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Corporate & Securities

Client Alert

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Update on Dodd-Frank Compensation-Related Rulemaking

On July 29, 2015, the U.S. Securities and Exchange Commission (SEC) gave public notice of the agenda for its August 5, 2015 meeting, which will include consideration of final rules to implement the chief executive officer pay ratio disclosure mandated by the Dodd-Frank Wall Street Reform and Consumer Protection Act of 2010 (Dodd-Frank). We will provide an update on that final rulemaking once it has occurred.

The CEO pay ratio disclosure is one of four remaining compensation-related Dodd-Frank provisions that have not yet been implemented as of the date of this client alert. Although the SEC has proposed rules for each of these four provisions, it has not yet issued final rules on any of them.

As we await final rulemaking, the following is a brief overview of the SEC's proposed rules for each of these four provisions.

Pay-for-Performance Disclosure (Dodd-Frank §953(a)) – Requires proxy statement disclosure of the relationship between executive compensation paid and the company's performance.

The SEC proposed rules on April 29, 2015, which generally provide the following:

- *Creation of New "Pay versus Performance" Table*. The proposed rule would require the inclusion of a new compensation table with the following columns:
    - *Year*. For the first year, the disclosure will include each of the three most recent fiscal years (parallel to what is reported in the Summary Compensation Table (SCT)). One additional year is added in each of the next two years following effectiveness of the new rule such that, once fully implemented, the table covers five years of compensation (all three years of the current SCT plus two years prior).
        - For smaller reporting companies, which are only required to report two years of compensation in their SCT, the disclosure will include one less year each year (first year will begin with two years and, once fully implemented, the table will cover four years of compensation).
    - *SCT Total for CEO*. Amount reported will be the same as what is reported in Summary Compensation Table as the CEO's total compensation.

    - *Compensation Actually Paid to CEO*. Amount reported will be the SCT total minus the reported value of pension accruals and stock and option awards for the year, but increased by vesting date fair value of stock awards that vested during the year and the service cost of pension accruals for the year.
    - *Average SCT Total for All Other NEOs*. Calculated the same as for CEO, but averaging all other NEOs together.
    - *Average Compensation Actually Paid to All Other NEOs*. Calculated the same as for CEO, but averaging all other NEOs together.
    - *Company TSR*. For the specified fiscal year, calculated the same as for the annual report performance graph.
    - *Peer Group TSR*. Calculated the same as company TSR. May use compensation discussion and analysis peer group if it is different from the peer group used in the annual report performance graph.
- *Related Disclosure*. Must also include a graphic or narrative description of the relationship between (1) company pay and TSR and (2) company TSR and peer group TSR, in both cases, over the same period covered by the table.
- *When Will Disclosure be Required*. In the first proxy statement filed after the rule becomes effective (<u>could be as early as the 2016 proxy statement</u>).

<u>CEO Pay Ratio Disclosure</u> (Dodd-Frank §953(b)) – Requires proxy statement disclosure of the ratio of the CEO's total annual compensation to the median annual total compensation of all of the company's other employees.

The SEC proposed rules on September 18, 2013, and subsequently published two separate memos in June 2015 to provide additional economic analysis. <u>As noted above, the SEC has given notice that it will consider final rules on this provision at its August 5, 2015, meeting</u>. The following is a general overview of the proposed rules:

- *Who Are "Employees."* All employees, including non-U.S. employees, part-time, seasonal, and temporary, who are employed by the company or its subsidiaries as of the fiscal year end.
- *How to Determine "Median Employee."* As proposed, there is considerable flexibility: the company can use any reasonable method, including the use of statistical sampling or a consistently applied compensation measure (such as payroll or tax records).
- *What is "Total Annual Compensation."* Determined in the same manner as for SCT.
- *Related Disclosure*. In addition to disclosing the total annual compensation of the CEO and the median employee and the ratio of the two, the company must disclose the methodology used to determine the median employee, plus any material assumptions, adjustments, and estimates used in the calculation.
- *When Will Disclosure be Required*. In proxy statement disclosure for the first fiscal year that begins following the date the final rules are effective (for example, <u>for companies with a December 31 fiscal year end, the earliest would be the 2017 proxy statement</u>, since compensation paid between January 1, 2016, and December 31, 2016, is not reported until the 2017 proxy statement).

