"Pay Vs. Performance: Lessons From Season 1"

Tuesday, June 13, 2023

Course Materials

“Pay Vs. Performance: Lessons From Season 1”

Tuesday, June 13, 2023

2 to 3 p.m. Eastern [archive and transcript to follow]

In August 2022, the SEC adopted final pay versus performance disclosure requirements — one of the most significant executive compensation disclosure changes in the past decade. Management teams, boards and advisors had to move quickly to understand the rule's prescriptive disclosure requirements, and companies devoted significant time and resources computing “compensation actually paid” for 2023 proxy statements. In this webcast, our panelists will review how companies approached pay versus performance disclosures in year one and how these new disclosures impacted shareholder engagements and voting outcomes in the 2023 proxy season.

Join these experts:

- **Howard Dicker**, Partner, Weil, Gotshal & Manges LLP
- **Nicole Foster**, Partner, Freshfields Bruckhaus Deringer LLP
- **Daniel Kapinos**, Partner, Aon Human Capital Solutions
- **Carol Silverman**, Partner, Mercer LLC

Among other timely topics, this webcast will cover:

- Challenges in the First Year and Approaches to Interpretive Questions
- Common Mistakes and Misconceptions
- Most Frequently Used Company-Selected Measures
- Trends in the Tabular List and Relationship Disclosures
- Use and Placement of Supplemental Disclosures
- Recommendations for Shareholder Engagements and Voting Impact
- Longer Term Impacts on Compensation Programs and Disclosures

“Pay Vs. Performance: Lessons From Season 1”

Course Outline/Notes

1. Challenges in the First Year and Approaches to Interpretive Questions

2. Common Mistakes and Misconceptions

3. Most Frequently Used Company-Selected Measures

4. Trends in the Tabular List and Relationship Disclosures

5. Use and Placement of Supplemental Disclosures

6. Recommendations for Shareholder Engagements and Voting Impact

7. Longer Term Impacts on Compensation Programs and Disclosures

“Pay Vs. Performance: Lessons From Season 1”

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5 Things to Know About the SEC's New Pay Versus Performance Rules

In August 2022, the SEC adopted final rules implementing the Pay Versus Performance Disclosure required by Section 953(a) of the Dodd-Frank Act. These rules go into effect for the 2023 proxy season and introduce significant new valuation requirements related to equity-based compensation paid to company executives. What does this mean, and how does it apply to you? What are the requirements, and why might there be significant valuation challenges involved? We discuss all that and more below.

Executive Summary

1. The new SEC proxy disclosure rules introduce several new requirements, including that registrants calculate and disclose a new figure (Compensation Actually Paid), alongside existing executive compensation information. For most registrants, the rules will apply to upcoming 2023 proxy season.
2. A new Pay Versus Performance table will detail the relationship between the Compensation Actually Paid, the financial performance of the registrant over the time horizon of the disclosure, and comparisons of total shareholder return.
3. The newly introduced concept of Compensation Actually Paid will require companies to measure the period-to-period change in the fair value of all equity-

based compensation awarded to named executive officers.

4. The type of equity awards that have been granted will determine the complexity of the valuation process. Equity-based awards such as stock options might require updated Black Scholes or lattice modeling, while awards with performance or market conditions may require more complex Monte Carlo simulations.
5. Registrants should understand that if equity awards have been granted on a consistent basis for a period of years, the new rules could require a large number of historical valuations for this initial proxy season and a significant amount of disclosure complexity.

Advance planning and processes will be needed to establish the scope and complexity of complying with the new rules, including identifying how many equity-based awards will require updated valuations to measure the period-to-period changes.

1. Overview and Background

The **new disclosures** were mandated by the Dodd-Frank Wall Street Reform and Consumer Protection Act and were originally proposed by the SEC in 2015. These rules will add a new item 402(v) to Regulation S-K and are intended to provide investors with more transparent, readily comparable, and understandable disclosure of a registrant's executive compensation. The new provisions apply to all reporting companies other than (i) foreign private issuers, (ii) registered investment companies, and (iii) emerging growth companies.

The rules apply to any proxy and information statement where shareholders are voting on directors or executive compensation that is filed in respect of a fiscal year ending on or after December 16, 2022. As such, the vast majority

of registrants will be required to include related disclosure for their 2023 proxy statements, though there are relaxed requirements for smaller reporting companies.

The new SEC proxy disclosure rules introduce several new requirements, including that registrants calculate and disclose a new figure (Compensation Actually Paid), alongside existing executive compensation information. For most registrants, the rules will apply to upcoming 2023 proxy season.

2. The Pay Versus Performance Table

The new rules require registrants to describe the relationship between the Executive Compensation Actually Paid ("CAP") and the financial performance of the registrant over the time horizon of the disclosure. Additional items include disclosure of the cumulative Total Shareholder Return ("TSR") of the registrant, the TSR of the registrant's peer group, the registrant's net income, and a company-selected measure chosen by the registrant as a measure of financial performance. These items are to be disclosed in tabular form (based on an example included in the final rule), which is replicated below.

FIGURE 1: Pay Versus Performance Table

(a)	(b)	(c)	(d)	(e)	(f)	(g)	(h)	(i)
					Value of Initial Fixed $100 Investment Based On:			
Year	Summary Compensation Table Total for PEO	Compensation Actually Paid to PEO	Average Summary Compensation Table Total for Non-PEO NEOs	Average Compensation Actually Paid to Non-PEO NEOs	Total Shareholder Return	Peer Group Total Shareholder Return*	Net Income	[Company Selected Measure]*
Y1	$	$	$	$	$	$	$	$
Y2	$	$	$	$	$	$	$	$
Y3	$	$	$	$	$	$	$	$
Y4*	$	$	$	$	$	$	$	$
Y5*	$	$	$	$	$	$	$	$

**Smaller reporting companies exempt from Years 4 and 5 and certain other disclosures*

Click here to expand the table above

The table includes the following components:

- **Year**. The form applies to the five most recent fiscal years (or three years for smaller reporting companies)

- **Summary Compensation Table Total for Primary Executive Officer (PEO)**. These are the same total compensation figures as reported under existing SEC proxy disclosure requirements. However, additional columns may need to be added if there was PEO turnover in the relevant periods.
- **Compensation Actually Paid to PEO**. For each fiscal year, registrants are required to make adjustments to the total PEO compensation reported in Item (b) for pension and equity awards that are calculated in accordance with US GAAP. This item is potentially complex and is discussed in detail below.
- **Average Summary Compensation Table Total for Non-PEO Named Executive Officers (NEOs)**. These average figures would be calculated using the same compensation figures as reported under existing SEC proxy disclosure requirements for NEOs. Different individuals may be included in the average throughout the five (or three) year period. Footnote disclosure is required to list the individual NEOs.
- **Average Compensation Actually Paid to Non-PEO NEOs**. These amounts would be calculated using the same methodology as in Item (c), but then averaging the amounts in each year.
- **Total Shareholder Return**. The registrant's TSR is to be determined in the same manner as is required by existing Regulation S-K guidance. TSR is calculated as the sum of (1) cumulative dividends (assuming dividend reinvestment) and (2) the increase or decrease in the company's stock price for the year, divided by the share price at the beginning of the year.
- **Peer Group Total Shareholder Return**. This is calculated consistently with the methodology used for Item (f). Registrants are required to use the same peer group they use for existing performance graph disclosures or compensation discussion and analysis.
- **Net Income**. This is simply GAAP net income for the relevant period.

- **Company Selected Measure**. This item is intended to represent the most important financial performance measure the registrant uses to link compensation paid to its PEOs and other NEOs to company performance. The registrant can select a GAAP or non-GAAP financial measure.

The remainder of this article focuses on the two shaded columns (c) and (e) which address Compensation Actually Paid and the valuation inputs that support these disclosures.

A new Pay Versus Performance table will detail the relationship between the Compensation Actually Paid, the financial performance of the registrant over the time horizon of the disclosure, and comparisons of total shareholder return.

3. What Is Compensation Actually Paid?

For each fiscal year, registrants are required to adjust the total compensation reported in Columns (b) and (d) for pension and equity awards that are calculated in accordance with US GAAP. The following table describes these adjustments in detail.

FIGURE 2: Compensation Actually Paid (CAP)	
Starting Point	Total Exec Compensation reported in the Summary Compensation Table ("SCT")
	Adjustments Related to Defined Benefit and Pension Plans
⊖	***Minus:*** the aggregate change in the actuarial present value of the accumulated benefit of all defined benefit and actuarial pension plans reported in the SCT
⊕	***Plus:*** the actuarially determined service cost for services rendered by the executive during the applicable fiscal year
⊕	***Plus:*** the entire cost of benefits granted in a plan amendment (or initiation) during the covered fiscal year that are attributed by the benefit formula to services rendered in periods prior to the plan amendment or initiation
	Adjustments Related to Equity-Based Compensation
⊖	***Minus:*** the grant date fair value of awards granted during the fiscal year reported in the SCT
⊕	***Plus:*** the year-end fair value of equity awards granted in the covered fiscal year that are outstanding and unvested as of the end of the fiscal year
⊕ ⊖	***Plus/Minus:*** the change in fair value of awards granted in prior years that are outstanding and unvested as of the end of the fiscal year. Compare current FYE with prior FYE
⊕	***Plus:*** the fair value, as of the vesting date, of awards that are granted and vest in the same covered fiscal year
⊕ ⊖	***Plus/Minus:*** the change in fair value, from the end of the prior FYE to the vesting date, of awards granted in prior years that vest in the fiscal year
⊖	***Minus:*** the fair value, at the end of the prior FYE, of awards granted in prior years that are deemed to fail to meet applicable vesting conditions during the covered year
⊕	***Plus:*** the amount of dividends/earnings paid on equity awards in the FY prior to the vesting date that is not otherwise reflected in the fair value of such awards or included in total compensation for the covered fiscal year.

The pension-related adjustments should be calculated using the principles in ASC 715, *Compensation – Retirement Benefits*. The equity-based compensation adjustments will require registrants to disclose the fair value of equity awards in the year granted and report changes in the fair value of the awards until they vest. This means that it will be necessary to measure the year-end fair value of all outstanding and unvested equity awards for the PEO and other NEOs under a methodology consistent with what the registrant uses in its financial statements. For most registrants, this will be ASC 718, *Compensation – Stock Compensation*.

Appropriate footnote disclosure may also be required to identify the amount of each adjustment and any valuation assumptions that materially differ from those disclosed at the time of the equity grant.

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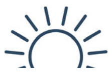

The newly introduced concept of Compensation Actually Paid will require companies to measure the period-to-period change in the fair value of all equity-based compensation awarded to

4. What Are the Different Types of Equity Awards?

The procedures used to calculate fair value will vary depending on the type of equity award.

- For **restricted stock and restricted stock units (RSUs)**, fair value can be calculated using observed share prices at the grant date, fiscal year-end, and the vesting date. The change in fair value would simply be the difference between these dates.
- For **stock options and stock appreciation rights (SARs)**, fair value at the grant date is often calculated using a Black-Scholes or lattice model. Therefore, updated fair values at year-end and at the vesting date should be based on updated assumptions in those models, including current stock price, volatility, expected term, risk-free rate, dividend yield, and consideration of a sub-optimal exercise factor (in a lattice model). Care should be taken to ensure that expected term appropriately considers moneyness of the options at the new date. The use of historical and/or option-implied volatility should be evaluated for consistency and continued applicability.
- For **performance shares and performance share units (PSUs)**, the fair value calculations may be more complex due to the presence of a performance condition (e.g., the award vests if revenues increase by 15% and EBITDA margin is at least 20%) or a market condition (e.g., the award vests if the registrant's total shareholder return over a three-year period exceeds its peer group by at least 5%). The performance condition will require updated probability estimates at year-end and at the vesting date. Awards with market conditions are typically valued at their grant date using Monte

Carlo simulation and so a reassessment at subsequent dates using a consistent simulation model with updated assumptions will be necessary.

The type of equity awards that have been granted will determine the complexity of the valuation process. Equity-based awards such as stock options might require updated Black Scholes or lattice modeling, while awards with performance or market conditions may require more complex

5. Special Considerations for Market Condition Awards Using Monte Carlo Simulation

Market condition awards come in many different flavors. Three of the most common types of plans include:

- **Market condition based upon performance in the registrant's own stock**. In this plan, vesting might be achieved if the registrant's share price exceeds a certain level for a defined number of trading days or reaches an agreed-upon measure of total shareholder return.
- **Market condition based upon relative total shareholder return**. In this plan, the award vests based upon the registrant's TSR in comparison to a similarly calculated TSR for a broad market benchmark index, an industry index, a peer company, or group of peer companies. Some plans employ a modification factor that adjusts the size of the award based upon varying levels of relative TSR performance.
- **Market condition based upon ranked total shareholder return**. In these plans, award vesting is based upon a numerical ranking of the registrant's TSR against the TSRs of a group of peer companies or all of the companies on a particular broad market or industry index. The numerical or percentile ranking then

determines the modification factor that adjusts the size of the award.

