have initially identified as in need of greater debate are:

- The disconnect between measuring equity fair value at the vesting date versus TSR at the end of the reporting period; for some companies, the share price could be materially different;
- The disconnect between the TSR measurement periods and the multiple measurement periods used for various long-term performance awards;
- The proposed mandate for a peer group comparison of TSR even though "actually paid" compensation for the peer group is not compared and some companies do not use a specified peer group of companies for making pay decisions. (Additionally, the Dodd-Frank Act does not require the disclosure of peer group TSR. See Note 2); and
- Finally, for companies that change CEOs during a fiscal year, the proposed rules include special treatment in years where there are multiple Principal Executive Officers. In such situations, the SEC has proposed that companies should report the aggregate compensation paid to both. Note: There are no special rules if there are additional NEOs; presumably, the registrant will still report the average compensation paid for all NEOs other than the Principal Executive Officer.

Additionally, for many firms, and specifically banks, "performance year pay" does not align to the current SCT disclosure rules. In many cases, firms will make equity awards in the first quarter that are intended as compensation for the prior performance year. Due to the SCT requirements, those equity awards will not be reported until the following year.

Further, due to pressure from the current regulatory environment unique to the banking industry, many firms have splintered their incentive plans to provide for more vehicles of variable compensation, such as. cash bonuses, mandatory deferrals, stock options, restricted shares/units, performance shares/units, and long term cash. In some cases, firms pay a portion of the annual cash incentive in stock or deferred cash (mandatory deferral). This ensures a higher percentage of variable compensation is deferred over a multi-year period and provides new avenues for expanded forfeiture and recoupment policies. However, in the case of mandatory deferrals into stock, the likely result will be a distortion to the pay and performance analysis, as firms will have to wait until that equity is vested to report it as "actually paid" per the proposed rules.

Small nuances such as these can further contribute to lengthy narrative needed to articulate alignment between pay as shown in the SCT and "actual pay" as defined under this proposal.

Things to Consider at This Time

The questions we believe that compensation professionals and compensation committees should be asking today are:

- Should we be trying to replicate the proposed disclosure now?
- Should we provide comments to the SEC?

- Does the SEC's proposed methodology for evaluating pay versus performance replace the internal realizable pay-to-performance analyses used to assess the pay-to-performance relationship?

We think it likely that the Pay Versus Performance rules will be finalized in the near future but that the disclosure requirements could change materially before they are finalized. Therefore, relative to these three questions, McLagan suggests:

- Begin to contemplate the data sources that will be needed to prepare the proposed tabular disclosure. For those companies that have not voluntarily provided alternative pay and/or pay-for-performance disclosures, consider the messages that will accompany the tables. For companies that have provided alternative pay and/or pay-for-performance decisions, consider how the proposal and the messaging may differ from what has been provided to shareholders;
- Consider providing comments directly to the SEC or indirectly through third parties. We will be formulating our own detailed comments and would certainly like to hear your thoughts; and
- McLagan believes the analysis required by the SEC should not replace the realizable pay-to-performance analyses used to **internally** assess a company's degree of pay-to-performance alignment. We believe realizable pay-to-performance analyses to be a better approach to comparing "earned" pay to target pay and for comparing pay and performance to peers.

Notes:

1. If desired, large filers can choose to show only three years of data in the first year of the new disclosure increasing the number of years disclosed in each succeeding year until five years are displayed. Smaller reporting companies will only be required to disclose three years of data.

2. Section 953(a) of the Dodd-Frank Act includes the following: "DISCLOSURE OF PAY VERSUS PERFORMANCE.—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 to be disclosed by the issuer under section 229.402 of title 17, Code of Federal Regulations (or any successor thereto), 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. The disclosure under this subsection may include a graphic representation of the information required to be disclosed."

About McLagan

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