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SEC's Pay vs. Performance Rule Requires Disclosure of Relationship Between Executive Officer Compensation, Company Performance

Go-To Guide:

- The SEC adopted long-awaited "pay versus performance" rules.
- Pay versus performance disclosure is required for many public companies for the 2023 proxy season.
- This GT Alert summarizes key aspects and considerations of the new rules for subject companies in the proxy drafting process.

In accordance with a mandate contained in the 2010 Dodd-Frank Act, on Aug. 25, 2022, the U.S. Securities and Exchange Commission (SEC) adopted a final rule creating Item 402(v) of Regulation S-K, requiring that public companies disclose the relationship between the compensation of their executive officers and company performance. Companies that are not exempt from the rule must comply with the new "Pay versus Performance" (PVP) disclosure requirements in applicable proxy and information statements containing executive compensation disclosure for fiscal years ending on or after Dec. 16, 2022.

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Emerging growth companies, registered investment companies, and foreign private issuers are exempt from the new rule. Smaller Reporting Companies (SRCs) are not exempt from PVP disclosure, but an SRC may elect to provide scaled disclosure, consistent with SRCs' reduced-compensation disclosure requirements under Item 402. Inline XBRL (machine-readable eXtensible Business Reporting Language) tagging is required for the PVP disclosure, but an SRC need not comply with XBRL tagging until its third filing with PVP disclosure.

The required PVP disclosure includes (1) a Pay Versus Performance table (PVP Table), (2) a tabular or narrative presentation of the relationships between named executive officer (NEO) compensation "actually paid" and certain financial metrics (including total shareholder return) and (3) a tabular or narrative presentation of the "most important" performance measures selected by the company (Financial Performance Measures List). Registration statements and Annual Reports on Form 10-K are not required to include PVP disclosure and, unless a company affirmatively incorporates the disclosure by reference, the PVP disclosure will not be deemed incorporated by reference into filings under the Securities Act or Exchange Act.

Prior to the new rule, public companies were not required to provide investors with comparisons between the company's performance and its executives' pay. Certain third parties, such as proxy advisors, have historically pressured companies to provide such information.

Background

During the 2007-2008 financial crisis, historically high executive compensation created political headwinds for companies receiving taxpayer-funded bailouts. Certain Dodd-Frank provisions address such concerns and promote corporate responsibility by requiring that public companies provide stockholders with additional information and the opportunity to express their opinions on public company executive compensation practices. Among other things, Dodd-Frank tasked the SEC with adopting rules to provide stockholders the opportunity to vote, on a non-binding advisory basis, on executive compensation, as well as require that public companies disclose PVP information, the ratio of the compensation of CEOs to the median employee compensation, and "golden parachute" compensation arrangements in connection with merger transactions, in each case to inform stockholder voting decisions. With the exception of PVP disclosure, the SEC adopted such rules in 2011 and 2015. The SEC proposed a PVP rule in 2015 but did not adopt a final rule after the open comment period. In January 2022, the SEC reopened the comment period for its PVP rule and proposed certain enhancements to the 2015 proposed rule.

The PVP disclosure requirements under the new rule differ from those of the 2015 proposed rule in several key ways, including the Financial Performance Measures List (which may include non-financial measures), the presentation in the PVP Table of net income and the "Company-Selected Measure" from the Financial Performance Measures List, analysis of the relationship between such metrics and NEO compensation "actually paid," and certain adjustments to the determination of what compensation was "actually paid" to applicable executives, such as the replacement of a fair value determination as of an equity award's vesting with a "mark-to-market" approach.

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How Registrants Can Prepare

Identify Financial Performance Measures

Non-SRC subject companies will need to identify the following in connection with preparation of their 2023 annual meeting proxy statements, and should allocate time *well in advance of drafting* executive compensation disclosure:

i) "Most Important" Financial Performance Measures List: three to seven financial performance measures, which in a subject company's assessment represent the most important financial performance measures used by that company to link compensation actually paid to its NEOs to company performance to be presented in the Financial Performance Measures List.

ii) Company-Selected Measure: a "Company-Selected Measure" to include in the PVP Table Financial Performance Measures List as described below. This requires that consideration be given as to which of the performance measure is most important to the determination of executive compensation. Because the rule requires that companies annually select a Company-Selected Measure, subject companies should incorporate this analysis into their annual proxy statement preparation planning process.

