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ALERT MEMORANDUM

Final Pay vs. Performance Rules: Teaching Old Disclosure New Tricks

September 9, 2022

On August 25, 2022 the SEC adopted final rules (the so-called "pay vs. performance" rules)[1] that will require U.S. public companies (including smaller reporting companies ("SRCs") but excluding emerging growth companies, foreign private issuers, and registered investment companies) to disclose information reflecting the relationship between executive compensation "actually paid" and company financial performance for the five most recently completed fiscal years (three years for SRCs). The disclosure will be required pursuant to a new subsection (v) to Item 402 of Regulation S-K ("Item 402") and is effective for a company's proxy or information statement covering a fiscal year ending on or after December 16, 2022.

The final rules will go into effect on October 8, 2022 which means that most companies[2] must comply with the disclosure for the fast-approaching 2023 proxy season. Given the complexity of the final rules, extensive calculations and disclosures, and compressed timeline, companies should begin the process of gathering necessary information and discussing the best way to present the disclosure with their advisors and internal constituents.

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[1] SEC Release Nos. 34-95607 (August 25, 2022) available at https://www.sec.gov/rules/final/2022/34-95607.pdf (the "Release").

[2] Applicable to companies with a fiscal year ending on or after December 16, 2022.

Background

In response to the 2008 financial crisis, the Dodd-Frank Wall Street Reform and Consumer Protection Act of 2010 (the "Dodd-Frank Act") was enacted, adding Section 14(i) to the Securities Exchange Act of 1934 (the "Exchange Act"), which directed the U.S. Securities and Exchange Commission ("SEC") to adopt rules requiring companies to disclose the relationship between the compensation actually paid to its named executive officers ("NEOs") and the financial performance of the company.

In April 2015 the SEC published proposed rules to implement Section 14(i) by adding a new subparagraph (v) to Item 402. The proposed rules would have required companies to include new tabular disclosure showing an SEC-prescribed method of calculating executive compensation "actually paid" and provide a clear description of the relationship between such compensation and the cumulative company total shareholder return ("TSR") and the relationship between the company's TSR and the TSR of a peer group chosen by the company, over each of the company's five most recently completed fiscal years.

The SEC re-opened the comment period to the proposed rules earlier this year, which SEC Chair Gary Gensler stated was done to "…[consider] whether additional performance metrics would better reflect Congress' intention in the Dodd-Frank Act and would provide shareholders with information they need to evaluate a company's executive compensation policies."[3] After twelve languishing years, the SEC, without an open meeting, adopted the final rules.

Required Disclosure

The final rules will require companies to provide (i) a "Pay vs. Performance" table, reflecting compensation "actually paid" to the company's Principle Executive Officer ("PEO") and its other NEOs, (ii) a clear description of the relationship between compensation actually paid to its PEO and other NEOs and company performance, and (iii) a tabular list of three to seven of the most important financial performance measures that the company uses to link executive compensation and company performance.

The final rules permit companies to voluntarily provide supplemental measures of financial performance and other supplemental disclosure, so long as any additional disclosure is clearly identified as supplemental, not misleading, and not presented with greater prominence than the required disclosures.[4]

1. *Pay vs. Performance Tabular Disclosure.* The new Item 402(v) will require tabular disclosure (as shown in the attached Appendix A, the "Pay vs. Performance Table") of the following information for each of the last five fiscal years (three for SRCs) (see "Compliance Dates" for initial phase-in periods):
   - total compensation as reported in the Summary Compensation Table ("Total Compensation") for the PEO and compensation "actually paid" to the PEO;
   - average of Total Compensation and the average of compensation "actually paid" to all of the NEOs other than the PEO;
   - the company's cumulative TSR presented as the current dollar value of an initial investment of $100;[5]
   - TSR for the company's self-selected peer group (SRCs are not required to provide this disclosure);[6]

[3] Statement, *Statement on Pay versus Performance* (January 28, 2022) (link).
[4] Release, *supra* note 1, at pages 13-14.
[5] The required disclosure is the same as Stock Price Performance Graph required under Item 201(e) of Regulation S-K ("Item 201(e)") which is already required for companies other than SRCs that will be subject to the new pay vs. performance rules.
[6] The peer group must be either the same index or peer group used for Item 201(e) or the peer group used in the Compensation Discussion and Analysis (the "CD&A") disclosure of the company's proxy. If a company changes the peer group from the one used in the previous fiscal year,

- the company's net income for the fiscal year calculated in accordance with U.S. GAAP; and
- a measure selected by the company as the most important financial performance measure used to link compensation actually paid to the company's PEO and other NEOs for the most recent fiscal year, (the "Company-Selected Measure").[7]

2. *Relationship Disclosure*. Using data within the Pay vs. Performance Table, companies must provide a clear description, either in narrative or graphical format, of the relationship between:
   - compensation "actually paid" to the PEO and other NEOs and the company's TSR over the last five fiscal years (three for SRCs);
   - compensation "actually paid" to the PEO and other NEOs and the company's net income over the last five fiscal years;
   - compensation "actually paid" to the PEO and other NEOs and the Company-Selected Measure; and
   - the company's TSR and the peer group TSR.

