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EXECUTIVE COMPENSATION

2020 Relative TSR Prevalence and Design of S&P 500 Companies

By Ben Burney

The economic consequences of the COVID-19 pandemic have upended countless budgets for 2020 and rendered long-term forecasts speculative at best. By now, most companies providing financial guidance have withdrawn it. Uncertainty abounds.

All the while, investors, proxy advisors, and other constituencies continue to demand pay-for-performance. Media and critics of executive compensation are culling through filings in search of companies taking actions that could be perceived as friendly to executives at the expense of stakeholders that may run counter to a strict pay-for-performance philosophy.

Common modifications that may be taken in the current market to set more reasonable financial goals for long-term incentives (*e.g.*, three consecutive one-year goals or use of discretion) risk being criticized by investors if outcomes do not surpass the goals set before the full impact

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of COVID-19 was apparent. In the absence of a reliable goal-setting process, compensation committees facing pressure to demonstrate pay-for-performance may increasingly turn to relative total shareholder return[1] (RTSR).

Before 2020, the use of RTSR as a performance metric was usually part of the conversation. Today, in part due to the difficulty to forecast reasonable financial goals, a discussion of long-term incentive metrics is remiss without consideration of RTSR. RTSR requires no goal setting, is simple to adopt, provides a defensible link to shareholder value, and has historically been accepted by shareholders and proxy advisors.

2020 Report Highlights

Prevalence of RTSR in long-term incentive plans increased 2% for 2020[2] to 60% of S&P 500 companies. Usage among companies in most industries increased slightly, and RTSR prevalence exceeds 40% for each S&P 500 sector for the first time. RTSR as a discrete metric is the most prevalent approach, used by 77% of companies, while 23% utilize RTSR as a modifier (an increase of 2% from 2019). Among companies employing RTSR as either a metric or modifier, 27% use a broad index group (*e.g.*, the S&P 500) and 73% use a focused peer group. The S&P 500 is used by 23% of companies using RTSR.

Prevalence

Energy and Utilities companies continue to be the primary users of RTSR across the S&P 500, with 93% of Energy and 96% of Utilities companies using RTSR. Real Estate and Materials companies report high RTSR prevalence as well, 87% and 75%, respectively. Within each of these high-prevalence sectors, companies tend to face similar commodity price pressures or economic similarities, potentially rendering RTSR a more reliable method for identifying financial and operational outperformance via market performance. (We refer to Energy, Materials, Real Estate, and Utilities companies collectively as the "Core" group of RTSR users, and the remaining companies as "Non-Core.")

We note that Non-Core RTSR companies use RTSR with less frequency than Core companies. Prevalence among other Non-Core companies is generally within the 40%–60% range.[3] We would posit that Non-Core companies experience a more diverse array of stock price pressures than do Core companies.

The table below reflects the prevalence of RTSR programs within selected industries.

Overall, prevalence of RTSR programs for 2020 is 2% higher than in 2019 and 19% higher than in 2013.

Peer Group

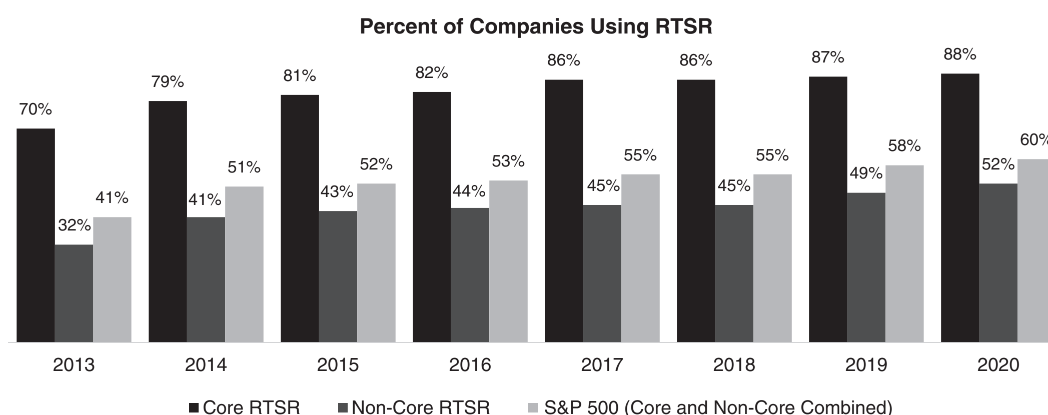
The selection of an RTSR peer group is a critical factor in the establishment of an RTSR program. We separate peer groups used by companies for measuring RTSR into four categories:

- Multi-sector index—a broad-based index comprising multiple sectors such as the S&P 500 or two or more sectors within a broad-based index (*e.g.*, S&P 500 excluding Financials).
- Single-sector index—a focused industry sector index (*e.g.*, MSCI US REIT Index, S&P 500 Utilities).
- Custom compensation peer groups—the custom compensation benchmarking peers.
- Custom performance peers—a custom peer group used solely for performance comparisons.

Peer group selection across industries may reflect the ease—or difficulty—companies have with picking peer groups and the degree

	GICS Sector (Selected GICS Subset)	# Within S&P 500	2020	2019	*% Increase*
Core RTSR	Utilities	28	96%	100%	*−4%*
	Energy	28	93%	83%	*+10%*
	Energy Equipment & Services	*6*	*100%*	*67%*	*+33%*
	Oil, Gas & Consumable Fuels	*22*	*91%*	*88%*	*+3%*
	Real Estate	31	87%	88%	*−1%*
	Materials	28	75%	76%	*−1%*
	Core RTSR	**115**	**88%**	**87%**	***+1%***
Non-Core RTSR	Information Technology	70	63%	62%	*+1%*
	Health Care	62	63%	60%	*+3%*
	Consumer Staples	33	52%	42%	*+10%*
	Food & Staples Retailing	*5*	—	—	*0%*
	Consumer Staples (Excluding Retailing)	*28*	*61%*	*50%*	*+11%*
	Industrials	70	51%	55%	*−4%*
	Communication Services	22	50%	45%	*+5%*
	Financials	65	43%	*38%*	*+5%*
	Consumer Discretionary	63	41%	*38%*	*3%*
	Retailing	*26*	*23%*	*22%*	*+1%*
	Consumer Discretionary (Excluding Retailing)	*37*	*54%*	*49%*	*+5%*
	Non-Core RTSR	**385**	**52%**	**49%**	***+3%***
	S&P 500	**500**	**60%**	**58%**	***+2%***

***Note**: Prevalence data for 2020 collected from proxies filed for S&P 500 companies with fiscal years ending March 2019 through February 2020.*



to which companies within certain sectors are comparable to each other. Across the S&P 500, 73% of companies use a focused peer group (industry index or custom group) and 27% use a multi-sector group such as the S&P 500. Overall, 55% use peer groups selected by third parties (*i.e.*, an index, either broad or focused).

Core companies, especially Energy, REITs, and Utilities, routinely use focused peer groups (Materials companies are an exception, discussed further below). Within the Energy sector, 100% of Oil and Gas companies benchmark RTSR against custom groups. This is likely due to the differing impacts oil prices have on companies within various segments of the Energy sector. For example, a rise (or fall) in global oil prices will affect exploration and production companies differently than oil transportation companies or oil refining companies. No Energy company uses the S&P 500 as its RTSR group, but a small number are adding the S&P 500 Index Composite as a performance peer.

In contrast, 52% of Utilities benchmark to a sector index group (*e.g.*, Philadelphia Utility Index). Utilities generally are more comparable to each other within the sector than are Energy companies, though 30% use a custom performance group, possibly in recognition of differences in business models such as regulated versus non-regulated asset mix. Two Utilities use the S&P 500 Index for secondary comparisons (*e.g.*, 25% weighting). Nearly one-half of REITs use multiple RTSR peer groups and 15% use a broad index, often alongside a focused peer group.

Peer group usage among Materials companies is somewhat different than other Core companies. Materials companies often have significant challenges setting three-year financial goals due to the impact of commodity prices (or other outside forces), not unlike how Energy companies are impacted by the price of oil. The key difference with Materials versus Energy is the diversity of exogenous factors: Materials companies range from chemicals to paper to metals and mining companies, all serving myriad consumers and companies.

