



The SEC's
**Pay for Performance
Rule: A Compliance Guide**

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Following multiple rounds of proposals, comments and re-proposals, the SEC has [finally released](#) its “Pay Versus Performance” disclosure rule. So much has changed in the years since the rule was originally proposed that the final rule seems to be “a day late and a dollar short,” as the Center argued in its comments to the SEC. Even though the mandated disclosure may be misleading (as it may contradict other pay for performance disclosures already in the proxy) and meaningless (because it is an assortment of unrelated items grouped together into a table), companies with fiscal years ending on or after December 16, 2022 will be required to include it in the 2023 proxy.

We have developed this Compliance Guide to help Center members negotiate not only the technical aspects of the rule but the potential external ramifications of the disclosure. Many consultants and advisors have published excellent technical guides, which we link below – our goal is to augment these overviews with a broader discussion of the implications of disclosure that the Compensation Committee and management may want to consider before the proxy is finalized.

Executive Summary

Timing and Covered Companies.

Timing and Covered Companies. The new disclosure is required for all fiscal years ending on or after December 16, 2022. This means that for most companies, the first disclosure will appear in the 2023 proxy (but not necessarily as part of the CD&A). Companies will have a transition period for compliance: the first disclosure need only include three years of data, with an additional year added annually until the full five years of data are disclosed. [Smaller Reporting Companies](#) have reduced reporting requirements and only three years of data are necessary.

What's Required.

The rule consists of three pillars, with the level of prescriptiveness ranging from moderate to significant.

Pillar One: The Pay Versus Performance Table.

The Pay Versus Performance Table (PVP) is the most prescriptive part of the rule. The SEC has mandated both the form and content of the table, pictured below:

					Value of \$100 Investment Based On:			
Year	SCT for PEO	Compensation Actually Paid for PEO	Average SCT for NEOs	Average Compensation Actually Paid for NEOs	TSR	Peer TSR	Net Income (GAAP)	Company Selected Measure
(a)	(b)	(c)	(d)	(e)	(f)	(g)	(h)	(i)
2022								
2021								
2022								
2019								
2018								

Pillar Two: The Tabular List of Metrics.

The Tabular List of Metrics requires an unranked list of the 3-7 “most important” financial metrics for determining pay in the previous fiscal year. The list can be combined or separated by individual executive. Non-financial metrics may be included as long as at least three financial metrics are included. However, as we will explore later in the Guide, this decision (among many others) may not be as simple as it appears at first glance.

Pillar Three: The Description of Relationships.

The Description of Relationships, while prescriptive in terms of required content, is flexible in terms of format. Companies can use narrative, graphics or a combination to disclose the following relationships over the five-year period required by the PVP Table:

- Company TSR vs. Peer Group TSR
- Compensation Actually Paid for the CEO and average NEO vs:
 - Cumulative TSR
 - Net Income
 - Company Selected Measure

Definitions of Pay and Performance.

How to Calculate “Compensation Actually Earned.”

The rule adds another definition of pay to the many already in existence. To some extent, the SEC’s hands were tied because of the explicit Congressional directive in Dodd-Frank to disclose “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...” The final rule, in response to comments by consulting and advisory firms, among others, strove to achieve something close to “realizable pay” to fulfill the intent of Congress – but in a way that is different from existing definitions of realizable pay, including those of ISS and Glass Lewis.

Under the rule, “Compensation Actually Earned” requires the following calculation. For a detailed explanation, see Equity Methods’ excellent brief [here](#).

- Start with Summary Compensation Table (SCT) pay for the CEO and an average of all NEOs
- For pensions, subtract the “change in actuarial value”, but add back service cost and prior service cost for the year
- For equity awards, subtract the grant date value as reported in the SCT, and add a new value calculated this way:
 - The year-end fair value of awards granted in the current fiscal year

PLUS or MINUS

 - The annual change in fair value as of year-end (for unvested awards) or as of vesting (for awards vested in the current fiscal year)

Keep in mind this calculation must be done individually for each NEO, then averaged for all NEOs other than the CEO. For awards granted and vesting in the same year, the fair value as of vest is used. The dollar value of dividends on unvested equity must also be included if they are not already in the SCT.