We expect most companies will use a graphical format to describe these relationships as it is likely the most concise. Additionally, for companies that are required to provide a performance graph under Item 201(e) (showing company TSR and stock price), they may leverage the TSR calculations to complete this relationship disclosure. The SEC encourages companies to supplement graphical disclosure with narrative explaining key assumptions, reasons underlying changes reflected in the table over time and reasons why TSR may or may not reflect actual financial performance.[8]

3. *Company Selected Measure Tabular Disclosure*. Item 402(v) will also require an unranked tabular list of three to seven financial performance measures that the company determines are its most important measures to link compensation actually paid to company performance for the most recent fiscal year other than TSR or net income. This disclosure will include the Company Selected Measure. Companies may include non-financial measures provided they have disclosed at least three (or fewer, if the company uses fewer) of the most important financial performance measures.

   If the company selected measures are non- GAAP financial measures, the company must also disclose how the number was calculated from the company's audited financial statements. Such financial measures will not be subject to reconciliation, equal prominence or other requirements under Regulation G and Item 10(e) of Regulation S-K.

We would note that based on the prescriptive method by which companies are required to calculate compensation "actually paid" under Item 402(v), a performance or financial measure selected as the Company-Selected Measure or other measure a company considers to be important to the design of its performance based compensation program might not be the metric that has the largest impact to the calculations displayed in this disclosure, which calculations will largely be driven by the U.S. GAAP fair value of equity awards, which are in turn largely driven by the company's stock price.

4. *Determining Compensation Actually Paid*. The final rule requires that companies disclose

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the company will only be required to include tabular disclosure of peer group TSR for that new peer group (for all covered years in the table) and include a footnote explaining the reason for the change, and compare the company's TSR to that of both the old and the new group.

[7] If the Company-Selected Measure changes year over year, then the new Company-Selected Measure will need to be recalculated for each of the covered years.

[8] The SEC noted examples of a graphic format, such as "graph providing executive compensation actually paid and change in the financial performance measure(s) (TSR, net income, or Company-Selected Measure) on parallel axes and plotting compensation and such measure(s) over the required time period." Release, *supra* note 1, at page 27.

compensation "actually paid" for the PEO and average of compensation "actually paid" for the other NEOs. However, the calculation prescribed for compensation "actually paid" includes amounts that are not yet paid nor earned, and as discussed below, in some cases require calculation methodologies that differ significantly from current Item 402 reporting methodologies and common practices. Companies will also need to include (i) one-time payments such as signing bonuses and severance payments, even though they may not be reflective of the company's compensation program[9] and (ii) with respect to clawbacks, consistent with the approach taken by companies reporting clawbacks in the Summary Compensation Table, the compensation "actually paid" initially reported for the applicable year should be adjusted to reflect the clawback with a footnote disclosure of the amount recovered.

Compensation "actually paid" will generally be calculated by taking Total Compensation as reported in the Summary Compensation Table and adjusting for amounts included for pension benefits (SRCs are not required to include pension benefits) and equity awards as follows:

<u>Pension Benefits</u>. To calculate pension benefits for purposes of compensation "actually paid", companies must deduct from the "change in pension value and nonqualified deferred compensation earnings" value within the Summary Compensation Table the aggregate change in the actuarial present value of all defined benefit and actuarial pension plans for the applicable year and add:

- actually determined service cost for services rendered by the executive during the applicable fiscal year; plus
- 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 service rendered in periods prior to the plan amendment or initiation,
- in each case, calculated in accordance with U.S. GAAP.

<u>Equity Awards</u>. The calculation for compensation "actually paid" in respect of equity awards is the largest departure from both the value attributable to equity awards in the Summary Compensation Table and the value frequently presented by companies who chose to disclose NEO realized pay in advance of the final "pay vs. performance" rules. For purposes of Item 402(v), compensation "actually paid" is not limited to the value of vested equity awards, equity awards for which performance thresholds have been met or the income received from equity awards. Instead, the SEC has defined compensation "actually paid" in respect of equity awards to roughly track the change in the U.S. GAAP fair value of outstanding unvested equity awards year over year, with performance awards calculated based on the probable outcome of the performance condition. This calculation may more appropriately be viewed as the annual value of the equity compensation the NEOs have the opportunity to earn, should they continue to serve in their roles and meet performance expectations, rather than the compensation actually paid.

