Securities Client Alert

SEC Adopts New Disclosure Requirements for "Pay Versus Performance"

By: Jeffrey T. Haughey and Bailey Barnes
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The Securities and Exchange Commission (SEC) recently adopted Final Rules requiring public companies to disclose certain data and to clearly describe the relationship between executive compensation and company performance. Set to go into effect on October 11, 2022, new Item 402(v) requires companies to make these disclosures in proxy statements and information statements for fiscal years ending on or after December 16, 2022, thus greatly impacting the 2023 proxy season.

Item 402(v) of Regulation S-K comes pursuant to Section 14(i) of the Securities Exchange Act of 1934 (Exchange Act) as mandated by Congress in Section 953(a) of the Dodd-Frank Wall Street Reform and Consumer Protection Act. The new rules are intended to provide investors with information to better assess a company's executive compensation program.

The Final Rules will require reporting companies to disclose information regarding executive compensation in several forms. First, they must include a Pay Versus Performance Table (PPT) disclosing total and actual executive compensation, the company's Total Shareholder Return (TSR), TSR for the company's chosen peer group, net income, and the company's most important financial performance measure ("Company-Selected Measure"). The rules also detail the complicated manner in which companies will calculate actual executive compensation for purposes of the PPT.

Additionally, companies subject to the new rules must clearly describe the relationship between executive compensation and other metrics disclosed in the PPT. This description can be presented in narrative form, graphically, or a combination of both. Finally, in tabular form, companies must disclose three to seven financial performance measures deemed by the company to be "most important," including the Company-Selected Measure.

I. Companies Affected

Reporting companies and smaller reporting companies (SRCs) are required to comply with Item 402(v). The SEC exempted foreign private issuers, registered investment companies, and emerging growth companies. Smaller reporting companies have scaled disclosure requirements. The new disclosures must be made in any proxy or information statement requiring disclosure under Item 402 for shareholder meetings in which directors are to be elected and executive compensation.

II. What is Required

Companies have flexibility to determine the location of the required disclosure in the proxy or information statement. The SEC made clear in the Final Rules that companies may, but are not required to, include the pay-versus-performance disclosures in their Compensation Discussion and Analysis (CD&A). This is to avoid potential confusion that may arise by suggesting that the company utilized the pay-versus-performance relationship to determine executive compensation, which may or may not be the case.

a. Pay Versus Performance Table

Reporting companies must provide the following Pay Versus Performance Table (PPT):

PAY VERSUS PERFORMANCE TABLE								
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:		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*								
*Disclosure not required for SRCs								

As indicated in the PPT, several categories of disclosures are required. Pursuant to column (a), companies will be required to provide the requisite information for the five most recently completed fiscal years. SRCs, however, will be permitted to provide requisite information for only the three most recently completed fiscal years.

Next, column (b) requires that companies disclose the principal executive officer's (PEO) (typically the CEO or president) total compensation for the covered fiscal year on the same basis as the Summary Compensation Table (SCT). If more than one PEO served during a covered fiscal year, a company must create additional columns disclosing the total compensation for each PEO. Column (c) requires companies to disclose a new measure entitled "compensation actually paid" to PEOs. The Final Rules provide the methodology to calculate compensation actually paid (described in more detail in section II.b.). Companies are required to provide footnotes to columns (c) and (e) to disclose the amounts of each change to the total compensation amounts to calculate the compensation actually paid.

A measure for average summary compensation table total for named executive officers (NEOs) as a group, other than the PEO, is required pursuant to column (d). Column (e) then requires companies to calculate the average compensation actually paid to those NEOs. In contrast to the disclosure requirements for PEOs, compensation for NEOs is an average. The SEC believes that providing this information as an average, instead of individually for each NEO, will better demonstrate to investors how the company's financial performance relates to NEO compensation over time. Notably, in a footnote to this disclosure, companies are required to identify the individual NEOs whose compensation is included in the average for each year "so that investors can consider whether changes in the average compensation reported from year to year were due to compositional changes in the included NEOs."

