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Legal Update

SEC Adopts Pay Versus Performance Disclosure Rule

On August 25, 2022, the US Securities and Exchange Commission (SEC) finally adopted a "pay versus performance" rule in accordance with a Dodd-Frank Wall Street Reform and Consumer Protection Act (Dodd-Frank Act) mandate that requires SEC-reporting companies to disclose in a clear manner the relationship between executive compensation actually paid and the financial performance of the company.[1] As adopted, the rule generally requires disclosure of five years of pay versus performance data in proxy and information statements in which executive compensation information is required to be included pursuant to Item 402 of SEC Regulation S-K. The new pay versus performance disclosures must be included in proxy and information statements that are required to include such compensation information for fiscal years ending on or after December 16, 2022. Thus, the new rule will generally apply for the upcoming 2023 proxy season.

Background

The Dodd-Frank Act added Section 14(i) to the US Securities Exchange Act of 1934, as amended (Exchange Act), directing the SEC to adopt a pay versus performance rule in proxy and information statements in which executive compensation information is required to be included pursuant to Item 402 of Regulation S-K. The SEC originally proposed the pay versus performance rule in 2015 (2015 Proposal), proposing new subsection (v) to Item 402 of Regulation S-K to require a new compensation table, showing the relationship between compensation actually paid to named executive officers (NEOs) and a company's performance, with performance measured both by the company's total shareholder return (TSR) and peer group TSR, as well as a description of the relationship of pay to performance. Earlier this year, the SEC reopened the comment period on the 2015 Proposal (as opposed to re-proposing its pay versus performance rule) and requested comments on additional disclosures that were not contemplated in the 2015 Proposal.

Requirements of Pay Versus Performance Rule

As adopted, new Item 402(v) of Regulation S-K requires:

- a new pay versus performance table,
- a clear description of the relationship between the compensation actually paid to the principal executive officer (PEO) and to the other NEOs (Remaining NEOs) and the company's performance across each of the measures included in the pay versus performance table, which may be presented as a narrative, a graph or a combination of the two, and

- a tabular list of the most important financial performance measures that the company uses to link NEO compensation to company performance.

Companies have flexibility as to the exact placement of the pay versus performance disclosures within the proxy or information statement, although these must appear with, and in the same format as, the rest of the executive compensation disclosures required to be provided by Item 402 of Regulation S-K. The disclosures may, but need not, be part of the Compensation Discussion and Analysis (CD&A).

Pay Versus Performance Table. The pay versus performance table must disclose the compensation paid to the PEO and the average compensation paid to the Remaining NEOs as compared to four performance measures. The performance measures required to be included are:

- company TSR,
- peer group TSR,
- net income, and
- a company-selected financial performance measure (Company-Selected Measure).

The new table must contain data for five years, except that smaller reporting companies (SRCs) are permitted to provide three years of data. The table is required to be in the following format, with the column titled "Company-Selected Measure" replaced with the name of the financial performance measure chosen by the company:

Pay Versus Performance

Year	Summary Compensation Table Total For PEO	Compensation Actually Paid to PEO	Average Summary Compensation Table Total for non-PEO Named Executive Officers	Average Compensation Actually Paid to non-PEO Named Executive Officers	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*								

*Denotes disclosures not required for SRCs.

Description of Pay Versus Performance Relationship. The required tabular disclosure must be accompanied by a clear description of the relationship between

- both executive compensation actually paid to the PEO and the average compensation actually paid to the Remaining NEOs, and each of the following:

    (1) company TSR,

    (2) company net income, and

    (3) the Company-Selected Measure; and

- the Company's TSR and the peer group TSR.

If a company elects to provide any additional measures in the table, each additional measure must be accompanied by a clear description of the relationship between such compensation actually paid and the additional measure over the company's five fiscal years displayed in the table. The descriptions can be provided in narrative or graphic form, or a combination of both. For example, the adopting release indicates that the relationship could be expressed as a graph providing executive compensation actually paid and change in financial performance measure(s) on parallel axes and plotting compensation and the measure(s) over the required time period. Companies are permitted to group the descriptions, but any combined description of multiple relationships must be clear.