This creates a significant challenge for identifying peers. There is a split in how Materials companies employ RTSR to address this challenge—most use highly focused custom peer groups (52%), while many others use a broad index such as the S&P 500 (38%). The inherent dissimilarities among Materials companies are likely why just one S&P 500 Materials company benchmarks to the S&P 500 Materials Index companies (one other company benchmarks to the S&P 500 Chemicals Index).

Non-Core companies are more likely to use broad indices, especially Information Technology and Communication Services (59% and 45%, respectively). Half of the Information Technology companies use the S&P 500, and 9% other broad indices. Within Communication Services (which includes traditional media and telecom, as well as social media), just 9% use the S&P 500 and 36% other indices (or selected S&P 500 sectors). Industrials and Financials are more likely to use custom performance peer groups, possibly due to their ability to confidently pick companies with similar business models (and higher stock price correlations) than other Non-Core companies. Consumer Staples favor custom compensation peers more than any other sector and rarely use the S&P 500, unlike other Non-Core companies.

RTSR Plan Design

RTSR as a Metric versus Modifier

Most companies employ RTSR as a discrete metric within a performance plan (77% of S&P 500 companies), while the remainder (23%) apply RTSR as a performance modifier.

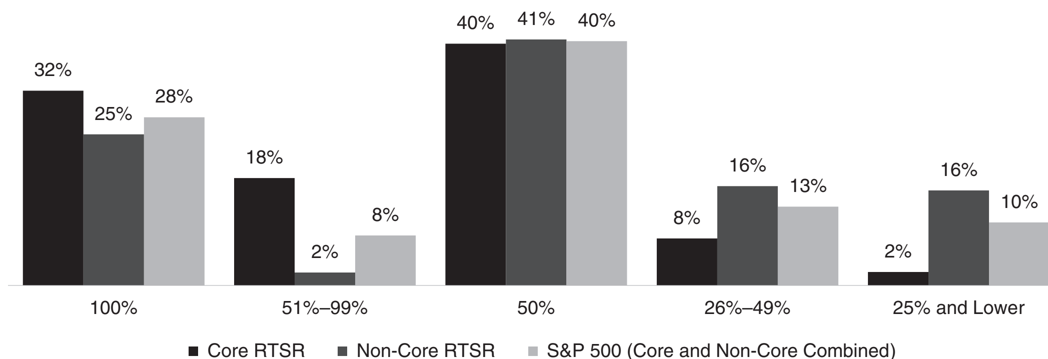
RTSR as a Discrete Metric

Used as a discrete metric, RTSR is assigned a weighting within the performance share plan (*e.g.*, 50% RTSR and 50% return on capital). The most common RTSR weight for a discrete metric is 50% for both Core and Non-Core companies. This is a notable change from 2019, when the most common RTSR weight among Core companies was 100%. Nonetheless, Core companies continue to place slightly greater weight on RTSR in performance plans than

	GICS Sector (Selected GICS Subset)	Multi-Sector Index	Single-Sector Index	Custom Group	
				Compensation Peers	Performance Peers
Core RTSR	Utilities	—	52%	19%	30%
	Energy	—	12%	31%	58%
	Energy Equipment & Services	—	*50%*	*17%*	*33%*
	Oil, Gas & Consumable Fuels	—	—	*35%*	*65%*
	Real Estate	15%	78%	4%	4%
	Materials	38%	10%	19%	33%
	Core RTSR	**12%**	**40%**	**18%**	**31%**
Non-Core RTSR	Information Technology	59%	23%	7%	11%
	Health Care	21%	38%	21%	21%
	Consumer Staples	6%	24%	41%	29%
	Food & Staples Retailing	—	—	—	—
	Consumer Staples (Excluding Retailing)	*6%*	*24%*	*41%*	*29%*
	Industrials	39%	11%	14%	36%
	Communication Services	45%	27%	18%	9%
	Financials	21%	18%	25%	36%
	Consumer Discretionary	38%	12%	23%	27%
	Retailing	*33%*	—	*33%*	*33%*
	Consumer Discretionary (Excluding Retailing)	*40%*	*15%*	*20%*	*25%*
	Non-Core RTSR	**35%**	**22%**	**19%**	**24%**
	S&P 500	**27%**	**28%**	**19%**	**26%**

Note*: Approximately 6% of RTSR users across the S&P 500 benchmark to more than one peer group. Most of these companies are REITs, which commonly benchmark to industry indices. Some percentages do not sum to 100% due to rounding.*

Weighting of RTSR as a Discrete Metric



Non-Core companies, with 32% of Core companies using RTSR as the only performance measure versus 25% of Non-Core companies. In 2019, 40% of Core companies used RTSR as the sole performance metric and 34% weighted it 50%. The graph below presents RTSR weightings as a percentage of total performance shares across Core and Non-Core companies.

Since 2014, the average weight given to RTSR as a metric has been slowly decreasing, a trend for both Core and Non-Core companies. The table below displays the average weight attributed to RTSR (excluding RTSR modifiers).

RTSR as a Modifier

As a modifier, RTSR generally adjusts the primary performance plan earned values, which typically measure a non-market metric (*e.g.*, return on capital). In most cases, RTSR modifiers provide for two-way (upward or downward) adjustments to plan payouts (*e.g.*, a modifier of ±25%), though some companies use one-way (downward or upward) modifiers. Of the companies using RTSR as a modifier, 83% use the two-way method and 17% use one-way modifiers. Use as a modifier is more common among Non-Core companies (29%) than Core companies (11%).

Modifiers may be applied in additive or multiplicative manners. An additive modifier adds or subtracts from pre-modifier performance share payouts (*e.g.*, financial performance payout plus 25% for outperformance). A multiplicative modifier uses a performance factor that is multiplied by pre-modifier performance share payouts (*e.g.*, financial performance payout multiplied by a factor of 1.25, or 125% for outperformance). Among S&P 500 companies using a two-way modifier, 54% use a multiplicative method and 46% use an additive method.

The table below provides examples of common performance plan determinations under the two methods.

Most companies using RTSR modifiers do not disclose imposing a cap on payouts at the plan maximum. For example, if financial performance pays out at 200% of target, then a modifier could increase the payout to above 200%. Eleven percent disclose capping the maximum payout at the plan maximum.

	Average Weight Attributed to RTSR							**Change from 2014**
	2014	**2015**	**2016**	**2017**	**2018**	**2019**	**2020**	
Core	75%	72%	72%	73%	71%	69%	67%	−8%
Non-Core	62%	62%	58%	59%	57%	55%	56%	−6%
S&P 500	68%	67%	64%	65%	63%	61%	61%	−7%

Financial Performance Payout	**Outperformance +25% Modification**		**Underperformance –25% Modification**	
	Additive (+25%)	**Multiplicative (×125%)**	**Additive (–25%)**	**Multiplicative (×75%)**
60%	85%	75%	35%	45%
100%	125%	125%	75%	75%
140%	165%	175%	115%	105%
175%	200%	219%	150%	131%

Companies using one-way modifiers tend to apply them as punitive measures for failing to achieve a threshold RTSR performance level, which may reduce (or cap) financial performance payouts. A small number of companies include upward modifiers to reward outperformance.

RTSR Performance Measurement

Performance measurement methodology is varied across S&P 500 companies. Most companies (89%) with RTSR plans use percentile rank or numerical rank methods for benchmarking relative performance. Among these companies, 86% use the percentile rank method, and 14% a numerical rank method. Of those using the numerical rank method, roughly 50% are Energy companies.

An alternative to the traditional ranking method is to measure the spread in TSR relative to a defined barometer of performance, such as an index composite or the median TSR of a peer group[4] (sometimes referred to as an "outperformance" method). This method is used by 12% of S&P 500 companies, but is most common among REITs, with roughly 43% measuring RTSR against an index composite figure or peer group median. This method is less than 10% prevalent across non-REIT S&P 500 companies.

The table below identifies the ways in which RTSR is used within selected industries.

