SEC adopts final pay versus performance disclosure rules

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In brief

On August 25, 2022, the Securities and Exchange Commission ("SEC") adopted rules requiring registrants to disclose the relationship between executive compensation actually paid compared to the financial performance of the company. The new rules require additional disclosures in annual proxy statements consisting of a table that provides specified executive compensation and financial performance measures for the five most recent fiscal years (three years for smaller reporting companies) as well as detail intended to illustrate a clear relationship between executive compensation and performance.

The new disclosures are for proxy and information statements that are required to include executive compensation disclosures pursuant to Item 402 of Regulation S-K for fiscal years ending on or after December 16, 2022. Only three years of information needs to be provided in the initial year of adoption, with an additional year added in each of the two subsequent proxy filings. Smaller reporting companies may provide two years in the initial year, with a third year added in the subsequent year.

The rules will apply to all reporting companies, except foreign private issuers, registered investment companies, and emerging growth companies.

In detail

Background

Pursuant to Section 953(a) of the Dodd-Frank Wall Street Reform and Consumer Protection Act, Section 14(i) was added to the Securities Exchange Act of 1934 (the "Exchange Act"). Section 14(i) directed the SEC to adopt rules requiring registrants to provide disclosure of pay versus performance.

The SEC issued proposed rules on April 29, 2015 and requested public comment. In January 2022, the SEC reopened the comment period for the 2015 proposed rules and provided the public with the opportunity to comment further and to address certain additional requirements that the SEC was considering in connection with the reopening of the comment period.

At the conclusion of the public comment periods, new rules adopted by the SEC added Item 402(v) of Regulation S-K, requiring registrants to describe the relationship between the executive compensation actually paid by the registrant and the financial performance of the registrant over the time horizon of the disclosure required in proxy or information statements in which executive compensation disclosure is required.

Pay versus performance table & new requirements

The new rules require a tabular disclosure of executive compensation information and financial performance measures for each of the five most recent fiscal years (three years for smaller reporting companies). The information is required to be provided for the principal executive officer ("PEO") and, as an average, for the other named executive officers ("NEOs"). The information required in the table includes compensation amounts from the Summary Compensation Table as well as a new measure reflecting "executive compensation actually paid." In years where there are multiple PEOs, the information would need to be provided separately for each PEO.

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	Value of Initial Fixed $100 Investment Based On:		Net Income	Company Selected Measure
					TSR	Peer Group TSR		
Y1								
Y2								
Y3								
Y4								
Y5								

As illustrated above, the table must show the following measures of financial performance:

(i) Total Shareholder Return ("TSR") for the registrant

(ii) TSR for the registrant's peer group;

(iii) The registrant's net income; and

(iv) Company-Selected Measure(s)

Registrants are required to use the information from the Pay Versus Performance Table to provide a clear description of the relationship between compensation actually paid to the PEO and average non-PEO NEOs and each measure of the registrant's financial performance disclosed in the table (i.e., TSR for the registrant, registrant's net income, and the Company-Selected Measure).

In addition to providing a clear description of the relationship between compensation paid and the registrant's financial performance, registrants will be required to provide a clear description of the relationship between the registrant's TSR and the TSR of a peer group chosen by the registrant over the five most recently completed fiscal years. If a company makes any changes to the peer group, it will require changes to the table for all years with the TSR for the new peer group, justification for changing the peer group, and a comparison of the TSR using the old peer group and the new peer group.

The rules allow certain flexibility as to the format of these descriptions, suggesting either graphical, narrative, or a combination of the two in order to describe these relationships. Additional flexibility is also provided on whether registrants want to combine any of the required relationship disclosures. The SEC notes that any combined description must be "clear."

Registrants will be required to provide an unranked list ("Tabular List") of the most important financial performance measures that the company uses to link executive compensation actually paid to company performance. The Tabular List may include non-financial performance measures to the extent they represent, from the company's perspective, the most important performance measures. The final rules require that the Tabular List include a minimum of three and a maximum of seven financial performance measures in the Tabular List. If fewer than three financial performance measures were used, the Tabular List must include all such measures.

Observations

The Pay Versus Performance Table adds a new disclosure requirement. We expect that much of this information will be readily available; however, the "executive compensation actually paid" is not information that most registrants currently track and will present new calculation requirements for many registrants (discussed further below).

Additionally, to the extent not already identified, registrants will need to develop a financial Company-Selected Measure that will be compared to executive compensation.

We note that most registrants currently align their executive compensation with performance and discuss such arrangements within the Compensation Discussion and Analysis ("CD&A"). Extending the discussion to the pay versus performance disclosure may be a natural extension for some registrants. Regardless of the measures currently used, registrants should consider the potential areas which may need to be addressed, including:

- *Not all metrics used for measuring performance of NEOs are strongly linked to TSR or net income but even for those metrics which are strongly linked, the effect on TSR may not be immediate.*
- *Both short-term and long-term incentives will likely be earned over performance periods which may not align to the periods over which TSR and the Company-Selected Measure are reported in the table.*
- *The meaningfulness and relevance of the Company-Selected Measure and how that may be expected to evolve over time.*

"Executive compensation actually paid"

The calculation of "executive compensation actually paid" is complex and meaningfully different from the proposed 2015 rules. The final rules define this amount as the total compensation amount included within the Summary Compensation Table, with certain adjustments for equity-based compensation and defined benefit pension plans. Specifically, to determine the compensation actually paid, a registrant would begin with the total compensation reported in the Summary Compensation table for a fiscal year, then:

- For equity-based compensation:

  − Deduct the amounts reported in the Summary Compensation Table as equity award amounts which are based on grant date fair values.

