

September 7, 2022

SEC FINALIZES PAY VERSUS PERFORMANCE (PVP) DISCLOSURE RULE, REQUIRING COMPLEX CALCULATIONS FOR 2023 PROXY STATEMENTS

On August 25th, the SEC released the long-awaited final rule that implements the requirement in the Dodd-Frank Act that proxy statements contain a “clear description” of “information that shows the relationship between executive compensation actually paid and the financial performance of the issuer, taking into account any change in the value of the stock.” While no changes are being made to the current Summary Compensation Table (SCT) requirements, the new PVP Rule will require recalculation of various SCT inputs and will result in:

- The creation of a new PVP Table,
- Many companies having to make hundreds of new calculations for the new table to replace the grant date stock values in the SCT with new stock values for the NEOs,
- Replacement of the pension cost number in the SCT with a new number representing service cost and the prior service cost for amendments during the year,
- Companies having to provide a clear description of the relationship between executive compensation, as newly defined, and various financial metrics, and
- Companies having to select its 3-7 most important financial metrics used to “link” executive compensation to performance and to provide financial information with respect to the most important measure.

The new rule is effective for proxy statements for fiscal years ending on or after December 16, 2022.

Background

The SEC has released its final rule on the PVP disclosure requirement mandated by section 953(a) of the Dodd-Frank Wall Street Reform and Consumer Protection Act (Dodd-Frank). As indicated by the fact that the final rule has come 12 years after the effective date of Dodd-Frank, the SEC wrestled with a number of complex issues in determining how to implement the statutory requirement that a company provide a “clear description” of “information that shows the relationship between executive compensation actually paid and the financial performance of the issuer, taking into account any change in the value of the shares of stock and dividends of the issuer and any distribution.”

The rule is effective with respect to proxy statements covering fiscal years ending on or after December 16, 2022, meaning that the required disclosures will first be reported in 2023 proxy statements for calendar year-end companies. The key requirement is creation of a PVP Table described in detail below.

The rule will require some new and complex calculations by issuers. There are also some complicated and potentially sensitive judgments that compensation committees will need to make with respect to determining the most important financial metrics used for linking executive compensation with performance.

We believe that the clearest way to explain the impact of the new rule is to focus on describing what the new 2023 disclosure will look like for a company with a fiscal year ending 12/31/22 in enough detail that the reader has a clear picture of the requirements to comply. We will not spend much time pondering the extent to which this final rule carries out the statutory mandate to show compensation “actually paid” or whether there were better approaches. The rule is final, so now the focus should be on how companies put together the new disclosure mandated for 2023 proxy statements.

1. Structure of the New Disclosure

The new disclosure will be a standalone section of the proxy statement, which can be located inside or outside the CD&A. In its simplest form, the disclosure might consist of essentially two tables, one or more graphs, and many footnotes:

- The PVP Table
- A table of three to seven financial measures (the “Tabular List”) that the company considers most important in linking compensation actually paid to its executive officers to company performance, one of which must be listed in the PVP Table (referred to as the Company-Selected Measure (CSM))
- A graph or graphs plotting a number of data points from the PVP Table used to satisfy the requirement that a “clear description” be provided of the relationship between the new pay calculation and the financial metrics in the PVP Table

Inline XBRL must be used to tag all the data in the PVP Table and much of the other information provided pursuant to the regulation.

2. The PVP Table

The PVP Table for 2023 needs to cover three years (2020-2022). In 2024, four years must be covered, and in subsequent years five years must be covered.

Below is a sample of what the table looks like for 2023. Following the table, we will explain the different columns, starting with the easiest columns and moving to the hardest.

Year (a)	SCT total for PEO (b)	Comp. actually paid to PEO (c)	Average SCT total for Non- PEO NEOs (d)	Average comp. actually paid to Non-PEO NEOs (e)	Value of initial fixed \$100 investment based on:		Net Income (h)	Company- Selected Measure (i)
					Company TSR (f)	Peer group TSR (g)		
2022								
2021								
2020								

(A) The easy columns — (b), (d), (f), (h), and (i)

Columns (b) and (d) are taken right from the SCT for 2020-2022. Notice that column (d) is the average of SCT compensation paid to named executive officers (NEOs) other than the chief executive officer, referred to as the Principal Executive Officer (PEO) in SEC parlance. Also, if there is more than one PEO during the year, each PEO gets a separate column. The compensation for the other NEOs is a simple average, with no special consideration to account for the number of other NEOs (so, former NEOs in the SCT are included) or one-time forms of compensation, such as retention bonuses, severance, etc.

Column (f) is also straightforward. The company's total shareholder return (TSR) is reported by showing the growth in a hypothetical \$100 investment over the years covered by the table. If, for example, there were no dividends and the stock grew 10% each year, the entries in column (f) for 2020, 2021, and 2022 would be \$110, \$121, and \$133. Note that the entries for later years do not show the return solely for that year but cumulatively for the period beginning at the start of the earliest year in the table (1/1/20 for the 2023 table) and running through the end of the relevant year.

