
Knowledge Group Webinar

Mastering the SEC's Pay vs. Performance Rule: Essential Guidance for Companies and Investors

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I'll show how the new PvP disclosures can be used to develop better measures of pay objectives and better pay plan designs

- The objectives of executive compensation have been the same for 100+ years: (1) providing strong incentives to increase shareholder value, (2) retaining key talent and (3) limiting shareholder cost.
- Effective pay design requires good measures of these basic objectives.
- Conventional pay design focuses on target pay mix and target pay percentile and conventional wisdom assumes that:
 - Percent of pay at risk is a good proxy for incentive strength, and
 - Maintaining a target pay percentile regardless of past performance (“competitive pay policy”) limits retention risk and shareholder cost; targeting pay at the 50th percentile:
 - Limits retention risk because target pay doesn’t fall below the 50th percentile, and
 - Limits shareholder cost because target pay doesn’t rise above the 50th percentile.
- I'll first show that competitive pay policy leads to weak incentives and low alignment of pay and performance (even when 100% of pay is in equity).
- I'll then show how the new PvP disclosures can be used to develop much better measures of a company's success in achieving the three basic objectives, and how these measures can be used to design more effective pay plans, i.e., plans that provide a perfect correlation of relative pay and relative performance.

The objectives of executive pay have been the same for 100+ years, but plan design has moved from value sharing to competitive pay

- The objectives of executive compensation have been the same for 100+ years: (1) providing strong incentives to increase shareholder value, (2) retaining key talent and (3) limiting shareholder cost.
- Executive pay in the first half of the 20th century was based on value sharing in economic profit:
 - General Motors' bonus pool was 10% of profit above a 7% return on capital, a formula it used for 25 years (1922-1947) without any change in the sharing percentage or threshold return. Most big companies had similar plans.
 - These plans provide strong incentives and control shareholder cost, but managing retention risk is challenging.
- Executive pay since the 1960s has been tied to competitive pay concepts, e.g., 50th percentile target pay regardless of past performance, and the belief that a high percent of pay at risk provides a strong incentive.
 - Modern executive pay plans provide surprisingly weak incentives and low alignment of pay and performance because competitive pay policy creates a systematic “performance penalty”.
 - If market pay is \$1 million and the stock price is \$100, 10,000 shares are needed to provide market pay, but
 - If stock price drops to \$50, 20,000 shares are needed to provide market pay.

Moving from target sharing to target dollar pay creates a “performance penalty” that weakens incentives and alignment

	Year 0	Year 1	Year 2	Year 3	Year 4	Year 5
Market pay		1,000	1,000	1,000	1,000	1,000
Beginning stock x (1 + industry return)	10.00	10.26	9.16	10.67	14.62	20.07

