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SEC Adopts Final Pay-Versus-Performance Disclosure Rules

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Introduction

On August 25, the U.S. Securities and Exchange Commission (SEC) adopted (with the two Republican SEC commissioners dissenting) final pay-versus-performance rules mandated by the Dodd-Frank Wall Street Reform and Consumer Protection Act in 2010. The SEC originally proposed pay-versus-performance disclosure rules in August 2015 and quietly reopened the comment period at the beginning of 2022. The SEC noted that the final rules are aimed at eliciting additional disclosures from registrants to provide investors with more transparent, readily comparable and understandable disclosure of a registrant's executive compensation actually paid relative to its financial performance. The new pay-versus-performance disclosure rules come at a time when executive compensation is under heightened scrutiny by the SEC, proxy advisory firms, and investors.

In a break from the more principles-based approach that the SEC embraced in the last administration with respect to, among other items, Risk Factor, Business, and MD&A disclosure requirements, the SEC adopted a standardized format and presentation for these new pay-versus-performance disclosures. The SEC believes that this format will provide for comparability of the disclosures across registrants and within registrants' filings over time and addresses the concern that registrants may cherry-pick information that is most favorable to them.

While the final rules will become effective 30 days after the release's publication in the *Federal Register*, the new Item 402(v) disclosure will be required in any proxy/information statement that presents executive compensation disclosures pursuant to Item 402 of Regulation S-K for fiscal years ending on or after December 16, 2022. For December 31 fiscal year-end registrants, this means that the new pay-versus-performance disclosures must be included in upcoming 2023 annual meeting proxy/information statements.

Item 402(v) requires a new pay-versus-performance table that discloses executive compensation and financial performance measures for a registrant's five most recently completed fiscal years. The final rules provide, however, that the five years will be phased in over time, with three years required for the first proxy/information statement filed under the new pay-versus-performance rules, adding a year of data until five full years are provided. Smaller reporting companies (SRCs) initially must provide two years of the required information as detailed below, adding an additional year of disclosure until three full years are provided.

The final pay-versus-performance rules apply to all reporting companies (including business development companies and SRCs), except emerging growth companies, foreign private issuers, registered investment

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companies, or companies with reporting obligations only under Section 15(d) of the Exchange Act, which are not subject to the proxy rules.

Importantly, the final pay-versus-performance rules do not prescribe a specific location in the proxy/information statement for where the new Item 402(v) pay-versus-performance disclosures must appear. This should provide flexibility for a registrant to determine the appropriate placement of the tabular and narrative disclosure in its proxy/information statement.

New Pay-Versus-Performance Table

The new Item 402(v) of Regulation S-K requires a standardized tabular disclosure format that includes for each year in the table the following information in separate columns:

- The Total Principal Executive Officer (PEO) compensation reported in the Summary Compensation Table;
- The value of executive compensation actually paid to a registrant's PEO;
- For Named Executive Officers (NEOs; as defined under Item 402 of Regulation S-K), (other than the PEO), the average total compensation reported in the Summary Compensation Table;
- The value of the average executive compensation actually paid to the NEOs (other than the PEO);
- The value of a fixed investment scaled by cumulative total shareholder return (TSR) for the registrant;
- The value of a fixed investment scaled by cumulative TSR for the selected peer group;
- The registrant's net income; and
- A measure chosen by the registrant and specific to the registrant as the measures of financial performance (Company-Selected Measure).

Additionally, a registrant will be required to provide a narrative, graphical, or combined narrative and graphical description of the relationships between executive compensation actually paid and each of the registrant's performance measures presented. The description must also include a comparison of the TSR for the registrant and the TSR for the peer group. According to the SEC, the required Item 402(v) pay-versus-performance table and relationship disclosures should provide investors with clear information from which they can determine the relationship between executive compensation actually paid and some basic features of a registrant's financial performance.

A registrant will be required to include a footnote to the table that identifies the individual NEOs whose compensation amounts are included in the average for each year, which the SEC believes will allow investors to consider whether changes in the average compensation reported year over year were due to changes in NEO composition or otherwise.

