WILMERHALE®

SEC Adopts Long-Anticipated Pay Versus Performance Disclosure Rules

AUGUST 26, 2022

On August 25, 2022, the Securities and Exchange Commission (SEC) adopted, by a 3-2 vote, the long-anticipated Pay Versus Performance disclosure rules. After two rounds of public comment (see our prior alert and the reopening of the comment period), the adoption of these rules implements Section 953(a) of the Dodd-Frank Act,[1] one of the remaining governance and executive compensation-related provisions applicable to public companies under the Dodd-Frank Act.

Overview

The amendments add new Regulation S-K Item 402(v), resulting in several significant changes that will affect proxy statements filed in 2023 for calendar year companies. The three major new disclosures that will be required are:

1. Pay versus performance table with specific tabular and footnote disclosures.
2. "Clear description" (graphically, narratively, or through a combination) that:
    - Explains the relationships between (a) executive compensation actually paid to the principal executive officer and (b) the average executive compensation actually paid to the other named executive officers, as compared to the company's (i) cumulative total shareholder return (TSR), (ii) net income, (iii) a "company-selected measure," and (iv) any other measure the company adds to the table, in each case over the last five fiscal years; and
    - Compares the company's cumulative TSR and cumulative TSR of the company's selected peer group over the last five years.

[1] Section 953(a) of the Dodd-Frank Act provides:

> *DISCLOSURE OF PAY VERSUS PERFORMANCE.— The Commission shall, by rule, require each issuer to disclose in any proxy or consent solicitation material for an annual meeting of the shareholders of the issuer a clear description of any compensation required to be disclosed by the issuer under section 229.402 of title 17, Code of Federal Regulations (or any successor thereto), including information that shows the relationship between executive compensation actually paid and the financial performance of the issuer, taking into account any change in the value of the shares of stock and dividends of the issuer and any distributions. The disclosure under this subsection may include a graphic representation of the information required to be disclosed.*

3. Tabular, unranked list of three to seven performance measures (at least three of which must be financial performance measures), which in the company's assessment represent the most important measures used by the company to link compensation actually paid to its named executive officers, for the most recently completed fiscal year, to company performance.

These new disclosures will be required to be tagged in inline XBRL.

Companies Subject to the New Disclosure Requirements

The new rules apply to all reporting companies except for emerging growth companies (which were exempted from the statutory requirement by Section 102(a)(2) of the JOBS Act), foreign private issuers (which are not generally subject to the proxy rules) and registered investment companies. Smaller reporting companies are subject to the new requirements, but with accommodations.

Pay Versus Performance Table

The adopted rules add a new tabular disclosure requirement to S-K Item 402(v), which, at a minimum, requires the columns and footnotes set out as follows:

PAY VERSUS PERFORMANCE

Year (a) **(1)**	Summary Compensation Table Total for PEO (b)	Compensation Actually Paid to PEO (c) **(2)**	Average Summary Compensation Table Total for Non-PEO Named Executive Officers (d)	Average Compensation Actually Paid to Non-PEO Named Executive Officers (e) **(2)**	Value of Initial Fixed $100 Investment Based on:		Net Income (h)	[Company-Selected Measure] (i) **(4)***
					Total Shareholder Return (f)	Peer Group Total Shareholder Return (g) **(3) ***		
Y1	$	$	$	$	$	$	$	$
Y2								
Y3								
Y4*								
Y5*								

(1) State the name of each named executive officer included as a principal executive officer (PEO) or in the calculation of the average remaining named executive officer compensation, and the fiscal years for which such persons are included.

(2) Disclose each of the amounts deducted from and added to the summary compensation table total pursuant to S-K Item 402(v)(2)(iii). For the value of equity awards added, disclose any assumption made in the valuation that differs materially from those disclosed as of the grant date of such equity awards. For disclosure of the executive compensation actually paid to named executive officers other than the PEO, provide such amounts as averages.

(3) If the peer group is not a published industry or line-of-business index, disclose the identity of the issuers composing the group. Additionally, if the company changes its peer group, disclose the reason(s) for the change and compare the company's cumulative total return with that of both the newly selected peer group and the peer group used in the immediately preceding fiscal year.

(4) If not a GAAP measure, disclose how the number is calculated from the company's audited financial statements.