Columns (h) and (i) are just reported results for two financial metrics—net income and the CSM. Net income is taken right from the GAAP financials. The chief complexity in (i) is determining what constitutes the CSM. The CSM is defined as the financial performance measure¹:

“which in the registrant’s assessment represents the most important financial performance measure (that is not otherwise required to be disclosed in the table) used by the registrant to link compensation actually paid to the registrant’s named executive officers for the most recently completed fiscal year, to company performance.”

¹ “Financial performance measures” means measures that are determined and presented in accordance with GAAP, any measures that are derived wholly or in part of such measures, and stock price and total shareholder return. This Alert assumes that a comparison of the company’s total shareholder return to that of a peer group is a financial performance measure although the wording of the definition is less clear than we would like.

Since columns (f), (g), and (h) contain information regarding the company's TSR, the TSR of its peer group, and net income, the CSM must be another financial measure.²

How difficult will it be to determine the CSM? We think it may vary broadly among issuers. If the CEO's long-term incentives make up 70% of his or her compensation and the performance metric is earnings per share (EPS), it seems obvious that EPS should be the CSM. On the other hand, suppose the long-term incentives consist of stock options, restricted stock units (RSUs), and performance awards based on relative TSR (rTSR) among peer companies. Further suppose the annual incentive plan uses three equally weighted financial metrics to determine the payout. It's not obvious which annual incentive plan metric should be chosen (the long-term incentive metrics are already in the PVP Table) or, for that matter, whether another metric could be chosen.

Regarding the CSM, the rule allows non-GAAP financial measures so long as there is disclosure as to how the CSM number is computed from the audited financial statements. Companies are also allowed to have more than one CSM in the PVP Table. The difference between including a second CSM in the PVP Table, as opposed to only including it in the Tabular List (discussed below), is that a financial measure included as a CSM is subject to additional disclosure requirements, as will be described.

(B) Column (g) — the value of \$100 using peer group TSR

The 10-K rules require a company to prepare a performance graph comparing its stock price return to (a) a broad equity market index and (b) one of two alternatives—a published industry or line-of-business index; or peer issuers “selected in good faith.”³ The PVP rule allows a company to choose to use the same industry or line-of-business index it is using in the performance graph. Since the performance graph uses the same methodology (growth of a \$100 investment), it will be easy to fill out column (g) if the company chooses to use the same index.

Alternatively, the company can fill out column (g) using the peer group it uses for purposes of its disclosures in the Compensation Discussion and Analysis (CDA) with respect to 2022 compensation. So, for example, if 2022 compensation was based on benchmarking with respect to peer companies selected in fall 2021 (not uncommon), column (g) can be filled out with respect to this 2021 CDA peer group.

The difficulty in using the CDA peer group will depend on the company. Some companies use the CDA peer group in constructing the 10-K performance graph. So, with one exception (described below), a company that has filed its 2023 performance graph using data for its 2021 CDA peer group (i.e., the peers selected in 2021 to set 2022 compensation), doesn't have to do more than move the data to the PVP Table. If a company has not previously computed an aggregate TSR for its CDA peer group, the task is more complicated. The

² There is one possible exception to this we should mention. As will be discussed, the peer group in column (g) is based on the peer group used to construct the performance graph in the 10-K. The 10-K peer group can be (1) a company-selected group of peer companies (such as the one used for benchmarking purposes), (2) a published industry or line-of-business index, or (3) both. If column (g) used the industry or line-of-business index used for the performance graph, could the CSM be the relative TSR of the companies used for benchmarking purposes? This seems a little disingenuous but does not appear to violate the literal language of the rule.

³ There is also the option to use companies of similar market capitalization if the company does not use a published industry or line-of-business index and doesn't believe it can reasonably identify a peer group. This option is used so rarely we will ignore it.

regulations require that TSR be computed on a market capitalization weighted basis, reweighting each year. The following table illustrates the calculation for a three-company peer group:

	Company A	Company B	Company C	Weighted Average Return
Initial Investment	--	--	--	\$100
Year 1 Initial Market Cap	\$100	\$50	\$50	--
Year 1 TSR	10%	5%	0%	--
Year 1 Composite Return	--	--	--	\$106
Year-end Acquisition	--	--	\$100	--
Year 2 Initial Market Cap	\$110	\$53	\$150	--
Year 2 TSR	-10%	5%	15%	--
Year 2 Composite Return	--	--	--	\$111
Year 3 Initial Market Cap	\$99	\$55	\$173	--
Year 3 TSR	15%	5%	5%	--
Year 1-3 Cumulative TSR	14%	16%	21%	--
Year 3 Composite Return	--	--	--	\$120