To calculate compensation "actually paid" in respect of equity awards, companies must deduct from Total Compensation the amounts reported in the "Stock Awards" and "Option Awards" columns for the covered fiscal year and compute the following,

- for equity awards granted during the covered fiscal year:
  - add the year-end fair value if the equity award is outstanding and unvested as of the end of the covered fiscal year; and

[9] The SEC noted "although those figures may not represent the executive's compensation in a 'typical' year where no such payment is made, they do reflect amounts that are "actually paid" to the executives." Release, *supra* note 1, at page 34.

- add the fair value as of the vesting date for awards that were granted and vested during the covered fiscal year.

– for equity awards granted prior to the covered fiscal year:

  - add or subtract 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 equity awards that are outstanding and unvested at the end of the covered fiscal year;
  - add or subtract any change in fair value as of the vesting date (from the end of the prior fiscal year) for equity award that vested during the covered year;
  - subtract the amount equal to the fair value at the end of the prior fiscal year for equity awards that failed to meet applicable vesting conditions during the covered fiscal year; and
  - 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 reflected in the fair value of such equity awards or included in any other component of Total Compensation for the covered fiscal year.

5. *Inline XBRL Tagging*. The final rule requires companies to separately tag in Inline XBRL format each quantitative value disclosed in the Pay vs. Performance Table and block-text tag footnotes and relationship disclosures.

Location of Disclosure

The final rules require pay vs. performance disclosure in any proxy or information statement for which disclosure under Item 402 is required where shareholder action is to be taken with respect to an election of directors or executive compensation. The SEC does not require the disclosure in other filings where disclosure under Item 402 of Regulation S-K is required, such as in registration statements filed under the Securities Act.

Companies will have flexibility to determine where within the proxy or information statement to place the disclosure. In issuing the final rules, the SEC noted that "mandating…[companies] to include the disclosure in the CD&A may cause confusion by suggesting that the [company]…considered the pay-vs.-performance relationship in its compensation decisions, which may or may not be the case."[10] Companies may want consider including the disclosure in proximity to the Summary Compensation Table as it may be helpful to investors to see the tables side by side as the Pay vs. Performance Table pulls data from the Summary Compensation Table.

Compliance Dates

1. *Generally*. Companies must begin to comply with the final rules for fiscal years ending on or after December 16, 2022 (i.e., the upcoming 2023 proxy season).
2. *Transition Relief*. As noted in the above "Required Disclosure," companies will be required to provide information for the last five fiscal years (three for SRCs). However, the SEC has provided transition relief, permitting companies to provide information for the three most recently completed fiscal years in the first applicable proxy or information statement after the final rules become effective, and adding another year of disclosure in each of the two subsequent annual proxy filings that require the disclosure. SRCs initially will be required to provide the disclosure for the two most recently completed fiscal years and adding an additional year in the subsequent annual proxy or information statement that requires the disclosure.

Final Thoughts and Considerations

For most companies, the final rules will be applicable for the 2023 proxy season. Given the short timeline between effective date of the final rules and upcoming

[10] Release, *supra* note 1, at page 24.

proxy season, companies should begin the process of gathering necessary information and discussing the best way to present the disclosure. In particular, tabular disclosure compiled in accordance with U.S. GAAP will require involvement from companies' accountants and may not entirely align with values used for other Exchange Act disclosure purposes. Finally, companies should consider the impact, if any, the disclosure required under the final rules will have on their current compensation philosophy and design.

The final rules attempt to help shareholders evaluate the relationship between compensation actually paid to NEOs and company performance by, in part, presenting this relationship through standardized calculations and disclosure. However, the final rules do not fully encompass the inherently complex and nuanced nature of executive compensation and may instead present information in a way that neither reflects compensation "actually paid" to NEOs nor reflects applicable company's long-term performance goals. In particular, the value of compensation "actually paid" to NEOs will heavily reflect the company's stock price, which may be positively or negatively influenced by macroeconomic conditions outside of the NEOs' control and angular to the company's strategic goals. Companies will want to take care in drafting associated narrative disclosure to help shareholders navigate the company's pay vs. performance tables, as well as note any assumptions, unique impacts on underlying data, and other information that the company considers important to highlight.

If you have any questions or would like to discuss this further, please do not hesitate to contact your contacts in the Executive Compensation and ERISA group.

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APPENDIX A

PAY VS. PERFORMANCE TABLE

Year	Summary Compensation Table Total Compensation for PEO	Compensation Actually Paid to PEO	Average Summary Compensation Table Total Compensation for Non-PEO NEOs	Average Compensation Actually Paid to Non-PEO NEOs	Value of Initial Fixed $100 Investment Based On:		Net Income	[Company-Selected Measure]*
					Total Shareholder Return	Peer Group Total Shareholder Return*		
(a)	(b)	(c)	(d)	(e)	(f)	(g)	(h)	(i)
Y1								
Y2								
Y3								
Y4*								
Y5*								

* Not applicable to SRCs.