SEC's New Pay Versus Performance Rule Updates

As registrants begin preparations for the 2023 proxy season, the SEC recently released additional guidance on the newly effective pay versus performance disclosure rule. This document reviews the rule's requirement and includes the 13 additional insights provided in the SEC's February 10 update to its Compliance & Disclosure Interpretations. Here's what you need to know.

Pay vs. Performance Effective Date → **Proxy & Information Statements beginning after December 16, 2022**

Background

The final rule requires new narrative and quantitative disclosures detailing how executive compensation for the principal executive officer (PEO) and other named executive officers[1] (NEOs) relates to a registrant's financial performance. These new disclosures will be required in any proxy or information statements in which executive compensation disclosure is required by Regulation S-K Item 402, which includes the 10-K and registration statements. These disclosures do not apply to emerging growth companies (EGCs), registered investment companies (RICs), or foreign private issuers (FPIs). Scaled disclosures have been provided for smaller reporting companies (SRCs).

New Regulation S-K Item 402(v) requires a five-year table that includes "actual" compensation paid and several performance measures:

- Registrant's total shareholder return[2] (TSR)
- TSR for the registrant's peer group
- Registrant net income
- Registrant's selected performance measure that represents the most important metric to link pay to performance

[1] NEOs for whom Item 402 of Regulation S-K executive compensation is required are defined as:

1) All individuals serving as the registrant's PEOs or acting in a similar capacity during the last completed fiscal year, regardless of compensation level
2) All individuals serving as the registrant's principal financial officer (PFO) or acting in a similar capacity during the last completed fiscal year, regardless of compensation level
3) The registrant's three most highly compensated executive officers other than the PEO and PFO who were serving as executive officers at the end of the last completed fiscal year
4) Up to two additional individuals for whom Item 402 of Regulation S-K disclosure would have been provided but for the fact that the individual was not serving as an executive officer of the registrant at the end of the last completed fiscal year

[2] As defined in Regulation S-K Item 201(e), TSR = (cumulative amount of dividends for the measurement period assuming reinvestment + difference between share price at end and beginning of the measurement period) ÷ share price at the beginning of the period

Scope

These new disclosures will be required in any proxy or information statements in which executive compensation disclosure is required by Regulation S-K Item 402, which includes the 10-K and registration statements. These disclosures do not apply to EGCs, RICs, or FPIs. Scaled disclosures are provided for SRCs.

Is the information mandated by Item 402(v) of Regulation S-K required to be included in Form 10-K, given that Item 11 of Form 10-K indicates that the registrant is required to furnish the information required under Item 402 of Regulation S-K?

No. Item 402(v) provides that the information required thereunder must be provided in connection with any proxy or information statement for which SEC rules require executive compensation disclosure pursuant to Item 402 of Regulation S-K, and Instruction 3 to Item 402(v) specifies that the information provided under Item 402(v) will not be deemed to be incorporated by reference into any filing under the Securities Act or the Exchange Act, except to the extent that the registrant specifically incorporates it by reference.

Pay vs. Performance Table

Five years of data for the following items are required (three years for SRCs):

- Summary Compensation Table total for PEO
- Compensation actually paid to PEO
- Average Summary Compensation Table total for non-PEO NEOs
- Average compensation actually paid to non-PEO NEOs
- Variable of initial fixed $100 investment based on:
    - TSR
    - Peer group TSR
- Net income
- Company-selected measure

A registrant must identify in footnote disclosure the individual NEOs whose compensation amounts are included in the average for each year.

