Alert
August 30, 2022

SEC Adopts Final Rules Requiring Pay Versus Performance Disclosure in 2023 Proxy Statements

by John O. Newell, Sean M. Donahue, Alexandra S. Denniston, James H. Hammons, Jr., Gail Pierce, Grace L. Wirth

Update: This alert was updated on September 7, 2022.

The U.S. Securities and Exchange Commission (SEC) has adopted final rules that will require significant new disclosures in proxy and information statements about the relationship between executive compensation actually paid by a company and the company's financial performance. Companies with a December 31 fiscal year end will be required to include these new disclosures in their proxy statements for 2023 annual meetings unless the company is exempt from the requirements of the final rules. For most companies, the disclosure required by the final rules is likely to require significant efforts at various levels, including the company's senior executive officers and its compensation committee and full board of directors. Many companies are likely to find that the new pay versus performance disclosure requirements are based on compensation amounts and performance metrics that are different from those currently used by the company and may find it useful to enhance their current disclosure to address these differences.

The final rules include three new disclosure obligations. First, the final rules require a table that reports, for each of the last five fiscal years, the compensation of the company's principal executive officer (PEO) and the average compensation of the company's other named executive officers (NEOs), both as reported in the Summary Compensation Table in the company's proxy or information statement and as "actually paid," as well as the company's total shareholder return (TSR), the TSR of companies in the company's peer group, the company's net income as reported in its audited financial statements and the financial performance metric identified by the company as the single "most important" financial performance metric used to link compensation actually paid to the company's PEO and other NEOs to the company's performance. Second, the final rules require a description, using the information presented in the table, of the relationships between the compensation actually paid to the PEO and the average compensation actually paid to the company's other NEOs over the company's five most recently completed fiscal years to each of the performance metrics reported in the table. Third, the final rules require a tabular list of at least three, and not more than seven, of the most important financial performance measures used by the company to link compensation actually paid to the company's PEO and other NEOs for the most recently completed fiscal year to company performance. The final rules require companies to comply with SEC Interactive XBRL rules when filing the new pay versus performance disclosures.

The final rules contain significant disclosure accommodations for smaller reporting companies (SRCs), described in greater detail below, and exempt emerging growth companies (EGCs), registered investment companies (RICs) and foreign private issuers (FPIs) from the disclosure requirements. The final rules will initially require companies that are not SRCs to present these disclosures for the three most recently completed fiscal years, adding an additional year in each of the two following years. The effective dates, disclosure phase-in requirements and SRC accommodations are described in further detail below.

Background

The Dodd-Frank Wall Street Reform and Consumer Protection Act, enacted in 2010, included a requirement that the SEC adopt regulations requiring public companies to disclose the relationship between executive compensation paid by the company and the company's financial performance. The SEC proposed rules in response to this rulemaking mandate in 2015. In January 2022, the SEC reopened the comment period on the rules proposed in 2015.

During the 12 years between the congressional rulemaking mandate and adoption of the final rules, a variety of influences have led many companies to include their own disclosures about how they take company performance into account in setting executive compensation. In the absence of SEC rulemaking, pay versus performance disclosure has taken on a wide variety of disclosure methods and forms. With the adoption of the final rules, most companies with a December 31 fiscal year end now have a period of only six or seven months – during which all of the usual year-end and annual meeting events and tasks will require attention – to prepare for compliance with the significant disclosure requirements of the final rules, while also evaluating how their previous pay for performance disclosures relate to the disclosures required by the final rules.

Companies Subject to the Final Rules

The final rules apply to all reporting companies other than EGCs, RICs and FPIs. In addition, the final rules include significant disclosure accommodations and a modified compliance timetable for SRCs, which are described below.

Effective Date and Compliance Phase-In Dates

Effective Date. The final rules will be effective 30 days after publication in the *Federal Register.* Companies must begin to comply with the new disclosure requirements in proxy and information statements that include the executive compensation disclosure required by Item 402 of Regulation S-K for fiscal years ending on or after December 16, 2022. As a result, companies that have a December 31 fiscal year end will be required to include the new disclosure in proxy and information statements for 2023 annual meetings.

