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Are We on the Cusp of Final Pay-vs.-Performance Disclosure Rules?

On January 27, 2022, the Securities and Exchange Commission (SEC) reopened the comment period on its proposed rule on the Dodd-Frank mandated pay vs. performance disclosure requirement and has suggested certain modifications to the proposed rule.

Meridian Perspective on Implications of Potential Rules

The magnitude of required disclosures within the proxy has grown exponentially over the past 30 years. While it is clearly in the interests of investors to closely monitor the alignment of executive pay and company performance, the existing proxy disclosure requirements currently provide an abundance of information to make this assessment. Additionally, investors and proxy advisors routinely apply their own pay and performance evaluations to assess pay alignment. It is not clear that investors would derive any meaningful benefit from reviving the Dodd-Frank pay-vs.-performance disclosure mandate. The incremental administrative burden of adding further pay vs. performance disclosure likely outweighs any benefit accrued to investors.

Areas to Understand

The reopening of the comment period may signal that SEC is on the cusp of issuing a Final Rule. To provide clarity on this recent development, this Client Update covers the following areas:

- Reopening of Comment Period
- Summary of Proposed Rule (as originally proposed in 2015)
- Suggested Modifications to Proposed Rule Raised by the SEC
- Questions Raised by the SEC on the Proposed Rule
- Timing and Implementation of Final Rule
- Current State of Pay-for-Performance Disclosures

Reopening of Comment Period

The SEC is now actively pursuing a strategy to implement certain outstanding Dodd-Frank mandates, including the Pay vs. Performance disclosure requirement. In that regard, the SEC announced the reopening of the comment period on January 27, 2022. The 30-day comment period ends on March 4, 2022.

Summary of Proposed Rule (as originally proposed in 2015)

The proposed rule would require a company to disclose and discuss in its annual proxy the five-year relationship between (i) annual compensation "actually paid" to its CEO and other named executive officers (NEOs) and (ii) cumulative Total Shareholder Return (TSR) of the company and its selected peer group.

Specifically, the proposed rule would require a company include the following two disclosures:

1. **Tabular disclosure showing prescribed compensation information for a company's CEO and other NEOs, the cumulative TSR of the company and its selected peer group, as shown in the tabular format below.**

(a)	(b)	(c)	(d)	(e)	(f)	(g)
Year	Summary Compensation Table Total Compensation For CEO	Compensation **Actually Paid** to CEO	Average Summary Compensation Table Total Compensation for Other NEOs	Average Compensation **Actually Paid** to Other NEOs	Cumulative Total Shareholder Return	Peer Group Cumulative Total Shareholder Return
1						
2						
3						
(Initial disclosure would cover a 3 fiscal year period that would be expanded to include an additional fiscal year for each of the next 2 fiscal years.)						

2. **An explanatory disclosure describing the relationship between compensation *actually paid* and company TSR and the relationship between company TSR and the TSR of its peer group**

- Determination of compensation actually paid to NEOs. Compensation "actually paid" for a fiscal year would equal an NEO's total compensation from the SCT:

  — ***Less*** the change in the actuarial present value of pension benefits reported in the SCT for the fiscal year and the grant-date fair value of any stock and option awards granted during the fiscal year

  — ***Plus*** the actuarial present value of pension benefits attributed to services rendered by the executive officer during the fiscal year and the "fair value" at vesting of stock awards and option awards that vested during the fiscal year

- Selection of peer group. The proposed rule would require a company to use as its peer group either (i) the peer group used in its performance graph (that typically is disclosed in Form 10-K) or (ii) the peer group used for benchmarking compensation and disclosed in its CD&A.

Suggested Modifications to Proposed Rules Raised by the SEC

The SEC is considering broadening the proposed rule to require tabular disclosure of up to three additional metrics alongside TSR: pre-tax net income, net income and a "company-selected measure", as shown in columns (h), (i) and (j) of the tabular illustration below.

