Latham & Watkins Executive Compensation, Employment & Benefits Practice

August 29, 2022 | Number 3004

SEC Imposes Expansive New "Pay Versus Performance" Disclosure Requirements on Public Companies

The new rules significantly expand required disclosure of the relationship between executive compensation and performance metrics, effective for the 2023 proxy season.

Key Points:

- On August 25, 2022, the Securities and Exchange Commission (SEC) adopted Release No. 34-95607 implementing a final rule (Final Rules) that requires covered publicly traded companies to provide both tabular and narrative and/or graphical disclosure of the relationship between executive compensation "actually paid" (as defined) by the company to its named executive officers and the company's performance over a specified time period (Pay Versus Performance Disclosure). The SEC has implemented this requirement through a new paragraph (v) to Item 402 of Regulation S-K.
- Impacted companies must begin to include the Pay Versus Performance Disclosure in any **proxy or information statement covering a fiscal year ending on or after December 16, 2022**.
- The new disclosure obligations under the Final Rules will require advance planning and effort for the 2023 proxy season.
- The Pay Versus Performance Disclosure is not required for emerging growth companies, foreign private issuers, or registered investment companies.

Summary of Final Rules

Companies Covered

The Pay Versus Performance Disclosure requirements apply to all publicly traded companies, except (i) emerging growth companies, (ii) foreign private issuers, and (iii) registered investment companies. As discussed further below, smaller reporting companies (SRCs) are subject to the Final Rules but are permitted to provide scaled disclosure.

Effective Date and Format

Pay Versus Performance Disclosure is required to be included in any proxy or information statement (in which disclosure under Item 402 of Regulation S-K is required) covering any fiscal year ending on or after December 16, 2022. The disclosure is not required to be included in an Annual Report on Form 10-K or in registration statements, even if Item 402 disclosure is otherwise required.

Inline XBRL must be used to tag the Pay Versus Performance Disclosure; however, SRCs will be permitted to phase in Inline XBRL tagging as described below.

Pay Versus Performance Table

Covered companies will need to provide the Pay Versus Performance Disclosure in the tabular format provided below (Pay Versus Performance Table) for the five most recently completed fiscal years or, for SRCs, the three most recently completed fiscal years, subject to the transitional rule described below:

(a)	(b)	(c)	(d)	(e)	(f)	(g)	(h)	(i)
					Value of Initial Fixed $100 Investment Based on:			
Year	Summary Compensation Table Total for PEO ($)	Compensation Actually Paid to PEO ($)	Average Summary Compensation Table Total for Non-PEO NEOs ($)	Average Compensation Actually Paid to Non-PEO NEOs ($)	Total Shareholder Return ($)	[Peer Group Total Shareholder Return ($)]*	Net Income ($)	[Company Selected Measure]*+
Y1								
Y2								
Y3								
[Y4]*								
[Y5]*								

**Not included for SRCs.*

+Column title to be replaced with the company's most important financial performance measure (e.g., Total Revenue).

Fiscal Year — *Column (a)*

The information provided in the Pay Versus Performance Table should generally cover the company's five most recently completed fiscal years or, for SRCs, the three most recently completed fiscal years.

However, to provide some transitional relief, the SEC will permit a company, for the first year in which the Pay Versus Performance Table is required, to limit the disclosure to only the three most recently completed fiscal years (or, for SRCs, the two most recently completed fiscal years). Thereafter, an additional year will be added in each subsequent annual filing in which the Pay Versus Performance Disclosure is required until the company discloses the requisite information for the five most recently completed fiscal years (or, for SRCs, the three most recently completed fiscal years).

Summary Compensation Table Total — *Columns (b) and (d)*

For each fiscal year covered by the Pay Versus Performance Table, the company must include (i) the total compensation of its Principal Executive Officer (PEO), as reported in the Summary Compensation Table (SCT), for the covered fiscal year (*column (b)*), and (ii) the average of the total compensation, as reported in the SCT, for all named executive officers (other than the PEO) for the covered fiscal year (*column (d)*).

If more than one PEO served during a covered fiscal year, the compensation for each PEO should be presented separately with added column(s) (i.e., the company would add an additional column (b) and column (c) for each person who served as PEO during a covered fiscal year).

Compensation Actually Paid — *Columns (c) and (e)*

For each fiscal year covered by the Pay Versus Performance Table, the company must also include (i) the compensation "actually paid" to its PEO (*column (c)*), and (ii) the average of the compensation "actually paid" to its other named executive officers (other than the PEO) for the covered fiscal year (*column (e)*).