How to Define Performance.

The SEC has mandated multiple measures of performance be included in the table. Here are the required metrics:

- Cumulative TSR (for the initial 3-year disclosure, 2022 will be 3-year TSR, 2021 will be 2-year TSR and 2020 will be 1-year TSR)
- Cumulative TSR for a peer group (either the same group used for the “performance graph” in the annual report, or the one used in the CD&A for compensation benchmarking) weighted based on market capitalization. Peer groups may be changed year to year (with disclosure).
- GAAP Net Income for the company
- Company-Selected Measure, defined as the company’s “most important” financial measure (other than TSR or net income) used to link pay and performance for the most recent fiscal year. In other words, it cannot be a measure that is generally aligned with pay or performance but is not actually used by the Compensation Committee to link pay and performance. It is important to note that if a company’s most important measure happens to be TSR or net income, the “next-most important measure” must be used.

Additional metrics may be added to the table on a voluntary basis.

Decisions To Be Made

From a technical perspective, the Pay Versus Performance rule is not as difficult as, for example, Pay Ratio, which required extensive collection of data from around the world, on thousands of employees, and involving multiple systems. In comparison, this rule is limited to Named Executive Officers only; the calculations required for the new definition of “Compensation Actually Paid” are complex, but can easily be outsourced to a third party if needed.

However, this disclosure deserves careful attention by management and the Compensation Committee because the potential for confusion between this and existing disclosures is significant. Investors, media and other stakeholders may find inconsistencies and weaknesses in the disclosure to criticize company pay practices.

Here are the key decisions that must be made and the possible alternatives.

Decision Point: Choosing the Location for Disclosure

This is in many ways the most important decision that companies must make regarding the Pay Versus Performance disclosure. The SEC specifically did not require the disclosure be placed in the CD&A, noting somewhat evasively that this could “cause confusion by suggesting that the registrant considered the pay-versus-performance relationship in its compensation decisions, which may or may not be the case.” This leaves companies the flexibility to determine where in the proxy the table should go.

Option One: In the CD&A.

Although not required, companies may feel that putting the table up front in the CD&A, perhaps even alongside existing pay for performance disclosures, will make it easier to explain why the two disclosures don’t align (or even have opposite outcomes). On the other hand, this will also bring attention to the SEC-mandated disclosure which it may not merit. Also, the Compensation Committee charter typically indicates that the Compensation Committee has reviewed and discussed with management all the items in the CD&A (this is also noted in the report). Including the SEC-mandated table in the CD&A may give the impression that it was considered as part of the Committee’s process for determining pay.

Option Two: In the proxy (after the CD&A).

Another choice is to place the table with the other pay-related tables, after the CD&A. This would be consistent with the placement of disclosures such as the Summary Compensation Table, and unlikely to run afoul of the SEC’s caution that existing pay for performance disclosures cannot “obscure the required disclosures, place the required disclosures in a less prominent position, or otherwise mislead or confuse investors.” The SEC goes so far as to note that if a company’s existing pay for performance disclosure is rendered duplicative by the new one, this potential “duplication” should be mitigated – an unlikely occurrence. In fact, the opposite is more likely to be true – the new disclosure may require extensive explanation of why it fails to align with existing disclosures.

Option Three: At the end of the proxy (for example, after Pay Ratio).

A third choice is to place the table at the very end of the proxy, even later than the tables – such as just after the Pay Ratio disclosure, which for many companies is one of the final entries in the entire proxy statement. This option is still likely to be within the “letter of the law,” as it is still in the proxy proper (rather than an appendix, which might go against the requirement that the disclosure not be “obscured”).

Decision Point: Choosing the Peer Group for TSR

Since the new table mandates the disclosure of “weighted peer group TSR,” companies must choose which peer group is to be used for the calculation. The rule provides two choices; either way, year-to-year changes to the peer group must be disclosed in a footnote and pay for the most recent year must be compared to both old and new peer group TSR. For further analysis, see Willis Towers Watson’s discussion [here](#).

