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SEC Reporting & Compliance Alert

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SEC Adopts Long-Awaited Final Pay Versus Performance Disclosure Rules

On August 25, 2022, the U.S. Securities and Exchange Commission (SEC) adopted final rules requiring public companies to disclose the relationship between the executive compensation actually paid to the company's named executive officers (NEOs) and the company's financial performance. The final rules implement the "pay versus performance" disclosure requirements mandated by Section 953(a) of the Dodd-Frank Wall Street Reform and Consumer Protection Act enacted in 2010. The SEC issued proposed pay-versus-performance rules in 2015 and reopened the comment period on the proposed rules in January 2022. There are a number of important differences between the proposed rules (summarized here) and the final rules (summarized below).

New Disclosure Requirements — Item 402(v) of Regulation S-K

The final rules require companies to include in those proxy or information statements that are required to include executive compensation disclosure a new "Pay Versus Performance" table with the following information:

- the total compensation of the CEO and the average total compensation of the other NEOs using the information currently required to be reported in the Summary Compensation Table in the proxy or information statement; if more than one person served as CEO during the most recent fiscal year, a separate column must be included in the Pay Versus Performance table for the total compensation paid to each CEO;
- the compensation "actually paid" to the CEO and the average total compensation "actually paid" to the other NEOs, calculated in accordance with the final rules as described below; if more than one person served as CEO during the most recent fiscal year, a separate column must be included in the table for the compensation "actually paid" to each CEO;
- the cumulative total shareholder return (TSR), calculated in the same manner as the performance graph already required pursuant to Item 201(e) of Regulation S-K, for both the company and its peer group; for its peer group, the company must use either the same index or issuers used by it for purposes of Item 201(e)(ii) of Regulation S-K or, if applicable, the company's peer group used for purposes of its disclosures in the Compensation Discussion and Analysis (CD&A) pursuant to Item 402(b)(2)(xiv) of Regulation S-K;
- the net income of the company;

- a financial performance measure selected by the company (the "company-selected measure") that in the company's assessment represents the single most important financial performance measure (not otherwise already included in the table (*e.g.*, net income or absolute or peer group TSR)) that the company used for the most recent fiscal year to link compensation actually paid to the company's NEOs to the company's performance;
- additional financial performance measures other than the company-selected measure may be included in additional columns to the table, provided that the additional columns and related disclosure is clearly identified as supplemental, not misleading and not presented with greater prominence than the required company-selected measure; and
- footnote disclosure to the table for any amounts deducted and added to total compensation of the NEOs to determine the amount of compensation "actually paid" (as described below) and certain related assumptions, as well as the name of each CEO and other NEO included in table for each year and the fiscal year for which they were included.

For the TSR columns in the new table, the TSR for the earliest year in the table will represent the one-year TSR, the TSR for the next year in the table will represent the two-year TSR, and so on, such that the TSR for the most recent fiscal year in the table will represent the cumulative TSR for the entire applicable period covered in the table. Peer group TSR will be weighted based on the initial market capitalization of each peer group company as of the beginning of the earliest year included in the table. If the company uses a different peer group than the peer group used for the prior fiscal year, the company must explain the reason for the change in a footnote and provide comparison information with respect to both the old and the new peer group.

Covered Issuers and Time Period

Except as described below, companies will be required to disclose the applicable information for their five most recently completed fiscal years, provided that in the first proxy or information statement in which a company provides this disclosure, it may provide the newly required disclosure for three years instead of five years, adding another year of disclosure in each of the two subsequent annual filings.

Smaller reporting companies will be subject to scaled disclosure requirements, including a three-year disclosure period subject to a phase-in period for the first applicable filing in which only two years of disclosure will be required. Smaller reporting companies are also not required to provide the peer group TSR or a company-selected measure in the new table.

Emerging growth companies, foreign private issuers and registered investment companies (other than business development companies) are entirely exempt from the new disclosure requirements.

For newly public companies, disclosure will be required only for the years in which the company was a reporting company pursuant to Section 13(a) or Section 15(d) of the Exchange Act. For example, for a company that completed an initial public offering (IPO) in 2022 that is not an emerging growth company, foreign private issuer or registered investment company, disclosure in the first applicable filing will be required only for 2022 (for the period following the IPO date), with additional years of disclosure added for each subsequent annual proxy filing until five years of disclosure (or three years if a smaller reporting company) are provided.

Listing of Important Financial Measures

Companies also must provide an unranked tabular list of at least three and up to seven financial performance measures (the "tabular list") that in the company's assessment represent the most important financial performance measures used by the company for the most recent fiscal year to link compensation actually paid to the company's CEO and other NEOs to the company's performance. Companies may include nonfinancial performance measures in this list if those measures are among the most important performance measures used by the company to link compensation actually paid to performance and the company has disclosed at least three financial performance measures (or fewer, if the company only uses fewer than three). The company-selected measure disclosed in the new Pay Versus Performance table described above must be one of the financial performance measures included in the tabular list. There are no additional disclosure requirements if the company changes the company-selected measure from year to year.

Companies are not required to provide the methodology used to calculate the financial performance measures included in the tabular list, but should consider if that disclosure would be helpful to understand the financial performance measures or necessary to prevent them from being confusing or misleading. If the company-selected measure is not a GAAP financial measure, high-level disclosure must be provided regarding how the number is calculated from the company's audited financial statements, but full GAAP reconciliation is not required.