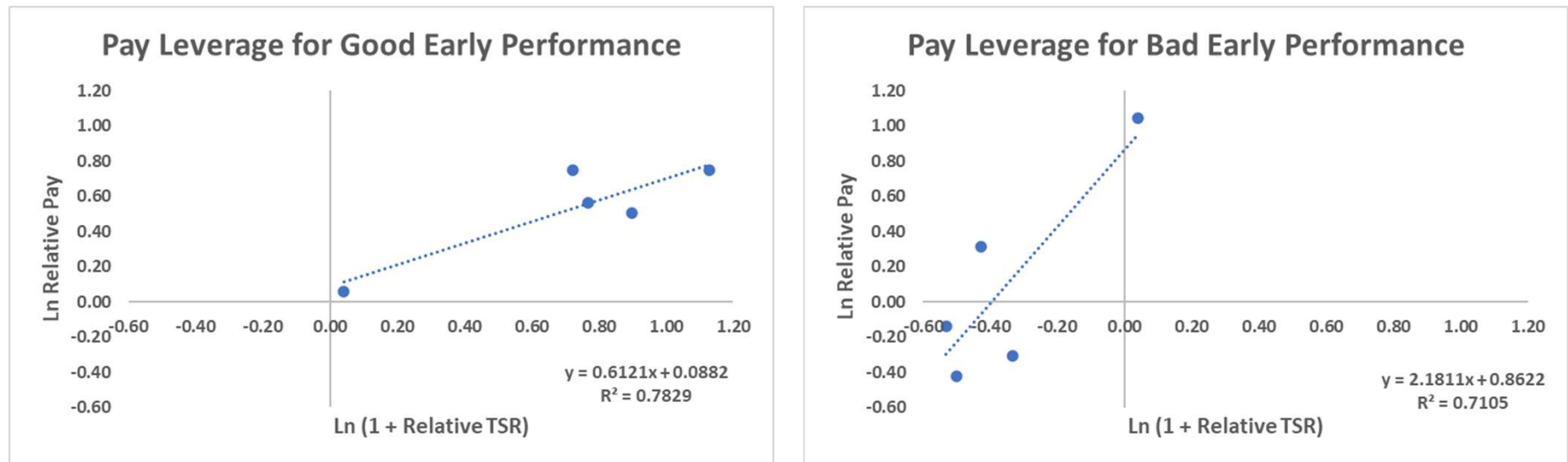
GOOD EARLY PERFORMANCE

Stock price	10.00	21.12	22.52	33.04	31.53	20.91
Shares (= market pay / BOY stock price)		100.0	47.4	44.4	30.3	31.7
Cumulative shares		100.0	147.4	191.8	222.0	253.8
Year end wealth		2,112	3,318	6,335	7,000	5,305

BAD EARLY PERFORMANCE

Stock price	10.00	7.36	5.55	6.27	9.54	20.91
Shares (= market pay / BOY stock price)		100.0	135.9	180.1	159.4	104.9
Cumulative shares		100.0	235.9	416.0	575.4	680.2
Year end wealth		736	1,310	2,610	5,487	14,221

Plotting relative pay vs relative TSR for this “mark to market” pay gives measures of incentive strength & performance adjusted cost



The graphs above plot relative cumulative pay on the vertical axis against relative cumulative TSR on the horizontal axis. The slope of the trendline slope gives us a measure of incentive strength (“pay leverage”) and the intercept gives us a measure of performance adjusted cost.

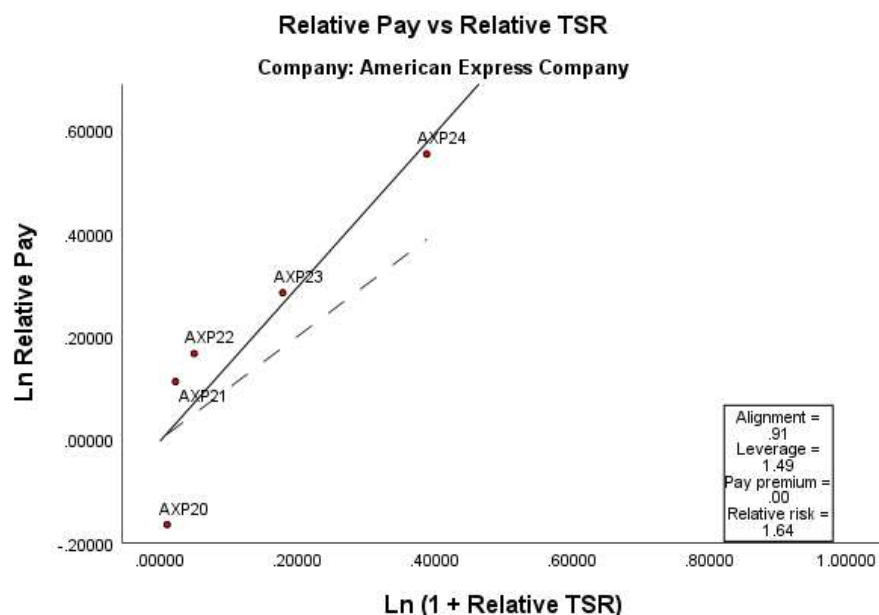
Good early performance leads to weak incentives but moderate cost. The slope of the trendline is 0.61, which tells us that a 1% increase in relative shareholder wealth increases relative pay by 0.6%. The intercept, 0.088, is the log pay premium at industry average performance. It implies a percentage pay premium of 9.2% ($= 100 * (\exp(.088) - 1)$). Bad early performance leads to strong incentives but very high cost. The slope of the trendline is 2.18 and the intercept is 0.86, which implies a percentage pay premium of 136% ($= 100 * (\exp(.86) - 1)$) at industry average performance.

