August 30, 2022

SEC Adopts Final Pay versus Performance Disclosure Rule

On August 25, 2022, the Securities and Exchange Commission (SEC) finalized its long-delayed pay versus performance disclosure rule, as required by Section 953(a) of the Dodd-Frank Wall Street Reform and Consumer Protection Act (Dodd-Frank Act).[1] The final rule requires public companies (with certain exceptions) to describe the relationship between the compensation "actually paid" to their named executive officers (NEOs) and the financial performance of the company, generally over a five-year period. The rule is effective for proxy and information statements for fiscal years ending on or after December 16, 2022 and will be implemented through a new Item 402(v) of Regulation S-K.

In this Alert, we describe the scope and application of the final rule.

Covered Entities

The pay for performance disclosure will be required for all reporting companies other than emerging growth companies, registered investment companies and foreign private issuers. Smaller reporting companies (SRCs) will be permitted to provide scaled disclosure.

Overview of Final Rule

For covered reporting companies, the final rule generally adds three new disclosure components to any proxy or information statement for which executive compensation disclosure under Item 402 of Regulation S-K is required:

I. **Pay-versus-Performance Table** – A standardized table containing, for each of the company's last five completed fiscal years (three fiscal years for SRCs):
   - the total compensation reported in the summary compensation table for the company's principal executive officer (PEO) and, as an average, for its other NEOs;
   - the total compensation actually paid to the company's PEO and, as an average, to its other NEOs;
   - the total shareholder return (TSR) for the company;
   - the TSR of the company's peer group (not required for SRCs);
   - the company's net income; and
   - a company-selected performance measure (the Company-Selected Measure) (not required for SRCs).

II. **Relationship Disclosure** – A description, depicted either graphically, narratively or in a combination of the two, covering the company's five most recently completed fiscal years (three fiscal years for SRCs), of the relationships between the compensation actually paid to the company's PEO and the average compensation actually paid to its other NEOs to:
   - the company's TSR;
   - the net income of the company; and
   - a Company-Selected Measure (not required for SRCs).

   In addition, for companies other than SRCs, this disclosure must include a description, depicted either graphically, narratively or in a combination of the two, covering the relationship between the company's TSR and its peer group's TSR for the company's five most recently completed fiscal years.

III. **Tabular List** – A table that discloses an unranked list of at least three, and up to seven, of the most important financial performance measures the company used to link compensation actually paid to its PEO and NEOs during the most recently completed fiscal year to its performance (not required for SRCs).

Manner and Location of Disclosure

The final rule provides companies flexibility in determining where in the proxy or information statement to provide the required disclosure and does not require the disclosure to be included in the Compensation Discussion and Analysis (CD&A). Other than the required Pay-versus-Performance Table, the other required components of the final rule may be disclosed graphically (but are not required to be).

I. Pay-versus-Performance Table

Below is a depiction of the Pay-versus-Performance Table required by the final rule, with an asterisk indicating requirements that do not apply to SRCs. Companies are permitted to supplement the tabular disclosure, as long as any additional disclosure is clearly identified as supplemental, is not misleading, and is not presented with greater prominence than the required disclosure.

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	Value of Initial Fixed $100 Investment Based On:		Net Income	[Company-Selected Measure]*
					Total Shareholder Return	Peer Group Total Shareholder Return*		
(a)	(b)	(c)	(d)	(e)	(f)	(g)	(h)	(i)
Y1								
Y2								
Y3								
Y4*								
Y5*								

In the event that there are multiple PEOs in a given year, the final rule requires companies to include columns for each PEO. Companies must identify in footnote disclosure to the table the individual NEOs included in the average for each year, so that investors can consider whether changes in the average compensation reported from year to year were due to compositional changes in the group of included NEOs.

A. Determination of Compensation "Actually Paid"

The final rule provides that compensation "actually paid" is the total compensation reported in the summary compensation table, with the following adjustments for pension benefits (other than for SRCs) and equity awards:

Pension Benefit Modifications	-	Aggregate change in actuarial present value of the NEO's accumulated benefit under all defined benefit and actuarial pension plans (as reported in summary compensation table)
	+	Sum of (i) service cost[x] and (ii) prior service cost[y] for all defined benefit and actuarial pension plans

[x] Service cost is calculated as the actuarial present value of each NEO's benefit under all such plans attributable to services rendered during the covered fiscal year.