Even for companies already using their 2021 CDA peer group in the performance graph there are some new complexities if there have been changes in the peer group from the prior year, i.e., the 2020 CDA peer group is different from the 2021 CDA peer group. In that case a footnote to the table must explain the reasons for the changes in the peer group and compare (1) the issuer's TSR for 2020-2022 to the TSR for 2020-22 using the 2020 CDA peer group and (2) the issuer's TSR for 2020-2022 to TSR using the 2021 CDA peer group. This appears to apply regardless of the reason for change, such as a company being removed from the 2020 peer group due to merger.⁴ Since the computation for the 2020 CDA peer group may involve years for which companies have been removed because of merger or bankruptcy (the computation for 2022 may involve a company in the 2020 CDA peer group that was removed in 2021), there will be a need to develop rules for handling such companies.⁵

One final fact that adds to the complexity is that, starting with the 2026 proxy statement, the TSR values for each year will change yearly. Let's use the year 2022 to illustrate this. In the 2023 proxy the TSR for 2022 will reflect performance from 1/1/20 through 12/31/22. In the 2024 proxy statement, four years will be captured (2020-2023) and the TSR for 2022 will still be computed the same, i.e., starting from 1/1/20. 2025 will capture five years but the earliest year will still be 2020. Starting in 2026, however, the earliest year will be 2021, so the starting point for all the calculations will be 1/1/21. The following year will start the computations on 1/1/22, and so forth. While the new math is no harder than the old math, it's just one more complication of using the benchmarking peer group.

⁴ This is different from the rules for the 10-K performance graph which appear to indicate that recalculation is not necessary if the prior company has disappeared or been eliminated due to pre-established performance criteria. There is a need, however, to disclose the changes in the 10-K.

⁵ Typically, a merged company is ignored if it is not there at the end of the computation period and a bankrupt company is treated as having a 0 value.

(C) Columns (c) and (e)

Columns (c) and (e) are where all the heavy lifting occurs. The basic idea is to start with the number in column (j) of the SCT, representing total compensation for the PEO and the other NEOs and to make two major changes. We will refer to the number now found in the SCT as “SCT Compensation” and the new number as “CAP,” standing for “compensation actually paid.” The basic thrust of the changes can be stated simply:

- With respect to equity awards, the current approach of showing their fair value on the grant date will be replaced by an approach that (1) estimates their value at the end of the year (or upon vesting or forfeiture, if earlier) and (2) compares that value to the value at the start of the year (for a grant during the year, that value is, of course, 0). So, the values for stock and option awards in columns (e) and (f) are subtracted from the total compensation value in column (j) of the SCT and a new value is added (or subtracted).
- With respect to pension costs, the current pension number compares the present value of the executive’s accrued benefit at the start of the year to the present value at the end of the year. This is replaced by a number computed by the pension actuary that generally represents the service cost during the year.⁶ So, the part of SCT column (h) representing change in pension value is subtracted and the new number is added.
- Column (c) reports the resulting number separately for the PEO (there are multiple columns if there are multiple PEOs during the year) and column (e) reports the average number for the NEOs other than the PEO.

Footnotes to the PVP Table must identify the NEOs in the table and report all amounts subtracted from the SCT totals for (1) the PEOs separately and (2) for the other NEOs in the aggregate. This should be done on a yearly basis, for example, stating that in 2022 the PEO’s SCT compensation was reduced \$w for equity awards and \$x for pension benefits and then \$y was added back for equity awards and \$z for pension costs.

(1) The new equity award calculations

(a) Many more calculations

The first thing to note about the new equity award calculations is that many more calculations are required. To illustrate, let’s assume the company long-term incentive program had four components: option awards vesting annually over four years, RSUs vesting annually over four years, performance stock units (PSUs) cliff vesting at the end of three years based on rTSR, and PSUs cliff vesting at the end of three years based on a financial metric. Both PSUs have a leverage curve, so that payout can be above and below target based on the final results. Finally, awards are always issued December 1. In our experience this structure is about medium in complexity for larger companies.

The SCTs for 2020-2022 would have 12 calculations for each NEO, reflecting the fair value of the four awards granted on 12/1 of each year. The number of additional required calculations is now 86 for each NEO (for the

⁶ As will be discussed, CAP includes prior service costs in some instances.

initial three-year transition period), for a total of 430 new calculations.⁷ Many of these new calculations will also require determination of new inputs. It is easiest to explain the increase with a chart, where x represents a fair value calculation:

