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SEC Releases Final Pay Versus Performance Rules

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On August 25, 2022, the Securities and Exchange Commission ("SEC" or "Commission"), in a 3-to-2 vote, adopted final rules implementing the pay versus performance disclosure requirement called for under Section 953(a) of the Dodd-Frank Wall Street Reform and Consumer Protection Act (the "Dodd-Frank Act"). The final rules require proxy statements or information statements that include executive compensation disclosures to include a new compensation table setting forth for each of the five most recently completed fiscal years, the "executive compensation actually paid" (as defined in the final rule) to the company's principal executive officer ("PEO") and the average of such amounts for the company's other named executive officers ("NEOs"), total compensation as disclosed in the Summary Compensation Table for the PEO and the average of such amounts for the other NEOs, total shareholder return (TSR), peer group TSR, net income and a company-selected financial measure that represents the "most important financial measure" used by the company to link compensation actually paid to company performance. In addition, based on the information set forth in the new table, a company must provide a clear description of the relationship between each of (1) the executive compensation actually paid to the PEO and to the non-PEO NEOs and the company's TSR, the company's net income and the company-selected financial measure over the previous five years, and (2) the company's TSR and the TSR of a peer group chosen by the company. Finally, the rule requires companies to provide a list of three to seven other financial performance measures that the company determines are its most important measures "used to link compensation actually paid . . . to company performance."

The final rule release is available here, and the SEC's pay versus performance fact sheet is available here. The final rule will become effective 30 days after its publication in the Federal Register, and companies will be required to comply with the requirements in proxy and information statements that are required to include executive compensation disclosures for fiscal years ending on or after December 16, 2022. Set forth below is a summary of the final rules and considerations for companies.

Summary of the Final Rules

New Tabular Disclosure under Item 402(v) of Regulation S-K. Section 953(a) of the Dodd-Frank Act instructs the Commission to adopt rules requiring companies to provide "a clear description of . . . information that shows the relationship between executive compensation actually paid and the financial performance of the issuer." To address this mandate, Item 402(v) of Regulation S-K will now require companies to include a new table (set forth below) in any proxy statement or information statement setting forth executive compensation disclosure, reporting:

- The "executive compensation actually paid" to the PEO and the total compensation reported in the Summary Compensation Table for the PEO. If more than one person served as the PEO during the covered fiscal year, then each PEO would be reported separately in additional columns with information provided for the applicable year such individual was a PEO.

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- An average of the “executive compensation actually paid” to the remaining NEOs and an average of the total compensation reported in the Summary Compensation Table for the remaining NEOs. Footnote disclosure of the names of individual NEOs and the years in which they are included is also required.
- The company’s cumulative annual TSR calculated and presented as the dollar value of an investment of $100 (i.e., in the same manner as in the Stock Price Performance Graph required under Item 201(e) of Regulation S-K).
- The cumulative annual TSR of the companies in a peer group chosen by the company (which must be the same index or peer group used for the purposes of Item 201(e) or, if applicable, the peer group used for purposes of the Compensation Discussion and Analysis disclosures). Footnote disclosure of any year-over-year changes in peer group constituent companies as well as the reasons for any such change will be required along with a comparison of the issuer’s cumulative annual TSR with that of both the new and prior fiscal year peer group.
- The company’s net income for the fiscal year calculated in accordance with U.S. GAAP.
- A financial performance measure chosen by the company (the “Company-Selected Measure”) that the company has determined represents the “most important financial performance measure” that the company uses to link compensation actually paid to the NEOs to company performance for the most recently completed fiscal year. If such measure is a non-GAAP measure, disclosure must be provided as to how the number is calculated from the issuer’s audited financial statements, but a full reconciliation is not required.

PAY VERSUS PERFORMANCE

Year (a)	Summary Compensation Table Total for PEO (b)	Compensation Actually Paid to PEO (c)	Average Summary Compensation Table Total for Non-PEO NEOs (d)		Average Compensation Actually Paid to Non-PEO NEOs (e)	Value of Initial Fixed $100 Investment Based On:	Net Income (
						Total Shareholder Return (f)	Peer Shareho

The table is required to set forth this information for each of the five most recently completed fiscal years, subject to a transition rule and certain exceptions described below.