Option One: The peer group used in the “[performance graph](#)” in the Annual Report (item 201(e) of Regulation SK) which can be an industry index or company-identified peer group.

The benefit of choosing this peer group is that annual disclosures regarding changes in the peer group will likely be unnecessary, and it will match the performance graph already in the Annual Report. However, that graph does not include pay. If the company uses a different peer group to benchmark pay and performance, then the performance of that peer group may be better aligned with pay than an index.

Option Two: A peer group disclosed in the CD&A for “compensation benchmarking.”

In this case, the company will have to disclose annual changes to the peer group, along with a comparison of pay to both old and new peer group, in a footnote to the table. The entire table must be updated to the new peer group (for all prior years as well). Since changes to the peer group are already disclosed in the CD&A, this may not be a major obstacle.

Decision Point: Choosing the Company-Selected Measure

A much-debated provision of the final rule requires companies to disclose, in addition to TSR, peer TSR and Net Income, a fourth metric: the financial measure that they consider the single “most important” when linking compensation actually paid to company performance for the most recent fiscal year. This measure cannot be TSR or Net Income, and it must also be included in the Tabular List (Pillar Three). The difficulty is in determining which metric is “most important,” since (as the Center emphasized to the SEC) most companies use a combination of metrics that correlate to long-term shareholder value.

Option One: A metric from the annual incentive plan.

When asked for the “most important financial metric” that they use to link pay and performance, many Compensation Committees might choose a metric from the annual or short-term incentive plan. These metrics are often the most immediate drivers of performance and the building blocks of long-term value for the company. However, at most large companies, the annual incentive comprises about 20-25% of total NEO pay. Can a metric which only drives a quarter (or less) of executive pay be said to be the “most important” metric? Consider too that the disclosure requires a comparison of this metric to total pay as represented in the table. If the majority of the total pay figure consists of long-term incentive, the alignment to a short-term metric may be less obvious. Finally, readers may look at relative weightings of metrics in the incentive plan to judge which metric is “most important.” If the metric selected has a lower weighting than others in the plan, this may raise questions.

Option Two: A metric from the long-term incentive plan.

Given the concerns above, companies may consider selecting a metric from the long-term plan as the “most important” financial metric. However, in this case, there may be a concern if most of the long-term incentive is tied to TSR. Since TSR is already in the table, the company must choose the next most important metric, which may drive a lower percentage of total pay and therefore appear less aligned.

Decision Point: Selecting the “Tabular List” Metrics (Pillar Two)

The “second pillar” of the disclosure requires an unranked list of the 3-7 most important financial metrics (with room for non-financial metrics if at least three financial metrics are disclosed) used to link pay to performance. Similar to the Company-Selected Measure in the Pay Versus Performance Table, these metrics are up to the company to determine (and in fact, the Company-Selected Measure must also appear in the Tabular List).

Option One: Select no more than the three financial metrics required.

Given that the company already provides extensive disclosure in the CD&A regarding the metrics used to link pay and performance, the immediate impulse may be to limit this new disclosure to the minimum three metrics required. However, this requires the company to select just three out of what could be a longer list of metrics used in the incentive plan. If that is the case, readers may question why the other metrics were not included, especially if they are weighted more heavily in the incentive plan design. Alternatively, if the metrics in this table do not match the incentive plan metrics, companies will likely be expected to explain the reason why.

Option Two: Include all financial metrics in the annual and long-term plan.

This choice avoids criticism of “cherry picking” the metrics that align best with pay and performance, but results in a longer disclosure with more opportunity for scrutiny. If the Pay Versus Performance Table does not show clear alignment (which would hardly be surprising given the items required), then the entire list of metrics may come under fire.

Option Three: Include a non-financial metric (along with at least three financial metrics).

Although the rule explicitly allows this, and several SEC Commissioners mentioned it when the rule was proposed, companies may be hesitant to include non-financial metrics given the requirement that they be the “most important” metrics used to link pay and performance. If a company states, for example, that human capital metrics are “most important” but the proportion of total pay actually tied to them is lower than financial metrics, there may be second-guessing as to whether this constitutes a sufficiently important metric to be included in the table. On the other hand, the absence of such a metric may invite criticism that companies are failing to consider ESG when setting pay.