Companies may supplement the required disclosure with additional pay versus performance measures or descriptions (in the table or elsewhere). However, any such supplemental disclosure must be clearly identified as supplemental, not be misleading and not be presented more prominently than the required disclosure.

Tabular List. Additionally, companies (other than SRCs) must provide an unranked list of the three to seven most important financial performance measures used to link executive compensation actually paid to NEOs during the last fiscal year with the company's performance. Alternatively, companies may elect to include one tabular list for the PEO and one list for the Remaining NEOs, or provide lists for each NEO, setting out the applicable three to seven financial performance measures used to link the relevant individual's compensation with company performance. Companies are permitted to include non-financial measures in the list if they consider such measures to be among their three to seven most important measures. If a company uses fewer than three measures to link NEOs' compensation to company performance, only measures actually used must be included.

Additional Information on Pay Versus Performance Rule

Companies Covered. The pay versus performance rule applies to all SEC-reporting companies, *except*:

- foreign private issuers,
- registered investment companies, and
- emerging growth companies.

Business development companies (a category of closed-end investment company) and SRCs are subject to the rule, although the disclosure requirements for SRCs are scaled.

Filings Covered. As previously noted, pay versus performance disclosure is required in proxy and information statements that are required to contain executive compensation disclosure pursuant to Item 402 of Regulation S-K. The pay versus performance information will not be deemed to be incorporated by reference into any filing under the US Securities Act of 1933, as amended, or the Exchange Act unless the company specifically incorporates it.

Executives Covered. The pay versus performance table must separately provide compensation information for the PEO, on an annual basis, for each of the past five fiscal years (three in the case of SRCs). If more than one person has served as PEO in any year, data for each PEO must be reported in separate columns.

In addition, the table must provide average (*i.e.*, mean) compensation, on an annual basis, for the Remaining NEOs for such years. The Remaining NEOs whose compensation amounts are included in the averages reported for a given year must be individually identified by a footnote. The footnote will allow investors to consider the average compensation reported with changes in composition of the Remaining NEOs.

Pay Covered. The elements of the compensation actually paid category reflects that information contained in the Summary Compensation Table is distinct from the compensation paid to an NEO in a given year. Under Item 402(v)(2) of Regulation S-K, compensation actually paid to each individual is comprised of total compensation disclosed in the Summary Compensation Table modified to adjust the amounts included for pension benefits, equity awards and above-market or preferential earnings on deferred compensation that is not tax qualified, each as described below.

For each year included in the pay versus performance table, companies will be required to deduct from the Summary Compensation Table total the aggregate change in the actuarial present value of all defined benefit and actuarial pension plans, and add back the aggregate of: (i) actuarially determined service cost for services rendered by the NEO during the applicable year (service cost); and (ii) 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 (prior service cost), in each case, calculated in accordance with US generally accepted accounting principles (GAAP). The change in actuarial present value would be deducted only if the value is positive. The scaled disclosure requirements do not require SRCs to make this pension adjustment.

The 2015 Proposal had proposed to treat equity awards as actually paid in the fiscal year in which such awards became vested. However, comments to the 2015 Proposal noted that such timing could create a perceived misalignment between pay and performance since such awards would be viewed as actually paid only in the year of vesting rather than actually paid in each fiscal year over the life of the award between the date of grant and the date of vesting. For example, where an award vests over a three-year period and the company's financial performance is positive in the first two years and negative in the third, reporting the full value of the award only in the vesting year may give investors the misleading impression that the executive was not rewarded for positive performance in years one and two and was rewarded despite negative performance in year three. To address these concerns, Item 402(v) of Regulation S-K, as adopted, generally requires that equity awards first be reported as compensation actually paid in the fiscal year during which the award is granted based on the fair value as of the last day of the year, and then, in each subsequent year, changes in the fair value of the award as of the last day of the fiscal year will be reported until a final fair value is reported for the fiscal year in which vesting occurs (i.e., the date that all applicable vesting conditions have been satisfied) determined as of the date of vesting. For any awards that are subject to performance conditions, the change in fair value is calculated based on the probable outcome of such conditions as of the last day of the fiscal year.