Choose Comparative Disclosure Method

The method for disclosing the relationships between the information set forth in the PVP Table can be in narrative or graphical form, or a combination of both, at a company's election. Each subject company should consider what form cogently describes to investors the pay versus performance relationships dictated by the rule, while also fitting with the proxy statement's overall tone and aesthetic.

Identify Location for PVP Disclosure

The SEC opted to provide companies with the flexibility to determine where in a proxy or information statement to locate PVP disclosure instead of requiring that it be placed within the Compensation Discussion & Analysis (CD&A) section (or Executive Compensation section for SRCs). Placing PVP disclosure within CD&A, the SEC noted, could confuse investors by inappropriately suggesting that the particular company used PVP disclosure to determine executive compensation, particularly for the first year for which PVP disclosure is required. Companies should carefully consider whether PVP disclosure is best situated alongside other narrative executive compensation disclosure, or whether it is best located in line with the other tables and disclosure required by Item 402.

Make Use of Phase-in Period

While non-SRC subject companies must provide five fiscal years of PVP disclosure, such companies may make use of a phase-in period by providing disclosure on three fiscal years in the first applicable filing, four fiscal years in the following year and, finally, five fiscal years in the third filing. A non-SRC subject company may provide PVP disclosure as follows: in its 2023 annual meeting proxy statement, PVP disclosure would cover fiscal years 2020-2022; in its 2024 annual meeting proxy statement, PVP disclosure would cover fiscal years 2020-2023; and in its 2025 annual meeting proxy statement, PVP disclosure would cover fiscal years 2020-2024.

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SRCs must present three fiscal years of PVP disclosure with the option to phase-in compliance by providing two fiscal years of PVP disclosure in the first applicable filing. For its 2023 proxy statement, a SRC may comply with Item 402(v) by providing disclosure covering fiscal years 2021 and 2022.

The new rules contain grace periods for newly public companies. PVP disclosure is not required in a company's IPO registration statement (or in any other registration statement). Additionally, a newly public non-exempt company need not provide PVP disclosure on fiscal years prior to the fiscal year in which the company began reporting under Exchange Act; e.g. a non-exempt company that conducts an IPO in 2023 would need to provide PVP disclosure on just fiscal year 2023 instead of the three fiscal years generally required by non-exempt companies utilizing the phase in described above (or two fiscal years for SRCs utilizing the phase-in) in its 2024 annual meeting proxy statement and PVP disclosure in the 2025 annual meeting proxy statement for fiscal years 2023 and 2024.

Remain Mindful of SEC Comments

While the PVP disclosure will not be incorporated by reference into other filings under the Securities Act or Exchange Act, subject companies should remain mindful that the PVP disclosure, if inconsistent with or potentially misleading in relation to disclosure that is so incorporated, may draw SEC comments or the attention of the plaintiffs' bar. Because the PVP disclosure regime is new and there is limited applicable SEC guidance, subject companies may choose to exercise caution by avoiding novel PVP presentations outside those provided for in the new rule.

PVP Table

Below is the model PVP Table set forth in Item 402(v) of Regulation S-K.

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)

Covered Years

Subject to compliance with the phase-in periods described above, the PVP Table for a non-SRC company must cover the last five complete fiscal years. For SRCs subject to the rule, PVP Table must cover the last three completed fiscal years.

Covered Executives and Compensation

PVP disclosure is required individually only for each person serving as a principal executive officer (PEO) during the applicable fiscal year. If there is more than one PEO, then additional columns would be added to the table above. The average compensation of the non-PEO executives named in the company's Summary Compensation Table (generally 2-4 individuals in addition to the PEO, depending on the status of the issuer) is also required. While the compensation of such NEOs is presented as an average, a footnote disclosing the names of the individual NEOs is required, which the SEC reasons will allow investors to consider how the composition of the NEOs affects overall executive compensation practices.