In years where a registrant has multiple PEOs, the final pay-versus-performance rules require that, in those years, such registrant includes separate disclosures for each PEO, which allows investors to distinguish compensation paid to separate PEOs and that the SEC believes will avoid potential confusion from presenting an aggregated figure in the table and having discussion of separate PEOs in a footnote or other narrative disclosure accompanying the Item 402(v) pay-versus-performance table.

A sample pay-versus-performance table is included in Annex A below.

Calculating Compensation Actually Paid To Executives

Under Item 402(v), "executive compensation actually paid" is calculated as total compensation as reported in the Summary Compensation Table, modified to adjust the amounts included for pension benefits and equity awards. With respect to pension plan compensation, the final pay-versus-performance rules require a registrant to deduct from the Summary Compensation Table total compensation figure the aggregate change in actuarial present value of all defined benefit and actuarial pension plans (if positive), and to add back the aggregate of two components: (1) actuarially determined service cost for services rendered by the executive during the applicable year (service cost); and (2) 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). The final pay-versus-performance rules also require that the calculation of executive compensation actually paid include above-market or preferential earnings on deferred compensation that is not tax-qualified, which are reported pursuant to Item 402(c) of Regulation S-K (Item 402(n) of Regulation S-K for SRCs). The SEC noted that excluding such amounts until their eventual payout would not be an accurate representation of compensation "actually paid" because it would make such amount contingent on a NEO's choice to withdraw or take a distribution from his/her account, rather than the registrant's compensatory decision to pay the above-market return.

With respect to equity awards in relation to total compensation reported in the Summary Compensation Table, the final pay-versus-performance rules use "fair value" as the measure of the amount of an equity award and adjust the date on which awards are valued such that the first fair value disclosure is made in the year of grant, and changes in the value of the award are reported from year to year until the award is vested, which the SEC noted would better align the timing of the disclosure and valuation with when the award is actually "earned" by an executive, resulting in disclosure that more clearly shows the relationship between executive compensation and a registrant's performance.

The final pay-versus-performance rules further require the deduction of equity award amounts reported in the Summary Compensation Table total and, instead of the addition of the vesting date fair value of stock awards and options, require the addition (or subtraction, as applicable) of the following:

- 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 (positive or negative) 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 that vest in the same covered fiscal year, the fair value as of the vesting date (note that there is no adjustment required for awards granted and determined not to vest in the same covered year);
- For awards granted in prior years that vest in the covered fiscal year, the amount equal to the change as of the vesting date (from the end of the prior fiscal year) in fair value;
- 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 (note for equity awards that fail to vest, a negative amount equal to the fair value of the end of the prior fiscal year would be included as part of the executive's compensation actually paid as of the date of the determination that the award will not vest, which takes the cumulative reported value of that award to $0 since it did not vest); 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 is not otherwise reflected in the fair value of such award or included in any other

component of total compensation for the covered fiscal year.

A chart summarizing these adjustments is included in Annex B below.

Financial Measures

TSR, Peer Group TSR, and Net Income

A registrant must use TSR and peer group TSR (other than SRCs) as measures of performance and disclose weighted peer group TSR (weighted according to the respective registrant's stock market capitalization at the beginning of each period for which a return is indicated), using either the same peer group used for purposes of Item 201(e) of Regulation S-K (performance graph) (Item 201(e)) or the peer group used in the Compensation Discussion and Analysis section for purposes of disclosing the registrant's compensation benchmarking practices. If the peer group is not a published industry or line-of-business index, the SEC requires the identity of the companies composing the group to be disclosed by footnote. Moreover, a registrant is permitted to comply with this requirement by incorporating by reference a peer group previously disclosed in prior filings with the SEC. In this case, if a registrant changes the peer group used in its pay-versus-performance disclosures from the one used in a previous fiscal year, it is only required to include tabular disclosure of the peer group TSR for that new peer group (for all years in the table), but it must explain the reason for the changes in a footnote, as well as compare the registrant's TSR to that of both the old and the new group.

The "measurement period" for these purposes is calculated in the same cumulative basis as is used in Item 201(e), measured from the market close on the last trading day before the registrant's earliest fiscal year in the table through and including the end of the fiscal year for which TSR is being calculated (TSR for the first year in the table will represent the TSR over that first year, the TSR for the second year will represent the cumulative TSR over the first and second years, etc.). TSR and peer group TSR should be calculated based on a fixed investment of one hundred dollars at the measurement point.

