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SEC Adopts Long-Considered Pay-Versus-Performance Disclosure Rule

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Background

On August 25, 2022, the Securities and Exchange Commission (SEC) adopted pay-versus-performance rules (codified in Item 402(v) of Regulation S-K), 12 years after the Dodd-Frank Wall Street Reform and Consumer Protection Act (Dodd-Frank Act) imposed on the SEC the obligation to craft such rules, and seven years after the SEC first proposed rules for this disclosure.

Final rules

Pay-versus-performance table

The final rules require covered companies to provide the information set forth in the table below (the pay-versus-performance table). *The asterisks indicate items from which smaller reporting companies (SRCs) are exempt.*

Year	Summary Compensation Table Total for PEO	Compensation Actually Paid to PEO	Average Summary Compensation Table Total for Non-PEO NEOs	Average Compensation Actually Paid to Non-PEO NEOs
(a)	(b)	(c)	(d)	(e)
Y1				
Y2				
Y3				
Y4*				
Y5*				

Time period covered

Covered companies must comply with the final rules in proxies and information statements covering fiscal years ending on or after December 16, 2022.

The final rules require inclusion of the pay-versus-performance disclosure for each of the company's five most recently completed fiscal years *(three years for SRCs*). In the first year of disclosure, non-SRC covered companies are only required to provide disclosure for three years (*two years for SRCs*) with an additional year added in each of the two subsequent years (*one subsequent year for SRCs*).

Summary compensation table totals

For each covered fiscal year, the pay-versus-performance disclosure must include the "total compensation" as reported in the company's Summary Compensation Table (SCT) for the principal executive officer (PEO) and as an average for the other named executive officers (NEOs).

Compensation actually paid

The pay-versus-performance disclosure must include "compensation actually paid" to the PEO and as an average to the other NEOs. **Compensation actually paid is not the same as compensation realized or received** and is calculated using a prescribed formula. The formula is based on the "total compensation" measure included in the SCT, with adjustments to the amounts disclosed for equity awards and pension benefits, as summarized below. These adjustments must be disclosed in footnotes to the columns showing compensation actually paid. Companies will also be required to disclose in footnotes any valuation assumptions that are materially different from those disclosed at the time of grant of such equity awards. *SRCs are not required to disclose amounts related to pension benefits for purposes of calculating compensation actually paid.*

Compensation actually paid must be calculated in accordance with the following steps:

Step 1: Start with the SCT total value for the applicable year.

Step 2: Make the following adjustments with respect to amounts reported in the SCT for equity awards and pension benefits.

Equity Awards

- **Deduct** the amounts reported in the SCT for equity awards
- For awards granted in the **covered fiscal year**:
  - **Add** the year-end fair value if the award is outstanding and unvested as of the end of the covered fiscal year;
  - **Add** the fair value as of the vesting date for awards that vested during the covered fiscal year; and
  - **Ignore** any such awards that were forfeited or determined to be ineligible to vest during the covered fiscal year
- For awards granted in **prior years**:
  - **Add or subtract** any change in fair value as of the end of the covered fiscal year (compared to the end of the prior fiscal year) if the award is outstanding and unvested as of the end of the covered fiscal year;
  - **Add or subtract** any change in fair value as of the vesting date (compared to the end of the prior fiscal year) if the award vested during the covered fiscal year; and
  - **Subtract** the amount equal to the fair value at the end of the prior fiscal year if the award was forfeited during the covered fiscal year
- **Add** the dollar value of any dividends or other earnings paid on equity awards in the covered fiscal year prior to the vesting date

Pension Benefits

- **Subtract** the aggregate change in the actuarial present value of all defined benefit and actuarial pension plans
- **Add** the following two components:
  - **Service cost** (i.e., the actuarially determined service cost for services rendered by the executive during the applicable year), calculated in accordance with generally accepted accounting principles (GAAP); and
  - **Prior service cost** (i.e., the entire cost of benefits granted in a plan amendment (or initial plan adoption) during the covered fiscal year that are attributed by the benefit formula to services rendered in periods prior to the plan amendment or adoption), calculated in accordance with GAAP; if the prior service cost is a **negative** amount as a result of an amendment that reduces benefits relating to prior periods of service, then such amount would **reduce** the compensation actually paid

Action items

- Coordinate efforts as soon as possible (i.e., well ahead of the usual proxy filing preparation timeline) with key company departments (e.g., finance/accounting, legal, human resources, investor relations, public relations) and outside advisers (e.g., compensation consultant, valuation expert and legal counsel); this calculation is likely to be very time-intensive, particularly with respect to stock options and market-based performance awards.
- Ensure the company is well-versed in calculating the fair value of stock awards and stock options on an ongoing basis after the grant date, and begin building these recalculations into the end-of-year process, to the extent not already done.
- Note that "compensation actually paid" is NOT equivalent to "realized pay," though companies should consider whether it is helpful to add voluntary disclosure addressing the connection between realized or realizable pay and performance.

Financial performance metrics

- **Total shareholder return.** Covered companies must include (1) the value of a fixed investment of $100 scaled by cumulative TSR for the company (calculated in the same manner as in the stock performance graph required under Item 201(e) of Regulation S-K), and (2) the value of a fixed investment of $100 scaled by cumulative TSR for the company's peer group (using either the same peer group used for the performance graph (Item 201(e)) or as set forth in the Compensation

Discussion & Analysis (CD&A)). Changes to the peer group used in a prior fiscal year must be explained in a footnote, including the reason for the change and a comparison of the company's TSR to both the old and new peer groups. For each fiscal year in the table, the amount included for the company and its peer group should be the cumulative TSR as of the end of that year, which means that the measurement period would begin with the market close on the last trading day before the earliest fiscal year in the table, through and including the end of the company's last completed fiscal year.