The final rule requires companies to provide disclosure accompanying the table that “use[s] the information provided in the table . . . to provide a clear description of the relationship” between:

- Executive compensation actually paid to the PEO and the other NEOs and the company’s TSR across the last five fiscal years;
- Executive compensation actually paid to the PEO and the other NEOs and the company’s net income across the last five fiscal years;
- Executive compensation actually paid to the PEO and the other NEOs and the Company-Selected Measure; and
- The company’s TSR and the peer group TSR.

These descriptions could include narrative or graphic disclosure (or a combination of the two). If any additional, voluntary performance measures are included in the table, the disclosure must also include a description of the relationship between executive compensation actually paid to the PEO and the other NEOs and the additional performance measure across the last five fiscal years.

In addition, under the final rule companies must provide a tabular list of three to seven other financial performance measures that the company has determined represent the

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most important financial performance measures used to link compensation actually paid for the most recent fiscal year to company performance. So long as at least three of the measures are financial performance measures, the company may include non-financial performance measures in the tabular list. If fewer than three financial performance measures were used by the company to link compensation and performance, such list must include all such measures, if any, that were used.

Companies will also be required to tag each value disclosed in the table, block-text tag the footnote and relationship disclosure, and tag specific data points within the footnote disclosures in interactive data format using eXtensible Business Reporting Language, or XBRL.

"Executive Compensation Actually Paid." Under the final rule, "executive compensation actually paid" is somewhat of a misnomer, as it includes both amounts paid or earned, as well as incremental accounting valuations for unvested equity awards that may never be earned or that could have different intrinsic values when earned. For these purposes, "executive compensation actually paid" is defined as the total compensation reported in the Summary Compensation Table, with adjustments made to the amounts report for pension values and equity awards.

Pension Values. With respect to pension values, the aggregate change in the actuarial present value of all defined benefit and actuarial pension plans will be deducted from the reported total compensation, and instead "executive compensation actually paid" will include both (1) the actuarially determined service cost for services rendered by the executive during the applicable year ("service cost") and (2) the entire cost of benefits granted in a plan amendment (or initial plan adoption) during the applicable year that are attributed by the benefit formula to services rendered in periods prior to the plan amendment or adoption ("prior service cost"), in each case, calculated in accordance with U.S. GAAP. If the prior service cost is a negative amount as a result of an amendment that reduces benefits relating to prior periods of service, then such amount would reduce the compensation actually paid.

Equity Awards. With respect to the stock award and option award values, the amounts included in the Summary Compensation Table, representing the grant date fair value, will be deducted, and the following adjustments will be made, in each case, with fair value calculated in accordance with U.S. GAAP:

- For awards granted in the covered fiscal year:
    - add the year-end fair value if the award is outstanding and unvested as of the end of the covered fiscal year; and
    - add the fair value as of the vesting date for awards that vested during the year.
- For any awards granted in prior years:
    - add or subtract any change in fair value as of the end of the covered fiscal year compared to the end of the prior fiscal year if the award is outstanding and unvested as of the end of the covered fiscal year;
    - add or subtract any change in fair value as of the vesting date (compared to the end of the prior fiscal year) if the award vested during the year; and
    - subtract the amount equal to the fair value at the end of the prior fiscal year if the award was forfeited during the covered fiscal year.
- Add the dollar value of any dividends or other earnings paid on stock awards or options 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.

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Footnote disclosure is required to identify the amount of each adjustment, as well as valuation assumptions used in determining any equity award adjustments that are materially different from those disclosed as of the grant date of such equity awards.

