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SEC Adopts Final Rule on Pay-Versus-Performance Disclosure

Finally, 12 years after the passage of the Dodd-Frank Wall Street Reform and Consumer Protection Act ("Dodd-Frank"), on August 25, 2022 the Securities Exchange Commission (SEC) adopted a final rule on the mandated pay-versus-performance disclosure.

The final rule will generally be effective for the 2023 proxy season as it takes effect for fiscal years ending on or after December 16, 2022. This gives public companies with a calendar year-end little time to interpret the final rule and implement procedures and controls to develop, review, evaluate and finalize their initial pay-versus-performance disclosure.

Highlights of Final Rule on Pay-Versus-Performance Disclosure

- Covers all public companies subject to SEC disclosure rules, except for foreign private issuers, registered investment companies and emerging growth companies
- Requires a company to include in its proxy a new tabular disclosure that compares "compensation actually paid" to its CEO and its other Named Executive Officers ("covered executives") and the following performance measures:
  - — Company total shareholder return (TSR),
  - — Peer group market capitalization weighted total shareholder return,
  - — Company's net income and
  - — Company-selected performance measure
- Defines compensation actually paid as an amount equal to a covered executive's total compensation as reported in the Summary Compensation Table (SCT) subject to required adjustments for pension benefits and equity awards
- Requires a company to describe the relationship between:
  - — Compensation actually paid to its covered executives and each of the financial performance measures included in the table and
  - — The company's TSR and its peer group's TSR.
- Requires a covered company to provide supplemental tabular disclosure listing three to seven financial performance measures that the company determines are its most important measures to linking compensation actually paid to its covered executives and company performance
- Allows a covered company to determine placement of disclosure within the proxy statement

Understanding the Required Tabular Disclosure

The required pay-versus-performance tabular disclosure shown below cross-references highlighted items with relevant sections of this Client Update.

Location of Disclosure – See page 7

Covered Companies and Effective Date – See page 3

Covered Executives – See page 3

(a)	(b)	(c)		(e)	(f)	(g)	(h)	(g)
Year[1]	SCT Total Compensation For CEO	Compensation **Actually Paid** to CEO	verage SCT Total Compensation for Other NEOs	Average Compensation **Actually Paid** to Other NEOs	Cumulative TSR	Peer Group Cumulative TSR	After-tax Net Income	Company Selected Performance Measure
1								
2								
3								
4								
5								

Determination of “compensation actually paid” – See pages 4 and 5

Calculation of TSR – See page 6

Identification of company selected measure – See pages 6 and 7

Phased transition period – See page 7

Required narrative disclosure following Table – See pages 4, 6 and 7
Permitted additional disclosure – See page 7

Details of Final Rule on Pay-Versus-Performance Disclosure

The following aspects of the Final Rule are discussed below:

1. Covered Companies and Effective Date
2. Covered Executives
3. Required Tabular Disclosure
4. Determination of Compensation Actually Paid
5. Measures of Performance
6. Time Period Covered
7. Permitted Additional Pay-Versus-Performance Disclosure
8. Location of Disclosure

1. Covered Companies and Effective Date

The final rule requires all reporting companies to include the new pay-versus-performance disclosure, except for foreign private issuers, registered investment companies and emerging growth companies ("covered companies"). Smaller reporting companies are required to provide scaled disclosure.

The new pay-versus-performance rules are effective for fiscal years ending on or after December 16, 2022. Therefore, covered companies with a calendar year end must include pay-versus-performance disclosure starting with their 2023 proxy statement, covering compensation awarded for 2022 and applicable prior years.

2. Covered Executives

The final rule applies to a company's proxy-disclosed named executive officers ("covered executives"). If more than one person served as the CEO of the company during a covered fiscal year, then the company would be required to include separate Summary Compensation Table total compensation and compensation actually paid columns for each CEO.

3. Required Tabular Disclosure

The final rule requires a covered company to make the following tabular disclosure:

(a)	(b)	(c)	(d)	(e)	(f)	(g)	(h)	(g)
Year[1]	SCT [2] Total Compensation For CEO	Compensation **Actually Paid** to CEO	Average SCT Total Compensation for Other NEOs	Average Compensation **Actually Paid** to Other NEOs	Cumulative TSR[3]	Peer Group Cumulative TSR	Post-tax Net Income	Company Selected Performance Measure
1								
2								
3								

[1] Initial disclosure would cover 3 fiscal years that would be expanded to include an additional fiscal year for each of the next 2 fiscal years
[2] SCT refers to a company's Summary Compensation Table
[3] TSR refers to total shareholder return

A company may present the tabular disclosure (i) in a single table, (ii) in two tables (one for the CEO and another for all other NEOs), or (ii) multiple, separate tables for CEO and each other NEO.