Specifically, to calculate compensation actually paid for equity awards for each year included in the pay versus performance table, companies need to deduct the equity award amounts shown in the Summary Compensation Table from total compensation and then add or subtract the following amounts, as applicable:

- 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;
- the amount of change as of the end of the covered fiscal year (from the end of the prior fiscal year) in fair value of any awards granted in prior years that are outstanding and unvested as of the end of the covered fiscal year;
- for awards that are granted and vest in the same covered fiscal year, the fair value as of the vesting date;
- for awards granted in prior years that vest in the covered fiscal year, the amount equal to the change in fair value as of the vesting date (from the end of the prior fiscal year);
- for awards granted in prior years that are determined to fail to meet the applicable vesting conditions during the covered fiscal year, a deduction for the amount equal to the fair value at the end of the prior fiscal year; and
- the dollar value of any dividends 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.

Vesting date valuation assumptions have to be disclosed by footnote if they are materially different from those disclosed as of the grant date.

Additionally, compensation actually paid must include above-market or preferential earnings on deferred compensation that is not tax qualified. Such amounts may be viewed to approximate the value that would be set aside currently by the company to satisfy its obligations in the future. Such amounts of deferred compensation that are not tax qualified must be included whether or not such amounts are vested and whether or not such amounts are actually paid during such year. According to the SEC, "excluding those amounts until their eventual payout would make the amount 'actually paid' contingent on an NEO's choice to withdraw or take a distribution from their account. . ." The SEC does not believe such treatment would accurately represent compensation "actually paid."

The pay versus performance table also must disclose, in an accompanying footnote, the amounts of compensation deducted from, and added to, the Summary Compensation Table total compensation in determining compensation actually paid to the PEO and Remaining NEOs.

Finally, any one-time payment, such as a signing or severance bonus, must be included in compensation actually paid. While such amounts may not be reflective of what an executive typically receives in a year, they are amounts that were actually paid in that year.

Measures of Performance. Company TSR and peer group TSR must be included as performance measures in the pay versus performance table, calculated in accordance with Item 201(e) of Regulation S-K, by "dividing the (i) sum of (A) the cumulative amount of dividends for the measurement period, assuming dividend reinvestment, and (B) the difference between the company's share price at the end and the beginning of the measurement period; by (ii) the share price at the beginning of the measurement period." Both company and peer group TSR are calculated based on a fixed $100 investment. The peer group TSR presented in the table must be weighted according to the respective issuers' market capitalization at the beginning of the relevant period. The peer group must be identified by footnote or such identification may be incorporated by reference from prior SEC filings, unless the peer group is a published industry or line of business index. Additional disclosures are required any time the company modifies the peer group used for TSR. SRCs do not need to provide peer group TSR.

In addition, the final rule requires companies to include net income for each year included in the pay versus performance table.

The last column included in the pay versus performance table sets out the Company-Selected Measure, which must be a numerically quantifiable financial performance metric. The Company-Selected Measure must be the most important financial performance measure used to determine NEO compensation not already included in the pay versus performance table in the company's view. The Company-Selected Measure can change from year to year.

Non-GAAP financial measures. The Company-Selected Measure, or additional measures included in the pay versus performance table, are permitted to be non-GAAP financial measures. Any disclosure of a non-GAAP financial measure that a company elects to provide as part of its pay versus performance disclosure will not be subject to Regulation G or Item 10(e) of Regulation S-K. However, the company must provide disclosure as to how the number is calculated from its audited financial statements.

XBRL. The pay versus performance table, footnotes and related disclosures all must be separately tagged using Inline XBRL. The footnotes and description of the relationship may be tagged using block-text tags, while individual data points must be separately tagged.