Award Type	Grant Date	Fair Value Calculations (n = 86)						
		12/31/19	12/1/20	12/31/20	12/1/21	12/31/21	12/1/22	12/31/22
Options 4-year vest	12/1/16	x	x					
RSUs 4-year vest	12/1/16	x	x					
Options 4-year vest	12/1/17	x	x	x	x			
RSUs 4-year vest	12/1/17	x	x	x	x			
PSUs 3-year Financial metric	12/1/17	x	x					
PSUs 3-year rTSR	12/1/17	x	x					
Options 4-year vest	12/1/18	x	x	x	x	x	x	
RSUs 4-year vest	12/1/18	x	x	x	x	x	x	
PSUs 3-year Financial metric	12/1/18	x		x	x			
PSUs 3-year rTSR	12/1/18	x		x	x			
Options 4-year vest	12/1/19	x	x	x	x	x	x	x
RSUs 4-year vest	12/1/19	x	x	x	x	x	x	x
PSUs 3-year Financial metric	12/1/19	x		x		x	x	
PSUs 3-year rTSR	12/1/19	x		x		x	x	
Options 4-year vest	12/1/20			x	x	x	x	x
RSUs 4-year vest	12/1/20			x	x	x	x	x
PSUs 3-year Financial metric	12/1/20			x		x		x
PSUs 3-year rTSR	12/1/20			x		x		x
Options 4-year vest	12/1/21					x	x	x
RSUs 4-year vest	12/1/21					x	x	x
PSUs 3-year Financial metric	12/1/21					x		x
PSUs 3-year rTSR	12/1/21					x		x
Options 4-year vest	12/1/22							x
RSUs 4-year vest	12/1/22							x
PSUs 3-year Financial metric	12/1/22							x
PSUs 3-year rTSR	12/1/22							x
		14	10	14	10	14	10	14

The first year in the PVP Table is 2020, so the beginning point is determining the fair value of all the equity awards outstanding as of 12/31/19. That requires 14 calculations, covering the last tranche of the 2016 options and RSUs, and some portion of all the equity awards in 2017-2019.

The next calculation date is 12/1/20. There are 10 calculations, covering the vesting from four years of option awards and RSUs and the 2017 PSUs. With respect to these 10 awards, the CAP value is the difference between the 12/1/20 value and the 12/31/19 value. It should be noted that here, as throughout the calculation, negative values can arise. For example, assume the PEO had been granted 10,000 RSUs at 12/1/16. If the company stock price value dropped from \$30 at 12/31/19 to \$20 at 12/1/20, the 12/1/20 value change of the 12/1/20 tranche of the 2016 RSUs (i.e., 2,500 shares) will be -\$25,000, which would be subtracted from SCT Compensation for 2020. Similarly, suppose the 2017 rTSR PSUs were forfeited in their entirety. There again would be a negative value, reflecting the difference between the 12/31/19 fair value of the rTSR PSUs and 0.

⁷ The total of 430 additional calculations assumes five NEOs that stay the same throughout the period. Changes in NEOs will increase the disparity.

The next calculation date occurs 12/31/20 and, as indicated in the chart, 14 calculations need to be made for the 14 outstanding equity awards. For the 10 awards outstanding as of 12/31/19, the change in value (positive or negative is calculated). For the four new awards granted 12/1/20, the CAP is their value at 12/31/20, not their grant date value.

The remaining 48 calculations are made using the same procedure, so we will not describe them. There are several important observations to be made about some of the methodological details.

(b) Calculation details

RSU calculations. These calculations appear to be the easiest. Unvested shares are multiplied by the price on the calculation date. The only nuance is the statement that CAP includes the value of dividends during the year “that are not otherwise included in total compensation for the year.”⁸ For example, assume 1,000 RSUs were granted during the year when the stock price was \$100 and the RSUs provide that RSU holders receive dividends the same as actual stockholders.⁹ Suppose \$5,000 in dividends were paid during the year. The SCT regulations provide that the \$5,000 is not included in the SCT because it was “factored into the grant date fair value required to be reported for the stock . . . award.”¹⁰ Does the rule require including the \$5,000 in CAP even though the initial valuation of the RSUs reflects the fact that dividends are being paid currently? Our initial interpretation is that it would.

To understand the SEC’s thinking, imagine two stocks each with an initial value of \$100. One stock appreciates 10%, so it has a year-end value of \$110. The other appreciates to \$105 and pays a \$5 dividend at year-end. The SEC has concluded that an apples-to-apples comparison requires adding the \$5 dividend in computing CAP. Note that this would not be the result if the RSUs provided that the \$5 dividend were deemed reinvested in additional RSUs (rather than paid currently) since the year-end value of the RSU would now be \$110 after taking into account the value of the additional RSUs.

Option calculations. Options need to be valued using a fair value model “consistent with the fair value methodology used to account for share-based payments in the registrant’s financial statements under generally accepted accounting principles.” At the minimum, this means that options can’t be valued at in-the-money value (exercise price compared to current stock price), but the valuation model instead needs to take into account the value of the option feature. Since many, if not most, companies use the Black-Scholes option pricing model for their SCT calculations, we expect many of them will continue to use this methodology for the CAP calculations.

One question raised by the reference to using a fair value model “consistent” with the model used in the financial statements is whether a different pricing model can be used for the CAP calculations. In particular, some commentators have noted that a lattice pricing model may provide more accurate estimates because it

⁸ Item 402(v)(2)(iii)(C)(1)(vi).

⁹ In our experience, it is very uncommon for RSUs to provide for a cash distribution when dividends are paid on the underlying stock, but we have seen that structure more frequently for restricted stock awards. We also know that the distribution is not technically a dividend.