While the compensation information disclosed in columns (b) and (d) derives directly from the "Summary Compensation Table" otherwise required by Item 402, the PVP table also requires compensation disclosure for the PEO and NEOs that notably differs from that in the Summary Compensation Table. Columns (c) and (e) of the PVP Table require disclosure of compensation "actually paid," as described below. Companies must calculate compensation actually paid in accordance with Item 402(v) and then detail in footnotes how the amount actually paid departs from the amounts set forth in the Summary Compensation Table. We describe below the adjustments to be made to the total compensation column of the Summary Compensation Table to arrive at the compensation "actually paid," which must be detailed in footnotes to the table. Companies may not exclude from compensation actually paid signing bonuses, severance bonuses, and other one-time payments on the premise that such figures do not represent an executive's typical compensation, as they still represent compensation "actually paid." Additionally, the adjustments required for equity awards and pension benefits apply even if those awards or benefits are unvested because the SEC's position is that PVP disclosure should track compensation as it is earned rather than at vesting to clearly capture how pay correlates to performance.

The "mark to market" approach valuing pension benefits and equity awards is new for public company compensation disclosure. Many commenters opposed this rule change, arguing that novel valuations of equity awards after the grant date (as is already required by SEC rules) would be burdensome or create confusion. The SEC's response was that because the rule requires a company to employ methodologies already used by such company in its financial statements under GAAP, the underlying information and expertise is already available, thus alleviating the anticipated burden.

Adjustments to Pension Values

The company must deduct the aggregate change in the actuarial present value from the value of defined benefit and actuarial pension plans reported in the Summary Compensation Table (which is not required for SRCs) and then add: (i) the service costs, calculated as the actuarial present value of the benefit under such plans attributable during the covered fiscal year and (ii) prior service costs, calculated as the entire cost of benefits granted (or credited) in a plan amendment or initiation during the covered year attributable by the benefit formula to services rendered in periods prior to the amendment, each calculated using GAAP-compliant methodology as used for the company's financial statements. Given the inclusion of defined benefit and pension plans in the Summary Compensation Table's total compensation figure, actuarial present value for the PVP disclosure is required to present the expected value of such contingent cash flow streams, factoring in updated expectations of those future inputs in each annual calculation of the expected value of such compensation.

Adjustments to Equity Awards

The company must deduct the grant date fair value from all equity awards reported in the "Stock Awards" and "Option Awards" columns of the Summary Compensation Table, subtract the fair value as of the prior fiscal year end of any equity awards that failed to meet vesting conditions during the covered year, and then add the following:

- The fair value as of the end of the covered fiscal year of all equity awards granted during such year that are outstanding and unvested at the end of such year;
- The amount equal to the change (positive or negative) in fair value from the end of the covered fiscal year from that of the prior year of any equity awards granted in prior fiscal years that are outstanding and unvested as of the end of the covered fiscal year;
- The fair value as of the vesting date for equity awards that are granted and vest in the same years;
- The amount equal to the change in fair value (positive or negative) as of the vesting date of any awards granted in any prior fiscal year for which all applicable vesting conditions were satisfied at the end of or during the covered fiscal year; and
- The dollar value of any dividends or other earnings paid on equity awards in the covered fiscal year prior to the vesting date that are not otherwise included in total compensation.