Under the Final Rules, the compensation "actually paid" to a named executive officer is calculated for a given fiscal year by adjusting the officer's total compensation, as reported in the SCT, for certain amounts relating to defined benefit pension plans and equity awards, as follows:

Step 1: Start with the officer's SCT "total compensation" for the covered fiscal year

Step 2: Make adjustments for equity award values —The Final Rules require companies to replace the grant date fair value of stock and option awards from the SCT (equity awards) with the fair value of the equity awards as determined under the Final Rules, which generally includes the fair value as of the specified fiscal year-end valuation dates or, if earlier, the vesting date during the year, plus dividends paid during the fiscal year (Adjusted Equity Award Value).

The Adjusted Equity Award Value will generally be taken into account in the officer's compensation "actually paid" as follows:

- **Subtract** any value reported under the "*Stock Awards*" or "*Option Awards*" columns in the SCT for the covered fiscal year from the officer's SCT "total compensation" for such year.

For equity awards granted during the covered fiscal year:

- **Add** the fair value determined as of the end of the covered fiscal year of any unvested equity awards held as of the end of the covered fiscal year.
- **Add** the fair value determined as of the applicable vesting date of any equity awards that were granted and vested during the covered fiscal year.
- **Ignore** any equity awards that were both granted and forfeited or determined not to be eligible to vest during the covered fiscal year.

For equity awards granted prior to the covered fiscal year:

- **Add** (or **subtract**) — with respect to any unvested equity awards held as of the end of the covered fiscal year, the change in fair value of the equity award from the end of the prior fiscal year to the end of the covered fiscal year.
- **Add** (or **subtract**) — with respect to any equity awards that vested during the covered fiscal year, the change in fair value of the equity award from the end of the prior fiscal year to the date on which the equity award vested in the covered fiscal year.

- **Subtract** the fair value determined as of the end of the prior fiscal year of any equity awards that failed to meet applicable vesting conditions during the covered fiscal year.

Add dividends if not accounted for:

- **Add** the dollar value of any dividends or distributions paid on any equity awards in the covered fiscal year prior to the applicable vesting date, to the extent that such dividends or distributions paid are not already included in the SCT.

Fair value determinations for this purpose are to be computed in a manner consistent with the fair value methodology used to account for share-based payments in the company's financial statements under generally accepted accounting principles (GAAP) (i.e., Financial Accounting Standards Board Accounting Standards Codification 718 (FASB ASC 718)), with performance awards that remain unvested at the end of the fiscal year to be valued based on probable outcome of the performance conditions as of the last day of such fiscal year.

Step 3: Make adjustments for pension plan amounts — The Final Rules require companies to replace the change in the actuarial present value of the officer's accumulated benefit under all defined benefit and actuarial pension plans from the SCT with the "service cost" for such plans (the Adjusted Pension Value).

The Adjusted Pension Value will generally be taken into account in an officer's compensation "actually paid" as follows:

- **Subtract** the aggregate change in the actuarial present value of the officer's accumulated benefit under all defined benefit and actuarial pension plans if included in the SCT (the change in actuarial present value would be deducted only if the value is positive, and therefore included in the SCT) from the officer's SCT "total compensation" for such year.

- **Add** the "service cost" (as defined under FASB ASC 715 as the actuarial present value of benefits attributed to services rendered by the officer during the covered year) and "prior service cost" (applicable to plan amendments or initiations) for all defined benefit and actuarial pension plans reported in the SCT for the covered fiscal year. Service cost and prior service cost are to be calculated in accordance with GAAP.

Step 4: Disclose executive compensation "actually paid" — Once the compensation "actually paid" to the named executive officers is calculated in accordance with the foregoing, the Final Rules require the company to disclose (by footnote) each of the following: (i) the adjustments made (if any) to determine compensation "actually paid" (as described in Steps 1 through 3 above), (ii) any valuation assumption made that is materially different from those disclosed as of the grant date of an equity award, and (iii) the names of the PEO and each other named executive officer included in the calculation, as well as the fiscal years in which such persons are included.

Financial Performance Metrics — *Columns (f), (g), (h), and (i)*

For each fiscal year covered by the Pay Versus Performance Table, the company must also report its cumulative total shareholder return (TSR) (*column (f)*), peer group cumulative TSR (*column (g)*), net income (*column (h)*), and a Company-Selected Measure (*column (i)*). SRCs are not required to include peer group cumulative TSR or a Company-Selected Measure.