¹⁰ Item 402(c)(2)(ix)(G). We acknowledge that in some cases companies still include the dividends.

can relate the expected life assumption to the degree to which the option is in- or out-of-the-money and the remaining life. While a fair value calculation using a lattice model might be different than using the Black-Scholes model to value options at grant, that does not necessarily mean it is inconsistent.

Another point to note, which applies to all the new equity award computations is that the regulations require footnote disclosure of any assumptions made in the valuation that differ “materially” from those disclosed as of the grant date. While we expect this means we will see a lot more footnotes, it is hard to say with much precision how many more. Some companies disclose the assumptions with great specificity in footnotes to the SCT. Others cross-reference to the footnotes in their financial statements and these footnotes sometimes express the assumptions using a range of numbers. In addition to making the new computations, companies will need to develop a methodology for deciding which additional footnotes are necessary.

PSU calculations. New fair value computations for rTSR PSUs raise issues generally similar to those raised for options. With respect to financial performance PSUs, one issue that will require consideration is the requirement that the calculation “take into account the probable outcome of [the performance conditions] as of the last day of the fiscal year.” To illustrate our concern, assume the calculation is being made as of 12/31/20 for the 2018 and 2019 PSUs with a payout range of 0% to 200% of target based on financial performance over a three-year period.

Companies almost uniformly assume that payout will be at target when computing fair value on the date of grant. So, if the PEO were granted 10,000 PSUs on 12/1/20 when the price was \$20, we would expect the fair value to be \$200,000. And we would expect the 12/31/20 value of the 12/1/20 PSUs to still be computed assuming target payout.¹¹ But what about the 12/31/20 valuation of the 12/1/18 and 12/1/19 PSUs? To what extent should the payout values be adjusted to reflect a different payout percentage than target?

Financial statement reporting for PSUs is already supposed to take into account changes in projected payout and our general impression is that, while most issuers don’t adjust projections away from target in the first four quarters, adjustments start being made in the 5th quarter to the extent current and projected results show a significant deviation from target. These results are, however, not separately called out in the financial statements. Having to now make these assumptions explicit has a couple of consequences.

One issue relates to whether some companies want to reexamine their approach to determining when the adjustments in the prior paragraph need to be made. Projecting outcomes is inherently difficult (while a PSU may be tracking well above target at the end of year two, a lot can happen in the final year) and, in the great majority of cases, whether a PSU pays out at 100% or 200% of target is immaterial in the context of the overall financial statement, so precision does not matter as much. 100% versus 200% of target will be much more material, however, when it comes to setting forth the PEO’s CAP. So, precision becomes more important.

Additionally, companies may be concerned over publicly providing confidential information. As noted above, the fair value assumptions need to be set forth in footnotes. A company may be internally projecting a great

¹¹ If equity awards are granted in the first quarter, rather than at the end of the year, we would think more extended analysis may be required before determining the payout projection.

result with respect to a particular financial metric but has not yet revealed it publicly. Does the need to provide an updated fair value computation require public disclosure of previously private information? We can imagine circumstances where this issue will create considerable tension.

(2) The new pension cost calculation

As many companies have experienced, the current pension number in the SCT is highly volatile. It reflects the entire present value of the NEO's accumulated pension benefit at the end of the year and compares it to the value at the start of the year. Changes in the interest rate used to compute the present value of the benefit can lead to big increases (when interest rates drop) or a negative value when interest rates increase (the SCT rules provide that a negative value is shown as 0, with an explanatory footnote).

In lieu of this calculation, the new rule requires the reporting of the service cost for the year in question. This is generally defined as the actuarial present value of benefits attributed by the pension benefit formula to services rendered by employees during that period. For example, suppose the PEO is hired at age 25, when the pension formula is 1% of final pay times years of service, implying a 40% benefit if retirement occurs at age 65. Further suppose the projected salary at age 65 is \$500,000, leading to a projected benefit of \$200,000 a year. The basic idea is that service cost is computed by allocating to the year in question the present value of a \$5,000 annuity at age 65, which represents the portion of the overall pension benefit (in this case a \$200,000 annuity) attributable to that year.

The new rule provides for the special situation in which the pension benefit is increased by an amendment changing the pension formula retroactively. For example, suppose the plan formula is amended to 1.5% of final pay times all years of service, leading to a final pension of 60%. To use actuarial terminology, this leads to a "prior service cost," reflecting the fact that too little was expensed in prior years because the company was calculating a pension cost based on a 1% assumption. For accounting purposes, this cost is not expensed in the amendment, but the additional cost is amortized over several years. The CAP definition attributes this entire cost to the year of amendment.

3. The Tabular List of Financial Performance Measures

The second table required by the PVP regulations is a list of generally at least three and no more than seven financial performance measures, which "in the registrant's assessment represent the most important financial performance measures used by the registrant to link compensation actually paid by the registrant's named executive officers, for the most recently completed fiscal year to company performance."¹² There is no requirement that the measures be ranked. The rule notes that separate Tabular Lists can be provided for (1) the PEO and the other NEOs as a group or (2) as separate tabular lists for each NEO. While it is obviously simpler to have just one list, it may be harder to avoid separate lists where one or more NEOs have different performance measures in either the annual or long-term incentive plan, such as the case where one of the NEOs is the chief operating officer of a major subsidiary and the financial performance of the subsidiary is a major metric in determining that NEO's compensation under the annual incentive plan.