The graphs show that competitive pay policy doesn’t provide consistent pay leverage or cost. It also shows that percent of pay at risk (100% in both graphs) is not a good proxy for incentive strength.

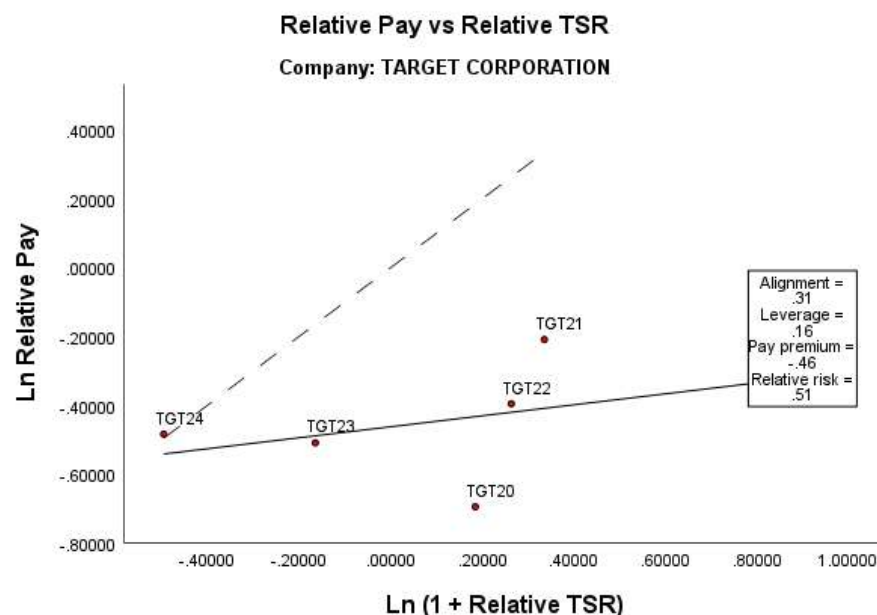
We can make this interesting pay leverage comparison because we have “mark to market” pay

- In our example, we can see the pay is very different in Good Early Performance than in Bad Early Performance because we are able to calculate “mark to market” pay. “Mark to market” pay values equity compensation based on the stock price at the end of year end.
- Prior to 2023, executive pay was always reported showing equity compensation based on the stock price at the date of grant date.
 - This “grant date” pay continues to be the basis for the Summary Compensation Table reported in the proxy statement.
 - If we were limited to grant date pay, our comparison of Good Early Performance and Bad Early Performance would show nothing interesting: both have total grant date pay of \$5,000.
- Since 2023, companies have been required to provide a supplemental analysis called “Pay Versus Performance” that shows mark to market pay, called “Compensation Actually Paid”, for the CEO and other top 5 executives.
 - In 2025 and subsequent years, companies have to report a five year history of mark to market pay.
 - This is a very significant change because it was very difficult to estimate mark to market pay from reporting grant date (I did it but very few others did). The new rules shift a major data calculation burden from investors to companies.

Relative pay vs relative TSR graphs using PvP data are highly informative



Solid line is the company trendline. Dashed line is leverage = 1.0 with pay premium of zero



Solid line is the company trendline. Dashed line is leverage = 1.0 with pay premium of zero

The left panel shows log relative pay vs log relative TSR for American Express CEO Stephen Squeri after excluding gains and losses from grants made prior to the performance measurement period 2020-2024. The regression trendline shows alignment (r-sq) of 83%, pay leverage of 1.46 and a ln pay premium at peer group average performance of 0.00. The percentage pay premium is 0% ($= 100 * (\exp(.00) - 1)$). The peer group used to compute relative TSR is the S&P Financials Index.