- **Total Shareholder Return.** According to the Final Rules and the SEC's comments, both the company cumulative TSR and peer group cumulative TSR measurements should be calculated for the covered fiscal year in the same cumulative manner as calculated under Item 201(e) of Regulation S-K for the performance graph. Accordingly, companies will have some level of familiarity with this requirement. Both company cumulative TSR and peer group cumulative TSR should be calculated based on a fixed investment of $100 at the measurement point.

- ***Applicable "Measurement Period."*** This period commences on the market close of the last trading day to occur before the earliest fiscal year reported in the Pay Versus Performance Table and ends on (and includes) the last day of the most recent covered fiscal year. For example, if the company's Pay Versus Performance Table covers fiscal years ending December 31, 2020, 2021, and 2022, the cumulative TSR reported for 2022 will have a three-year measurement period, commencing on the last trading day to occur before January 1, 2020, and ending on December 31, 2022.

- ***CD&A Peer Group or Stock Performance Graph Peer Group.*** In addition, the peer group cumulative TSR should be determined using either the same peer index that companies used for purposes of Item 201(e) or, if applicable, the same peer group as described in the company's Compensation Discussion and Analysis (CD&A). If the peer group used is not a published industry or line-of-business index, the company must name the companies in the peer group in a footnote to the Pay Versus Performance Table. The company must also include a footnote disclosing the name of any company that was added or removed from the peer group used in the prior fiscal year, along with an explanation for the change and a comparison of the cumulative TSR as between any company that was removed from the peer group and its replacement. This is an area where companies will already have some familiarity as the rules are consistent with those under Item 201(e).

- **Net Income.** Companies must report their net income for the covered fiscal year.

- **Company-Selected Measure.** Under the Final Rules, the company must select at least one Company-Selected Measure from the company's Tabular List (as discussed below) to be reported in the Pay Versus Performance Table for the covered fiscal years. A Company-Selected Measure is what the company believes to represent its most important "financial performance measure" for the last completed fiscal year other than TSR or net income. For example, if the company's most important financial performance measure is net income and, therefore, is already included in the Pay Versus Performance Table, the company must select its "next-most" important financial performance measure to be used as the Company-Selected Measure.

  - ***Financial Performance Measures.*** The Final Rules define a "financial performance measure" as any measure determined and presented in accordance with the accounting principles used in preparing the company's financial statements, any measures that are derived wholly or in part from such measures, and stock price and total shareholder return. This financial performance measure need not be reported in the company's financial statements.

  - ***Non-GAAP Measures.*** If the Company-Selected Measure (or any additional performance measures that the company decides to include in the Pay Versus Performance Table) is not a financial measure under GAAP, the company must disclose how the measure is calculated from the company's audited financial statements. Disclosure of the measure is not otherwise subject to Item 10(e) of Regulation S-K or Regulation G.

- ***Certain Exceptions*.** According to the SEC, if the company did not use any financial performance measures in setting pay-for-performance compensation in the last completed fiscal year, or if the company only uses financial performance measures that are already included in the Pay Versus Performance Table (i.e., TSR and/or net income), the company is not required to (i) include a Company-Selected Measure in the table, or (ii) describe a Company-Selected Measure in the narrative and/or graphical disclosure to the table (as discussed below).

Tabular List of Important Financial Performance Measures

Under the Final Rules, companies (other than SRCs) are required to include a "Tabular List" of the most important financial performance measures used by the company in setting pay-for-performance compensation for the most recently completed fiscal year.

The Tabular List must include at least three, but not more than seven, performance measures in no particular order or rank. However, if the company considers only two or fewer financial performance measures when assessing pay-for-performance compensation, the company need only include the number of measures actually considered (which may be zero). Further, in addition to the financial performance measures, the company may also include non-financial performance measures (i.e., any performance measures that are not "financial performance measures") in the company's Tabular List if such measures are among its most important performance measures and it has disclosed its most important three financial measures (or fewer, if fewer financial performance measures are used by the company).

The Tabular List disclosure may be provided as one list, two lists (separating the measures applicable to the PEO and, as a group, the other named executive officers), or multiple lists (separating the measures applicable to each named executive officer). Companies should consider including explanatory narrative disclosure to the Tabular List if doing so would help investors understand the measures included in the Tabular List or otherwise prevent confusion.

The SEC has acknowledged that the Tabular List may include performance measures that are the same or similar to those already described in the CD&A. However, while the CD&A requires disclosure of performance measures that are "material elements" of the named executive officers' compensation, the Pay Versus Performance Disclosure requires only the "most important" performance measures used by companies to link pay to performance. Accordingly, although there may be overlap between the two disclosure requirements, they are not necessarily the same.