	GICS Sector (Selected GICS Subset)	LTI Metric	LTI Modifier	Method	
				Rank	Outperformance
Core RTSR	Utilities	85%	15%	96%	4%
	Energy	88%	12%	100%	—
	Energy Equipment & Services	*67%*	*33%*	*100%*	—
	Oil, Gas & Consumable Fuels	*95%*	*5%*	*100%*	—
	Real Estate	100%	—	52%	48%
	Materials	81%	19%	100%	—
	Core RTSR	**89%**	**11%**	**86%**	**14%**
Non-Core RTSR	Information Technology	77%	23%	75%	25%
	Health Care	67%	33%	82%	18%
	Consumer Staples	82%	18%	100%	—
	Food & Staples Retailing	—	—	—	—
	Consumer Staples (Excluding Retailing)	*82%*	*18%*	*100%*	—
	Industrials	72%	28%	97%	3%
	Communication Services	82%	18%	91%	9%
	Financials	57%	43%	96%	4%
	Consumer Discretionary	65%	35%	92%	8%
	Retailing	*50%*	*50%*	*83%*	*17%*
	Consumer Discretionary (Excluding Retailing)	*70%*	*30%*	*95%*	*5%*
	Non-Core RTSR	**71%**	**29%**	**89%**	**11%**
	S&P 500	**77%**	**23%**	**88%**	**12%**

Other Design Elements

Pay/Performance Leverage

Unlike other design elements of RTSR plans, pay/performance leverage varies less across industries.

Although the single most common maximum performance percentile remains at the 75th, it is a majority practice for companies to require performance to exceed this level. Nearly 60% of all S&P 500 companies require performance above the 75th percentile for RTSR plans to pay at maximum. Core companies tend to require higher performance levels for a maximum payout than Non-Core companies, with 68% of Core companies requiring performance exceeding the 75th percentile, versus 52% for Non-Core companies. The general trend is towards increased performance requirements, with companies requiring higher performance levels to achieve a maximum payout. The table on the next page displays maximum performance percentiles required to achieve maximum payouts.

Above-Median Target Performance Percentile

The standard performance target in RTSR plans is the peer group median. An increasing number of companies, however, are targeting levels above the median. The reasons companies do so may be tied to trying to guard against proxy advisor criticism of pay plans or seeking to demonstrate more strenuous pay-for-performance requirements. Proxy advisors, especially ISS, are scrutinizing RTSR plans and occasionally criticizing companies for prescribing a target-level payout at median performance.

Nonetheless, despite this ISS criticism, 89% of S&P 500 companies target the peer group median for their awards granted annually and 11% target above the median (the same prevalence as Exequity reported in 2018; 2019 prevalence was 9%). Among those targeting above the median, 25% target the 60th percentile, 66% the 55th percentile, two companies between the 55th and 60th percentiles, and one company the 75th percentile.

Negative TSR Cap

Some companies impose a "cap" on RTSR payouts when absolute TSR is negative. Prior to the COVID-19 pandemic, some compensation committees were already uncomfortable with the possibility of abovetarget RTSR payouts when shareholder returns over the measurement period are negative. With negative returns in several hard-hit industries, media and other

	Median Performance Requirement		Median Payout	
	Threshold	Maximum	Threshold	Maximum
Core RTSR	25%	90%	45%	200%
Non-Core RTSR	25%	80%	50%	200%
S&P 500	25%	80%	50%	200%

***Note**: When RTSR is used as a modifier, the most common performance hurdles are 25th and 75th percentiles (threshold and maximum, respectively), and the median/mode percentage modifier is ±25%. Data displayed in the above table excludes performance ranges for companies using RTSR as a modifier.*

	<75th	75th	>75th–<90th	90th	>90th–100th
Core	3%	29%	18%	33%	17%
Non-Core	1%	47%	25%	16%	11%
S&P 500	2%	40%	23%	23%	13%

interested observers are beginning to focus more on RTSR plans and whether companies are employing this feature. Proxy advisors favor capping awards at target when absolute TSR is negative.

Currently, 26% of S&P 500 companies disclose caps on RTSR awards. Despite the attention negative TSR caps have received, prevalence increased just 6% from 2017 and 1% since 2019. Slightly more Core companies use negative TSR caps than Non-Core companies (29% and 24%, respectively). More Energy companies employ RTSR caps (42%) than any other sector.

When absolute TSR is negative, the method most companies use to cap payouts is to set the maximum payout at 100% of target. A small number of companies use other methods, including negative modifiers or even alternative pay-for-performance scales. To date, proxy advisors seem to prefer caps that disallow above-target payouts when absolute TSR is negative.

Multiple Performance Periods

A feature not often discussed in RTSR awards is the use of multiple performance periods. In this construct, a single RTSR grant is divided into multiple performance periods. The most common is a structure where there are three discrete periods of one, two, and three years. Just 5% of companies using RTSR use multiple performance periods, but about one-half of the companies using this construct weight RTSR at 100%. Using multiple performance periods is a way of mitigating the risk of no payout in a given three-year RTSR performance cycle.

Stock Price Averaging

Companies commonly use stock price averaging periods to smooth out daily volatility at the beginning and end of the performance period. Among companies disclosing averaging periods, approximately 66% use a period of one week to one month (with 20 trading or 30 calendar days being the most prevalent periods), 20% use a period of five to ten weeks, and 14% use 90 calendar days or longer.

Decision Points for Companies Considering RTSR

Companies considering RTSR for the first time, or making changes to an existing plan, should give thought to the key attributes of RTSR plans to avoid last-minute decisions or confusion when performance is assessed. A summary of key decision points is presented below.

- **Peer group**. What is the compensation committee's philosophy with respect to performance measurement?
  - Some believe comparisons to the broader capital markets are appropriate (*e.g.*, S&P 500).
  - Others seek to reward for outperformance of only those companies most like the sponsor (*e.g.*, focused groups such as custom compensation peers, performance peers, sector indices).
- **Metric versus modifier**. Will RTSR be used as a discrete performance metric, or will it modify financial/strategic performance conditions?
  - Should an additive or multiplicative modifier be used? What should the maximum payout be?
- **Performance assessment**. Should performance be assessed using a ranking method or outperformance method?
  - If a rank method, then numerical rank or percentile rank?
  - If outperformance, then versus an index composite or peer median?
- **Performance requirements**. What levels of relative performance (or outperformance)

S&P 500 RTSR Prevalence and Design Results Detail

			Companies Using RTSR in Long-Term Incentive Plans								RTSR Peer Group			
					RTSR as Long-Term Incentive Metric				Method					
GICS Sector (Selected GICS Subset)		S&P 500	# Using RTSR	% Using RTSR	% Using	Median % of Performance Share Units	Mode % of Performance Share Units	RTSR as Long-Term Incentive Modifier	Rank	Outperformance	Broad-Based/ Multi-Sector Index	Single-Sector Index	Custom Comp. Peers	Custom Perf. Peers
Core RTSR	Utilities	28	27	96%	85%	50%	50%	15%	96%	4%	—	52%	19%	30%
	Energy	28	26	93%	88%	100%	100%	12%	100%	—	—	12%	31%	58%
	Energy Equipment & Services	*6*	*6*	*100%*	*67%*	—	—	*33%*	*100%*	—	—	*50%*	*17%*	*33%*
	Oil, Gas & Consumable Fuels	*22*	*20*	*91%*	*95%*	*100%*	*100%*	*5%*	*100%*	—	—	—	*35%*	*65%*
	Real Estate	31	27	87%	100%	71%	100%	—	52%	48%	15%	78%	4%	4%
	Materials	28	21	75%	81%	50%	50%	19%	100%	—	38%	10%	19%	33%
	Core RTSR	**115**	**101**	**88%**	**89%**	**62%**	**100%**	**11%**	**86%**	**14%**	**12%**	**40%**	**18%**	**31%**
Non-Core RTSR	Information Technology	70	44	63%	77%	50%	100%	23%	75%	25%	59%	23%	7%	11%
	Health Care	62	39	63%	67%	50%	50%	33%	82%	18%	21%	38%	21%	21%
	Consumer Staples	33	17	52%	82%	50%	50%	18%	100%	—	6%	24%	41%	29%
	Food & Staples Retailing	*5*	*0*	—	—	—	—	—	—	—	—	—	—	—
	Consumer Staples (Excluding Retailing)	*28*	*17*	*61%*	*82%*	*50%*	*50%*	*18%*	*100%*	—	*6%*	*24%*	*41%*	*29%*
	Industrials	70	36	51%	72%	50%	50%	28%	97%	3%	39%	11%	14%	36%
	Communication Services	22	11	50%	82%	67%	100%	18%	91%	9%	45%	27%	18%	9%
	Financials	65	28	43%	57%	50%	50%	43%	96%	4%	21%	18%	25%	36%
	Consumer Discretionary	63	26	41%	65%	42%	50%	35%	92%	8%	38%	12%	23%	27%
	Retailing	*26*	*6*	*23%*	*50%*	—	—	*50%*	*83%*	*17%*	*33%*	—	*33%*	*33%*
	Consumer Discretionary (Excluding Retailing)	*37*	*20*	*54%*	*70%*	*50%*	*50%*	*30%*	*95%*	*5%*	*40%*	*15%*	*20%*	*25%*
	Non-Core RTSR	**385**	**201**	**52%**	**71%**	**50%**	**50%**	**29%**	**89%**	**11%**	**35%**	**22%**	**19%**	**24%**
	S&P 500	**500**	**302**	**60%**	**77%**	**50%**	**50%**	**23%**	**88%**	**12%**	**27%**	**28%**	**19%**	**26%**

***Note**: Some percentages do not sum to 100% due to rounding.*

should define threshold, target, maximum performance? What are the payouts for these performance levels?