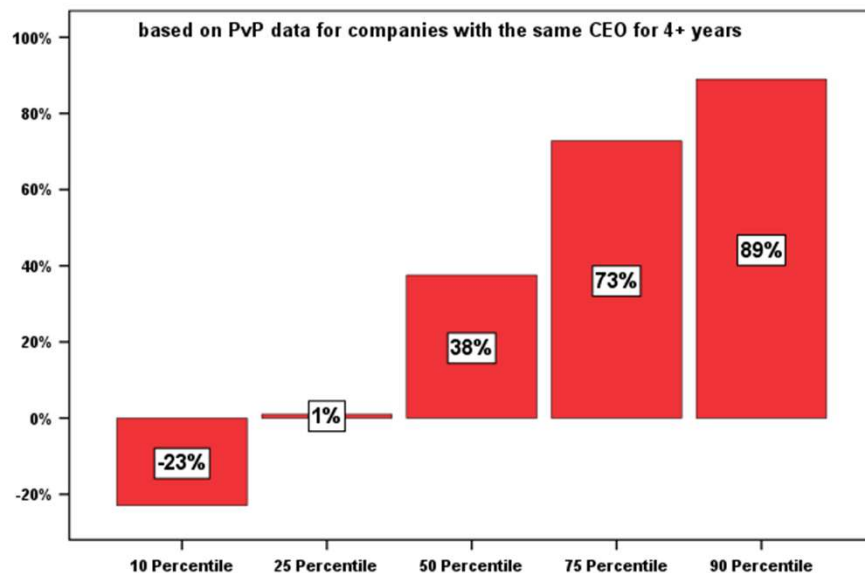
The right panel shows log relative pay vs relative TSR for Target CEO Brian Cornell. The regression trendline shows alignment (r-sq) of 10%, pay leverage of 0.16 and a ln pay premium at peer group average performance of -0.46. The percentage pay premium is -37% ($= 100 * \exp(-.46) - 1$). The peer group used to compute relative TSR is 19 retailing companies selected by Target.

The new PvP disclosures (and a little effort) provide the data for this highly informative graph

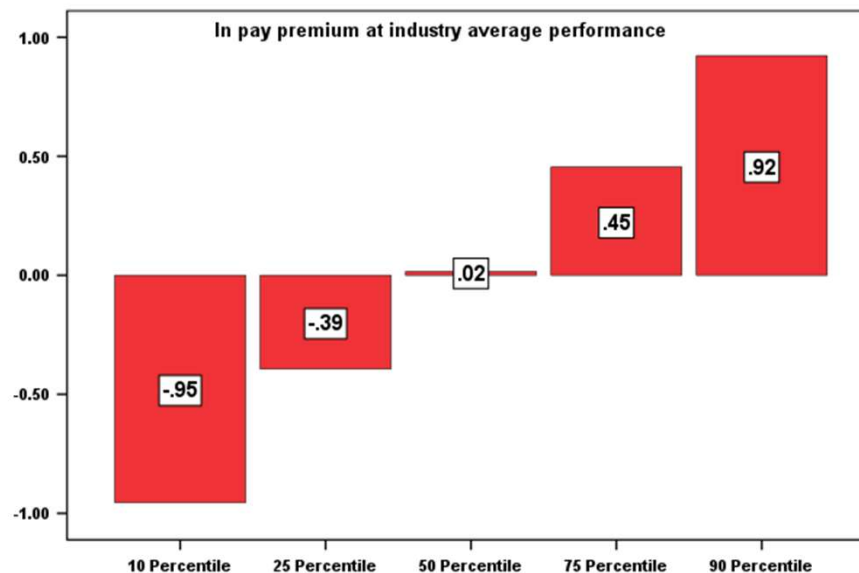
- We need to make two adjustments to the reported data:
 - The first adjustment is estimating and backing out pay attributable to grants before the five year measurement period. This is needed to match pay and performance periods
 - The second adjustment is adding up the annualized CAP figures to get cumulative realizable (or “mark to market”) pay for each year. This is needed to give the pay and performance periods the same duration.
- We need two pieces of supplemental information:
 - Market rates of pay.
 - My market rates are based on single regression trendlines relating the log of grant date pay to the log of revenue.
 - I do trendlines by industry and position/pay rank.
 - The expected annual accretion in pay.
 - Market rates are present value numbers, while mark to market pay is a future value number. The accretion factor is needed to convert market rates to future values.
 - Market rates and the accretion factor are needed to get an accurate estimate of the pay premium at industry average performance [which has a negative effect on future stock returns]. I use 5% as my estimate of the expected annual accretion in pay.

