

Practical Considerations for New Pay vs. Performance Disclosure Requirement

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The [SEC's final rule on Pay Versus Performance](#) becomes effective on October 8, 2022, and will require new executive compensation disclosures for the upcoming proxy season (for annual proxy statements that include executive compensation disclosure for fiscal years ending on or after December 16, 2022). The new rule implements a requirement of the 2010 Dodd-Frank Act that public companies disclose “a clear description” of compensation paid to their top executives, including information “showing the relationship between executive compensation *actually paid* and the financial performance of the issuer.”

Complying with the new rule will require significant effort, but the underlying substance is not entirely new. Most of the information is already provided in the proxy statement and financial reports; and during the twelve years since Dodd-Frank became law, shareholder advisory services (such as ISS and Glass-Lewis) have refined extensive quantitative and qualitative analysis to assess executive compensation against company performance. Their identification of “pay misalignment” (and corresponding “no vote” recommendations) is now a part of the executive compensation landscape.^[1] The SEC acknowledged this in its adopting release, and also acknowledged that proxy statements already disclose information for the public to assess executive compensation against performance. Nevertheless, the SEC offered the following reasons for why it considers the new rule to add value:

- It is designed to provide in a “single space” in the proxy statement direct comparisons of “actual pay” with the company’s financial performance (without the need for time-consuming and costly analysis);
- The prescribed format will allow for “comparability” across registrants and prevent registrants from choosing “to report only the most favorable information,” and
- The rule will “level the playing field” and provide “all investors” (not just institutional investors with access to shareholder advisory services) with pay vs. performance information.

Below we describe the basics of the new requirements and we offer practical considerations. (Our Corporate Defense and Disputes colleagues provide their perspective on the new rule [here](#).)

The Basics

Who. The new requirements apply to all companies that are registered under Section 12 of the Securities Exchange Act of 1934 (the “Exchange Act”) and subject to the federal proxy rules (*i.e.*, most US-listed public companies), but do not apply to (i) foreign private issuers, (ii) companies with reporting obligations only under Section 15(d) of the Exchange Act, or (iii) emerging growth companies. Business Development Companies (“BDCs”) and Smaller Reporting Companies (“SRCs”) are subject to the new rule, but the requirements are less onerous for SRCs.^[2] The requirements apply only when the registrant files an annual proxy or information statement for which executive compensation disclosure is required (generally, the proxy or information statement filed for the annual shareholder meeting).

What. A new table, plus a tabular list of three to seven performance measures and a related narrative.

The final rule requires a new table in a registrant’s proxy statement (or other information statement) for annual shareholder meetings that shows named executive officers’ (“NEOs”) **total compensation** (as reported in the summary compensation table) and “**compensation actually paid**” next to the following financial performance metrics:

1. *Total shareholder return (“TSR”)* for the registrant and the registrant’s peer group (weighted according to market capitalization as of the beginning of the fiscal year); TSR is expressed as a dollar value from an investment of \$100. For this purpose, the peer group can be either the peer group (if any) that the registrant identifies in its Compensation Discussion and Analysis (“CD&A”) for compensation benchmarking purposes or the index that the registrant uses for the required performance graph in its annual report on Form 10-K. If the peer group is not from a published index, it must be disclosed in a footnote. The peer group can change from year to year, but the TSR disclosures for a changed peer group must be provided for each of the lookback years and the change would need to be explained in a footnote. (SRCs are not required to provide peer group information);
2. *Net income*; and

3. *A metric selected by the company* (not required for SRCs). This metric—which the rule refers to as a “financial performance measure”—must be a financial metric (other than TSR or net income) that the company identifies as the most important financial metric to link compensation actually paid to financial performance. It must be taken from the list of three to seven metrics described below. Under the rule, a “financial performance measure” other than stock price or TSR generally must be determined and presented in accordance with the accounting principles used for financial statements; this accounting nexus should be considered when selecting financial metrics other than stock price and TSR.

The registrant must show the compensation information for its principal executive officer(s) (“PEO(s)”) and an average for its other NEOs. If there is more than one PEO during any fiscal year covered by the table, the information must be provided separately for each one. Numbers must be provided for each of the last five completed fiscal years, subject to the following exceptions:

- For SRCs, the lookback is reduced to three fiscal years, and only two fiscal years will be required for the first disclosure;
- The five-year lookback (for everyone except SRCs) will be phased in over three years: for the first year, the lookback will be only three fiscal years; for the next year, it will increase to four fiscal years; and for subsequent years, the lookback will be five fiscal years; and
- If the registrant was not required to report for any of the preceding five fiscal years, the information is required only for the years for which the registrant was required to report.

A sample table from the regulation is shown at the end of this post. The rule requires use of Inline eXtensible Business Reporting Language (Inline XBRL) to tag data in the disclosure.