Phase-In. The general phase-in for the rule will require pay versus performance disclosure for three years in the first proxy or information statement in which such disclosure is required for all companies, other than SRCs, for fiscal years ending on or after December 16, 2022. In each of the two subsequent years, another year of disclosure would be added. SRCs only need to provide information for two years for the first filing requiring such disclosure for fiscal years ending on or after December 16, 2022, with a third year added in their next annual proxy or information statement that requires executive compensation disclosure. Also, SRCs will not have to comply with the XBRL requirement until the third annual filing containing pay versus performance disclosure.

Newly reporting companies do not need to include pay versus performance information for fiscal years prior to their first completed fiscal year as a reporting company.

Practical Considerations

Informing the Board. Companies should inform their boards of directors, and particularly their compensation committees, of the SEC's adoption of the pay versus performance rule. Companies should also consider involving the audit committees if non-GAAP financial measures are used in pay versus performance disclosure, even if Regulation G and Item 10(e) of Regulation S-K are not triggered because there may be scrutiny by the market and the SEC with respect to benchmarking to non-GAAP financial measures.

2023 Proxy Season Implications. The pay versus performance rule is a significant and sensitive requirement impacting 2023 annual meeting proxy and information statements. Public companies should begin preparing for this new disclosure requirement right away. Compliance with the pay for performance rule will most likely require companies to calculate values that have not been calculated in the past, including the actuarially determined service cost for services rendered by an individual NEO with respect to a pension plan (as this was most likely only calculated on a plan-wide basis) and including the fair value of unvested equity awards as of the last day of each fiscal year. Compensation committees, assisted by management and their compensation consultants, should carefully consider which Company-Selected Measure to use for the table and which measures to include in the list of three to seven most important measures. The pay versus performance rule is distinct from the CD&A, but it is important that the CD&A be consistent with the new disclosure. Companies should draft the pay versus performance disclosures well in advance of the proxy statement filing to allow time for review by their law, human resources, investor relations and public relations departments, compensation committees and boards of directors, as well as outside counsel and compensation consultants. Companies may want to perform a retrospective look to determine what the company's disclosures would have been in prior years, for example, by preparing a draft of what the pay versus performance disclosure would have looked like in last year's proxy statement had the final rules been in effect at that time.

Say-On-Pay. Because the new pay versus performance disclosures are an element of executive compensation disclosure pursuant to Item 402 of Regulation S-K, the new disclosure can affect the say-on-pay advisory vote. Companies should begin to reflect on how these disclosures may impact advocacy for favorable say-on-pay results.

Realized Pay. Many companies have already been including realized or realizable pay in their proxy statements. These companies will need to consider whether to conform their existing presentation formats to that required by the rule or to retain their presentations in addition to that required by the new rule. To the extent companies choose to retain their existing disclosures, they will also have to consider whether any presentation changes are needed so that their supplemental realized or realizable pay disclosures are no more prominent than the mandated pay versus performance table and related description of relationships. Companies that do not currently include realized or realizable pay will want to consider whether there are supplemental measures that they want to provide in order to better explain their compensation decisions.

Peer Groups. For purposes of pay versus performance disclosure, companies must include peer group TSR in their tables, using either the peer group for the stock performance graph or the peer group identified in the CD&A. Therefore, companies should consider which peer group would be more appropriate for a pay versus performance analysis and whether they want to make any adjustments to either of these two peer groups. Because companies may choose between two alternatives to calculate peer group TSR, there potentially could be different peer groups for pay versus performance and CD&A purposes in the proxy statement. In that situation, companies should expect to explain the rationale for having different peer groups used in the context of executive compensation disclosure.

If, going forward, the company changes the peer group used for pay-versus-performance disclosure 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). Additionally, the company will need to explain, in a footnote, the reasons for the change, and compare the company's TSR to both the old and the new peer group.

Proxy Advisory Firms. It is possible that the new pay versus performance disclosure requirements will lead to proxy advisory firms, investors or other stakeholders targeting what they would consider to be an acceptable range or correlation between company performance and executive compensation that they will seek to apply across the board with respect to their decisions regarding the company. Companies may want to consider in advance how they would respond to such treatment in light of their particular facts and circumstances.

