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The New SEC Pay-for-Performance Rules Require A Thoughtful Approach

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Section 953(a) of the Dodd-Frank Wall Street Reform and Consumer Protection Act of 2010 directs the SEC to adopt rules requiring public companies to provide disclosure of executive pay as compared to company performance. The SEC did not propose rules in response to this mandate until 2015, and for a time thereafter the proposal disappeared from the SEC's agenda. In January 2022, the SEC reopened the comment period and updated its proposal. With some additional changes, the new pay-for-performance rules were adopted on August 25, 2022.

Given the changes in compensation and disclosure practices that have transpired since the adoption of the Dodd-Frank Act, it might be tempting to underestimate the potential challenges posed by the new rules. The basic idea behind the rules seems simple: compare the change in the amount paid in executive compensation over time to the change in total shareholder return (TSR) for the same period. Many companies already explain how they view the relationship between executive compensation and TSR in the Compensation Discussion and Analysis section of the proxy statement, where they are required to address the relationship of executive compensation to measures of performance used by the company. Say-on-pay voting has, in general, encouraged companies to discuss the relationship of pay to financial performance. In shareholder engagement and similar contexts, companies are accustomed to explaining their pay practices in light of stock performance. ISS uses TSR (and the TSR of a company peer group) in evaluating executive compensation for purposes of providing advice on say-on-pay and other shareholder voting.

The problem is that the pay-for-performance rules could change the way a company is seen by altering the way its compensation is measured in ways that may not be easily predictable. As companies will need to comply with the new rule in the upcoming proxy season, they should begin analyzing how their executive compensation will be viewed under the new rules as soon as possible. For many companies, the goal will be to preserve the way shareholders currently view the overall relationship between company performance and executive compensation. But achieving this minimalist goal may require some advance preparation.

The new rules require a tabular presentation of the following items, for a period of up to three years (for smaller reporting companies) or five years (for other companies covered by the rule):[1]

[1] Emerging growth companies and foreign private issuers are exempt from the pay-for-performance rules. Smaller reporting companies will begin by reporting one year of compensation and will phase into the full three years of reporting required of them over the following two years. Other companies covered by the rules will begin by reporting three years of compensation and will phase into the full five years of reporting over the next two years.

- the total compensation of the principal executive officer (PEO) as shown in the Summary Compensation Table in the proxy statement and as adjusted pursuant to the rules;
- the average total compensation of all other "named executive officers" as shown in the Summary Compensation Table and as adjusted pursuant to the rules;
- the company's TSR, based on the investment of $100 as of the beginning of the period shown in the table;
- a peer group TSR, based on the peer group shown in the company's performance graph or the peer group used in the company's Compensation Discussion and Analysis (if a peer group is used in this context) (not required for smaller reporting companies);
- the company's net income; and
- the company's performance over the period shown in the table, based on a company-selected financial measure (again, not required for smaller reporting companies).

The most difficult technical issue will be determining compensation "actually received" in accordance with the pay-for-performance rule. Using the compensation reported in the Summary Compensation Table as a base, companies are required to recalculate how equity compensation is included in each year, counting both vested and unvested equity granted during the year and changes in the fair value of equity granted in prior years that remains unvested or that vested during the reported year. Companies may not exclude one-time payments for things like severance or change in control. Companies must also make certain recalculations of pension amounts. The new rules require a footnote explanation of the adjustments made to numbers in the Summary Compensation Table. But companies should be prepared for potentially significant differences between the compensation numbers reflected in the company's Summary Compensation Table and the adjusted numbers required for the pay-for-performance table.

Companies other than smaller reporting companies are required to select one other financial measure to be included in the table. From the company's point of view, this measure should be the most important financial measure used to determine executive compensation (other than, potentially, TSR or net income). For many companies, this may be EBITDA or some form of adjusted EBITDA. The selection of this measure should be consistent with other disclosures that the company makes concerning how it determines executive compensation.

In either a narrative or a "graphical representation," companies are required to explain the relationship between the compensation provided to the PEO and the other named executive officers, on the one hand, and the company TSR, net income, and (except for smaller reporting companies), the company-selected financial measure.

In addition, all companies are required to provide an "unranked list" of between three and seven other financial criteria used to determine executive compensation. A company may include non-financial criteria if it determines that those criteria are among the top three to seven criteria and it includes at least three financial criteria. A company may include different criteria for its PEO and for its other named executive officers.

The selection of financial and other measures, and any narrative discussion, should, of course, be consistent with the company's other compensation and financial disclosures.

To prepare for the pay for performance disclosures, companies should:

- calculate the compensation amounts as soon as possible, using estimates for the current year where needed;
- work with the company's compensation committee and compensation consultants to identify the most important financial and non-financial criteria used for determining executive compensation, keeping in mind the relationship of those criteria to other elements of the company's strategy and its existing disclosures;
- identify the peer group that the company would like to use for peer group TSR disclosure; and
- consider the need for any additional disclosures that may be triggered by the pay for performance requirements.

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