The new PvP disclosures can be used to benchmark multiple pay dimensions, not just pay level

Mark to Market Pay Alignment (r-sq)



Mark to Market Pay Premium



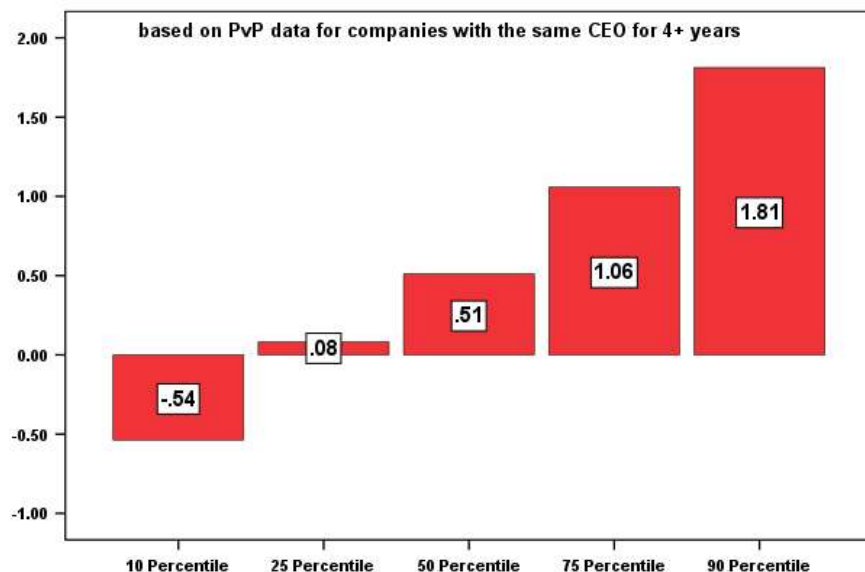
The left panel shows the distribution of alignment (r-sq) for CEOs of public companies filing their PvP disclosure in XBRL before June 6, 2025. The chart is limited to 1,174 companies with the same CEO for 4 or 5 years (244 for 2020-2023 and 930 for 2020-2024). Alignment (r-sq) is the squared correlation of relative cumulative CAP and relative cumulative TSR. The r-sq for companies with negative correlations is shown as a negative so readers can see the magnitude and direction of the relationship.

The right panel shows the distribution of the log pay premium at industry average performance for the same sample. The percentage premium is equal to $100 \times [\exp(\ln \text{ pay premium}) - 1]$. The percentage pay premium is -61% ($= 100 \times (\exp(-.95) - 1)$) at the 10th percentile and 151% ($= 100 \times (\exp(0.92) - 1)$) at the 90th percentile.

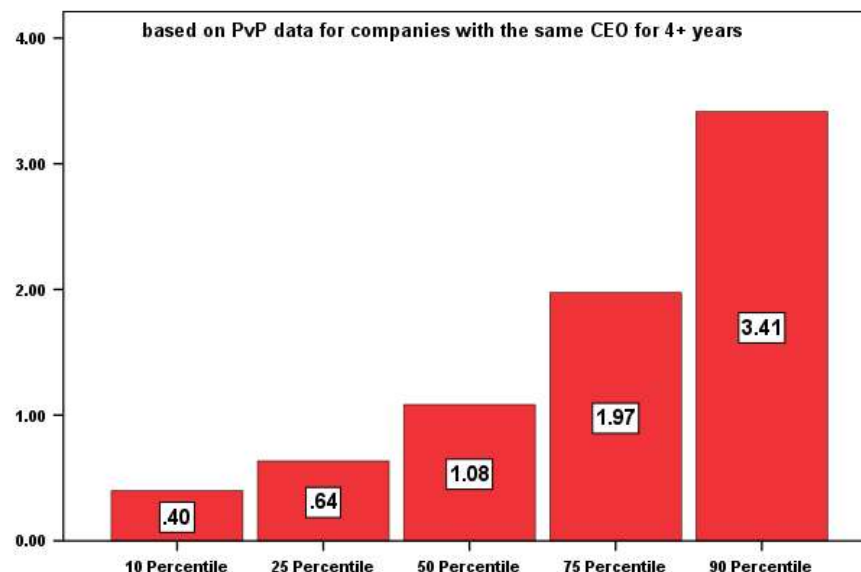
42% of the companies have alignment (r-sq) of 50%+, but 18% have high shareholder cost (pay premium > 25%) and 12% have high retention risk (pay premium < -25%), leaving only 12% achieving the three basic objectives.

