Cooley

Comp Talks

Key Takeaways

SEC's Pay-Versus-Performance Rules – What Now and What's Next

At the Comp Talks session on October 25, 2022, **SEC's Pay-Versus-Performance Rules – What Now and What's Next**, our panelists – Cooley partner Alessandra Murata and Compensia principal Mark Borges – discussed the substantive requirements of the new pay-versus-performance rules mandated by the Dodd-Frank Act, recommended best processes and practices, and flagged potential pitfalls to watch for. Here are some of the key takeaways summarized by Cooley lawyer Vince Flynn:

The pay-versus-performance rules effectively impose three new proxy disclosure requirements. The new disclosure requirements are intended to show the relationship between "compensation actually paid" (a new compensation measure) to named executive officers (NEOs) and the financial performance of the issuer. The panelists anticipate these disclosures will generally be placed outside of the CD&A and likely after the executive compensation tables.

- **The pay-versus-performance table and related footnote disclosures will be a heavy lift for most companies.** Companies must provide a new pay-versus-performance table disclosing, for each covered fiscal year, (1) both the compensation reported in the Summary Compensation Table (SCT) and the compensation actually paid to the company's NEOs, (2) the cumulative total shareholder return (TSR) for the company and a selected peer group, (3) the company's net income, and (4) an additional financial performance measure that, in the company's assessment, represents the most important performance measure used by the company to link executive compensation actually paid during the most recently completed fiscal year to company performance (the Company-Selected Measure). The panelists stressed that compliance with this data-heavy requirement, which will involve drafting extensive footnote disclosures, will require significant time and resources, particularly in the first year of disclosure, so companies should begin developing the table now.

- **The relationship disclosures are the crux of the pay-versus-performance rules.** Using the information presented in the pay-versus-performance table, companies must provide clear descriptions of (1) the relationship between executive compensation actually paid and each financial performance presented in the pay-versus-performance table and (2) the relationship between the company's cumulative TSR and the peer group's cumulative TSR, in each case over the covered period. These relationship disclosures are the centerpiece of the new rules, the panelists argued, so companies should dedicate meaningful time to determining how best to describe their pay-for-performance relationship in these disclosures. The panelists anticipate most companies will use a combination of narrative and graphical disclosures to fulfill this requirement.

- **The tabular list requires strategic decision-making and compensation committee involvement.** Companies must provide an unranked list of the most important financial (and, in some cases, non-financial) performance measures used by the company to link executive compensation actually paid during the most recently completed fiscal year to company performance, and the Company-Selected Measure must be drawn from that list. The natural starting point for this exercise, the panelists advised, is for companies to focus on the performance measures selected for their short-term and/or long-term incentive plans, and then to gauge which of these measures were "most important" in driving executive compensation actually paid during the most recently completed fiscal year. Compensation committees should be involved in the finalization of the tabular list (and thus the selection of the Company-Selected Measure) to ensure the selected measures align with the committee's understanding of which metrics are driving the executive compensation program.

Most public companies will be required to include the new pay-versus-performance disclosures in their 2023 proxy statements. All public companies, with the exception of emerging growth companies (EGCs), foreign private issuers, and registered investment companies, must begin to include the new pay-versus-performance disclosures in any proxy or information statement (in which disclosure under Item 402 of Regulation S-K is required) covering a fiscal year ending on or after December 16, 2022 (generally, proxy statements filed in 2023). Smaller reporting companies are eligible to use scaled disclosure requirements. The pay-versus-performance disclosures are not required in registration statements filed in connection with an initial public offering, and the panelists noted that newly public non-EGCs are only required to provide the disclosures for the covered fiscal years in which the company was public at any time during such years.

Calculating "compensation actually paid" is likely to be the most burdensome new requirement. Compensation actually paid is not the same as realized or realizable pay, nor is it generally aligned with the way compensation committees determine executive compensation at the start of a fiscal year. It is a new measure of compensation that is calculated using a prescribed formula based on the "total compensation" measure included in the SCT, with adjustments made to the amounts disclosed for equity awards and pension benefits. The panelists warned that the prescribed adjustments for equity awards can involve considerable complexity, and the first year of disclosure will likely be the most demanding, given the number of retrospective calculations that will need to be performed. Specifically, companies will need to re-calculate the fair values of each NEO's equity awards for each covered fiscal year, which may become particularly tedious for stock options and market-based awards (e.g., relative TSR awards), both in terms of the number of calculations that will need to be made and the re-assessment of the assumptions used in the calculations.

Providing voluntary disclosures to supplement the required disclosures may be necessary. The panelists noted that, to the extent the relationship between executive compensation actually paid and company performance is not adequately described through the mandated financial performance measures (i.e., TSR, net income, and the Company-Selected Measure), companies should consider providing supplemental disclosures to support a clearer and more transparent narrative, which may involve adding an additional financial performance measure to the pay-versus-performance table. The panelists cautioned, however, that if an additional measure is voluntarily included in the pay-versus-performance table, that measure will also be subject to the relationship disclosure requirement. In addition, the panelists emphasized that CD&A disclosures and pay-versus-performance disclosures should be harmonized, so if apparent discrepancies exist between the two disclosures, clear and thoughtful supplemental disclosure will be particularly important. Importantly, any supplemental disclosures must be clearly identified as supplemental, not misleading, and not presented with greater prominence than the required disclosures.

Advance and strategic preparation will be critical. Compliance with the pay-versus-performance rules will require a substantial undertaking to collect and prepare the information necessary for the new disclosures. The panelists urged companies to start (1) forming a team composed of key internal departments (e.g., finance/accounting, legal, human resources, investor relations, and public relations) and outside advisers (e.g., compensation consultant, valuation expert, and legal counsel) that will assist in complying with the new disclosure requirements, (2) educating the company's compensation committee on the new disclosure requirements and preparing them for what they will need to do prior to filing these disclosures, (3) gathering the information needed to comply with the new disclosure requirements, (4) calculating compensation actually paid for 2020 and 2021, (5) determining which performance measures will be included in the tabular list, and (6) considering how best to clearly present the relationship disclosures.

Outstanding issues and questions remain. The panelists are hopeful that the SEC will provide additional guidance on a number of outstanding issues and questions, including, among many others, whether relative TSR is considered a separate financial performance measure for purposes of the Company-Selected Measure and the tabular list, whether simplified methodologies are permitted when calculating the fair value of an equity award for purposes of calculating compensation actually paid, and whether a CD&A peer group can be used for purposes of reporting peer group cumulative TSR in the pay-versus-performance table if such peer group has not been used for "benchmarking" purposes as defined by the SEC Staff.

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