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*Client Alert*

# SEC Issues Final Pay Versus Performance Rules

EXEQUITY

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On August 25, 2022, the SEC issued its final pay versus performance (PVP) rules under Section 953(a) of the Dodd-Frank Act,[1] effective for proxy and information statements covering fiscal years ending on or after December 16, 2022. The SEC also issued a fact sheet on its new PVP rules.[2]

## Final Rules

New Item 402(v) of Regulation S-K will require companies to provide a table (PVP Table, in a required format[3]) that discloses specified executive compensation and financial performance measures for the five most recently completed fiscal years (with the transition rules generally only requiring three years initially).

Companies will need to include the principal executive officer's (PEO) total compensation from the Summary Compensation Table (SCT), the average of total compensation for the other non-PEO named executive officers (NEOs), as well as a new measure, executive compensation actually paid (CAP) for both the PEO and the average of all the other NEOs.

The financial performance measures that must be included in the PVP Table are:

- Total shareholder return (TSR) for the company;
- TSR for the company's peer group on a market capitalization adjusted basis;
- Net income of the company; and
- A company-chosen financial performance measure (Company Selected Measure) that represents the most important financial performance measure used to link CAP to its NEOs for the most recently completed fiscal year.

Companies will also be required to disclose in a tabular list (Tabular List) a minimum of three (or fewer if the company uses less than three) to a maximum of seven financial performance measures that they determine are their most important measures used to link CAP to its NEOs. Companies are permitted to include non-financial measures in the list, but only if they are considered among their three to seven most important measures.

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1 See SEC Press Release 2022-149, *SEC Adopts Pay Versus Performance Disclosure Rules* (August 25, 2022), and SEC Release Nos. 34-95607; File No. S7-07-15, *Pay Versus Performance* (August 25, 2022).
2 See SEC Fact Sheet, *Pay Versus Performance* (August 25, 2022).
3 See the Appendix to this *Client Alert* for the required tabular format.

## The PVP Table

### *Executives*

The final rules indicate that if a company has multiple PEOs within a single fiscal year, it cannot aggregate their pay information. Instead, the company must include all individuals that served as PEO in the latest fiscal year and separately disclose their compensation amounts. Similarly, there is no limit on the number of NEOs, so if a company experiences executive group changes that result in a higher number of NEOs for the year, the pay of all must be included in the tabular disclosures.

### *Executives' Compensation*

The PVP Table must disclose the SCT total compensation for both the PEO and the other NEOs (as an average), as well as their CAP.

To determine the **CAP**, companies start with the **total compensation** for the fiscal year set out in the SCT, and then:

- ***Deduct*** the aggregate change in actuarial present value of the executive's accumulated benefit under all defined benefit and actuarial pension plans reported in the SCT.
  - ***Add*** the aggregate of the service cost, calculated as the actuarial present value of each NEO's benefit attributable to services rendered during the covered fiscal year, and prior service cost, calculated as the entire cost of benefits granted in a plan amendment during the covered fiscal year that is attributed by the benefit formula to services rendered in periods prior to the amendment.
- ***Deduct*** the amounts reported in the SCT for stock and option awards, and then ***include*** an amount calculated as follows for all stock and option awards:
  - ***Add*** the fair value as of the end of the covered fiscal year of all awards granted during the fiscal year that are **outstanding and unvested** as of fiscal year-end.
  - ***Add*** the amount equal to the change as of the end of the covered 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.

    *Note that the fair value of awards that are subject to performance conditions must be based on the most probable outcome at the end of the covered fiscal year.*
  - ***Add***, for awards that are **granted and vest** in the same year, the fair value as of the vesting date.
  - ***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.
  - ***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.

- ***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.

The instructions indicate that for the PEO's CAP amounts in the table, companies must disclose the above amounts that are added and subtracted from total compensation in a footnote to the new PVP Table, but for the average CAP amounts for the NEOs other than the PEO, these disclosures of additions and subtractions are to be made on an average basis. Additionally, companies must disclose the names of all PEOs and NEOs included for each fiscal year in a footnote.