New companies. Information for fiscal years prior to the last completed fiscal year will not be required if the company was not required to file reports pursuant to Section 13(a) or 15(d) of the Securities Exchange Act of 1934 at any time during that year.

Compliance Dates and Phase-In. For companies that are not SRCs, the final rules initially require disclosure for three fiscal years, adding an additional year in each of the following two years so that the disclosure will cover five fiscal years when fully phased-in. For SRCs, the final rules will initially require disclosure for two fiscal years, adding an additional year in the following year so that the disclosure will cover three fiscal years when fully phased-in. The table below shows the required compliance dates for filings subject to the final rules.

Company Type (assumes December 31 fiscal year end)	Disclosure Required in 2023	Disclosure Required in 2024	Disclosure Required in 2025

	(number of fiscal years)	(number of fiscal years)	(number of fiscal years)
Domestic Operating Company (not SRC)	3	4	5
SRC	2	3	3

Inline XBRL. The final rules require certain portions of the new disclosure to comply with SEC requirements for Inline XBRL tagging in SEC filings and require companies to file an Interactive Data File containing the Interactive XBRL information. As described below, the final rules permit SRCs to defer complying with SEC Inline XBRL data tagging requirements until the third filing that includes pay versus performance disclosure.

What Companies Should Be Doing Now

The time horizon to prepare for compliance with the final rules is short. The final rules will require significant new disclosures in 2023 proxy statements and some elements of the new disclosures are complex and will require review and discussion among senior executive officers and members of the compensation committee and full board of directors. One area that is likely to require significant focus by companies is determination of the three to seven most important financial performance metrics and selection of the single most important of these metrics used by the company for purposes of making pay versus performance compensation decisions.

Companies should begin the process of establishing the personnel and data sources required to comply with the final rules immediately. In many cases, this may include the company's compensation consultants and outside legal counsel. The following discussion may help companies manage the process of preparing to deal with the final rules.

Consider the Big Picture. Many of the compensation amounts and financial performance metrics required by the final rules are different from the compensation amounts and performance metrics actually used by many of the companies that have adopted pay versus performance policies and practices. These differences may make it advantageous, or in some cases even require, a company to include additional disclosure to explain the reasons for these differences. Companies should consider stepping back and taking a look at their compensation disclosure globally. Does it respond to all of the currently-applicable executive compensation disclosure requirements? Does it describe clearly the company's executive compensation policies and practices, including which performance metrics are considered and how they relate to executive compensation decisions? Does it explain the company's executive compensation program in a manner that allows the reader to understand how the company's executive compensation program operates and why it is appropriate for the company?

With this overall view of the company's current executive compensation disclosure in mind, consider the differences between the current disclosure about the company's pay versus performance policies and practices and the disclosure required by the final rules. Will additional disclosure be required to explain these differences and why the company has adopted its pay versus performance program?

A good example of these differences would be the requirement in the final rules to describe the relationship of compensation actually paid by the company and the company's TSR and net income, where the company calculates compensation amounts on a basis that is different than compensation amounts calculated under SEC rules and does not use company TSR or net income as a performance measure when considering company performance as part of compensation decisions. In a case like that, the best disclosure might respond to the specific disclosure requirement of the final rules – *i.e.,* state that the company calculates compensation on a basis different than compensation actually paid as calculated under SEC rules and doesn't use company TSR or net income as a performance measure when making pay for performance decisions. The company would also describe how it calculates compensation, which performance measures the company uses when making pay for performance decisions, why it does so and why the company believes that its policies and practices are more appropriate for the company than the specific metrics and relationships required by the final rules. These disclosures may be in different places within the company's executive compensation disclosure, but should be consistent and work together to explain the company's executive compensation policies and decisions as a whole and how (and on what bases) these policies and decisions are related to the company's performance.

A related big picture consideration is the relationship between the performance metrics and executive compensation disclosure required by the final rules and any alternative or supplementary compensation table or other narrative or graphic disclosure that explains how the company actually evaluates compensation components and amounts, including any discussion about how company performance is reflected in this disclosure.

