Pay Governance Responds to SEC's Proposed Rules for P4P Disclosures

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Introduction

In 2010, the U.S. Congress passed the Dodd-Frank Wall Street Reform and Consumer Protection Act ("Dodd-Frank"). One of the important provisions of the Dodd-Frank legislation was the requirement that companies registered with the Securities and Exchange Commission (SEC) disclose how the executive compensation actually paid (CAP) by the registrant company relates to the company's financial performance in both tabular and narrative disclosures. This disclosure mandate is referred to in Dodd-Frank and by the SEC as "Pay versus Performance," although we prefer to describe it as pay-for-performance (P4P), as it more accurately describes one of the primary objectives of companies' compensation programs.

In 2015, the SEC released its initial proposal for meeting the Dodd-Frank P4P disclosure requirement. However, 6 years passed without resolution regarding the initial SEC proposal. On January 27, 2022, the SEC released a supplemental proposal adding additional financial disclosures to the P4P proposal. At that time, the SEC announced that it was reopening the initial release of 2015 for public comment as well as inviting comment to the 2022 supplemental release. The SEC extended a 30-day comment period for written comments to be submitted to both the 2015 and 2022 proposed disclosure rules.

The original 2015 P4P proposal remains unchanged from its original submission by the SEC. This initial proposal is quite extensive and includes proposed reporting of CAP to the company's Named Executive Officers (NEOs), the company's Total Shareholder Return (TSR) as a financial metric, use of a designated peer group for comparative disclosures, and other requirements. The 2022 supplemental proposal stipulates two additional financial metrics considered important by the SEC and an option for companies to include a Company Selected Metric (CSM).

Pay Governance LLC, in its role as a consultant advisor to corporate boards on executive compensation, submitted its views on the SEC's P4P disclosure requirements with written responses in both 2015 and 2022. The purpose of this Viewpoint is to share with you the highlights of our response to the SEC and how we believe the SEC's proposal could be enhanced by our experience in advising companies on P4P issues and reporting.

Pay Governance Commentary on, and Suggestions for, Enhancing the SEC P4P Proposal to Facilitate Useful Analysis

The SEC's proposed "Pay Versus Performance" disclosures — if designed properly — could be very valuable in shaping shareholders' and other parties' views of companies' compensation policies, corporate governance practices, and board of directors' effectiveness. This topic has been challenging for all companies, but the SEC's selected approach is highly controversial and of limited utility given the wide-ranging views on what constitutes compensation, performance, and the time frames for measuring this relationship.

Pay Governance strongly endorses using the proxy tables and Compensation Discussion and Analysis (CD&A) as tools to demonstrate to shareholders the alignment of executive compensation with shareholder value creation. This alignment is very important to shareholders, especially given another Dodd-Frank mandate requiring non-binding say on pay votes, as P4P alignment can signal that the board of directors and management team are managing the company effectively. This is especially true if TSR and compensation are strongly aligned over multiple years and business cycles. In order to be useful for shareholders and other parties to properly evaluate pay and performance alignment**, the measurement periods for evaluating both performance and actual pay should be the same or as similar as possible.**

However, the SEC's proposed definition of CAP and **performance period methodology does not achieve this objective.** This is primarily, but not solely, due to companies' prevalent and significant usage of performance stock units (PSUs) to deliver long-term incentive award opportunity. PSU grants typically vest 3 years from the date of grant, thus there is *no* performance period included in the SEC's proposal that properly compares performance for the completed PSU performance cycles from grant to vest/payout. There is a similar issue for time-vested shares (RSUs) and stock options. Further, every year t**he beginning of TSR measurement period will change for each year's P4P disclosures *but the CAP stays the same for each fiscal year*. This means that the shareholder alignment for CAP can change dramatically year on year from "strongly-aligned to misaligned"—and yet compensation did not change at all. This is a major flaw in the process.**

Additional Perspective, Commentary, and Suggestions

1. **ADVANCES IN P4P ASSESSMENTS**
   The SEC's 2022 release notes that "executive compensation practices related to company performance have continued to develop and evolve."[1] Pay Governance has also observed a significant increase in the sophistication of institutional shareholders in assessing P4P when determining their say on pay votes and other governance-related decisions since the SEC's 2015 proposed rules were issued. We find that these shareholders use their own proprietary P4P models, companies' disclosures of P4P, and detailed P4P analyses prepared by the two major proxy advisory firms in their decision-making. **The SEC's proposal, in contrast, appears to be out of step with these more sophisticated approaches of relating pay and performance.**