Three to seven metrics. In addition to the table, covered registrants (other than SRCs) must provide a tabular *list* of at least three and up to seven metrics that the registrant determines represent the most important financial performance metrics that were used to link compensation actually paid for the last fiscal year to company performance. The list need not be ranked and need not be the same for the CEO and other NEOs. If the registrant did not use three financial performance metrics, the list must include all financial performance metrics that were used (if any). The list may include non-financial performance metrics, if the registrant determines they were among its three to seven most important performance metrics. But the non-financial metrics cannot be a substitute for financial metrics: the registrant still must disclose at least three financial metrics used (or, if fewer, the number of financial metrics actually taken into account).

Description of relationship between “compensation actually paid” and metrics. Covered registrants must also provide a clear description of the relationship between compensation actually paid and each financial metric that is included in the table (*i.e.*, TSR, peer group TSR, net income, and the company-selected measure, if applicable). This description may be graphic or narrative (or a combination of the two), and must include a comparison of the registrant’s TSR to the peer group’s TSR. (Again, SRCs are not required to show peer group TSR or a company-selected measure.)

Defining total compensation and “compensation actually paid”. It is critical to appreciate that neither “total compensation” nor “compensation actually paid” is a true reflection of compensation that an executive actually receives. **Total compensation** is simply the total compensation reported on the registrant’s summary compensation table.

Compensation actually paid is a bit of a misnomer, in that it requires assumptions about value of equity and vesting that might not actually play out in reality—which means the value an executive actually receives could be considerably less (or more) than the reported compensation actually paid.

Specifically, “compensation actually paid” is defined as total compensation, adjusted as follows for *defined benefit pensions, equity awards, and above-market earnings on deferred compensation*:

- For *pension benefits*, the compensation actually paid disclosure replaces aggregate change in the actuarial present value of pension benefits with (i) “service cost,” which is the actuarial present value of new benefits accrued for service during the

last fiscal year, and (ii) “prior service cost,” which shows the impact (positive or negative) of any amendments made during the last fiscal year. Both service cost and prior service cost are calculated using the same methodology as used for the registrant’s financial statements. This calculation excludes the impact of changes to actuarial assumptions (*g.*, changes in interest or mortality assumptions) and compensation; and there is no adjustment for vesting conditions. (As noted below, SRCs need not include any amount for pension benefits.)

- For *equity awards*, the compensation actually paid disclosure replaces aggregated grant date fair values of stock and options with the following:
 - For new awards granted during the fiscal year, the fair value as of the earlier of the vesting date or the last day of the fiscal year; *plus*
 - For awards granted in prior fiscal years (and not vested as of the first day of the covered fiscal year), the change in fair value (positive or negative) from the end of the last fiscal year to the earlier of the vesting date or the end of the covered fiscal year; *plus*
 - Dividends and other earnings (if any) paid on awards before the vesting date (to the extent not otherwise reported); *minus*
 - Previously reported awards that will not vest due to a failure to meet the vesting conditions.

Fair value is determined using the same GAAP methodology as for other financial reporting (FASB ASC Topic 718). Compensation actually paid does not include dividends or changes in value that occur after the vesting date.

- If an executive received *above-market or preferential earnings* on deferred compensation, that amount must also be included in compensation actually paid—again, without regard to whether it is vested.

In its release, the SEC acknowledged that equity award fair value involves some subjective assumptions leading to an estimate of compensation, but the SEC nevertheless concluded that it is a “reasonable measure” of an NEO’s actual pay and would present a fair picture of compensation actually paid.

Relaxed Requirements for SRCs. As noted above, the disclosure requirements are relaxed for SRCs in the following ways:

- Instead of showing information for five fiscal years, the table can show information for the preceding three fiscal years (reduced to two fiscal years for the first disclosure);

- SRCs need not include peer group TSR or a company-selected measure in the table;
- SRCs need not include a tabular list of three to seven metrics that the registrant determines represent the most important financial performance metrics used to link compensation actually paid for the last fiscal year to company performance;
- Compensation actually paid need not include any amount for defined benefit pensions; and
- SRCs may delay tagging the required Inline XBRL data until the third filing in which they provide this disclosure (instead of the first).

When. The new disclosures are required in proxy statements (or, if applicable, other information statements that include executive compensation disclosure for the annual shareholder meeting) for fiscal years that end on or after December 16, 2022. This means registrants on a calendar fiscal year will need to include the new disclosures in their next proxy statement (filed in early 2023 for their 2023 annual meeting). The new disclosures are not required in registration statements, such as Form S-1 registration statements.

