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# Pay vs. Performance: What Do Public Company Directors Need to Know?



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The SEC recently adopted a new disclosure rule aimed at highlighting the relationship between executive compensation and company performance. The mandate, effective for the upcoming proxy cycle, introduces a new definition of executive compensation ("Compensation Actually Paid" or “CAP”) relative to a variety of performance metrics, some of which are prescribed and some of which are selected by each company. Although we won't cover all the technical details here (that will take place on an upcoming NACD webinar on 10/27), below is a summary of what you need to know today about the new rules, and the potential implications of the new disclosure that warrant conversation in your fall meetings.

## There are two new tables and a required narrative.

The first table (the “PvP Table”) includes three years of historical data for executive pay and company performance (building to five years of historical data over the next two years). Executive pay includes disclosed Total Compensation from the Summary Compensation Table (SCT) plus the new definition of "Compensation Actually Paid" for both the CEO and the Average of the other NEOs. Performance disclosures are (i) Company TSR, (ii) Peer Group TSR, (iii) Company Net Income, and (iv) a Company-Selected Metric. An explanation of the relationship among the various disclosures of pay and performance must be provided in narrative or graphical format (or both). The second table (“Tabular List”) requires a listing of 3-7 financial (and/or non-financial) metrics that are most relevant to the Company's determination of executive compensation.

## Compensation committees should be aware of, or weigh-in on, four key decisions.

The four key decisions are:

- Which company-selected performance metric to include the PvP Table;
- Which “peer group” to include for TSR purposes in the PvP Table;

- Which additional metrics to include in the Tabular Table; and
- Where the required disclosure should be placed within the proxy.

We suspect that many companies will select (i) the earnings metric in their short-term incentive plan, (ii) an index used in their Performance Graph in the 10-K or Annual Report, (iii) a minimal listing of metrics that are currently included in the incentive plan designs, and (iv) placement after the existing required compensation tables (i.e., not within the CD&A).

## "Compensation Actually Paid" is not what you think.

Although the opportunity existed to require something like "Realizable" or "Realized" compensation, the new rules simply adjust the figures already disclosed in the Summary Compensation Table (SCT) with respect to equity-based compensation and pensions. For example, the equity-based compensation adjustments are *not* based on realized compensation (e.g., option exercises, performance share units [PSUs] earned, restricted stock vested, etc.) but rather reflect an annual “mark to market” based on fair value estimates at each new measurement date (e.g., updated Black-Scholes valuation for options, updated Monte-Carlo valuation for PSUs with rTSR metrics, etc.)

## What are the potential implications of the new disclosure?

Nobody wants the tail to wag the dog, but there are some potential implications of this new disclosure for executive-level incentive compensation plan designs going forward.

- The choice of incentive plan metrics has greater visibility. Because the company-selected metric for the PvP Table and the list of three to seven additional metrics for the Tabular List will likely originate from the metrics currently used in the executive-level short-term and long-term incentive plan designs, the choice of metrics should at least *consider* how this will appear to shareholders in this new disclosure in the future. In other words, does the current incentive framework really capture all the important metrics? Are there metrics being considered for inclusion in the new list that are not currently included in the incentive plan designs but should be?
- This is another potential spotlight on ESG-related metrics. If you don't have any ESG-related metrics in your list of three to seven, are they not important? If you do have ESG-related metrics in your list but they're not directly incorporated into your incentive plan design, why not? The fact that these metrics will be "tagged" in the disclosure will make it relatively easy for researchers, proxy advisors, and governance groups to assemble comparisons and identify outliers.
- There are potential disconnects with "the story" in the CD&A. The new required narrative following the CAP table may or may not fully align with the more complete pay-for-performance narrative within the CD&A given the different metrics, time frames, and pay definitions. To some extent, these narratives will need to be reconciled.
- Relative TSR plans just became more costly. The number of required Monte-Carlo valuations (typically provided by a third party) has expanded from a single valuation

on the grant date to multiple valuations during the life of the award: (i) at the grant date and (ii) at the end of each fiscal year during the performance period, and (iii) at the end of the performance period. Furthermore, there may be an additional calculation of final actual value if there is a difference between the end date of the performance period and the ultimate vesting date.

- Equity awards with quarterly or monthly vesting are quite cumbersome. Because the definition of "Compensation Actually Paid" requires re-measurement of outstanding awards at either (i) fiscal year-end or (ii) vesting, awards with more frequent vesting provisions add considerable complexity to the calculation of "Compensation Actually Paid." For example, an award with monthly vesting will require valuation on the grant date and on each of the 12 subsequent vesting dates.

## Is this a big deal?

The answer is both yes and no. Yes, because it's a new required table with an entirely new definition of pay and a potentially confusing narrative trying to make pay-for-performance connections between variables and time frames that may not be well aligned. And no, because it is likely to be separate and apart from the CD&A, and therefore may not become an integral component of how the executive compensation program is evaluated externally (i.e., more akin to the impact, if any, of the CEO Pay Ratio disclosure). However, it is brand new, it needs to be done, and only time will tell how much attention it ultimately receives or the impact it has on the design of executive pay programs.

## About the Author

Greg is a consulting team leader with 25+ years advising compensation committees and executives on executive and non-employee director pay, including performance metrics, governance, and SEC disclosure.

## About Pearl Meyer

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