— Should target performance be set at the median? Or a higher level, such as the 55th percentile?

- **Performance cycle**. Should performance be measured in three-year increments? Or a combination of periods?

— If a company operates in a highly cyclical industry and business cycles do not align with the standard three-year periods, should multiple performance periods be used to reward for performance across cycles?

- **Averaging period**. Should performance be measured based on the first and last trading days of the performance cycle, or an average trading price at both ends? The emerging standard is roughly one month, though longer (or shorter) averaging periods may be reasonable.

- **Negative TSR cap**. Should payouts be capped at target if absolute TSR is negative?

— Proxy advisors sometimes criticize companies without negative TSR caps.

Notes

1. Total shareholder return is defined as the change in stock price plus reinvested dividends.

2. S&P 500 companies with fiscal years ending March 2019 through February 2020.

3. In prior years, this range was 40%–50%, but prevalence has increased across several sectors.

4. A company employing this method compares its TSR to that of the index composite figure and adjusts payouts based on the spread between the two figures. For example, if the company's TSR is 15% and the index composite TSR is 5%, then the company beat the index by 10 percentage points. Assuming a payout of 2% of each percentile of outperformance, this would yield a 110% payout.

Assessment of ISS's Use of EVA in CEO Pay-for-Performance Model

By Ira Kay, Marizu Madu, and Phil Johnson

In 2017, Institutional Shareholder Services (ISS) introduced their secondary quantitative test, the Financial Performance Assessment (FPA). This was in response to criticisms that their primary pay-for-performance (P4P) tests, which measure the alignment of CEO pay and total shareholder return (TSR) relative to an ISS-developed peer group, only focused on TSR as the primary performance metric.

The FPA test (as used in 2017-2019) compared the company's financial and operational performance versus the ISS peer group, utilizing three or four GAAP metrics that were selected and weighted based on the company's industry. The GAAP metrics include return on invested capital (ROIC), return on assets (ROA), return on equity (ROE), EBITDA growth, and cash flow (from operations) growth.

For 2020, ISS has changed its policy on the FPA test. Economic Value Added (EVA) will replace the GAAP metrics for the vast majority of companies. The new FPA test will generally utilize four equally weighted EVA-based metrics as defined by ISS: EVA Margin, EVA Spread, EVA Momentum vs. Sales, and EVA Momentum vs. Capital. See Appendix for definitions.

In 2018, ISS acquired EVA Dimensions LLC, a firm founded by Bennett Stewart, one of the original creators of EVA. ISS and Mr. Stewart wrote a white paper published in April 2019, arguing that EVA is the best metric to use in assessing managers' performance in creating value, whether used in incentive plans or not.

According to Mr. Stewart, "Increasing EVA is the key to creating wealth, maximizing NPV (net present value of cash flows), and generating TSR, all at the same time!"[1]

Stewart attempts to prove this theory by showing that change in EVA is highly correlated with change in MVA (Market Value Added). MVA is the spread between a firm's overall market value, or enterprise value, given its current share price and the capital invested in its business assets. Stewart, however, did not show/evaluate the direct correlation between EVA and TSR.

Is EVA a better performance evaluation/incentive metric than TSR, GAAP, or non-GAAP financial metrics? Will ISS's introducing EVA encourage companies to at least consider using EVA in their incentive plans?

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the Corporate Governance advisor

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These are the questions we address in this article:

What Is EVA?

EVA measures company profits in excess of the cost of capital (debt and equity). EVA is thus net operating profit after taxes (NOPAT), less a weighted average cost of capital charge applied to invested capital.

EVA, as a performance metric, offers certain benefits. It is a measure of shareholder value creation or destruction: positive EVA indicates value creation, while negative EVA highlights potential value-destroying investments. EVA provides an internal, management-controllable measure, whereas TSR is external and not directly controllable by management.

On the other hand, EVA has its share of criticisms. Using EVA as a performance metric could discourage growth and acquisition of new capital by managers. When an investment is made, the full cost of the investment is reflected in EVA, frequently before profits are realized from the investment, which reduces EVA. In addition, EVA may not be easily understood by management and other employees unless broken down into primary drivers (*e.g.*, revenue, expense control, capital cost/charges, and ROIC).

Academic research by Pataky[2] found that using EVA as an investment strategy does not offer higher returns for an investor compared to other financial metrics. Furthermore, academic research by Griffith[3] shows there is no correlation between companies adopting EVA and subsequent shareholder returns. Before companies in the sample adopted EVA as a measure of performance, they underperformed peers and the market, and they continued to underperform significantly after implementing the EVA compensation systems. Academic research by Robert Ferguson et al.[4] shows there is insufficient evidence to conclude that poor stock performance leads firms to adopt EVA or that adopting EVA improves stock performance. There, however, is limited recent academic research on EVA, given its limited current usage. We anticipate that research will increase, given the new ISS EVA methodology.

Pay Governance Analysis

To help determine whether EVA is a better performance metric than GAAP metrics, as ISS implies in their study,[5] Pay Governance analyzed the correlation between EVA growth and TSR among the S&P 500 over a three-year period (2016-2018).[6] **We test a simple theory: companies with positive or higher percentage growth in EVA should experience positive/superior levels of TSR (Exhibit 1)**. This is the basic premise of the ISS P4P test using EVA.

We also analyzed the correlation of selected GAAP metrics and TSR for comparison. We used TSR as the benchmark for comparison because it is a widely accepted measure of the shareholder experience and is the ultimate score that investors and management teams keep track of.

Our analysis shows the following:

- Of all the metrics we reviewed, EBITDA growth has the highest correlation to TSR. EBITDA growth has a higher correlation than EVA growth and EVA Momentum (Capital) (Exhibit 1) correlation of 0.41 for EBITDA growth vs. 0.24 for EVA growth (see Exhibit 1 below).

- EVA growth[7] and EVA Momentum (Capital)[8] have **similar but not superior** correlations to TSR as GAAP metrics such as Sales Growth, EPS growth, Average Return on Assets, and Average Return on Capital (Exhibit 1).

- Furthermore, EVA growth and EVA Momentum (Capital) show very low or negative correlation to TSR for companies in the Energy sector (Oil & Gas companies) and Real Estate Investment Trust (REIT) sector. EVA has lower correlation to TSR for

Exhibit 1: Correlations with TSR

Metric	All Companies	Energy	Real Estate
EBITDA Growth	0.41	0.25	0.49
EVA Momentum (Capital)	0.26	-0.26	0.09
EVA Growth	0.24	-0.25	0.08
Sales Growth	0.23	0.26	0.44
EPS Growth	0.21	0.05	0.15
Average Return on Assets	0.18	0.33	0.00
Average Return on Capital	0.18	0.31	0.03
Free Cash Flow Growth	0.04	0.04	0.24
Average Return on Equity	-0.42	0.52	-0.05

Exhibit 2: Comparison of High and Low TSR Companies with their Associated EVA Growth and EBITDA Growth

		3-Year Median CAGR Performance (2016-2018)		
Category	Count	TSR	EVA Growth	EBITDA Growth
Companies with high TSR	242	16%	5%	10%
Companies with low TSR	243	1%	-4%	4%
All Companies	485	9%	1%	7%

companies in these industries partly because these companies tend to have delayed profits from capital investments. Profits can be realized years after the investment is made.

