Pearl Meyer

CLIENT ALERT | FEB 2023

Decoding the SEC's Updates on Pay Versus Performance Rules

Deb Lifshey

MANAGING DIRECTOR

Many issues remain open for imminent filers

Final Pay Versus Performance (PVP) disclosure rules were published nearly six months ago leaving many advisors and companies scrambling to interpret the complexities of one of the last remaining compensation-related requirements under the Dodd-Frank Act. Our earlier Client Alert took a detailed look at those rules. With deadlines for most companies to publish their first PVP disclosures fast approaching, the SEC released 15 updated interpretations on February 10, 2023. While this guidance is certainly welcome and deals with several outstanding questions, it failed to address many of the more granular issues around equity reconciliation. Below we summarize the new guidance by topic area and note where remaining questions persist.

TSR Peer Group

Total Shareholder Return (TSR) peer group may include CD&A peer groups even if they are not used for "benchmarking" (Question 128D.05)

The PVP rules require companies to pick a peer group and include that group's cumulative TSR in the PVP table. Permitted peer groups include those used in the company's performance graph in the 10-K (with the exception of a broad index) or those used in the CD&A of the proxy statement. This would presumably include the group of companies used in a relative performance measure-based plan such as relative total shareholder return (rTSR). Wording in the SEC's original release led many practitioners to conclude that TSR peer groups could only come from the CD&A peer group that was specifically used for benchmarking levels of compensation. The guidance clarifies that companies can use any peer group actually used to help determine executive pay, even if such peer group is not used for "benchmarking." While picking the 10-K performance graph industry index still seems to be the peer group of choice for many companies, the possibility of using a "performance peer group" may now be attractive for those companies whose "compensation actually paid" (CAP) better aligns with the TSR of the performance group it compares itself to for long-term incentive payouts.

No exemptions for 2022 peer group changes (Question 128D.07)

The PVP rules state that if a company uses a different peer group in the most recent year from previous years, it must explain in a footnote the reasons for the change and compare the company's cumulative TSR with both the newly selected peer group and the peer group used in the immediately preceding fiscal year in a footnote. Many companies were hopeful that if the peer group changed in 2022, for the first filing in 2023 the rule would exempt prior changes and not require additional disclosure. However, the new clarification states that if the peer group changes in 2022, companies may not use the 2022 peer group for 2020 and 2021 cumulative TSR disclosures, but must use the actual peer group in place in each of those years to calculate respective cumulative TSR.

Required Adjustments and Footnotes to Derive CAP

Footnote reconciliation from SCT to CAP is required for each year in the PVP Table initially, and generally only for most recent year going forward (Question 128D.03)

The PVP rules require that amounts reported in the CAP columns for the CEO and other non-CEO NEOs must be reconciled with SCT amounts by showing the required additions and subtractions under the PVP rules. The SEC was asked whether the reconciliation was required each year in the PVP Table (which many practitioners drafting their proxies presumed), or only for the most recent year. In response, the SEC guidance provides that all three years (or two in the case of a smaller reporting company) must be reconciled for 2023 proxies, but going forward only the most recent year reconciliation will be required (unless historical reconciliation is material to an investor's understanding of the information reported in the most current PVP Table).

Reconciliation adjustments from SCT to CAP may not be aggregated (Question 128D.04)

Those companies that have already started calculating CAP know that there are potentially hundreds of adjustments depending on the number of NEOs in the PVP Table and the number of equity awards covered (both in terms of type of equity award as well as vesting tranches). With the lack of guidance as to how much detail is needed in this adjustment footnote, many companies had proposed providing a simple chart reconciling total equity and pension amounts subtracted from and added back to the SCT amounts to derive the CAP amounts for each year for the CEO and average NEO columns.

