

What SEC's Final Exec Comp Disclosure Rule Means For Cos.

By **Brian Soares and Celia Soehner** (September 13, 2022, 5:01 PM EDT)

The U.S. Securities and Exchange Commission adopted new Item 402(v) of Regulation S-K on Aug. 25, which requires companies to provide a table disclosing specified executive compensation and financial performance measures for their five most recently completed fiscal years.

Companies must begin to comply with the new disclosure requirements in applicable proxy and information statements[1] for fiscal years ending on or after Dec. 16. Therefore, calendar year-end companies will need to address Item 402(v) in their 2023 proxy statements.

Companies also will be required to provide a list of three to seven financial performance measures that they determine are their most important performance measures for linking actual executive compensation to company performance.

Background

In 2015, the SEC proposed a new rule to implement Section 953(a) of the Dodd-Frank Act by creating a new requirement in Item 402 of Regulation S-K that would require a company to provide a clear description of:

- The relationship between executive compensation actually paid to the company's named executive officers, or NEOs — including the company's principal executive officer, or CEO — and the cumulative total shareholder return, or TSR of the company; and
- The relationship between the company's TSR and the TSR of a peer group chosen by the company, over each of the company's five most recently completed fiscal years.

The SEC reopened the comment period for the proposed rules in 2022 and subsequently included the pay versus performance final rules as part of its spring 2022 rulemaking agenda.

The final rules reflect several significant distinctions from the proposed rules, as described below.

Pay Versus Performance Disclosure



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New Item 402(v) requires tabular disclosure containing the following information, in each case over the last five fiscal years:

- Total compensation, using the summary compensation table measure of total compensation;
- Quantitative information reflecting executive compensation actually paid to NEOs, which is required on an individual basis for the PEO and as an average for the other NEOs;
- TSR for both the company and its peer group, based on a fixed \$100 investment;
- The company's net income; and
- A company-selected measure, which is a financial performance measure chosen by, and specific to, the company that represents, in the company's view, the most important financial performance measure it uses to link NEO pay and performance for the most recently completed fiscal year.

Companies must provide a clear description, either in narrative or graphical format, of the relationships between each of the financial performance measures included in the table, and the executive compensation actually paid to the PEO and, on average, to the other NEOs.

Item 402(v) also will require a description of the relationship between the company's TSR and its peer group TSR, which the SEC believes will

provide a useful point of comparison to assess the relationship between the company's executive compensation actually paid and its financial performance compared to the performance of its peers during the same time period.[2]

In addition, companies must provide a list of three to seven financial performance measures — the tabular list — that the company believes are its most important measures to link pay and performance, using the same approach as taken for the company-selected measure.

Companies are permitted, but not required, to include nonfinancial measures in the tabular list if they consider such measures to be among their three to seven most important measures, and may also disclose supplemental measures of compensation or financial performance as long as such measures are "clearly identified as supplemental, not misleading and not presented with greater prominence than the required disclosure."

Companies may provide the tabular list disclosure as a single list, as two separate lists — one for the PEO and one for all NEOs other than the PEO — or as separate tabular lists for the PEO and each NEO other than the PEO.

Company-Selected Measure

The final rules require the following with respect to a company-selected measure:

- The company-selected measure must be a financial performance measure included in the tabular list.

- The company-selected measure must reflect the company's assessment that it is the most important performance measure that is not otherwise required to be disclosed in tabular disclosure required under Item 402(v) — i.e., TSR or net income — for linking pay and performance.
- If the company's most important measure is already included in the Item 402(v) tabular disclosure — i.e., TSR or net income — the company would select its next most important measure as its company-selected measure.
- The company-selected measures may differ from one year to the next.[3]

In the adopting release, the SEC recognizes that companies may opt to provide a non-generally accepted accounting principles, or non-GAAP, financial measure as their company-selected measure.

The SEC expressed its belief that "it is appropriate to treat non-GAAP financial measures provided under Item 402(v) of Regulation S-K consistently with the existing CD&A provisions," and thus determined that non-GAAP financial measures will not be subject to Regulation G and Item 10(e) of Regulation S-K.

However, companies must disclose how the number is calculated from the company's audited financial statements.

Meanwhile, companies that do not use any financial performance measures to link pay and performance, or that only use measures already required to be disclosed in the table — i.e., TSR and net income — would not be required to disclose a company-selected measure or its relationship to executive compensation actually paid.

Effects on Say-on-Pay Votes

Pay-versus-performance disclosure has the potential to significantly affect the say-on-pay advisory vote under Rule 14a-21(a) of the Exchange Act.

Indeed, the SEC acknowledged in the adopting release that

the required disclosure may be most useful to shareholders when they are deciding whether to approve the compensation of NEOs through the say-on-pay-vote.

On the one hand, the new disclosure will provide a direct link between the company's performance — albeit viewed through the company's lens — and compensation paid to certain NEOs.

On the other hand, investors have had access to much of this information for over a decade, perhaps with the exception of compensation actually paid.

Investors have long been able to review a company's summary compensation table and compare it against the audited financials to assess for themselves whether pay is in line with company performance.