Pay versus performance table								
(a)	(b)	(c)	(d)	(e)	(f)	(g)	(h)	(i)
					Value of initial fixed $100 investment based on:			
Year	Summary compensation table total for PEO	Compensation actually paid to PEO	Average summary compensation table total for non-PEO NEOs	Average compensation actually paid to non-PEO NEOs	Total share-holder return	Peer group total share-holder return	Net income	Company-selected measure

Pay versus performance table										
(a)	(b)	(b)	(c)	(c)	(d)	(e)	(f)	(g)	(h)	(i)
							Value of initial fixed $100 investment based on:			
Year	Summary compensation table total for first PEO	Summary compensation table total for second PEO	Compensation actually paid to first PEO	Compensation actually paid to second PEO	Average summary compensation table total for non-PEO NEOs	Average compensation actually paid to non-PEO NEOs	Total share-holder return	Peer group total share-holder return	Net income	Company-selected measure
Y1	N/A	$	N/A	$	$	$	$	$	$	$
Y2	$	$	$	$	$	$	$	$	$	$
Y3	$	N/A	$	N/A	$	$	$	$	$	$
Y4	$	N/A	$	N/A	$	$	$	$	$	$
Y5	$	N/A	$	N/A	$	$	$	$	$	$

For each amount disclosed in columns (c) and (e) of the Pay Versus Performance table, footnote disclosure of each of the amounts deducted and added is required. May a registrant satisfy this requirement by providing the aggregate amount calculated for pension value adjustments and equity award adjustments?

No. The registrant should provide footnote disclosure of each of the amounts deducted and added.

Item 402(v)(3) of Regulation S-K requires, for each amount disclosed in columns (c) and (e) of the Pay Versus Performance table, footnote disclosure of each of the amounts deducted and added. Is footnote disclosure required for each of the fiscal years presented in the table?

Footnote disclosure for years other than the most recent fiscal year included in the Pay Versus Performance table would be required only if it is material to an investor's understanding of the information reported in the Pay Versus Performance table for the most recent fiscal year, or of the relationship disclosure. However, in the registrant's first Pay Versus Performance table under the new rules, the registrant should provide footnote disclosure for each of the periods presented in the table.

When calculating the peer group TSR, may a registrant use any compensation peer group that is disclosed in its Compensation Discussion & Analysis (CD&A), or is the registrant limited only to a peer group used in the CD&A for purposes of disclosing the registrant's compensation benchmarking practices?

The registrant may use a peer group that is disclosed in its CD&A as a peer group actually used by the registrant to help determine executive pay, even if such peer group is not used for benchmarking.

What time period must a registrant present for its cumulative TSR and peer group TSR when the registrant went public during the earliest year included in the Pay Versus Performance table?

Consistent with the calculation of TSR, if the class of securities was registered under Section 12 of the Exchange Act during the earliest year included in the Pay Versus Performance table, the measurement point for calculating TSR and peer group TSR should begin on the registration date.

In each of 2020 and 2021, a registrant provided the same list of companies as a peer group in its CD&A but provided a different list of companies in its 2022 CD&A. For a registrant providing initial Pay versus Performance disclosure in its 2023 proxy statement for three years, may the registrant present the peer group TSR for each of the three years using the 2022 peer group?

No. In this situation, the registrant should present the peer group TSR for each year in the table using the peer group disclosed in its CD&A for such year.

If a registrant has multiple PEOs in a fiscal year, the final rule requires the registrant to provide separate columns for each PEO in the Pay Versus Performance table. May the registrant aggregate, *i.e.*, use the total sum of, the compensation of such PEOs in a given year for purposes of the narrative, graphical, or combined comparison between compensation actually paid and TSR, net income, and the Company-Selected Measure?

To the extent the presentation will not be misleading to investors, the staff will not object if a registrant aggregates the PEOs' compensation for purposes of the narrative, graphical, or combined comparison between compensation actually paid and TSR, net income, and the Company-Selected Measure.

Net income is required in column (h) of the Pay Versus Performance table. May a registrant use other net income amounts presented in the audited financial statements? For example, may a registrant that consolidates subsidiaries that are not wholly owned use net income attributable to the controlling interest or registrant to satisfy this requirement? May a registrant with material discontinued operations during the fiscal year use income or loss from continuing operations to satisfy this requirement?

No. The registrant is required to provide in column (h) its net income or loss as required by Regulation S-X to be disclosed in the registrant's audited GAAP financial statements.

