SEC Mulls Changes to Proposed "Pay Versus Performance" Disclosure Rules

The Securities and Exchange Commission has taken another step towards completing the executive compensation-related rulemaking triggered almost 12 years ago by the Dodd-Frank Act. In January 2022, the SEC announced that it was reopening the comment period on rules it originally proposed in 2015 (the "Proposed Rules") to satisfy new Section 14(i) of the Securities Exchange Act of 1934 which requires public companies to disclose the relationship between the compensation actually paid to their Chief Executive Officer and other named executive officers (the "NEOs") and their financial performance. The Reopening Release solicits additional comments on the Proposed Rules and includes several questions about possible changes to the rules (the "2022 Rule Proposals").

This Thoughtful Pay Alert summarizes the original framework of the Proposed Rules and highlights key aspects of the 2022 Rule Proposals, which could dramatically expand the information that companies would be required to disclosure about the relationship between their executive pay and their financial performance. For a detailed analysis of the Proposed Rules, see our Thoughtful Pay Alert, SEC's Proposed "Pay versus Performance" Disclosure Rules Likely to Present Numerous Challenges (May 20, 2015).

Background

Section 953(a) of the Dodd-Frank Act, as enacted in 2010, added Section 14(i) to the Exchange Act which required public companies to disclose in their proxy statements for their annual meeting of shareholders a clear description of any compensation required to be disclosed under the SEC's executive compensation disclosure rules, including information that shows the relationship between executive compensation actually paid and the financial performance of the company, taking into account any change in the value of the shares of stock and dividends of the company and any distributions.

The SEC published the Proposed Rules to implement Section 14(i) in April 2015. However, until earlier this year, no further action was taken on this rulemaking. In January 2022, the SEC announced that it was reopening the comment period to solicit additional information on the Proposed Rules in light of subsequent developments in the intervening years and to further consider its mandate under the statutory provision.

The Proposed Rules

The Proposed Rules would require public companies to include as part of the executive compensation disclosure in their proxy statements a new "pay versus performance" table containing the following information for each of the last five fiscal years:

- The amount reported in the "Total Compensation" column of the Summary Compensation Table for the Chief Executive Officer and the average of the amounts reported in the "Total Compensation" column for the remaining NEOs;
- The "compensation actually paid" to the Chief Executive Officer and the average compensation actually paid to the remaining NEOs (for this purpose, equity awards would be valued at their fair value at the time of vesting);
- The company's cumulative total shareholder return ("TSR") on an annual basis; and
- The cumulative TSR on an annual basis of either the companies in the peer group identified by the company in its stock performance graph or the compensation peer group disclosed in its Compensation Discussion and Analysis.

Using this information, companies would be required to provide a clear description of the relationship between the compensation actually paid to their NEOs and their cumulative TSR and to describe the relationship between their cumulative TSR and the cumulative TSR of the peer group included in the table. This disclosure could be in narrative form, presented as a graphic (or series of graphics), or a combination of the two.

To ease the transition to the new disclosure, the first filing in which a company would be required to provide the foregoing information need cover only three, rather than five, years. Thereafter, the company would provide disclosure for an additional year in each of the two subsequent annual filings in which the disclosure is required.

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SEC Mulls Changes to Proposed "Pay Versus Performance" Disclosure Rules (continued)

Proposed Pay Versus Performance Table

Year (a)	Summary Compensation Table Total for PEO (b)	Compensation Actually Paid to PEO (c)	Average Summary Compensation Table Total for non-PEO Named Executive Officers (d)	Average Compensation Actually Paid to non-PEO Named Executive Officers (e)	Total Shareholder Return (f)	Peer Group Total Shareholder Return (g)

The 2022 Rule Proposals

In addition to seeking further comment on the Proposed Rules, the Reopening Release contains a series of questions raising the possibility of some significant enhancements to the rules that could increase the compliance burden for public companies. The most notable questions include the following:

- ***Introduction of Additional Performance Measures*** – The SEC has asked whether, in addition to TSR, the following three financial performance measures should be disclosed in the new table – pre-tax net income, net income, and a measure specifically chosen by the company (the "Company-Selected Measure"). This latter measure would be the measure (that is not already in the table) deemed most important to link compensation actually paid during the fiscal year to company performance. The SEC has also asked whether these measures should be included in the "clear description" of the relationship between pay and performance that is required to accompany the tabular disclosure.