It will be interesting to see whether a strong correlation develops between pay-versus-performance disclosure and say-on-pay approval.

Perhaps equally as interesting will be how companies will modify their pay-versus-performance disclosure, if at all, in reaction to negative say-on-pay votes.

Pay-Versus-Performance Disclosure in Other SEC Filings

The SEC noted in the adopting release that they are "not requiring pay-versus-performance disclosure in other filings where [Item 402 disclosure] is required"[4] since the language of Section 14(i) of the Dodd-Frank Act requires disclosure "in any proxy or consent solicitation material for an annual meeting of the shareholders." [5]

Accordingly, Instruction 3 to Item 402(v) states that information required by that paragraph will not be deemed to be incorporated into any filing under the Securities Act or the Exchange Act, except to the extent that the company specifically incorporates it by reference.

Interplay With ESG Performance

Several comments to the proposed rules addressed environmental, social and governance metrics, noting, among other things, that the practice of linking ESG performance to pay has been increasing.[6]

Some commenters asked that the SEC mandate the inclusion of ESG metrics in a ranked list of most important measures used by companies to link compensation and performance.[7]

While the SEC acknowledged in the adopting release that linking pay to ESG performance "appears to be a growing practice," it noted further that ESG metrics typically are not tied to specific quantitative goals and "are generally used in short-term incentive plans" rather than long-term incentive plans.[8]

The final rules bucket ESG metrics as nonfinancial performance goals, along with measures of individual performance or broader strategic goals.

Therefore, while the final rules do not require disclosure of ESG metrics, companies may supplement their mandatory pay-for-performance disclosure with a discussion of ESG metrics — or any other nonfinancial performance measure — consistent with the requirements of Item 402(v)(6)(iii).[9]

New Companies

Information for fiscal years prior to the last completed fiscal year will not be required if the company was not required to report under the Exchange Act at any time during that year.

For example, a company with a calendar fiscal year-end that goes public in 2023 would not be required to provide pay versus performance disclosure beyond fiscal year 2022.

Next Steps

Companies are required to comply with the new amendments in proxy and information statements that are required to include Item 402 executive compensation disclosure for fiscal years ending on or after Dec. 16.

This means the vast majority of companies must provide pay-versus-performance disclosure in their annual proxy statements being filed next spring. Given the short time frame to provide this disclosure,

companies should take action now to avoid delaying their annual proxies.

Specifically, companies can take the following steps as soon as possible:

- Determine the company peer group to be used in calculating peer group cumulative TSR;
- Determine the company-selected measure and tabular list;
- Calculate compensation actually paid for applicable prior years, including year-end and vesting date fair values and pension service cost;
- Assess placement of pay-versus-performance table and narrative disclosure within the proxy statement;
- Inform their boards of directors, compensation committees and any other board committees, as appropriate, about the new disclosure requirements; and
- Consider how the new disclosure can affect the company's advocacy efforts for favorable say-on-pay results.

Conclusion

Calendar-year companies must include the new pay-versus-performance disclosure in their proxy statements for their 2023 annual meetings. Therefore, companies ought to begin considering the new disclosure requirements as soon as possible.

This also entails discussing the new disclosure requirements and their implications with the board of directors, compensation committee or other relevant committees

Since Item 402(v) requires more than one year's worth of data, companies can begin working on draft disclosure now based on historical data.

These include calculating compensation actually paid, total shareholder return — including determining the composition of the peer group — and choosing the company-selected measure.

Having the disclosure framework set up before the end of the year will help calculate the compensation data required to be disclosed for 2021.

Lastly, it remains to be seen how investors will interpret and react to the new pay-versus-performance disclosure, and whether the disclosure will have any impact on subsequent say-on-pay votes.

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[1] Companies must provide pay-for-performance disclosure under Item 402(v) of Regulation S-K when they file proxy statements or information statements in which executive compensation disclosure pursuant to Regulation S-K Item 402 is required. Proxy statement disclosure obligations only arise under Section 14(a) of the Securities Exchange Act of 1934, as amended, when a registrant with a class of securities registered under Section 12 chooses to solicit proxies. Whether a registrant has to solicit proxies depends on requirements set forth in the registrant's charter or bylaws, or whether such requirements are imposed by state law or the stock exchange on which the registrant's securities are listed.

[2] Release at p. 26.

[3] In the adopting release, the SEC noted that the Company-Selected Measure may differ from year to year. In such cases, companies would have to provide that measure for each fiscal year covered in the pay versus performance table.

[4] Release at p. 16-17.

[5] Section 14(i) of the Exchange Act.

[6] Release at p. 134.

[7] See comments from As You Sow 2022; Better Markets; Ceres; PRI; Public Citizen 2022; and RAAI.

[8] Release at p. 134.

[9] Item 402(v)(6)(iii) permits companies to include nonfinancial performance measures (i.e., performance measures other than those that fall within the definition of financial performance measures) used by the registrant to link pay and performance if it determines that such measures are among its three to seven most important performance measures, and it has disclosed its most important three (or fewer, if the registrant only uses fewer) financial performance measures, in accordance with the other provisions of Item 402(v)(6).