

## Preparing for Year Two of Pay versus Performance Disclosures

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### Introduction

The SEC's final Pay versus Performance (PVP) disclosure rules were issued on August 25, 2022. Given the number of implementation issues that were raised as companies struggled to comply with the new rules, the SEC staff issued several Compliance and Disclosure Interpretations (CDIs) to clarify the disclosure requirements: fifteen CDIs were issued on February 10<sup>th</sup>, nine CDIs were issued on September 27<sup>th</sup>, and ten CDIs (including revisions to two prior CDIs) were issued on November 21<sup>st</sup>.

This Viewpoint highlights some of the most important SEC guidance that companies should consider in preparing their 2024 PVP disclosure.

### Key 2024 PVP Disclosure Considerations

The following list of key 2024 PVP disclosure considerations addresses some of the more challenging issues that companies grappled with due to the SEC's lack of clarity and varying opinions among experts on how to interpret the SEC rules. The full list of CDIs can be found on the SEC's [website](#), with all the PVP-related topics under Sections 128D and 228D.

1. **Retirement eligibility alone is not a vesting event for compensation actually paid (CAP) purposes** — CDI 128D.18 clarified that equity awards which include “double trigger” vesting provisions (i.e., participant is retirement eligible and must actually retire to receive or exercise the award) are *not* considered vested when calculating CAP. Instead, the CAP calculation should treat the award as vested on the contractual vesting date or retirement if earlier.
2. **Companies using custom peer groups** — February's CDI 128D.07 guided companies who use a custom peer group disclosed in the Compensation Discussion and Analysis (CD&A) to show total shareholder return (TSR) in the PVP table using the peer group disclosed in each year's proxy. Amended CDI 128D.07 issued in November tells such companies to revert to the long-standing performance graph rules under Item 201(e) for the 2024 proxy, which requires a company to report TSR for the most recent custom peer group for all years disclosed in the table. In other words, for calendar year companies, TSR for 2020, 2021, 2022, and 2023 is to be based on the 2023 peer group.

For companies using custom peer groups, CDI 128D.27 confirmed that if the peer group changed due to (i) an entity omitted solely because it is no longer in the line of business or industry or (ii) the changes are the result of the application of pre-established objective criteria, the disclosure requirement to compare the TSR of the old and new groups is not required. For example, a peer group change due to merger and acquisition activity would only require a footnote to highlight the change to the peer group, and no comparison of the current year and prior year's peer group market cap weighted TSR would be required.

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3. **Simplified footnote disclosure of amounts deducted and added (“adjustments” from Summary Compensation Table Total to CAP)** — CDI 128D.03 states that starting with the second year of the disclosure, companies are only required to footnote the *current year’s Summary Compensation Table (SCT) compensation to CAP calculation* unless such footnote disclosure for previous years would be material to an investor’s understanding of the PVP table for the most recent year or relationship disclosure provided under Item 402(v)(5).
4. **Expected term used in option valuations** — CDI 128D.21 confirmed that both the “short-cut” approach of simply subtracting elapsed time from the original expected term used for grant date valuations and the “simplified” method are not appropriate methods for calculating expected term. Unfortunately, the SEC staff did not provide any safe harbors for determining the expected option term, which could lead to second guessing of a company’s assumptions by the SEC staff.
5. **Smaller Reporting Companies (SRCs) losing status as of January 1, 2024** — CDI 128D.28 allows such companies to provide the scaled disclosure for an additional year (e.g., FY2021, FY2022, and FY2023). They will be subject to the full, non-scaled disclosure beginning with their 2025 proxy for fiscal year 2024, though the FY2021, FY2022, and FY2023 information does not need to be revised from scaled to non-scaled disclosure.
6. **Treatment of dividends** — CDI 128D.23 provides that dividends and dividend equivalents paid on unvested shares or options must be included in CAP in the year paid and labeled as dividends paid in the SCT to CAP reconciliation footnote to the PVP table if the value of such dividends or dividend equivalents were not reflected in the fair value of the awards. However, the guidance does not clarify whether dividends paid (i) currently or (ii) deferred until underlying shares vest are to be treated similarly. Additionally, the guidance does not address the treatment of prior dividend payments for awards for which the initial fair value included the value of future dividend payments.
7. **Broad-based index used to vest shares cannot be used as the TSR peer group in the PVP table** — CDI 128D.25 states that a broad-based index, even if used for measuring relative TSR performance for performance-based equity, cannot be used as the TSR peer group in the PVP table. This may come as a surprise to some companies who may have relied on 128D.05, which indicated “The registrant may use a peer group that is disclosed in its CD&A as a peer group actually used by the registrant to help determine executive pay, even if such peer group is not used for ‘benchmarking’ under Item 402(v)(2)(xiv) of Regulation S-K.”

## Closing Remarks

We believe that the preparation of the second year’s PVP disclosure will be far less burdensome than the past year, as only one year of CAP needs to be calculated instead of three years (two years for SRCs) of CAP; companies have established processes and controls to manage the disclosure; and selected SEC staff guidance, including the retirement vesting clarification, has removed some of the disclosure uncertainty.

However, portions of the guidance included in the thirty-two CDIs may conflict with positions taken by companies in their initial disclosure, which raises issues of how to best address such inconsistencies; as noted above, some interpretative issues are still unresolved.

This Viewpoint is intended to inform compensation committees, executives, and compensation professionals about developments that may affect their companies; it should not be relied on as specific company advice or as a substitute for legal, accounting, or other professional advice.

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