To further illustrate the correlation of EBITDA growth to TSR, and EVA growth to TSR, we separated our sample into two categories: companies with high TSR (above median TSR for all companies in the sample) and companies with low TSR (below median TSR).

Exhibit 2 below shows that the high TSR companies also have higher EVA and EBITDA growth than the low TSR companies. High TSR companies have annualized median TSR of 16% over the three-year period ending 12/31/18, corresponding with annualized EVA growth of 5%, and EBITDA growth of 10%. The low TSR companies have a lower annualized median TSR of 1%, corresponding with lower EVA growth of -4% and EBITDA growth of 4% at the median.

We also found [not shown] that for companies with negative EVA growth, most (71%) have positive TSR. This partially explains why the correlation of EVA growth to TSR is not stronger than it is: in theory, we would expect companies with negative EVA growth to have negative TSR.

Conclusion

Our study has shown that EVA may not be the ideal performance evaluation/incentive metric for all companies. In fact, EBITDA proves to be a better metric based on TSR correlation. This finding is consistent with another firm's study[9] which found that EBITDA is more highly correlated with TSR performance than EVA growth.

Based upon the research of Pay Governance and others, it is possible that using EVA will

Appendix—ISS EVA Definitions

Metric	Definition
EVA Margin (EVA ÷ Sales)	The percent of sales remaining after covering all operating and capital costs; a combined measure of profit and loss (P&L) efficiency and balance sheet asset management.
EVA Spread (EVA ÷ Capital)	The EVA yield on capital, which equals the spread between the firm's return on capital (ROC) and its cost of capital (COC).
EVA Momentum vs. Sales (Change in EVA ÷ Prior Sales)	The trend line annual growth rate in EVA over the past three years, scaled to Sales.
EVA Momentum vs. Capital (Change in EVA ÷ Prior Capital)	The trend line annual growth rate in EVA over the past three years, scaled to Capital.

yield a number of "false negatives" of companies with poor EVA values in the ISS test but positive/strong TSR. That being said, EVA may work well as a performance evaluation/incentive metric for some individual companies.

ISS has also stated that they do not believe companies should necessarily incorporate EVA as a performance metric in their incentive programs. ISS's incorporation of TSR as their primary P4P metric, however, has influenced the widespread adoption of TSR in incentive plans, with almost 60% of S&P 500 companies having adopted it.[10]

Pay Governance advises our clients that companies should continue to select incentive plan metrics strategically and to investigate before relying on metrics selected by ISS for its P4P assessments. Preferred/appropriate metrics will vary by industry and by company-specific circumstances and may include one or more GAAP or non-GAAP metrics (including EVA), strategic objectives, company stock price targets, or TSR. In addition to rigorous goal setting, companies should consider a thorough review of chosen metrics in the context of the link to shareholder value creation, strategy, business model, and motivation of management.

Over time, focusing on company-specific drivers of value creation will translate into shareholder value creation, greater clarity to incentive plan participants as to organizational priorities, and positive Say-On-Pay outcomes.

Notes

1. Bennett Stewart. "The Link Between TSR and EVA." ISS. April 4, 2019. (go back)

2. Tamas Pataky. "Is economic value added (eva) the best way to assemble a portfolio?" University of Central Florida, Fall 2012. *https://stars.library.ucf.edu/cgi/viewcontent.cgi?article=2367&context=honorstheses1990-2015*.(go back)

3. John M. Griffith. "The True Value of Eva." *Journal of Applied Finance*, Fall/Winter 2004. *https://papers.ssrn.com/sol3/papers.cfm?abstract_id=670387*.(go back)

4. Robert Ferguson et al. "Does Economic Value Added (Eva) Improve Stock Performance or Profitability?" *Journal of Applied Finance*. Fall/Winter 2005. *https://papers.ssrn.com/sol3/papers.cfm?abstract_id=808425*.(go back)

5. Bennett Stewart. "The Link Between TSR and EVA." ISS. April 4, 2019.(go back)

6. Our study included 485 companies from the S&P 500 as of September 2019, excluding those without three years of TSR or financial performance history.(go back)

7. EVA as calculated using S&P Capital IQ methodology and inputs: ((NOPAT/Invested Capital)—WACC) * Invested Capital. WACC: weighted average cost of capital. (go back)

8. EVA momentum (Capital) is defined as a change in EVA (2015-2018) divided by average capital over the three-year period ending 2018.(go back)

9. EXEQUITY, "ISS, EVA, and Economic Voodoo." August 20, 2019. *https://www.exqty.com/uploads/6/9/9/0/69908991/ecomonic_voodoo_20190820.pdf*. (go back)

10. EXEQUITY. "2019 Relative TSR Prevalence and Design of S&P 500 Companies." September 25, 2019. *https://www.exqty.com/uploads/6/9/9/0/69908991/rtsr_prev_and_design_of_sp500_20190925.pdf*.

SEC's COVID-19 Supplemental Guidance Reinforces Importance of High-Quality Financial Reporting

By David I. Meyers and Mashal S. Shah

On June 23, 2020, in light of the ongoing global COVID-19 pandemic, the Securities and Exchange Commission's (SEC) Division of Corporation Finance released CF Disclosure Guidance: Topic No. 9A (the *Supplemental Guidance*), which supplements CF Disclosure Guidance Topic No. 9 (the *Original Guidance*). The Supplemental Guidance provides the Division's additional views regarding operations, liquidity, and capital resources disclosures that companies should consider with respect to business and market disruptions due to the COVID-19 pandemic.

In the Original Guidance, the Division addressed disclosure requirements, trading on insider information and reporting earnings, and financial results in light of COVID-19. The Supplemental Guidance provides companies additional considerations to assist their evaluation of COVID-19–related effects and generate robust, forward-looking disclosures.

In the Supplemental Guidance, the Division reiterates that it continues to monitor companies' disclosures of the impacts and risks of the ongoing COVID-19 pandemic on their businesses, financial condition, and results of operations. As with the Original Guidance, the Division urges companies to actively revise and update disclosures to help investors assess the actual and future impact of COVID-19 through the lens of management.

The Division notes that "[t]hese disclosures should enable an investor to understand how management and the Board of Directors are analyzing the current and expected impact of COVID-19 on the company's operations and financial condition, including liquidity and capital resources."

The Division addresses three general topics in the Supplemental Guidance:

1. Operations, Liquidity, and Capital Resources

Companies have had to make a broad range of material operational changes in response to the effects of the pandemic, including the transition to remote-work, supply-chain and distribution adjustments, and changes related to health and safety guidelines to protect employees, contractors and customers, including in connection with transitions back to the workplace.

The Supplemental Guidance notes that companies should carefully consider their obligation to disclose such substantial changes to investors. In addition, the current economic climate has pushed many companies to undertake a wide range of financing activities, such as obtaining new credit facilities, accessing public and private markets, and negotiating new or modified financing programs.

Since the new financing tools may include novel terms and structures, the Division urges companies to provide transparent disclosures about their plans to manage short- and long-term liquidity and funding risks, especially pertaining to new risks faced by their businesses. The Division notes a potential discrepancy about these disclosures being included in earnings releases but not included in Management's Discussion and Analysis (*MD&A*), and advises that companies consider whether to include these disclosures, in light of their potential materiality, in MD&A.

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See Appendix A for a list of questions the Division believes companies should consider when assessing their specific situation in the context of the ongoing COVID-19 pandemic.

2. Government Assistance—The CARES Act

Many companies have been receiving financial assistance and tax relief under the Coronavirus Aid, Relief, and Economic Security Act (*CARES Act*) in the form of loans, deferred or reduced payments, and possible refunds. The Division recommends that companies receiving federal assistance should consider the short- and long-term effects of that assistance on their financial condition, operations, liquidity, capital resources, appropriate disclosures (*e.g.*, MD&A and U.S. GAAP disclosures), accounting estimates and assumptions. Appendix A also includes questions the Division believes companies should consider with respect to financial assistance and tax relief under the CARES Act.