For amounts added pursuant to the above formula for equity awards to compute CAP, companies will be required to disclose the assumptions used in determining the above fair values in a footnote if they are materially different from those used to determine the grant date fair values.

***Exequity Comments****: Since the assumptions used to determine the fair values for purposes of equity awards in calculating the CAP are likely to differ from the assumptions used in determining those awards' grant date fair value, as a practical matter, most companies will need to provide these assumptions in footnotes to the new PVP Table.*

*We expect that calculating the CAP will require a significant amount of interpretation and effort. Thus, companies should work on this before year-end to develop a process with which they can familiarize their staff. Then, when the actual year-end numbers are available, everyone knows how the calculation works, where to get the necessary values, and how these will flow into a CAP figure for each PEO and NEO.*

*Given the methodology the new PVP rules employ, there could be large swings in the value of equity awards from year to year, which still may not track the ultimate payouts to executives disclosed in the Compensation Discussion and Analysis (CD&A) section and compensation tables in the proxy.*

*In addition, changes in the executive group will result in potential volatility in the new PVP disclosures. In particular, a change at the CEO level will require additive PEO values and increased tabular complexity. Other NEO changes could result in material year-over-year differences in PVP Table pay levels due to inducement awards for new executives, severance pay for departing executives, and the need to include a greater number of NEOs for that year.*

*We expect most companies will include additional context and some tempering language regarding the interim values being included for equity awards to indicate that these may not ultimately reflect actual payouts under the company's incentive plans.*

### *TSR*

For the TSR calculations, the SEC indicated that these must be presented assuming a fixed $100 initial investment, and then shown on a cumulative basis, i.e., the Year 1 amount is from the beginning of the 5-year period until the end of Year 1, the Year 2 amount is from the beginning of the 5-year period until the end of Year 2, etc. In other words, while CAP is disclosed for the relevant fiscal year, the corresponding TSR may cover multiple years.

***Exequity Comments**: While companies currently calculate TSR using this methodology for purposes of the performance graph included in their Form 10-K, the methodology is likely a bit different than how they calculate and present TSR for purposes of any incentive compensation plans disclosed in their CD&A. Consequently, it will be important to understand the differences between TSR as calculated for the new PVP Table and how TSR will be calculated for purposes of incentive compensation disclosed in the CD&A and currently for the 10-K's Performance Graph. If the calculations result in vastly different figures, it may be prudent to consider including a discussion of the reasons for such differences in the CD&A.*

*If the peer group a company uses for RTSR has one or two large market capitalization companies (compared to the rest of the RTSR peer group), the TSR results for these one or two large companies will disproportionately drive the market cap-adjusted TSR results shown in the new PVP Table (if the RTSR peer group is used as the Item 201(e) performance group for purposes of the Form 10-K's Performance Graph).*

### Company Selected Measure

The Company Selected Measure is an additional financial performance measure (beyond the required inclusion of Net Income) that the company believes is the **most important financial performance measure** (that is not otherwise required to be disclosed in the new PVP Table) used to link CAP to the company's PEO(s) and NEOs for the most recently completed fiscal year. The SEC indicated that financial performance measures are measures determined and presented in accordance with the accounting principles used in preparing the company's financial statements, any measures that are derived wholly or in part from such measures, or stock price and TSR.

***Exequity Comments**: In all likelihood, the Company Selected Measure will be a measure a company is already using and is most heavily weighted in its short- or long-term incentive plans.*

### Peer Group

The company must use either the same peer group it uses for its Performance Graph required by Item 201(e) of Regulation S-K (a published industry or line-of-business index; peer issuers selected in good faith; or companies with similar market capitalizations) or the peer group used in the CD&A for purposes of disclosing the company's compensation benchmarking practices. If a company changes the peer group used in the PVP Table, it is required to include the TSR of the latest peer group in the new PVP Table and explain in a footnote the reason for the change and compare the company's TSR to that of both the old and the new PVP Table peer groups. This is already required for changes if the compensation peer group is disclosed in the 10-K. In addition, if a company uses the Item 201(e) peer group for purposes of the PVP Table, disclosing the composition of the group can simply be done by incorporating by reference to the disclosure in prior filings.