Decision Point: Determining the Number of Tabular Lists

Although only one metric is allowed to be labeled as the “Company-Selected Measure” in the PVP Table, the rule allows companies to separate (if desired) the Tabular Lists by executive in three possible ways:

Option One: Disclose one Tabular List for all executives (CEO and NEOs).

Companies may choose this option if financial metrics are the same, or nearly the same, for all Named Executive Officers including the CEO. It has the advantage of being the simplest method. However, if metrics are substantially different for NEOs, or for a certain NEO, it may be difficult to combine them into just one list.

Option Two: Disclose two Tabular Lists: one for the CEO and one for all other NEOs.

This may be a wise option for companies where the CEO has substantially different metrics than the rest of the NEOs. This may also arise if the CEO, unlike the rest of the NEOs, has a substantial component of pay tied to non-financial metrics (the non-financial metric could be disclosed alongside the minimum of three financial metrics).

Option Three: Disclose a separate Tabular List for each executive individually.

Although this will lengthen the disclosure, it may be the best choice for a company with (for example) multiple NEOs who are Business Unit Presidents. Since the “most important” metrics used to link pay and performance may differ considerably by executive in this type of model, disclosing a separate list for each executive may make the most sense despite the added length.

Decision Point: Selecting the Format for the Description of Relationships (Pillar Three)