<u>Compensation Clawback Policy</u> (Dodd-Frank §954) – Exchange-listed companies will be required to adopt and enforce compensation recovery policies to recoup incentive compensation resulting from certain accounting restatements. This statutory provision is broader than the clawback under the Sarbanes-Oxley Act of 2002

(SOX) in three notable respects: (1) it applies to all current and former executive officers, rather than just the CEO and CFO; (2) it does not require any misconduct; and (3) it has a three-year (rather than one-year) look-back.

The SEC proposed rules on July 1, 2015. Because the statute requires that this provision be enforced through listing standards, implementation will require additional steps beyond SEC rulemaking. Specifically, once the SEC has issued final rules, each exchange will go through its own rulemaking process (the exchange must propose rules within 90 days of the date the final SEC rule is published, and the exchange's final rules must become effective within one year of the publication date of the SEC final rule). The following is a general overview of the proposed rules:

- *Who is Covered*. All of the company's current or former executive officers, defined to include all officers subject to Section 16 of the Securities Exchange Act of 1934, as amended.
- *Restatements that Could Trigger Recovery*. Any restatement to correct an error that is material to previously issued financial statements (a facts and circumstances test), with a three-year look-back.
- *Compensation Covered*. The policy must cover "incentive-based compensation," which, under the proposed rule, means any compensation that is granted, earned, or vested in whole or in part upon the attainment of any financial reporting measure. This means that the Dodd-Frank clawback would not be applicable to time-based equity awards, performance-based compensation that does not include financial reporting measures, or discretionary bonuses.
- *Limited Discretion to Seek Recovery*. The board would have very limited discretion over whether to seek recovery under the policy. Specifically, the board's discretion would be limited to situations where either (1) the cost of the recoupment would exceed the recoverable amount or (2) the recoupment would violate home country law.
- *Disclosure of Recovery Policy.* The policy would need to be included as an exhibit to the Form 10-K. In addition, any recoupment pursuant to the policy would need to be disclosed in the proxy statement.
- *Interaction with SOX Clawback*. A company's CEO and CFO may be subject to both the Dodd-Frank and SOX clawbacks. In the event that recovery was required under both, amounts recovered under the SOX clawback would be credited towards any amount recoverable under the Dodd-Frank clawback.
- *When Will Disclosure be Required*. In the first proxy statement filed after the rule becomes effective (could be as early as 2016 proxy statement; however, this seems unlikely given the number of steps remaining before final exchange rulemaking).

Employee and Director Hedging Disclosure (Dodd-Frank §955) – Requires proxy statement disclosure of whether any employee or director (or designee of either) is permitted to purchase financial instruments designed to hedge or offset any decrease in the market value of equity securities (whether granted as part of that person's compensation or otherwise held, directly or indirectly, by him or her).

The SEC proposed rules on February 9, 2015, which generally provide the following:

- *Covered Transactions*. The proposed rule is slightly broader than the statute, requiring that the disclosure encompass any transactions that have economic consequences similar to the purchase of financial instruments designed to hedge or offset decreases in market value.
- *Disclosure of Policy*. Companies must disclose:
    - which categories of hedging transactions are permitted and which are prohibited,

    - which categories of persons are permitted to, or prohibited from, engaging in such transactions, and
    - if applicable, the scope of permitted transactions.
- *When Will Disclosure be Required*. In the first proxy statement filed after the rule becomes effective (could be as early as 2016 proxy statement).

We expect to issue additional client alerts as each of these provisions is implemented.

For further information, please contact Kelly C. Simoneaux or Hope M. Spencer.

Remember that these legal principles may change and vary widely in their application to specific factual circumstances. You should consult with counsel about your individual circumstances. For further information regarding these issues, you may also contact:

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