Actual Compensation Paid

Registrants should start with compensation as reported in the Summary Compensation Table and adjust for pension benefits and equity awards. Footnote disclosure will be required for amounts adjusted, detailed below.

From the total compensation in the Summary Compensation Table, a registrant would deduct the aggregate change in the actuarial present value of all defined benefit and actuarial pension plans and add back the actuarially determined service cost rendered during the applicable year (service cost) and the entire cost of benefits granted in a plan amendment during the covered fiscal year that are attributed by the benefit formula to services rendered in periods before the amendment (prior service cost). The service cost and prior service cost should be calculated in accordance with U.S. GAAP. Compensation actually paid also would include above-market earnings on deferred compensation that are not tax qualified.

For equity awards, the following items would be added (or subtracted, as applicable) to the Summary Compensation Table amount:

- 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 fiscal year
- The change in fair value of any awards granted in prior years that are outstanding and unvested as of the end of the fiscal year
- For awards that are granted and vest in the same covered fiscal year, the fair value as of the vesting date
- For awards granted in prior years that vest in the covered fiscal year, the change in fair value as of the vesting date
- For awards granted in prior years that are determined to fail to meet the applicable vesting conditions during the covered fiscal year (forfeitures), a deduction for the amount equal to the fair value at the end of the prior fiscal year
- 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 reflected in the fair value of such award or included in any other component of total compensation for the covered fiscal year

In calculating the equity award adjustments, are equity awards granted to a first-time NEO in a year prior to (and not otherwise related to) their appointment as a NEO required to be included? For example, if a non-NEO employee is granted a stock option in year 1, and subsequently appointed as a NEO in year 2, must that NEO's "compensation actually paid" in year 2 reflect the required adjustments with respect to the stock option granted in year 1?

Yes. Although such awards may not be reported in the Summary Compensation Table, the change in value of such awards during the executive's tenure as a NEO should be included in the calculation of compensation actually paid.

Most Important Performance Measures List

A registrant also will be required to provide a list of at least three and up to seven of their most important performance measures used to link compensation actually paid to performance for the most recently completed fiscal year.

The final rule clarifies the list is not ranked and registrants are not required to provide the methodologies used. Registrants are not prohibited from disclosing the methodologies if they would be helpful to investors or to prevent the list from being misleading or confusing.

A registrant has the option of including nonfinancial performance measures in the list but only if such measures are included in their three to seven most important performance measures, and it has disclosed at least three most important financial performance measures. A maximum of seven measures is allowed.

Registrants will be able to cross-reference to existing disclosures elsewhere in filings that describe the various processes and calculations that go into determining NEO compensation as it relates to these metrics.

Company-Selected Measure & Required Descriptions

The company-selected measure is a financial performance measure chosen by the registrant and specific to the registrant that—in the registrant's assessment—represents the most important financial performance measure the registrant uses to link compensation actually paid to the registrant's NEOs to company performance for the most recently completed fiscal year. This measure must be one of the three to seven listed performance measures noted in the section above.

Registrants also would be required to provide a clear description (narrative or graphical) of the relationship of the company-selected measure to executive compensation actually paid.

The new table will include the numerically quantifiable performance of the issuer under the company-selected measure for each covered fiscal year, *e.g.*, if the company-selected measure for the most recent fiscal year was total revenue, the company would disclose its quantified total revenue performance for each year. Disclosure of the calculation methodology for the company-selected measure is not required.

Registrants are permitted to supplement their company-selected measure disclosure, so long as any additional disclosure is clearly identified as supplemental, not misleading, and not presented with greater prominence than the required disclosure.

Would it be appropriate for a registrant to disclose its stock price as its company-selected measure if the registrant does not use any financial measures to otherwise link pay and financial performance, but the "compensation actually paid" reported in the pay versus performance table includes the fair value of time-vested share-based awards, which value is largely tied to stock price?