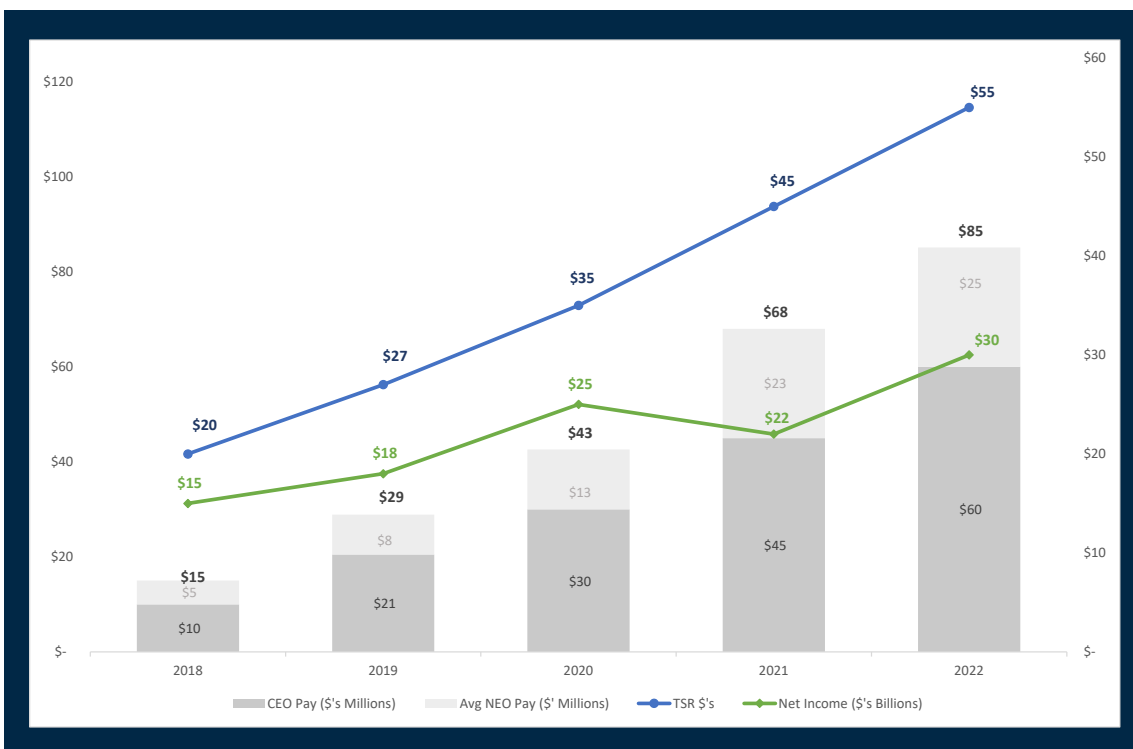
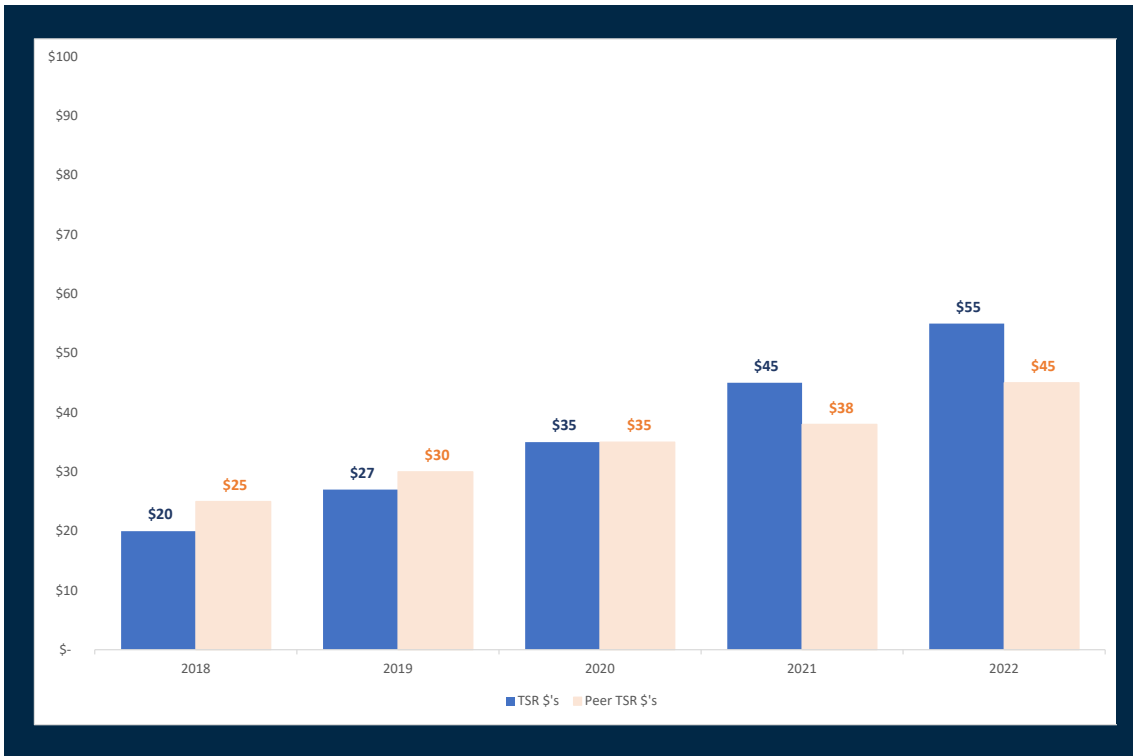
The third and final pillar of the rule requires companies to disclose the relationships between company TSR and peer group TSR as well as the relationships between pay and all the company metrics in the Pay Versus Performance Table (TSR, Net Income and Company-Selected Measure). If additional metrics are disclosed in the table voluntarily, their relationship to pay must also be discussed.

The rule suggests the option of a graph showing CEO and average NEO Compensation Actually paid versus the change in TSR, Net Income and Company Selected Measure (such as Revenue), along with the relationship between company and peer group TSR. Here are some options for how this could be done.

We have included some sample graphics for ideas only – the Finance team should be involved quickly to determine which types of tables are appropriate and build them out using real company data.

Option One: Disclose one graph with TSR vs Peer TSR, and another with pay versus TSR, Net Income and Company Selected Measure.

This option could plot the ratio between pay and each metric or the percentage change in pay and required metrics. A second chart would show just TSR vs Peer TSR or could duplicate the Performance Graph in the 10-K.