Each of the above plans has inputs and assumptions that drive the Monte Carlo simulation. When performing a subsequent year-end or vesting date fair value analysis, each of the grant-date assumptions will need to be reevaluated. For example, for a relative TSR plan with a three-year term, the subsequent year-end valuations will necessarily have shorter terms (2-year and 1-year), which will require new inputs for volatility and correlation factors. Shorter terms may make the use of option-implied volatility more relevant if sufficient market data is available.

For relative TSR plans that reference a group of companies or an index, some of the peers may have been acquired or merged in the subsequent periods. The plan documentation will often describe the steps to be taken when the composition of the peer group changes or there is a change in the benchmark index. A different group (or number) of companies will affect the correlation assumption as well as the percentile calculations in a ranked plan.

Regardless of the type of plan, it is important for registrants to understand how even a relatively simple award, if granted consistently for a period of years, can lead to a large number of Monte Carlo simulations for this initial proxy season and a significant amount of disclosure complexity.

As shown in Figure 3 below, if a company has made annual PSU grants (with a market condition) for each of the last five years, then up to eight Monte Carlo valuations could be required to calculate the CAP in each period.

FIGURE 3: Illustrative Example of Monte Carlo Valuation Requirements for Initial Disclosure

Illustrative Fact Pattern

Award Type:	Annual PSU Grants with relative TSR market condition
Grant Dates:	January 1 of each year
Term:	3-year terms

			For Initial 3-Year CAP Disclosure		
Grant Year	**Grant Date**	**FYE 2019**	**FYE 2020**	**FYE 2021**	**FYE 2022**
2018	Grant Date 1/1/18	Year-End Val* Monte Carlo #1	Year-End Val Actual Perf		
2019	Grant Date 1/1/19	Year-End Val* Monte Carlo #2	Year-End Val Monte Carlo #3	Year-End Val Actual Perf	
2020	Grant Date 1/1/20		Year-End Val Monte Carlo #4	Year-End Val Monte Carlo #5	Year-End Val Actual Perf
2021	Grant Date 1/1/21			Year-End Val Monte Carlo #6	Year-End Val Monte Carlo #7
2022	Grant Date 1/1/22				Year-End Val Monte Carlo #8

Denotes Monte Carlo valuation required

CAP calculated using actual market performance

**Needed to calculate change in fair value for 2020 CAP*

Click here to expand the example above

In the example above, the blue boxes indicate when a valuation of prior grants would be necessary to calculate the change in fair value for each period of the CAP disclosure. For the final period of a relative TSR market condition plan, the company could use the actual market performance of its stock (and the comparative index) to calculate the expected value of the award.

Registrants should understand that if equity awards have been granted on a consistent basis for a period of years, the new rules could require a large number of historical valuations for this initial proxy season and a significant amount of disclosure complexity.

Summary and Next Steps

While the new SEC Pay Versus Performance disclosure rules can seem daunting, they can be managed with proper planning and a systematic approach. For the CAP disclosures, registrants need to understand the details of all equity awards that have been awarded to named executive

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officers (how many and what type of award). The award characteristics will determine which valuation method is most appropriate and how many valuations need to be performed.

If you have questions about the valuation techniques used for the various types of equity compensation awards or would like to discuss the process, please contact a Mercer Capital professional.

About the Author

Lucas Parris

Lucas Parris leads Mercer Capital's Financial Reporting Valuation Group. He provides public and private clients with fair value opinions and related assistance pertaining to goodwill and other intangible assets, purchase price allocations, stock-based compensation, and ...

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KEY CONTACTS

Lucas Parris, CFA, ASA-BV/IA
(901) 322-9784

parrisl@mercercapital.com

Sujan Rajbhandary, CFA, ABV
(901) 322-9749

sujanr@mercercapital.com

J. David Smith, ASA, CFA
(832) 432-1011

smithd@mercercapital.com

Travis W. Harms, CFA, CPA/ABV
(901) 322-9760

harmst@mercercapital.com

Samantha L. Albert, ASA, ABV

(901) 322-9702

alberts@mercercapital.com

Zachary M. Barber, CPA/ABV

(901) 322-9718

barberz@mercercapital.com

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A deep dive into the long awaited pay-for-performance disclosures

By Mercer's Carol Silverman and Amy Knieriem
Aug. 31, 2022

Twelve years after the Dodd-Frank Act became law and seven years after the SEC initially proposed a rule to implement the mandated pay-versus-performance disclosure, the SEC has approved a **final rule**. The rule requires US public companies to provide a table that (i) discloses the relationship between executive pay and company performance using total shareholder return (TSR), net income and a company-selected performance measure, and (ii) compares company and peer group cumulative TSR performance, each over a five-year period. Companies must describe the relationship of pay to the measures in the table using graphics and/or narrative and also list three to seven important measures that link pay to performance. The disclosure must be included in proxy and information statements for fiscal years ending on or after December 16, 2022. There's a phase-in period for the table so only three years of information will be required for the 2023 proxy. Complying will require new equity award and pension calculations and analyses.

Given how extensive the new disclosures are, companies should quickly take the following steps: form a team of HR, accounting and legal experts, compensation consultants, and pension plan actuaries; identify three to seven performance measures and choose which one to include in the table as the most important measure; implement processes (or build on existing processes) to calculate compensation actually paid and company and peer company cumulative TSR; populate a pro forma table; and consider what conclusions investors might draw and what narrative disclosures would best demonstrate the company's pay-for-performance link.

Highlights

The final rule (new Item 402(v) of Regulation S-K) expands executive pay disclosures by adding a nine-column "pay-versus-performance" table and descriptions of the relationships between a company's actual executive pay and performance, and between cumulative TSR performance of the company and its peer group companies. The disclosure must be in proxy and information statements in which executive compensation disclosure is required.

New table and narratives. Proxies and information statements must include:

- A table showing for each of the five most recently completed fiscal years (subject to a phase-in period):
  - CEO Summary Compensation Table (SCT) total compensation and the total compensation "actually paid" to the CEO (i.e., SCT pay with adjustments to equity and pension values)

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- Average total SCT compensation and compensation actually paid to other named executive officers (NEOs)
- Company's cumulative TSR
- Cumulative TSR of a company-selected index or peer group (weighted according to market capitalization at the beginning of each period for which TSR is reported)
- Company's net income
- Company-selected financial performance measure used to link pay to performance

• Descriptions (using graphs or narrative, or both) of:
  - Compensation actually paid to the CEO and other NEOs compared with the company's cumulative TSR
  - Company's cumulative TSR compared with peer group cumulative TSR
  - Relationship between compensation actually paid and each performance measure

• List of three to seven performance measures most important for linking compensation actually paid to performance

Compensation actually paid is total SCT compensation with adjustments for equity awards and pension values (discussed below).

Scope of the rule

Covered executives. Pay for the CEO (referred to in the rule as the principal executive officer or PEO) is disclosed individually. If a company had more than one CEO during any of the years covered by the table, the total amount paid to each CEO would be reported separately in additional columns (with N/A for years the individual wasn't CEO). But because the identity and number of NEOs varies from year to year, average pay is shown for the remaining NEOs in single column.

Covered years and phase-in period; newly public companies. Companies, other than Smaller Reporting Companies (SRCs), disclose information from the five most recently completed fiscal years. But the requirement to show five years of data is phased in: For the first filing that includes the disclosures, only the most recent three years of information is required. Another year is added in each of the next two filings. For newly public companies, disclosure is required only for years that the company was public and isn't required for Form S-1 "going public" registration statements.

Smaller reporting companies. The disclosures are scaled down for SRCs. SRCs have to provide information for only three years, and don't have to include peer company TSR. As is the case for all SRC filings, covered executives include the CEO and two other NEOs, and pension amounts are excluded. Inline XBRL tagging (discussed below) isn't required until the third year of compliance. For the first filing

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where compliance is required, information for only two years must be provided; another year will be added in the next proxy filing.

Covered companies. The rule covers public companies subject to US executive pay disclosure rules but exempts:

- Emerging growth companies, which provide simplified SCT disclosure and are specifically exempt from the pay-for-performance requirement by the JOBS Act
- Foreign private issuers, which are not subject to US proxy rules
- Registered investment companies, which are typically externally managed and don't have NEOs

There's no exemption for controlled companies.

Pay-versus-performance table and narrative

Pay-versus-performance table. The nine-column table shows CEO compensation and average compensation of the other NEOs, measured two ways — SCT total compensation and compensation "actually paid" — alongside TSR for the company and for a peer group or index, the company's net income and a company-selected performance measure:

Year	Summary Compensation Table Total for PEO	Compensation Actually Paid to PEO	Average Summary Compensation Table Total for Non-PEO NEOs	Average Compensation Actually Paid to Non-PEO NEOs	Value of Initial Fixed $100 Investment Based On:		Net Income	[Company-selected Measure]*
					Total Shareholder Return	Peer Group Total Shareholder Return*		
(a)	(b)	(c)	(d)	(e)	(f)	(g)	(h)	(i)
Y1								
Y2								
Y3								
Y4*								
Y5*								

* Not required for SRCs.

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Footnotes must:

- Explain the equity award and pension values deducted from or added to the SCT total compensation figure to produce the amounts in columns (c) and (e) and any assumptions made in the valuation of equity awards that differ materially from SCT assumptions
- Name each CEO and other NEO included in the table for each year and the fiscal years in which they were included

Narrative or graphic description of pay-for-performance relationship. The company must clearly describe, using the information presented in the table, the relationships between each of the financial performance measures in the table and the compensation actually paid to the CEO and, on average, the other NEOs over the company's five most recently CFYs, as well as the relationship between the company's TSR and the TSR of the companies in its peer group or index. This disclosure has no prescribed format — companies can use graphs or narratives, or both.

List of performance measures. Companies must provide a tabular list naming the three to seven performance measures that the company considers are most important to measure the link between executive compensation and company performance. The list must include the financial performance measure the company chooses for the table's company-selected measure. Companies may also include non-financial measures that they consider to be among their most important measures as long as they list at least three financial measures (or fewer if they use less than three) but can't disclose more than seven in total. Companies may have separate lists for the CEO and other NEOs but each list must separately satisfy these requirements. Except for the most important company-selected measure that appears in the full table, companies don't have to rank or describe the measures, or discuss their relationship to pay.

Financial performance measures include stock price, TSR, and measures presented in accordance with the accounting principles used in preparing the company's financial statements or measures derived from those measures. They don't have to be included in the company's financial statements or SEC filings. All other performance measures are considered non-financial performance measures.

Calculating compensation actually paid

Compensation actually paid is the SCT total compensation figure with adjustments to equity award and pension values. There's no adjustment to any of the other SCT columns or the SCT above-market or preferential earnings on nonqualified deferred compensation value that is in the same SCT column as the pension value. The pension and equity adjustments are intended to align values with "realizable pay".

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Equity-award adjustments. Companies must subtract the grant date fair value reported in the stock awards and option awards columns of the SCT and add or subtract the following:

Award	Calculation
Awards granted in covered fiscal year (CFY) that are outstanding and unvested as of end of CFY	Add year-end fair value
Prior year awards outstanding and unvested as of end of CFY	Add positive (or subtract negative) change in fair value as of end of CFY (from end of prior year)
Awards that are granted and vest in the same CFY	Add fair value as of vesting date
Prior year awards that vest in CFY	Add positive (or subtract negative) change in fair value as of vesting date (from end of prior year)
Prior year awards that fail to meet vesting conditions during CFY	Subtract fair value at end of prior year
Dividends or other earnings paid on all awards in CFY prior to vesting date	Add dollar value, unless otherwise reflected in fair value of award or included in another component of total compensation for CFY
Repriced vested options or stock appreciation rights (SARs)	Add incremental fair value

For performance awards, the number of shares valued as of the end of the CFY is based on the probable outcome of the vesting conditions as of the last day of the year.

