SEC ADOPTS FINAL PAY-VERSUS-PERFORMANCE DISCLOSURE RULES

Alert | 09.16.2022
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On August 25, 2022, the Securities and Exchange Commission (SEC) adopted **final rules** implementing the "pay-versus-performance" disclosure requirement called for under Section 953(a) of the Dodd-Frank Wall Street Reform and Consumer Protection Act. The final rules will require disclosure of information reflecting the relationship between executive compensation actually paid by a public company and the company's financial performance.

The rules will apply to all reporting companies, except foreign private issuers, registered investment companies and emerging growth companies. Smaller reporting companies (SRCs) will be permitted to provide scaled disclosures.

Disclosure under the new rules will be required in all proxy and information statements that are required to include Regulation S-K Item 402 executive compensation disclosure for fiscal years ending on or after December 16, 2022. Accordingly, calendar year-end public companies will be required to provide this new disclosure beginning with their 2023 proxy statements.

Summary of New Rule

Tabular Disclosure

New Item 402(v) of Regulation S-K will require companies to provide the following tabular disclosure:

Pay Versus Performance

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]*

Total Shareholder Return

Peer Group Total Shareholder Return*

(a)

(b)

(c)

(d)

(e)

(f)

(g)

(h)

(i)

Y1

Y2

Y3

Y4*

Y5*

** Indicates portions of the final rules from which SRCs are exempt.*

The new table calls for disclosure of the specified metrics for the company's five most recently completed fiscal years:

- the company's Summary Compensation Table measure of total compensation for the company's principal executive officer (PEO) and, as an average, for the company's other named executive officers (NEOs);
- "executive compensation actually paid" for the company's PEO (or PEOs);
- "executive compensation actually paid," as an average, for the company's other NEOs;

- total shareholder return (TSR) for the company;
- TSR for the company's peer group (weighted according to the respective issuer's stock market capitalization at the beginning of each period for which a return is indicated);
- the company's net income; and
- an additional financial performance measure chosen by the company (the Company-Selected Measure) that represents the most important financial performance measure the company uses to link executive compensation to the company's performance for the most recently completed fiscal year.

Executive Compensation Actually Paid

Compensation actually paid in this context is not the same as compensation realized and must be calculated using the formula prescribed by the final rules. The starting point for the calculations is the total compensation for each executive from the Summary Compensation Table, which is then adjusted for equity awards and pension benefits as specified in the final rules. In general, the adjustments are designed to align the compensation attributable to equity awards and pension benefits to the amounts "earned" by the executives during the applicable fiscal year. These adjustments must be disclosed in footnotes to the columns showing compensation actually paid. In particular, the calculations for equity awards, which will be applicable to a broader number of public companies, require a number of new and complex disclosures that go beyond simply reporting the fair value of the awards that vested during the year.

Peer Group TSR

A company may use either the same peer group used for its performance graph in its Form 10-K or one used for disclosing its compensation benchmarking practices in its compensation discussion and analysis. As with the performance graph, if a company changes the peer group from the one used in the previous fiscal year, it will only be required to include tabular disclosure of peer group TSR for that new peer group (for all years in the table), but must explain, in a footnote, the reason for the change and compare the company's TSR to that of both the old and the new group.

Permitted Supplemental Disclosure

Companies may provide additional performance measures as new columns in the table. However, such additional disclosures may not be misleading or obscure the required information, and the additional performance measures may not be presented with greater prominence than the required disclosure.

Relationship Disclosure

In addition to the tabular disclosure described above, companies will be required to provide a clear description of, in each case over the company's five most recently completed fiscal years, the relationships between:

- executive compensation actually paid to the company's PEO and, on average, its other NEOs and the company's TSR;
- executive compensation actually paid to the company's PEO and, on average, its other NEOs and the net income of the company;

- executive compensation actually paid to the company's PEO and, on average, its other NEOs and the company's Company-Selected Measure; and

- the company's TSR and its peer group TSR.

The descriptions may be graphical, narrative or a combination, and, if "clear," may be grouped together.

Other Performance Measure Disclosure

Companies also must provide an unranked tabular list of three to seven financial performance measures that they determine are their most important measures for linking executive compensation actually paid to company performance, based on the last fiscal year.

A company has the option of including non-financial performance measures in this list, provided that at least three of the performance measures are financial performance measures.

Inline XBRL

Companies will be required to separately tag each value disclosed in the table, block-text tag the footnote and relationship disclosures and tag specific data points (such as quantitative amounts) within the footnote disclosures, all in Inline XBRL.

Scaled Disclosure for SRCs

In the tabular disclosure, SRCs must disclose the required amount for the three, rather than five, most recently completed fiscal years and are not required to disclose weighted TSR for a peer group, disclose a Company-Selected Measure or disclose amounts related to pensions. As such, SRCs are not required to provide a description of the relationships between executive compensation actually paid to the company's PEOs and, on average, its other NEOs and the company's Company-Selected Measure, or the relationships between the company's TSR and its peer group TSR. Finally, SRCs are not required to disclose a list of their most important performance measures and will have until their third filing with pay-versus-performance disclosure, instead of their first, to provide the required Inline XBRL data.

Transition Period

Under the transition rules, companies will only be required to provide three years of information (or two, in the case of SRCs) in the first proxy or information statement in which disclosure is required. Thereafter, companies will be required to provide one additional year in each of the two subsequent annual filings in which the disclosure is required (except that SRCs will only be required to provide three total years of information). Companies are not required to make disclosures for any fiscal years in which they were not a reporting company under U.S. securities laws.

Practical Takeaways

Considering the short timeline for implementation and the substantial obligations created by these rules, companies are strongly encouraged to familiarize themselves with the new rules and begin collecting the information that will be necessary for the disclosure as soon as possible.

While much of the information required in the pay-versus-performance disclosure is based on or can be derived from information that is already required elsewhere in the executive compensation disclosure and financial statements provided by companies, the disclosures called for by the new rule may require companies to track performance measures that they have not historically tracked, such as their TSR or the TSR of their peer group. Particular attention should be paid to the "compensation actually paid" metric, which, as discussed above, requires complex calculations, including for several prior fiscal years, to satisfy disclosure obligations. To the extent that there is a disconnect between how compensation committees evaluate performance in awarding executive compensation and how compensation and performance will be presented under the new rules, some companies may determine to include additional voluntary disclosure that reflects how they view the connection between realized or realizable compensation and company performance.

Companies should also begin discussions regarding what financial performance measure should be utilized as the Company-Selected Measure, understanding that it should be focused on the most recently completed fiscal year (i.e., 2022 for companies with calendar year fiscal years), and which three to seven other financial performance measures are most important in setting compensation. Further, the rules require companies to disclose relationships that, in many cases, companies may not have previously disclosed, such as the relationship of their executive compensation to net income and TSR. Consultation with the company's compensation committee and its independent compensation consultant will be key in ensuring that appropriate performance measures are utilized.

For many boards and compensation committees, these computations and selection of metrics will be new decisions, adding another layer to an already complex process of setting and determining executive compensation. Companies are encouraged to begin preparation of their proxy statements early enough to ensure timely compliance with the required computations and disclosures, design formats and Inline XBRL tagging and to ensure appropriate review by management, in-house counsel, outside counsel and members of the board of directors.

If you have any questions related to this alert, please do not hesitate to contact any member of the Public Companies group or your regular Smith Anderson lawyer.

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