¹² If fewer than three financial performance measures were used, the Tabular List must include all the measures that were used.

As best we read the regulations, the Tabular List can be as simple as this:

TABULAR LIST OF FINANCIAL PERFORMANCE MEASURES USED TO LINK COMPENSATION ACTUALLY PAID TO NEOS FOR THE MOST RECENTLY COMPLETED FISCAL YEAR TO COMPANY PERFORMANCE
The Company-Selected Measure
Measure 2, for example, EPS
Measure 3, for example, revenue

It also appears that the other two measures can be company TSR and rTSR, even though these measures are already captured in the PVP Table. This seems logical since the listing of TSR and rTSR in the PVP Table does not indicate how important the company considers them since inclusion is mandated by the rule. In fact, we expect most companies will include stock price/absolute TSR in their Tabular List because they provide the majority of executive officer pay in the form of equity.

Finally, the rule allows the company to include non-financial measures in the Tabular List, provided that at least three financial measures are included (assuming there are three financial measures) and no more than a total of seven measures are listed. We can imagine situations where a company wants to highlight its focus on ESG by including its ESG metric. In deciding whether to do so, a company should assume that inclusion will increase demands by activist investors for a clear illustration of how performance on ESG metrics affects the amount of CAP.

More generally, the rule leaves us wondering how a company should approach a situation where a particular metric is clearly important but not directly linked to NEO CAP through the annual incentive plan or the long-term incentives. Suppose long-term incentives consist of options and RSUs and the annual incentive plan is based on EBITDA with a 30% adjustment factor based on performance against a number of strategic goals. Can rTSR be included in the Tabular List even though it is nowhere explicitly “linked”? We would hope so, since for many companies, relative performance is a significant consideration of compensation committees when determining executive pay. If implicit performance measures are to be included in the Tabular list, we confess some uncertainty as to how a compensation committee is to determine their relative importance as opposed to explicit measures used in incentive plans.

One question we considered is the extent to which a company needs to discuss changing its CSM or other reported metrics. While we don’t see any requirement in the regulations to discuss the rationale for such a change, we expect investors will want to know the reason, so companies are advised to put their rationale into the proxy statement ahead of the questioning. Expected investor concern over such a change is another reason companies should emphasize metrics that are expected to endure over at least the short- and medium-term.

4. The Clear Description Requirement

Perhaps the most puzzling aspect of the rule is a requirement that the company provide a “clear description” of the relationships between CAP of the PEO and the NEOs with:

- the company’s TSR,
- the company’s net income, and
- the CSM¹³

These three clear descriptions must also include a comparison of the company’s TSR to the cumulative TSR of the peer group.

The rule does not provide specific guidance for understanding the mandate for a “clear description.” You will recall that the “clear description” verbiage is from the statutory language, so it is left to the company to decode Congressional intent. Helpfully, however, the rule states that a clear description can be provided “graphically, narratively, or a combination of the two.” We read this to mean that a graphical description can suffice and, since we often favor graphs in demonstrating alignment, our current thinking is to provide the clear description graphically.

The next question is what such a graph/graphs would look like. Rather than invent data, the charts below are based on publicly available data for a company (regarding the last column—CSM—we, of course don’t know what metric would have been chosen and used revenues solely for illustrative purposes).¹⁴ Here are the numbers:

Year	SCT total for PEO (\$ Mil.)	Comp. actually paid to PEO (\$ Mil.)	Average SCT total for Non-PEO NEOs (\$ Mil.)	Average comp. actually paid to Non-PEO NEOs (\$ Mil.)	Value of Initial \$100 Investment Based On:		Net Income (\$ Mil.)	Revenue (\$ Mil.)
					TSR	Peer TSR		
2021	\$19.2	-\$11.9	\$24.2	-\$4.9	\$227	\$311	-\$376	\$1,595
2020	\$19.1	\$61.5	\$9.8	\$25.8	\$460	\$225	-\$83	\$1,184
2019	\$9.8	\$33.4	\$8.3	\$17.4	\$205	\$150	-\$54	\$903

While we could have used one table to capture all the required relationships, we concluded it was clearer to use three tables. Initially, we considered using lines rather than bars, to depict changes in net income and company revenue. We realized, however, that net income, like other potential financial metrics, can be