No. While stock price is considered a "financial performance measure," it should not be disclosed as the registrant's company-selected measure if the registrant does not use it to link compensation actually paid to its NEOs to company performance, even if it has a significant impact on the amounts reported in the pay versus performance table. That is, if the only impact of stock price on a NEO's compensation is through changes in the value of share-based awards (which would be evident from the registrant's Summary Compensation Table disclosure), the registrant could not include its stock price as the company-selected measure. However, if, for example, the registrant's stock price is a market condition applicable to an incentive plan award or is used to determine the size of a bonus pool, it may be included as a registrant's company-selected measure.

Can the company-selected measure included in the pay versus performance table be measured over a multiyear period that includes the applicable fiscal year as the final year, similar to the use of multiyear measurement periods for calculating TSR, as long as such performance period is used consistently for all years in the table?

No. The company-selected measure is the measure which in the registrant's assessment represents the most important financial performance measure (that is not otherwise required to be disclosed in the table) used by the registrant to link compensation actually paid to the registrant's NEOs, for the most recently completed fiscal year, to company performance.

A registrant's company-selected measure must be a financial performance measure that is not otherwise required to be disclosed in the pay versus performance table. The required financial performance measures include net income and the registrant's cumulative TSR. May a registrant provide a company-selected measure that is derived from, a component of, or similar to these required measures, such as earnings per share, gross profit, income or loss from continuing operations, or relative TSR?

Yes, the company-selected measure can be any financial performance measure that differs from the financial performance measures otherwise required to be disclosed in the table that meets the definition of company-selected measure in Item 402(v)(2)(vi), including a measure that is derived from, a component of, or similar to those required measures. Any such measures also could be included as financial performance measures in the tabular list.

A registrant uses a "pool plan" to determine its annual bonus awards. Under the plan, a bonus pool is available for payout only upon achievement of a financial performance measure or the size of the pool is determined based upon the extent such measure is achieved. Once that financial performance measure is achieved, the compensation committee may allocate bonus payouts to participants in its discretion, based on criteria independent of the achievement of any financial performance measure(s). If the registrant's executive compensation does not use any other financial performance measures, may the registrant omit the tabular list and the company-selected measure and the related relationship disclosure required from its disclosure?

No. Because the size of the bonuses paid from the "bonus pool" is determined based wholly or in part on satisfying the financial performance measure, the registrant is using the financial performance measure to link the executive compensation actually paid to company performance.

Non-GAAP Measures

A registrant's company-selected measure or additional measures included in the table may be non-GAAP financial measures. The final rules specify that disclosure of a non-GAAP measure will not be subject to Regulation G and Item 10(e) of Regulation S-K; however, disclosure must be provided as to how the number is calculated from the registrant's audited financial statements.

Narrative Disclosures

Registrants must use the tabular information to provide clear descriptions of the relationships between compensation actually paid and three measures of financial performance—the registrant's TSR, the peer group's TSR, and the company-selected measure. Registrants have flexibility as to the format in which to present the descriptions of these relationships, whether graphical, narrative, or a combination of the two. Registrants also will have the flexibility to decide whether to group any of these relationship disclosures together when presenting their clear description disclosure, but any combined description of multiple relationships must be "clear."

Effective Date & Transition

Companies—other than EGCs, RICs, or FPIs—must begin to comply with these disclosure requirements in proxy and information statements that are required to include Item 402 of Regulation S-K disclosure for fiscal years ending on or after December 16, 2022.

Registrants—other than SRCs—are required to provide the disclosures for three fiscal years, in the first applicable filing after the rules became effective, and to provide disclosure for an additional year in each of the two subsequent annual proxy filings where disclosure is required.

SRC Accommodations

SRCs are only required to provide disclosure for the three most recently completed fiscal years. In addition, SRCs would only be required to provide disclosure for the last two fiscal years in the first applicable filing after the rules became effective. In addition, SRCs would not be required to disclose amounts related to pensions for purposes of disclosing executive compensation actually paid or to present peer group TSR.

Conclusion

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