SEC Adopts New Rules for "Pay Versus Performance" Disclosure Requirement

The SEC has taken another significant stride towards completing its executive compensation-related rulemaking required by the Dodd-Frank Wall Street Reform and Consumer Protection Act. On August 25, 2022, the SEC adopted a new rule to implement the Dodd-Frank Act "pay-versus-performance" disclosure requirement. This Thoughtful Pay Alert summarizes the new rule and offers our initial observations on the potential impact of this significant new disclosure requirement.

Executive Summary

The new rule requires public companies to address the relationship between the compensation actually paid to their senior executive officers and their financial (including stock price) performance. The new rule becomes effective October 11th, 2022 and will generally apply to proxy or information statements covering a fiscal year **ending on or after December 16, 2022** (generally, proxy statements filed in 2023). As described in detail in the rest of this Alert, compliance will be both burdensome and require technical information that most companies will not have previously provided in their proxy statement filings. Planning for and developing your draft disclosure well in advance of your annual proxy statement timeline is advisable.

Overview

Essentially, the new rule supplements a company's Compensation Discussion and Analysis ("CD&A") with three specific disclosure requirements:

- A new "pay-versus-performance" table requiring disclosure of both the compensation reported in the Summary Compensation Table and the compensation actually paid to the company's named executive officers ("NEOs"). The table must also contain the company's total shareholder return ("TSR"), the TSR of a peer group chosen by the company, the company's net income, and an additional financial performance measure selected by the company (the "Company-Selected Measure).

- The table must be accompanied by a clear description of the relationships between the compensation actually paid to the company's Principal Executive Officer ("PEO") and other NEOs to (a) its cumulative TSR, (b) its net income, and (c) the Company-Selected Measure. In addition, companies are also required to provide a clear description of the relationship between the company's TSR and the TSR of the selected peer group. Companies will have flexibility as to the format in which to present the descriptions of these relationships, whether graphical, narrative, or a combination of the two.

- An unranked list of the most important financial (or non-financial) performance measures (containing between three and seven measures) used by the company to link executive compensation actually paid to the company's NEOs during the last fiscal year to company performance.

- The new rule gives companies flexibility in determining where in the proxy or information statement to provide the required disclosure. We believe that most companies will include the disclosure with or immediately following their executive compensation tables, although it will be interesting in the first year of compliance to see what different approaches are taken.

Specific Requirements

The Table

The Tabular format required by the SEC is as follows

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)		
One								

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Fiscal Years Covered

The table must generally cover a company's five most recently completed fiscal years or, for Smaller Reporting Companies ("SRCs"), the three most recently completed fiscal years. Initially, the table need cover only three years and two years, respectively.

Summary Compensation Table Total

For each covered fiscal year, the table must include the total Summary Compensation Table ("SCT") compensation of its PEO and the average of the total SCT compensation for all other NEOs.

If a company had more than one individual who served as Chief Executive Officer during a covered fiscal year, the compensation for each Chief Executive Officer must be presented separately with columns added for the additional Chief Executive Officer(s). The company must identify in footnote disclosure the individual NEOs whose compensation amounts are included in the average for each fiscal year.

Observations: Over a five-year period, extensive footnotes may be required for many companies to describe annual changes to their NEO group. We expect many companies will use a chronological narrative or table to coherently present this information.

Compensation Actually Paid

The table must also include the "compensation actually paid" for each of the covered fiscal years. Essentially, the SCT columns for "Stock Awards," "Option Awards," and, if applicable, the "Change in Pension Value and Nonqualified Deferred Compensation Earnings" must be adjusted. The primary adjustments for most technology and life science companies will be for equity awards held by the covered individuals.