3. Ability to Continue as a Going Concern

Companies should evaluate whether the total economic effects of COVID-19 raise substantial doubt about their ability to continue as a going concern. If the adverse impact of the pandemic raises substantial doubt about a company's ability to meet its obligations as they become due within one year after the issuance of the financial statements, the Division advises that management should provide appropriate disclosures in the financial statements and outline any plans to alleviate such doubt, as required by U.S. GAAP.

Appendix A includes questions the Division believes companies should consider with respect to MD&A disclosures related to a company's ability to continue as a going concern.

4. Additional Information

As it did in the Original Guidance, the Division again emphasizes that companies should consider the impact of COVID-19 on other disclosures, including disclosure controls and procedures (*DCP*) and internal control over financial reporting (*ICFR*). The Division also refers to the SEC Chief Accountant Safar Teotia's Statement on the Continued Importance of High-Quality Financial Reporting for Investors in Light of COVID-19 with respect to accounting and auditing matters related to COVID-19 (the *June OCA Statement*).

The June OCA Statement on the Continued Importance of High-Quality Financial Reporting

In conjunction with the Division's Supplemental Guidance, the Office Chief Accountant (*OCA*), issued the June OCA Statement regarding the importance of high-quality financial reporting in the context of COVID-19. The June OCA Statement expands and supplements the April OCA Statement released by the OCA on April 3, 2020. In particular, the June OCA Statement focused on:

1. Significant Estimates and Judgments

As noted in the April OCA Statement, many companies had to make important judgments in accounting and financial reporting matters. The June OCA Statement urges companies to ensure that significant judgments and estimates are disclosed in a manner that is "understandable and useful to investors, and that the resulting financial reporting reflects and is consistent with the company's specific facts and circumstances."

2. Disclosure Controls and Procedures and Internal Control over Financial Reporting

The June OCA Statement emphasizes the importance of robust internal accounting controls to high-quality, reliable financial

reporting. Some companies have adopted, or are adapting, their financial reporting processes as they respond to the changing environment. These changes may include consideration on how controls operate or can be tested and if there is any change in the risk of the control operating effectively in a telework environment.

In addition, changes to the business and additional uncertainties may result in additional risks of material misstatement to the financial statements in which new or enhanced controls may need to be implemented to mitigate such risks. The June OCA Statement reminds companies that if any change materially affects, or is reasonably likely to materially affect, an entity's ICFR, such change must be disclosed in its Quarterly Report on Form 10-Q for the fiscal quarter in which it occurred (or the Annual Report on Form 10-K, in the case of the fourth quarter).

3. Ability to Continue as a Going Concern

The June OCA Statement reminds companies that management should consider whether relevant conditions and events, taken as a whole, raise substantial doubt about the company's ability to meet its obligations as they become due within one year after the issuance of the financial statements.

In instances where substantial doubt about a company's ability to continue as a going concern exists, management should consider whether its plans alleviate such substantial doubt and make appropriate disclosures to inform investors. Such disclosures should include information about the principal conditions giving rise to the substantial doubt, management's evaluation of the significance of those conditions relative to the company's ability to meet its obligations, and management's plans that alleviated substantial doubt. If after considering management's plans substantial doubt about a company's ability to continue as a going concern is not alleviated, additional disclosure is required.

In addition, the June OCA Statement also states that although an auditor's review of interim financial information is not designed to identify conditions or events that indicate substantial doubt about a company's ability to continue as a going concern, the auditor may become aware of such conditions or events in the course of performing review procedures.

In such cases, the auditor should inquire with management and consider the adequacy of the relevant disclosures' conformity with GAAP. The June OCA Statement reminds auditors that after performing such procedures, to the extent the auditor determines the relevant disclosure is inadequate such that it represents a departure from GAAP, the auditor should extend the procedures, evaluate the results and communicate as appropriate with the company and its audit committee.

4. Vital Audit Committee Role

The June OCA Statement reiterates the key role that audit committees play in the financial reporting system through their oversight of financial reporting, including ICFR and the external, independent audit process. The OCA intends to continue to be proactive in engaging with audit committee members to understand current market developments as well as to solicit their perspectives on improving the oversight of financial reporting.

Appendix A

Operations, Liquidity, and Capital Resources Questions

- *Operational Challenges.*
  - What are the material operational challenges that management and the Board of Directors are monitoring and evaluating?
  - How and to what extent have you altered your operations, such as implementing

health and safety policies for employees, contractors, and customers, to deal with these challenges, including challenges related to employees returning to the workplace?

  - How are the changes impacting or reasonably likely to impact your financial condition and short- and long-term liquidity?

- *Liquidity*.

  - How is your overall liquidity position and outlook evolving?

  - To the extent COVID-19 is adversely impacting your revenues, consider whether such impacts are material to your sources and uses of funds, as well as the materiality of any assumptions you make about the magnitude and duration of COVID-19's impact on your revenues.

  - Are any decreases in cash flow from operations having a material impact on your liquidity position and outlook?

- *Accessing Capital*.

  - Have you accessed revolving lines of credit or raised capital in the public or private markets to address your liquidity needs?

  - Are your disclosures regarding these actions and any unused liquidity sources providing investors with a complete discussion of your financial condition and liquidity?

- *Changes to Accessing Capital*.

  - Have COVID-19–related impacts affected your ability to access your traditional funding sources on the same or reasonably similar terms as were available to you in recent periods?

  - Have you provided additional collateral, guarantees, or equity to obtain funding?

  - Have there been material changes in your cost of capital?

  - How has a change, or a potential change, to your credit rating impacted your ability to access funding?

  - Do your financing arrangements contain terms that limit your ability to obtain additional funding? If so, is the uncertainty of additional funding reasonably likely to result in your liquidity decreasing in a way that would result in you being unable to maintain current operations?

- *Covenants*.

  - Are you at material risk of not meeting covenants in your credit and other agreements?

- *Metrics*.

  - If you include metrics, such as cash burn rate or daily cash use, in your disclosures, are you providing a clear definition of the metric and explaining how management uses the metric in managing or monitoring liquidity?

  - Are there estimates or assumptions underlying such metrics the disclosure of which is necessary for the metric not to be misleading?

- *CapEx and Human Capital*.

  - Have you reduced your capital expenditures and if so, how?

  - Have you reduced or suspended share repurchase programs or dividend payments?

  - Have you ceased any material business operations or disposed of a material asset or line of business?

  - Have you materially reduced or increased your human capital resource expenditures?

- Are any of these measures temporary in nature, and if so, how long do you expect to maintain them?

- What factors will you consider in deciding to extend or curtail these measures?

- What is the short- and long-term impact of these reductions on your ability to generate revenues and meet existing and future financial obligations?

- *Debt Servicing*.

  - Are you able to timely service your debt and other obligations?

  - Have you taken advantage of available payment deferrals, forbearance periods, or other concessions?

  - What are those concessions and how long will they last?

  - Do you foresee any liquidity challenges once those accommodations end?

- *Customers*.

  - Have you altered terms with your customers, such as extended payment terms or refund periods, and if so, how have those actions materially affected your financial condition or liquidity?

  - Did you provide concessions or modify terms of arrangements as a landlord or lender that will have a material impact?

  - Have you modified other contractual arrangements in response to COVID-19 in such a way that the revised terms may materially impact your financial condition, liquidity, and capital resources?

- *Suppliers*.

  - Are you relying on supplier finance programs, otherwise referred to as supply chain financing, structured trade payables, reverse factoring, or vendor financing, to manage your cash flow?

  - Have these arrangements had a material impact on your balance sheet, statement of cash flows, or short- and long-term liquidity and if so, how?

  - What are the material terms of the arrangements?

  - Did you or any of your subsidiaries provide guarantees related to these programs?

  - Do you face a material risk if a party to the arrangement terminates it?

  - What amounts payable at the end of the period relate to these arrangements, and what portion of these amounts has an intermediary already settled for you?

- *Subsequent Events*.

  - Have you assessed the impact material events that occurred after the end of the reporting period, but before the financial statements were issued, have had or are reasonably likely to have on your liquidity and capital resources and considered whether disclosure of subsequent events in the financial statements and known trends or uncertainties in MD&A is required?

CARES Act Financial Assistance and Tax Relief Questions

- *Loan Impacts*.

