More Money, More Problems?

How the SEC's New Executive Compensation Disclosure Rule Could Impact the 2023 Proxy Season.

Teneo Insights / September 2022

On August 25, 2022, the Securities and Exchange Commission adopted final rules on company pay for performance disclosure required under the 2010 Dodd-Frank Act.

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Overview

To help companies prepare for 2023 proxy statements and annual shareholder meetings, we summarize below the key elements of the final rules, how key stakeholders (activists, investors, proxy advisors) may use them and key considerations for companies subject to the new disclosure rules.

Executive Summary

- The new rules require the following qualitative and quantitative disclosure in the company's 2023 Proxy Statement (or similar disclosure) regarding the relationship between executive pay and company performance:
  - A table including certain executive compensation measures (including a new measure: Compensation actually paid) and certain financial

performance measures (company total shareholder return or TSR peer TSR, net income and a financial metric of the company's choosing), covering five years of data.

- A description (narrative, graphical or both) of the relationship between executive compensation actually paid and the measures included in the table.
- A description of the relationship between the company's TSR and the peer groups' TSR as a whole.
- A list of three to seven performance metrics (in no particular order) that are deemed the most important in determining executive compensation for the most recently ended fiscal year (the covered year).
- Companies with a calendar fiscal year end are required to implement the disclosure in their 2023 proxy statements.
- Details of the rule are described in greater detail in the Appendix on page 4.

- Investors and proxy advisors are very likely to utilize this new disclosure to inform their analysis of the company's 2023 "Say on Pay" vote, potentially flagging companies with higher compensation actually paid during years of declining performance or those that frequently change performance metrics.
- Given this potential impact on investors and proxy advisors, ensuring an effective narrative in your company's proxy statement and engagement materials will be essential heading into the 2023 proxy season.

How will stakeholders use this new information?

Proxy Advisors

- **In their quantitative pay-for-performance analysis.** It is likely that proxy advisors will incorporate elements of "Compensation Actually Paid" into their quantitative analyses to determine pay-for-performance outliers at some point in the next several years. Compensation actually paid includes elements of both realized and realizable pay. It includes the value of equity vesting in the year as well as the change in value of outstanding awards (including the addition of new grants) as of year-end.
- While ISS and Glass Lewis display realizable and realized pay in their analyses, respectively, their quantitative P4P models currently consider granted pay only. Using the new information, they could build more nuanced models that incorporate elements of compensation actually paid and performance. For instance, companies with a "low concern" of a granted pay-performance misalignment could be flagged for further analysis if compensation actually paid increases significantly during periods of declining performance. Conversely, the quantitative model could consider strong alignment of compensation actually paid and performance as a factor that reduces the initial P4P concern level, similar to how ISS currently incorporates operating financial performance in its model.
- **In their qualitative analysis of pay.** Proxy advisors are also very likely to consider the new information in their qualitative analysis of pay, which presents both challenges and opportunities for companies. For instance, frequent changes of the "company selected measure" will likely raise concerns of cherry picking. On the other hand, companies have the opportunity to explain their key performance indicators or any anomalous performance at a high level. This is information that proxy advisors, who have thousands of companies to assess and limited bandwidth, might not otherwise know of or consider in their analyses.

Institutional Investors

- **To inform their engagement with issuers and 2023 "Say on Pay" votes.** In addition to performing their own analyses of the new information to identify outliers, we believe investors will likely use this information to inform their engagement strategy. Investors are likely to reach out to companies where pay and performance appear to be misaligned or for additional information, particularly if there is limited explanation in the proxy or if such companies received negative recommendations from proxy advisors on the basis of compensation actually paid. Managers of active funds are likely to reach out for discussion if they feel the "most important" performance measures disclosed by the company are not actually the key drivers of growth.

Activists

- **In rankings of highly paid executives**. Groups that put out rankings of high executive pay packages, such as As You Sow, are likely to use this information to continue to "name and shame" high paying, low performing companies. Companies at the tops of these lists are often subject to negative media attention.

- **In "Vote No" campaigns.** Similar to companies with a granted pay-performance misalignment, companies with a significant misalignment between performance and compensation actually paid would be vulnerable to vote no campaigns against the say-on-pay proposal and compensation committee members.

- **In proxy fights.** Activist investors frequently reference executive compensation in proxy battles and could make use of this new information. As with the CEO pay ratio disclosure requirements, more pay information provides more opportunities for criticism and anything a company says may be used against them. In many cases, executive pay is criticized without context, even for companies that aren't outliers. In each of these cases, one of the best defenses is to take ownership of the story in the proxy narrative.

Conclusion

While potentially challenging to implement, particularly for companies with multiple equity tranches to value or those that do not use TSR or net income as performance metrics, the rules do present opportunities for companies to tell their story in the proxy. Companies are invited to explain anomalous performance, showcase the alignment between compensation paid and performance and educate investors on the key performance factors that drive pay decisions.

Taking advantage of this opportunity is important given the likelihood that proxy advisors and investors will incorporate the new data into their say-on-pay recommendations and votes. Further, as with any new disclosure, activists are likely to use this information against companies in proxy fights and vote no campaigns. The best defense is clear and descriptive disclosure that showcases the thoughtfulness of the compensation committee's pay-for-performance approach.

Given the near-term time frame for implementation, companies will need to work closely with legal counsel to interpret and implement the disclosure requirements and move fairly quickly to gather the necessary data and perform assessments to determine the selected performance measures.

