

Publications

SEC Adopts “Pay Versus Performance” Executive Compensation Disclosure Rules

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On August 25, 2022, the Securities and Exchange Commission (SEC) adopted final rules¹ implementing the “Pay versus Performance” disclosure requirements mandated by Congress in the Dodd-Frank Wall Street Reform and Consumer Protection Act (Dodd-Frank Act). In April 2015, the SEC first proposed amendments to Item 402 of Regulation S-K to implement Section 14(i) of the Securities Exchange Act of 1934, as amended (the “Exchange Act”), as added by Section 953 (a) of the Dodd-Frank Act, directing the SEC to adopt rules requiring a registrant to disclose the relationship between executive compensation actually paid and the financial performance of the registrant. The April 2015 proposed amendments were not finalized, but instead the SEC reopened the comment period in January 2022 to ask whether the initial proposal should be amended to include more information on companies’ performance.

The new disclosure requirements will apply to all companies that are registered under Section 12 of the Exchange Act (registrants) and are therefore subject to the federal proxy rules, other than Emerging Growth Companies, registered investment companies and foreign private issuers. Smaller Reporting Companies (SRCs) will be permitted to provide scaled disclosures.

The final rules will become effective 30 days after publication in the *Federal Register*. Registrants must begin to comply with the new disclosure requirements in proxy statements that are required to include Item 402 executive compensation disclosure for fiscal years ending on or after December 16, 2022.

What’s Required

New Item 402(v) of Regulation S-K will require registrants to provide a table, in a prescribed format, disclosing specified executive compensation as well as financial performance measures, in each case for the registrant’s five most recently completed fiscal years, in order beginning with the most recent fiscal year.²

Compensation Disclosure Requirements in Mandated Table

- Summary Compensation Table measure of total compensation for the principal executive officer (the PEO) and, as an average, for the other named executive officers (the NEOs).
- A new “Compensation Actually Paid” measure for the PEO and, as an average, for the other NEOs, differing from the Summary Compensation Table measure of total compensation as follows:
 - Instead of including the full change in actuarial present value of defined benefit plans, the new measure includes only the “service cost” attributable to services by the PEO and the other NEOs during the applicable fiscal year and the “prior service cost” attributable to new benefits accrued during the applicable fiscal year in connection with services by the PEO and the other NEOs performed in prior periods. Service cost and prior service cost are both determined in accordance with the methodology otherwise used by the registrant.
 - Instead of including the full value of equity awards (i.e., stock awards and option awards), the new measure only includes:
 - the fair value as of the end of the covered fiscal year of all equity awards granted during such year that remain outstanding and unvested at the end of such year;
 - the year-over-year change in the fair value (whether positive or negative) of any equity awards granted in any prior fiscal year that are outstanding and unvested at the end of the covered fiscal year;
 - the fair value as of the vesting date of any equity awards that are granted and vest in the same year;
 - the change in fair value (whether positive or negative) from the prior fiscal year end to the vesting date for any equity 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; and
 - the dollar value of any dividends or other earnings paid on equity awards in the covered fiscal year prior to the vesting date that are not otherwise reflected in the total compensation for the covered fiscal year.

There are special rules for any option or stock appreciation right that has had an amended exercise price during a fiscal year. Awards that are subject to performance conditions must calculate the change in fair value based upon the probable outcome of the conditions, measured as of the last day of the fiscal year.

Performance Disclosure Requirements in Mandated Table

- Cumulative total shareholder return (TSR) for the registrant over the periods designated in the final rules.
- Cumulative TSR for the registrant’s peer group, which is to be the same index or group of issuers used for purposes of the performance graph required by Item 201(e) of Regulation S-K, over the periods designated in the final rules.
- The registrant’s net income for each fiscal year.
- An amount for each fiscal year attributable to an additional “financial performance measure”³ (other than a measure already described in the table) that the registrant deems the most important financial

performance measure used by the registrant to link compensation actually paid to the registrant's PEO and other NEOs, for the most recently completed fiscal year, to company performance (the "Company-Selected Measure").

New Item 402(v) will also require a registrant to provide a clear description (graphically, narratively or using a combination of presentation formats) of the relationships between each of the financial performance measures included in the table, in each case across the last five completed fiscal years -- the cumulative TSR of the registrant; the registrant's net income; and the Company-Selected Measure -- and the executive compensation actually paid to the registrant's PEO and, on average, to the registrant's other NEOs over the registrant's five most recently completed fiscal years. A registrant will be required to also include a description of the relationship between the registrant's cumulative TSR and its peer group's cumulative TSR over the same period.

A registrant will also be required to provide a tabular list of three to seven financial performance measures that the registrant determines are its most important financial performance measures to link compensation actually paid to the registrant's NEOs, for the most recently completed fiscal year, to company performance (the Tabular List). A registrant is permitted, but not required, to include non-financial performance measures in the Tabular List if the registrant considers such measures to be among the registrant's three to seven "most important" performance measures, as long as the registrant has disclosed its most important three financial performance measures. Provision is made within the final rules for modification of the performance measures to be included in the Tabular List if a registrant has used fewer than three financial performance measures to link compensation actually paid to the NEOs, for the most recently completed fiscal year, to company performance.

Registrants will be required to use Inline XBRL to tag their "Pay versus Performance" disclosure. However, an SRC will only be required to provide the required Inline XBRL data beginning in the third filing in which the SRC provides "Pay versus Performance" disclosure, instead of the first.

What's Ahead

The "Pay versus Performance" disclosure requirements are detailed and will require the collection of information not previously disclosed in other executive compensation tables and narrative. Communication between each registrant's financial reporting team and executive compensation team will be more important than ever. As with prior releases of final executive compensation disclosure rules, we anticipate the SEC will provide interpretative guidance in the coming months. In the interim, please contact your Vorys attorney if you have any questions about the "Pay versus Performance" disclosure rules and how they will impact your company's proxy statement disclosures in the 2023 Proxy Season.

¹ See SEC Release No. 34-95607: "Pay Versus Performance" dated August 25, 2022 (<https://www.sec.gov/rules/final/2022/34-95607.pdf>) and the related Fact Sheet (<https://www.sec.gov/files/34-95607-fact-sheet.pdf>)

² Registrants, other than SRCs, have the option to provide the information for three years (instead of five years) in the first proxy statement in which they provide the disclosure, adding another year of disclosure in each of the two subsequent annual proxy statements that require the disclosure. SRCs will initially be required to provide the information for two years, adding an additional year in the subsequent annual proxy statement that requires the disclosure.

³ For purposes of Item 402(v), “financial performance measures” include measures that are determined and presented in accordance with the accounting principles used in preparing the registrant’s financial statements, any measures that are derived wholly or in part from such measures, and stock price and TSR.