The new guidance—although almost as vague as the rules themselves—seems to indicate that aggregate additions and subtractions for pension and equity awards is not enough, but that footnote disclosure should be provided for "each of the amounts" added and deducted pursuant to Items 402(v)(2)(iii)(B)(1)(i) – (ii) and Items 402(v)(2)(iii)(C)(1)(i) – (vi). Read quite literally, this would mean at a minimum the following numbers would need to be disclosed for the CEO and the average NEOs for each of the years represented in the PVP Table:

Pensions:

- Amount deducted for aggregate change in actuarial present value from SCT
- Amount added for service cost
- Amount added for prior service cost impacting current year

Equity:

- Amount deducted for grant date values in the SCT
- Amount added for year-end fair value of unvested awards granted in the current year
- Amount added for year-over-year difference of year-end fair values for unvested awards granted in prior years
- Amount added for fair values at vest date for awards granted and vested in current year
- Amount added for difference in fair values between prior year-end fair values and vest date fair values for awards granted in prior years
- Amount deducted for forfeitures during current year equal to prior year-end fair value
- Amount added for dividends or dividend equivalents not otherwise included in the

total compensation

We have seen disclosures that provide an even further breakdown of these numbers, but at this juncture it seems clear the SEC is asking for more than one aggregated disclosure for equity and pension adjustments.

Pearl Meyer Perspective: *Missing from this guidance which many of us were hoping to see is more information about how much more detail is needed with respect to each award and each tranche. It also doesn't discuss how detailed assumptions with respect to equity valuations need to be. Companies also question whether a full reconciliation to GAAP should be restated in the footnotes to the CSM or whether they can simply cross-reference to the reconciliation provided in other parts of the proxy. Finally, there are many lingering questions regarding how to capture dividend payments and/or fair values of equity with an equity acceleration feature when granted to retirement-eligible individuals. Unfortunately, absent further guidance prior to filing deadlines (which is unlikely), companies will need to make reasonable assumptions and provide clear footnote disclosure describing their inclusions and exclusions.*

Net Income

Net income must come from the company's audited GAAP financial statements (Question 128D.08)

The PVP Table requires that a company's net income be presented for all years in the chart. In the absence of a specific definition of net income, some companies were hopeful to use a variant of company net income for special circumstances (e.g., controlling interest net income or continuing operations net income). The SEC clarified that top-level company net income is required despite special circumstances.

Company Selected Measure (CSM)

The CSM may include rTSR and other metrics derived from net income or cumulative TSR (Question 128D.09)

The rules require the company to report a financial CSM that is not already required to be disclosed in the PVP Table (i.e., net income and cumulative TSR). However, the SEC has clarified that financial metrics that are similar to or derived from these metrics, such as earnings per share, gross profit, income or loss from continuing operations, or rTSR are permissible CSMs.

The CSM may include stock-price based metrics in only certain scenarios (Question 128D.10)

Many companies expressed curiosity about whether stock price may be used as the CSM, as in most cases it would align nicely with CAP in each respective year. The SEC clarified that stock prices may not be used where the only impact of stock price on Named Executive Officers' (NEOs) compensation is through changes in the value of share-based awards. However, if, for example, the company's stock price is a market condition applicable to an incentive plan award, or is used to determine the size of a bonus pool, it may be included as a CSM.

The CSM cannot be a multiple year measure (Question 128D.11)

Many companies inquired as to whether the CSM could be measured over a multi-year period that includes the applicable fiscal year as the final year (similar to the use of multi-year measurement periods for calculating total shareholder returns). The SEC clarified that the CSM must be the financial performance measure used by the company for the most recently completed fiscal year only.

Financial Measurements used to determine discretionary bonus pools do not evade CSM or the Tabular List disclosure requirements (Question 128D.12)

When the PVP rules were released, many practitioners wondered whether a discretionary bonus pool could be used to omit disclosure of relevant financial measures either as a CSM or in the Tabular List. However, the SEC guidance clearly states that if the size of a bonus pool is determined based wholly or in part on satisfying a financial performance measure, the company is using the financial performance measure to link CAP to company performance. Therefore, such financial measure must be in the Tabular List (or listed as a CSM with accompanying relationship disclosure if it is the most important financial measure tied to CAP).

Pearl Meyer Perspective: *Many companies find the language regarding 3-7 financial measures to the Tabular List to be confusing in the PVP rules. The rules seem to indicate that companies must have three financial measures in order to also report non-financial measures. Clarification that non-financial measures may be presented even if there are no financial measures would have been welcomed.*

NEO Changes Over the Course of the PVP Table Years

Compensation of multiple CEOs in one year may be aggregated but only for narrative/graphical comparisons (Question 128D.13)

The rules require that for anyone who served as a company's CEO during any year, a separate column must be shown for that CEO's CAP. In certain cases (i.e., where an individual only served as a CEO for a small portion of the year), a graphical display of the compensation versus other financial performance measures yielded illogical results. The SEC has stated it would not object to companies aggregating the compensation of multiple CEOs in a given year for purposes of these comparisons if the presentation will not be misleading to investors. However, it will not permit companies to aggregate such amounts in the PVP Table itself.