Footnotes must include the following:

- Each of the amounts added and deducted due to equity award adjustments
- Any assumptions made in the valuation of equity awards that differ "materially" from those disclosed as of the grant date (when multiple awards are being valued, the footnote may show a range or use a weighted average amount)

Observations. For financial reporting and SCT and Grants of Plan-Based Awards Table purposes, companies show the grant date fair value of equity awards. But to populate the 2023 proxy table with changes in value from one year to the next, companies will need the following year-end fair values for awards that remain outstanding at the end of the CFY and interim fair values for awards that vest or are forfeited during a CFY for each of fiscal years' 2020, 2021 and 2022:

	Granted in CFY	Granted in Prior Years*
Awards outstanding at end of year	Yes	Yes
Awards vested during year	Yes	Yes
Awards forfeited during year	No	Yes

* *To calculate changes in value for 2020, companies will need 2019 values.*

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The complexity of calculating year-end and interim values depends on the types of awards granted:

- Service-based full value awards. The fair value generally equals the stock price times the number of shares underlying the awards.
- Performance shares with "performance" (e.g., earnings per share) conditions. The fair value generally equals the stock price times the number of shares underlying the award that are expected to vest. Companies already (i) adjust accounting expense each quarter based on the number of shares expected to vest and (ii) show the number and value (based on stock price) of shares expected to vest as of the end of the year in the Outstanding Equity Awards Table.
- Performance-based awards with "market" conditions (TSR or stock price). The fair value is the Monte Carlo simulation value (using updated valuation assumptions which already incorporate the number of shares underlying the award that are expected to vest).
- Stock options and SARs. The fair value is the Black-Scholes value (using updated valuation assumptions) times the number of shares underlying the award.

Companies can leverage their current processes but should alert their internal and/or external resources responsible for calculating grant date fair values that they will need additional calculations.

Pension adjustment. Companies must adjust SCT compensation by subtracting the change in the actuarial present value of the executive's defined benefit and actuarial pension plans and adding the following:

Component	Calculation
Service cost	Actuarially determined present value of benefits for CFY
Prior service cost	Entire cost of benefits attributed to services rendered in periods prior to a plan amendment or initiation

Service cost and prior service cost must be calculated using the same methodology and assumptions used for the company's financial statements under US GAAP in accordance with FASB ASC Topic 715. A footnote must include each of the amounts added and deducted due to pension value adjustments.

Observations. Including service cost, instead of the SCT change in actuarial present value for pension benefits, better represents benefits actually earned during the year. This approach removes most of the volatility associated with discount rate and mortality table changes that can significantly affect the SCT value. However, service cost includes an allowance for future pay increases that may never materialize and doesn't fully capture the effect of unanticipated increases or decreases in pay levels.

Prior service cost was added because service cost doesn't fully account for changes in the value of an executive's expected benefit following plan amendments or initiations. However, it might overstate pay for the year because it includes, all in one year, the full impact of a plan amendment or initiation regardless of the period over which the benefits are amortized (although this is also true for the SCT value).

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Companies should alert their actuaries that they will need service cost and prior service cost for each individual NEO for each CFY in the table. Actuaries already provide these amounts on an aggregate basis for all plan participants for financial statement reporting.

Measuring financial performance

The table must include three financial performance measures: TSR, net income and a company-selected financial measure.

TSR. Companies must calculate and compare their cumulative TSR and that of their peers over a five-year "measurement period." Companies can use either the peer group or index used in the performance graph already included in the annual report (under Item 201(e) of Regulation S-K), or the peer group discussed in their CD&A for compensation benchmarking. The measurement period starts as of the market close on the last trading day before the earliest fiscal year covered by the table and runs through the end of the last CFY.

Consistent with the annual report's performance graph:

- The closing price at the start is converted into a fixed investment of $100 in the company's (or each peer company's) stock. For each fiscal year, the amount included in the table is the value of this fixed investment based on the cumulative TSR as of the end of that year. In other words, Y1 includes TSR for just the first year in the table, Y2 is cumulative TSR over two years, etc., so that Y5 includes cumulative TSR over the full five-year period covered by the table.
- If the peer group isn't a published industry or line-of-business index, the names of the companies must be disclosed.
- Each peer company's returns must be weighted according to market capitalization at the beginning of each period for which TSR is reported.
- If the peer group changes, the company must restate all of the years in the table using the new peer group TSR, and explain, in a footnote, the reason for the change, and compare the company's cumulative TSR to that of both the old and new group.

Observations. Companies that use their compensation benchmarking peers for the TSR comparison rather than the same peers as are in the annual report performance graph will have more work to do, particularly if the peer group is frequently updated.

Net income. Companies must report their total net income for each CFY. The SEC believes that, although net income may not be frequently used directly in setting compensation, it's closely related to other profitability measures that are used and is a widely understood and standardized GAAP measure. The SEC also believes it could complement TSR, particularly where a company thinks TSR doesn't fully reflect company performance.

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Company-selected financial measure. Companies must select, from the list of three to seven financial performance measures, the most important financial measure that isn't required to be included in the table but is used to link compensation actually paid to performance for the most recent CFY (i.e., if the most important measures are TSR and net income, the company would have to select a different measure). This financial performance measure doesn't have to be in the company's financial statements or an SEC filing but the company must explain how the number is calculated from the audited financial statements; a formal GAAP reconciliation is not required.

If a company selects a different measure than the one used in the prior fiscal year, the table header would show the new measure and the column would be restated even though the new measure may not have been the most important measure for the entire period covered by the table. The release includes this 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."

Observations. Including a company-selected performance measure in the table and providing a list of three to seven measures gives companies more flexibility to tell their pay-for-performance story but the pay-for-performance comparison in the table is company TSR to peer company TSR, keeping the primary focus on TSR.

Supplemental disclosures

Companies can supplement the required disclosures with additional pay or performance measures or additional years of data if doing so provides useful information about the relationship between pay and company performance. Supplemental disclosures must be clearly identified, not misleading, and no more prominent than the required disclosures.

Observations. Companies may want to explain pay-for-performance disconnects that arise, such as:

- Pay and TSR performance timelines may not align (e.g., long-term incentive awards cover different service or performance periods than the periods shown in the cumulative TSR column).
- If peer companies change, or the company selects a new performance measure to include in the table, prior period performance results are restated using the new peer companies and new performance measure, neither of which applied for those periods.

Finally, the table doesn't compare company pay to peer company pay. At the risk of making proxies even longer, companies may want to supplement the required disclosures with additional metrics and peer company pay comparisons if that would better tell their story.

Disclosure location and tagging

Location. The rule doesn't specify where the disclosures should be located within the proxy or information statement. The disclosures aren't technically part of the Compensation Discussion and Analysis (CD&A), although companies may choose to include them there. But because the disclosures

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— unlike the CD&A — aren't incorporated by reference into Securities Act filings, companies may decide to put them in a separate section to limit liability for disclosure violations.

Inline XBRL tagging. The table and accompanying narrative and graphics must be presented in Inline XBRL — a tagging format already required for Form 10-K financial statements, but a first for proxies. Inline XBRL format is machine readable, making it easier for investors to download and analyze the pay-for-performance data and compare it across companies. The Inline XBRL version will be an exhibit to the proxy or information statement filed with the SEC. Each data element in the pay-for-performance table must be tagged separately, and footnotes and narrative/graphics are block-text tagged.

Action steps

The new disclosures are extensive and will require a lot of work and increase the length and complexity of executive pay disclosures. The rule is effective for the 2023 proxy season so there's no time to waste. To prepare for the new requirements, companies should:

- Form a team of HR, compensation consultants, accounting and legal experts, and pension plan actuaries
- Identify three to seven performance measures and choose which one to include in the table as the most important company-selected measure for the CFY
- Implement processes (or build on existing processes) to calculate compensation actually paid and company and peer company TSR, and consult outside experts as necessary
- Populate a pro forma table
- Monitor policy updates to see whether proxy advisors and investors decide to use the SEC's version of compensation actually paid in their pay-for-performance assessments (e.g., ISS has its own realizable pay calculation)
- Consider what conclusions investors might draw from the disclosure, and what narrative disclosures would best demonstrate the company's pay-for-performance link

Many companies already compare realized or realizable pay, with varying definitions, to company performance in their proxies so this new requirement may be an extension of what companies are already doing. However, the table is prescriptive except for the company-selected measure, not principles-based, so advance preparation will be critical in ensuring the disclosure is compliant. Where companies do have flexibility is in how they discuss the pay-for-performance relationships (e.g., narrative or graphics) and whether they include supplemental disclosures to best tell their own pay-for-performance story.

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Final SEC Rules on "Pay Versus Performance" Significantly Increase Disclosure Obligations for Public Companies

Brandon Gantus, Lori Goodman Nicole Foster, August 29, 2022

On August 25, 2022, the U.S. Securities and Exchange Commission (the **SEC**) issued final rules on the "pay versus performance" disclosure. These rules, which were in process for over seven years, dramatically expand the information that public companies will be required to disclose regarding the relationship between their executive compensation and the company's financial and stock price performance.

Under the final rules, most public companies are required to provide in their annual proxy statement or other information statement covering executive compensation:

- a table featuring their executive compensation (both as reported in the summary compensation table (**SCT**) and adjusted to represent amounts actually paid), their net income, their total shareholder return (**TSR**), the TSR of their compensation peer group, and a financial performance measure chosen by the company (the **Company-Selected Measure**), generally over the last five most recently completed fiscal years;
- a clear description of the relationship between the compensation actually paid to their executives and the financial metrics disclosed in the table as well as the relationship between the company's TSR and the compensation peer group TSR; and
- a table (the **Tabular List**) of the most important performance measures used by the company to link compensation actually paid to the executives to company performance.

These new disclosures must be included with proxy statements or other information statements that cover executive compensation for fiscal years ending on or after

December 16, 2022. For most public companies, including calendar-year public companies whose fiscal year ends on December 31, this disclosure will be required beginning with their next annual proxy statement to be filed with the SEC in 2023.

Considering this short timeline and the significant obligations created by these new rules, companies are strongly encouraged to quickly familiarize themselves with these rules and begin working with their outside advisors to prepare for these burdensome disclosure requirements, including educating board members on the scope and potential impact of the final rules.

I. Background

Section 953(a) of the Dodd-Frank Wall Street Reform and Consumer Protection Act of 2010 added Section 14(i) to the U.S. Securities and Exchange Act of 1934, as amended, which required public companies to disclose in their annual proxy statement information that shows the relationship between executive compensation actually paid and the financial performance of the company.

In 2015, the SEC published proposed rules on "pay versus performance" disclosure, but until recently, no further action was taken on this rule.

In January 2022, the SEC reopened the comment period to solicit additional information on the proposed rules in light of subsequent developments and intervening events. In its reopening release, the SEC asked several new questions signaling the possibility of significant enhancements to the rules that could increase the compliance burden for public companies.

On August 25, 2022, the SEC issued the final rules that create new Item 402(v) of Regulation S-K requiring the "pay versus performance" disclosures described below. The final rules largely incorporate (and, in some cases, expand upon) the proposed rules and themes raised in the SEC's January 2022 reopening release.

II. Key Provisions of the Final SEC Rules on "Pay versus Performance" Disclosure

"Pay Versus Performance" Table

Under the final rules, public companies must include the following "pay versus performance" table in their proxy statement or information statement disclosing executive compensation. This table is intended to show the relationship between the compensation of the company's Chief Executive Officer (**CEO**) and its other named executive officers (**NEOs**) and the financial performance and TSR indicated below for the company's five most recently completed fiscal years.

Year	Summary Compensation Table Total for CEO	Compensation Actually Paid to CEO	Average Summary Compensation Table Total for Non-CEO NEOs	Average Compensation Actually Paid to Non-CEO NEOs	Value of Initial Fixed $100 Investment Based On:		Net Income	Company -Selected Measure *
					Total Shareholder Return**	Peer Group Total Shareholder Return*, **		
Y1								
Y2								
Y3								
Y4*								
Y5*								

** Indicates portions of the final rules from which small reporting companies (**SRC**) are exempt.*

*** Total Shareholder Return, or TSR, is calculated on the same cumulative basis as is used in Item 201(e) of Regulation S-K, measured from the market close on the last trading day before the company's earliest fiscal year in the table through and including the end of the fiscal year for which TSR is being calculated (i.e., the TSR for the first year in the table will represent the TSR over that first year, the TSR for the second year will represent the cumulative TSR over the first and the second years, etc.).*

As indicated in the table above, SRCs are subject to reduced disclosure obligations, including only needing to show the required information for the company's three most recently completed fiscal years.

In addition, to ease the transition to these new requirements, the first year the company is required to provide this disclosure, the table only needs to cover three (or two, in the case of SRCs) fiscal years. Thereafter, the company is required to provide disclosure for an additional year in each of the two subsequent annual filings in which the disclosure is required. Companies are not required to disclose for any fiscal years in which they were not a reporting company under U.S. securities laws.

If more than one person serves as CEO in a given fiscal year, additional columns will need to be added to the table for each person serving as CEO for the fiscal years presented.