Narrative and/or Graphical Disclosure to Pay Versus Performance Table

Under the Final Rules, using the information provided in the Pay Versus Performance Table, companies must provide a "clear description" of the relationship between certain amounts reported in the table for the five most recently completed fiscal years.

The description may be provided in narrative or graphical form, or a combination of the two. Specifically, the narrative and/or graphical disclosure to the Pay Versus Performance Table is required to describe the following relationships over the five most recently completed fiscal years (and for the first and second years in which the Pay Versus Performance Disclosure is included, such shorter period that is shown in the table):

- the relationship between:
  - the compensation actually paid to the PEO;

  - the average of the compensation actually paid to each other named executive officer (other than the PEO); and

  - each of (i) company cumulative TSR, (ii) net income, and (iii) the Company-Selected Measure; and

- the relationship between the company's cumulative TSR and the peer group cumulative TSR.

Smaller Reporting Companies

As mentioned above, SRCs are subject to scaled disclosure requirements under the Final Rules. Initially, SRCs need only report the information required by the Pay Versus Performance Table for the two most recently completed fiscal years, rather than the three most recently completed fiscal years. After the first year in which the Pay Versus Performance Table is required, SRCs may limit the disclosure to the three most recently completed fiscal years.

In addition, an SRC is not required to:

- account for the Adjusted Pension Value in computing the compensation "actually paid" to its named executive officers;

- report, in the Pay Versus Performance Table, peer group cumulative TSR or a Company-Selected Measure; or

- include a Tabular List of financial performance measures.

An SRC will be required to provide disclosure in the prescribed table in Inline XBRL format beginning in the third filing in which it provides Pay Versus Performance Disclosure.

Initial Public Offerings

Since the Pay Versus Performance Disclosure is not required to be included in registration statements, the new disclosures are not required to be included in a registration statement filed in connection with a company's initial public offering.

Similar to the initial public offering transition rules provided for other compensation-related disclosures under Item 402 of Regulation S-K, companies that are newly public companies are generally only required to include Pay Versus Performance Disclosure for fiscal years during which the newly public company is a reporting company.

Key Determinations and Actions Required

The Final Rules will require companies to both gather information not previously required in proxy statements and to determine the optimal way to present the required disclosure. Companies should begin to consider how they intend to comply with the Final Rules — especially those aspects of the Final Rules that are described in more detail below — and prepare to provide complete and effective Pay Versus Performance Disclosure for the coming proxy season.

- ***Determine the Tabular List and the Company-Selected Measure.*** Companies will need to consider which measures they will disclose as their "most important" three to seven performance measures to be included in the Tabular List and, from that set, the Company-Selected Measure that they believe represents their most important financial performance measure. The Company-Selected

Measure will be captured in the Pay Versus Performance Table and will be subject to the additional narrative and/or graphical disclosure, as described above.

- ***Determine the Format of Disclosure for Describing Relationships Between Pay and Performance.*** Companies should begin to think about the narrative and/or graphical disclosure format that will work best based on their particular circumstances for describing the relationship between the compensation actually paid as reflected in the Pay Versus Performance Table and the company's cumulative TSR, net income, and Company-Selected Measure as well as between the company's cumulative TSR and the peer group cumulative TSR. There is no mandated format for this disclosure. Formats suggested in the SEC's release include: (i) a graph providing executive compensation actually paid and change in the financial performance measure (TSR, net income, or Company-Selected Measure) on parallel axes and plotting compensation and such measure(s) over the required time period, and (ii) disclosing the percentage change over each year of the required time period in both executive compensation actually paid and the financial performance measure, together with a brief discussion of that relationship.

- ***Determine the Company Peer Group.*** Companies are permitted to use, for purposes of determining peer group cumulative TSR, either the same peer group/index used for purposes of Item 201(e) of Regulation S-K or the peer group used in their CD&A. Companies will need to assess which group makes the most sense for them to use, based on both historical comparative performance and their go-forward compensation strategies.

- ***Calculate Year-End and Vesting-Date Fair Values to Calculate Compensation Actually Paid.*** Companies will need to run fair value calculations for outstanding equity awards as of their past fiscal year-end (e.g., December 31, 2021, for calendar year companies), in order to provide the fair value changes that occurred during 2022 for equity awards outstanding on that date, as well as the fair value of any equity awards that vested or were forfeited during the current fiscal year or otherwise remain outstanding as of the end of the covered fiscal year (e.g., December 31, 2022, for calendar year companies). In doing so, companies should assess whether any necessary processes need to be implemented for tracking and calculating such amounts going forward. The SEC noted that companies will likely rely on their existing fair value processes and internal controls for stock-based compensation. Further, the SEC noted that the option and contingent-equity valuation models are well-developed and that related software solutions are widely available, which should mitigate any additional burdens and concerns related to valuation approach and related inputs.

