SEC Finalizes Pay Versus Performance Rules; Companies Should Begin Preparing Now for New Disclosure Requirements in Upcoming Proxies

SEPTEMBER 7, 2022

Overview

On August 25, 2022, the Securities and Exchange Commission (SEC) adopted long-anticipated final rules (the "Final Rules") implementing the pay versus performance disclosure requirements mandated by Section 935(a) of the Dodd-Frank Wall Street Reform and Consumer Protection Act more than a decade ago with its addition of Section 14(i) to the Securities Exchange Act of 1934 (the "Exchange Act"). The SEC had initially released proposed rules in April 2015 and reopened the comment period in January of this year. The purpose of the disclosures is to give investors a clearer picture of how compensation "actually paid" by companies to their top executives aligns with the companies' financial performance.

The newly required disclosures apply to all reporting companies except foreign private issuers, registered investment companies, and emerging growth companies. Smaller reporting companies (SRCs) may provide scaled disclosure (as discussed in more detail below), and companies that have recently gone public will only be required to report information for the years in which they were reporting companies pursuant to Section 13(a) or Section 15(d) of the Exchange Act.

The Final Rules, which become effective 30 days after publication in the *Federal Register*, amend Item 402 of Regulation S-K to include new tabular and narrative disclosures illustrating the relationship between (i) compensation paid to a company's principal executive officer (PEO) and other named executive officers (NEOs) and (ii) the company's financial performance. Companies must comply with the new disclosure requirements in their proxy statements, information statements, and other filings that require disclosure of executive compensation for fiscal years ending on or after December 16, 2022. This means calendar year companies will need to comply with the latest disclosure requirements in their 2023 proxy statements. Because these new rules are very complex, companies should begin preparing now.

Pay Versus Performance Table

New Item 402(v) of Regulation S-K will require companies to provide a table disclosing specified executive compensation and financial performance measures for each of the last five most recently completed fiscal years (the past three most recently completed fiscal years for SRCs) in the specified format shown below. Items listed with an "*" are not applicable to SRCs:

					VALUE OF INITIAL FI INVESTMENT BASED
YEAR (A)	SUMMARY COMPENSATION TABLE TOTAL FOR PEO (B)	COMPENSATION ACTUALLY PAID TO PEO (C)	AVERAGE SUMMARY COMPENSATION TABLE TOTAL FOR NON-PEO NEOS (D)	AVERAGE COMPENSATION ACTUALLY PAID TO NON-PEO NEOS (E)	TOTAL SHAREHOLDER RETURN (F)
Year 1					
Year 2					
Year 3					
Year 4*					

					VALUE OF INITIAL FIX INVESTMENT BASED	
YEAR (A)	SUMMARY COMPENSATION TABLE TOTAL FOR PEO (B)	COMPENSATION ACTUALLY PAID TO PEO (C)	AVERAGE SUMMARY COMPENSATION TABLE TOTAL FOR NON-PEO NEOS (D)	AVERAGE COMPENSATION ACTUALLY PAID TO NON-PEO NEOS (E)	TOTAL SHAREHOLDER RETURN (F)	
Year 5*						

Each tabular disclosure requirement is discussed in greater detail below. Companies may, in their discretion, include additional measures in the tabular disclosure besides the Company Selected Measure. However, doing so will result in increased disclosure obligations as noted below in "Describing the Relationship between Pay and Performance."

Total Compensation

The tabular disclosure requirements under Item 402(v) require companies to list total compensation, as reported in the Summary Compensation Table (SCT) for the company's PEO, and an average of total compensation, as reported in the SCT, for all of the company's other NEOs.

Compensation Actually Paid

The company must provide information on compensation "actually paid" to (i) its PEO and (ii) all its other NEOs, on average. As the SEC noted in the Final Rules, "Although Section 14(i) refers to compensation required to be disclosed under Item 402 of Regulation S-K, it also uses the phrase 'actually paid,' which differs from disclosure required under Item 402 of 'compensation awarded to, earned by or paid to' the NEOs." This approach reflects the SEC's belief that Congress intended for executive compensation "actually paid" to be a separate and distinct disclosure from total compensation otherwise reportable under Item 402.