2. **THE DEFINITION OF CAP DOES NOT ALIGN WITH THE PERFORMANCE PERIOD**
   We see several major shortcomings with the SEC's proposed methodology using CAP to test the alignment of P4P. CAP solely reflects amounts vesting or paid out (salary/bonus) in a given year. Our primary issue is the timing for reporting the CAP amounts is mostly *not* aligned with the performance period in which it was earned, thus distorting the true economic underpinnings of the payout and the reliability of the test of P4P alignment. This is particularly acute for PSUs where typical vesting occurs in the year following the completion of the performance period.

   To illustrate: assuming a 3-year PSU plan, a PSU is granted on February 15, 2022 and earned based on relative TSR from January 1, 2022, to December 31, 2024. The earned shares (if any) vest on February 15, 2025. The SEC proposal requires the PSUs vesting in 2025 be compared to

performance ending in 2025. Irrespective of whether it is 1 year's data or rolling 5-year data, the mismatch in the performance periods and payouts could yield a significant amount of allegedly "misaligned" payouts.

Our second issue is how the SEC has defined CAP. While we understand the SEC is bound by the statutory language in Dodd-Frank to use CAP, we note that the vesting of stock options represents potential compensation and is only CAP to the executive upon exercise of vested stock options. **Moreover, the use of the Black-Scholes value of vested stock options, which considers future stock price performance rather than the "in-the-money" value of stock options (i.e., FMV minus exercise price), further departs from the true amount of CAP and creates the potential for additional P4P alignment issues.**

3. EXPANDING THE P4P TABLE TO INCLUDE FINANCIAL METRICS

Inclusion of Pre-Tax Net Income and Net Income: Mandating the use of pre-tax net income and net income because they are familiar to investors and are easily found in the Generally Accepted Accounting Principles (GAAP) financial statements is not enough to overcome the major shortcomings of both metrics.

- **Neither of these metrics is among the most commonly used to determine incentive pay**; thus, any correlation of CAP with these measures would be low or random.
- Second, **when pre-tax net income and net income are used to determine incentive pay, they are almost always adjusted for unusual items that distort the company's operating performance.** For example, if a company makes a large acquisition, it is likely pre-tax net income, and net income will increase. Incentive payouts often exclude the impact of acquisitions and divestitures on the reported GAAP results.
- Third, **the use of absolute measures in dollar values provides little to no context to evaluate performance let alone P4P**. The original and current proposals require companies to report their cumulative TSR and the TSR of their peers (i.e., growth metrics), which allows for a relative comparison of performance. The SEC's proposal does not include a requirement to report the peers' pre-tax net income and after-tax income, therefore omitting important perspective investors need when evaluating performance.
- Fourth, **pre-tax net income and net income are essentially the same metric with the only major difference being the companies' effective tax rates**. Thus, it is unlikely these overlapping measures will provide investors with a more complete picture of company performance that the SEC intends with the new rule.
- Fifth, not including the peer groups' compensation also omits an important investor perspective, namely, how does compensation earned compare to the company's peers? To illustrate, if a company's pay is increasing but is still well below its peers, investors may be far more willing to support increases in pay to ensure the management team is not vulnerable to recruitment by competitors. Conversely, if compensation is well above peers but performance is far below peers, investors may have reason to question the P4P alignment.

Addition of a CSM: We believe allowing companies to include a CSM is a welcome addition to the P4P disclosure; however, we still have significant reservations about its usefulness given the current format of the P4P table, namely:

1) the mismatch of time frames and the SEC's definition of CAP;

2) both the dollar denomination of these metrics and the lack of relative financial performance and pay levels described in the previous sections; and

3) companies must use the same CSM for all 5 years included in the table, yet the financial metrics used to support a company's objectives are often subject to change during the prescribed timeframe for the P4P disclosure. Thus, the current year's CSM may have only been in place for a portion of the 5-year performance period displayed in the table.