- ***Calculate Pension Service Cost to Calculate Compensation Actually Paid.*** The Final Rules require companies with defined benefit pension plans to determine and report separately the service cost for each year. As an individual's service cost is not an item that a company would normally calculate annually, companies should ensure that their actuaries are advised of the new requirements, so that each named executive officer's service cost can be computed in time for the required disclosure.

- ***Consider Placement of Pay Versus Performance Table and Related Disclosure.*** The SEC has not mandated any particular location in the proxy or information statement for the Pay Versus Performance Table and related disclosures. The Final Rules clarify that the disclosure is not required to be included in the CD&A, noting that companies may be hesitant to place the disclosure in that section if the compensation committee did not consider the information in making its pay decisions for the applicable fiscal year. Companies are likely to include the Pay Versus

Performance Table with the other Item 402 executive compensation tables and disclosures immediately following the CD&A.

Coming Attractions

The SEC's rulemaking agenda includes other noteworthy upcoming items, which are previewed here:

- **Clawbacks.** The SEC initially issued proposed rules regarding clawbacks in July 2015 to implement Section 954 of the Dodd-Frank Act. Most recently, in June 2022, the SEC reopened the comment period for its proposed clawback rules. The SEC has indicated that final rules may be adopted in the coming months. In order to allow companies to claw back compensation under possible Dodd-Frank final clawback rules, or pursuant to misconduct under other clawback policies that might be adopted in the future, companies that have not already done so should review and consider adding provisions in their incentive compensation plans and agreements providing that all payments and awards made thereunder are subject to such clawback policies. For more information, see SEC press release June 8, 2022.

- **Corporate Board Diversity.** The SEC has indicated that it intends to propose rules related to "Corporate Board Diversity," including enhanced disclosure requirements regarding the demographics of board members and nominees. While the SEC has not provided details regarding what the enhanced corporate board diversity disclosure would entail, in August 2021, the SEC approved Nasdaq's new listing rules requiring disclosure of director diversity statistics beginning in August 2022, which may indicate the type of diversity disclosure the SEC expects to propose. Under Nasdaq's rule, listed companies generally must either have, or explain why they do not have, at least two directors from underrepresented communities. The SEC's approval of the Nasdaq rule is being challenged in court. Nevertheless, given these trends, public companies should consider their approaches to board composition and succession planning. For more information, see Release No. 34-92590 (August 6, 2021).

- **Proposed Amendments to Rule 10b5-1.** The SEC proposed amendments to Rule 10b5-1 under the Securities Exchange Act of 1934 in December 2021 and has indicated that final rules could be adopted by early next year. The proposed amendments would impose additional disclosure requirements on public companies and limit the availability of the affirmative defense by, among other things, imposing a cooling-off period before trading can commence under a Rule 10b5-1 plan and prohibiting overlapping trading plans. As the SEC has not yet confirmed whether certain sell-to-cover and net share withholding arrangements used to satisfy tax obligations in connection with equity compensation plans will be exceptions to the overlapping plans proposal, companies should consider whether the tax withholding methods they impose with respect to the equity awards held by their service providers should change. For more information, see SEC press release December 15, 2021.

If you have questions about this Client Alert, please contact one of the authors listed below or the Latham lawyer with whom you normally consult:

Holly M. Bauer
holly.bauer@lw.com
+1.858.523.5482
San Diego

Paul M. Dudek
paul.dudek@lw.com
+1.202.637.2377
Washington, D.C.

James A. Metz
james.metz@lw.com
+1.650.463.3044
Silicon Valley

Maj Vaseghi
maj.vaseghi@lw.com
+1.650.470.4852
Silicon Valley

Bradd L. Williamson
bradd.williamson@lw.com
+1.212.906.1826
New York

Regina M. Schlatter
regina.schlatter@lw.com
+1.714.755.8261
Orange County

Jordan Barnes
jordan.barnes@lw.com
+1.213.485.1234
Los Angeles

Alisa Hand
alisa.hand@lw.com
+1.212.906.4531
New York

Sara E. Schlau
sara.schlau@lw.com
+1.714.755.8135
Orange County

Tal A. Simon*
tal.simon@lw.com
+1.312.777.7075
Chicago

**Not admitted to practice in Illinois. Admitted to practice in Ohio only*