  - How does a loan impact your financial condition, liquidity, and capital resources?

  - What are the material terms and conditions of any assistance you received, and do you anticipate being able to comply with them?

- Do those terms and conditions limit your ability to seek other sources of financing or affect your cost of capital?

- Do you reasonably expect restrictions, such as maintaining certain employment levels, to have a material impact on your revenues or income from continuing operations or to cause a material change in the relationship between costs and revenues?

- Once any such restrictions lapse, do you expect to change your operations in a material way?

- *Tax Relief*.

  - Are you taking advantage of any recent tax relief, and if so, how does that relief impact your short- and long-term liquidity?

  - Do you expect a material tax refund for prior periods?

- *New Material Accounting Estimates or Judgments*.

  - Does the assistance involve new material accounting estimates or judgments that should be disclosed or materially change a prior critical accounting estimate?

  - What accounting estimates were made, such as the probability a loan will be forgiven, and what uncertainties are involved in applying the related accounting guidance?

Going Concern MD&A Disclosure Questions

- *Substantial Doubt*.

  - Are there conditions and events that give rise to the substantial doubt about the company's ability to continue as a going concern? For example, have you defaulted on outstanding obligations?

  - Have you faced labor challenges or a work stoppage?

- *Company Plans to Address Going Concern*. What are your plans to address these challenges? Have you implemented any portion of those plans?

DOJ and SEC Issue Long-Awaited Update to FCPA Resource Guide

By Matthew Miner, Eric Sitarchuk, Jaclyn Whittaker, and Amanda Robinson

The US Department of Justice Criminal Division and the US Securities and Exchange Commission on July 3 published the Second Edition of *A Resource Guide to the U.S. Foreign Corrupt Practices Act*, the consolidated manual that practitioners rely on heavily in navigating the Foreign Corrupt Practices Act.

A Resource Guide to the U.S. Foreign Corrupt Practices Act (Resource Guide), which the US Department of Justice (DOJ) and US Securities and Exchange Commission (SEC) originally published in 2012, was revised only once before—in 2015—with primarily nonsubstantive changes that were released in a similarly below-the-radar fashion. While the core of the Resource Guide remains the same, the Second Edition, which the DOJ and SEC released over the July 4 holiday weekend, offers updated guidance on the definition of a "foreign official," the jurisdictional reach of the Foreign Corrupt Practices Act (FCPA), the mens rea required for criminal violations of books and records and internal controls provisions, and the limitations period for violations of the accounting provisions.

The greater willingness of defendants to challenge FCPA prosecutions has led to an expansion of the body of case law interpreting the FCPA. The Second Edition incorporates these developments, including recent court decisions in *United States v. Hoskins* and *SEC v. Liu*.

Notably, the Second Edition incorporates the FCPA Corporate Enforcement Policy, among other policies, for the first time. As before, the updated guidance continues to provide a detailed compilation of information about the FCPA, its provisions, and DOJ and SEC enforcement.

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Notable Updates

Importantly, the Second Edition provides additional clarity on the hallmarks of an effective compliance program, policies regarding mergers and acquisitions (M&A) issues, and more comprehensive examples of declinations.

The newest guidance makes the following notable updates:

- Providing additional focus on M&A and corporate successor liability: The Second Edition speaks in greater depth to the principles of corporate successor liability under the FCPA, including a detailed discussion of successor liability in the M&A context. It provides recent examples of DOJ enforcement actions in connection with (M&A) and offers practical advice to companies with respect to due diligence and disclosure.

- Clarifying the FCPA's application to weaknesses in issuers' internal *accounting* controls systems: The Second Edition clarifies the Resource Guide's earlier language relating to the FCPA's "internal controls" provisions to make clear that those provisions apply to a company's system of internal *accounting* controls by adding the word "accounting" to the earlier text. Importantly, the Second Edition also makes clear that "a company's internal accounting controls are not synonymous with a company's compliance program," and further explains how, in the view of the DOJ and SEC, effective compliance programs "contain[] a number of components that may overlap with a critical component of an issuer's internal accounting controls."

- Supplementing compliance guidance: The Second Edition builds on the previous Resource Guide's compliance program guidance and discussion of effective compliance programs. It clarifies the DOJ's position that "the truest measure of an effective compliance program is how it responds to misconduct" and includes additional compliance program resources and guides.

- Incorporating new DOJ and SEC policies: The Second Edition summarizes new policies applicable to the FCPA that have been announced in the DOJ's and SEC's continuing efforts to provide increased transparency, including the DOJ's FCPA Corporate Enforcement Policy, Selection of Monitors in Criminal Division Matters, Coordination of Corporate Resolution Penalties (or the anti-piling-on policy), and the Criminal Division's Evaluation of Corporate Compliance Programs.

- Providing additional examples: Critically, the Second Edition provides additional examples, including replacing some of the prior enforcement examples with what appears to be more recent case examples. Practitioners and companies rely heavily on these examples for guidance and insight. The Second Edition includes new examples concerning, among other things, FCPA jurisdiction, the standard for "intent," travel and entertainment violations, hiring relatives of foreign officials, hospitality, charitable donations, third-party/partner violations, local law exceptions, internal controls, and books and records violations.

- Explaining guiding enforcement principles: The Second Edition includes a dedicated chapter, Guiding Principles of Enforcement, which explains the DOJ principles of federal prosecution. It also provides additional examples of cases where the DOJ has issued declinations, bringing additional transparency to enforcement decisions.

- Providing updated guidance on the definition of "agent" for liability purposes under the FCPA: In *United States v. Hoskins*, the US Court of Appeals for the Second Circuit ruled that individuals not directly covered by the FCPA antibribery provisions could not be found guilty of conspiring to violate the FCPA unless the DOJ could prove that the individual acted unlawfully as an agent of a domestic concern. The Second Edition explains *Hoskins* and contrary authority, asserting the DOJ's position that the question is "unsettled." The Second Edition also clarifies the DOJ's position that "[u]nlike the FCPA anti-bribery provisions, the accounting provisions apply to 'any person,' and thus are not subject to the reasoning in the Second Circuit's decision in *United States v. Hoskins* limiting conspiracy and aiding and abetting liability under the FCPA anti-bribery provisions."

- Clarifying the definition of "instrumentality": The FCPA defines "foreign official" as "any officer or employee of a foreign government or any department, agency, or instrumentality thereof." Just a few years after the original Resource Guide was published, the US Court of Appeals for the Eleventh Circuit ruled that that "instrumentality" meant "an entity controlled by the government of a foreign country that performs a function the controlling government treats as its own." The Second Edition addresses this intervening development in case law and adopts this definition, asserting that the term is "broad" and making a determination requires a fact-specific inquiry. It also endorses the Eleventh Circuit's list of factors for conducting this fact-based inquiry and advises companies to "consider these factors" when evaluating compliance programs and assessing risk.

- Clarifying DOJ's position on the limitations period for FCPA violations: For substantive violations of the FCPA antibribery provisions, the five-year limitations period set forth in 18 USC § 3282 applies. For violations of the FCPA accounting provisions, which are defined as "securities fraud offense[s]" under 18 USC § 3301, there is a limitation period of six years.

- Incorporating court rulings on disgorgement: In *Kokesh v. SEC* and *SEC v. Liu*, the US Supreme Court clarified that the civil disgorgement remedy is subject to a five-year statute of limitations and that disgorgement is permissible equitable relief when it does not exceed a wrongdoer's net profits and is awarded for victims. The Second Edition includes a brief discussion of these recent decisions but does not provide a fulsome analysis.

- Correcting the mens rea standard for criminal liability for books and records and internal controls violations: The Second Edition revises the original Resource Guide's language regarding the standard for criminal liability under the FCPA's books and records and internal controls provisions. The updated text makes clear that a criminal violation requires a "knowing and willful" failure to maintain accurate books and records or implement an adequate system of internal accounting controls.

As with the prior version, the Second Edition remains "non-binding, informal, and summary in nature." And, many FCPA provisions remain open to interpretation notwithstanding this updated guidance. However, despite the increased number of challenges to FCPA prosecutions, there remains a dearth of case law interpreting the FCPA's provisions, and the Resource Guide will continue to serve as a key resource in advocating to the DOJ and SEC.