These calculations can be summarized as follows:

Equity Awards Granted in Last Completed Fiscal Year		**Equity Awards Granted in Prior Fiscal Years**	
Unvested as of end of last completed fiscal year	Granted and vested in last completed fiscal year	Unvested as of end of last completed fiscal year	Vested in last completed fiscal year
- Add (or subtract) incremental change in fair value from grant date to end of last completed fiscal year - Exclude any awards forfeited due to failure to meet vesting conditions (performance or otherwise) in last completed fiscal year	- Add fair value calculated as of vesting date	- Add (or subtract) incremental change in fair value from end of previous fiscal year to end of last completed fiscal year	- Add (or subtract) incremental change in fair value from end of previous fiscal year to vesting date - Subtract fair value as of end of previous fiscal year for any shares forfeited due to failure to meet vesting conditions (performance or otherwise) in last completed fiscal year

For purposes of the new rule, "fair value" calculations are to 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 (that is, Financial Accounting Standards Board Accounting Standards Codification Topic 718). Performance awards that are unvested at fiscal year-end should be valued based on the probable outcome of the performance conditions on the last day of the fiscal year.

Observations: The "compensation actually paid" requirement is likely to be the most burdensome obligation under the new rule. Companies will need to re-calculate the fair values of their equity awards for each covered fiscal year. While that shouldn't be too difficult for most full value awards, re-calculating the fair value of their stock options and relative TSR awards may become tedious, both in terms of the number of calculations that will need to be made and re-assessment of the assumptions used in the calculations.

Companies with defined benefit and actuarial pension plans must also adjust their "Change in Pension Value and Nonqualified Deferred Compensation Earnings" column by replacing the change in the actuarial present value of an NEO's accumulated benefit with the "service cost" for such plans.

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For a more detailed summary of the calculations required to determine "compensation actually paid," see Appendix A.

Financial Performance Metrics

For each fiscal year covered by the table, a company must also report its cumulative TSR, peer group cumulative TSR, net income, and a Company-Selected Measure. SRCs are not required to include either peer group cumulative TSR or a Company-Selected Measure in the table.

Total Shareholder Return

Both company cumulative TSR and peer group cumulative TSR should be calculated based on a fixed investment of $100 for the measurement period in the same cumulative manner as calculated for the performance graph comparing a company's cumulative TSR with a broad equity market index and either a published industry index or a company-determined peer group that is required to be included in its annual report to shareholders.

This "measurement period" generally commences on the market close of the last trading day to occur before the earliest fiscal year reported in the table and ends on the last day of the last completed fiscal year.

In addition, the peer group cumulative TSR should be determined using either the same peer index that the company used for purposes of constructing its performance graph or, if applicable, the same peer group as described in the company's CD&A. If the peer group used is not a published industry index, the company must identify the companies in the peer group in a footnote to the table.

Observations: Presently, it is not clear whether companies must use the performance graph index before being allowed to use the CD&A peer group, or whether they can simply use either peer group as they determine. We believe that either approach may be used. We expect that most companies will want to calculate their TSR against both the performance graph index and its compensation peer group to determine the most favorable approach. However, if flexibility is permitted, we believe that it is likely most companies will use the published industry index TSR for purposes of this disclosure (similar to what they do now in presenting their performance graph). Further, it is not clear whether a company that discloses a relative TSR peer group in its CD&A may use that peer group (on a market capitalization-weighted basis) in the table.

Net Income

A company must report its net income for each covered fiscal year.

Company-Selected Measure

A company must select at least one Company-Selected Measure from its Tabular List (as discussed below) to be reported in the table for the covered fiscal years. A Company-Selected Measure is what the company believes to represent its most important "financial performance measure" for the last completed fiscal year other than TSR or net income.

For purposes of the new rule, a "financial performance measure" is any measure determined and presented in accordance with the accounting principles used in preparing the company's financial statements, any measure that is derived wholly or in part from such measures, and stock price and total shareholder return.

A company may include a non-GAAP financial measure as its Company-Selected Measure, however it must disclose how the measure is calculated from the company's audited financial statements.

The SEC has indicated that if a company did not use any financial performance measures in setting compensation in the last completed fiscal year, or if it only uses financial performance measures that are already included in the table, it is not required to either include a Company-Selected Measure in the table or describe a Company-Selected Measure in the narrative and/or graphical disclosure to the table.

Description of "Pay-Versus-Performance" Relationships

In addition to the new "pay-versus-performance" table, companies must provide a "clear description" of the following relationships:

- the relationship between:
  - – the compensation actually paid to the PEO;
  - – the average of the compensation actually paid to each other NEO; and
  - – each of (i) company cumulative TSR, (ii) net income, and (iii) the Company-Selected Measure; and
- the relationship between the company's cumulative TSR and the peer group cumulative TSR.