- ***"Compensation Actually Paid" Determination***

The “compensation actually paid” to the CEO and, on average, the other NEOs equals the amount in the total compensation column in the SCT, subject to the following adjustments:

- a pension adjustment to include actuarial service cost instead of the change in pension value; and
- an equity award adjustment to deduct the equity award values from the SCT for the most recently completed fiscal year and instead calculate equity award value for that year by applying the following principles:

	Vested during most recently completed fiscal year	Unvested as of end of most recently completed fiscal year	Forfeited during most recently completed fiscal year	Other Impact
Equity Award Granted in Most Recently Completed Fiscal Year	Add fair value as of the vesting date	Add fair value as of last day of most recently completed fiscal year	N/A	-
Equity Award Granted in an Earlier Fiscal Year	Add change in fair value (+/-) as of the vesting date from the last day of the fiscal year immediately before the most recently completed fiscal year	Add change in fair value (+/-) as of the last day of the most recently completed fiscal year from the last day of the fiscal year ending immediately before the most recently completed fiscal year	Subtract fair value as of the last day of the fiscal year ending immediately before the most recently completed fiscal year	-
Equity Award Modified in Last Fiscal Year	-	-	-	Add excess fair value, if any, of any such modified award over the fair value of the original award as of modification date
Dividends or Earnings Paid on Equity Awards in Most Recently Completed Fiscal Year	-	-	-	Add dollar value if not otherwise included in the total compensation in the SCT

In this context, fair value is calculated consistent with the fair value methodology used to account for share-based payments in the company’s financial statements under generally accepted accounting principles (**GAAP**). For performance-based equity awards, the change in fair value as of the end of the most recently completed fiscal year is based upon the probable outcome of such conditions as of the last day of that fiscal year.

The final rules on equity award adjustment for this calculation meaningfully deviate from the proposed rules (which required valuing equity awards based on fair value only on the vesting date). The final rules are expected to create significant burdens on the company to run these calculations.

- ***"Company-Selected Measure" Definition***

  The "Company-Selected Measure" is determined by the company and should represent the most important financial performance measure (that is not otherwise required to be disclosed in the "pay versus performance" table) used by the company to link compensation actually paid to the NEO for the most recently completed fiscal year to company performance. This measure must be included in the Tabular List and quantified in the "pay versus performance" table. This measure can change from year-to-year. See "Tabular List" discussion below.

Explanatory Disclosure to "Pay versus Performance" Table

Public companies must also include additional disclosure to explain the data presented in the "pay versus performance" table and the relationship between:

- The compensation actually paid to the CEO and, on average, its other NEOs and each of the company's TSR, net income, and Company-Selected Measure for the fiscal years presented in the table; and
- The company's TSR and the peer group's TSR for the fiscal years presented in the table.

This explanatory disclosure may be presented through graphs, narrative description, or a combination of the two. The company may group any of these explanatory disclosures as long as any combined description of the multiple relationships is clear.

Tabular List

Public companies also must provide a Tabular List in their proxy statement or information statement disclosing executive compensation. This list generally must include an unranked list of between three and seven performance measures that the company believes are the most important performance measures used by the company to link compensation actually paid to the executives to company performance during the company's most recently completed fiscal year.

At least three of these performance measures must be financial performance measures.

However, if the company has fewer than three financial performance measures to link compensation actually paid to their executives for the most recently completed fiscal year to company performance, the Tabular List only needs to include the actual measures that were used, if any. This clarification is expected to provide helpful relief for many newly public companies, particularly those in the life sciences industry who generate minimal or no revenue, and whose business is primarily focused on drug-development and distribution and less on financial performance.

At the company's discretion, the Tabular List may be one combined list, one list for the CEO and one list for all other NEOs, or a separate list for the CEO and each NEO. Companies may cross-reference other parts of the proxy (e.g., CD&A) where performance measures are otherwise described.

Covered Companies

These disclosure requirements apply to all U.S. listed public companies, except emerging growth companies, registered investment companies, and foreign private issuers. In addition, as noted above, SRCs are subject to reduced disclosure requirements under this rule.

Supplemental Disclosure Permitted

Companies generally may provide additional pay-versus-performance information beyond what is specifically required, so long as doing so would not be misleading and would not obscure the required information.

III. Key Takeaways and Action Items

Administratively Burdensome Obligations for Satisfying Disclosure Requirements

The computations required to complete the new "pay versus performance" table are likely to present meaningful challenges for most companies, including:

- The equity award adjustment calculation that is required to determine the "compensation actually paid" to the CEO and other NEOs involves unorthodox calculations and comparisons that most companies historically have not

performed. These calculations require producing and monitoring historical values for equity awards granted over several prior fiscal years that the company likely has not been tracking for its executives.
- Many companies have not historically tracked their TSR or the TSR of their compensation peer group, and even if they have, they may not have performed the TSR calculations as the final rules prescribe. As a result, companies will need to perform these complex calculations for several prior fiscal years to satisfy their disclosure obligations.

Companies and their finance teams would be well-advised to begin collecting the necessary information for making these disclosures.

Potential Inconsistency Between Company Business Goals and Results of "Pay versus Performance"

The new "pay versus performance" disclosure emphasizes the company's performance in net income and TSR (on an absolute and relative (as compared to its compensation peer group) basis)). For many public companies, these metrics historically have been de-emphasized in favor of other criteria designed to drive the growth in the business. For example, it is not uncommon for high-growth technology companies to weight "top-line" metrics (e.g., revenue or EBITDA) in their incentive compensation program in order to incentivize growth and expansion of the business. Similarly, early-stage life science companies are often focused on drug development and distribution. In each case, these companies may have little to no net income, but provide competitive executive compensation that rewards achievement of key business milestones.

The results of the "pay versus performance" disclosure for these and other public companies could lead to confusion among investors regarding the executive's pay as compared to how the company performs against metrics that its board (and, in many cases, its investors) identify as important for the business.

The inclusion of a "Company-Selected Measure" in the "pay versus performance" table is expected to mitigate the effects of this issue. However, it remains to be seen how strongly investors will weigh the "Company Selected Measure" particularly since companies have the ability to change the measure from year to year.

Uncertain Impact on Executive Compensation Design and Objectives

The final rules require public companies to disclose items that, in many cases, they have not publicly disclosed, including:

- The relationship of their executive compensation to net income and TSR; and
- The identification of the most important performance measures used in setting compensation for the most recently completed fiscal year.

It remains to be seen whether these disclosures will change executive compensation design and the metrics that public companies use to incentivize and reward their executives.

- Will public companies that have not historically used net income or TSR in their incentive compensation plans start incorporating one or more of these metrics to better align their executive compensation with achievements of these metrics?
- Will companies identify environmental, social, and corporate governance (**ESG**) metrics in their Tabular List? While ESG initiatives have been a focus of institutional investors in recent years, many public companies, particularly technology companies, have been slower to incorporate ESG metrics into their incentive compensation plans given the challenges of identifying the appropriate ESG metrics and potential accounting ramifications. The Tabular List disclosure presents an opportunity for companies to highlight their ESG goals and achievements without using them as metrics in their incentive compensation plans.
- Will investors react to these additional disclosures by providing more feedback to companies on their compensation programs and design that could further alter the process and structures of executive compensation?

Potential Institutional Investor Reaction

Many institutional investors and proxy advisory firms (e.g., ISS and Glass Lewis) are likely to favor the additional disclosure that these rules require because they provide more information to investors. It remains to be seen how these investors and advisory firms will react to companies' "pay versus performance" disclosures.

- How will the disclosures impact their votes and recommendations on proxy proposals on board members, "say on pay," and other compensation-related

proposals?
- Will these investors and advisory firms designate preferred performance measures (financial and/or non-financial) that companies should use as being the "most important" for purpose of the Tabular List?
- Will these investors and firms prescribe ranges of ratios between executive compensation and the performance disclosed in the "pay versus performance" table that they deem appropriate?

Additional Burdens on Compensation-Setting and Determinations Process for Board Members

The final rules also are expected to create additional burdens for boards of directors and compensation committees:

- While the new rules do not require that the "pay versus performance" disclosure be included in the compensation discussion and analysis section of the proxy statement, the new disclosures will nonetheless require careful review and oversight by board members each year before they are included in the company's proxy statement or other information statement.
- As part of the new disclosures, the company is required to make subjective assessments of the "most important" performance measures to include in the Tabular List and, from this list, to identify the "Company-Selected Measure" to include in the "pay versus performance" table. For many boards and compensation committees, these will be new decisions, and will add another layer to an already-complex process of setting and determining executive compensation. Given that these determinations will be expected as soon as the next proxy statement, public companies are encouraged to begin speaking to their board and compensation committees, and their advisors, soon so that they can make these new decisions in a timely manner.

For more information on these final rules or any related matter, please contact a member of the U.S. executive compensation and benefits group.

Governance & Securities Alert

Weil

From the Public Company Advisory Group of Weil, Gotshal & Manges LLP

January 19, 2023

Heads Up for the 2023 Proxy Season: Key Disclosure and Engagement Topics

In today's stakeholder-centric landscape marked by global economic and political uncertainty, the pressures on public company boards and management to address the demands of a myriad of constituencies and the ever-evolving regulatory landscape are greater than ever. In this Alert, we highlight some of the key disclosure and engagement topics for the 2023 proxy season.

Key Topics for Consideration for 2023 Proxy Season and Beyond

Executive Compensation and Human Capital Disclosure

- Pay Versus Performance
- Clawbacks
- Human Capital Management and Diversity, Equity and Inclusion

Board Governance: Leadership, Composition and Diversity

- Board Leadership and Risk Oversight
- Board Composition, Diversity and Skills
- DOJ Enforcement Sweep: Interlocking Directorates
- DGCL Amendments Permitting Officer Exculpation

ESG Oversight and Disclosure

- Continued Focus on ESG "Story" and Board Oversight
- ESG Enforcement and Greenwashing

Annual Meetings

- Universal Proxy
- Shareholder Engagement
- Rule 14a-8 Shareholder Proposals

Other Annual Meeting Considerations

Executive Compensation And Human Capital Disclosure

Pay Versus Performance. The most challenging new SEC requirement affecting companies for this proxy season likely is the new pay-versus-performance (PvP) disclosure. The PvP disclosure must be included in proxy and information statements in which executive compensation disclosure is required for companies with a fiscal year ended on or after December 16, 2022. Emerging growth companies, foreign private issuers, and registered investment companies are not subject to this new requirement. PvP disclosure will add several additional pages to the proxy statement, involve considerable additional time and analysis to prepare, and require input from the company's compensation committee and likely from a third party valuation consultant, as well as advice from a compensation consultant and legal counsel.

The new rule (Item 402(v) of Regulation S-K) mandates a new table that will disclose the following:

- For the principal executive officer (PEO) and for the other named executive officers (NEOs), as an average, the existing total compensation measure reflected in the Summary Compensation Table.
- For the PEO and for the other NEOs, as an average, a new measure – compensation actually paid (CAP) – which is to be calculated in accordance with the rule.
- The cumulative total shareholder return (TSR) of the company based on the value of a fixed investment of $100 and calculated in the same manner as in the stock performance graph required under Item 201(e) of Regulation S-K.
- The cumulative TSR of the company's peer group using either (i) the same peer group used for the stock performance graph required under Item 201(e) of Regulation S-K or (ii) the peer group used in the Compensation Discussion & Analysis (CD&A) for the purposes of disclosing the company's compensation benchmarking practices. If the peer group is not a published industry or line-of-business index, the identity of the companies included in the group must be disclosed in a footnote. If a company changes the peer group from the one used in the previous fiscal year, it will only be required to include in the PvP table the peer group TSR for that new peer group (for all years in the table), but must explain, in a footnote, the reason for the change, and compare the company's TSR to that of both the old and the new group.
- The company's net income.
- A self-selected financial performance measure that is the "most important" measure the company uses to link the CAP for the most recently completed fiscal year to company performance.

Accompanying the table will be a significant number of footnotes with additional required disclosures. Companies are finding that one of the most complex and arduous aspects of the new rule is the calculation of the CAP, which, among other things, requires many different valuations of equity-based compensation previously awarded to the NEOs.

Calculating the CAP requires taking the total compensation as reported in the Summary Compensation Table and adjusting the amounts used for equity awards and pension values. The PvP table requires companies to calculate the value of equity awards by calculating the end-of-year value of awards granted in the covered fiscal year plus, among other things, the change in the fair value of unvested awards granted in prior years, regardless of if, when or at which intrinsic value they will actually vest (not the grant date fair value or the dollar value realized upon vesting).

PvP disclosure also requires a clear narrative description of the relationships between each of the financial performance measures included in the table and the CAP to its PEO and, on average, to its other NEOs and a description of the relationship between the company's TSR and the TSR of the company's self-selected peer group. Companies likely will satisfy these "relationship" disclosures through a combination of graphs, tables, and narrative.

For all companies subject to the rule (other than smaller reporting companies (SRC)), the rule requires a tabular list of between three and seven of the company's "most important" financial performance measures used in the most recently completed fiscal year to link the CAP with company performance. The list may include non-financial measures so long as at least three measures included are financial measures, and the list must include the company-selected financial performance measure included in the pay-versus-performance table.

There is a two-year phase-in period allowing most companies to begin with three years of PvP disclosure in the first year of the rule, increasing each year to include data for five years (except that SRCs may begin with two years of data and then phase-in to three years of data so long as they meet the SRC requirements). Newly reporting companies do not need to include PvP information for fiscal years prior to their first completed fiscal year as a reporting company.

