AGENDA

SEC Raises New Hurdles on PvP Disclosure

Comp committee members might need more time to review new information

By Amanda Gerut | February 27, 2023

The **SEC**'s guidance on its pay-versus-performance compensation rule came just weeks before hundreds of companies file proxy statements during early March. The rule clarifications could kick off more rounds of questions among boards and management teams as companies respond to the guidance by reworking draft proxy disclosures that comp committees may have already reviewed.

Now the compressed deadlines companies were working under to comply with the rule have become even more so, given that the guidance is prompting some management teams to revisit or completely reverse course on previously made decisions. The internal vetting process for proxy statement production involves legal and internal and external audit, for instance, and introducing new material at this stage is less than ideal, sources said.

Fortunately, the SEC's compliance and disclosure interpretations, commonly referred to as CD&Is, don't really impact the calculation of compensation actually paid (CAP), which is the most complicated aspect of the new required disclosure, said **Irv Becker**, vice chairman of the executive pay and governance practice at **Korn Ferry**.

However, for companies that already made decisions on the company-selected measure (CSM) or peer group comparisons that now need to be walked back, the CD&Is have raised new challenges.

"If a management team had already presented a draft to the comp committee with a certain metric or peer group and now they're going to have to go back and make that change, it's going to create some confusion," he said. "Board members are going to be curious. They understand this is management's responsibility to pull this together, but they've been involved in the discussion along the way. They'll want to understand what changed and why."

For boards, the timing of the guidance means compensation committees are likely to review the pay-versus-performance (PvP) table and disclosure at the same time they review the draft CD&A, Becker said.

"Some of my clients have been ahead of the curve and have been showing drafts to the compensation committee at the last couple of meetings as they've been working on them," said Becker. "We've always been caveating that the final calculations and numbers will be ready closer to when they're reviewing the CD&A draft, which is right about now for fiscal year-end companies."

According to Becker, he has asked clients to create a reconciliation or "waterfall" to show how the CAP figure is derived and calculated from the summary compensation table (SCT). The reconciliation can help address potential questions from board members about how a positive SCT figure turned into a negative CAP number, for example, or how a smaller SCT figure turned into a larger CAP amount.

"There can be a lot of movement between those two columns, and board members will want to make sure they understand the reconciliation," said Becker.

Indeed, one of the other points to emerge in the coming weeks as companies craft final PvP disclosures will be how to thread the information together and get senior management and comp committees comfortable with the final product, said **Takis Makridis**, president and CEO of equity valuation consulting firm **Equity Methods**.

"We've been putting a lot of energy into how to package up the results," said Makridis. "If you just vomit the table onto a slide, it's very difficult for internal stakeholders — and even the compensation committee — to get comfortable with the process. If you give them all the raw work product, that's overwhelming. There's a lot of effort going into the packaging."

'Mind-Blowing' Questions

Under the SEC's PvP rule, companies must disclose CAP paid to the CEO, average CAP paid to NEOs and other data points in a table, including peer TSR and GAAP net income. Companies also have to select a financial measure, the CSM, that represents the "most important" performance measure not already included in the table that is used by the board to link CAP during the fiscal year to company performance. The SEC stated in the rule release that it included the CSM requirement to lessen the likelihood that the required figures in the tables would "misrepresent or provide an incomplete picture of how pay relates to performance."

Among the areas that could send companies back to the drawing board include the SEC's stance on stock price as a CSM, the peer group permitted for calculating TSR and the use of multiyear metrics.

Among other topics, the CD&Is clarified that any peer group disclosed in the CD&A and used to help determine executive pay can be used to calculate peer TSR in the table. It was previously unclear as to whether a company could use any peer group disclosed in the CD&A, or if the peer group used to calculate TSR had to have been used explicitly for pay benchmarking.

Yet, the CD&Is also stated that if a company uses the CD&A peer group to calculate peer TSR, the peer group used for the calculations must be the specific peer group from 2020, 2021 and 2022 — rather than just the 2022 peer group. In that event, Makridis noted that there could be three peer groups "living inside the table, which poses comparability challenges," he said.

According to **Mike Kesner**, a partner at **Pay Governance**, that point was one of strangest aspects of the CD&Is in his view and is "the polar opposite" of what the SEC published in its final rule release.