***** Not applicable to smaller reporting companies.

Calculation of Compensation Actually Paid

The method of calculating the amount of compensation "actually paid" has been significantly changed from the original rule proposal, with several new and technical provisions. Under the adopted rules, companies must calculate and disclose in a footnote to the pay versus performance table a series of prescribed adjustments to arrive at compensation actually paid. At a high level, the formula for calculating compensation actually paid begins with the total compensation amount reported in the summary compensation table (SCT) and makes the following adjustments for defined benefit and actuarial pension plans and stock and option awards:

Adjustment Category	Subtractions	Additions
Defined Benefit and Actuarial Pension Plans (not applicable to smaller reporting companies)	Aggregate change in the actuarial present value of the accumulated benefit reported in the SCT (assuming such change is positive)	Aggregate sum of: ***(i)*** "<u>service cost</u>," calculated as actuarial present value of each named executive officer's benefit under all such plans attributable to services rendered during the covered fiscal year and ***(ii)*** "<u>prior service cost</u>," calculated as the entire cost of benefits granted (or credit for benefits reduced) 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 amendment.
Stock and Option Awards (Calculation Notes: ***(1)*** take into account, for modified awards, the excess fair value, if any, of any such modified award over the fair value of the original award as of the date of such modification; ***(2)*** fair value amounts must be computed in a manner consistent with the fair value methodology used to account for share-based payments under GAAP; and ***(3)*** for any awards that are subject to performance conditions, calculate the change in fair value as of the end of the covered fiscal year based upon the probable outcome of such conditions as of the last day of the fiscal year.)	Grant date fair value reported in the SCT	Aggregate sum of the following adjustments: ***(i)*** add the fair value as of the end of the covered fiscal year of all awards granted during the covered fiscal year that are outstanding and unvested as of the end of the covered fiscal year; ***(ii)*** add the amount equal to the change as of the end of the covered fiscal year (from the end of the prior fiscal year) in fair value (whether positive or negative) of any awards granted in any prior fiscal year that are outstanding and unvested as of the end of the covered fiscal year; ***(iii)*** add, for awards that are granted and vest in the same year, the fair value as of the vesting date; ***(iv)*** add the amount equal to the change as of the vesting date (from the end of the prior fiscal year) in fair value (whether positive or negative) of any awards granted in any prior fiscal year for which all applicable vesting conditions were satisfied at the end of or during the covered fiscal year; ***(v)*** subtract, for any awards granted in any prior fiscal year that fail to meet the applicable vesting conditions during the covered fiscal year, the amount equal to the fair value at the end of the prior fiscal year; and ***(vi)*** 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 included in the total compensation for the covered fiscal year.

Other Adjustments and Considerations

- **<u>Multiple PEOs</u>**. In a departure from the rule proposal, the adopted rules provide that if a company has more than one PEO during a fiscal year, separate columnar disclosure for each PEO must be provided in the pay versus performance table.

- **Total Shareholder Return**. The TSR columns are calculated similar to the TSR calculation presented in the performance graph required by S-K Item 201(e), with a few modifications. The TSR amounts disclosed in the table must be presented in dollars and assume a fixed investment of one hundred dollars, with the reported amount reflecting the value of such fixed investment based on the cumulative TSR as of the end of that year. Moreover, rather than a constant five-year "measurement period" as applies in S-K Item 201(e), for purposes of the pay versus performance table, the relevant "measurement period" for any given year presented 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 TSR is being calculated. For instance, the TSR for the earliest year in the table will represent the TSR over that "first" year while the TSR for the next earliest year will represent the cumulative TSR over the first and the second years.

- **Company Selected Measure(s)**. The new rules require disclosure of a financial performance measure that the company selects from its tabular list (described below), which in the company's assessment is the "most important financial measure (that is not otherwise required to be disclosed in the table)." For this purpose, measures that are not financial measures under GAAP are treated similarly to how they are treated in CD&A – they are not subject to Regulation G or Item 10(e) of Regulation S-K; however, disclosure must be provided as to how the number is calculated from the company's audited financial statements. Companies may also add columns to the table to present additional performance measures.

Explanation of Relationships Between Pay and Performance

Under the adopted rule, per Section 953(a) of the Dodd-Frank Act, companies must also provide a "clear description," which may be presented graphically, narratively, or through a combination of both, that compares pay versus performance. Specifically, companies must describe the relationships between executive compensation actually paid to the principal executive officer and the average executive compensation actually paid to the other named executive officers across the last five fiscal years, as compared to the company's (a) cumulative total shareholder return (TSR), (b) net income, (c) a "company-selected measure," and (d) any other measure the company adds to the table. A comparison is also required between the company's cumulative TSR and cumulative TSR of the company's selected peer group over the same period.