Fair value assesses the actual selling value of an asset as set by the company, factoring in both its present intrinsic value as a liquid asset and its ongoing time value of allowing the holder to capture additional future upside without the commensurate downside risk. Fair value must be calculated in a manner consistent with FASB ASC Topic 718, which companies already use for, among other things, the calculation of the grant date fair value of awards (and incremental fair value if awards are repriced or modified) to prepare the Summary Compensation Table. Any adjustments or amendments made to the exercise price of an equity award subsequent to the original award date must be reflected in the fair value calculations described above, and, if a company's assumptions used for fair value calculations depart materially from those used at the grant date, then the company must detail such departure in a footnote. For performance-based awards, the company must base the calculation of the change in fair value as of the end of the covered year on the probable outcome of the performance conditions as of the last day of the fiscal year. Whenever multiple awards are being valued in a given year, the company may choose to disclose a range of the assumptions used or a weighted-average amount for each assumption.

Value of Initial Fixed $100 Investment

Total Shareholder Return (TSR)

The TSR calculation methodology is already required for non-SRC issuers that must prepare the stock performance graph pursuant to Item 201(e) of Regulation S-K, including the selection of the subject company's peer group, with a fixed investment amount of $100 to illustrate returns . The measurement period begins on the market close on the last trading day before the earliest fiscal year presented in the PVP Table through the end of the last fiscal year presented therein.

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Peer Group TSR

The peer group must be either the same used in the stock performance graph or, if applicable, that used in the CD&A section for purposes of disclosing the company's compensation comparison or benchmarking practices. If the peer group is not a published industry or line-of-business index, the identity of the issuers composing the group must be disclosed in a footnote, and any changes to the peer group in subsequent years must be explained in a footnote, which must also compare the company's TSR to that of both the old and the new group, which may deter changing peer groups.

Company-Selected Measure

Subject companies must select one of the metrics presented in the Financial Performance Measures List (discussed in further detail below) to include in the PVP Table. The Company-Selected Measure cannot be one of those already required in the PVP Table, and must, in a company's assessment, represent the most important financial performance measure such company uses to link compensation actually paid to the NEOs for the most recently completed fiscal year to company performance. If the Company-Selected Measure is not a financial measure under GAAP, then the issuer must disclose how the number is calculated from its audited financial statements; however, such figure will not be subject to Regulation G or Item 10(e) of Regulation S-K regarding the disclosure of non-GAAP financials measures (e.g., a reconciliation to the nearest GAAP measure is not required).

Comparative Disclosure

Companies are expressly permitted to choose whether to present a descriptive comparison of the information set forth in the PVP Table graphically, narratively, or through a combination of the two. Whatever the method, a company must provide clear descriptions of the relationship (x) between the compensation actually paid to the PEO and the other NEOs with (i) cumulative TSR, (ii) net income, and (iii) the Company-Selected Measure, and (y) between the company's TSR with the peer group TSR. Supplemental information regarding compensation or performance may be included in the descriptive comparison as long as such information is clearly identified as supplemental, not misleading, and not presented with greater prominence than the required disclosure, which provides flexibility on presentation. If a company elects to include additional financial performance measures in the PVP Table, a clear description of the relationship each such additional measure must also be accompanied by a clear description of the relationship between the compensation actually paid to the PEO and the other NEOs with such additional measures over the covered years.

The flexibility on presentation of comparative disclosure aligns with the SEC's overall trend in recent years to favor a principles-based approach to disclosure, encouraging disclosure that conveys management's perspective on financial and operational results to investors. Graphical PVP disclosure might plot out on the y-axis the compensation actually paid to the PEO set off against the Company-Selected Measure, with year-over-year comparison taking place along the x-axis. Further graphical comparison may include additional metrics, such as the entry of compensation actually paid to non-PEO NEOs alongside PEO data, or the composition of such compensation actually paid (e.g., cash, equity, other awards). Graphs can also be used to plot out TSR as a function of initial fixed investment, providing a clear and concise view of many investors' most important concern, though care should be taken to avoid unnecessary duplication with the stock performance graph. Comparatively, registrants might use narrative text coupled with a peer group graphical comparison to highlight outperformance of certain metrics, or to explain inconsistencies resulting from peer group comparisons. The SEC noted narrative text as potentially useful in discussing how corresponding changes in data are related, in addition to

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directing investors more efficiently to relevant performance data. Tabular disclosure can also present percentage changes year-over-year in compensation actually paid and financial performance measures, highlighting overall trends within a graphical framework. Narrative text disclosure might also effectively serve to detract attention away from disappointing performance more easily visible in a graphical format.