The CD&I related to the peer group to be used for peer TSR calculations seems to supplant the text from the final rule for the first transitional year of the PvP disclosure. The CD&I hypothetical illustrates the way investors will look at each year's TSR in conjunction with that year's peer group. In subsequent years, it appears that companies will be able to include tabular disclosure with the current year peer group for all the years in the table, in line with the adopting release.

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However, for experts in the field, the inconsistency has been frustrating.

The rule states that the PvP table must show cumulative TSR for fiscal years 2020, 2021 and 2022. If the peer group changed in 2022, the original text of the final rule release stated that companies should use the 2022 peer group to calculate cumulative TSR from the end of 2019 until the end of 2022, using the 2022 peer group.

Based on the final rule text, that's how companies approached the rule, said Kesner.

However, the CD&Is stated that if a company had different peer groups during the period, the different peer groups each year should be used to calculate annual TSR.

PvP Contradiction?

The SEC's CD&Is on pay versus performance seem to go against the rule's language

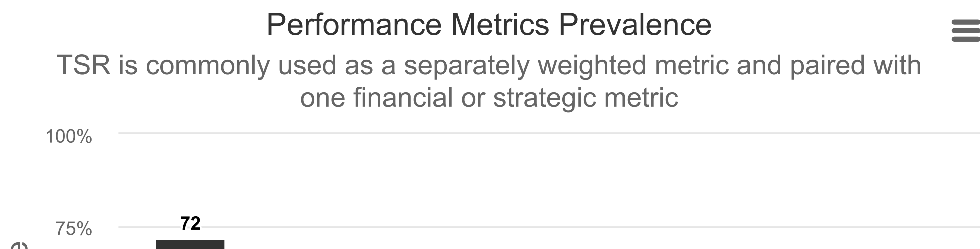
"That's a head scratcher," said Kesner. "No one can figure out why the CDI was issued in the manner it was — it directly conflicts with the rule itself."

Another CD&I that Kesner described as "mind-blowing" was the SEC's view on what can be reported in the PvP table if the CSM is measured over a multiyear period.

The most common plan design when it comes to performance shares is using a three-year performance period, said Kesner. The results are typically measured over the three years to determine the percentage of performance shares to be awarded to an executive. The CD&I, however, indicated that while a multiyear measure can be a CSM, only the current year's performance can be reported in the table, he said. In most cases, the current year's performance is likely to be "meaningless in determining compensation actually paid," said Kesner.

"It demonstrates a general lack of knowledge on how most multiyear incentive plans work, which is very troubling," he added.

According to the results of **FW Cook**'s annual analysis of pay practices among the largest 250 companies, 94% of companies included performance awards in long-term incentive plans. Performance awards were also the largest component of the mix in plans, at 59%, compared to restricted stock at 22% and stock options at 19%. Further, among the companies that grant performance awards, 72% use TSR. Their analysis also found that 92% of the largest companies measure performance-based long-term incentives over three years. Only 6% of the companies studied have a performance period of one year or less.



While the CD&I's requirement that the CSM be a one-year metric even though that metric's utilization in the incentive plan may be a three-year metric, Makridis said that the impact might not be all that significant; if long-term incentive plans have a three-year metric, finance teams will have the one-year version.

"I can't have a three-year number without knowing the component parts to it," he said. "Primarily, it is loading up a spreadsheet that already exists and finding the number on it."

Given the potential pivot on the CSM selection — or if a CSM selection has not yet been finalized — board members should be sure to ask for clarification if they don't know or understand why a CSM was selected by the company, said **Gillian Emmett Moldowan**, a partner at **Shearman & Sterling**.

"When you are informing the board or compensation committee as to what's been selected as to the CSM, it's very helpful to share with them how the company selected the measure and, depending on the circumstances, maybe that's short and maybe it's a more involved description," she said. "That's a very good question for boards to ask and for management teams to get ready to present to boards."

Ultimately, it's likely that the CSM and comparison between CAP and other measures are less useful portions of the rule to investors than the comparison between CAP and TSR, explained **Marc Hodak**, a partner at **Farient Advisors**.

"The combination of realized and realizable pay is good information when it's combined with total shareholder return," said Hodak. "It's something investors haven't seen before and it's interesting and useful for them to see it, and it's something companies can write a story around if they're doing anything close to a reasonable job on their compensation program."

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