Companies that consider fewer than three financial performance measures when linking compensation to company performance are required to list only the number of financial performance measures actually considered, and a company that does not use any financial performance measures to link compensation actually paid to performance in the most recent fiscal year is not required to present a tabular list or disclose a company-selected measure. Smaller reporting companies are also not required to provide a tabular list or disclose a company-selected measure.

Executive Compensation Actually Paid

For purposes of the new Pay Versus Performance table described above, executive compensation "actually paid" will be the total compensation for the covered fiscal year for the CEO and each other NEO, as disclosed in the Summary Compensation Table, but adjusted:

- to deduct the grant date fair value of equity awards granted during the year that appears in the Summary Compensation Table and:
  - add back: (i) the year-end fair value of any equity awards granted in the fiscal year that are outstanding and unvested as of the end of the fiscal year (for awards subject to performance conditions, based on the probable outcome of such conditions); (ii) the amount of change as of the end of the fiscal year (from the end of the prior fiscal year) in the fair value (whether positive or negative) of any awards granted in prior years that are outstanding and unvested as of the end of the fiscal year; (iii) for awards that are granted and vest in the same fiscal year, the fair value as of the vesting date; (iv) for awards granted in prior years that vest in the fiscal year, the amount equal to the change in the fair value (whether positive or negative) as of the vesting date (from the end of the prior fiscal year); and (v) any dividends or other earnings paid on equity awards in the fiscal year prior to the vesting date that are not otherwise reflected in the fair value of such award or included in any other component of total compensation for the fiscal year; and
  - subtract the amount equal to the fair value at the end of the prior fiscal year of any awards that fail to meet the vesting requirements and are forfeited in the fiscal year; and
- to deduct the positive amount of any aggregate change in the actuarial present value of defined benefit and actuarial pension plans that appears in the Summary Compensation Table (for companies other than smaller reporting companies) and
  - add back: (i) the actuarially determined pension service cost for services rendered during the fiscal year; and (ii) any prior service costs introduced in connection with a plan amendment or initiation during the fiscal year, regardless of whether any of the pension benefits are currently vested; and
  - subtract the amount of any credit for reduced benefits introduced in connection with a negative plan amendment during the fiscal year.

Description of the Relationship Between Pay Versus Performance

Using values reflected in the new Pay Versus Performance table, companies will be required to describe (i) the relationship between (a) the executive compensation "actually paid" to the CEO and the average total compensation "actually paid" to the other NEOs and (b) the company's TSR, its net income and the company-selected measure and (ii) the relationship between the company's TSR and the TSR of its peer group. In addition, companies will be required to describe the relationship between (a) the executive compensation actually paid to the CEO and the average total compensation actually paid to the other NEOs and (b) any supplemental measures voluntarily included in the new table in addition to the required company-selected measure. Smaller reporting companies will only be required to describe (i) the relationship between the executive compensation actually paid to the CEO and the average total compensation actually paid to the other NEOs and (ii) the company's TSR and net income. Companies will be permitted to describe these relationships either through a narrative discussion, a graphical presentation or a combination of both. The relationship disclosures may be grouped together, as long as any combined description of multiple relationships is clear.

The rules also provide flexibility to companies regarding the location of the new disclosure in the proxy or information statement. The disclosure is not required to be included in the CD&A because that may cause confusion by suggesting that the company considered the pay-versus-performance relationship in its compensation decisions for the applicable fiscal year, which may or may not be the case for all of the relationships required to be described other than the company-selected measure.

Supplemental Disclosures

Companies will be permitted to supplement the new disclosure by providing pay-versus-performance disclosure (in tabular format or otherwise) based on other compensation measures such as "realized pay" or "realizable pay" if they believe such supplemental disclosures would provide useful information about the relationship between the compensation paid and the company's financial performance. The supplemental disclosure, however, may not be misleading or presented more prominently than the required new disclosure. This prominence requirement should be given particular consideration by companies with pay-for-performance discussions in the executive summaries of their proxy or information statements and may require companies to modify the way that performance information is disclosed in the CD&A.

Applicable Filings

The new pay-versus-performance disclosure will be required in any proxy or information statement that is required to include executive compensation disclosure, including those with respect to the election of directors. The disclosure will not be required in annual reports on Form 10-K (other than with respect to the incorporation of proxy disclosure by reference), Securities Act registration statements or Exchange Act registration statements (*e.g.*, registration statements on Form S-1 for IPO companies). The disclosure also will not be deemed to be incorporated by reference into any filing under the Securities Act or the Exchange Act, except to the extent that the company specifically incorporates it by reference.

XBRL

The new disclosure must be tagged in interactive data format using Inline eXtensible Business Reporting Language (Inline XBRL). Smaller reporting companies may phase in Inline XBRL tagging.

Implications

The new disclosure requirements regarding pay versus performance will become effective 30 days following publication of the release in the Federal Register. Companies should prepare to incorporate these new items into those proxy or information statements that include executive compensation disclosure for fiscal years ending on or after December 16, 2022, meaning that calendar year companies will need to include this new disclosure in their proxy statements filed in 2023.

A copy of the final rules can be found here. For additional information on the proposed rules, see the press release and fact sheet issued by the SEC.

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