This description may be provided in narrative or graphical form, or a combination of the two.

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Tabular List of Important Financial Performance Measures

Under the new rule, reporting companies (other than SRCs) are required to include a "Tabular List" of the most important financial performance measures used by the company in setting pay-for-performance compensation for the most recently completed fiscal year. This list must include at least three, but not more than seven, performance measures in no specific order or rank. If the company considers only two or fewer financial performance measures when assessing pay-for-performance compensation, the company need only include in the list the measures actually considered (which may be zero). Further, in addition to the financial performance measures, the company may also include non-financial performance measures (i.e., operational performance measures) in the list if such measures are among its most important performance measures as long as it has disclosed its three (or fewer, if the company only uses fewer) most important financial measures.

Observations: Companies should start developing their Tabular List as soon as practicable, as the Company-Selected Measure must be drawn from that list. We anticipate that most companies will start this exercise by using the performance measures selected for their short-term and/or long-term incentive plans, focusing on whether these are the "most important" measures for purposes of driving their compensation program. As reflected in our most recent Tech 200 survey, the most common measures for technology companies are revenue, operating income or EBITDA, and earnings-per-share and for life sciences companies are relative TSR and revenue.

Smaller Reporting Companies

As previously noted, SRCs are subject to scaled disclosure requirements under the new rule. Initially, SRCs need only report the information required by the "pay-versus-performance" table for the two most recently completed fiscal years. After the first year in which the table is required, SRCs need only provide disclosure for the three most recently completed fiscal years.

In addition, an SRC is not required to:

- account for the Adjusted Pension Value in computing the "compensation actually paid" to its NEOs;
- report, in the required table, peer group cumulative TSR or a Company-Selected Measure; or
- include a Tabular List of financial performance measures.

Voluntary Disclosure

The new rule permits companies to voluntarily provide supplemental measures of compensation or financial performance (either in the table or in other disclosure), and other supplemental disclosures, so long as any such measure or disclosure is clearly identified as supplemental, not misleading, and not presented with greater prominence than the required disclosure. If additional performance measures are included in the table, each additional measure must be accompanied by a clear description of the relationship between compensation actually paid to the PEO, and, on average, to the other NEOs.

Compliance Date

Companies subject to the new rule must begin to include the required disclosure in any proxy or information statement covering a fiscal year **ending on or after December 16, 2022**. Initially, the table need cover only three years (two years for SRCs). For more detailed information on the compliance date and transition provisions for the new rule, see Appendix B.

Observations: Companies, together with their compensation committees, should begin to consider the process for complying with the new rule now. Although not formally part of the CD&A, it will be important to coordinate the new "pay-versus-performance" disclosure with any similar analysis in the CD&A. It is important to note that the compliance process will require technical information not previously included or relied on in proxy statements. Companies will also have to determine where to locate the disclosure and devise a format for presenting the required information in a way that will be accessible to investors. In this latter regard, it will be important to develop an approach that will simplify (to the extent possible) the required description of the relationship between the compensation actually paid to their NEOs and the various required performance measures. While there is no requirement that this information be provided in a specified format, the SEC suggests considering a graphical presentation. Since for most companies, the "pay-versus-performance" table will include information for fiscal 2020 and fiscal 2021 they can begin familiarizing themselves with the new rule's requirements by performing the calculations now for fiscal 2020 and 2021.

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Need Assistance?

Compensia has extensive experience in helping companies understand how the corporate governance and executive compensation-related disclosure provisions of the Dodd-Frank Act will affect the design, operation, and disclosure of their executive compensation program. If you would like assistance in analyzing how the new "pay-versus-performance" rule is likely to impact your executive compensation disclosure in 2023, or if you have any questions on the subjects addressed in this Thoughtful Pay Alert, please feel free to contact Jason Borrevik at 408.876.4035 or jborrevik@compensia.com or Mark A. Borges at 415.462.2995 or mborges@compensia.com.

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APPENDIX A

COMPENSATION ACTUALLY PAID

The new rule contains a number of adjustments and other provisions that address the calculation of "compensation actually paid" for purposes of the "pay-versus-performance" table. They are as follows:

Equity Awards

To make the necessary adjustments for equity awards, a company starts by subtracting from the "Total" column of the Summary Compensation Table the grant date fair value of stock awards and option awards reported in the table.

