Evaluating the New "Pay Versus Performance" Disclosures

With the peak of the 2023 proxy season behind us, it's possible to begin to take stock of the new "pay-versus-performance" disclosures that have appeared in definitive proxy statements during the first half of the year. Intended to provide investors and other stakeholders with a more comprehensive understanding of the relationship between executive compensation and corporate performance, Compensation Committees have begun to ask what we have learned from the more detailed information and additional perspectives provided by this new disclosure.

This Thoughtful Pay Alert offers our initial assessment of the utility of this disclosure in achieving these goals and our expectations for how it may evolve in the near term.

Our Initial Disclosure Observations

- ***Wide variation in actual disclosures –*** Currently, it is unclear whether the SEC will provide substantive guidance to address the wide variations in the format and content of the actual disclosures or issue additional interpretive guidance to address areas that are still uncertain and/or opaque
- ***Institutional shareholders and their advisors (that is, ISS and Glass Lewis) –*** These stakeholders have yet to disclose what, if any, effect the pay-versus-performance disclosure will have on their Say on Pay voting recommendations
- ***Uncertain future impact –*** A down stock market in 2022 may have reduced the impact of the initial round of disclosures since the critical amount – "compensation actually paid" – was generally less than the "total compensation" reported in the Summary Compensation Table and sometimes a negative amount
- ***Activist investors and the media have yet to weigh in –*** Activist investors and the media will likely scrutinize these new disclosures closely next year. Consequently, companies should make sure that they have clearly addressed the relationship between "compensation actually paid" and their financial performance. Companies also should carefully evaluate their Compensation Discussion and Analysis to ensure that their discussion of their "pay-for-performance" philosophy is clear and meaningful.

Disclosure Objectives

The new "pay-versus-performance" disclosure is intended to supplement the current disclosure that many companies provide in their Compensation Discussion and Analysis ("CD&A") on the correlation between the compensation that they pay their senior executives and their short-term and long-term financial results and the effectiveness of their executive compensation program in incentivizing the achievement of a company's business objectives and its ability to create sustainable long-term shareholder value.

Disclosures Varied Significantly

As we learned from our experience in advising clients on complying with the new disclosure requirements and our review of disclosures within the technology and life sciences sectors, companies used a variety of formats and approaches in complying with the new disclosure requirements and describing the relationship between the "compensation actually paid" ("CAP") to their Chief Executive Officer and other named executive officers and their financial performance as measured by a set of prescribed financial metrics. Among other things, we learned that, as part of their pay-versus performance disclosure, many companies indicated that the prescribed net income metric often was not pivotal in designing and structuring their executive compensation program, with most companies referred readers to their CD&A for a more fulsome discussion of how they linked pay with performance.

Significant Stakeholders Have Yet to Weigh In

While a number of observers have offered some preliminary conclusions as to what the resulting data says and how it may be used to assess the effectiveness of a company's executive compensation program and some organizations, such as the major proxy advisory firms, have begun to consider how they may be able to make use of this information to enhance their analyses and understanding of a company's compensation philosophy and program execution, we believe that it is still too early to fully understand the meaning of this information and how it may be viewed and used by various stakeholders and by compensation committees themselves in improving their compensation programs and comparing the relative merits of different program designs and approaches.

As a result, at present it is difficult to determine the future impact of the new information that is now available. We expect Institutional Shareholder Services ("ISS") and Glass Lewis & Co., the most prominent proxy advisory firms, to take a critical analysis of the data as they decide whether – and, if so, how – it will be reflected in their review and analysis of executive compensation programs. As they do each year, these firms will soon be soliciting input from stakeholders on possible revisions to their executive compensation policies and analytical methodology. At that time, we will get our initial indication as to how they intend to make use of this information in the future. It remains to be seen whether institutional shareholders will incorporate aspects of the new disclosure in their policy guidelines for 2024 and beyond.

In addition, the SEC has indicated informally that it intends to review the new disclosures more carefully this fall, a common practice when a significant new disclosure requirement has been adopted. Although we do not know the extent of this review, the Commission's heavy fall rulemaking agenda may affect the availability of resources to devote to this task. Consequently, at present it is unclear as to the scope of this review and whether it will result in a written report (as was the case when the current executive compensation disclosure rules were adopted in 2006) or some other form of formal guidance. Unless there has been a significant misunderstanding with respect to some aspect of compliance, we do not expect the SEC to revise or modify the current disclosure requirement in the foreseeable future. Given the range of approaches used to present the required information in the initial round of disclosures, we anticipate that, at a minimum, the Staff of the Division of Corporation Finance is likely to issue some interpretive guidance, but the subject of any such guidance and its potential impact on how companies prepare their disclosure in 2024 is uncertain.

Possible Near-Term Impact

In the near term, as companies begin to focus on what they have learned from their own compliance experience and from reviewing the disclosures of their peers and the broader market, we believe that the following factors should also be considered when preparing the next round of disclosure.

Activist Investors

Activist investors are certain to scrutinize the new disclosure to determine whether it can be used to strengthen their positions with respect to their target companies. The minimal explanations provided by some companies in their disclosure may make the CAP amounts an attractive weapon for some investors to bolster their arguments of a compensation program's ineffectiveness by demonstrating poor alignment of pay and performance.

Market Uncertainty

One of the most striking aspects of the initial disclosures has been the large year-over-year changes in the CAP amounts. Reflecting the heavy weighting of equity compensation granted to executives and the significant volatility in the market in recent years, many disclosures reflected large increases in CAP (almost entirely because of stock price appreciation) in 2020 and 2021 followed by dramatic decreases in 2022 as stock prices plunged as a result of the worldwide economic uncertainty. This had a tendency to limit any concerns between pay and performance when CAP was lower (and sometimes negative) compared to the total compensation reported in the Summary Compensation Table ("SCT"). As the market rebounds and stock prices begin to climb, the reporting of large CAP amounts for senior executives would likely draw negative attention from the media, which could also affect how the institutional shareholder community and their advisors view the disclosure.

Enhancing "Pay for Performance" Disclosure in CD&A

Given this state of affairs, we believe that technology and life sciences companies should carefully evaluate the current "pay for performance" disclosure in their CD&A to confirm that it provides a clear, thorough explanation of the relationship between their compensation decisions and their subsequent financial and/or operational outcomes based on the actual performance metrics used in their short-term and long-term incentive compensation programs.

While arguably the "pay-versus-performance" disclosure may serve as a convenient platform for evaluating pay and performance, some of this information should be evaluated to determine whether it is more appropriate that it be incorporated into the CD&A discussion.

Need Assistance?

Compensia has extensive experience in helping companies analyze the requirements of the SEC's "pay-versus-performance" disclosure rule, as well as drafting the required disclosure. If you would like assistance in preparing your "pay-versus-performance" disclosure, or if you have any questions on the subjects addressed in this Thoughtful Disclosure Alert, please feel free to contact the authors of this Alert , Mark A. Borges at 415.462.2995 or mborges@compensia.com, or Hannah Orowitz at 332.867.0566 or horowitz@compensia.com.

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