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MERIDIAN
COMPENSATION PARTNERS

SEC Issues Guidance on Pay Versus Performance Disclosure

The Securities and Exchange Commission staff has issued new guidance on the pay versus performance disclosure ("PvP") requirement. This guidance clarifies a number of issues associated with the computation of an executive officer's "compensation actually paid."

Background

Companies are required to disclose in their proxies a description of the relationship between "compensation actually paid" (CAP) to executive officers and the financial performance of the company for the five most recently completed fiscal years (three for smaller reporting companies). Refer to Merdian Client Update dated September 6, 2022 for a detailed summary of the SEC's PvP disclosure requirement. For calendar year companies, this disclosure appeared for the first time in their 2023 proxies. The determination of CAP requires extensive calculations of changes in fair value of equity awards granted to executive officers. This requires companies to calculate fair value over the life cycle of an equity award (i.e., (i) grant date, (ii) end of fiscal year for each year outstanding and unvested and (iii) vesting date).

SEC Staff Guidance on the Determination of Compensation Actually Paid

On September 27, 2023, the SEC Division of Corporation Finance staff issued compliance and disclosure interpretations that address a limited number of issues on the calculation of fair value and CAP. This guidance is summarized below.

- *Determination of Fair Value of Equity Awards Subject to a Market Condition*.
  - **Issue**: How should companies determine the fair value of an equity award subject to a market condition (e.g., relative TSR) over the life cycle of the award?
  - **Answer**: Generally, taking into consideration a market condition, like relative TSR, requires a company to use a mathematical valuation model (e.g., Monte Carlo simulation) to determine the fair value of the award on each relevant point over the award's life cycle, until vested.
  - **Meridian comment**. We have observed some companies disregard market conditions in determining the post-grant date fair value of equity awards. The new guidance clarifies that the SEC will not permit such a valuation approach.
- *Determination of Vesting Date for Equity Awards Subject to a Retirement Provision.*
  - **Issue**: For stock and option awards that accelerate vesting upon an employee's retirement, should companies treat as a vesting date the date on which the employee becomes retirement eligible?

— **Answer**: Yes. Companies should treat as a vesting date the date on which an executive officer satisfies the condition for retirement eligibility, even though the employee has not actually retired. For awards with substantive conditions in addition to retirement eligibility, the other conditions must also be considered in determining when an award has vested. For example, some retirement eligibility provisions require an executive to provide one year advance written notice of a planned retirement date. This one-year notice requirement acts as a substantive service-based vesting requirement and therefore, would push back the vesting date from the date of retirement eligibility to the end of the one-year notice period.

— **Meridian comment**. The SEC's prescribed approach for determining vesting dates for equity awards subject to retirement provisions presents complexity for equity awards subject to pro rata vesting on an annual, monthly or daily basis. For daily pro rata vesting, each day of continued employment would be a vesting date. We have observed companies ignore retirement eligibility provisions when determining the vesting dates for equity awards, and instead base vesting on each award's non-accelerated vesting schedule. The new guidance clarifies that the SEC will generally not permit this approach.

- *Determination of Vesting Date for Equity Awards Subject to a Performance Condition that "Vests" Upon Board/Committee Certification of Payouts.*

— **Issue**: An equity award subject to a performance condition may provide that the award does not vest until the Board/Committee certify the level of payouts. Should companies treat the certification date as the vesting date for such an award?

— **Answer**: Generally, yes. If a performance-based equity award is not considered vested by its terms until Board/Committee certification, the certification date should be treated as the award's vesting date. However, if an award vests by its terms regardless of whether the employee remains employed through the certification date, then the last day of the performance period should be treated as the vesting date.

— **Meridian comment**. We have observed companies disregard certification requirements in determining vesting of a performance-based award, even though the covered executive must be employed through the date of certification to vest in the award. The new guidance clarifies that the SEC will not permit this approach.

- *Use and Disclosure of Materially Different Valuation Techniques to Determine Post Grant Date Fair Value of Equity Awards.*

— **Issue**: May a company determine the fair value an equity award (for post-grant date valuations) based on a valuation technique that differs materially from the one used to determine the award's grant date fair value?

— **Answer**: Yes. Companies may determine the fair value of an equity award based on a valuation technique that differs materially from the one used to determine the award's grant date fair value. However, companies are limited to using valuation techniques acceptable under applicable GAAP standards. In addition, in a footnote to the PvP table, a company should disclose (i) the change in valuation technique and (ii) the reason for the change.

— **Meridian comment**. The SEC does not address the issue as to the required disclosure when assumption inputs change rather than when there is a change in the valuation technique. Generally, we have observed many PvP disclosures do not disclose change of assumption inputs when the same valuation technique is used.

- *Use of Simplifying Assumptions to Determine Post-Grant Date Fair Value of Options.*
  - — **Issue**: May a company determine the post-grant date fair value of option awards based on simplifying assumptions/methods?
  - — **Answer**: No. Unless the simplifying assumptions/methods are prescribed by applicable GAAP methods, simplifying assumptions/methods may not be used to determine fair value of option awards over the award's life cycle. For example, the expected term assumptions used for Black-Scholes' calculations may not be determined by simply subtracting from the grant date expected term the number of years that have elapsed since the grant date.

    Similarly, the expected term for options should not be determined using the 'simplified' method described in the SEC Staff Accounting Bulletin unless the options meet the SEC's 'plain vanilla' criteria at the re-measurement date, such as when the option is out-of-the-money.
- *Non-disclosure of Assumptions Covering Confidential Information.*
  - — **Issue**: May a company omit information on valuation assumptions which cover confidential information?
  - — **Answer**: Yes. A company may omit information on valuation assumptions that cover confidential trade secrets or confidential commercial or financial information if such disclosure would result in competitive harm to the company. Such confidential information may include the range of performance outcomes or how a performance condition impacted the fair value. However, a company relying on this exception must provide as much information related to the valuation methodology as possible without disclosing the confidential information.
- *Determination of Fair Value of Equity Awards Granted Prior to an IPO*.
  - — **Issue**: How should companies value equity awards granted prior to going public?
  - — **Answer**: A company may need to value equity awards granted to executive officers prior to going public. For example, if a company granted pre-IPO awards on June 1, 2024 and went public in 2025, the company would need to determine the fair value of such awards as of December 31, 2024. This determination of fair value should be based on the facts and circumstances present on December 31, 2024 and should not be based on share price on the date of the IPO.
- *Determination of Fair Value of Equity Awards Granted Prior to an Equity Restructuring*.
  - — **Issue**: Should awards granted in fiscal years prior to an equity restructuring, such as a spin-off, that are retained by the holder be included in the calculation of executive compensation actually paid?
  - — **Answer**: Yes. Equity awards granted in fiscal years prior to an equity restructuring, such as a spin-off, that are retained by an executive officer during a covered fiscal year should be included in the calculation of the executive officer's compensation actually paid. In addition, any incremental compensation cost recognized due to the modification of an equity award in connection with an equity restructuring should be taken into account when computing an executive officer's compensation actually paid.

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