To address commenters' concerns with respect to the use of TSR and peer group TSR as the sole measures of performance, a registrant must include net income and a Company-Selected Measure as performance measures in the pay-versus-performance table and is permitted to voluntarily include additional measures of its choosing in the pay-versus-performance table, subject to certain requirements, which are discussed in more detail below.

Tabular List of Most Important Financial Measures

The final pay-versus-performance rules require a registrant to provide a list of its "most important" financial measures used to link executive compensation actually paid during the fiscal year to company performance (Tabular List) and permit a registrant to include nonfinancial performance measures in the Tabular List if these measures are among the registrant's most important performance measures used by the registrant. The "most important" determination is made by reference to the most recently completed fiscal year. The Tabular List must disclose at least three, and up to seven financial performance measures (including nonfinancial performance measures), and it is not required to be ranked (*i.e.,* most important to least important). A registrant may only include nonfinancial performance measures if it has disclosed at least three (or fewer if the registrant only uses fewer) most important financial performance measures.

A registrant may disclose the Tabular List in one list or in multiple lists, one for each of the PEO and the NEOs (either individually or as a group).

If a registrant elects to provide the Tabular List disclosure in multiple lists, each list must include at least three, and up to seven, financial performance measures and may include nonfinancial performance measures, if applicable. A registrant is also permitted to cross reference to other disclosures elsewhere in the applicable disclosure document that describes the registrant's processes and calculations for determining NEO compensation as it relates to the Tabular List performance measures.

Additionally, although not required by the final pay-versus-performance rules, the SEC noted that registrants should consider if disclosure of the methodology used to calculate the financial performance measures constituting the Tabular List would be helpful to investors for understanding those measures or to prevent the Tabular List from being confusing or misleading.

Company-Selected Measure(s)

The pay-versus-performance table required by new Item 402(v) must include a Company-Selected Measure. This Company-Selected Measure must be a financial performance measure that, in a registrant's assessment, represents the most important performance measure (that is not otherwise required to be disclosed in the Item 402(v) pay-versus-performance table) used by the registrant to link executive compensation actually paid to the registrant's NEOs for the most recently completed fiscal year to company performance. If the registrant's "most important" measure is already included in the Item 402(v) pay-versus-performance table, the registrant would select its next-most important measure as its Company-Selected Measure. Given the Company-Selected Measure must also be a measure included in the Tabular List, the determination of "most important" that a registrant uses for selecting a Company-Selected Measure is the same as the determination that it must use for selected required measures for the Tabular List (*i.e.,* the "most important" determination is made by reference to the most recently completed fiscal year, and the measures required to be disclosed are financial measure of performance).

Although a registrant is only required to provide one Company-Selected Measure in the Item 402(v) pay-versus-performance table, it may provide additional measures as new columns in the pay-versus-performance table if the additional disclosures are not misleading, do not obscure the requirement information, and are not presented with greater prominence than the required disclosure. Additionally, in situations where a registrant describes multiple measures because it believes multiple measures are equally the "most important," such registrant must still select one Company-Selected Measure to be included in the Item 402(v) pay-versus-performance table, but could provide explanatory disclosure, for example, about why additional measures are added and the reason that the additional measures are selected.

If a registrant elects to include additional performance measures in the Item 402(v) pay-versus-performance table, each additional measure must also be accompanied by a clear description of the relationship of the additional performance measure to executive compensation actually paid the PEO, and on average, the other NEOs, and the additional performance measure, in narrative or graphical form, or a combination of the two. A registrant may cross reference to other disclosures that describe the processes and calculations that go into determining NEO compensation as it relates to the additional performance measure, if desired, and a registrant is also permitted to supplement its Company-Selected Measure disclosure if the additional disclosure is identified as supplemental, is

not misleading, and is not presented with greater prominence than the required disclosure.

Lastly, the final pay-versus-performance rules clarify that while Company-Selected Measures that are non-GAAP financial measures will not be subject to the non-GAAP disclosure requirements set forth in Regulation G and Item 10(e) of Regulation S-K, a registrant must disclose how such Company-Selected Measure is calculated from its audited financial statements.

