THOUGHT LEADERSHIP FROM FW COOK

PREPARING FOR PAY VERSUS PERFORMANCE

A long time in the making, the SEC's final rule on Dodd-Frank's disclosure requirement poses some questions for comp committees.

TWELVE YEARS IS A LONG TIME, even for a regulatory body. So when it takes the SEC that long to hammer out a final version of a proposed rule, it's safe to anticipate that the requirements within it will be relatively complex. Such is the case with the long-awaited release of rules implementing the pay versus performance (PVP) disclosure required by the 2010 Dodd-Frank Act.

Released on August 25, 2022, the SEC's final rule addresses the Act's statutory requirement that a company provide a "clear description" of the relationship between "executive compensation actually paid" and financial performance. Dana Etra, a managing director at FW Cook, explains that much of the complexity centers on how best to comply with the requirement to calculate and show pay components and performance components side-by-side in the standardized format now required by the SEC.

"A lot of the nuance and difficulty comes from the fact that compensation actually paid (CAP) is not a calculation that existed or was required previously," she says. "Currently, proxy statements disclose the value of an equity grant on the date it is granted and then, later in the proxy, the value on the day it vests or is exercised. The final rule requires that all unvested equity awards be valued as of the end of the year, which results in significant complexities. For example, companies with awards that have stock options or a stock price condition may need to arrange for third-party valuation firms to run Black-Scholes valuations and Monte-Carlo simulations."

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Timing also factors into the challenge the requirements represent for companies: Because the new rule is in effect for fiscal years ending on or after December 16, 2022, companies operating on a calendar year will need to meet the PVP disclosure requirements in their 2023 proxy statements.

INTRODUCING THE PVP TABLE

The new rule requires disclosure of compensation and performance measures for the company's five most recent fiscal years in a standardized tabular format (see The PVP Table Template, below). This table must include:

- The total compensation as presented in the Summary Compensation Table and a measure of "executive compensation actually paid" for the principal executive officer (PEO) and, as an average, for the other named executive officers (NEOs), to be calculated as set forth in the rules.
- The company's total shareholder return (TSR).
- Indexed TSR for the company's performance graph or executive compensation benchmarking peer group.
- The company's net income.
- A financial performance measure selected by and specific to the company

The PVP Table Template

The SEC now mandates that pay-versus-performance data be disclosed in standardized tabular format.

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 Paid to Non-PEO Named Executive Officers (e)	Value of Initial Fixed $100 Investment Based on: Total Shareholder Return (f)	Value of Initial Fixed $100 Investment Based on: Peer Group Total Shareholder Return (g)	Net Income (h)	[Company Selected Measure] (i)
Year 1								
Year 2								
Year 3								
Year 4								
Year 5								

as the most important financial performance measure it uses to link compensation actually paid to the NEOs to company performance for the most recently completed fiscal year.

Also required is a second table listing at least three and up to seven performance measures believed to be the company's most important metrics over the most recently completed fiscal year. "Three of them must be financial metrics, then the company can include up to four additional metrics, financial or nonfinancial," says Etra.

Finally, companies must provide a clear description of the relationship between the executive compensation actually paid (CAP) and the performance metrics provided in the table (TSR, net income and the company-selected measure).

DISCLOSURE DILEMMAS

The requirements outlined above are prompting discussion among compensation committee members, who are charged with choosing:

1. A peer group for TSR comparison
2. A company-selected measure
3. A list of financial measures

In choosing a company-selected financial performance measure, compensation committees look to identify the metric with the biggest material impact on pay. "A lot of companies have four or five different measures that they use within their incentive plans so the challenge is to identify which permeates most," says Michael Kenney, a principal at FW Cook. The metric with the highest weighting between the annual and long-term incentive plans often becomes the company-selected measure (CSM), and the weighting of the remaining metrics informs the tabular list of financial measures.

While straightforward for many companies, designating a CSM could be tricky for some. For example, in a case where three equally weighted financial metrics are used to determine a CEO's long-term incentive payout, which metric to choose may not be clear.

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Both the implications of highlighting a specific measure and disclosing the importance of various metrics have been topics of focus for boards. "There's been a lot of discussion in boardrooms about how shareholders will react," says Etra. "Directors are asking, 'If the CSM appears misaligned with CAP, will it seem like we're prioritizing the wrong thing?' So it's not just the technical execution that's raising concerns but the disclosure and optics implications of the decisions as well."

Such questions and concerns, coupled with the complexity of calculating CAP are already having an unintended—and unfortunate—impact on compensation planning. "A new consideration for companies thinking of adding stock options or relative TSR to a performance share program is doing these complex valuations every single year," says Kenney. "So these disclosure requirements could impact incentive design decisions, which really should be driven by strategy and what will motivate the right behaviors and translate to organizational value."

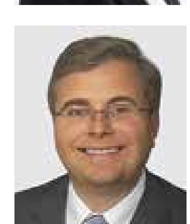
PICKING PEERS

Another key decision point is designating a peer group. The new rule allows companies to choose between a published index or a group of peer issuers selected in good faith. "Most companies have been opting to use the same peer group used in their 10-K performance stock price chart to explain the relationship between compensation actually paid and performance metrics, as well as between the company's TSR and that of its peer group," says Kenney. "Should it be a simple narrative or a more granular discussion with charts and graphics to help illustrate the relationships between CAP and TSR and financial performance?"

The answer will vary by company. Given the newness of the rules and the time constraints in addressing them, many companies are choosing a conservative approach to PVP disclosure. However, some situations, such as significant stock price swings within a fiscal year, may call for a more robust explanation. "One of the oddities with this table and the CAP calculation is that in cases where the stock price declines, it can show pay as negative," notes Etra. "I've seen drafts of these tables where the CEO pay is negative millions, which is a little hard to wrap your head around intellectually."

Directors are also spending time making sure they understand the potential for inconsistencies between CAP, the Summary Compensation table and the CD&A disclosures due to the difference in metrics, timeframe and pay calculation methods. "The compensation actually paid calculation is really the only new piece of information this will give investors—and we just don't know how much interest it will garner," says Kenney. "Ultimately, how investors react will determine whether companies will need to enhance shareholder engagement to clarify their compensation stories in its wake."

Dana Etra is managing director and head of the Boston office at FW Cook.



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