In some cases, it may be beneficial to include additional performance measures in additional columns in the Pay Versus Performance Table, as permitted by the final rules. This may provide a broader context and present a more complete picture of how the company's pay versus performance policies and practices operate and the relationship between the company's compensation decisions and its compensation policies and key performance measures.

Prepare a Separate Mock-Up. As the culmination of the potential action items described in the paragraphs that follow, companies should consider preparing a mock-up of the disclosures required by the final rules. In most cases, this will be most beneficial if it is prepared separately from the company's customary process and timeline for producing its annual meeting proxy statement. This will help identify process and "ownership" issues that require further attention. It will also provide an opportunity for more focused review by the company's senior executives, compensation committee and full board of directors, as well as the company's outside counsel, in advance of the often very busy period when the company's Form 10-K annual report, annual meeting proxy statement and annual report to shareholders are being prepared and reviewed.

Identify Data Sources and Compile Required Data. Preparing the disclosure required by the final rules will require review of the company's pay versus performance metrics and methods and compensation decisions during the fiscal years covered by the Pay Versus Performance Table. Non-exempt reporting companies other than SRCs that have a December 31 fiscal year end will need to prepare disclosure for 2020, 2021 and 2022 in their 2023 proxy statements. SRCs that have a December 31 fiscal year end will need to include disclosure for 2021 and 2022 in their 2023 proxy statements, although the final rules contain other significant accommodations for SRCs, as discussed in more detail below.

Engage Internal and External Contributors Promptly. Preparation, review and verification of the new disclosure is likely to require significant amounts of time and participation by a large number of individuals. Consider engaging internal legal, accounting, and finance personnel and the company's compensation consultants and outside legal counsel promptly to identify issues and ensure alignment.

Assess and Enhance, As Needed, Disclosure Controls and Procedures. Companies should review their disclosure controls and procedures and consider whether changes in the company's disclosure controls and procedures are necessary or desirable in light of the disclosure required by the final rules. At a minimum, companies should consider whether complying with the final rules will require additional personnel, information flows or other procedures to collect, review and verify the accuracy of the new quantitative and narrative/graphic disclosures.

Determine the "Most Important" Financial Performance Metrics. Companies that have adopted pay versus performance policies and practices should review the financial performance metrics used in recent years to link the company's performance to the compensation paid to its NEOs, including the PEO. The final rules require the company to provide a tabular list of at least three, and not more than seven, financial performance measures that, in the company's assessment, are the "most important" financial performance measures (not including any measures that the final rules require to be disclosed in the Pay Versus Performance Table) used by the company to link its performance to the compensation actually paid to its NEOs. The final rules also require the company to include the most important of these financial performance measures in the Pay Versus Performance Table as the "Company-Selected Measure," which is described in greater detail below. Assessment of which financial performance measures are most important should therefore be included in the tabular list, and which of these measures is *the* most important financial performance measure is likely to require significant consideration by the company's senior management, as well as the compensation committee and the board of directors.

Assess Recent Pay Versus Performance Disclosure. Many companies already include disclosure about the company's pay versus performance policies and how the compensation paid to the company's NEOs reflects these policies. These companies should identify all pay for performance disclosure in the most recent proxy or information statement and determine whether these disclosures should be relocated, revised or deleted.

Review Disclosure for Consistency. Companies that have included disclosure about pay versus performance policies and decisions in recent proxy or information statements should evaluate whether the disclosure required by the final rules will be consistent with the company's recent pay versus performance disclosure. In particular, the new disclosure about the relationships of compensation actually paid to the PEO and other NEOs to company and peer group TSR, the company's net income and the Company-Selected Measure, as well as the metrics identified in the list of the most important financial performance measures, may benefit from this review.

Evaluate Current Pay Versus Performance Policies and Practices. If they have not already done so as part of one of the other action items described in this section, companies that have adopted pay versus performance policies and practices may wish to review the disclosure required by the final rules and consider whether, in light of these new disclosures, the company may want to consider changes in its current pay versus performance policies and practices. A disclosure mock-up may be particularly helpful when making this review.