The new PvP disclosures can be used to benchmark multiple pay dimensions, not just pay level (continued)

Mark to Market Pay Leverage



Relative Pay Risk

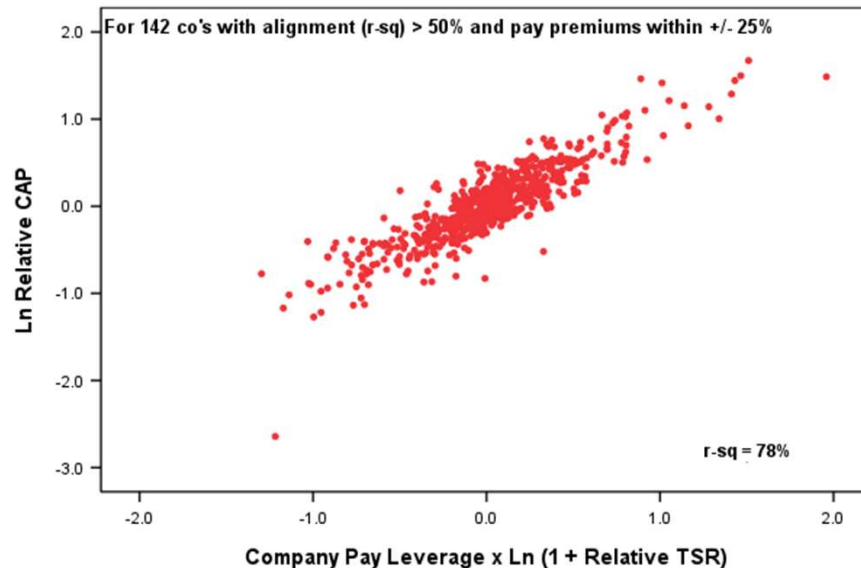


The left panel shows the distribution of pay leverage for CEOs of public companies filing their PvP disclosure in XBRL before June 6, 2025. The chart is limited to 1,174 companies with the same CEO for 4 or 5 years (244 for 2020-2023 and 930 for 2020-2024). Leverage is the sensitivity of relative pay to relative performance. The median leverage of 0.51 means a 1% increase in relative shareholder wealth increases relative cumulative pay by 0.51%.

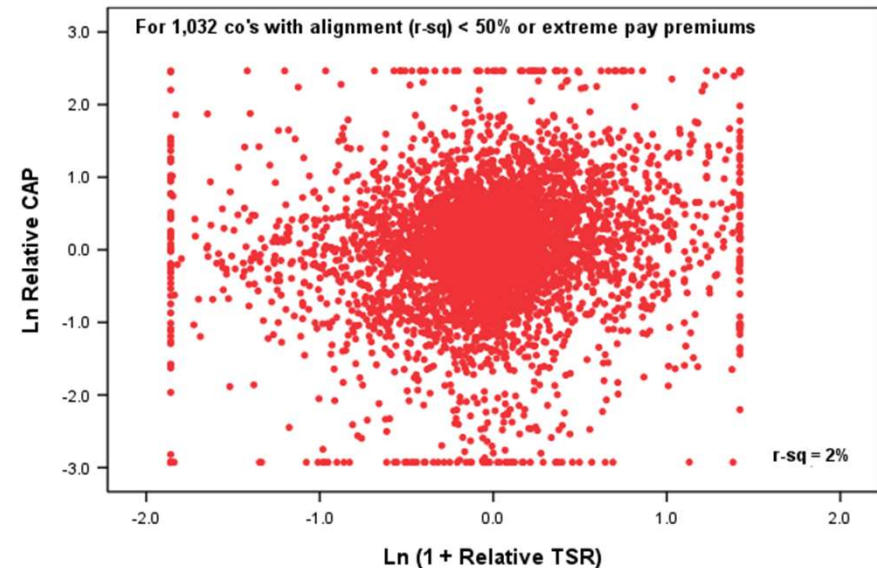
The right panel shows the distribution of relative pay risk for the same sample. Relative pay risk is the ratio of relative pay variability to relative performance variability (where variability is measured by standard deviation). It is calculated by dividing pay leverage by pay alignment. The 75th relative pay risk of 1.97 means that pay is almost twice as volatile as performance.