The Final Rules require that companies calculate compensation "actually paid" by making the following adjustments to the total compensation figure already required to be reported in the SCT:

- For equity awards, begin by subtracting the amount reported for these awards in the SCT and then:

FOR EQUITY AWARDS GRANTED DURING THE *COVERED FISCAL YEAR*:	FOR EQUITY AWARDS GRANTED DURING *ANY PRIOR FISCAL YEARS*:
• Add the fair value as of the end of the covered fiscal year that remains outstanding and unvested at the end of the covered fiscal year; and • Add the fair value as of the vesting date to the extent there were any awards that were granted and vested during the covered fiscal year.	• Add an amount equal to the 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 that are outstanding and unvested as of the end of the covered fiscal year; • Add an amount equal to the change as of the vesting date (from the end of the prior fiscal year) in fair value (positive or negative) for awards that vested during the covered fiscal year; and • Subtract an amount equal to the fair value at the end of the prior fiscal year for any awards granted in any prior fiscal year that failed to meet the applicable vesting conditions during the covered fiscal year.
Companies will also need to add 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 included in the total compensation for the covered fiscal year	

- For defined benefit and actuarial pension plan compensation reported in the SCT (if any):
  - Similarly, begin by deducting the aggregate change in the actuarial present value of the NEO's accumulated benefit under all of the company's defined benefit and actuarial pension plans; and
  - Then add the total of the "service cost" plus the "prior service cost," calculated using the same methodology used for the company's financial statements in accordance with generally accepted accounting principles (GAAP).
    - "Service cost" equals the actuarially determined present value of each NEO's benefit under the plan(s) that is attributable to the services the NEO provided to the company during the covered fiscal year; and
    - "Prior service cost" equals the entire cost of benefits granted (or credited if benefits were reduced) in a plan amendment (or initiation) during the covered fiscal year that are attributable under the benefit formula to

services the NEO provided to the company prior to the plan amendment or initiation.

Multiple PEOs

If the company had multiple PEOs during the period covered by the table, separate SCT "total compensation" and compensation "actually paid" columns will need to be inserted for each PEO.

Total Shareholder Return (TSR)

Companies will need to provide their cumulative TSR and, other than SRCs, the cumulative TSR of their peer group.

Cumulative TSR should generally be calculated in accordance with Item 201(e) of Regulation S-K. The Final Rules require calculation during a measurement period that is defined to begin at market close on the last trading day before the company's earliest fiscal year listed in the Item 402(v) tabular disclosure, and that extends through, and includes, the end of the fiscal year for which cumulative TSR of the company or its peer group is being calculated. This means that for the first year of this disclosure (generally covering fiscal years 2020, 2021, and 2022), the cumulative TSR will be based on the company's results beginning with the final trading day of 2019 and ending on December 31, 2022.

For its peer group, the company must use either the same peer group used for the Form 10-K performance graph disclosure or the peer group described in the Compensation Discussion & Analysis (CD&A) section of the company's annual meeting proxy statement. If the peer group is not a published index, the identity of the issuers included in the peer group must be disclosed in a footnote. If the company has previously disclosed the composition of such peer group in prior filings, it may comply with the disclosure requirement through incorporation by reference to those filings. If the company selects a different peer group from that used in the prior fiscal year, it must explain, in a footnote, the reason(s) for this change and compare its cumulative total return with that of both (i) the newly selected peer group and (ii) the peer group used in the prior fiscal year.

Net Income (Loss)

Item 402(v) requires disclosure of the company's net income (loss) for each applicable fiscal year, calculated in accordance with GAAP.

Company Selected Measure (CSM)

Item 402(v) requires companies to select one financial performance measure from its Tabular List (described below) for purposes of the CSM tabular disclosure. The CSM is the financial performance measure chosen by the company that, in the company's view, represents the most important financial performance measure that is not otherwise required to be disclosed in the table (i.e., TSR or net income) used by the company to connect compensation actually paid to NEOs to the company's performance during the fiscal year. The CSM may differ from year to year.

Tabular List of Most Important Financial Performance Measures

Each company will need to provide a list (in tabular format) of three to seven financial performance measures that the company determines to be the most important performance measures that it uses to tie NEO compensation actually paid to the company's performance for the most recently completed fiscal year. Nonfinancial measures can be included in the Tabular List if the company determines them to be among its most important performance measures. The measures need not be ranked. Companies may present a single list for all NEOs, two separate lists (one for the PEO and one for the other NEOs), or separate lists for the PEO and each NEO other than the PEO.

