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SEC Adopts Pay Versus Performance Disclosure Rules With Important Impacts On Public Companies

September 20, 2022

Highlights

The SEC has adopted broad new rules requiring public companies to disclose the relationship between executive compensation actually paid and financial performance

The new rules apply to all reporting companies, with some exceptions and with scaled disclosures permitted for smaller reporting companies

For calendar year companies, the new disclosures will be required in proxy statements and information statements beginning with the 2023 proxy season

On August 25, 2022, the Securities and Exchange Commission (SEC) adopted final rules requiring public companies to disclose the relationship between executive compensation actually paid and the financial performance of the company, also known as the pay versus performance requirement.

Pay versus performance was mandated by the Dodd-Frank Wall Street Reform and Consumer Protection Act of 2010, and the SEC initially proposed rules to implement the mandate in April 2015. However, final pay versus performance rules were not adopted until this summer after the SEC reopened the comment period for the proposed rule in January 2022 and made this a priority for its 2022 rulemaking agenda.

The final rules added a new Item 402(v) to Regulation S-K requiring public companies to disclose in proxy and information statements which include executive compensation disclosures under Regulation S-K Item 402 information reflecting the relationship between executive compensation actually paid by the company and the company's financial performance over the time horizon of the required disclosure. The new rules apply to all reporting companies except for foreign private issuers (FPIs), registered investment companies, and emerging growth companies (EGCs). However, smaller reporting companies (SRCs) will be permitted to provide scaled disclosures.

The new rules will become effective on Oct. 11, 2022. Public companies will need to comply with these new disclosure requirements for proxy and information statements for fiscal years ending on or after Dec. 16, 2022. Accordingly, calendar year companies will need to comply with the new disclosure requirements for the 2023 proxy season. For newly public companies, they will only need to provide pay versus performance disclosures for years they were a reporting company pursuant to Section 13(a) or Section 15(d) of the Exchange Act.

Phase-In Periods

The following summarizes the SEC's phase-in periods for the disclosure requirements under the new rules:

- For companies covered by the new rules (other than SRCs):
    - Year 1: Provide pay versus performance disclosure for the ***three*** most recently completed fiscal years. *Inline XBRL tagging is required.*
    - Year 2: Provide pay versus performance disclosure for the ***four*** most recently completed fiscal years. *Inline XBRL tagging is required.*
    - Year 3: Provide pay versus performance disclosure for the ***five*** most recently completed fiscal years. *Inline XBRL tagging is required.*
- For smaller reporting companies (SRCs):
    - Year 1: Provide pay versus performance disclosure for the ***two*** most recently completed fiscal years.
    - Year 2: Provide pay versus performance disclosure for the ***three*** most recently completed fiscal years.
    - Year 3: Provide pay versus performance disclosure for the ***three*** most recently completed fiscal years. *Inline XBRL tagging is required.*

Disclosure Requirements

The final rules include, among other things, the following new disclosure requirements to be included in proxy statements and information statements in which executive compensation disclosure is also required:

- **Pay Versus Performance Table**: Companies will be required to provide a table with certain executive compensation and financial performance measures for the registrant's five most recently completed fiscal years (or, in the case of SRCs, two years of data in the first applicable filing, and three years of data thereafter). The table will include, for the chief executive officer (CEO) and, as an average, for the other named executive officers (NEOs), the Summary Compensation Table measure of total compensation and a measure reflecting "executive compensation actually paid," calculated as prescribed by the new rule. Following are the financial performance measures to be included in the table:
    - total shareholder return (TSR) for the registrant;
    - TSR for the company's peer group (SRCs are not required to disclose TSR for the company's peer group);
    - the registrant's net income; and
    - a financial performance measure chosen by the registrant and specific to the registrant (the "Company-Selected Measure") that, in the registrant's assessment, represents the most important financial performance measure the company uses to link compensation actually paid to the company's NEOs to company performance for the most recently completed fiscal year (SRCs are not required to disclose a Company-Selected Measure).

In addition, companies are required to use the information in the pay versus performance table to provide clear descriptions of the relationships between compensation actually paid and the three measures of financial performance identified in the table (which are TSR, net income and the Company-Selected Measure). Companies are also required to provide a clear description of the relationship between the registrant's TSR and the TSR of a peer group chosen by the registrant. The descriptions are required to address the time horizon of the required disclosures in the table. These types of disclosures may be particularly challenging for companies to draft.