***Exequity Comments**: Companies might think it would be appropriate to simply use the peer group disclosed in their CD&As for pay benchmarking purposes. However, given the requirements to explain changes in peer group from year to year, including showing what the TSR would have been using the old and new peer groups, we expect many companies will use the same peer group used for the Item 201(e) performance graph (which in all likelihood is not going to be the same as the compensation peer group) as the Item 201(e) peer group typically does not change too often for most companies, compared to compensation benchmarking peer groups, which usually are evaluated (and updated) annually.*

*In addition, in many cases a company's compensation benchmarking peer group will include companies that are not directly within the company's line of business, and therefore will tend to have TSR* *performance that does not correlate well with the company's TSR. Blending the TSR results across a group of companies that operate in varied industry sectors will often result in an aggregated TSR that bears little similarity to the TSR of a given company operating within one distinct industry sector. As such, making TSR comparisons against a compensation benchmarking peer group will often make little sense.*

*Some companies disclose both a compensation benchmarking peer group and a separate performance peer group used for RTSR purposes in the CD&A. Assuming the Item 201(e) peer group is not used, the rules indicate that it should be the compensation benchmarking peer group, not the performance peer group that is used. This also could lead to divergent TSR results in the PVP Table versus the performance incentive awards' using RTSR. This discrepancy may be mitigated and explained if the Item 201(e) peer group is used instead of the compensation peer group.*

*That noted, there appears to be a planning opportunity that could mitigate the difference in comparative TSR relationships. Specifically, the rules governing the Form 10-K disclosure of the company's TSR versus a reference group of companies allows the company to establish a customized peer set for purposes of reflecting the company's TSR in relation to a reference group of companies. Accordingly, if a company wishes to ensure greater consistency of the disclosed RTSR performance outcomes across the group used in its RTSR incentive program and the new PVP comparisons, the company could incorporate the incentive plan's RTSR peer set in the Form 10-K Performance Graph. The company would thereby be able to import this RTSR incentive plan peer group into the new PVP disclosures, resulting in greater consistency between the payout outcomes of the RTSR incentive plan and the new PVP disclosures.*

*Generally speaking, we do not expect the new PVP rules will be a major factor in the selection of companies to be included in either a compensation benchmarking group or a performance peer group, particularly if the Item 201(e) group is used for PVP Table. Reasons for selecting compensation or performance peers for purposes of incentive plans should be based on the factors typically used in selecting a compensation or performance peer group and should not be driven by the disclosure required in the PVP Table.*

## Relationship Between Compensation and Performance

The final rules also require a company to provide a clear description (graphically, narratively, or a combination of the two) of the relationships between the executive CAP and each of the performance measures included in the new PVP Table for the fiscal years covered.

***Exequity Comments****: It is unclear what the SEC will accept as an adequate explanation of the relationships between the CAP and the measures included in the new PVP Table. Theoretically, it could suffice to simply include bar charts that show pay compared to each measure. However, we think most companies will land on some combination of a graphic/table/illustration and a narrative explanation of the relationships.*

*The Company Selected Measure can change from year to year. However, for most companies, we believe this will be infrequent. If these measures change too often, it could be interpreted by shareholders as a lack of direction at the company, unless a compelling explanation is also provided of why changes were necessary and appropriate.*

## Tabular List

Beyond the above required disclosures of financial metrics, the new rules require companies to include a list of a minimum of three (or fewer, if less than three are actually used) to a maximum of seven financial metrics that the company believes are its most important measures for linking CAP to executives for performance in the most recent fiscal year. For this purpose, companies may include non-financial performance measures that they use to link CAP to the PEOs and NEOs to company performance for the most recent fiscal year, but only if they determine that such measure is among its top three to seven most important performance measures and provided the company has disclosed its most important three (or fewer, if the company uses less than three) financial measures.

The listed measures do not need to be ranked. Companies can provide separate lists of measures for the PEO(s) and other NEOs. There is also no required format for the Tabular List.