Disclosure Required by the Final Rules

The final rules are principally codified as Item 402(v) of Regulation S-K. Item 402(v) contains three disclosure elements:

- A table that shows specified compensation information and financial performance measures (the Pay Versus Performance Table);

- A “clear description,” which may be in narrative or graphic form or a combination of both, of the relationships over the company’s five most recently completed fiscal years between (1) the compensation actually paid to the company’s PEO and other NEOs and (2)(A) company and peer group TSR, (B) the company’s net income as reported in its audited financial statements and (C) the “Company-Selected Measure,” which is the financial performance measure that, in the company’s assessment, represents the most important financial performance measure used to link compensation actually paid to the company’s PEO and other NEOs to company performance, selected from the tabular list described in the next bullet; and

- A tabular list of at least three, and not more than seven, financial performance measures that the company has determined are the most important financial performance measures used by the company to link compensation actually paid to the company’s PEO and other NEOs to company performance for the most recently completed fiscal year.

The final rules provide companies with flexibility to determine where to provide the required disclosure. The SEC specifically states in the adopting release that the final rules do not require companies to include the new disclosure in the Compensation Disclosure and Analysis section of the proxy or information statement.

Pay Versus Performance Table

The final rules require a table that presents information about executive compensation and several financial performance measures, which include company and peer group TSR, the company's net income and a financial performance measure "which, in the [company's] assessment represents the most important financial performance measure (that is not otherwise required to be disclosed in the table) used by the [company] to link compensation actually paid to the [company's] named executive officers, for the most recently completed fiscal year, to company performance." The final rules define this as the "Company-Selected Measure," and it must be one of the financial performance measures shown in the tabular list of the most important financial performance measured used by the company to link compensation actually paid to the company's PEO and other NEOs for the most recently completed fiscal year to company performance. The tabular list is discussed in the next section of this alert.

The example of the Pay Versus Performance Table below represents the table as it will appear in disclosure by companies that are not SRCs when the final rules are fully phased-in. Initially, companies that are not SRCs are required to include disclosure only for the three most recently completed fiscal years. SRCs are required initially to include disclosure for only two years and will not be required to include disclosure for more than three years. SRCs can also elect to delete several of the columns in the table, as discussed below under "Smaller Reporting Companies."

Pay Versus Performance

Year	Summary Compensation Table Total for PEO	Compensation Actually Paid to PEO	Average Summary Compensation Table Total for Non-PEO Named Executive Officers	Average Compensation Actually Paid to Non-PEO Named Executive Officers	Value of Initial Fixed $100 Investment Based On:	
					Total Shareholder Return	Peer Group Total Shareholder Return
(a)	(b)	(c)	(d)	(e)	(f)	(g)
Year 1						
Year 2						

Year 3						
Note that Year 4 and Year 5 are subject to a compliance phase-in						
Year 4						
Year 5						

The Pay Versus Performance Table must include the disclosure summarized below.

- The fiscal year *(column a).*

- The total compensation for that fiscal year for the PEO *(column b)*, and the average of the total compensation for that fiscal year for the company's other NEOs as a group *(column d)*, each as reported in the Summary Compensation Table. If more than one person served as the company's PEO during a covered fiscal year, the total compensation for each person who served as the PEO during that fiscal year should be shown separately in an additional column b.

- The executive compensation actually paid to the PEO *(column c)* and the average executive compensation actually paid to the remaining NEOs as a group *(column e)*. If more than one person served as the company's PEO during a covered fiscal year, the compensation actually paid to each person who served as the PEO during that fiscal year should be shown separately in an additional column c.

  For purposes of columns (c) and (d), compensation actually paid is total compensation for that fiscal year for the PEO and each of the other NEOs as reported in the Summary Compensation Table, with adjustments specified in Item 402(v)(2)(iii). The adjustments reflect principally amounts related to defined benefit and actuarial pension plans, stock and option awards and any options or SARs that have been materially modified.