Tabular Summary of Most Important Financial Performance Measures

Companies (other than smaller reporting companies) must also provide an unranked, tabular list of three to seven performance measures that represent, in the company's assessment, the most important measures used by the company to link compensation actually paid to its named executive officers to company performance, for the most recently completed fiscal year.

The tabular list may be presented in any of the following three ways: (a) one tabular list, (b) two separate tabular lists (one for the PEO and another for all other named executive officers), or (c) separate tabular lists for the PEO and each of the other named executive officers. Regardless of the option chosen, each list must contain three to seven financial performance measures. In the event that fewer than three financial performance measures were used for the most recently completed fiscal year, all measures that were used must be listed. Companies may also choose to list non-financial performance measures that are used to link compensation actually paid to performance, if such measures are among the most important in the list of three to seven, provided the list includes at least three (or such lesser number actually used by the company in the last fiscal year) financial performance measures. A non-financial performance measure may not be selected as the company-selected measure required to be included in the pay versus performance table.

Companies are not required to provide the methodology used to calculate the measures included in the tabular list(s), but should consider whether such disclosure is useful for investors to understand the measures included or necessary to prevent the tabular list disclosure from being confusing or misleading.

Inline XBRL

Companies are required to tag the new disclosures in inline XBRL. This will be the first time inline XBRL will apply to proxy statement disclosures. Specifically, companies must separately tag each value disclosed in the table, block-text tag the footnote and relationship disclosures, and tag specific data points (such as quantitative amounts) within the footnote disclosures. The inline XBRL tagging requirement is limited to S-K Item 402(v) and does not extend to other compensation information disclosed in the proxy statement. This requirement is phased in for smaller reporting companies, so that they are not required to comply with the tagging requirement until the third annual filing in which the pay versus performance disclosure is provided.

Subject to Say-on-Pay Vote

Because the new disclosures are provided under S-K Item 402, the disclosures are subject to the say-on-pay advisory vote required under Rule 14a-21(a).

Filings to Which the New Rules Apply

The new disclosures in S-K Item 402(v) are required solely in proxy statements or information statements for which executive compensation disclosure is required. For instance, the disclosure is not required to satisfy the requirements in Part III of Form 10-K. Moreover, these disclosures are not deemed to be incorporated by reference into any filing under the Securities Act or the Exchange Act, except to the extent that the company specifically incorporates such disclosures by reference.

Smaller Reporting Company Accommodations

Smaller reporting companies are:

- Only required to present three, instead of five, fiscal years of disclosure under new S-K Item 402(v);
- Permitted to provide two years of data, instead of three, in the first applicable filing after the rules became effective;
- Not required to adjust for or disclose amounts related to pension plans for purposes of disclosing executive compensation actually paid;
- Not required to present peer group TSR or a company-selected measure;
- Not required to provide the tabular list disclosure; and
- Permitted to wait until their third filing for which pay versus performance disclosure is required to comply with inline XBRL tagging requirements.

Timing and Transition Relief

The new rules will be effective 30 days after publication in the Federal Register and will first apply to proxy statements filed with respect to fiscal years ending on or after December 16, 2022, so will affect 2023 proxy statements for calendar year companies. While the pay versus performance table requires five years of data (other than for smaller reporting companies), companies are permitted to present three years when the requirement first becomes effective and build up to five years over time.

Preliminary Takeaways

Companies should begin preparing for these new disclosures now. Among other preparations, consideration should be given to the current reporting systems and the steps required to collect the data inputs necessary for the calculation of compensation actually paid. For the tabular summary of most important financial performance measures and the “clear description” that compares pay to performance, compensation committees may want to consider prior CD&A disclosures about the relationship between pay and performance, the impact those prior disclosures might have on preparing disclosures under the newly adopted disclosure requirements, and any changes that might be desirable to implement ahead of the upcoming proxy season.

Contributors

Lillian Brown

PARTNER

lillian.brown@wilmerhale.com

+1 202 663 6743

Meredith B. Cross

PARTNER

meredith.cross@wilmerhale.com

+1 212 295 6644

Alan J. Wilson

COUNSEL

alan.wilson@wilmerhale.com

+1 202 663 6474

Jonathan Wolfman

PARTNER

jonathan.wolfman@wilmerhale.com

+1 617 526 6833