Column (f) requires the company to disclose Total Shareholder Return (TSR) during each covered fiscal year. The SEC instructed companies to calculate TSR in Item 201(e) of Regulation S-K by "dividing the sum of the cumulative amount of dividends for the measurement period, assuming dividend reinvestment, and the difference between the registrant's share price at the end and the beginning of the measurement period; by the share price at the beginning of the measurement period. For purposes of the PPT, the relevant "measurement period" for each covered year in the PPT is the market close on the last trading day before the company's earliest fiscal year presented in the table, through and including the end of the fiscal year for which cumulative shareholder return is being calculated. For

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example, TSR for the first covered fiscal year will represent TSR for that year only, TSR for the second covered fiscal year will represent TSR for both the first and second covered fiscal years, and so on.

Utilizing the same calculation, column (g) requires disclosure of the TSR of the company's chosen peer group, weighted according to each company's stock market capitalization at the beginning of each period for which a return is indicated. Companies can use the same the peer group from its performance graph disclosure required by Item 201(e)(1)(ii) of Regulation S-K. Both columns must be in dollars and based on an assumed fixed investment of $100.

Next, column (h) requires a company to disclose its net income for each covered year. The company will use this metric to describe the relationship between net income to executive compensation actually paid.

Finally, the company is required to disclose, in column (i), a Company-Selected Measure, which will be replaced with the name of the measure selected by the company. This measure must be a financial performance measure from the company's tabular list (described below) and represent what the company believes to be its most important financial performance measure. The company cannot select net income or TSR. However, if the company did not use financial performance measures to determine executive compensation, or if the company's only financial performance measures are already included in the PPT, the company is not required to include a Company-Selected Measure in the table or describe a Company-Selected Measure in the description of the table.

b. Methodology for Calculating Compensation "Actually Paid"

The Final Rules explain the complicated manner in which companies are to calculate executive compensation actually paid in order to comply with columns (c) and (e). Executive compensation actually paid is calculated by modifying the total compensation depicted in columns (b) and (d) to account for pension benefits and equity awards. Additionally, the final calculation must include above-market or preferential earnings on deferred compensation that is not tax qualified.

Generally speaking, pension benefit compensation is calculated by deducting from the PPT total (column (b) for PEO and column (d) for NEOs) the aggregate change in the actuarial present value of all compensation defined benefits and actuarial pension plans. Next, the calculation requires adding back the aggregate of two components:

- Service Cost: actuarially determined service cost for services rendered by the executive during the applicable year; and
- Prior Service Cost: 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.

The SEC explained in the Final Rules that this approach to calculating pension compensation reflects an executive's expected benefits based on additional service during the covered fiscal year (service cost) and based on changes in the pension contract the executive has with the company (prior service cost). According to the SEC, the calculated pension compensation will reflect the amount the company has set aside to fund relevant pension benefits payable upon retirement for the service provided for the covered fiscal year.

Next, companies will modify the SCT totals in columns (b) and (d) to reflect equity awards. Consistent with financial statement accounting, equity awards must be measured by fair value. The fair value disclosure for purposes of executive compensation actually paid should be made in the year of the grant, and changes in the value of the award are reported from year to year until the award is vested. The SEC believes this approach will "better align the timing of the disclosure and valuation with when the award is actually 'earned' by the executive, resulting in disclosure that more clearly shows the relationship between executive compensation and the registrant's performance." Regarding stock with

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performance-based conditions, fair value will be determined by the change in fair value at the end of each covered fiscal year based on the probable outcome of the conditions.

Equity awards are properly calculated by adjusting the SCT totals in the following manner.

For awards granted in the covered fiscal year, companies must:

- Add any outstanding and unvested equity awards granted in the covered fiscal year measured by the year-end fair value; and
- Add or subtract, based on the fair value as of the vesting date, awards that are granted and vest in the same covered fiscal year.

For awards granted in prior years, companies must:

- Add or subtract awards granted that vest in the covered fiscal year the amount equal to the change from the end of the prior fiscal year as of the vesting date in fair value;
- Subtract awards that are determined to fail to meet the applicable vesting conditions during the covered fiscal year based on the amount equal to the fair value at the end of the prior fiscal year; and
- Add or subtract the amount of change from the prior fiscal year to the end of the covered 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.

