Davis Polk

Pay versus performance: Tackling unanswered questions

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Introduction

In August 2022, the SEC issued its final rule regarding "pay versus performance" disclosure, which was mandated by Section 953 of the Dodd-Frank Act in 2010.

The final rule adds new Item 402(v) to Regulation S-K and requires companies to disclose:

- A new ***"pay versus performance" table***, covering up to 5 years that shows the following for each covered year:
  - "Compensation actually paid" (CAP) to the company's PEO, and total compensation paid to the PEO as reported in the Summary Compensation Table
  - Average CAP for the company's other NEOs, and average of total compensation paid to such NEOs as reported in the Summary Compensation Table
  - (i) Cumulative TSR of the company, (ii) cumulative TSR of the company's peer group, (iii) the company's net income and (iv) an amount attributable to a "company-selected measure" (CSM)
- A ***description of the relationships*** between the performance measures included in the table and the CAP for the company's PEO and average CAP for the other NEOs over all covered years, as well as the relationship between the company's cumulative TSR and that of its peer group
- An unranked ***tabular list of 3-7 of the "most important" performance measures*** used by the company to link CAP to company performance for the most recent covered year
  - The CSM included in the table must be the "most important" financial performance measure included on this tabular list

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)	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]*ƚ (i)
Y1								
Y2								
Y3								
Y4*								
Y5*								

*The asterisked items indicate components of the table from which smaller reporting companies are exempt.

ƚ The title of this column would be replaced with the name of the company's "most important" measure, and that column would include the numerically quantifiable performance of the company under such measure for each covered fiscal year. For example, if the Company-Selected Measure for the most recent fiscal year was total revenue, the company would title the column "Total Revenue" and disclose its quantified total revenue performance in each covered fiscal year.

Compensation Actually Paid (CAP)

Equals the amount reported in the "Total" column of the Summary Compensation Table for the covered fiscal year, adjusted with respect to equity awards and pension benefits

Equity awards:

- Subtract the grant date fair values of equity awards granted in the year, as reported in the Summary Compensation Table
- Add the fair value of awards granted during the year (measured at the end of the year, unless they vested during the year, in which case as of vesting date)
- Add the change in fair value (whether positive or negative) for awards granted in prior years (measured at the end of the year, unless they vested during the year, in which case as of the vesting date)
- Subtract any forfeited awards (measured as of the end of the prior year)
- Add the dollar value of any dividends or other earnings that are not otherwise included in another component of total compensation for such year

Pension benefits:

- Subtract the aggregate change in the actuarial pension value of the accumulated benefit
- Add the service cost for the year and prior service cost for any plan amendment

Tabular list of the “most important” performance measures

Each company is required to disclose a tabular list of the 3-7 “most important” performance measures used by the company to link CAP for the NEOs to company performance for the most recently completed fiscal year

- This list does not need to rank the performance measures, but the CSM must be selected from this list (i.e., as the “most important” financial performance measure for the last covered year).
- This list may be presented in the form of:
  - a single list covering all NEOs;
  - two lists, with one covering the PEO and the other covering all of the non-PEO NEOs; or
  - a separate list for the PEO and each non-PEO NEO.
- If fewer than 3 financial performance measures were used by the company to link CAP for the company’s NEOs to company performance for the most recently completed year, the tabular list must include all such measures that were used, if any
- The tabular list may include non-financial performance measures, if the company determines that such measures are among its 3-7 most important performance measures and it has disclosed its most important 3 (or fewer, if the company only uses fewer) financial performance measures

Company-Selected Measure (CSM)

Must be a <u>financial</u> performance measure that is among the 3-7 measures included in the tabular list (described on slide 1) that the company believes is the "most important" financial performance measure for the most recent covered year (that is not already included in the table) to align CAP for the NEOs with company performance

