Pearl Meyer

ASK THE EXPERT INTERVIEW | APR 2023

The Reader's Guide to Pay Versus Performance



Mark Rosen

MANAGING DIRECTOR



Deb Lifshey

MANAGING DIRECTOR

The leaders of Pearl Meyer's Technical Services Team, Mark Rosen and Deb Lifshey, share thoughts on how they would suggest reading the new pay versus performance (PvP) disclosures and interpreting the new data.

Mark: The 2023 proxy season has been buzzing with activity around the new required table and related disclosure known as pay versus performance ("PvP"). The SEC hatched it just in time for the 2023 proxy season a mere twelve years after it was directed to do so under the Dodd-Frank Wall Street Reform and Consumer Protection Act of 2010. The original goal was ostensibly to provide important information to investors, which is a reasonable exercise. But in its ultimate format, will it be helpful for investors, compensation committees, or even the casual retail proxy reader in decision-making? Probably not. I don't believe it is fully illustrative of the relationship between executive pay and company performance. What it does do is create costly and administratively time-consuming exercises for companies, their lawyers, and accountants. Why do we even need this disclosure?

Deb: We don't, really. The SEC received a mandate from Congress to promulgate rules in 2010, following an extreme fiscal crisis and resulting public perception that viewed executives as prospering at the expense of shareholders. The idea behind the pay versus performance requirement was to find a normalized way to capture executive "pay" and company "performance" which was not already required in proxy statements. It took two

rounds of proposals and hundreds of comment letters to arrive at final rules twelve years later. As the rule came to life, disclosures in the summary compensation table ("SCT") already captured grant-date accounting values, and many companies were already disclosing "realized pay" with supplemental tables. Consultants, proxy advisors, and some institutional investors have their own models for comparing the relationship between pay and performance. It appears that the SEC worked long and hard to find a novel approach, but the value of this approach to the public remains unclear.

Mark: Does the current Summary Compensation Table ("SCT") give us enough information about what executives earn?

Deb: Not exactly. The SCT shows cash in the year paid (or for bonuses, with respect to the year paid), and the value of equity when granted. Since equity is seldom earned or realized by the grantee at the same stock price as it was on the grant date, the grant-date value doesn't reflect what an executive takes home. This disconnect is even more pronounced for performance-based grants, which may be earned or realized at above or below target where it is typically valued at grant date. It's an opportunity to earn, but not something that is liquid on the day it is granted—and it may never be.

Mark: The criticism of the SCT is that it doesn't reflect realizable pay. The assumption is PvP corrects for that with Compensation Actually Paid ("CAP"). Finally, we can see what executives are actually paid—right?

Deb: Again, not really. CAP isn't actually paid, despite its name. In fact, some of it may never be paid. CAP is cash compensation paid in a given year plus a hypothetical value of equity that has either vested in that year or is outstanding at year-end. Cash compensation is generally the same amount as that shown in the SCT. The difference is the value of equity, which is a snapshot of equity vested during the year and unvested equity valued at year-end. The snapshot, however, is riddled with assumptions and estimates about the hypothetical value of equity to the executive at a point in time. For example, if the stock price drops, the CAP could actually be negative in the PvP table. Similarly, if the actual number of shares earned is less than previously assumed, CAP could also be negative.

Mark: Whoa! You can have negative compensation actually paid? Does the executive have to pay something back?

Deb: No, nothing like that. If a company's stock price drops from one year-end to the next, an executive's unvested equity similarly drops in value. The more unvested equity an executive has, the larger the potential negative number. If the decline in stock price is precipitous, it can even offset salary and any other compensation paid.

This experience is not simply hypothetical and academic. In the proxies that have been filed to date, we see many examples of negative CAPs. For example, technology and pharma stocks generally did well in 2021 but poorly in 2022. What we see is very large CAP for 2021 and small or negative CAP for 2022. In many cases, 2021 CAP is huge while 2022 CAP is either small (and much less than the SCT shows) or negative, in some cases unusually negative. The more volatile the stock price year over year, the bigger the swings

in CAP.

Mark: So how should I think about colossally large CAPs, especially when they are many multiples of SCT compensation?

Deb: They should be given as much credence as negative CAP numbers. Because this is a point in time, while it may look like an executive has “outsized” equity awards, it could disappear in the following year’s proxy. To say that an executive is overpaid based on CAP values is taking a very narrow and even faulty view of how an executive is actually compensated.

Mark: So PvP is all about changes in stock price?

Deb: For the most part, yes. Most executive compensation philosophies for public companies put the emphasis on long-term equity compensation. If the stock price changes materially, it’s going to overwhelm other elements of compensation. That’s why we are seeing some disclosures with very large numbers in one year and negative numbers in the next.

What exacerbates the CAP problem is longer vesting periods. The more unvested stock, the more a small change in stock price can cause big changes in CAP. Companies may be penalized for longer vesting periods. Ironically, longer vesting—which encourages executives to hold for the long term—is something investors find favorable and even demand.

Mark: I feel like the goal of the new rule was to provide useful information to investors—and to potentially influence how companies design their compensation plans. But that was impossible this year, correct?

Deb: Correct—unless they were clairvoyant. The SEC sprung this on everyone late in 2022. Most companies barely had time to analyze the rule and create the disclosure, let alone think about the implications and use the resulting information to change pay programs already in flight. PvP did not—and in fact could not—have had any impact on 2023 compensation decisions. As such, in this first year, many took the approach to treat this as a compliance exercise because providing rationale simply didn’t make sense.

Mark: Will companies make plan design changes because of PvP disclosures and if they do, could this create unintended consequences?

Deb: I expect companies to compare their PvP disclosure to their peers. Going forward, while committees should be aware of optics presented in the new disclosure, we are not sure how design can or should be a function of the disclosure, especially when stock price tends to drive CAP values. Trying to accomplish good optics at the expense of sound

compensation strategy would certainly be one potential unintended consequence.

Mark: Will this disclosure go the way of the CEO Pay Ratio, which got a lot of press when it first came out and now is just another page at the back of the proxy?

Deb: You and I are in agreement on this: disclosure should not replace or determine sound plan design. Good governance demands alignment of compensation and strategy. How it will be disclosed should be understood, but it should not be the guiding factor driving the design. It remains to be seen what impact the PvP rule will have long-term, but just as with the CEO Pay Ratio, these mandatory disclosed relationships don't generally provide materially helpful information for investors, nor do they help compensation committees develop pay programs that are better aligned to business goals.

About the Authors

Mark is a consulting team leader who brings 20+ years advising on executive and board pay, including benchmarking, retirement plan design, and tax/accounting and governance considerations.

Deb advises on executive compensation from a legal and regulatory perspective, including securities disclosure, tax and governance matters, contract negotiation, 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.