Cause and Effect Problem. If TSR disclosure in the proxy statement becomes the measuring stick for a company's success in linking pay to company performance, companies may need to consider whether, as a practical matter, they should use TSR as the relevant performance criteria in all performance-related equity grants. While many companies already use TSR (both absolute and relative), many other companies prefer to use TSR in combination with other performance measures and others do not use TSR at all. If a company uses a combination of measures, or a measurement for vesting other than TSR, the company will run the risk of future disclosure of increased pay at a time when the TSR may not have increased proportionally (or, of course, decreased pay at a time when the TSR has increased). Companies that do not use TSR (or only use it as one of many factors) will at least need to consider how their choice of performance conditions in equity awards will need to be disclosed beginning in the 2023 proxy season.

Additionally, after each company identifies which measures it considers the "most important," research analysts, investors, potential litigants and proxy advisory firms may place considerable attention and perhaps undue focus on the Company-Selected Factor, as well as any changes to the tabular list. The pay versus performance disclosures will inevitably be scrutinized and compared to the selected measures used by other companies in the same industry. Any changes to the company's identified measures will likely require additional details in the narrative to avoid unnecessary speculation or negative connotation.

Average Pay Disclosure. Although the new rule only requires tabular disclosure with respect to the Remaining NEOs on an average basis, companies may want to consider whether also providing information for each individual NEO provides investors with a more meaningful picture of their "compensation actually paid" and, if so, where to add this disclosure.

Definition of Vesting. The vesting date of equity awards is not defined in the final rules, and the limited guidance on this topic leaves open questions regarding the correct timing for when an award would be considered "vested" for purposes of this disclosure. The determination of when an equity award is considered vested is significant under Item 404(v) as the year in which such award becomes vested is the last year in which any amount needs to be included with respect to such award in the pay versus performance table.

For federal tax purposes, vesting is generally analyzed as occurring at the point in time when the equity award is no longer subject to a substantial risk of forfeiture (although the concept is defined differently in different sections of the Internal Revenue Code). Under Item 404(v), it would be necessary to include the fair value for an equity award in the pay versus performance table until the year in which vesting occurs but Item 404(v) does not offer any guidance on the complexities of analyzing when all applicable vesting conditions would be satisfied in many equity award grants or in identifying which conditions constitute vesting conditions.

To illustrate how complicated a vesting date determination can be, consider a company that grants restricted stock units that become fully vested on the earlier of the three-year anniversary of the date of grant or the executive's retirement, and the grant is made to an executive who meets the criteria for retirement. Additionally, the restricted stock unit grant provides that shares will be distributed to the executive one year following the year in which the restricted stock units become vested, and the shares distributed are subject to a clawback for two years following the date of distribution. If the executive remains employed through the entire three-year vesting period and receives such shares in year four (one year after the date of vesting), it is unclear when such restricted stock units should be considered vested for purposes of the pay versus performance table. In this example, the restricted stock units would be considered vested on the date of grant for federal tax purposes because the shares would no longer be considered to be subject to a substantial risk of forfeiture, and the executive would be taxed on the fair market value of the shares in year four when distributed.

Under Item 404(v), it is not clear when this restricted stock unit award would be considered to have satisfied all applicable vesting conditions. The restricted stock units could be considered vested on the date of grant if the fact that the executive met the conditions of the retirement definition on the date of grant was analyzed as the point in time where the applicable vesting conditions were satisfied (similar to the federal tax analysis leading to the conclusion that this equity award was substantially vested on the date of grant). Alternatively, the restricted stock units could be considered vested on the completion of the three-year vesting period or when the executive receives the fully vested shares in year four and is able to realize the economic gain of the shares by selling them. Finally, the restricted stock units could be considered vested only after the end of the clawback period because until such period is complete there is a possibility that the executive will forfeit the shares.

For more information about the topics raised in this Legal Update, please contact the authors of this Legal Update, Laura D. Richman at +1 312 701 7304 or Katelyn M. Merick at +1 202 263 3116, any of the following lawyers, or any member of our Corporate & Securities practice.

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ENDNOTES

[1] *Release Nos. 34-95607, available at* Final rule: Pay Versus Performance (sec.gov).