Where. Registrants have flexibility to choose where in the proxy statement (or other information statement) to include the information. For most registrants, it will be desirable to keep the disclosure separate from the CD&A—particularly in the first year of the disclosure—to avoid suggesting that the tabular disclosures drove compensation decisions (except in the rare case where the tabular disclosures happen to align with the CD&A’s narrative).

Practical Considerations

The new disclosure requirements will require collection of information and new calculations that are outside the scope of “routine” proxy cycles of prior years. It is important to address the disclosure earlier in the 2023 proxy process, and to gain perspectives from compensation consultants, accountants, and counsel. Registrants should be sensitive to nuances in the SEC rule that could create distortions or comparisons that can easily be taken out of context—for example, by the media or other non-investor stakeholders—to reflect poorly on the registrant.

Below we offer some considerations to assist registrants in incorporating the new pay-versus-performance requirements:

1. **Focus on an Integrated Presentation in the Proxy Statement.** The new disclosures were not developed on a clean slate. They are being dropped into an existing framework that is already detailed and nuanced. The new disclosures will supplement the existing detailed CD&A presentation, and could inadvertently highlight results that vary from stated compensation goals and objectives. For example, the first disclosures in 2023 will highlight pay vs. performance for legacy compensation programs from 2022, 2021, and 2020, all of which were approved before the new rule. Registrants will need to be sensitive to the potential ripple effect of the new disclosure, and should consider explaining any disconnects between the new disclosures and the registrant’s business objectives and compensation philosophy. This could involve references back to relevant discussion in the CD&A, as well as discussion of the extent to which “compensation actually paid” is still at risk of forfeiture or reduction.

Similarly, where a number for compensation actually paid is based on “fair value” of equity, which in turn depends on certain assumptions (such as interest rates, mortality and share price volatility), it might help to explain the assumptions and how any deviation from the assumptions could affect the actual value the executive realizes.

Each registrant will have to review its own situation, but we think it will be important to think past the new table list, to how the new disclosure integrates with the rest of the compensation discussion.

2. **Consider using graphs and tables to make it easy.** The simplified format of the new disclosure will not present a comprehensive picture. Where the actual story is more nuanced and complex, it might help to use graphics and tables that illustrate the full picture—without requiring the reader to comb through dense prose. In this vein, the regulation gives registrants flexibility to supplement the required tables, subject to the caveat that supplemental disclosures not be presented with greater prominence than the required disclosure. But registrants should tread carefully, particularly in the first year, to ensure that the new disclosures are not given more significance than is warranted under the circumstances.
3. **Plan ahead, and work with consultants and accountants.** Registrants (and compensation committees) should consider the new disclosures in designing and approving new compensation arrangements. It will be important to review pro forma valuation calculations and model out compensation trends that might deviate from the TSR and net income metrics. Registrants (and compensation committees) will want to identify at least one other financial metric that aligns compensation with positive company performance for use in the company-

selected measure. All this will take time and consultation with outside compensation consultants, accountants and counsel; and it is important to have a designated team leader overseeing the process to ensure integrated and accurate disclosures.

The New Table

The final rule includes the following sample table:

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

¹ Title for column (i) would be replaced with the name of the registrant's most important financial measure (other than net income or TSR).

*Smaller Reporting Companies are exempt from items marked with an asterisk.

** All registrants may provide the required disclosure for three years, instead of five years, in the first filing in which they provide this disclosure, and may provide disclosure for an additional year in each of the two subsequent annual filings in which the disclosure is required.

The final rule does not prescribe a format for the tabular list of three to seven performance metrics.

[1] Dodd-Frank also required the SEC to issue other executive compensation rules and those other rules were issued relatively quickly after passage of the law. For example, in 2011 the SEC issued rules implementing the now familiar "say on pay" and "say on pay frequency" shareholder advisory votes.

[\[2\]](#) The requirements to qualify for the “emerging growth company” exception and the relaxed requirements for an SRC are detailed and require consultation with outside counsel. To qualify as an exempt “emerging growth company,” an issuer generally must have had total annual gross revenues during its most recently completed fiscal year of less than \$1.07 billion, *and* the issuer must not: (i) have reached the fifth anniversary of its first sale of common equity securities under an effective registration statement, (ii) have issued more than \$1 billion in non-convertible debt within the last three years, or (iii) be deemed to be a large accelerated filer. To qualify as an SRC, an issuer generally must not be an asset-backed issuer or a majority-owned subsidiary of a parent that is not an SRC, *and* must have either: (i) a public float of less than \$250 million (as of the last business day of the issuer’s most recently completed second fiscal quarter) or (ii) annual revenues of less than \$100 million (as of the most recently completed fiscal year for which audited financial statements are available) *and* either no public float or a public float of less than \$700 million (determined as of the last business day of the issuer’s most recently completed second fiscal quarter).

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