Multi-company graphs provide startling visual evidence that conventional pay plans provide low alignment for most companies

Relative CAP vs Relative TSR



Relative CAP vs Relative TSR



The left panel shows 142 companies (12%) that do a good job managing CEO pay. These companies have alignment (r-sq) > 50% and a pay premium within +/-25% at industry average performance. For these companies, relative TSR explains 78% of the variation in relative CEO pay. Median pay leverage is 0.83. The independent variable is pay leverage x ln(1 + relative TSR) to recognize differences in pay leverage. Pay leverage for these 142 companies is 0.35 at the 10th percentile and 2.02 at the 90th percentile. The outlier point on the lower left of the chart is 2020-2021 for Revolution Medicines.

The right panel shows 1,032 companies (= 1,174 – 142) that don't do a good job managing pay. These companies have alignment (r-sq) <50% and/or pay "premiums" outside +/-25%. For these companies, relative TSR explains only 2% of the variation in relative CEO pay. Adjusting relative TSR for pay leverage reduces the r-squared to 0.6%.

A simple pay plan – with two departures from conventional practice – has a perfect correlation of relative pay & relative TSR

	Year 0	Year 1	Year 2	Year 3	Year 4	Year 5
Market pay		1,000	1,000	1,000	1,000	1,000
Beginning stock x (1 + industry return)	10.00	10.26	9.16	10.67	14.62	20.07

GOOD EARLY PERFORMANCE

Stock price	10.00	21.12	22.52	33.04	31.53	20.91
Relative return (beginning of year)		0%	106%	146%	210%	116%
Target pay (= market x (1 + relative return))		1,000	2,057	2,458	3,095	2,157
Grant shares (= target pay / BOY stock price)		100.0	97.4	109.2	93.7	68.4
Industry return from grant to end of year 5		101%	96%	119%	88%	37%
Year 5 vesting multiple (= 1 / (1 + industry return))		0.50	0.51	0.46	0.53	0.73
Vesting grant shares		49.8	49.8	49.8	49.8	49.8
Cumulative vesting shares		49.8	99.7	149.5	199.3	249.2
Ending wealth						5,209

BAD EARLY PERFORMANCE

Stock price	10.00	7.36	5.55	6.27	9.54	20.91
Relative return (beginning of year)		0%	-28%	-39%	-41%	-35%
Target pay (= market x (1 + relative return))		1,000	717	606	588	652
Grant shares (= target pay / BOY stock price)		100	97	109	94	68
Industry return from grant to end of year 5		101%	96%	119%	88%	37%
Year 5 vesting multiple (= 1 / (1 + industry return))		0.50	0.51	0.46	0.53	0.73
Vesting grant shares		49.8	49.8	49.8	49.8	49.8
Cumulative vesting shares		49.8	99.7	149.5	199.3	249.2
Ending wealth						5,209

The perfect correlation pay plans solve the retention vs incentive problem companies have been wrestling with for 100+ years