- The cumulative TSR for the company *(column f)* and the peer group or index used by the company for purposes of the stock performance graph required to be included in the company's annual report to shareholders, or, if applicable, the companies used as a peer group for purposes of the company's executive compensation disclosures *(column g).*

The measuring period for calculating cumulative TSR for the company and its peer group begins at the close of the last trading day before the beginning of the company's earliest fiscal year for which TSR is shown in the table; the measuring period ends at the end of the fiscal year for which cumulative TSR is being calculated for the company or its peer group. The final rules require a company to use the same methodology for calculating company TSR and peer group TSR, and include other requirements that apply to weighting of peer group companies and TSR calculations.

If the peer group is not a published industry or line-of-business index, the company must identify the companies included in the peer group in a footnote. If the company selects or otherwise uses a peer group that is different than the peer group used for the immediately preceding fiscal year, the company must explain the reasons for the change and compare the company's cumulative TSR with the TSR for both the new peer group and the peer group used in the immediately preceding fiscal year in a footnote.

- The company's net income for each fiscal year *(column h).*

The Company-Selected Measure, which is the amount for each year that is attributable to an additional financial performance measure included in the tabular list described below that, in the company's assessment, represents the most important financial performance measure (not otherwise required to be disclosed in the Pay Versus Performance Table) that the company uses to link compensation actually paid to the company's PEO and other NEOs for the most recently completed fiscal year to the company's performance *(column i).*

Additional Financial Performance Measures. The SEC states in the adopting release that companies are permitted to include additional performance measures of their own choosing in additional columns in the Pay Versus Performance Table. The SEC notes that any additional disclosures must not be misleading or obscure the required information. If a company elects to include multiple additional measures in the table, it should consider whether the addition of those measures modifies the disclosure in such a way that the disclosure becomes misleading or obscured, or the additional measures are presented with greater prominence than the required disclosure. In addition, if a company elects to provide multiple measures because they believe multiple measures are equally the “most important,” the final rules still require the company to select one measure as the Company-Selected Measure. The company would be permitted to provide explanatory disclosure about the additional measure, such as why the company selected the Company-Selected Measure and why the company included the additional measure.

“Financial performance measures” for purposes of Item 402(v) means measures that are 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 TSR. Item 402(v) does not require that the Company Selected Measure must be presented within the company’s financial statements or otherwise included in a company filing with the SEC.

Non-GAAP Financial Measures. Item 402(v)(2)(iv) provides that any Company-Selected Measure, and any additional measure that the company elects to provide, that is not a financial measure under generally accepted accounting principles (GAAP) will not be subject to Regulation G or Item 10(e) of Regulation S-K, although the company must disclose how the measure is calculated from the company’s audited financial statements. This means that, when included in the Pay Versus Performance Table in a proxy or information statement as required by Item 402(v)(2)(vi), requirements such as reconciliation to the most directly comparable GAAP financial measure and presentation of the most directly comparable GAAP financial measure with equal or greater prominence will not apply to the Company-Selected Measure or such other additional measures.

Description of Relationship Between Compensation Actually Paid and Selected Performance Metrics

The final rules require companies to provide “a clear description” of the relationships between the compensation actually paid by the company to its PEO and the average compensation actually paid to the other NEOs over the last five years, as shown in the Pay Versus Performance Table, to each of the following, in each case as shown in the table:

- The TSR for the company and a comparison of the company's TSR to the TSR of the company's peer group over the same period;
- The company's net income; and
- The Company-Selected Measure.

This description may be in narrative or graphic form, or a combination of both.

If the company elects to provide any additional measures in the Pay Versus Performance Table, the final rules require the company to include a clear description of the relationship between the same amounts of compensation actually paid and the additional measure over the company's five most recently completed fiscal years.

Although the final rules require the descriptions of the specified relationships for the company's five most recently completed fiscal years, during the phase-in period these descriptions should cover only the years presented in the Pay Versus Performance Table.

The Tabular List of Most Important Financial Performance Measures

The final rules require a tabular list of not less than three, and not more than seven, financial performance measures that the company used to link compensation actually paid to the company's PEO and other NEOs for the company's most recently completed fiscal year to the company's performance. The final rules define this as the "Tabular List." The final rules do not require companies to explain the methodologies the company uses to calculate the financial performance measures included in the Tabular List, nor do the final rules require the company to rank these measures.