  + Add the year-end fair value of any equity awards granted in the covered fiscal year that are outstanding and unvested as of the end of the covered fiscal year.

  + Add the amount of change in fair value as of the end of the covered fiscal year (from the end of the prior fiscal year) of any awards granted in prior years that are outstanding and unvested as of the end of the covered fiscal year.

  + Add the fair value as of the vesting date for awards that are granted and vest in the same covered fiscal year.

  + Add the amount of change in fair value from the end of the prior fiscal year to the vesting date for awards granted in prior years that vest in the covered fiscal year.

  − Deduct the amount of fair value at the end of the prior fiscal year for awards granted in prior years that forfeited during the covered fiscal year.

  + Add the dollar value of any dividends, dividend equivalents, or other earnings paid on stock or option awards in the covered 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 covered fiscal year.

- For pension values:

  − Deduct the amounts reported as the change in pension benefits which is the aggregate change in actuarial present value for all defined benefit and actuarial pension plans.

  + Add the service cost, as defined in Accounting Standards Codification (“ASC”) 715, *Compensation — Retirement Benefits* (“ASC 715”), attributable to services rendered in the fiscal year.

  + Add the prior service cost, as defined in ASC 715, which is the entire cost of benefits granted in a plan amendment (or initiation) during the covered fiscal year that are attributed by the benefit formula to services rendered in periods prior to the plan amendment or initiation.

Observations

The calculation of “executive compensation actually paid” is a new metric although some registrants may be tracking similar metrics. Therefore, the development of this metric and/or the required narratives may pose challenges for some registrants.

For equity-based compensation, the year-end or vesting date fair value requirement will require registrants to develop new fair value assumptions appropriate at the time of measurement (year-end and/or vesting date). As the rules require the calculation to be in accordance with ASC 718, Compensation—Stock Compensation, the SEC expects registrants to determine the fair value with the same level of diligence as would be necessary if an award were being modified for accounting purposes. In its commentary, while the SEC noted that although it was aware that these requirements could be burdensome for some registrants with complex equity grants, it is not adopting a *safe harbor or simplified assumptions approach other than those generally accepted under ASC 718. That is, the SEC would not find intrinsic value or other simplification techniques acceptable.*

For pensions, while the service cost for pension plans is a new requirement for the executive compensation disclosures, the service cost for the registrant in total is generally known and calculated as part of a registrant's normal accounting for such plans. A registrant should generally be able to identify the service cost for the specific individuals in question using existing calculations. Similarly, to the extent that a registrant amends their plans, we believe that prior service cost information will generally be calculated and known.

Time period covered and phase-in

The pay versus performance disclosures will be required for the five most recently completed fiscal years, which is greater than the three years of information reported in the Summary Compensation Table. To phase-in the new requirements, a registrant's first filing after the new rules become effective will only require disclosure for the three most recently completed fiscal years. The disclosures will require one more year of information during each of the next two years after the new rules become effective after which the full five years of pay versus performance comparisons will then be required.

Observations

While the new disclosure is only required for the three most recently completed fiscal years (e.g., 2020, 2021, and 2022), in the initial year, registrants will also need to prepare equity-based compensation fair values for equity awards that are outstanding as of the beginning of the earliest period presented in order to prepare the appropriate adjustments or changes in fair value to "executive compensation actually paid" amount for that period.

Smaller reporting companies

Smaller reporting companies disclose only two years of information in the Summary Compensation Table but would be required to disclose three years of pay versus performance information and thus have a similar phase-in. In the first year, the pay versus performance disclosures will only be required for the two most recently completed fiscal years and the full three years will be required for each year thereafter. Smaller registrants are also exempt from certain requirements such as providing peer group TSR, a Company-Selected Measure, and inclusion of pension amounts in executive compensation actually paid in the new table. Additionally, smaller reporting companies do not need to include the Tabular List.

Disclosure and format

The new rules provided flexibility as to where in the proxy the pay versus performance information is included and does not require it to be contained within or following the CD&A. In general, the new rules provide that registrants should provide: i) a numerical table of compensation actually paid, including TSR and the Company-Selected Measure, ii) a disclosure of the relationship among the measures presented in the table and net income, iii) a footnote of deductions and additions used to determine executive compensation actually paid.

As the new rules are intended to provide comparability across registrants, the information must be submitted with Inline reporting and tagging requirements in a consistent format among registrants. Specifically, the numerical information contained with the table should be tagged. The other supporting information should be tagged as three blocks of information.

The takeaway

The focus of the new rules to standardize the pay versus performance disclosures across registrants for comparability may not be ideal but may prove meaningful to stakeholders. Some stakeholders may also find added benefit with registrants that do not currently explain the linkage between the performance metrics used to determine executive compensation and company financial performance.

The new rules are required for the 2023 proxy statement and registrants should begin planning now. The introduction of additional reporting requirements for executive compensation disclosures, which have already become a lengthy exercise for some, will take time to interpret and implement. While much of the information will be readily available and will help minimize the reporting burden, other required information (primarily the executive compensation actually paid and equity-based compensation adjustments) is new. Therefore, companies should begin preparations to develop the newly required disclosure information.

Let's talk

For a deeper discussion on how these requirements will impact your business, please contact

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