Lastly, companies should add the dollar value of any dividends or other distributions 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.

c. Description of the Relationship Between Executive Compensation and Financial Performance

Item 402(v) requires companies to clearly describe—in either narrative form, graphically, or through a combination of both—the relationship between compensation actually paid and the required measures of financial performance. The SEC directs companies to do this by describing the relationship, over the company's five most recently completed fiscal years, between the following:

- The executive compensation actually paid to the PEO and the average compensation actually paid to NEOs
- The executive compensation actually paid to the PEO and the company's TSR
- The executive compensation actually paid to the PEO and the company's net income
- The executive compensation actually paid to the PEO and the Company-Selected Measure
- The average compensation actually paid to NEOs and the company's TSR
- The average compensation actually paid to NEOs and the company's net income and
- The average compensation actually paid to NEOs and the Company-Selected Measure
- The company's TSR and its peer group's TSR

Additionally, companies are permitted to provide supplemental measures. If a company chooses to do so, such disclosures must be clearly identified as supplemental, not be misleading, and not be presented with greater prominence than the required disclosures.

d. Tabular List of Financial Performance Measures

Next, the company must disclose, in tabular form, three to seven financial performance measures deemed by the company to be "most important." Defined by the SEC in the Final Rules, financial

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measures are those determined and presented in accordance with financial statements (or any measures derived wholly or in part from financial statements), stock price, and TSR.

After the company has provided at least three financial measures, the rest can be non-financial so long as they are among the company's most important means to calculate executive compensation. Companies are only required to provide methodology if its omission would be misleading to investors or if it utilizes a non-GAAP financial measure. If the company uses the latter, it must disclose the methodology from its audited financial statements (consistent with existing CD&A provisions).

III. Requirements for Smaller Reporting Companies

SRCs must disclose the required information for three fiscal years rather than five and need not identify a Company-Selected Measure. SRCs are also exempt from providing a tabular list of financial performance measures.

The SEC has instructed that SRCs do not need to disclose peer group TSR because, unlike reporting companies, SRCs are not required to provide peer group TSR in their CD&A. SRCs are also subject to a scaled compensation disclosure that does not include pension plans and, as a result, are not required to include pension benefits in executive compensation actually paid.

Finally, SRCs are permitted to disclose only two years instead of three for the transition period, and a phase-in period allows SRCs to use Inline XBRL in their third pay-versus-performance disclosure rather than their first.

IV. Applicable Filings

Disclosure pursuant to Item 402(v) will be required in any proxy or information statement in which executive compensation is required. This equips shareholders with information in situations in which action is to be taken for an election of directors or executive compensation. Pay-versus-performance disclosures will not be required in other filings where disclosure under Item 402 of Regulation S-K is required, however, because Section 14(i) of the Exchange Act indicates that the information was to be presented in conjunction with a shareholder vote. As a result, such disclosures are not required in a company's Form 10-K or registration statements.

V. Inline XBRL

Companies will be required to tag Item 402(v) in accordance with Inline XBRL. Companies must (i) separately tag each value disclosed in the table, (ii) block-text tag the footnote and relationship disclosures, and (iii) tag specific data points within footnote disclosures. Smaller reporting companies are not required to comply with the tagging requirement until the third annual filing.

VI. Transition Period

To ease the transition, reporting companies are permitted to include disclosure for only the three most recently completed fiscal years, and provide disclosure for an additional year in each of the two subsequent annual filings in which this disclosure is required. SRCs, however, are permitted to provide only two years of data in the first applicable filing and provide disclosure for an additional year in subsequent annual filings.

VII. How to Respond

Because disclosures pursuant to Item 402(v) are required for companies with fiscal years ending on or after December 16, 2022, calendar-year companies should begin gathering the requisite information and determining the best way to present this information. Moreover, companies should anticipate potentially heavy costs associated with compliance. While the SEC acknowledged the reality of the cost imposed by complying with Item 402(v), it asserted that these costs will be mitigated by the

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transition period. Notably, however, SEC Commissioner Mark Uyeda—who voted against new Item 402(v)—stated that the SEC is relying on outdated and inaccurate data in analyzing the potential cost imposed on registrants.

For questions regarding pay-versus-performance disclosure requirements and related changes, please contact your GableGotwals attorney or a member of our Corporate & Securities team.

Jeffrey T. Haughey
918-595-4837
jhaughey@gablelaw.com

Bailey S. Barnes
918-595-4841
bbarnes@gablelaw.com

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