Additional Metrics under Consideration

Disclosure Items Included in Proposed Rule (as Original Proposed)

(a)	(b)	(c)	(d)	(e)	(f)	(g)	(h)	(i)	(j)
Year	Summary Compensation Table Total Compensation For CEO	Compensation Actually Paid to CEO	Average Summary Compensation Table Total Compensation for Other NEOs	Average Compensation Actually Paid to Other NEOs	Cumulative Total Shareholder Return	Peer Group Cumulative Total Shareholder Return	Pre-Tax Net Income (Loss)	Net Income (Loss)	Company-Selected Measure
1									
2									
3									
(Initial disclosure would cover a 3 fiscal year period that would be expanded to include an additional fiscal year for each of the next 2 fiscal years.)									

The company-selected measure should represent the "most important" performance measure used by the company (other than those measures already included in the table) to align compensation actually paid during the fiscal year with company performance, over the time horizon presented.

In addition, the SEC is considering whether to separately require companies to include a list of the five most important measures used to align compensation actually paid during the fiscal year with company performance.

Questions Raised by the SEC on the Proposed Rule

The SEC is also requesting comments on a series of questions posed in the release announcing the reopened comment period, specifically:

- Whether the tabular disclosure should be required to include financial performance measures other than TSR, such as pre-tax net income, net income or other measures? Should the disclosure of additional financial metrics be optional with companies permitted to include them if they believed such additional disclosure would be beneficial?
- Whether to require disclosure of the company's five most important performance measures, instead of just one? If the company considers fewer than five performance measures in determining NEO compensation, should the disclosure be limited to the lesser number of measures actually considered by the company?
- How should the SEC define the company-selected measure?
- Whether the SEC should define "most important" for purposes of selecting the company-selected measure and the ranking of other performance measure, if required? If so how?
- Whether the definition of "company-selected" measure should be limited to only financial measures? Or should the SEC allow any measure to be used (e.g. operational, ESG)?

- How companies should present the newly required disclosure when different measures are important in different years or when different measures apply to different NEOs?
- Whether the misalignment between the time period to which pay is attributed (under the definition of compensation actually paid) and the time period in which performance is being measured would be more aligned if the required disclosure included additional financial performance measures?
- Whether the SEC should clarify the time periods to be used when presenting TSR (e.g., a five-year cumulative and rolling average, a cumulative average within the five-year period covered by the table, an annual year-over-year figure or some other time period)?
- Whether there is an alternative approach to the definition of "Compensation Actually Paid" that would reduce the risk of misalignment between "Compensation Actually Paid" and financial performance?
- Whether there are any alternative methods of calculating the fair value of options at the vesting date, rather than the grant date?

Timing and Implementation of Final Rule

The SEC is under no obligation to adopt a final rule within a specified timeframe. However, the reopening of the comment period strongly suggests that the SEC, at the direction of Chair Gensler, has prioritized finalizing the pay vs. performance disclosure rule. We believe it is possible that the SEC could adopt a final rule as early as mid to late 2022.

If the SEC adopts the final rule in 2022, then the date on which companies would have to comply with the mandated pay-versus-performance disclosure would likely occur sometime in 2023.

As outlined in the original proposal, the SEC would provide transition relief to assist companies in complying with the new disclosure rules. Specifically, the proposed rule would be phased in over a *three-year period*. The initial year's disclosure would cover three fiscal years and then would be expanded to cover one additional fiscal year for each of the next two fiscal years. For a newly public company, the proposed disclosure would only cover those fiscal years during which the company was public.

"Smaller Reporting Companies" would be subject to a scaled back version of the proposed rule. Such companies would only need to provide the required disclosure for three years, instead of five years, and the Final Rule would be phased in over a *two-year period*. The initial year's disclosure would cover two fiscal years and then would be expanded in the following year to cover one additional fiscal year.

Additionally, "Emerging Growth Companies" would be exempt from the proposed rule by virtue of the JOBS Act; foreign private issuers and registered investment companies would also be exempt.

Current State of Pay vs. Performance Disclosures

Since the passage of Dodd-Frank, a sizable minority of companies have developed and adopted their own pay-for-performance disclosures to demonstrate the strong link between executive pay and company performance. Specifically, in 2021, approximately 24% of 200 large public companies surveyed by Meridian voluntarily included in their proxy statements a pay and performance disclosure comparing NEO pay to company performance in an effort to show alignment.

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