Filings and Timing of Disclosures. Companies will be required to include the pay versus performance disclosure in all proxy and information statements that are required to include executive compensations disclosures under Item 402 of Regulation S-K for fiscal years ending on or after December 16, 2022. Under the transition rules, companies will only be required to provide disclosure for three years in the first proxy or information statement in which disclosure is provided, adding one additional year in each of the two subsequent years. In addition, disclosure is only required for fiscal years in which the company was a reporting company. The Item 402(v) disclosure will be treated as "filed" for the purposes of the Exchange Act and will be subject to the say-on-pay advisory vote under Exchange Act Rule 14a-21(a).

Issuers Subject to the Final Rules. The final rules require pay versus performance disclosure for all companies other than emerging growth companies (which are statutorily exempt from the requirements pursuant to the Jumpstart Our Business Startups Act), foreign private issuers, and registered investment companies.

Smaller reporting companies are subject to scaled disclosure requirements. They are not required to provide peer group TSR or any Company-Selected Measure, and the calculation of executive compensation actually paid may exclude amounts relating to pensions. In addition, smaller reporting companies are only required to provide disclosure for the most recent three years and are allowed initially to provide disclosure for two years, adding one additional year in the next year. Smaller reporting companies also are afforded a transition period with respect to XBRL requirements and are not required to provide inline XBRL data until the third filing in which it provides the pay versus performance disclosure.

Observations and Considerations for Companies

The new rules will require extensive calculations and disclosures. For many companies, however, the biggest challenge will be drafting disclosure that uses the information in the table to provide a clear description of the relationship between "compensation actually paid" and the prescribed performance measures. This disclosure is, appropriately, not presented in the Compensation Discussion and Analysis, as it will not necessarily relate to the performance measures utilized by a company's compensation committee in designing and awarding executive compensation. Indeed, in our experience few compensation committees (if any) currently evaluate executive compensation based on the "compensation actually paid" formula prescribed under the new rules. As such, the required description may best be viewed as an after-the-fact review of whether and how this prescriptive and non-routine measure of "compensation actually paid" aligns with the discrete measures of corporate performance prescribed under the rule, if at all. In light of this disconnect between how compensation committees evaluate performance in awarding and paying out executive compensation and how compensation and performance will be presented under the new rules, some companies may determine to include additional voluntary disclosures that reflect how they view the connection between realized or realizable compensation and corporate performance. Indeed, while the final rules check the box in fulfilling a Dodd-Frank mandate to require a pay-for-performance presentation, it's unclear whether the manner in which the Commission chose to implement the Dodd-Frank mandate justifies the time and expense that companies will need to expend to produce the disclosures and whether investors will expend the effort that would be needed to assess the disclosures.

For companies with calendar year fiscal years, the pay versus performance disclosures will be required in the 2023 proxy statement, and for companies that are not smaller reporting companies, the first year of disclosure will cover the 2022, 2021 and 2020 fiscal years. Given the substantial undertaking required to prepare the historical disclosures and

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the likelihood that significant interpretive questions will arise when applied to companies' particular facts, companies should begin preparing for the new rules now by collecting the information that will be necessary for the disclosures, particularly with respect to the historical pension and equity award adjustments for calculating executive compensation actually paid, and should begin to mock up the required table now for historical periods. In addition, companies should begin discussions regarding what financial performance measure should be utilized as the Company-Selected Measure, understanding that it should be focused on the most recently completed fiscal year (i.e., 2022 for companies with calendar year fiscal years). Consultation with the company's compensation committee and its independent compensation consultant will be key in ensuring that appropriate performance measures are utilized for both the Company-Selected Measure and in the tabular list. As well, companies should also consider whether any supplemental, voluntary disclosures or presentations may be appropriate. For instance, TSR amounts presented in the table may not align with the performance periods applicable to incentive and equity compensation awards.

The following Gibson Dunn lawyers assisted in the preparation of this alert: Krista Hanvey, Thomas Kim, Ronald Mueller, and Gina Hancock.

Gibson Dunn's lawyers are available to assist with any questions you may have regarding these issues. To learn more about these issues, please contact the Gibson Dunn lawyer with whom you usually work in the firm's Executive Compensation and Employee Benefits or Securities Regulation and Corporate Governance practice groups, or any of the following practice leaders and members:

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