[y] Prior service cost is the entire cost of benefits granted (or credit for benefits reduced) in a plan amendment (or initiation) during the covered fiscal year that are attributed by the benefit formula to services rendered in periods prior to the amendment. Both service cost and prior service cost must be calculated using the same methodology as used for the company's financial statements under GAAP.

Equity Award Modifications	-	Summary compensation table amounts representing aggregate grant date fair value of stock and option awards (computed in accordance with FASB ASC Topic 718)
	+	Fair value as of the end of the covered fiscal year of all awards granted during the covered fiscal year that are outstanding and unvested at the end of the covered fiscal year

- \+ Change in fair value as of the end of the covered fiscal year (from the end of the prior fiscal year) of any awards granted in any prior fiscal year that are outstanding and unvested as of the end of the covered fiscal year
- \+ Fair value as of the vesting date of any awards that are granted and vest in the same year
- \+ Change in fair value as of the vesting date (from the end of the prior fiscal year) of any 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
- \- Fair value at the end of the prior fiscal year for any awards granted in any prior fiscal year that fail to meet the applicable vesting conditions during the covered fiscal year
- \+ 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 included in the total compensation for the covered fiscal year

Fair value measurements are computed in a manner consistent with the company's financial statements under GAAP, with the change in fair value for any awards subject to performance conditions calculated based on the probable outcome of such conditions as of the last day of the fiscal year.

Other than the adjustments described above, the amounts included in the Pay-versus-Performance Table are generally the same as those reported in the summary compensation table, reflecting the SEC's belief that to the extent the summary compensation table approach aligns with the Dodd-Frank language of "actually paid" and the purpose of the disclosure, adjustments to the summary compensation table figures should be minimized. As a result, companies are not permitted to voluntarily exclude unvested amounts of deferred compensation that are not tax qualified, nor are they permitted to remove signing bonuses, severance, or other one-time payments from the amount of compensation actually paid.

B. TSR and Peer Group TSR

The Pay-versus-Performance Table requires companies to disclose their TSR and, for covered reporting companies other than SRCs, the weighted (based on market capitalization) TSR of their peer group. For this purpose, TSR is generally calculated in the same manner as under Item 201(e) of Regulation S-K and is measured from the market close on the last trading day before the company's earliest fiscal year in the table through and including the end of the fiscal year for which TSR is being calculated (i.e., the TSR for the first year in the table will represent the TSR over that first year, the TSR for the second year will represent the TSR over the first and the second years, etc.). Both TSR and peer group TSR should be calculated based on a fixed investment of one hundred dollars at the applicable measurement point.

For peer group TSR, companies can use either the same peer group used for purposes of Item 201(e) disclosure or the peer group used for purposes of the company's disclosures in the CD&A. If the peer group is not a published industry or line-of-business index, the companies composing the group must be disclosed in a footnote. If a company changes its peer group from the one used in the previous fiscal year, it must explain, in a footnote, the reason for the change, and compare its TSR to that of both the old and the new peer groups.

C. Net Income

The Pay-versus-Performance Table requires companies to include net income as another indicator of company performance. According to the SEC, although net income may not be frequently used by companies in determining compensation, it is closely related to other profitability measures that companies may use in setting compensation, while also being widely understood and standardized under GAAP and International Financial Reporting Standards.

D. Company-Selected Measure

The Pay-versus-Performance Table requires companies to designate a financial performance measure, the Company-Selected Measure, which, in the company's assessment, represents the most important performance measure that is not otherwise required to be disclosed in the Pay-versus-Performance Table (i.e., it is neither TSR nor net income) that the company uses to link compensation actually paid to performance. The Company-Selected Measure may change from one year to the next, but the Pay-versus-Performance Table must include the numerically quantifiable performance for the most recent fiscal year's Company-Selected Measure for each covered fiscal year. The final rule specifies that a Company-Selected Measure may be a non-GAAP performance measure, and consistent with the disclosure of non-GAAP performance targets in the CD&A, non-GAAP performance measures will not be subject to Regulation G and Item 10(e) of Regulation S-K; however, disclosure must be provided as to how the non-GAAP performance measure is calculated from the company's audited financial statements.