Change in fair value of unvested equity includes amounts granted to NEOs prior to becoming an NEO (Question 128D.02)

In order to calculate CAP, the fair value at the end of each year (or at vesting) must be compared to the fair value at year-end of the previous year. The SEC clarified that equity awards granted to a first-time NEO in a year prior to (and not otherwise related to) their appointment as an NEO must be included in the PVP Table (i.e., if a non-NEO employee is granted a stock option in 2021, and is subsequently appointed as an NEO in year 2022, the NEO's CAP in year 2022 must reflect the changes in fair value in that stock option from 2021 to 2022). The SEC takes this position despite the fact that such amount may not appear in the Summary Compensation Table with a grant date fair value.

Pearl Meyer Perspective: *Missing from the guidance is how to report compensation for an NEO who is promoted to CEO during the course of a year reported in the PVP Table. Should all of that person's compensation for prior service as a non-CEO NEO be shifted to the CEO column? Or should it be* *bifurcated in the year of the promotion? This remains an important outstanding question.*

Miscellaneous Timing Questions

PVP disclosures are not required to be in Form 10-K, but can be later reported in the proxy statement (Question 128D.01)

There was some ambiguity around whether the PVP disclosure was required to be filed ahead of time in the Form 10-K (rather than waiting to report in the proxy, which is where compensation is typically reported). The SEC clarified that filers may wait for the proxy.

If a company changes its fiscal year, provide stub period information and do not annualize data (Question 228D.01)

The SEC provides the following example to illustrate this point: In late 2022, a company changed its fiscal year-end from June 30 to December 31. In the company's first PVP Table, provide disclosure for each of the following four periods: July 1, 2022 to December 31, 2022; July 1, 2021 to June 30, 2022; July 1, 2020 to June 30, 2021; and July 1, 2019 to June 30, 2020. The SEC instructs to continue providing such disclosure, including the stub period, until there is disclosure for five full fiscal years after the stub period.

Cumulative TSR measurement period tracks performance graph information for partial years based on emergence from bankruptcy (Question 228D.02)

The SEC provides an example of a company that emerges from bankruptcy in September 2020 and thus its reportable performance graph information starts in that month. The guidance concludes that companies may report their own TSR and peer group TSR using a measurement period from September 2020 through December 2022.

Companies that went public during a year required to be shown in the PVP Table can use a measurement period for TSR purposes that starts on the date of IPO (Question 128D.06)

If the company's securities are registered during a year included in the PVP Table, the measurement point for purposes of calculating TSR and peer group TSR should begin on such registration date, with footnote disclosure describing this approach.

Conclusion

Given current timing, we are unlikely to get additional guidance from the SEC before most calendar year companies are required to file their proxy statements. As noted above, this latest release from the SEC answered some questions, but left others unresolved. As a result, companies will be eagerly awaiting the earliest proxy filers to glean any available insights regarding trends and best practices. In the meantime, those involved in the drafting process should immediately and carefully review this newest round of guidance to ensure compliance, particularly with respect to the level of detail that needs to be reconciled in footnotes. Pearl Meyer will continue to monitor this space and provide updates as necessary.

About the Author

Deborah Lifshey is a managing director at Pearl Meyer, where she specializes in advising clients on compensation matters from a legal perspective including securities disclosure, taxation

and corporate governance issues, negotiation contracts, and reasonableness opinion letters.

About Pearl Meyer

Pearl Meyer is the leading advisor to boards and senior management helping organizations build, develop, and reward great leadership teams that drive long-term success. Our strategy-driven compensation and leadership consulting services act as powerful catalysts for value creation and competitive advantage by addressing the critical links between people and outcomes. Our clients stand at the forefront of their industries and range from emerging high-growth, not-for-profit, and private organizations to the Fortune 500.