Following the tabular disclosure, a company must describe:

- The relationship between compensation actually paid and each of the following three measures of the company's performance:

  — Cumulative TSR,

  — Net income and

  — Company-selected financial performance measure.

  A company has discretion to determine the content of this explanatory disclosure and the form of disclosure (e.g., narrative and/or graphic).

- The relationship between the company's TSR and its peer group TSR.

- Three to seven performance measures that the company determines are its most important measures used to link compensation actually paid to the NEOs to company performance. Companies are permitted, but not required, to include non-financial measures in the list if they consider such measures to be among their three to seven "most important" measures.

- In a footnote to the tabular disclosure, the amounts that are deducted from, and added to, SCT total compensation amounts reported in columns (b) and (d) to calculate the compensation actually paid and reported in columns (c) and (e), respectively.

- In a footnote to the tabular disclosure, the valuation assumptions used in determining any equity award adjustments that are materially different from those disclosed as of the grant date of such equity awards.

4. Determination of Compensation Actually Paid

Covered companies will be required to calculate each covered executive's "compensation actually paid" during each covered fiscal year. For this purpose, compensation actually paid is equal to a covered executive's total compensation as reported in the SCT, but modified to adjust the amounts reported for pension benefits and equity awards. Covered companies may not deduct above market earnings on nonqualified deferred compensation from a covered executive's SCT total compensation.

Adjustments for Pension Benefits

A covered company whose NEOs participate in a pension plan will require the services of an actuary to determine the adjustment for reported pension benefits. This adjustment requires a covered company to:

- Deduct from an NEO's SCT total pay any amount reported for the aggregate change in the actuarial present value of all defined benefit and actuarial pension plans, and

- Add (i) actuarially determined service cost for services rendered by an NEO during the covered fiscal year and (ii) the entire cost, if any, 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. Each of these components would be calculated in accordance with GAAP.

Adjustments for Equity Awards

Adjustments for equity awards first requires a covered company to deduct from an NEO's SCT total pay any amount reported for stock awards and stock options for a covered fiscal year. Further adjustments for equity awards roughly reflect mark-to-fair value principles under ASC Topic 718 (accounting for share-based payments). The following table illustrates the application of the required adjustment to equity awards for a single fiscal year. Among other assumptions, this illustration assumes the grant date fair value of equity awards disclosed in the SCT for 2022 was $5 million and the year-end fair value of those same awards was $6 million.

Covered Fiscal Year - 2022	Adjustment to Equity Awards	Amount of Addition/Deduction to SCT Total Pay
Grants Made During 2022 Fiscal Year and Unvested at Year End	Deduct – Grant date fair value of $5 million Add – Year end "fair value" of $6 million	Add: $1 million
Grants Made in Prior Fiscal Year(s) and Unvested at Year End 2022	Add – Change in fair value from end of prior year ▪ Year-end fair value: $4.0 million ▪ End of prior year fair value: $3.0 million	Add: $1 million
Grants Made in Prior Fiscal Years and Vested during 2022	Add – Change in fair value from end of prior year to vesting date ▪ Vesting date fair value: $7.0 million ▪ End of prior year fair value: $5.0 million	Add: $2 million
Grants Made in Prior Fiscal Years that are Forfeited during 2022	Deduct – Fair value of forfeited awards determined at end of prior year ▪ End of prior year fair value: $1.0 million	Deduct: $1 million
Net Addition to SCT Total Pay		**$3 million**

Lastly, a covered company is required to add back the dollar value of any dividends or other earnings paid on stock or stock 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.

Calculation of Fair Value Amounts

Fair value amounts must be computed in a manner consistent with the fair value methodology used to account for share-based payments in the company's financial statements under GAAP. For any awards that are subject to performance conditions, the change in fair value as of the end of the covered fiscal year must be calculated based upon the probable outcome of such conditions as of the last day of the fiscal year. The first fair value disclosure of an award is made in the year of grant, and *changes* in fair value of the award are reported from year to year until the award is vested.

5. Measures of Performance

The final rule requires a covered company to include the following measures of performance in the table to facilitate pay-versus-performance comparisons:

- The company's cumulative TSR over the covered time-period
- The market value-weighted TSR of either its compensation peer group or peer group disclosed in its Form 10-K filing performance graph (as selected by a covered company)
- The company's after-tax net income for each fiscal year of the covered time-period
- A company-selected financial performance measure

A covered company may volitionally include additional measures in the table.