What to Do Now:

- **Coordinate Key Function Areas.** The PvP rule is a significant and highly technical new disclosure obligation for public companies, and as such will require input and coordination across various areas of the company that could include finance, human resources, legal and investor relations, as well as outside advisors, such as compensation consultants, equity valuation experts and legal counsel. The disclosure and related calculations can be very time-intensive, especially with respect to valuation of stock options and performance-based equity awards.
- **Determine PvP Peer Group.** Companies should seek the input of the compensation committee's independent compensation consultant when selecting the PvP peer group. Any changes to the peer group could impact TSR disclosure. Companies should consider preparing a pro forma TSR calculation reflecting both the performance graph index peer group and the CD&A benchmarking peer group to help in the selection decision with their compensation committees, and also reconsidering critically the previously selected peer groups. Our expectation is that many companies likely will use their performance graph peer group since the peer group disclosed in the CD&A can only be used for the PvP disclosure if that peer group was used for "benchmarking" purposes.
- **Identify "Company-Selected Measure" and Tabular List Measures.** Companies should be focusing on identifying the "most important" performance measures, including the company-selected measure. Given that companies already discuss pay for performance in CD&A, they should take care to ensure that the measures identified align with that discussion and the compensation committee's views. The compensation committee and independent compensation consultant should be involved in determining and approving the appropriate performance measures for the Company-Selected Measure and the Tabular List.
- **Analyze Requirements for Calculating "Compensation Actually Paid."** The devil is in the details, and there are many to consider in this rule. Among these include how to derive CAP from the compensation amounts included in the summary compensation table, especially when it comes to valuing stock-based awards and pension values. Compensation teams should review these new rules and engage with internal and external accounting, compensation and valuation experts.
- **Consider Internal Controls.** Companies must also consider what, if any, additional internal controls and processes they may need to put in place regarding valuations needed for the PvP table, including the assumptions used in determining fair value of existing equity awards.
- **Impact on Say-on-Pay.** Although Item 402(v) disclosure will be treated as "filed" for the purposes of the Securities Exchange Act of 1934, as amended (the "Exchange Act") and will be subject to the say-on-pay advisory vote under Exchange Act Rule 14a-21(a), the effect the new PvP disclosures may have on investor voting remains to be seen and will likely develop over time. Thus far, neither ISS nor Glass Lewis have adopted voting policies for 2023 relating to PvP.

- **XBRL.** Note that inline XBRL tagging is required for PvP disclosure, which can add additional time for design and formatting. Companies should ensure sufficient time, especially if using notice and access or if a preliminary proxy statement filing is required.

Clawbacks. As we discussed in our prior Alert, the SEC has adopted rules directing the stock exchanges to adopt requirements for listed companies to develop, implement and comply with written recoupment or "clawback" policies, or be subject to delisting. Companies listed on NYSE and Nasdaq will be required to adopt and comply with written "clawback" policies requiring the recovery of erroneously awarded incentive compensation from current or former executive officers who received such compensation during the three fiscal years preceding the date on which the listed company is required to prepare an accounting restatement due to material noncompliance with any financial reporting requirement. In stark contrast to clawback policies that most companies currently have, the new rule requires that listed companies must adopt a clawback policy for executives that will leave little discretion to the board of directors, apply irrespective of misconduct, and be triggered by both "Big R" and "little r" restatements. The requirements will apply to all listed companies, including foreign private issuers, controlled companies, and debt-only issuers. The rules also require listed companies to provide disclosure about such policies and how they are being implemented. Listed companies also will have to file their policy as an exhibit to their annual report and disclose how they have applied the policy as well as use Inline XBRL to tag their compensation recovery disclosure.

What to Do Now:

- **Monitor Compliance Dates and Develop a Compliant Policy.** The SEC's rules were published in the Federal Register on November 28, 2022, which means that the stock exchanges must propose their listing standards by February 27, 2023, and the final listing rules must become effective no later than November 28, 2023. A listed company will be required to adopt a compliant clawback policy no later than 60 days following the date on which the applicable listing standard becomes effective. The stock exchanges will have very limited ability to vary from the prescriptive SEC rule, and accordingly, companies need not wait until the exchanges' listing rules are proposed and approved prior to developing policies.
- **Consider Clawback Program Holistically; Review Existing Clawback Arrangements.** Companies should consider these new requirements holistically, as part of their compensation program and risk assessment in order to evaluate the risk profile of the executive compensation program. Companies that have already adopted clawback or recovery policies should begin to review such policies to determine whether changes will be necessary to existing polices or forms of employment or award agreements.
- **Consider More Expansive Policy.** New Rule 10D-1 sets out the minimum requirements that a clawback policy must meet. Companies may wish to adopt clawback polices that are more expansive and cover matters beyond restatements, including situations involving employee misconduct leading to reputational damages to the company or breaches of company codes of conduct and policies.

Human Capital Management. Amendments to Item 101(c) of Regulation S-K that became effective November 9, 2020, require companies to disclose in the Form 10-K information about material human capital resources, measures or objectives that management focuses on in managing its business. Because the SEC has not defined the term "human capital management," companies take a variety of approaches to comply with the disclosure rule. Generally, companies have included disclosure relating to workforce composition and demographics, talent and succession planning, employee compensation, COVID-19 pandemic response, diversity, equity and inclusion in the workplace, and employee training and retention. A greater number of companies have begun to disclose future goals and measures. We can expect further rulemaking from the SEC in 2023 mandating additional human capital management disclosures, including relating to workforce diversity and corporate board diversity. Moreover, human capital management remains a strategic priority for management and the board, as well as a key engagement priority for investors. In addition to critical health and safety concerns relating to the pandemic, the range of human-capital issues for management to tackle includes employee retention, compensation, training and development, diversity and inclusion, and adapting the workforce to remote environments.

What to Do Now:

- **Continue to Evaluate Human Capital Issues and Disclosure.** Companies should continue to evaluate the human capital and diversity issues that are material to their businesses and stakeholders, including employees, shareholders, communities, and regulatory constituencies. Companies should review disclosure regarding their commitment to human capital issues and ensure that their underlying policies align with their public commitments and disclosure.
- **Consider Board and Committee Oversight.** Ensure that the board of directors, or a committee of the board, is expressly responsible for oversight of human capital issues, such as pay equity, culture, health and safety, and diversity, equity and inclusion. Many companies have been adding these oversight responsibilities to the responsibilities of the compensation committee. If the role of the compensation committee expands, consider updating the committee name to reflect this expanded scope of responsibility.

Board Governance: Leadership, Composition, Diversity

Board Leadership and Risk Oversight. In 2022, the SEC Staff issued a series of comments to a number of companies requesting specific and targeted information focused on enhancing disclosure of board leadership structure and the board's risk oversight function as required by Item 407(h) of Regulation S-K. See the box below with examples of these SEC Staff comments. In these comments, the Staff requested disclosure that extends far beyond the specific mandate of Item 407(h), and some companies are finding the questions posed divorced from the reality of the boardroom. In advance of the 2023 proxy season, companies should take a critical review of proxy statement disclosure on the board's leadership structure and risk oversight functions and evaluate whether such disclosure is meaningful and specific to the company's facts and circumstances, rather than boilerplate. We anticipate that even companies that have not received this comment will be enhancing disclosure around these items.

SEC Staff Comments on Board Leadership and Risk Oversight

Board Leadership

- Expand discussion of the reasons the company believes that its leadership structure is appropriate as opposed to an alternative structure
- Address circumstances under which the company would consider having the chair and CEO roles filled by a single individual (if currently held by two) or vice versa, and if the change were to occur, would shareholders be notified or given a chance to provide input into this decision
- Explain the role of the lead independent director or the independent chair in the leadership of the board, and why this structure is utilized
- State who may represent the board in communications with shareholders and stakeholders
- Explain if the board's vote is required to override the CEO or if the chair may do so on any risk matters
- Address whether the chair may provide input on the design of the board itself
- Elaborate on the extent of the board's role in risk oversight and the effect that this role has on the board's leadership structure

Risk Oversight

- Consider the role of the board in providing oversight of risk
- Disclose the timeframe over which the company evaluates risks (i.e. short, intermediate or long term)
- Discuss the different standards used to evaluate risks based on the immediacy of the risk assessed
- Avoid boilerplate disclosure of risk and uncertainties your company is facing
- Update potential future risk disclosure frequently
- Include whether the company consults with outside advisors and experts to anticipate future threats and trends
- Provide insight into how frequently the company re-assesses its risk environment
- Discuss how the board interacts with management to address existing risks and emerging risks
- Identify the company's chief compliance officer, if any, and to whom this person reports
- Ensure that the risk oversight disclosure adequately reflects the material risks disclosed in your financial report filings

What to Do Now:

- **Enhance Disclosure of Board Leadership and Risk Oversight.** These SEC Staff comments make abundantly clear that board leadership and risk oversight disclosures are priority areas for scrutiny. Companies that have received a comment letter have generally responded that they will address the comments in their future SEC filings. Moreover, it would also be prudent for all companies to review existing proxy statement disclosures and evaluate whether such disclosure could be enhanced to address some of the comments, as applicable.
- **Consider Board Self-Assessment Process.** A robust board and committee self-evaluation process can contribute to the discussion around the leadership roles of the board chair, CEO, and/or lead director, as appropriate, as well as the effectiveness of the board's risk oversight function. Companies should consider addressing these topics in their next board self-evaluation process.

Board Composition, Diversity and Skills. Board composition remains a focal point for investors and regulators alike. Although legislation seeking to mandate board diversity has seen setbacks in states like California, market forces continue to demand and influence greater board diversity, including through the voting policies of ISS and Glass Lewis, as well as institutional investor engagement priorities, and the Nasdaq diversity rules. See below for these diversity policies at-a-glance. The SEC's regulatory agenda for 2023 also includes proposed rule amendments to enhance disclosure around board diversity. As a result, companies are continuing to focus on enhancing board diversity. For the 2023 proxy season, we expect an increase in the use of skills and diversity matrixes and other methods of enhanced disclosure of board composition and diversity. This trend is to be expected, in part, as a result of Nasdaq's disclosure requirement, as well as shareholder proposals and letter writing campaigns requesting that companies provide a tabular disclosure of the board's skills and diversity characteristics. The SEC's proposed cybersecurity and climate change disclosure rules, when finalized, will likely impose additional requirements on disclosure relating to board composition, which companies should begin to consider in evaluating board skills, composition and future recruiting efforts.

Diversity Policies At-A-Glance

ISS

ISS will generally vote against or withhold from the chair of the nominating committee (or other directors on a case-by-case basis) where a board does not have:

- At least one gender diverse director at Russell 3000 or S&P 1500 companies for annual meetings held on or after February 1, 2022
- At least one racially/ethnically diverse director at Russell 3000 or S&P 1500 companies for annual meetings held on or after February 1, 2022
- At least one gender diverse director at all companies for annual meetings held on or after February 1, 2023

Glass Lewis

Glass Lewis will generally recommend against the chair of the nominating committee where a board does not have:

- At least two gender diverse directors at all Russell 3000 companies for annual meetings held on or after January 1, 2022
- At least one gender diverse director at all companies with six or fewer directors for annual meetings held on or after January 1, 2022
- At least 30% gender diverse directors at all Russell 3000 companies for annual meetings held on or after January 1, 2023
- Following state law mandates on board diversity for annual meetings held on or after January 1, 2022

For Nasdaq-Listed Companies (updated as of December 14, 2022)

Nasdaq-listed companies are required to do the following, subject to a one-year phase-in for newly public companies and a grace period for vacancies:

- Disclose in proxy statement or on website the Nasdaq-required board matrix
- Have one diverse director or explain why none (including boards with five or fewer directors) by December 31, 2023
- For boards with six or more directors, have two diverse directors or explain why not by December 31, 2025, for companies listed on the Nasdaq Global Select Market or Nasdaq Global Market, and by December 31, 2026, for companies listed on the Nasdaq Capital Market

What to Do Now:

- **Continuously Refresh Skills and Composition "Gap" Analysis.** The board should continue to evaluate its composition, including its leadership, competencies, independence, diversity, tenure and effectiveness, to determine whether it aligns with the company's strategic objectives. Further, boards should continuously and carefully reassess the skills and qualifications of directors to ensure that they have the right directors to meet the evolving needs and strategic direction of the company. Assess the board through the eyes of an activist investor to determine vulnerabilities and skills gaps on the board. Ensure that the skills highlighted in the company's skills matrix or other forms of skills disclosure are aligned with the company's disclosure around its strategy.