We recommend that companies consider the narrative disclosure accompanying this information through an investor lens, take ownership of their story and use this as an opportunity to inform and educate their shareholders.

Appendix – FAQ

What is the required new disclosure?

The final rules require several new disclosure elements to be included in the proxy statement, which include:

- A table disclosing specified executive compensation and financial performance measures for their five most recently completed fiscal years.
  - Executive compensation data to be presented in the table are:
    - Summary Compensation Table Total Compensation Value for the Principal Executive Officer (or PEO, most often the CEO) as well as the average Summary Compensation Table Total for the Non-PEO NEOs
    - Compensation actually paid, a new total compensation calculation, for both the PEO and non-PEO NEOs on average. Compensation actually paid includes different calculations for equity compensation and pension compensation than the Summary Compensation Table and is described in greater detail below.
- Financial measures include TSR for the company, the TSR of companies in the company's peer group, company net income, and a financial performance measure of the company's choosing (the company selected measure).
  - TSR is measured on a cumulative basis (e.g., 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.) and is calculated based on an initial fixed investment of $100.
  - The company selected measure is determined based on a company assessment to determine the most important financial performance measure it uses to link compensation actually paid to the NEOs to company performance for the most recently completed fiscal year.

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: 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								

* A sample table presented by the SEC in the final rules. In the first year, companies will be required to include only three years of data.

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- Using the information presented in the table, companies will be required to describe, either graphically, in narrative form or through a combination of both:
  - The relationships between the executive compensation actually paid and each of the performance measures in the table; and
  - The relationship between the company's TSR and the TSR of its selected peer group as a whole.
- Companies are also required to provide an unranked list of three to seven financial performance measures that it determines are its most important performance measures for linking executive compensation actually paid to company performance for the covered year.
  - The company-selected metric should be included in this list.
  - Smaller reporting companies will be subject to scaled disclosure requirements under the rules.
  - Companies may include multiple lists if different metrics apply to different executives. For instance, companies can include two lists: One for the CEO and one for other NEOs, or a separate list for each NEO.
  - Companies that use fewer than three metrics need only disclose the number of metrics that they use. Companies that don't use any performance measures to determine pay do not need to include the list of performance measures; however, this would raise serious investor and proxy advisor concerns.
- The final rules allow companies to provide additional information beyond what is required, including additional compensation measures or financial measures, as long as doing so would not be misleading, obscuring or presented with greater prominence than the required disclosure.
  - If multiple company-selected performance measures are included in the table, then the company is required to describe the relationship between compensation actually paid and performance for each measure.

Where is the new disclosure located in the proxy?

The final rules allow for flexibility in determining where in the proxy statement to provide the new disclosure and do not require it to be included in the Compensation Discussion and Analysis (CD&A). The final rules note that mandating registrants to include the disclosure in the CD&A may cause confusion by suggesting that the pay-versus-performance relationship was considered in the company's compensation decisions, which may or may not be the case.

When will companies need to implement the rules?

Although the final rules are many years in the making, companies must move swiftly to address them. The rule will become effective 30 days after its publication in the Federal Register on September 8 and registrants must begin to comply with the new disclosure requirements in proxy and information statements disclosure for fiscal years ending on or after December 16, 2022. This means that most companies with a calendar year end will need to include the new disclosure in the 2023 proxy statement. In the first year, most companies (aside from smaller reporting companies), are required to include data for the last three years in the table, with an additional year of data added in the following two years. New reporting companies with fewer than three years of data need only report for the years for which they were reporting companies.

Appendix – FAQ

How does "compensation actually paid" differ from compensation disclosed in the Summary Compensation Table?

"Compensation actually paid" includes many of the elements included in the Summary Compensation Table in the proxy, but uses different calculations for equity awards and for pension and non-qualified deferred compensation. The deductions and additions to the Summary Compensation Table total necessary to derive compensation actually paid are summarized below:

Deduct from Total Compensation in the Summary Compensation Table	Add In
Grant date fair value of stock awards and option awards	**For awards granted in the covered year:** • The year-end fair value* of any equity awards granted in the covered fiscal year that are outstanding and unvested as of the end of the covered fiscal year • The vesting date fair value of stock awards and options (with or without stock appreciation rights) that vest in the covered year • There is no adjustment for awards that are granted and determined not to vest in the same covered fiscal year
	For awards granted in prior years: • The amount of change as of the end of the covered fiscal year (from the end of the prior fiscal year) in fair value of any awards granted in prior years that are outstanding and unvested as of the end of the covered fiscal year • For awards granted in prior years that vest in the covered fiscal year, the amount equal to the change as of the vesting date (from the end of the prior fiscal year) in fair value • For awards granted in prior years that are determined to fail to meet the applicable vesting conditions during the covered fiscal year, a deduction for the amount equal to the fair value at the end of the prior fiscal year
The aggregate change in the actuarial present value of all defined benefit and actuarial pension plans (if positive)	The dollar value of any dividends or other earnings paid on stock or option awards in the covered fiscal year prior to the vesting date that are not otherwise reflected in the fair value of such award or included in any other component of total compensation for the covered fiscal year
	The service cost, defined as the actuarial present value of benefits attributed by the pension plan's benefit formula to services rendered by the employee during the period
	The prior service cost, which is 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

* In each case fair value is computed in accordance with the fair value guidance under U.S. GAAP. Companies are required to disclose the amount of each adjustment in a footnote, as well as the valuation assumptions used in determining equity award adjustments that differ materially from those disclosed on the grant date.

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