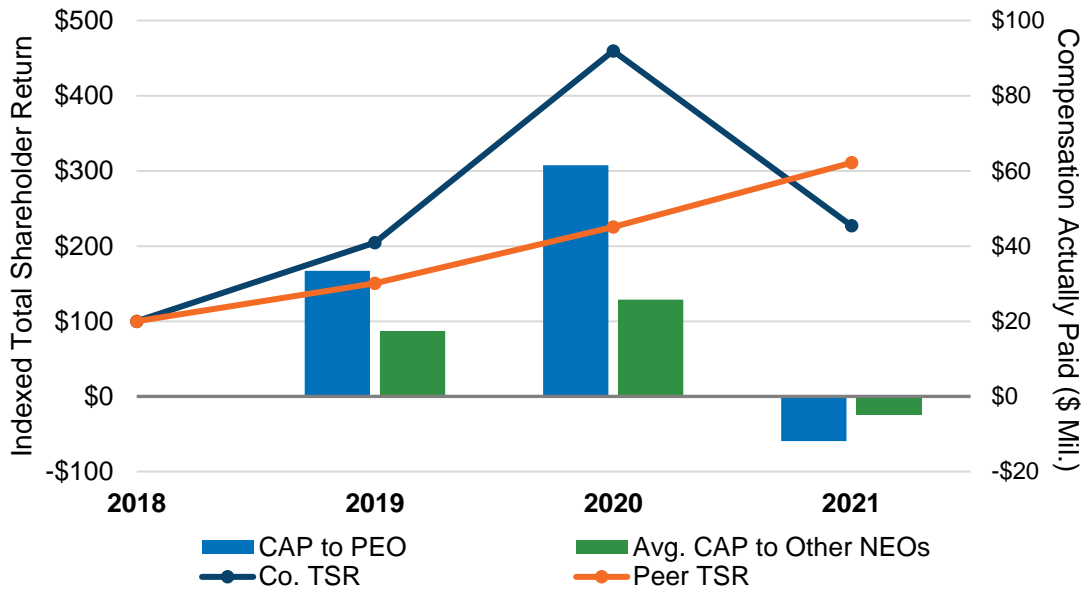
¹³ If an additional financial measure is provided in the PVP Table, a clear description of the relationship between that measure and PEO and NEO CAP must also be provided.

¹⁴ We calculated for 2019-2021 given that 2022 numbers are not yet available.

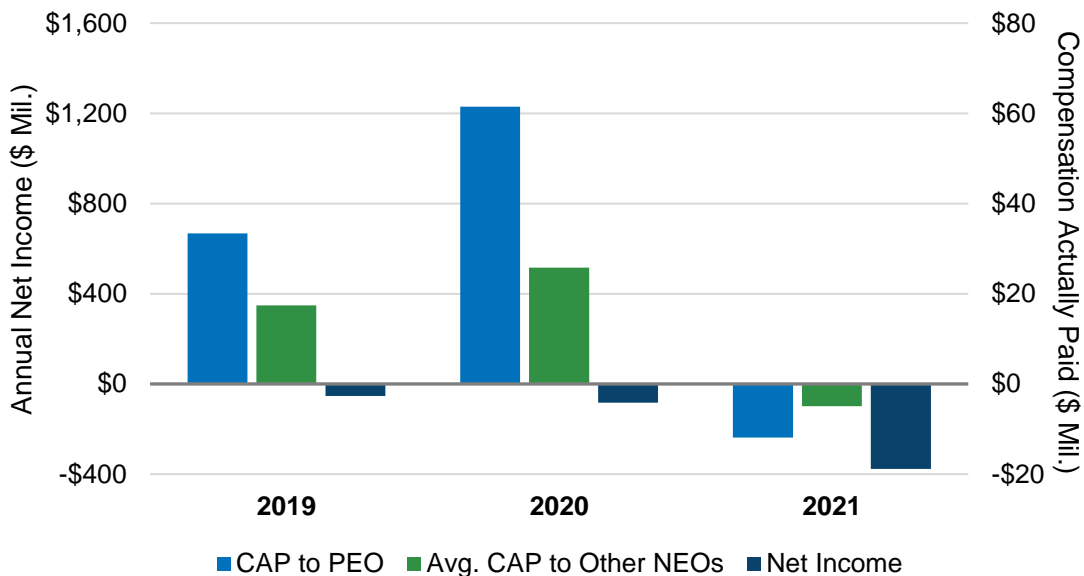
negative, which presents complex problems in years when the metric switches from positive to negative, or vice versa. So, it was clearer to use bar charts.