Supreme Court Upholds Limited SEC Right to Obtain Disgorgement in Court Enforcement Proceedings

By David F. Wertheimer and Richard J. Parrino

In June 2020, the US Supreme Court issued its long-awaited decision in *Liu v. Securities and Exchange Commission*, No. 18-1501, which resolved a cloud over the remedial powers of the Securities and Exchange Commission (SEC) that had been hovering since 2017. In a decision written by Justice Sotomayor for an eight-member majority, the Court held that disgorgement is an available remedy in an SEC enforcement action in federal court under 15 U.S.C. § 78u(d)(5) (Section 78u(d)(5)). This provision of the Securities Exchange Act of 1934 entitles the SEC, in any federal court action for violations of the federal securities laws, to "any equitable relief that may be appropriate or necessary for the benefit of investors."

Although the Supreme Court upheld the SEC's authority to obtain disgorgement as "equitable relief" under Section 78u(d)(5), the Court recognized several limitations on the remedy and left it to the lower courts to define further the contours of those limitations. The Court's open-ended ruling raises issues that likely will bedevil SEC enforcement proceedings for years to come.

Supreme Court Decision

The *Liu* decision had its origin in a scheme by a husband and wife to defraud foreign nationals using an investment project structured around the federal government's EB-5 Immigrant Investor Program. The program permits non-citizens to apply for permanent residence in the United States by investing in approved projects for promoting economic growth. Sales of investments in the projects are subject to the federal securities laws.

The SEC accused the defendants of employing a false offering memorandum to raise investor funds for a project. It charged that, while some of the funds were spent on project-related tasks, the bulk of the funds (approximately $20 million) were misapplied, including for the defendants' own personal use. The district court agreed with the SEC's allegations and, among other remedies, ordered the defendants to disgorge the full amount they had raised from investors, less a minor sum still held in the defunct project accounts. The US Court of Appeals for the Ninth Circuit affirmed the district court's judgment.

In their appeal to the Supreme Court, the defendants challenged the SEC's right to obtain disgorgement, contending that it did not qualify as "equitable relief" under Section 78u(d)(5). That issue had been percolating since the Court ruled in *Kokesh v. SEC*, 137 S.Ct. 1635 (2017), that a disgorgement order in an SEC enforcement action imposed a "penalty" for purposes of the applicable limitations statute (28 U.S.C. § 2462). Because a penalty historically has been deemed inconsistent with equitable relief, the *Kokesh* decision spawned doubt over whether disgorgement was included within Section 78u(d)(5)'s grant of equitable remedies.

The Supreme Court, however, made short work of the defendants' argument. The Court noted that, in the *Kokesh* decision, it expressly reserved the question of whether courts have authority to order disgorgement in SEC enforcement proceedings. Examining that question directly in *Liu*, the Court found that disgorgement historically has been treated — by commentators and courts, including the Supreme Court itself — as an equitable remedy, on par with such other forms of equitable relief as restitution and an accounting. Consistent with this

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historical treatment, the Court held that "a disgorgement award that does not exceed a wrongdoer's *net profits* and is *awarded for victims* is equitable relief permissible under § 78u(d)(5)." (Emphasis supplied.)

The Supreme Court's careful articulation of the hallmarks of a disgorgement award that render it "equitable relief" under Section 78u(d)(5) was no accident. The Court observed that, in various judicial decisions issued over time, the disgorgement remedy had expanded beyond the scope of traditional equitable relief, and rejected the SEC's position that Section 78u(d)(5) authorized such an expansive scope. Instead, the Court identified the following three criteria that serve to cabin a disgorgement award within equity's historical limits and prevent the award from being transformed into a penalty:

- the disgorgement award generally must be limited to the "net profits from wrongdoing after deducting legitimate expenses";
- the amounts ordered as disgorgement generally must be returned to the victims of the wrongdoing; and
- the disgorgement award generally must be entered against "individuals or partners engaged in concerted wrongdoing, not against multiple wrongdoers under a joint-and-several liability theory."

Despite identifying the broad criteria for determining what constitutes an "equitable" disgorgement award, the Supreme Court declined to adopt any bright-line tests. Instead, the Court left it to the Court of Appeals for the Ninth Circuit on remand to determine whether the disgorgement award in *Liu* constituted equitable relief and, more generally, to the lower courts to explore the boundaries of disgorgement awards that would meet the *Liu* standards. The Court did acknowledge some of the issues to be considered, including the following:

Net Profits. The restriction of disgorgement awards to a wrongdoer's "net profits" requires courts to determine the "legitimate expenses" incurred by the wrongdoer that must be deducted from an award. Expenses, however, do not always have to be deducted. As the Court noted, where the "'entire profit of a business or undertaking' results from the wrongful activity," no deduction for expenses may be required. Whether the *Liu* defendants had to disgorge all the money raised from investors (as the district court had ordered) or only the portion they misapplied was one of the issues the Court left for decision on remand.

Payment to Victims. In addressing the return of disgorged funds to the victims of the misconduct, the Court noted that, as a general matter, a disgorgement award that does not distribute the funds to victims, although benefiting the public at large by depriving wrongdoers of their ill-gotten gains, does not qualify as equitable relief. That rule, the Court noted, raised a question whether the SEC's practice of returning some disgorged funds to victims, while depositing other amounts with the Treasury, would satisfy Section 78u(d)(5) — a substantial issue given that, as the *Liu* defendants argued, the SEC in 2019 reported that it had obtained disgorgement awards for \$3.248 billion while returning only \$1.2 billion to injured investors. The Court further questioned whether an exception to the requirement might be warranted where the return of funds to investors was not feasible.

Application to Multiple Wrongdoers. The Court observed that the limitation of a disgorgement award to those who profit from misconduct, rather than persons who are jointly and severally liable for the misconduct, is not absolute. Rather, an exception exists "for partners engaged in concerted wrongdoing." The Court indicated that the exception might apply in the case of the husband and wife defendants in *Liu*, who appeared to have actively cooperated in pursuing their fraudulent scheme.

Implications of *Liu*

The implications of the *Liu* decision could be wide-ranging and include, among others, effects

on the structuring of SEC settlements, court consideration of disgorgement orders under other statutes, and the scope of insurance coverage of disgorgement awards.

As is typical with Supreme Court decisions that pronounce broad rules with nuanced exceptions, further litigation can be expected before a dependable set of fact-based guidelines is developed. That process may auger longer proceedings before the SEC and afford more opportunities for the charged parties to negotiate advantageous settlements.

For example, the issue of what constitutes "legitimate expenses" to be deducted from a disgorgement award is likely to spark protracted debate. To the extent that distribution to supposedly injured investors can be negotiated with the SEC as part of a disgorgement award, the distribution could reduce any claim for damages made in a parallel private securities action. Furthermore, there likely will be questions raised over whether a disgorgement remedy is available at all, for example, in the case of "tipper" liability for insider trading here the defendant received no monetary benefit for disclosing insider information.

In addition, the Supreme Court's articulation of the equitable constraints on disgorgement awards under Section 78u(d)(5) may affect courts' consideration of disgorgement orders under other statutes. For example, in administrative proceedings to enforce the federal securities laws, the SEC explicitly is empowered by 15 U.S.C. § 77h-1(e) to order disgorgement. It is possible that courts now will construe that statute's explicit reference to disgorgement as imbued with equity's traditional limitations, as categorized by the Supreme Court in *Liu*, rather than as authorizing a broader form of relief.

The *Liu* decision also may affect disputes with insurers over the coverage of disgorgement awards under particular policy terms. As a general matter, the characterization of a disgorgement award as an equitable remedy rather than a penalty may support an argument that the award should be covered. At the same time, and depending on the particular insurance policy, a disgorgement award may not be considered an insured "loss," consistent with the reasoning in *Level 3 Communications, Inc. v. Federal Insurance Co.*, 272 F.3d 908 (7th Cir. 2001), in which the court held that disgorgement of wrongfully obtained funds is not a covered loss.

The *Liu* decision brings some clarity to SEC enforcement remedies by affirming the SEC's right to obtain disgorgement awards in federal court actions, while constraining the amount of such awards and the circumstances affecting their issuance. The federal courts now will have to build on *Liu* to define how restrictive the equitable limitations of a disgorgement award must be to support exercise of this remedy.

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