We suggest that the SEC allow companies to select the metric that was used to determine pay for a given period, rather than use the same metric for all five years if it was not applicable or relevant during a portion of the 5 years represented in the table.

4. THE NEW "TOP FIVE" METRIC TABLE

The SEC has proposed including an additional table in the P4P section of the proxy that lists the companies' top five metrics used to drive compensation outcomes. The SEC release explains the need for this supplemental table as follows:

> There is no existing rule that specifically mandates disclosure of the performance measures that actually determined the level of recent NEO compensation actually paid. Tabular disclosure of a list of the five most important performance measures that drove compensation actually paid may be useful to investors in addition to the more detailed disclosure relate to the consideration of the registrant's corporate performance and individual performance in the design of NEO compensation required in the CD&A.[2]

It would appear the rationale described above is partially valid as it relates to the discussion of long-term incentive payouts, but it is inconsistent with both our understanding of the proxy rules and first-hand observations of hundreds if not thousands of proxies where the overwhelming practice is full disclosure of performance metrics and the resulting payouts of the annual incentive plan. **We believe that instead of adding a simple table that lists the top five metrics, the SEC should instead provide additional guidance on the disclosure of the payout calculations for the annual and long-term incentive plan to improve the transparency of performance outcomes and the corresponding payouts.**

Alternative Potential Definitions of Dodd-Frank's "CAP":

Through our client work and research, we have demonstrated that alternative measures of "performance-adjusted pay" (described below) are superior pay values for testing this alignment and addresses this timing issue. Our experience with clients is that the boards of directors greatly appreciate the P4P analysis using performance-adjusted pay in addition to the amounts reported in the Summary Compensation Table (SCT).

In addition, as pointed out in the release, this is further complicated by the current important movement by companies toward linking ESG metrics and stakeholder values to executive compensation. Stakeholder value changes may take time to show up in TSR and, in the short-term, could adversely impact a company's financial results as it invests in new technologies, training, and research and development.

There are several possible alternative definitions of performance-adjusted pay the SEC could select to determine P4P — including realized pay, incentive payout alignment, and realizable pay. While Pay Governance endorses relative comparisons of pay and TSR to peers, we believe that CAP is not an ideal compensation value for that purpose. Based upon our firm's research, we believe that some of the alternative definitions of performance-adjusted pay would be a better pay definition for this type of comparison than CAP. These alternative definitions of performance-adjusted pay also have their limitations and do not precisely reflect "compensation actually paid." As previously noted, the SEC's definition of CAP includes the Black-Scholes value of vested but unexercised stock options, which does not literally reflect "compensation actually paid." We believe several other definitions that meet the Dodd-Frank definition are arguably the optimal value for these P4P purposes.

Pay Governance and many of its clients have used various performance-adjusted pay definitions over the last 12 years to demonstrate the degree of alignment of companies' pay and performance to compensation committees, management teams, investors, and the public/media. We believe many of the other definitions of performance adjusted pay could meet the Dodd-Frank standard better than CAP but with better *a priori* theoretical alignment with performance. In addition, several of these definitions facilitate peer comparisons as an important context for investors, which is absent in the SEC's proposal. Similar methodologies — both realized and realizable pay — have been incorporated into shareholder voting analyses by ISS, Glass Lewis, and large institutional shareholders. While not perfect, we believe that several of these pay definitions are superior to CAP when evaluating P4P alignment.

We urged the SEC to utilize a different form of CAP. However, the new rules will allow companies to include their own P4P analysis as long as the disclosure is not misleading or more prominent than the SEC's mandated table.

General questions about this Viewpoint can be directed to John Ellerman at john.ellerman@paygovernance.com, Mike Kesner at mike.kesner@paygovernance.com or Ira Kay at ira.kay@paygovernance.com.

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[1] U.S. Securities and Exchange Commission. "Reopening of Comment Period for Pay Versus Performance." February 2, 2022. https://www.federalregister.gov/documents/2022/02/02/2022-02024/reopening-of-comment-period-for-pay-versus-performance.
[2] U.S. Securities and Exchange Commission. "Proposed Rule: Reopening of Comment Period for Pay Versus Performance." January 27, 2022. https://www.sec.gov/rules/proposed/2022/34-94074.pdf.