Describing the Relationship between Pay and Performance

Using the information from the tabular disclosure set forth above, the company must provide a clear description – in narrative or graphical format, or a combination of the two – of the relationships between the executive compensation actually paid by the company to its PEO and the average of the executive compensation actually paid to all of the company's other NEOs and the following performance metrics from the tabular disclosure: (i) the company's cumulative TSR; (ii) the company's net income; and (iii) the company's CSM. Comparative disclosure of the TSR performance metrics is also required (i.e., the company's cumulative TSR versus its peer group's TSR over the same five most recently completed fiscal years). If a company opts to include additional measures in the tabular disclosure, comparison of the executive compensation actually paid by the company to its PEO and the average of the executive compensation actually paid to the company's other NEOs against any additional measure(s) will also be required.

Scaled Disclosure Requirements for SRCs

Under the Final Rules, SRCs may provide scaled disclosures, which include:

- Tabular disclosure for the past three most recently completed fiscal years instead of five;
- No requirement to provide disclosures related to peer group cumulative TSR or to disclose a CSM;
- No requirement to adjust SCT total compensation amounts for pension benefits when calculating compensation "actually paid" to NEOs; and
- No Tabular List requirement.

Implementation

Companies, except SRCs, will be required to provide the information required by new Rule 402(v) of Regulation S-K for the three most recently completed fiscal years in the first proxy statement or information statement in which the disclosure is provided, adding another year of disclosure in each of the two following annual proxy statement filings or information statements that require this disclosure. SRCs will be required to provide the information required by new Rule 402(v) for the two most recently completed fiscal years in the first proxy statement or information statement in which the disclosure is provided, adding an additional year of disclosure in the subsequent proxy statement filing or information statement that requires this disclosure.

Additional Considerations

Disclosure Location

The Final Rules permit companies to choose where to include these newly required disclosures in their proxy statements and information statements. We expect that the new disclosures would appear in the proxy statement after the disclosure and discussion of the company's executive compensation required by Item 402 of Regulation S-K. While the CD&A may seem a logical place for such disclosure, the SEC has indicated that including it in the CD&A may cause confusion if the pay versus performance relationship was not considered by the company as part of its executive compensation decisions.

XBRL Tagging

The newly required disclosures are required to be tagged using Inline XBRL. SRCs will have until the third filing in which this disclosure is provided to comply with the Inline XBRL tagging requirement.

Key Takeaways

With fall nearing and the 2023 proxy season fast approaching, companies impacted by these Final Rules, and their compensation committees, should begin preparing now for compliance with the requirements under new Item 402(v) and consider taking the following steps:

- Develop an action plan to begin preparing a *pro forma* Pay Versus Performance Table;
- Begin working now with internal departments and external advisors (compensation consultants, actuaries, etc.) to collect the necessary data to comply with the Final Rules, including the potential complexities in calculating compensation "actually paid";
- Calculate the 2020 and 2021 TSR and compensation "actually paid," and estimate the 2022 numbers;
- Analyze the peer group to be used for TSR comparisons; and
- Carefully consider the relationship between executive compensation practices and company performance, including which "performance measures" are considered most important for purposes of selecting a CSM and preparing the tabular list.

Please contact any member of the Winston & Strawn Employee Benefits and Executive Compensation Practice Group or your regular Winston contacts for further information.

9 Min Read

Authors

Joseph S. Adams

Scott Landau

Sey-Hyo Lee

David A. Sakowitz

Kevin Smith

Ashley E. Dumoff

Marissa Sims

Related Locations

Chicago | New York | Washington, DC

Related Topics

Securities and Exchange Commission (SEC)

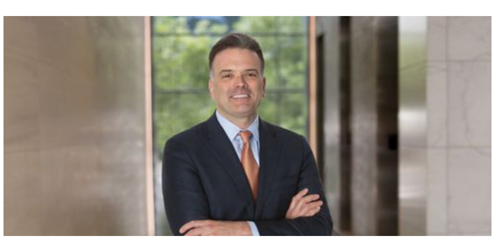
Related Capabilities

Labor & Employment | Capital Markets

Related Regions

North America

Related Professionals



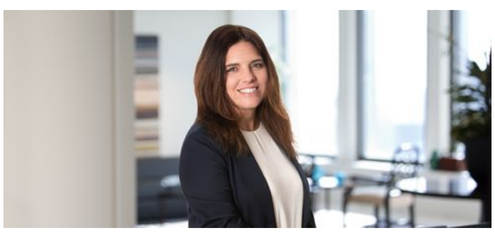
Joseph S. Adams

Scott Landau

Sey-Hyo Lee

David A. Sakowitz

Kevin Smith



Ashley E. Dumoff

Marissa Sims

This entry has been created for information and planning purposes. It is not intended to be, nor should it be substituted for, legal advice, which turns on specific facts.