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Could New ‘Smaller Reporting Company’ Rules Affect GC Compensation?

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In June of this year, the Securities and Exchange Commission (SEC) voted to approve rule amendments (referred to in this article as the amendments) that specifically expand the definition of the so-called “smaller reporting company.” The amendments, that become effective this September, will result in 966 additional companies becoming eligible for smaller reporting company status. As a result, almost 1,000 companies can take advantage of scaled-down disclosures in their periodic reports and proxy statements, which includes opting out of executive compensation disclosures entirely. This article explores whether such an opportunity could affect executive compensation decisions altogether.

Let us begin by reviewing the amendments. The definition of smaller reporting company, prior to the amendments, comprises of companies with a public float of less than $75 million. As result of the Amendments, smaller reporting companies will include all companies with a public float of less than $250 million, as well as companies with annual revenues of less than $100 million for the previous year and either no public float or a public float of less than $700 million. Why the change to the definition? It primarily stems from the current administration’s desire to open the capital markets. In addition, SEC Chairman Jay Clayton previously explained that “expanding the smaller reporting company definition recognizes that a one-size regulatory structure for public companies does not fit all.”

Under current securities rules, smaller reporting companies are eligible to provide scaled disclosure in periodic reports. For example, such companies only need to provide a two-year (as opposed to a three-year) management discussion and analysis comparison. These companies also do not need to provide risk factors in their filings. With respect to compensation, no discussion and analysis with regard to compensation decisions is required. Many have suggested that since the compensation disclosure rules were implemented over a decade ago, compensation decisions have been affected because companies are required to explain to shareholders their reasoning for all executive compensation decisions. By expanding the definition of smaller reporting company, more companies will be able to take advantage of the rules that permit companies to avoid disclosing the rationale for their executive compensation decisions and, consequently, elicit less public scrutiny of their executive compensation decisions.

Executive compensation disclosures are required by Item 402 under Regulation S-K which mandates that non-smaller reporting companies disclose: (1) who are their top five named executive officers (those most highly compensation); (2) three years of compensation information for such individuals; (3) a compensation discussion and analysis of how and why such compensation was paid to the named executive officers; (4) a detailed grants of plan-based awards table; (5) a detailed option exercises and stock vested table; (6) a detailed pension benefits table; (7) a detailed nonqualified deferred

compensation table; (8) a comprehensive discussion of compensation policies and practices related to risk management of compensation; and (9) a pay ratio disclosure which is a requirement that companies disclose their CEO-to-median employee pay ratios. In contrast, smaller reporting companies are eligible to provide disclosure regarding (1) their top-three named executive officers (as opposed to five) and (2) only two years (rather than three years) of compensation information for such individuals. Moreover, such companies can completely disregard items (3) to (9) described above. There are, however, some smaller reporting companies that voluntarily provide information related to items (3) to (9) based on investor pressure.

Executive compensation disclosures are often regarded as burdensome to public companies; thus, it is predicted that the amendments will result in an increase in the number of companies that will choose to provide less compensation disclosure—in particular, it would not be unusual if such companies will refrain from providing the compensation discussion and analysis (commonly known as CD&A) as well as the pay ratio disclosures.

Interestingly, the amendments come at a time when executive compensation is increasing at noticeable rates. In 2017, larger companies, earning revenues in excess of $18 million, increased executive salaries by 17.6 percent on average from a year earlier. By comparison, the same companies increased nonexecutive employee salaries by only 0.3 percent on average. Recent SEC enforcement actions against companies for compensation disclosure missteps also highlight the sensitivity around the topic of compensation disclosure. Historically, the SEC has not brought many enforcement actions in this area, but has recently been targeting companies—and sometimes individuals at companies—for failing to properly disclose executive compensation. The SEC has recently fined public companies for failing to disclose certain expenses as executive perquisites. Companies are being asked to retain independent consultants to review and revise compensation policies and employee training around compensation disclosures. In addition, the SEC recently charged the former CEO of a public company for failing to disclose matters around personal loans. The SEC also alleged that the former CEO submitted expense reimbursements that were "unreasonable, personal in nature, and/or not supported by sufficient documentation."

When the amendments come into effect in September, it is anticipated that fewer current public companies and fewer companies that undergo an initial public offering will provide fulsome executive compensation disclosure. This may lead to fewer opportunities for the SEC to bring enforcement actions in this area. Moreover, with fewer companies disclosing executive compensation in detail, there may also be a newfound opportunity for smaller reporting companies to protect executive compensation from the scrutiny of the investing public. In light of the uptick in executive compensation generally, this may be concerning to investors interested in ensuring that executive pay is commensurate with a respective company's performance. The 966 companies that will be faced with the decision of whether to continue to provide fulsome executive compensation disclosure will have to evaluate what executive compensation means to their investors and how to proceed under the new amendments.

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