Checklist: Executive Compensation Disclosure — Pay Versus Performance

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Note: This checklist addresses the pay versus performance disclosure required by Section 953(a) of Dodd-Frank and Item 402(v) of Regulation S-K. See also our "Pay Versus Performance" Handbook posted on CompensationStandards.com. For a discussion of the pay-for-performance disclosure that companies include in the Compensation Discussion & Analysis section of their proxy statements, see our "Checklist: Executive Compensation Disclosure — Pay-for-Performance Disclosure in Compensation Discussion & Analysis."

Pursuant to Section 953(a) of the Dodd-Frank Act, in 2022, the SEC adopted Item 402(v) of Regulation S-K, which requires registrants to provide pay versus performance disclosure, including a table presenting the following information for each fiscal year covered by the table: (1) the total compensation paid to the registrant's principal executive officer as set forth in the Summary Compensation Table, as well as the principal executive officer's "compensation actually paid"; (2) the average total compensation of each of the registrant's other named executive officers as set forth in the Summary Compensation Table and the other named executive officers' average "compensation actually paid"; (3) the registrant's cumulative total shareholder return; (4) the registrant's peer group cumulative total shareholder return group; (5) the registrant's net income; and (6) a financial performance measure selected by the registrant as the most important financial measure used to link compensation actually paid to the registrant's performance.

Registrants also must disclose: (1) in narrative or graphical form, the relationship between executive compensation actually paid and the financial performance measures reported in the table, as well as the relationship between their total shareholder return and the peer group's total shareholder return; and (2) a table listing at least three, and no more than seven, of the most important performance measures used by the company to link executive compensation actually paid for the most recently completed fiscal year to company performance (including the Company-Selected Measure).

1. **Don't underestimate the time it will take to prepare pay versus performance disclosures or the complexity involved:** As practitioners dove into the final rules, it quickly became apparent that calculating compensation actually paid is a complicated process. For the first year's disclosures, the typical company with multiple types of equity awards for each of the covered

fiscal years needed to do many — possibly a few hundred — new calculations to estimate the fair value of its equity awards as of each vesting date and fiscal year end.

Even for year two and possibly future years, don't expect that the next year is just going to be a repeat of the prior year. The SEC staff may provide additional formal interpretive guidance — and some clarity is likely to come out through the comment process — that may change your calculations of compensation actually paid for year two or your approach to the comparative disclosure.

2. **Strongly consider engaging outside help:** A multi-disciplinary team is needed to prepare the pay versus performance disclosure, which likely needs to include outside advisers such as valuation consultants, at least for the initial years of these disclosures. Many companies found that they didn't have the expertise or the capacity to handle the calculation of compensation actually paid using only internal resources. Using outside service providers turned out to be particularly helpful in the first year since valuation and other outside consultants gained more experience than in-house teams by working with other companies and could provide expert guidance on how to calculate compensation actually paid for the different factual situations involving your outstanding equity awards and equity awards granted during the fiscal years covered by the pay versus performance table.

   However, outside consultants were stretched thin in the first year with the number of companies needing support. For the reasons described above, this may continue in year two, so identify any need for outside service providers and engage them early. Of course, this also means ensuring you have capacity in your budget for this resource.

   Outside advisers can also help ensure you develop appropriate controls and procedures for preparing the pay versus performance disclosure. In the first year, companies needed to document decisions regarding the various disclosure elements and establish appropriate controls and a procedure to be implemented in future years, particularly for the valuations that are used to calculate compensation actually paid. In the second year, companies will need to reassess those controls and procedures, and either implement a consistent process or update documentation, controls and procedures in light of evolving guidance and market practice (as discussed below).

3. **Engage your Compensation Committee:** In the first year, the Compensation Committee needed to get up to speed on these new disclosure requirements.

Compensation actually paid was a brand new formulation of executive pay and very unfamiliar, and most companies made multiple presentations to their Compensation Committee (including an initial presentation explaining the requirements of the new rule) and sought feedback at various stages in the process.

Several important decisions also need to be made for purposes of the pay versus performance disclosures — companies need to identify their three to seven most important financial performance measures for purposes of the tabular list and identify their company-selected measure (the most important financial performance measure the company uses to link compensation actually paid to the company's NEOs to company performance for the most recently completed fiscal year). Each of these decisions involves input from several stakeholders within the company, including the Compensation Committee. Since the tabular list and CSM refer to "the most recently completed fiscal year," these were not one-time decisions and will need to be reconsidered with the Compensation Committee each year, particularly in years when changes are made to the metrics used in the company's annual or long-term incentive compensation programs.

Substantively, the Compensation Committee will need to consider how the new disclosures will impact compensation decisions going forward — that is, if and how pay versus performance data of the company and/or its peers will be considered in compensation decisions. There's been some debate regarding the utility of compensation actually paid and whether traditional realizable pay provides better data for this purpose, but as pointed out in a memo by WTW, compensation actually paid is easy to collect and consistent and comparable across companies, so at a minimum, Compensation Committees are likely to want readily available peer data to be collected and analyzed.

4. **Keep up with formal SEC interpretive guidance and comment letters:** In 2023, companies found that some prior pay versus performance disclosure decisions needed to be reconsidered and changed as the SEC Staff provided interpretive guidance and market practice evolved during the proxy season. For example, after initially providing informal oral guidance that a compensation peer group disclosed in the CD&A could only be used for peer group TSR if that peer group was truly used for benchmarking, the Staff issued CDI 128D.05 in February 2023, which allows a compensation peer group to be used for this purpose if it was "actually used" to help determine executive pay, even if the peer group is not used for "benchmarking."