Financial Performance Measures List

Three to seven of the "most important" financial performance measures used by a subject company to link compensation actually paid to its NEOs for the most recently completed fiscal year must be set forth in either one tabular list, two separate tabular lists, with one for the PEO and the other for the other NEOs, or separate tabular lists for each NEO. Financial performance measures are any that are directly set forth in, or derived in whole or in part from, the subject company's financial statements, stock price and TSR. The financial performance measures must actually be used by a company to link compensation actually paid to performance; therefore, if a company uses fewer than three, such company must disclose the financial performance measures actually used. The Financial Performance Measures List may include non-financial performance measures if used by the company to link compensation actually paid to performance and has already disclosed its most important three (or, if applicable, fewer) financial performance measures.

Although the SEC stipulated that the Financial Performance Measures List is unranked, many companies may present the list with an informal ranking. Further, companies may seek to keep the Financial Performance Measures List consistent for ease of presentation and may prefer to utilize previously disclosed measures to the extent possible.

Scaled Disclosure for SRCs

SRCs may elect to provide scaled PVP disclosure. In addition to providing three fiscal years of PVP disclosure instead of five fiscal years, as well as a more generous phase-in compliance period as described above, SRCs may omit from PVP disclosure:

- Peer Group TSR;
- the Company-Selected Measure;
- Adjustments relating to pension plans in computing executive compensation actually paid;
- the Financial Performance Measures List; and
- iXBRL tagging until the third filing in which the PVP disclosure is required.

SRCs will need to calculate their own TSR, which SRCs were not required to do prior to the adoption of the new rules.

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SEC Guidance

In February 2023 the SEC issued 15 new compliance and disclosure interpretations (C&DIs) on PVP disclosure requirements. A brief overview of the salient guidance provided by those C&DIs follows:

- Compensation Actually Paid Adjustment Footnotes:
  - footnotes to the PVP table detailing each of the amounts deducted and added from compensation actually paid is not required after the most recent fiscal year unless they are material to an investor's understanding of PVP table information for the most recent fiscal year;
  - such footnotes may not aggregate adjustments in lieu of disclosing each adjustment; and
  - adjustments to reflect changes in fair value of awards granted prior to becoming a NEO must be disclosed.
- Peer Group Disclosure:
  - any peer group identified in CD&A may be used, not only those used for benchmarking practices (disclosable under Item 402(b));
  - the measurement point for calculating a newly public company and its peer group's TSR is the date of such company's registration under the Exchange Act; and
  - if different peer groups were used in CD&A, peer group TSR disclosure for each year must use the peer group disclosed in CD&A for such year.
- Net Income Disclosure:
  - net income presented in the PVP table is that required in the company's audited financial statements in accordance with GAAP.
- Company-Selected Measure Disclosure:
  - the Company-Selected Measure can be derived from, a component of, or similar to the other required PVP table measures;
  - stock price may not be used as the Company-Selected Measure if it is not used to link compensation actually paid to company performance, even if it affects the amount paid (e.g., solely changing the value of share-based awards);
  - the Company-Selected Measure cannot be measured over a multi-year period that includes the applicable fiscal year as the final year; and
  - if a bonus pool becomes available only upon, or the size of the pool is determined by, achievement of a financial performance measure, even if allocation of payouts is at the discretion of the compensation committee, such measure can be the Company-Selected Measure.
- Multiple PEOs
  - a company may aggregate the compensation of multiple PEOs serving in the same fiscal year for narrative, graphical and comparison purposes if not misleading to investors.
- Changed Fiscal Year
  - If a company changes its fiscal year, PVP disclosure does not need to be annualized or restated, only "stub" period disclosure is required.

With proxy season underway, companies seeking guidance on the pay versus performance rules should consult with experienced corporate counsel.

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