- **Review Diversity Disclosure.** Ensure that proxy statement disclosure is clear about the company's policies around board diversity and the existing composition of the board. Although many companies still prefer to aggregate diversity disclosure as a total number or percentage of the board, we expect to see more companies disclosing diversity characteristics of individual directors in light of recent shareholder proposals and letter-writing campaigns seeking such disclosure.
- **Update D&O Questionnaires.** Consider how to best obtain information from directors regarding their diversity and backgrounds, including by making updates to D&O questionnaires. In advance of the SEC's proposed climate change and cybersecurity disclosure rules, companies are starting to add questions regarding background, qualification and expertise in climate and cyber to their questionnaires in order to gauge existing expertise.
- **Monitor Legal Requirements and Consider Director Recruitment.** In light of SEC's proposed climate and cybersecurity rules, which would require companies to disclose to what extent board members possess cybersecurity expertise and whether any board member has expertise in climate-related risk, companies should begin to assess whether any director currently possess such skills, or whether such skills are necessary for near term recruitment. Companies may wish to consider asking directors to provide information about specific courses or certifications or other experience that they have that would support their expertise in areas such as ESG, climate or cybersecurity.
- **Understand ISS and Glass Lewis in Director Elections.** As discussed in our prior Alert, ISS and Glass Lewis policy updates for the 2023 proxy season focused on the accountability of the board of directors and its committees for climate, diversity and ESG oversight. Companies should familiarize themselves and their boards with the new and updated policies, which will influence the results of director elections and support for shareholder proposals in the 2023 proxy season.

DOJ Enforcement Sweep: Interlocking Directorates. The Department of Justice has recently emphasized its enforcement of Section 8 of the Clayton Act, which prohibits an individual from simultaneously serving as an officer and/or director at competing companies if the companies satisfy certain economic thresholds established by the Clayton Act. In April 2022, DOJ Assistant Attorney General Jonathan Kanter put companies on alert that the DOJ is "ramping up efforts to identify violations . . . , and [we] will not hesitate to bring Section 8 cases to break up interlocking directorates." The DOJ announced in October 2022 that seven directors at five companies resigned following DOJ inquiries.

What to Do Now:

- **Establish Controls and Enforce Notification Policies for Service on Other Boards.** Companies should establish appropriate controls around the notification and evaluation of new directorship for its officers and directors, or the change of primary employment of directors. For example, often company policies require employees to request permission to join a board, and directors to notify the board chair or nominating committee chair in advance of joining a new board or upon a change in primary employment, each of which can serve as an alert to potential conflicts of interests and interlocks issues.
- **Review and Update D&O Questionnaires.** In addition to establishing and enforcing companies' policies, D&O questionnaires can also serve as an important tool for identifying potential interlocks. A question requesting a list of all public, private and not-for-profit boards where directors and officers serve can assist the company in ensuring that it has all of the information to evaluate potential interlocks, related party transactions and any other actual or potential conflicts.

DGCL Amendments Permitting Officer Exculpation. Effective August 1, 2022, Section 102(b)(7) of the Delaware General Corporation Law (the "DGCL") was amended to authorize the exculpation of certain senior officers from personal liability for monetary damages for breaches of the fiduciary duty of care for direct claims only (not derivative claims). Historically, officers have been the target of stockholder litigation where exculpation has not been available. The amendments provide officers with similar protections as previously available only to directors,

except directors may also be exculpated for derivative claims. If a Delaware corporation wishes to implement officer exculpation as now permitted by the DGCL, the board will need to approve and recommend to stockholders for approval an amendment to the certificate of incorporation and receive the requisite stockholder support. Although we expect to see a number of companies seek stockholder approval of an amendment to provide for officer exculpation during the 2023 proxy season, many companies are adopting a "wait and see" approach this year. No doubt that one reason for this approach might be that a "preliminary" proxy statement filing with the SEC would be required for this proposal, likely accelerating the timetable for the preparation of the proxy statement in a year that companies already may be very busy with the new PvP disclosure requirement.

What to Do Now:

- **Analyze Potential for Support of Amendment Proposal.** Companies should consider engaging a proxy solicitor to assist in evaluating the potential support for this proposal, especially given that the required vote threshold is at least a majority of the outstanding shares under Delaware law and brokers cannot vote uninstructed shares. Proxy solicitors can also assist with understanding the voting behaviors of the stockholder base and soliciting "retail" stockholders.
- **Provide Clear Disclosure and Engage with Investors.** Companies seeking to implement officer exculpation as a result of the DGCL amendments should provide clear and reasoned disclosure of why they are doing so. ISS's policy provides that it will recommend case-by-case on proposals on director and officer indemnification, liability protection, and exculpation in consideration of the stated rationale for the proposed change and other factors, including the extent to which the provision will eliminate liability for monetary damages for violations of the duty of care or duty of loyalty. Glass Lewis's policy provides that it will closely evaluate proposals to adopt officer exculpation provisions on a case-by-case basis and will generally recommend voting against eliminating monetary liability for breaches of the duty of care for officers, unless a compelling rationale for the adoption is provided by the board. To date, ISS has generally recommended in favor of these proposals, while Glass Lewis has recommended against at least one proposal since its policy became effective for meetings held after January 1, 2023.

Environmental, Social And Governance (ESG) Oversight And Disclosure

Continued Focus on ESG "Story" and Board Oversight. ESG continues to dominate the engagement priorities of institutional investors. Investors and the SEC are reviewing company disclosures to understand their commitment and approach to overseeing risks relating to climate change, sustainability and social responsibility matters. In particular, they are looking for measurable results that demonstrate commitments and related oversight. Accordingly, many companies have enhanced disclosure in their proxy statements by highlighting board oversight of ESG, including specific allocations across committees, disclosure in alignment with the Task Force on Climate-related Financial Disclosures (TCFD) and Sustainability Accounting Standards Board (SASB) frameworks, identifying priorities and measurable goals and highlighting progress toward such goals and how the company has been recognized by third parties.

Board oversight of ESG matters continues to be an increasingly complex and scrutinized topic for investors and regulators. An increasing number of companies continue to review and refresh their board guidelines and committee charters to clarify the board's oversight of ESG-related matters and enhance disclosure in their proxy statements by highlighting board and committee oversight responsibilities on these matters.

What to Do Now:

- **Enhance disclosure around board and committee accountability and oversight of ESG.** Companies should review and update disclosure relating to oversight of ESG initiatives and how ESG is linked to company-wide strategic planning decisions wherever relevant.

Beginning in 2023, Glass Lewis will generally recommend voting against the chair of the governance committee of companies in the Russell 1000 index that fail to provide explicit disclosure concerning the board's role in overseeing environmental and/or social issues.

For companies in the Russell 3000 and instances where Glass Lewis identifies material oversight concerns, Glass Lewis will review a company's overall governance practices and will identify which directors or committees have been charged with oversight of environmental and/or social issues. When evaluating a board's role in overseeing ESG, Glass Lewis will examine a company's proxy statement and governing documents (such as committee charters) to determine if directors maintain a meaningful level of oversight of and accountability for a company's material environmental and social impacts.

As discussed in our prior Alert, ISS and Glass Lewis are holding boards accountable for risk oversight of climate change and related risks. Boards should educate themselves on the policies of key shareholders. In 2023, ISS will generally recommend voting against directors at companies in the Climate Action 100+ Focus Group list if the company does not have adequate climate risk disclosure, based on TCFD standards, and the company does not have either medium-term GHG emissions reduction targets or Net Zero-by-2050 GHG reduction targets for its operations (Scope 1) and electricity use (Scope 2). Similarly, starting in 2023, Glass Lewis will recommend against responsible directors in the absence of clear and comprehensive disclosure in line with TCFD standards regarding climate risk mitigation and oversight at companies where GHG emissions represent a financially material risk. ISS ESG, the responsible investment arm of ISS, recently added 23 new factors to its Governance QualityScore, building out its analysis in seven different areas, including information security, director skills, director and executive pledging, emerging risk oversight, DEI, and pay-for-performance.

- **Understand and Be Prepared to Engage with Major Investors; Consider ESG Skills and Experience.** Companies should expect and be prepared to continue to engage with stakeholders on various ESG matters. In their recently published proxy season voting and engagement guidelines, major institutional investors such as BlackRock, State Street, Vanguard and others have identified ESG issues as some of their most significant engagement priorities. Furthermore, companies should be prepared to discuss and highlight skills and expertise, if any, of board members that help illustrate their ability to oversee ESG risks facing the company and its industry.

ESG Enforcement & Greenwashing. The SEC's focus on ESG-related issues has implications for public companies that tout their ESG bona fides. The SEC has clearly signaled that "greenwashing" is a top priority for the agency's Division of Enforcement. Furthermore, if adopted, the SEC's March 2022 proposed climate change disclosure rules will require public companies to provide detailed information about potential financial risks related to climate change and greenhouse gas (GHG) emissions.

What to Do Now:

- **Be Mindful of ESG Commitments and Disclosures.** Companies should regularly review their ESG-related commitments and disclosures to support the accuracy and verifiability of statements made in SEC reports, on websites, in sustainability reports and representations regarding products in marketing materials, and to regulators. If any issues or inconsistencies are identified, consider the best approach for proactively getting out in front of such issues, which can cause reputational damage, as well as legal and regulatory challenges.
- **Ensure Disclosure is Consistent.** Companies preparing ESG or sustainability reports should ensure that disclosure in such reports is consistent with Form 10-K and proxy statement disclosure and across the company's communications platforms and SEC filings. Companies should also review the SEC Division of Corporation Finance's published Sample Comment Letter containing comments that the Staff intends to issue to companies regarding their climate change disclosure. For example, one comment requests an explanation of what consideration the company gave to providing the same type of climate-related disclosure in the company's SEC filings as the company included in its corporate social responsibility (CSR) report.

Universal Proxy. As discussed in our prior Alerts available here and here, this will be the first full proxy season where, in a contested election of directors, the company and the shareholder activist will use a "universal" proxy card (i.e., a proxy card that includes the names of both parties' nominees), as required by new SEC Rule 14a-19, which took effect for meetings after August 31, 2022. Subject to some minor procedural requirements, activists therefore now have easier access to a company's proxy card without the minimum ownership requirements or guardrails on the types of proposals that they can put forth required by other means of access – e.g., proxy access and the Rule 14a-8 shareholder proposal system, respectively.

The SEC also adopted other proxy disclosure requirements and updates at the same time as it adopted of the universal proxy rules. The SEC updated Rule 14a-4(b) to require proxy cards for all director elections to include an "against" option, rather than a "withhold authority" to vote option if the company's state law gives legal effect to votes cast against a nominee. In a majority voting situation, shareholders must be given the option to "abstain" when they do not support any nominee, rather than "withhold authority." Companies must also clearly identify in their proxy statements how votes will be counted and the treatment of all votes, including the "withhold" option, if provided. The SEC also updated Rule 14a-5(e) to require proxy statements to state the deadline for a potential insurgent's notice of a solicitation of proxies in support of its director nominees pursuant to Rule 14a-19.

- **Be Prepared for Activists.** The likelihood of activist campaigns may increase because the price of entry onto the company's proxy card under this rule is low.
- **Review the Qualifications of Each Board Nominee.** Companies should carefully review, through an activist's lens, the qualifications, attributes and potential vulnerabilities of each board nominee in the context of the overall composition of the board.
- **Review Advance Notice Bylaws.** Companies should review their advance notice bylaws and consider whether to include additional procedural safeguards for the use of Rule 14a-19. In December 2022 (Question 139.04), the SEC Staff confirmed that dissident stockholders must comply with both Rule 14a-19 and the company's advance notice bylaw requirements.
- **Review New Proxy Statement Disclosure and Proxy Card Format Requirements Application in All Elections.** The amended rules include requirements designed to help ensure that universal proxy cards clearly and fairly present information. As noted in our prior Alert, the adopted rules also included amendments to the form of proxy and proxy statement disclosure requirements relating to voting options and standards that would apply to all director elections, contested or not.
- **Review SEC Staff CD&Is.** In August 2022 and December 2022, the SEC issued additional guidance on Rule 14a-19 (available here) (Questions 139.01 to 139.06), including clarifications around (i) listing alternate nominees in Rule 14a-19 notices (Question 139.01), (ii) notice requirements related to multiple dissident stockholders (Question 139.02), (iii) the application of Rule 14a-19 vis-à-vis a company's advance notice by-laws (Questions 139.03 to 139.05), and (iv) solicitation obligations of dissident stockholders (Question 139.06).

Shareholder Engagement. In today's environment driven by stakeholder interest and scrutiny of corporate ESG programs and related disclosures, investor relations and, particularly, proactive engagement by companies with their various stakeholders on these and other topics of focus can serve to develop productive relationships with stakeholders and gain an understanding of areas where the company can make a meaningful impact.

