ALERT

Viewpoint on Executive Compensation

Key Takeaways from SEC's Pay Versus Performance CDIs

MIKE KESNER, ED SIM AND BEN STRADLEY

The SEC issued 15 Compliance and Disclosure Interpretations ("CDIs") on February 10th, 2023, to clarify the new Pay Versus Performance rules, which were finalized on August 25, 2022. The CDIs arrive just as many companies are wrapping up their proxies, and in some cases may require changes to elements such as company-selected measures ("CSMs"), how such measures are calculated, and the inclusion of more detailed footnotes.

The SEC CDIs can be found under Sections 128D and 228D at:
https://www.sec.gov/divisions/corpfin/guidance/regs-kinterp

Here are our key takeaways:

1. Stock price can be a CSM if it is used as a measure which directly determines compensation, such as achievement of a stock price hurdle or to determine the size of a bonus pool. The CDIs explicitly precludes the use of stock price as a CSM if its only impact on compensation is through changes in the value of awards.

2. As a derivative of the required total shareholder return disclosure, Relative TSR ("rTSR") may be selected as a company selected metric if it is used to determine compensation.

3. The CSM must be reported in the table based on the most recently completed year's results, not a multi-year performance period ending with the current fiscal year.

   - 1-year rTSR performance is an acceptable CSM; 3-year cumulative rTSR performance is not.

   - This guidance would also preclude the reporting of multi-year performance for other measures commonly used in incentive plans (e.g., average ROIC, cumulative EPS growth, etc.).

4. Peer companies disclosed in the CD&A "actually used to help determine" compensation can be used as the TSR peer group, even if not technically used to "benchmark" compensation.

5. The footnotes that reconcile SCT to CAP must include all the components listed in the rules:

   - Pension service cost.

   - Prior service cost to the extent modifications to the plan were made during the year.

   - Fair value, at the end of the year, of equity awards granted during the year that remain unvested at year-end.

   - Fair value, at the vest date, of equity awards granted and vested in the same year.

- Change in fair value, during the current year, of unvested equity awards at the beginning of the year that remained unvested at year-end.

- Change in fair value, during the current year, of unvested equity awards at the beginning of the year that vested during the year.

- Forfeitures of prior year awards that failed to vest during the current year.

- Dividends paid on unvested shares during the current year.

6. Because this is the first year of the disclosure, the information listed in item 5 above must be provided for each year required to be included in the table, thereafter, only the current year's SCT to CAP reconciliation will be generally required.

Additionally, the new guidance provided by the CDIs may create some confusion relating to the proper determination of TSR performance in the PVP table when there is a change to the CD&A peer group used for TSR purposes. While the issuing release suggested peer TSR would be based only on the newly selected CD&A peer group, the CDIs direct companies to use the CD&A peer group's TSR performance for the peer group used in each respective year of the table. Companies using a line of business or industry index or a peer group used to satisfy the performance graph requirements of Item 201(e) would not appear to be affected by this CDI.

As noted above, the CDIs will require that companies review their draft PVP disclosure to ensure they have incorporated the additional guidance provided by the CDIs.

General questions about this Viewpoint can be directed to Mike Kesner (mike.kesner@paygovernance.com), Ed Sim (edward.sim@paygovernance.com) or Ben Stradley (bentham.stradley@paygovernance.com).