Inline XBRL

The final rules require registrants to separately tag each value disclosed in the Item 402(v) pay-versus-performance table, block-text the footnote and relationship disclosure, and tag specific data points (such as quantitative amount) within the footnote disclosures, using inline machine-readable extensible business reporting language (Inline XBRL). There is no phase-in requirement for the application of the Inline XBRL requirement for registrants (other than for SRCs), and therefore, the first filing containing the pay-versus-performance disclosures must be tagged in Inline XBRL accordingly. As noted below, SRCs do not need to comply with this requirement until the third filing in which they provide pay-versus-performance disclosures. The Inline XBRL tagging requirement is limited to Item 402(v) disclosures and does not extend to other compensation information disclosed in proxy/information statements.

Required Disclosures for SRCs

Although SRCs must comply with Item 402(v), the SEC has provided for more limited-scaled disclosures. Specifically, SRCs are:

- Permitted to provide only two years of data, instead of three, for the first proxy/information statement subject to the new rules;
- Required to present only three, instead of five, fiscal years of disclosure for subsequent proxy/information statements;
- Not required to disclose amounts related to pensions for purposes of disclosing executive compensation actually paid;
- Not required to present peer group TSR, a Company-Selected Measure, or a Tabular List; and
- Not required to use Inline XBRL formatting for the Item 402(v) pay-versus-performance table until the third filing in which it provides pay-versus-performance disclosures.

Conclusion

The new pay-versus-performance disclosures will require substantial time and attention by registrants, particularly for calendar year-end companies. Compliance with the new rules will require significant resources, and registrants should evaluate their disclosure controls in light of the new rules and adjust them appropriately in order to be in a position to accurately prepare the required disclosures. Registrants will need to not only obtain the information required by the new pay-versus-performance rules (much of which has not previously been required to be disclosed), but also will need to determine how best to present the new required pay-versus-performance disclosures. Registrants should engage their compensation committees and outside advisors to ensure that the correct performance measures are used for the Company-Selected Measure and the Tabular List and the relationships between pay and performance are properly described.

Annex A

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: Total Shareholder Return	Peer Group Total Shareholder Return *	Net Income	[S I
Y1								
Y2								
Y3								
Y4*								
Y5*								

***** Not Applicable to SRCs

Annex B

Permitted Adjustments for Defined Benefit and Actuarial Pension Plans and Stock and Option Awards

Category	Subtraction Adjustment	Addition Adjustment
Defined Benefit and Actuarial Pension Plans	Total change in the actuarial present value of the accumulated benefit reported in column (h) of the Summary Compensation Table, if positive	Aggregate sum of: (1) Service Cost: calculated as actuarially determined present value of service costs fo services rendered by each NEO during the applicable fiscal years covered in the table. **plus** (2) Prior Service Cost: the entire cost of ben granted (or credit for benefits reduced) in a p amendment (or initiation) during the covered year that are attributed by the benefit formul services rendered in periods prior to the plan amendment (or initiation).

Stock and Option Awards	Grant date fair value reported in the Summary Compensation Table

RELATED INDUSTRIES + PRACTICES

- Corporate
- Corporate Governance
- Employee Benefits + Executive Compensation
- Health Care + Life Sciences

covered fiscal year (from the end of the prior year) in fair value (positive or negative) of ar awards granted in prior years that are outsta and unvested as of the end of the covered fi year;

(3) Add, for awards that are granted and ves same covered fiscal year, the fair value as o vesting date;

(4) Add, for awards granted in prior years th the covered fiscal year, the amount equal to change as of the vesting date (from the end prior fiscal year) in fair value (positive or neg

(5) Subtract, for any awards granted in prior that are determined to fail to meet the applic vesting conditions during the covered fiscal deduction for the amount equal to the fair va the end of the prior fiscal year; and

(6) Add the dollar value of any dividends or earnings paid on stock or option awards in th covered fiscal year prior to the vesting date not otherwise reflected in the fair value of su award or included in any other component o compensation for the covered fiscal year.

Sum of the following **six** adjustments:

(1) Add the year-end fair value of any equity granted in the covered fiscal year that are outstanding and unvested as of the end of th covered fiscal year;

(2) Add the amount of change as of the end

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