- **Tabular List of Financial Measures**: A company (other than an SRC) will be required to disclose an unranked list of three to seven financial performance measures that the company determines are its most important measures to link executive compensation actually paid during the fiscal year to company performance (the Tabular List). Companies are allowed, but not required, to include non-financial measures in the list if they considered such measures to be among their three to seven “most important” measures.

The “most important” determination is made on the basis of looking only to the most recently completed fiscal year, as opposed to the time horizon of the disclosure for the pay versus performance table described above. The SEC is not requiring companies to provide the methodology used to calculate the measures included in the Tabular List. However, they should consider if such disclosure would be helpful to investors to understand the measures included in the Tabular List, or necessary to prevent the disclosure from being confusing or misleading. Further, if a company discloses a measure that is not a financial measure under GAAP, it must also disclose how the number is calculated from its audited financial statements.

A company can provide the Tabular List in three separate ways: (i) as a single list with respect to all NEOs, (ii) two separate lists, one for the CEO and one for the other NEOs, or (iii) separate lists for the CEO and each of the other NEOs.

- **Executive Compensation Actually Paid**: The final rule defines “executive compensation actually paid” under Item 402(v) of Regulation S-K as the total compensation as reported in the Summary Compensation Table, modified to adjust the amounts included for pension benefits and equity awards. However, SRCs are not required to disclose amounts related to pensions for purposes of disclosing executive compensation actually paid. The new formulas for calculating “executive compensation actually paid” for the pay versus performance disclosures are complex and will likely be time consuming for companies. For example, amounts for equity awards will be calculated differently than from the grant date fair values presented in the Summary Compensation Table or the value of equity awards realized upon vesting in the Options Exercised and Stock Vested Table.

- **Voluntary Supplemental Disclosures**: The new rules allow registrants to provide additional pay versus performance information beyond what is specifically required by Item 402(v) of Regulation S-K, as long as it would not be misleading and would not obscure the required information. Any supplemental measures of compensation or financial performance and other supplemental disclosures provided by public companies must be clearly identified as supplemental, not misleading, and not presented with greater prominence than the disclosure required under the new rules.

Practical Considerations

The new disclosure requirements under Reg. S-K Item 402(v) are likely to have important practical impacts on registrants.

First, the new disclosure requirements may be challenging and require complicated calculations. The compilation of the financial measures and data to be included in the new tables will likely be time consuming and require critical analysis to determine the most desirable and useful manner of presentation, both for the company and shareholders. Accordingly, we recommend that companies start planning ahead soon for the 2023 proxy season and the new disclosures that will be required.

In particular, companies may want to begin considering early on which financial performance measure to select as their Company-Selected Measure, as well as which three to seven financial measures to include in the Tabular List. In addition, companies should begin preparing for the narrative discussions that will appear in the pay versus performance disclosures. As XBRL tagging will also be required for non-SRCs in the first year, we suggest companies build in sufficient time to complete that step in their proxy season calendars.

Companies also should be prepared for the impact the pay versus performance disclosures will have on their “say-on-pay” shareholder advisory votes on executive compensation. As a result of the new rules, companies now will be required to provide a direct comparison between the company’s financial performance and the compensation the company pays its named executive officers. Moreover, this comparison will be presented in the same proxy statement where shareholders are being asked to approve NEO compensation (albeit in an advisory fashion).

While shareholders have had the financial information necessary to make these comparisons at their fingertips for years, for the first time companies will be required to directly link, in one place in the proxy statement, performance to compensation. This may provide shareholders (particularly, activist shareholders) with a foundation to vote against the say-on-pay proposal if the company’s performance does not correlate to the level of disclosed executive compensation. If a company’s say-on-pay vote fails or receives an elevated level of “against” votes upon the inclusion of the pay versus performance disclosures, the company should be prepared to address this matter with its board and shareholder base, including through increased shareholder outreach efforts throughout the year in preparation for the company’s next say-on-pay vote.

Companies also should be prepared for activist shareholders to use a company’s pay versus performance disclosures against the company in dissident communications, demand letters, or proxy contests if financial performance lags compensation growth. This is acutely important in the current economic environment facing most public companies. Therefore, companies should consider using critical analysis in crafting their pay versus performance disclosures and be ready to justify any divergence between performance and compensation.

Finally, companies should inform and educate their finance departments, human resources staff, board, and compensation committees now regarding the new disclosure rules and the practical effects they may have on the upcoming proxy season. Mock-ups of the new disclosures should be prepared now in preparation for the 2023 proxy season, because the new disclosures will be more time-consuming than companies may think.

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