- ***Definition of "Most Important"*** – The SEC has asked whether it should define the term "most important" for purposes of the selection of the Company-Selected Measure and whether the focus should be on the measure used to link only Chief Executive Officer compensation actually paid to company performance.

- ***List of Other Measures*** – The SEC has asked whether companies should be required to provide a list of their five most important performance measures used to link compensation actually paid to company performance.

- ***Use of Different Performance Measures*** – The SEC has asked what disclosure should be required if different measures are important in different years or if different measures determine compensation actually paid to different NEOs.

- ***Compensation Actually Paid*** – The SEC has asked whether there are alternative approaches to define "compensation actually paid" that would reduce the risk of misalignment of compensation actually paid with the associated financial performance and still provide for appropriate comparability across companies. The SEC has also asked whether there are other approaches to valuing stock options rather than using the fair value at the vesting date.

- ***TSR Time Periods*** – The SEC has asked whether it should clarify the time periods that should be disclosed in the TSR portions of the proposed table. For example, should TSR be a five-year cumulative and rolling average, a cumulative average within the five-year period in the table, or an annual year-over-year figure.

- ***Other Developments*** – The SEC has asked whether there have been any other developments since the Proposing Rules was issued (such as the use of qualitative measures and/or ESG metrics) that should affect its consideration of the Proposed Rules or their potential economic effects.

Many Issues to be Decided in Developing Final Rules

The Proposed Rules present many challenges for companies which were raised in the initial comments submitted in 2015, all of which remain to be addressed. The introduction of the 2022 Rule Proposals makes this task even more daunting. Here are some of the key issues that the SEC is going to need to resolve in adopting final rules:

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- ***Reconciling Timing Disparities*** – The Proposed Rules require companies to disclose executive compensation and their cumulative TSR for each of the fiscal years covered by the required table and, using this information, to describe the relationship between the compensation actually paid to their NEOs and their cumulative TSR through the end of the last completed fiscal year. This assumes that a meaningful correlation between pay and performance can be explained by comparing the compensation actually paid during a fiscal year and the TSR generated through the end of that year. Unfortunately, it's more likely that this disclosure will highlight the timing differences between the stock prices on the vesting dates when equity award values must be calculated and the year-end stock price used by a company to determine its annual TSR. This issue will confront companies that customarily grant performance stock unit ("PSU") awards with a multi-year (typically, three-year) performance period. It will also affect companies that grant stock options and time-based restricted stock unit ("RSU") awards – in many cases, the value realized from the award will have accumulated over several years and be unrelated to the company's cumulative TSR for the year of vesting. We expect that companies may struggle to identify a meaningful relationship between the compensation amounts being disclosed and their financial performance, or need to explain why no such relationship exists.

- ***Focus on TSR*** – Although TSR is a widely-understood performance measure, it is not necessarily used in the incentive compensation design at many companies, which, instead, may use other financial or operational measures that are more closely tied to their annual and long-term objectives to set executive pay. If TSR is retained as the primary (or only) measure of financial performance for purposes of the required disclosure, many companies will need to provide a second explanation of pay and performance which corresponds to their choice of the drivers of corporate performance. As some have suggested, a less prescriptive approach may be preferable which continues to include TSR (for comparability purposes), but allows companies to select an additional measure or measures of their own choosing (along the lines of the Company-Selected Measure discussed in the 2022 Rule Proposals) if they believe it will be useful to their shareholders.

- ***Introduction of Additional Performance Measures*** – The addition of pre-tax net income and net income to the performance measures to be included in the tabular disclosure (and possibly addressed in the narrative description of the relationship between compensation actually paid and a company's financial performance) is problematic since few companies use either measure in their incentive compensation plans. In addition, where such measures are used, it is our experience that they are typically adjusted for exceptional items that would otherwise distort the company's actual operating performance. Further, the proposed inclusion of a separate table listing the five most important performance measures used to drive the compensation actually paid is unlikely to be helpful to shareholders since most companies already address the material performance measures used in their incentive compensation plans in their Compensation Discussion and Analysis ("CD&A"). Thus, we are concerned that the introduction of additional performance measures such as these will make the disclosure longer without necessarily making it more meaningful to shareholders.

