

## Issue Brief

# What You Need to Know About the SEC Pay-for-Performance Proposal

On April 29, 2015, the SEC released its long-awaited proposed guidance on pay-for-performance disclosures as required under Section 953(a) of the Dodd-Frank Wall Street Reform and Consumer Protection Act (which we'll just call "Dodd-Frank").

The world of executive compensation continues to change at lightning speed. We gave a presentation in 2007 predicting a future in which hedge funds and investors have access to mountains of compensation data which they use to make buy/sell decisions. Now, many years later and in a post-XBRL world, we're seeing waves of new quantitative information entering even the proxy, and tagged for easy retrieval by investors. The jury is still out whether and how investors might really *use* all this information, but the story is definitely getting more interesting.

The SEC clearly stated it wants more information on pay-versus-performance alignment for named executive officers so that shareholders can make more informed decisions about say-on-pay and other proxy voting topics. Below, we describe what the proposed rule entails and add some thoughts of our own.

Under the proposed pay-for-performance rules (if signed into law without subsequent revisions), companies would have to disclose the relationship between executive compensation actually paid and the financial performance of a company. The SEC's proposed rules require two key metrics:

1. A description of the relationship between the executive compensation actually paid to the top executives and the company's cumulative total shareholder return (TSR). Cumulative TSR is calculated for the measurement period like so:

*(cumulative dividends + share price at end – share price at beginning) / share price at beginning*

2. The relationship between the issuing company's TSR and the TSRs of selected peers over the recent five-year period.

The rules aim to create a standard measure that allow shareholders to compare performance across companies and industries. TSR is arguably the only way to do this since operational metrics can be calculated differently under GAAP and are susceptible to noise resulting from M&A and restructuring (among other things). The use of *relative* TSR is widely viewed as filtering out general market ups and downs that bear little on corporate outperformance or underperformance.

One very interesting question is whether the SEC's clear preference for relative TSR as the gauge for evaluating performance will lead to even broader adoption of relative TSR *awards* (versus other award design varieties). Based on a survey we conducted in early 2015, 57% of companies use some form of a relative TSR award design. The SEC's proposed rules could cause this number to grow as companies look to mechanically force symmetry between award payouts and the manner in which their pay for performance is being disclosed in the proxy.

Based on a 2015 survey, 57% of companies use some form of a relative TSR award design.

One concern is whether the use of a single metric could lead to gamesmanship. Stock prices, however, are tough to game over long periods of time. It's also interesting that the SEC proposes the use of a five-year measurement period, instead of the three-year period driving the Summary Compensation Table values. That said, the five-year measurement framework will be phased in such that only three years of historical information will be needed in the first year of disclosure.

The pay-for-performance disclosure should include the CEO on a standalone basis and then the average value from the four other NEOs in each year. We agree with averaging the other NEO values given movement in and out of the NEO group that occurs over time. A prescribed tabular format is provided by the SEC, and discussion of the relationship between pay and performance should occur below

the table in narrative and/or graphical form. Customized graphs are permitted but not required. XBRL tagging is required.

One highlight on the proposed rules is the determination of executive compensation “actually paid.” This is different from the framework applied in calculating values disclosed in the Summary Compensation Table. As [the SEC explains](#),

We believe that Congress intended executive compensation “actually paid” to be an amount distinct from the total compensation as reported under Item 402 because it used a term not otherwise referenced in Item 402.

Therefore, the starting point will be the values disclosed in the Summary Compensation Table, but equity award and pension values will be adjusted. Pension amounts will be adjusted based on changes during the service period, but excluding changes relating purely to interest rates, age, and other actuarial assumptions.

The calculation adjustment most interesting to us is the one for equity awards, where fair value on the vesting date—not the grant date—should drive the pay-for-performance disclosure. We’re not surprised. In fact we agree, because this yields a better measure of the equity value being delivered in exchange for services rendered over the requisite service period (as defined in ASC 718).

In most cases, fair value measured as of the vesting date will be straightforward. For example, the fair value on the vesting date of a restricted stock unit will simply be the stock price on that date. Aside from complexity in layering in the incremental cost on any modified awards, there are two cases in which the implementation of this rule will be challenging.

First, even for full value awards, there will be calculation complexity whenever the vesting date is not the settlement or share delivery date. A post-vest holding period, for example, inserts a wedge between vesting and delivery. Therefore, a calculation needs to be performed as of the vesting date that takes into consideration any value-reducing award features still present. On an award with a post-vest holding period, a Finnerty or Chaffe discount model is most likely appropriate. And, as always, watch out for the nuances involved in a relative TSR award since [peer firms change over time](#).

Second, estimating the fair value of a stock option that is neither at-the-money nor newly granted is *much* trickier than performing a grant-date fair value estimate. The Black-Scholes formula has known limitations which make it inappropriate for valuing options that are not at the money. Additionally, the reason Black-Scholes is relatively “easy” to run on plain vanilla newly granted options is that a wide dispersion of historical data exists to help formulate the expected term.

But since exercise decisions are highly tied to stock price trajectories, and options at vest are going to be in-the-money or out-of-the-money by varying degrees, how will companies reliably develop an expected term that takes the level of moneyness into account?

For these reasons, we believe the best practice is to use a lattice model for non at-the-money options. The lattice model produces an expected term as an *output* based on how far the option is in its life and its current moneyness level.

New rules bring new compliance costs. While our firm specializes in automating novel and niche financial calculations, proxy disclosures are clearly becoming more involved and complex with each rollout of a Dodd-Frank component. Smaller reporting companies (as defined in Rule 12b-2 under the Exchange Act) will have simpler requirements of running the calculation over only three years and not referencing the TSRs of peer firms. For all company sizes, we’re expecting the SEC to afford a lengthy ramp-up period, with the earliest year of disclosure being 2017.

The best practice is to use a lattice model for non at-the-money options.

We're looking forward to seeing the final rules. Meanwhile, here are some actions you might consider:

- **Keep watch.** The proxy is changing at light speed. This change and the soon-to-be released pay ratio guidance (and the *hopefully* soon-to-be released clawback guidance) will cause major changes to the proxy and overall executive compensation landscape.
- **Beta test.** We're already running pro forma estimates of fair value at vest for clients so they can size up the likely outcome.
- **Evaluate your process.** The proxy is becoming a much more quantitative document, which means streamlined and automated calculation processes are important for control and accuracy purposes.

David Outlaw  
[david.outlaw@equitymethods.com](mailto:david.outlaw@equitymethods.com)  
480.428.3305

Fan Wang  
[fan.wang@equitymethods.com](mailto:fan.wang@equitymethods.com)



[equitymethods.com](http://equitymethods.com)