Companies that do not use any financial measures to link CAP to performance are not required to provide a Tabular List.

***Exequity Comments***: *Importantly, the Tabular List should reflect the measure(s) used to link CAP and performance in the* ***most recently completed fiscal year****.*

*Given the instructions, we believe most companies will select measures already used in their short- and long-term incentive plans. That said, focus will likely be on the most heavily-weighted measures used in such incentive plans, resulting in measures that receive little weight (such as how ESG measures have generally been weighted) not being included in the Tabular List.*

*We also do not believe non-quantitative or non-financial measures will end up in the Tabular List all that often. However, if an incentive plan places heavy weighting on such a non-quantitative or non-financial measure, it is possible it could end up in the Tabular List.*

## Smaller Reporting Companies

If a company qualifies as a smaller reporting company, then instead of having the PVP Table and other disclosures cover the past five fiscal years, they can instead cover the last three fiscal years. For the first time a smaller reporting company is required to provide this new disclosure, it can include only two fiscal years of data rather than three, and can leave out TSR, net income, the Company Selected Measure, and the Tabular List.

## Location of the New PVP Disclosure

The final rules do not mandate a specific location (as is the case with the CEO Pay Ratio disclosure), so companies are free to place the new PVP Table and narrative pay-for-performance disclosure wherever they want within the proxy. That said, the three places that these new disclosures would appear to be most appropriately located for most companies are: (1) just after the executive summary (if one is included)—but likely not until several years after these new disclosures have been provided; (2) at the end of the CD&A; or (3) after the executive compensation tables and related disclosures.

## Timing

The final rules become effective 30 days following publication. Companies must start complying with these rules in proxy and information statements that are required to include Item 402 executive compensation disclosure for **fiscal years ending on or after December 16, 2022**. Accordingly, calendar-year companies will be subject to the new disclosure requirements in the impending 2023 proxy season.

The SEC is offering a **transition period** for companies to comply with these new disclosure requirements. In the first filing in which a company must include the new disclosure, instead of providing data for the past five fiscal years, a company could instead provide data for the **last three fiscal years**

**and then include an additional fiscal year in each of the next two annual filings** in which the new disclosure is required, i.e., would get to a full five years' worth of data disclosed and discussed under the new disclosure requirements in the 2025 proxy statements filed by calendar-year companies.

For **newly public companies**, the SEC indicates that they generally will only be required to disclose data for years in which they were public.

## Next Steps and Practical Considerations

As noted above, if your company has a fiscal year ending on or after December 16, 2022 (which all calendar-year companies have), you will need to include these new disclosures in your next proxy statement, i.e., for your proxy statement filed in 2023. So, while most companies do not start working on their proxy statements until later in the year, there are several practical actions you could consider taking before then:

- Test and determine which additional financial performance measure you will use in the new tabular disclosure as your company's most important Company Selected Measure;
- Evaluate the relationships between the metrics to be included in the new PVP Table and the CAP and start creating a table/graphic to explain these relationships and/or drafting the narrative explaining these relationships;
- Evaluate and establish a method to calculate the CAP with the required additions and subtractions;
- Determine which measures will be included in your Tabular List and why;
- If the company currently provides its own voluntary pay-for-performance disclosure, determine if that disclosure should continue to be provided; and
- Consider whether to include a customized peer set in the next Form 10-K statement that can be used in the new PVP disclosures, and that will help convey the most appropriate portrayal of the relationship between pay and performance.

# Appendix

## Pay Versus Performance

| Year (a) | Summary Compensation Table Total for PEO (b) | Compensation Actually Paid to PEO (c) | Average Summary Compensation Table Total for Non-PEO Named Executive Officers (d) | Average Compensation Actually Paid to Non-PEO Named Executive Officers (e) | Value of Initial Fixed $100 Investment Based On: | | Net Income (h) | [Company-Selected Measure] (i) |
|---|---|---|---|---|---|---|---|---|
| | | | | | Total Shareholder Return (f) | Peer Group Total Shareholder Return (g) | | |
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