– The "most important" measure determination is made based on the most recently completed year (e.g., if total revenue is a company's "most important" measure for 2022, but in 2023 the company's "most important" measure is EBITDA, EBITDA would also apply for all prior covered years (including 2023) for purposes of "pay versus performance" disclosure in the 2024 proxy statement
– If the company's "most important" measure is already included in the tabular disclosure (i.e., TSR and net income), then the company is required to select its next-"most important" financial performance measure as the CSM
– If the company does not use any financial performance measures to link CAP to company performance (or uses only measures already required to be disclosed in the table), then the company is not required to disclose a CSM, but must disclose this fact
– If the CSM is a non-GAAP measure, the company must disclose how the number is calculated from the company's audited financial statements (but is not otherwise required to comply with Reg G)

Peer group

Means the same index or peers that the company uses either for purposes of the stock performance graph required under Item 201(e)(1)(ii) of Regulation S-K or in the CD&A for purposes of disclosing compensation benchmarking practices

Item 201(e)(1)(ii) requires companies to provide a line graph comparing the yearly percentage change in their cumulative TSR with that of any of the following:

- A published industry or line-of-business index;
- Peer companies selected in good faith by the company; or
- Companies with similar market capitalizations (but only if the company does not use a published industry or line-of-business index and does not believe it can reasonably identify a peer group).

Alternatively, if the company uses a different peer group in the CD&A for purposes of describing compensation benchmarking practices, it may use that peer group

Relationship between performance measures and CAP

Companies are required to use the information in the "pay versus performance" table to provide descriptions of the following relationships, in each case over the company's 5 most recently completed fiscal years (or shorter transitional period, if applicable):

- Relationship between (i) the PEO's CAP and average CAP for the other NEOs and (ii) cumulative TSR of the company
- Relationship between (i) PEO's CAP and average CAP for the other NEOs and (ii) net income of the company
- Relationship between (i) PEO's CAP and average CAP for the other NEOs and (ii) the CSM
- Relationship between (i) cumulative TSR of the company and (ii) cumulative TSR of the company's peer group
- If the company elects to provide any additional measure(s) in the table, each additional measure must also be accompanied by a description of the relationship between (i) the PEO's CAP and average CAP for the other NEOs and (ii) such additional performance measure(s)

Relationships can be described graphically or narratively or a combination of the two (including tabular or chart format)

Other points

- Disclosure will first be required in the 2023 proxy statement for calendar-year companies
  - Companies will only be required to provide 3 years of information (i.e., 2022, 2021 and 2020) in the 2023 proxy statement, and then scaling up annually through 2025 to 5 years of information
- Disclosure is only required in proxy statements and information statements (not in a Form 10-K)
- Applicable to all companies, except for
  - Emerging growth companies
  - Foreign private issuers
  - Registered investment companies
- Slightly reduced requirements for smaller reporting companies
- Companies can include this information anywhere in the proxy or information statement

Common questions

01

As companies consider the content of their pay versus performance disclosure, a number of questions have come up that were not directly addressed by the rules and there has yet to be any formal guidance.

02

Some of the questions appear to have a straight forward answer, while others are more challenging.

Next steps

- Start preparing the historical disclosure – companies can model how their cumulative TSR for the past two years (2021 and 2020) compares to the CAP for its PEO and other NEOs for such years and to the cumulative TSR of its peers, as well as how such CAP compares to net income during such period
- Determine what peer group to use and calculate their cumulative TSR
- Start thinking about what performance measures (both financial and non-financial measures) the company considers to be most important for 2022 with respect to linking NEO pay and company performance and preparing a list of those measures
  - In considering this, companies should consider which financial measure is the “most important” to linking NEO pay to performance (if any) for 2022, and especially which measure will be the CSM for purposes of the 2022 tabular disclosure

Next steps (cont.)

- Consider whether supplemental disclosure and/or alternative performance measures may be useful to address any perceived disconnect between pay and performance that might result from the mandated disclosure
  - Supplemental disclosure and alternative measures are allowed, so long as they are identified as supplemental, not misleading and not presented more prominently than the mandated disclosure
- Consider where to disclose the “pay versus performance” table and related narrative disclosure in the 2023 proxy statement, and start developing that disclosure
- Consider how the new “pay versus performance” disclosure may impact or interact with the other CD&A disclosure regarding performance measures, including ensuring that the chosen “most important” performance measures align with the company’s incentive plans
- Inform the company’s board of directors or the relevant committee(s) of the final rule and the story that it may tell regarding the relationship between NEO pay and company performance

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