- **Net income.** Covered companies must include their net income for each covered fiscal year, calculated in accordance with GAAP.
- **Company-selected measure.** Covered companies must disclose a financial performance measure chosen by the company as the "most important" financial measure it uses to link compensation actually paid to company performance for the most recently completed fiscal year. The measure is not required to be reported in the company's financial statements; however, similar to disclosure of non-GAAP target levels in the CD&A, if the company-selected measure is a non-GAAP financial measure, the company must disclose how the number is calculated from audited financial statements. Companies that do not use any financial performance measures to link executive compensation actually paid to performance, or that only use measures already required to be disclosed in the table (i.e., TSR and net income), are not required to disclose a company-selected measure or its relationship to executive compensation actually paid.

Action items

- Carefully determine the company's peer group with input from the compensation committee's independent compensation consultant, as any changes to the peer group will impact the TSR reporting requirements.
- Prepare an initial draft of the pay-versus-performance table to determine (1) how executive compensation actually paid to the NEOs will be viewed when compared to the TSR and other required performance measures, and (2) whether it would be appropriate to include any voluntary additional measures in the required table.

Narrative and/or graphical disclosure using the pay-versus-performance table

Following the pay-versus-performance table, the rules also require a clear description, in narrative or graphical form (or both), of (1) the relationship between compensation actually paid to the company's NEOs as shown in the table and the company's financial performance measures included in the table, and (2) the relationship between the company's TSR and the TSR of the peer group. In addition, companies that elect to provide additional voluntary performance measures in the pay-versus-performance table must also include a description of the relationship between executive compensation actually paid and each such performance measure across all covered fiscal years.

Action item

- Determine the most appropriate format for the relationship disclosure, ensuring that it is consistent with CD&A disclosure.

Tabular list of 'most important' performance measures

In addition to the tabular disclosure discussed above, the final rules require covered companies (other than SRCs) to disclose an unranked list of three to seven of the company's "most important" financial performance measures used by the company to link executive compensation actually paid to company performance for the most recently completed fiscal year (the Tabular List). The Tabular List must include the company-selected measure. Companies will be permitted to include non-financial performance measures in this list if they are among the company's most important performance measures, but only if the company discloses at least three financial measures (or fewer if the company only uses fewer, which is permitted if all are listed), and would still be subject to a maximum of seven performance measures. Companies that do not use any financial performance measures to link executive compensation actually paid to company performance would not be required to present a Tabular List.

Companies have the option to disclose this list in three different ways:

- in one list with at least three and up to seven performance measures
- in two separate lists, one for the PEO and one for the remaining NEOs
- in separate lists for the PEO and each NEO

If the company elects to provide separate lists, each list must include three and up to seven performance measures, subject to exception for companies using fewer measures.

Action items

- Consider the "most important" performance measures for the Tabular List, including the company-selected measure; compensation consultant input will be vital.
- Consider whether these measures will differ from measures that are expected to be disclosed in the CD&A and whether additional narrative disclosure would be helpful in explaining the selected measures or in justifying executive compensation decisions in the CD&A (including, for example, disclosures regarding realized or realizable pay versus performance).

Additional considerations

- **Location of disclosure.** The final rules provide companies with flexibility in determining where in the proxy or information statement to provide the required disclosure. Companies may choose to cross-reference other disclosures describing the company's processes and calculations for determining executive compensation included elsewhere in the applicable filing.
- **Inline XBRL.** Consistent with other recent disclosure rules proposed and adopted by the SEC, the final rules require companies to separately tag each amount disclosed in the pay-versus-performance table, block-text tag the footnote and relationship disclosure, and tag specific quantitative data points within the footnote disclosures, all in Inline XBRL. *SRCs only have to provide the required Inline XBRL data beginning with the third filing in which they provide the pay-versus-performance disclosure.*

Action items

- Determine placement of the pay-versus-performance table, which we expect will generally be outside of the CD&A, unless the compensation committee used the underlying information in making executive compensation decisions.
- Note that tagging will result in increasing the accessibility of the data required by the final rules, so it is likely to be considered by institutional investors and proxy advisory firms, though the impact is still yet to be seen.

Final takeaways

Companies should **start preparing for the required disclosures now**. With the final rules applying as soon as the 2023 proxy season, we recommend beginning to consider and gather the information that will be needed to comply with the requirements in the rule, especially because this is a data-heavy requirement, and disclosure will be required for fiscal years prior to 2022.

Create a team of key members of the company's human resources, accounting and finance, legal, investor relations and corporate communications departments and **engage early and often** with the company's compensation committee and outside compensation, valuation and legal advisers to ensure all are aligned on the steps necessary to comply with the final rules and coordinate efforts prior to the start of the 2023 proxy season.

Keep in mind that the final rules are focused on "compensation actually paid," which does not generally align with the way compensation committees determine executive compensation at the start of a fiscal year and is not the same as realized pay. The pay-versus-performance table and the other required disclosures may not capture the design considerations taken into account when executive compensation is awarded. **Clear and thoughtful CD&A disclosure will be especially important in the 2023 proxy statement in the event there are apparent discrepancies between information disclosed in the CD&A and the pay-versus-performance disclosure.**

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