Only one Company-Selected Measure is required to be included in the Pay-versus-Performance Table; however, companies may provide additional performance measures as new columns in the table so long as such additional disclosures are not misleading and do not obscure the required disclosure, and the additional performance measures are not presented with greater prominence than the required disclosure. If a company elects to provide additional performance measures in the table, each additional measure must also be accompanied by a clear description of the relationship between compensation actually paid to the company's PEO, and, on average, to the other NEOs, and that measure.

II. Relationship Disclosure

As noted above, the final rule requires companies (other than SRCs) to use the information in the Pay-versus-Performance Table to provide clear descriptions (whether graphically, narratively or in a combination of the two) of the relationships between compensation actually paid and the three measures of financial performance, as follows: (a) the compensation actually paid to the company's PEO and (b) the average of the compensation actually paid to the company's other NEOs to (i) the TSR of the company; (ii) the net income of the company, and (iii) the company's Company-Selected Measure, in each case over the company's five most recently completed fiscal years. The final rule also requires a description of the relationship between the company's TSR and the TSR of its chosen peer group over the company's five most recently completed fiscal years.

For SRCs, disclosure is only required for the company's three most recently completed fiscal years, and no disclosure is required relating to the peer group TSR or a Company-Selected Measure.

III. Tabular List

The final rule requires companies (other than SRCs) to provide a Tabular List of the most important financial performance measures used to link executive compensation actually paid during the most recently completed fiscal year to company performance. The Tabular List should generally include a minimum of three, and as many as seven, different measures, and these measures need not be ranked in order of importance. If a company considers fewer than three financial performance measures when it links executive compensation actually paid during the fiscal year to company performance, the company will be required to disclose only the number of measures it actually considers. Furthermore, if a company does not use any financial performance measures to link executive compensation actually paid to company performance, then it would not be required to present a Tabular List.

For this purpose, "financial performance measures" refers to any measures that are determined and presented in accordance with the accounting principles used in preparing the issuer's financial statements, any measures that are derived in whole or in part from such measures, and stock price and TSR, whether or not presented within the financial statements or otherwise included in a filing with the SEC. Companies are permitted to include non-financial performance measures as well in their Tabular Lists, but should they choose to do so, they must still provide at least three financial measures and no more than seven total measures in the list.

Recognizing that different performance measures may apply to different executives in determining compensation actually paid, the final rule permits the Tabular List to be depicted in three different formats:

(i) A Tabular List for the PEO and the remaining NEOs combined;

(ii) A Tabular List for the PEO and a Tabular List for the remaining NEOs combined; or
(iii) A Tabular List for the PEO and one for each individual remaining NEO.

Implementation Dates and Transition Rules

Companies must comply with the final rule in proxy and information statements that are required to include executive compensation disclosure under Item 402 of Regulation S-K for fiscal years ending on or after December 16, 2022. The final rule includes a two-year transition period, during which a non-SRC covered reporting company may provide the disclosure required by the final rule for three years, instead of five years, in the first filing in which it is required to provide this disclosure, and may provide disclosure for an additional year in each of the two subsequent annual filings in which this disclosure is required. SRCs are permitted to provide two years of disclosure, instead of three, in the first applicable filing after the rules become effective. In addition, newly public companies are only required to provide disclosure for years that they were a reporting company pursuant to Section 13(a) or Section 15(d) of the Securities Exchange Act of 1934.

Companies, together with their compensation committees, should begin to consider the process for complying with the final rule. In particular, consideration should be given to determining the appropriate peer group (in the case of companies that are not SRCs) and performance measures (including the Company-Selected Measure) for the disclosure as well as how they fit in with the company's prior disclosure on the relationship between pay and performance.

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If you would like to learn more about the issues in this Alert, please feel free to contact any member of Ropes & Gray's securities & public companies or executive compensation & employee benefits practice groups or your usual Ropes & Gray contact.

[1] Section 953(a) of the Dodd-Frank Act added Section 14(i) to the Securities Exchange Act of 1934, which mandates that the SEC shall, by rule, require each issuer to disclose in any proxy or consent solicitation material for an annual meeting of the shareholders of the issuer a clear description of any compensation required to be disclosed by the issuer under Item 402 of Regulation S-K (or any successor thereto), including, for any issuer other than an emerging growth company, information that shows the relationship between executive compensation actually paid and the financial performance of the issuer, taking into account any change in the value of the shares of stock and dividends of the issuer and any distributions. Section 14(i) also states that an issuer may include a graphic representation of the information required to be disclosed.