- Figuring out how to provide (1) fixed sharing to create strong incentives *and* (2) competitive pay to retain key talent has been the great challenge of executive pay for the last 100 years. The perfect pay plans show how to do this.
- The perfect correlation pay plans can be used with:
 - Market or operating measures of relative performance; on this page, we use relative TSR.
 - With pay leverage of 1.0, less than 1.0 or more than 1.0; on this page, we use 1.0.
- The perfect correlation pay plans combine market pay with fixed sharing ratios:
 - Cumulative earned pay = cumulative FV of market pay x (1 + rTSR) [for 1.0 leverage]
 - Excess earned pay = cumulative FV of market pay x rTSR
 - Dollar excess return = market equity₀ x (1 + iTSR) x rTSR
 - Sharing ratio = cumulative FV of market pay / market equity₀ x (1 + iTSR)
 - Cumulative earned pay = cumulative market pay + sharing ratio x dollar excess return
- Conventional performance share design leverages the industry return instead of removing the industry return:
 - Vested stock value = stock value x (1 + rTSR) = stock price₀ x (1 + iTSR) x (1 + rTSR)²
 - Perfect pay stock value = stock price₀ x (1 + expected iTSR) x (1 + rTSR)

Pushed by proxy advisors & institutional investors, companies have increasingly embraced the conventional wisdom

- The conventional wisdom is that companies should set target pay at the median (regardless of past performance) and have a high percentage of pay in performance based equity.
- A growing commitment to setting target pay at the median is evident in:
 - Grant date pay is getting closer to the ISS market pay measure, i.e., the median of the company's industry-size group.
 - One study by Jochem, Ormazabal & Rajamani (2024) found that the average deviation from ISS market pay has fallen by 45% since 2007.
 - The “performance penalty” in equity compensation grants has doubled since 1995.
 - Maintaining equity compensation at a target dollar level leads to a “performance penalty” because stock price increases must be offset by a reduction in grant shares and stock price declines must be rewarded with an increase in grant shares.
 - A complete commitment to target dollar pay (regardless of stock performance) would make the log share change = $-1 \times$ the log price change.
 - A study by Ferrari, Jain, O'Byrne, Rajgopal and Reggiani (2024) shows that the average response to the log price change has increased from -.3 in 1995 to -.7 in 2021.
- A growing commitment to a high percentage of pay in equity is evident in:
 - The percent of CEO pay in equity has increased from 40% in 1992 to 65% in 2022. The percentage of companies using performance shares increased from 30% in 2008 to 75% in 2022, Hodak, Lo & Zhao (2025).
 - A study by Cabezon (2024) found that the variability of CEO pay mix has declined by 24% since 2006.

Some companies (and all private equity funds) have resisted the conventional wisdom by front-loading many years of pay

- Some companies have resisted the conventional wisdom by front-loading many years of pay.
 - In 2011, Apple granted CEO Tim Cook restricted stock with a grant date value of \$376 million.
 - In 2018, Tesla granted CEO Elon Musk stock options with a grant date value of \$2.3 billion.
 - In 2019, Alphabet granted CEO Sundar Pichai restricted and performance stock with a grant date value of \$276 million.
 - In 2020, Palantir Technologies granted CEO Alexander Karp stock and options with a grant date value of \$1.1 billion.
- Investment management fees for private equity funds also front load many years of pay. The typical management fee for a private equity fund is the sum of:
 - An annual fee equal to 2% of initial capital, plus
 - An option, or “carried interest”, on 20% of the fund value exercisable at the value of the initial capital contribution.

A few final words about the new PvP disclosures

- The new PvP disclosures can be used to measure four pay dimensions: pay leverage, pay alignment, the pay premium at industry average performance and relative pay risk. These measures are far more informative than the conventional measures used to guide plan design (target percent of pay at risk and target pay percentile).
- The relative pay vs relative performance trendline used to measure the four pay dimensions leads to a perfect correlation performance share plan, i.e., a simple pay plan with annual grants of performance shares that provides a perfect correlation of relative pay and relative performance. This perfect pay plan highlights 3 critical shortcomings of conventional pay practice:
 - Making target pay equal to market pay instead of market pay adjusted for trailing relative performance,
 - Making the stock vesting measure $[1 + \text{relative TSR}]$ instead of $[1/(1 + \text{industry return})]$, and
 - Allowing unconditioned cash payouts instead of treating all cash paid out as an advance against the retirement year value of the performance shares.
- The pay dimension measures quantified from PvP disclosure can be used to assess a company's absolute and relative success in the achieving the three basic objectives of executive compensation. These measures show that only 12% of public companies achieve high alignment of relative pay and performance ($r\text{-sq} > 50\%$) with a modest pay premium at industry average performance (+/- 25%).