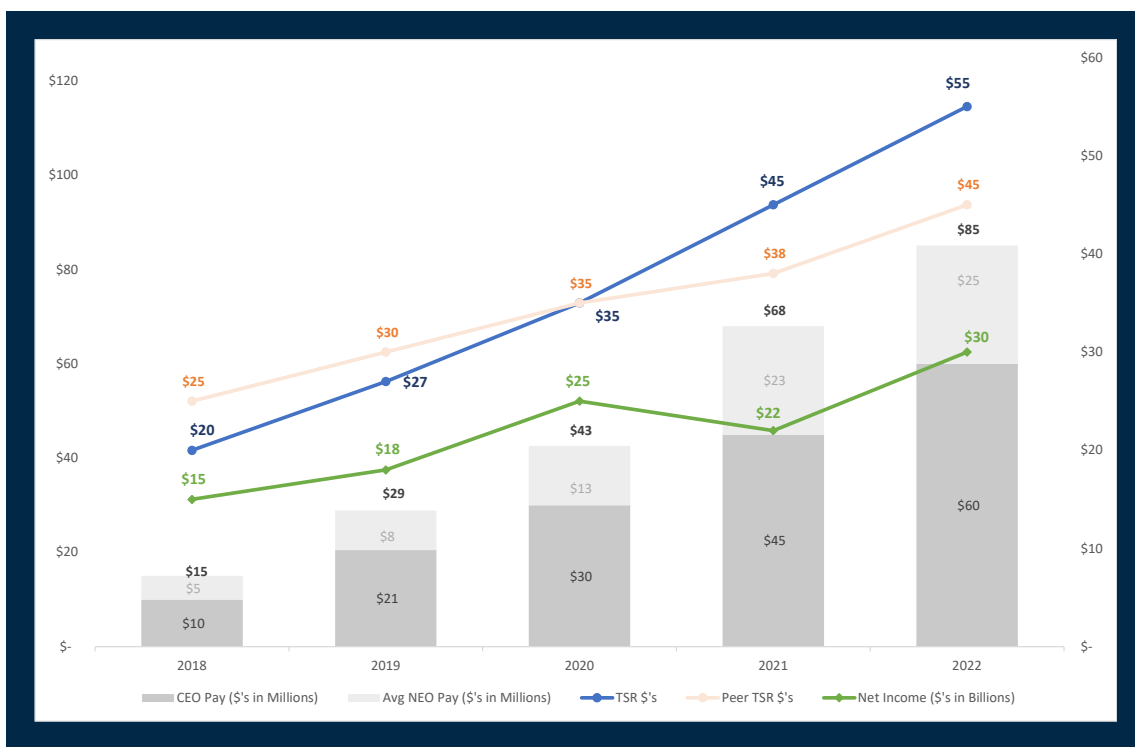
Option Two: Disclose each relationship in a separate graph.

Option Three: Disclose all relationships in a single table, with or without narrative.

This option could plot the ratio between pay and each metric in the table, along with the ratio between TSR and Peer TSR, on one graph with parallel axes, as below. This has the advantage of being the shortest form of disclosure, with every required relationship in one table, but it may not be the clearest way since the ratios may differ considerably in size.

Option Four: Disclose the relationships using narrative only, with no graphs.

The rule does not require that any graphs or charts be used at all, if the company does not desire to do so. Some companies may feel that the easiest way to comply is simply to add a few sentences of narrative describing how each element of pay and required performance metrics are related. Although some investors are likely to prefer the use of at least one table, the Compensation Committee may feel that a visual representation of the relationship between definitions of pay and performance not actually considered by the Committee is misleading.



Next Steps

Given the tight timeframes for calendar filers, we recommend that the Compensation Committee review the new requirement, and possibly a draft disclosure, at the September/October meeting followed by a second “bite at the apple” at the November/December meeting.

Companies should put together a project team including the Head of Rewards, Finance, Legal, and outside counsel (if they have input into proxy drafting) in collaboration with the Compensation Committee consultant. Start thinking through the data requirements and whether you will perform the necessary calculations and wordsmithing internally or with external help.

So far, the reaction of proxy advisory firms has been muted. The definitions of pay and performance in the rule differ from those used by both ISS and Glass Lewis, so it is difficult to see how these advisors use the new disclosures. Companies should continue to monitor this.