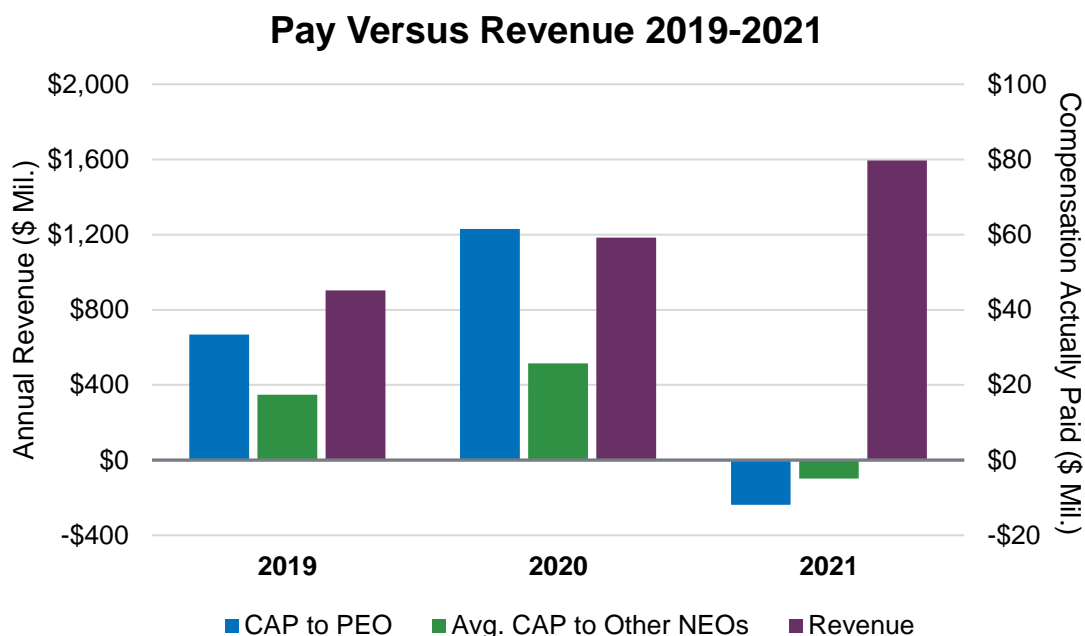
Readers will form their own conclusions by examining the charts, but they reinforce one conclusion that is an inevitable consequence of the new approach to equity awards—CAP will swing wildly with stock price changes. This is evidenced by PEO CAP dropping from \$61.5 million to -\$11.9 million from 2020 to 2021, reflecting a significant drop in the company’s stock price.

Pay Versus TSR 2019-2021



Pay Versus Net Income 2019-2021





There's nothing wrong with supplementing the charts with additional information, but it may be difficult in many cases to say much more that is significant.

5. Smaller Reporting Companies, Emerging Growth Companies, Registered Investment Companies, and Foreign Private Issuers

There are several simplifying changes for smaller reporting companies (SRCs).¹⁵

- The PVP Table need only cover two years in the first compliance year, rising to three years in the next year.
- The SRC need not compute TSR for any peer group.
- The SRC need not meet the clear description requirement with respect to the CSM.
- The SRC need not provide a Tabular List.
- CAP does not include the pension adjustment, only the equity award adjustment.
- The XBRL tagging requirement is delayed two years.

Emerging growth companies, registered investment companies, and foreign private issuers are exempt from the PVP regulations.

One issue we have wrestled with is what SCT and CAP calculations are required for newly public companies that are not emerging growth companies (this would occur, for example, if the company's revenues were more than \$1.07 billion). If the company IPO'd in 2022, then the PVP rule would apply to the 2023 proxy statement, which would appear to require fair value computations starting 12/31/19 and SCT computations starting in

¹⁵ A smaller reporting company is generally defined as a public company with a public float of less than \$250 million (rising to less than \$700 million if revenues are below \$100 million).

2020, even though a SCT is not otherwise required for 2020. We think the right answer is that information only need be provided for 2022 pursuant to Instruction 2 to the rules, which provides: “New registrants. Information for fiscal years prior to the last completed fiscal year will not be required if the registrant was not required to report pursuant to Section 13(a) or 15(d) of the Exchange Act (15 U.S.C. 78m(a) or 78o(d)) at any time during that year.”

6. Next Steps

For most companies the hardest work will be computing the many new equity values required by the PVP Table. Other than questions related to probable outcomes for financial metric PSUs, our initial reaction is that, while the necessary calculations will be time consuming and involve choices between several alternatives, it is unlikely that the choice between methods will have a significant impact on the PVP Table in most cases. We have not yet been involved in modeling the impact of alternative methods, so our perspective may change as we become involved in the actual calculations.

We think the key area of compensation committee involvement will arise in selecting the CSM and the other financial metrics that are included in the Tabular List, as well as determining whether to include any non-financial metrics in the Tabular List. Even if shareholders have difficulty making sense of the PVP Table, they will find it easy to focus on a company’s list of its three most important financial metrics. In some cases, the structure of a company’s annual and long-term plans will make the choices easy. In other situations, the choices may not be at all obvious and deciding what to choose may require significant attention by the compensation committee. We expect in many cases that this process will be carried out by management’s identifying metrics for committee consideration.

General questions about this summary can be addressed to the following individuals:

David Gordon at 310-734-0111 or by email at dave.gordon@fwcook.com

Ken Sparling at 312-894-0030 or by email at ken.sparling@fwcook.com

Dina Bernstein at 310-734-0144 or by email at dina.bernstein@fwcook.com

Andrew Lash at 415-659-0210 or by email at andrew.lash@fwcook.com

Samantha Nussbaum at 310-734-0145 or by email at samantha.nussbaum@fwcook.com

David Yang at 312-894-0074 or by email at david.yang@fwcook.com

Copies of this summary and other published materials are available on our website at www.fwcook.com.