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Publications

SEC Finalizes "Pay-Versus-Performance" Rules Under Dodd-Frank Act

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On August 25, the Securities and Exchange Commission ("SEC") adopted the final rules that require a public company to disclose the relationship between the compensation of its top executives and the company's financial performance. 87 Fed. Reg. 55134 (Sept. 8, 2022). The "pay-versus-performance" rule is the most recent set of rules issued by the SEC under the Dodd-Frank Wall Street Reform and Consumer Protection Act (the "Dodd-Frank Act"), enacted in 2010.

In April 2015, the SEC proposed amendments to the pay-versus-performance requirement, and in January 2022, reopened the comment period for the proposed rules ("Reopening Release") where they considered adopting additional disclosure requirements. We previously discussed the proposed pay-versus-performance rule in our May 1, 2015 client update, available here. While closely resembling the proposed rules in most respects, the final rules include several important changes identified below. The following is a brief summary of the 64 pages of *Federal Register* content.

New Pay-Versus-Performance Table

The final rules require public companies to include in their annual proxy or information statements a new table setting forth the following information for each of the last five fiscal years. The first four measures listed below relate to a company's executive compensation, while the last four relate to the company's financial performance. The last two company financial performance measures were just added.

- the principal executive officer's ("PEO") ***total*** compensation from the summary compensation table;
- the compensation "actually paid" to the PEO;
- the ***total*** average compensation for other named executive officers ("NEOs");
- the average compensation "actually paid" to the NEOs;
- the total shareholder return ("TSR") for the company;
- TSR for the company's peer group, which group is chosen by the company;

- the company's net income; and
- a financial performance measure, selected by and specific to the company (Company-Selected Measure), which represents the most important financial performance measure that the company uses to relate the "compensation actually paid" to its NEOs to company performance for the most recently completed fiscal year.

Clear Description Comparing Pay with Performance

The final rules require the table to be accompanied by clear descriptions, over the last five fiscal years, of the relationships between the following measures: (1) executive compensation actually paid and the company's TSR, (2) the company's TSR and the peer group TSR, (3) executive compensation actually paid and net income and (4) executive compensation actually paid and the Company-Selected Measure. The last two required descriptions were added by the final rules.

Unranked List of Financial Performance Measures

A new rule requires companies (other than small reporting companies ("SRCs")) to provide an unranked list of three to seven financial performance measures that are determined by the company to be the most important. A company may include non-financial measures as their three to seven most important measures. Similar to the Company-Selected Measure, the list should link the compensation actually paid to the company's NEOs to the company's performance for the most recently completed fiscal year. However, if the company actually uses fewer or no financial performance measures, then strict compliance with the numerical minimum of three measures is not required.

Executive Compensation Actually Paid

The final rules modify the calculation of "executive compensation actually paid," requiring more details, including more frequent updates on equity award values, than the proposed rules. Executive compensation "actually paid" means total compensation as reported on the Summary Compensation Table ("SCT Total Compensation"), with certain adjustments for pension benefits, equity awards, and other earnings. The adjustments are intended to mitigate the timing mismatch between when compensation is attributed and the period that the corresponding performance is reported.

Specifically, the executive compensation actually paid is defined as SCT Total Compensation reduced by (1) the fair value of equity awards on the grant date and (2) the aggregate change in present value of all defined benefit and actuarial pension benefits, each as reported in the summary compensation table, but including, among others, the following adjustments:

- For equity awards granted in the covered fiscal year, the addition of the fair value of such awards determined at year-end or at vesting, as applicable;
- For equity awards granted in prior years, the addition or subtraction of the change in fair value of such awards determined at year-end or at vesting, as applicable, and compared against the end of the prior fiscal year;
- The addition of any above-market or preferential earnings on deferred compensation that is not tax qualified;
- The addition of the actuarially determined value of service cost for services provided by the executive during the covered fiscal year under all defined benefit pension plans, calculated in accordance with generally accepted accounting principles ("GAAP"); and
- The addition or subtraction of the value of benefits granted (or reduced) by a plan amendment to any defined benefit pension plan (or adoption of a new defined benefit pension plan) during the covered fiscal year that takes into account, in its benefit formula, any services of the executive prior to the date of such amendment, calculated in accordance with GAAP.

Other Key Points:

- **Five-year Time Period and Transition Rule:** The final rules generally require public companies (other than SRCs) to provide disclosure for the five most recently completed fiscal years subject to a transition period that requires only three years of data in their first table (two years for SRCs) as companies adjust to the full five-year requirement. Over the next two years, companies must add to their annual filings one additional year of data each year.

- **Multiple PEOs Across Five Year Period:** The final rules remove and replace a proposed requirement– instead of requiring aggregation of PEO compensation in years where a company had multiple PEOs, the rules require new columns to be added to the table for each additional PEO.
- **NEO Identification:** The final rules add an identity/compensation footnote requirement for individual NEOs—they require that in a footnote companies identify each individual NEO who is included in the average for each year.
- **Peer Group Comparisons:** The final rules require companies to compare their own TSR to the TSR of its peer group members. Companies may use either the peer group used for purposes of Item 201(e) of Regulation S-K or a peer group used in the Compensation Discussion and Analysis ("CD&A") portion of their proxy statement for purposes of disclosing company's compensation benchmarking practices. In either case, the returns for each member of the peer group must be weighted based on the member's stock market capitalization at the beginning of the relevant measurement period.

The final rules require companies to disclose the identities of the issuers comprising the peer group in a footnote if the peer group is not a published industry or line of business index. The footnote requirement may be met by referring to peer groups disclosed in prior filings. Moreover, if the peer group changes from the group used in the previous fiscal year, the company is required to include tabular disclosure of the peer group TSR for the new peer group (for all years in the table). The company must use a footnote to explain the reason for the change and compare the company's TSR to that of both the old and new group.

- **New Requirement to Disclose Net Income:** The final rules add to the tabular disclosure a "net income" column as well as a required description for net income for the respective year of service. The latter requires that the company clearly describe the relationship of net income to executive compensation actually paid, in narrative or graphical form, or a combination of the two. Unlike the Reopening Release, the final rules do not require disclosure of income or loss before income tax expense.

What's Next?

The final rules are effective October 11, 2022, and apply for proxies and information statements covering fiscal years ending on or after December 16, 2022. Essentially, the new requirements will supplement a public company's CD&A. Companies have flexibility in determining where in the proxy or information statement they include the required disclosures. Initially the table must cover only three fiscal years, rather than five, as noted above.

We expect the final rules to begin applying to proxies and information statements filed in 2023. Although the transition rule only requires data for the three most recently completed fiscal years, compliance with these rules is different than the technical information currently required in proxy statement filings (*e.g.*, re-calculating fair value calculations for each equity award in computing "compensation actually paid"). As a result, the manner in which data must be calculated makes both the collection and calculation of such data under the final rules costly and time consuming. Therefore, companies should begin drafting and planning annual disclosures well before their annual proxy statements are due.

Please contact any of our Groom attorneys for assistance in this area, such as for items affecting nonqualified retirement benefits, incentive plans and stock-based compensation.

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