Calculation of Company and Peer Group TSR

The company's TSR and peer group TSR must be calculated:

- Using a measurement period beginning at the measurement point established by the market close on the last trading day before the company's earliest fiscal year in the table, through and including the end of the applicable fiscal year and
- Based on a fixed investment of one hundred dollars at the measurement point.

For each fiscal year, the amount included in the table must be the value of such fixed investment based on the cumulative TSR as of the end of that year. To calculate weighted peer group TSR, the returns of each component issuer of the group must be weighted according to stock market capitalization at the beginning of each period for which a return is indicated. If the peer group is not a published industry or line-of-business index, the identity of the companies composing the group must be disclosed in a footnote. If a covered company uses a different peer group than the one used for the immediately preceding fiscal year, the company must explain in a footnote (i) the reason(s) for this change and (ii) compare the covered company's cumulative total shareholder return with that of both the newly selected peer group and the peer group used in the immediately preceding fiscal year.

Company-Selected Financial Performance Measure

A covered company must select a financial performance measure that, in the company's assessment, represents the most important financial performance measure the company uses to link compensation actually paid to its NEOs to company performance for the most recently completed fiscal year ("Company-Selected Measure"). The Company-Selected Measure does not need to be a financial performance measure that is presented within the company's financial statements or otherwise included in a SEC filing. However, a company that includes a non-GAAP financial measure must include a description of how the measure is calculated from the company's audited financial statements.

Most Important Financial Performance Measures

A covered company must also provide tabular disclosure of the three to seven financial performance measures that the company determines are "most important" to linking compensation actually paid to its NEOs to company performance for the most recently completed fiscal year. A "financial performance measure" is any GAAP measure, any measure derived wholly or in part from a GAAP measure, stock price or TSR. If a company used fewer than three such measures, the company must include all such measures that it used, if any.

A covered company may disclose one or more *non-financial* performances measure provided that the company:

- Used the measure to link compensation actually paid to the company's NEOs, for the most recently completed fiscal year, to company performance,
- Determines such measures are among its three to seven most important performance measures and
- Discloses at least its most important three (or fewer, if applicable) financial performance measures.

The list of financial performance measures may be disclosed in one of the following three ways:

- One list with at least three, and up to seven, performance measures,
- Two separate lists, one for the CEO and one for the remaining NEOs or
- Separate lists for the CEO and each NEO.

If a company elects to provide multiple lists, each list must include at least three, and up to seven, financial performance measures. In addition, such lists may include non-financial performance measures provided such measures are among the company's most important performance measures.

6. Time Period Covered

The final rule provides the following transition rules for the time period covered by a company's pay-versus-performance disclosure:

- Initially, covered companies (except smaller reporting companies) must disclose the relationship between pay-versus-performance for a three-year period (i.e., 2020 to 2022 for companies with a calendar-year end). This period will be expanded to include an additional fiscal year for each of the next 2 fiscal years.
- Initially, smaller reporting companies must disclose the relationship between pay-versus-performance for a two-year period, which will be expanded to a three-year period the following fiscal year.

The final rule also provides that a covered company's pay-versus-performance disclosure would solely cover years during which it was a reporting company.

7. Permitted Additional Pay-Versus-Performance Disclosure

Covered companies may provide additional pay-versus-performance information beyond what is specifically required by the final rule, so long as doing so would not be misleading and would not obscure the required information and is clearly identified as "supplemental".

The final rule provides the following examples of additional disclosures that may (but is not required to) be included in a covered company's proxy statement:

- A public company that is already providing voluntary pay-versus-performance disclosures may generally continue to provide such disclosures in their present format.
- A public company could include disclosure of long-term performance metrics measured over periods longer than a single fiscal year.
- A public company could include additional compensation and performance measures, or additional years of data, in the newly required table.

Any supplemental measures of compensation or financial performance and other supplemental disclosures provided by a public company must be clearly identified as supplemental, not misleading, and not presented with greater prominence than the required disclosure.

For example, depending on the facts and circumstances, a public company could use a heading in the table indicating that the disclosure is supplemental, or include language in the text of its filing stating that the disclosure is supplemental.

8. Location of Disclosure

The new disclosures must be included in any proxy or consent solicitation material for an annual meeting of a covered company's shareholders. However, the final rule does not mandate where the pay-versus-performance disclosure must be placed within a company's proxy or information statement. Rather, the placement of the new disclosure is left to the discretion of each covered company.

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