- ***Introduction of "Company-Selected Measure"*** – Permitting companies to include their own selected performance measure (or measures) in addition to or instead of TSR may be preferable when it comes to describing the relationship between compensation actually paid and their financial performance. While the Company-Selected Measure may serve this purpose, we note that it appears that companies would be expected to use the same measure for each of the years reflected in the table. This may be problematic for many companies since, in our experience, it is not unusual for a company to change metrics within any given five-year time frame as its business objectives change and, thus, its corresponding financial focus will change to support its current objectives. If the SEC moves forward with this proposal, it should allow flexibility for companies to change the measure to match what it is using in any given year to drive performance and, within a single year, to use alternative measures reflecting the variation in performance objectives and priorities among NEOs. Interestingly, this flexibility would mirror what's already disclosed by most companies in the CD&A.

- ***Using a Comparator Peer Group*** – While the Proposed Rules permit companies a choice when selecting a peer group for purposes of establishing the TSR against which their TSR is to be compared and analyzed, it is unclear how the rule would address the fact that most companies update their compensation peer group each year. This raises the question of whether showing cumulative five-year TSR against the most recent peer group being used reflects a fair assessment of performance.

- ***Defining "Compensation Actually Paid"*** – The Proposed Rules define "compensation actually paid" as the amount disclosed in the "Total Compensation" column of the Summary Compensation Table, as adjusted to value pension benefits and equity awards. As previously noted, equity awards would be considered "actually paid" on the date of

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vesting based on their accounting fair value on that date. This approach is problematic for stock options since, unless immediately exercised, there will be no compensation actually paid to the NEO at that time. This problem would be exacerbated where the option is "underwater," which may preclude the option from ever being exercised. A similar challenge arises where a company uses PSU awards for part, if not the majority, of their long-term incentive compensation opportunities. As some commenters have suggested, it may be preferable to select one of the currently-available performance-adjusted pay definitions, such as "realizable pay," for purposes of evaluating "pay-for-performance" alignment rather than creating a wholly-new definition of "compensation" for purposes of this disclosure.

Is an Enhanced CD&A a Better Solution?

At its essence, the objective of the Proposed Rules, as well as the 2022 Rule Proposals, is to provide greater transparency about the correlation between the compensation actually paid to a company's NEOs and its corresponding financial performance. The CD&A already requires companies to describe the material performance measures used to determine the outcomes of a company's incentive compensation plans and the rationale used in selecting those performance measures. Further, many companies already include in their Executive Summary to the CD&A a "pay-for-performance" analysis. Consequently, we view the rulemaking as an opportunity to enhance the CD&A to provide shareholders with better information about the amounts paid to the NEOs, which are in large part derived from the company's incentive compensation arrangements, and how its financial measures led to those outcomes. We question whether adding more compensation measures (along with a narrative description of the relationship between pay and performance) to the required disclosure will make that explanation any easier. Consequently, we believe that the SEC should consider satisfying the objectives of new Section 14(i) by adding the necessary information to what is already contemplated by the CD&A, rather than creating a separate requirement which will, to some extent, overlap with what companies are already disclosing.

Need Assistance?

Compensia has extensive experience in helping companies understand how the corporate governance and executive compensation-related disclosure provisions of the Dodd-Frank Act will affect the design, operation, and disclosure of their executive compensation program. If you would like assistance in analyzing how the Proposed Rules are likely to impact your executive compensation disclosure, or if you have any questions on the subjects addressed in this Thoughtful Pay Alert, please feel free to contact Jason Borrevik at 408.876.4035 or jborrevik@compensia.com or Mark A. Borges at 415.462.2995 or mborges@compensia.com.

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About Compensia

Compensia, Inc. is a management consulting firm that provides executive compensation advisory services to Compensation Committees and senior management.

Offices

Silicon Valley
50 W San Fernando Street
Suite 1350
San Jose, California 95113
408.876.4025

San Francisco
One Embarcadero Center
Suite 2830
San Francisco, California 94111
415.462.2990

Principals

Thomas G. Brown, Chairman
tbrown@compensia.com
408.876.4023

Ralph Barry
rbarry@compensia.com
858.603.2288

Erik Beucler
ebeucler@compensia.com
408.907.4314

Mark A. Borges
mborges@compensia.com
415.462.2995

Jason Borrevik
jborrevik@compensia.com
408.876.4035

Amanda Feyerabend
afeyerabend@compensia.com
415.462.2988

Aaron Johansen
ajohansen@compensia.com
408.907.4310

Lori Koenig
lkoenig@compensia.com
415.462.0231

Tom LaWer
tlawer@compensia.com
408.907.4309

Greg Loehmann
gloehmann@compensia.com
408.907.4319

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