Parts of the rule remain subject to interpretation following the 2023 proxy season. For example, additional interpretive guidance would be welcome regarding: (1) the timing of accounting for accrued dividends or dividend equivalents in the calculation of compensation actually paid, and (2) whether the requirement to disclose "any assumption made in the valuation that differs materially from those disclosed as of the grant date of such equity awards" when calculating updated fair values for the equity awards included in compensation actually paid applies when the assumption methodology was unchanged but the values of the assumption inputs have changed compared to the grant date fair value assumptions. While unrelated to these specific questions, at the ABA's Business Law Section 2023 Spring Meeting, Corp Fin Director Erik Gerding stated that the SEC Staff may consider providing more broadly applicable interpretive guidance.

Also at the ABA's Business Law Section 2023 Spring Meeting, Gerding and Chief Counsel Michael P. Seaman discussed the Staff's planned approach to the review program for the first year of pay versus performance 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, and the Staff may consider asking 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.

For at least the first few years, it'll be particularly important for issuers to focus on SEC interpretive guidance and comment letters on pay versus performance disclosure so they can make sure they are identifying updates and revising disclosures appropriately. In year two, companies should also carefully check their disclosures against all the requirements of the rule, even in the absence of additional interpretive guidance, particularly for common first-year errors. For example, if you use your "published industry or line-of-business index" as your peer group, you should make sure that you are using the correct group, as many companies used a broad equity market index (and not a true "published industry or line-of-business index" as required by the rule) in their first year disclosures.

5. **<u>Keep up with peer disclosures:</u>** Since market practice is still evolving and, as with any new disclosures, companies are still considering how to present the pay versus performance information where there's room for discretion (such as whether to present the relationship disclosures in graphical form, with narrative disclosure or both), this is also an area where companies should pay particular attention to peer disclosures and compare approaches, both in year one and by tracking early filers in year two.

6. **<u>Keep up with proxy advisers' use of pay versus performance disclosures:</u>** For 2023, ISS chose not to incorporate the pay versus performance data into its quantitative pay-for-performance analysis, but did note that the disclosures may be considered during the qualitative evaluation, particularly when a quantitative misalignment exists. ISS also included data from the pay versus performance table in its 2023 research reports. Glass Lewis announced that the new rules would not change its pay-for-performance methodology for the 2023 proxy season. While their use has been limited to date, the proxy advisers' approach to and use of the information contained in pay versus performance disclosures may evolve in subsequent years, and ISS and Glass Lewis may consider increasing the role that the pay versus performance data plays in their pay-for-performance analyses.

7. **<u>Ensure consistency with your pay-for-performance CD&A disclosure and reconsider other disclosures:</u>** In the 2023 proxy season, companies largely maintained their existing pay-for-performance disclosure in the CD&A and referenced that disclosure in the newly required section on pay versus performance. However, for the first time, companies needed to consider consistency between the related CD&A discussion and this new disclosure, and the level of alignment (or lack thereof) between compensation actually paid and the financial performance measures reported in the table became yet another data point to consider when formulating pay-for-performance disclosure in the CD&A. Additional explanation may be appropriate if there is a misalignment. It remains to be seen whether companies start expanding their pay-for-performance discussion in the CD&A to start to include a — or to expand on an existing — discussion of realized or realizable pay in light of the new pay versus performance disclosure.

   The back and forth on whether it was permissible to use a compensation peer group for the required TSR comparison also caused some companies to consider whether their compensation peer group was truly used for benchmarking. This prompted many companies to look at CD&A disclosures to

see what they said about how the Compensation Committee is using peer group data. As Dave Lynn pointed out in our June 2023 proxy season post-mortem webcast, "benchmarking" refers to a specific practice that was common around the time the compensation disclosure rules were last amended in 2006 where many companies were focused on targeting specific elements of compensation to specific percentiles in the peer group. The specificity of this practice is now generally disfavored, and most companies do not use peer group data for true benchmarking purposes. Companies should consider revisiting that disclosure and avoiding the term "benchmarking," if appropriate.

Panelists at our June 2023 pay versus performance webcast noted that preparing the pay versus performance disclosures also caused some companies to reconsider the inputs to their Summary Compensation Table (including assumptions used in calculating grant date fair value) and their Outstanding Equity Awards Table. Since the calculation of compensation actually paid began with the Summary Compensation Table total, with adjustments for pension value and equity awards, the newly required calculation caused companies to take a close look at the inputs they have historically used in the Summary Compensation Table, some of which needed to be reconsidered. For example, some companies discovered that they were needlessly and inappropriately adding dividends and dividend equivalents in the "All Other Compensation" column of the Summary Compensation Table, which resulted in double counting since they are usually already factored into the grant date fair value reported in the "Stock Awards" column.

Preparing the pay versus performance disclosure also renewed focus on the probable achievement of outstanding performance-based awards. This caused some companies to reconsider and — to the extent they were reporting performance-based awards without following the guidance in Instruction 3 to Item 402(f)(2) — to fix their disclosure practices for the Outstanding Equity Awards Table.

Finally, as Mark Borges pointed out in his "Proxy Disclosure Blog" on CompensationStandards.com, companies may need to modify their customary incorporation by reference language in Form 10-K filings to avoid inadvertently incorporating by reference the pay versus performance disclosure from their proxy statements. Some early filers inadvertently incorporated pay versus performance disclosure in Item 11 of Part III of Form 10-K by cross-referencing a section of the proxy statement without excepting the pay versus performance subsection.