What to Do Now:

- **Maintain Year-Round Engagement Program.** It remains essential for companies to engage with shareholders year-round to receive feedback on important matters such as executive compensation, board composition and governance, shareholder proposals, as well as strategy and performance more generally. Annually, the major institutional investors identify ESG issues as significant engagement priorities.
- **Brief Board on Investor Concerns and Priorities.** In connection with drafting the upcoming proxy statement, companies should consider investor feedback from the prior years' engagement efforts to improve and clarify

disclosure on key topics. Companies also should brief their boards of directors on investor concerns and engagement priorities.

- **Be Prepared for ESG Activism.** ESG activist campaigns did not see as much success in 2022 in comparison to Engine No. 1's successful proxy contest at ExxonMobil in 2021, among others. However, the 2022 campaigns did bring attention to the issues to which proxy contests were tied. For example, the use of gestation crates for pregnant pigs by pork suppliers that was at the center of Carl Icahn's campaigns did not gain him any board seats, but generated many headlines about the treatment of pigs. We expect ESG activism to continue as investors continue to focus on specific ESG issues that they believe are important to the growth of their investments and to promote operational and governance changes that they believe will advance these issues.
- **Consider Impact of "Pass Through" Voting on Engagement.** In late 2021, Blackrock unveiled a new pass-through voting program to give certain institutional investors the option to vote the shares that they hold through the Blackrock index funds. Blackrock has expanded the program to cover institutional investor clients representing 47% of its index equity assets, and eventually aims to expand the program to all investors, including individual investors. As the pass-through voting concept begins to gain steam, proxy advisors such as ISS and Glass Lewis may become even more influential, particularly because Blackrock's pass-through voting program allows investors to align its votes with an off-the-shelf policy from a proxy advisory firm. Solicitations could also become more challenging and costly, as companies may have to engage both with Blackrock directly and with Blackrock's individual investors. Finally, pass-through voting is likely to be piloted or adopted by other large institutional investors. In November 2022, Vanguard unveiled a pass-through voting trial program for the 2023 proxy season that will pilot a number of proxy voting policy options for individual investors to choose from in several Vanguard-managed equity index funds. Other institutional investors such as State Street are likely also to replicate this model in the near future.

Rule 14a-8 Shareholder Proposals. The number of Rule 14a-8 shareholder proposals submitted for inclusion in company proxy statements has been increasing year over year. The largest category of submissions in 2022 (and we expect for 2023) are social/political proposals on topics such as political contributions, civil rights/racial equity audits, pay equity, DEI (diversity, equity and inclusion), reproductive rights, and other human capital proposals such as mandatory arbitration of employee claims, harassment issues, paid sick leave, employee safety, food supply chain and animal rights. Governance proposals, while declining in number overall, reflect the greatest levels of support. Over the last two years, the most prevalent governance proposals have been to adopt or lower the threshold for a shareholder special meeting right, to adopt shareholder action by written consent, and to adopt an independent board chair. Environmental proposals, such as those relating to climate targets, transitions plans, packaging and plastics, and general reporting, are growing in number but are also becoming so granular and prescriptive that some institutional investors, such as BlackRock, have stated that they expect to support proportionately few climate-related proposals.

Additionally, as we discuss in our prior Alert, in July 2022, the SEC proposed amendments to Rule 14a-8, which would revise three of the potential bases for a company's exclusion of a Rule 14a-8 shareholder proposal – "substantial implementation," "duplication" and "resubmissions." The proposal is intended to "improve the shareholder proposal process and promote consistency." However, without additional clarifications, the proposed amendments could create confusion and pose a greater challenge for companies seeking to exclude shareholder proposals under these rule exclusions. Since these rule changes have not yet been adopted, they will not impact the no-action process for 2023 for calendar-year end companies.

What to Do Now:

- **Strategically Evaluate Alternatives; Consider SEC Staff Guidance.** As companies consider shareholder proposals for their upcoming 2023 annual meetings, companies should evaluate available alternatives, taking into consideration their stockholder profile, support for prior proposals, as well as optics and investor relations issues. In evaluating whether to include a proposal in the proxy statement or seek to exclude it either through the SEC no-action letter process or negotiation with the proponent, companies should consider that it has become

more difficult to obtain favorable no-action letter relief under certain circumstances. The SEC staff's recent position enumerated in Staff Legal Bulletin 14L significantly narrowed its interpretation of the scope and applicability of two exceptions frequently relied upon by companies to exclude proposals – Rule 14a-8(i)(5) (the "economic relevance" exception) and Rule 14a-8(i)(7) (the "ordinary business" exception).

- **Consider Disclosing the Proponent.** While not required by the SEC rules, Glass Lewis' new voting policy for 2023 will recommend against the governance committee chair when a company does not clearly disclose the identity of a shareholder proponent (or lead proponent when there are multiple filers) in their proxy statement.

Other Annual Meeting Considerations

It is important to consider the agenda and expectations for the annual meeting concurrently with the preparation of the proxy statement. In addition to director elections, say-on-pay, auditor ratification and shareholder proposals, this year many companies will need to include an advisory vote on say-on-pay frequency.

What to Do Now:

- **Say-on-Pay Frequency.** SEC Rule 14a-21(b) first required public companies to conduct an advisory vote on the frequency of the say-on-pay vote at the first annual or other meeting of shareholders on or after January 21, 2011, with subsequent frequency votes to take place no more than every six years thereafter. Companies that held their last frequency vote in 2017 will need to include such vote on the agenda for the upcoming 2023 annual meeting, requesting that shareholders vote on whether the say-on-pay vote should take place every one, two or three years. Following the meeting, companies also must disclose in an Item 5.07 Form 8-K (or in an amendment within 150 calendar days after the meeting) the frequency with which the company determined to hold the say-on-pay vote (a decision that most likely should be made by the board of directors). Failure to timely disclose the frequency decision can result in the loss of Form S-3 eligibility.
- **Determine Annual Meeting Format and Year-Over-Year Improvements.** According to Broadridge, during the 2021 season, it hosted over 2,300 virtual shareholder meetings, with 98% of those being virtual-only. During the 2022 season, Broadridge data continued to show most companies conducting virtual-only meetings, suggesting that virtual-only meetings are here to stay given the conveniences and efficiencies they offer for companies and shareholders alike. Consider feedback on the prior years' annual meetings, including with respect to the format, the interface with the company for virtual formats and investors' ability to engage with the company. Consider prior years' experience and ways to improve the experience for the company and shareholders and improve on any technical difficulties experienced.
- **Review Prior Year's Say-on-Pay Results; Consider Plan Proposals.** According to Semler Brossy, say-on-pay approval in 2022 was the lowest in ten years at an average of 89.2% for the Russell 3000. Companies should review the prior year's say-on-pay result and feedback from investor engagement efforts to support this year's say-on-pay disclosure and executive compensation decision making. In addition, the CD&A requires companies to disclose whether and, if so, how the company has considered the results of the most recent say-on-pay vote and, if so, how that consideration has affected the company's executive compensation decisions and policies. ISS released updated FAQs on Compensation Policies in December 2022 covering updates and clarifications to compensation policies, equity compensation plans, and peer group methodology, which provide general guidance on how ISS will analyze those and other compensation issues.

* * *

Weil

If you have questions concerning the contents of this alert, or would like more information about Weil's Public Company Advisory Group, please speak to your regular contact at Weil.

Howard Dicker	View Bio	howard.dicker@weil.com	+1 212 310 8858
Lyuba Goltser	View Bio	lyuba.goltser@weil.com	+1 212 310 8048
Kaitlin Descovich	View Bio	kaitlin.descovich@weil.com	+1 202 682 7154
Catherine Dixon	View Bio	catherine.dixon@weil.com	+1 202 682 7147
Adé Heyliger	View Bio	ade.heyliger@weil.com	+1 202 682 7095
P.J. Himelfarb	View Bio	pj.himelfarb@weil.com	+1 202 682 7208
Alicia Alterbaum	View Bio	alicia.alterbaum@weil.com	+1 212 310 8207
Steven Bentsianov	View Bio	steven.bentsianov@weil.com	+1 212 310 8928
Rachel Alpert	View Bio	rachel.alpert@weil.com	+1 212 310 8061
Shira Barron	View Bio	shira.barron@weil.com	+1 212 310 8336
Bianca Lazar	View Bio	bianca.lazar@weil.com	+1 212 310 8748
Julie Rong	View Bio	julie.rong@weil.com	+1 212 310 8201
Eleni Samara	View Bio	eleni.samara@weil.com	+1 212 310 8617

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← FSB on Climate Metrics in Compensation Frameworks | Main | Trends Impacting Say-On-Pay in 2023 →

May 3, 2023

More on PVP: Corp Fin Speaks about Review Program

Corp Fin Director Erik Gerding and Chief Counsel Michael P. Seaman joined the "Dialogue with the SEC Senior Staff" session on Friday at the ABA's Business Law Section Spring Meeting. Reminding us that Corp Fin's hard work doesn't end with the rule adoption, Erik noted that once a rule is effective, lots of work goes into implementation – training folks in the disclosure review program, working through the comment process and deciding how to provide guidance. Erik then outlined the Staff's plan for the review program for PVP disclosures, which the SEC is considering in two buckets:

> – For issuers that omitted the disclosures – either entirely or in part – comments will be issued asking about the missing pieces. Take note: Erik called out that the Staff may ask those issuers to delay an annual meeting until the required disclosures are made!
>
> – For issuers that provided the required disclosures, the Staff may issue comments at the end of proxy season that are prospective in nature, recognizing the complexity of the rules and the number of interpretive questions. The Staff may also consider providing more broadly applicable guidance.

Erik notes that the Staff doesn't see the first season as establishing a settled practice and reserves the right, going forward, to make further comments as to how the rule should be interpreted. Liz previously blogged about commentary from the Staff earlier this year that the PVP comment process will be iterative and the Staff isn't looking to be punitive for companies who presumably put in a good-faith effort to comply with the requirements, so that certainly seems consistent.

– **Meredith Ervine**

Posted by Meredith Ervine
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Pay Versus Performance: Tracker For Real-Time Trends

From the folks who brought you the say-on-pay tracker and other tools, the team at Farient Advisors has now announced the launch of "PVP Tracker" – which can help you stay on top of how S&P 500 competitors and peers are sharing data. Here's more detail:

> Included in our newly launched PvP Tracker™ is coverage of both qualitative and quantitative elements. On the qualitative side, the PvP Tracker™ summarizes trends in peer group selection, the "most important" performance measures, and the formats employed when describing the relationships between CAP and measures of financial performance, among other elements.

Here are a couple of early findings that the real-time data reveals:

> – When companies reference the relationship between CAP and performance measures, they most commonly (55% of S&P 500 companies) disclose those relationships in a graphic format only. Another 34% of companies use a combination of graphs and narrative. A slim minority (11%) of S&P 500 companies disclose these relationships in a strictly narrative format. Thus, a visual representation is the preferred approach either because it helps to better show the connection between pay and performance, or because no additional narrative is needed to satisfy SEC reporting requirements.
>
> – In terms of the "most important" company-selected metric (CSM), Farient's PvP Tracker™ finds that a majority (54%) of companies are choosing an earnings metric, such as operating profit or EPS, followed by returns (15%) and cash flow (13%). Of course, CSM trends vary by industry—for instance, 37% of companies in the financial sector select a returns measure as their CSM.

You can sort the data by industry to show comparisons of CAP to SCT compensation and to explore disclosure trends. It's a very handy tool for anyone tasked with benchmarking – or just curious about how these disclosures are shaping up.

– Liz Dunshee

Posted by Liz Dunshee
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AON

September 2022

SEC Adopts Final Pay Versus Performance Disclosure

On August 25, 2022, the Securities and Exchange Commission ("SEC") adopted final rules to require companies to disclose information reflecting the relationship between executive compensation actually paid by a company and the company's financial performance in annual meeting proxy statements making it effective for the 2023 proxy season. The rules implement one of the last two executive compensation requirements mandated by the Dodd-Frank Act of 2010 (clawback policies are still on the horizon). The SEC proposed pay versus performance disclosure rules in 2015 and reopened the comment period in January of this year. Aon described the proposal earlier this year here.

The final rules will require public companies to provide a table of information for their five most recently completed fiscal years featuring:

- the total compensation reported in the Summary Compensation Table ("SCT") for the Principal Executive Officer ("PEO" which is most often the chief executive officer) and an average of the total compensation reported in the Summary Compensation Table for the other Named Executive Officers ("NEOs"),
- the compensation "actually paid" to the PEO, and an average of the compensation "actually paid" to the other NEOs,
- the company's total shareholder return ("TSR"),
- the TSR of companies in the company's peer group,
- the company's net income, and
- a financial performance measure chosen by the company.

This chosen performance measure, in the company's assessment, must represent the "most important" financial performance measure the company used to link compensation actually paid to NEOs to company performance for the most recently completed fiscal year.

Companies will be required to describe the relationships between the executive compensation actually paid and each of the performance measures shown in the table, as well as the relationship between the company's TSR and the TSR of its selected peer group (if applicable). These relationships can be disclosed graphically, using descriptive text, or a combination of the two provided the selected description make the connection clear.