The company then must calculate the fair value of the outstanding equity awards and add the results to the Summary Compensation Table as follows:

For equity awards granted during the covered fiscal year:

- Add the year-end fair value of any equity awards granted in the covered fiscal year that are outstanding and unvested as of the end of the covered fiscal year; and
- Add for awards that are granted and vest in the same covered fiscal year, the fair value as of the vesting date. The company may ignore any equity awards that were both granted and forfeited or determined not to be eligible to vest during the covered fiscal year.

For equity awards granted prior to the covered fiscal year:

- Add (or subtract) the amount of change as of the end of the covered fiscal year (from the end of the prior fiscal year) in fair value of any awards granted in prior years that are outstanding and unvested as of the end of the covered fiscal year;
- Add (or subtract) for awards granted in prior years that vest in the covered fiscal year, the amount equal to the change as of the vesting date (from the end of the prior fiscal year) in fair value; and
- Subtract for awards granted in prior years that are determined to 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.

Further, the company must provide footnote disclosure of the adjustments made to determine "compensation actually paid," any valuation assumption made that is materially different from those disclosed as of the grant date of an equity award, and the names of the PEO and each other NEO included in the calculation, as well as the fiscal years in which such individuals are included.

Change in Pension Value

To make the necessary adjustments for pension plan amounts, a company starts by subtracting from the "Total" column of the Summary Compensation Table the change in the actuarial present value of the NEO's accumulated benefit under all defined benefit and actuarial pension plans reported in the table.

The company then must calculate the "service cost" for such plans and add the results to the Summary Compensation Table as follows:

- Subtract the aggregate change in the actuarial present value of the NEO's accumulated benefit under all defined benefit and actuarial pension plans if included in the Summary Compensation Table (the change in actuarial present value would be deducted only if the value is positive, and therefore included in the Summary Compensation Table) from the NEO's "total" compensation for such year.
- Add the "service cost" (as defined under FASB ASC 715 as the actuarial present value of benefits attributed to services rendered by the NEO during the applicable year) and "prior service cost" (applicable to plan amendments or initiations) for all defined benefit and actuarial pension

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plans reported in the Summary Compensation Table for the covered fiscal year. Service cost and prior service cost are to be calculated under GAAP

Other Applicable Provisions

Other notable aspects of the calculation of "compensation actually paid" are as follows:

- *Signing bonuses, severance bonuses and other one-time payments.* Companies are not permitted to remove signing bonuses, severance bonuses, and other one-time payments from the amount of executive compensation actually paid, because, although those figures may not represent the executive's compensation in a 'typical' year where no such payment is made, they do reflect amounts that are "actually paid" to the NEOs.
- *Above-market or preferential earnings.* Companies must include above-market or preferential earnings on non-qualified deferred compensation.
- *Dividends.* Companies must include 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, if such amounts are not reflected in the fair value of the award or included in any other component of total compensation for the covered fiscal year.

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APPENDIX B

COMPLIANCE DATE AND TRANSITION RULES

Companies subject to the new rule must begin to include the "pay-versus-performance" disclosure in any proxy or information statement covering a fiscal year ending on or after December 16, 2022. While the new rule requires companies to provide the "pay-versus-performance" disclosure for a five-year period, to simplify transition, once it becomes effective companies (other than SRCs) will be required for the first year to provide the disclosure for only the three most recently completed fiscal years, and to provide disclosure for an additional fiscal year in each of the two subsequent annual proxy or information statement filings where disclosure is required until the company is disclosing the required information for the five most recently completed fiscal years. SRCs will only be required to provide the disclosure for the two most recently completed fiscal years in the first applicable filing after the rule becomes effective, and then add the third fiscal year in their subsequent filing.

The new disclosure is not required to be included in an Annual Report on Form 10-K or in registration statements, even if disclosure under Item 402 is otherwise required.

A companies must provide the required disclosure only for years that it was a reporting company pursuant to Section 13(a) or Section 15(d) of the Exchange Act. So newly-public companies that are not SRCs or EGCs will only have to provide the required disclosure one year at a time.

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