In the original proposal, companies were required to list GAAP pre-tax income as part of the table but that requirement was dropped from the final rule.

Under the final rule, companies must provide a **tabular list** of three to seven other financial performance measures that the company has determined represent the most important financial performance measures used to link compensation actually paid for the most recent fiscal year to company performance. Unlike the proposed rule, this table is no longer required to be listed in ranked order of importance. So long as at least three of the measures are financial performance measures (or fewer than three, if the company uses fewer than three financial performance measures), the company may include non-financial performance measures in the tabular lists which for example, may include measures focuses on Environmental, Social, or Governance ("ESG") or, for life science companies, goals towards drug development. A company that does not use any financial performance measures to link

compensation actually paid to performance in the most recent fiscal year is not required to present a tabular list or disclose a company-selected financial measure.

Effective Dates

The rules which will be added as Item 402(v) to Regulation S-K will become effective 30 days following publication of the release in the Federal Register. Companies that are subject to the new rule (see below) must begin to comply with these disclosure requirements in proxy and information statements that are required to include Item 402 executive compensation disclosure for fiscal years ending on or after December 16, 2022.

Reporting Companies Subject to the New Disclosure Rules

The final rules require pay versus performance disclosure for all companies except for emerging growth companies (which are statutorily exempt from the requirements), foreign private issuers, and registered investment companies other than business development companies ("BDCs") and does not require disclosure for any fiscal year prior to the company going public.

Transitioning to the New Disclosure Rules Including Smaller Reporting Companies

Companies, other than smaller reporting companies ("SRCs"), will be required to provide the information for a total of five years, providing three years in the first proxy or information statement in which they provide the disclosure, adding another year of disclosure in each of the two subsequent annual proxy statements. Also, all non-SRC companies will have to submit their tabular disclosure using Inline XBRL, while SRCs will be exempt until their third filing.

SRCs will be required to provide the information for a total of three years (rather than five years), providing two years of disclosure initially, and adding one additional year of disclosure in the subsequent annual proxy or information statement. In addition, an SRC is not required to provide the peer group TSR or the company-selected financial performance measure in the new table, and an SRC is not required to provide the tabular list of other financial performance measures. SRCs will also not have to adjust the pension amounts in the executive compensation actually paid calculation.

Disclosure Structure

Following is the table companies must provide together with certain required footnote disclosure, and which will be followed by the additional narrative and/or graphic comparative requirements and table of additional metrics.

Year	SCT Total for PEO	Compensation actually paid to PEO	Average SCT Total for non-PEO NEOs	Average Compensation actually paid to non-PEO NEOs	Value of Initial Fixed $100 Investment based on:		Net income	Company-selected measure*
					TSR	Peer Group TSR*		
(a)	(b)	(c)	(d)	(e)	(f)	(g)	(h)	(i)
Year 1								
Year 2								
Year 3								
Year 4*								
Year 5*								

* SRCs are not required to include the items noted with an asterisk in the above table.

If a company had more than one PEO during the year, the rule requires the addition of an additional column(s) showing the Summary Compensation Table total (column (b)) and Compensation Actually Paid (column (c)) for the other PEOs.

Calculation of Compensation Actually Paid

The calculation of compensation actually paid is the same information reported in the Summary Compensation Table with adjustments for equity awards and pension values. The final rules change how the adjustments were calculated from what was proposed, increasing the complexity of these calculations.

Pension Values

The proposed rules required companies to deduct the aggregate change in the actuarial present value of all defined benefit and actuarial pension plans that appear in the Summary Compensation Table, while adding back in service cost. The final rules require the same deduction as well as the addition of service cost (calculated as the actuarial present value of each NEO's benefit attributable to services rendered during the fiscal year), but also require the addition of prior service cost (calculated as the entire cost of benefits resulting from a plan amendment or initiation during the fiscal year). As noted above, SRCs are not required to make this adjustment to pension value.

Equity Awards

The SEC expanded and made more complex the calculation of compensation actually paid for equity awards. The proposed rules required the value of outstanding equity awards upon vesting in a covered year to be presented in the disclosure. The final rules expand the value of outstanding awards significantly, requiring companies to determine the value of both unvested and vested awards in each covered year of disclosure, in a manner consistent with the methodology required in the Summary

Compensation Table, using fair value as calculated in accordance with ASC Topic 718. Specifically, companies must determine the following values for each equity award:

Award Type / Situation	Valuation Date / Methodology
For any awards granted in the covered fiscal year that are outstanding and unvested at year end	The fair value of those awards at year-end
For any awards granted in prior years that are outstanding and unvested at year end	The change in fair value of those awards from the prior year end to the current year end
For any awards granted in the covered fiscal year that are vested in the same year	The fair value of those awards at the vest date
For any awards granted in prior years that vest in a covered fiscal year	The change in fair value of those awards from the prior year to the vest date
For any awards granted in prior years that do not vest and are forfeited	A reversal of the fair value of those awards calculated at the prior year end
For any dividends and earnings paid on awards in the covered fiscal year prior to the vest date	The total value of such dividends and earnings that are not already included in the fair value of the award

In the Appendix, we have provided an overview of the general valuation process for different types of equity awards.

Peer Group Selection, Calculation of TSR and Net Income

For the TSR calculation, the company may select the same peer group as disclosed in the Compensation Discussion and Analysis section ("CD&A") of the proxy statement, or it may use the index or peer group disclosed in the stock performance graph requirements of Item 201(e) of Regulation S-K (this is the 5 year stock performance graph required in a company's annual report). The disclosure each year must reflect any changes made to the company's peer group, and supplemental disclosure must be provided to discuss the rationale of the changes as well as how the change impacted performance in compliance with Item 201(e) of Regulation S-K. Note, no peer group or TSR disclosure is required for SRCs.

The company must also calculate TSR in a manner consistent with the stock performance graph disclosure requirements under Item 201(e) of Regulation S-K. Additionally, the TSR will be represented over a cumulative period over the period covered in disclosure (i.e., for the first year in the table will represent the TSR over the first year, the TSR for the second year will represent the cumulative TSR over the first and the second years, etc.). Additionally, TSR must be calculated to cover the covered fiscal year, with a base investment of $100. The same methodology must be applied to the peer group's calculation of TSR, where the TSR is weighted by each peer's market cap at the beginning of the period.

The calculation of net income will be as disclosed under U.S. GAAP, and the company selected measure may be a non-GAAP financial measure. If a non-GAAP measure is used, a full reconciliation is not required but any adjustments must be disclosed and determinable from the company's audited financial statements.

Aon's Perspective

While the final rules were expected once the SEC reopened the comment period in 2022, the final rules have arrived very quickly with some significant changes, such as the representation of equity values over time, that will create further complexity around this disclosure. The Aon Human Capital Solutions team is here to help you and your company understand this new required disclosure, calculate the equity and TSR measures as well as draft and provide graphics for the additional required disclosure. Please do not hesitate to contact us if you need any support.

Authors

Dan Kapinos, Partner
Richard Harris, Partner
David Kritz, Associate Partner
Mike Xu, Director
Pam Greene, Partner
Damon Daniel, Associate Partner
Derrick Neuhauser, Associate Partner
Julia Franke, Senior Consultant

About Aon Human Capital Solutions

Aon's human capital business provides leaders with a powerful mix of data, analytics and advice to help them make better workforce decisions. Our team, spanning 2,000 colleagues in more than 30 countries, includes the firm's rewards, talent assessment, and performance & analytics practices. To learn more, visit humancapital.aon.com.

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Aon plc (NYSE: AON) exists to shape decisions for the better—to protect and enrich the lives of people around the world. Our colleagues provide our clients in over 120 countries with advice and solutions that give them the clarity and confidence to make better decisions to protect and grow their business.

Appendix

Under ASC Topic 718, the accounting for share-based payments is tied to the "fair value" of the instruments being issued to employees. Since the final rules of this disclosure require companies to value both unvested and vested equity in accordance with ASC Topic 718, it is worth understanding the valuation process associated with different awards at different points in time. Please see the table below summarizing the general valuation process for these scenarios. Note, specific circumstances can exist with certain awards where a different or supplemental valuation may be needed, such as the fair value discount associated with a post-vest holding period. Aon's Equity Services team is happy to review your awards to help you determine the best valuation process for you going forward.

Award Type	Process at Grant[1]	Process for Unvested Awards at Year End	Process for Vested Awards at Vest Date	Award Type
Stock Options and Stock Appreciation Rights	Valuation performed using an option pricing model with assumptions as of the grant date	Valuation performed using an option pricing model at year end with assumptions as of year-end, including an updated expected life	Valuation performed using an option pricing model at the time of vest with assumptions as of the vest date, including an updated expected life	Stock Options and Stock Appreciation Rights
Time-Based Restricted Stock Awards and Units	Valuation based on the Fair Market Value of the stock on the grant date[2]	Valuation based on the Fair Market Value of the stock at year end[2]	Valuation based on the Fair Market Value of the stock on the vest date[2]	Time-Based Restricted Stock Awards and Units
Performance-Based Stock Awards and Units based on Non-Market Conditions[3]	Valuation based on the Fair Market Value of the stock on the grant date[4]	Valuation based on the Fair Market Value of the stock at year end[5]	Valuation based on the Fair Market Value of the stock on the vest date[6]	Performance-Based Stock Awards and Units based on Non-Market Conditions[3]
Performance-Based Stock Awards and Units based on Market Conditions	Valuation using Monte Carlo Simulation on the grant date	Valuation using Monte Carlo Simulation at year end[7]	Valuation based on the Fair Market Value of the stock on the vest date[8]	Performance-Based Stock Awards and Units based on Market Conditions

Footnotes:

1 – The process at grant aligns with the valuation methodology and numbers reported in the Summary Compensation Table

2 – The fair value could be discounted for any dividends not provided to employees through the award

3 – Non-market conditions would be internal metrics, like earnings or revenue, not tied to stock price

4 – Total cost at grant is based on the expected payout in the future, typically target on the grant date

5 – Total cost at year end is based on the updated expected payout including data through year end

6 – Total cost at vest is based on the number of shares actually earned underlying performance

7 – The updated valuation must include performance through the year-end date, which could drastically change the fair value from the grant date

8 – Ultimately the final value illustrated will represent the number of shares earned multiplied by the vest date Fair Market Value

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May 1, 2023

Takeaways from PVP Disclosures

During our recent webcast "The Top Compensation Consultants Speak," Ira Kay described a Pay Governance study that used pay versus performance data of 50 S&P 500 companies that filed their proxies on or before March 10, 2023 to calculate the level of alignment of "compensation actually paid" with TSR, relative TSR, GAAP net income, and the company selected measure, which we subsequently blogged about. Now that more time has passed, Pay Governance has reviewed PVP disclosures of 160 S&P 500 companies that filed their annual proxies as of March 31, 2023 and has released a viewpoint with more takeaways for us. Here are the key findings from that data, the first of which confirms the conclusion in their prior study with this larger sample size:

> – The new PVP disclosure is supportive of the current executive compensation framework used by most companies, as compensation outcomes are directionally aligned with shareholders' interests. It also justifies their significant support for Say on Pay during the Say on Pay era these past 12 (going on 13) years.
> – The fair value of the current year's equity award has the greatest impact on the CAP absolute dollar amount.
> – Higher performing companies (as measured by TSR) reported significantly higher CAP values than lower performing companies for each of the last three years (2020-2022).
> – As explicitly expected by the SEC, CAP can be very volatile between years due to stock price changes and adjustments to expected performance outcomes.
> – Changes in SCT total compensation, on the other hand, tend to move within a narrow range because the biggest drivers of the change relate to the current year's annual incentive, a relatively small portion of total compensation, and changes in the grant date value of the current year's equity awards, which are generally conservative.

Given these findings, the study concludes with thoughts for management and compensation committees:

> In general, we do not believe companies should or will make program design changes to try to improve their PVP disclosure. However, we do recommend management and Compensation Committees consider the questions investors and other stakeholders might ask at the next shareholders' meeting based on the new disclosure. These might include:
>
> – Is the relationship of CAP and TSR sufficiently aligned?
> – Are the relationships of CAP to the other financial performance measures included in the PVP table (GAAP net income and the company selected measure) sufficiently aligned, and if not, are the reasons explainable?
> – Is the company's TSR in line with its peers?
> – Is the absolute quantum of CAP reasonable?
> – Are the year-over-year changes in CAP driven by the company's performance?
> – Is the use of grant date fair values — as presented in the SCT and used as the primary pay-for-performance test by the proxy advisors, or the equity values as presented in the PVP disclosure — the best way to evaluate pay-for-performance? Or is some type of realizable/realized pay, that

> considers expected (realizable pay, similar to PVP disclosures) or actually realized pay outcomes, a better approach?

– **Meredith Ervine**

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