The company can provide the Tabular List disclosure as a single tabular list for all NEOs, as two separate tabular lists (one for the PEO and the other for all NEOs other than the PEO), or as separate tabular lists for each NEO other than the PEO. If a company provides multiple tabular lists, each must include at least three, and not more than seven, financial performance measures that are the most important financial performance measures used to link compensation actually paid to the relevant named executive officer, or officers, to the company's performance.

If a company used less than three financial performance measures to link compensation actually paid to the company's performance, the Tabular List must include all such measures, if any, used by the company for the most recently completed fiscal year.

If a company determines that one or more non-financial performance measures were among the three to seven most important performance measures used to link compensation actually paid for the most recently completed fiscal year to company performance, the company may include these non-financial measures in the Tabular List if it has disclosed its most important three (or fewer, if the company uses less than three) financial performance measures as required by the final rules. The Tabular List must not exceed seven performance measures, regardless of whether the Tabular List includes non-financial performance measures.

Smaller Reporting Company Disclosure Accommodations

In addition to the adjusted phase-in timetable for compliance with the final rules and the deferral of the compliance date for compliance with the Interactive XBRL requirements described above, companies that qualify as an SRC can elect to comply with the disclosure requirements below in lieu of the disclosure requirements summarized in the preceding sections of this alert *(Item 402(v)(8)).*

- SRCs can include disclosure for three years, rather than five years, in the Pay Versus Performance Table *(Item 402(v)(1)).*
- SRCs can provide the disclosure required by the final rules for only two fiscal years in the first filing in which an SRC provides this disclosure *(Item 402(v), Instruction 1).*
- *Pay Versus Performance Table.* SRCs can eliminate the following columns from the Pay Versus Performance Table *(Item 402(v)(2))*:
    - The cumulative TSR for the company's peer group *(column g)*; and

- The Company-Selected Measure *(column i)*.

The Pay Versus Performance Table required by the final rules for an SRC will be as shown below when the final rules are fully phased-in.

Year	Summary Compensation Table Total for PEO	Compensation Actually Paid to PEO	Average Summary Compensation Table Total for Non-PEO Named Executive Officers	Average Compensation Actually Paid to Non-PEO Named Executive Officers	Value of Initial Fixed $100 Investment Based on Total Shareholder Return
(a)	(b)	(c)	(d)	(e)	(f)
Year 1					
Year 2					
Note that Year 3 is subject to a compliance phase-in					
Year 3					

- *Relationship to Peer Group TSR.* SRCs can omit the description of the relationships between the compensation actually paid by the company to the PEO and the average compensation paid by the company to the other NEOs to the peer group TSR *(Item 402(v)(5)).*

- *Tabular List of Company-Selected Measures.* SRCs can omit the tabular list of three to seven financial performance measures that are the most important financial performance measures used by the company to link compensation actually paid for the most recently completed fiscal year to the company's performance *(Item 402(v)(6)).*

- SRCs not required to comply with the Interactive XBRL tagging requirements to provide the related Interactive Data File as an exhibit to the related proxy statement until the third filing in which an SRC provides the pay versus performance disclosure required by Item 402(v) *(Item 402(v)(7)).*

Like the other disclosure accommodations provided for SRCs in SEC rules and forms, these disclosure accommodations are optional. SRCs can rely on some, all or none of these disclosure accommodations in any documents required to be filed or furnished under SEC rules. SRCs can also change whether they rely on these disclosure accommodations from one fiscal year to another or within any single fiscal year, although companies that do so should consider issues such as disclosure clarity, consistency and comparability and should also consider reviewing disclosure changes with the company's legal counsel before doing so.

Contacts:

John O. Newell
Counsel
+1 617 570 1475
jnewell@goodwinlaw.com

Sean M. Donahue
Partner
+1 202 346 4207
+1 212 459 7094
sdonahue@goodwinlaw.com

Alexandra S. Denniston
Partner
+1 617 570 1539
adenniston@goodwinlaw.com

James H. Hammons, Jr.
Knowledge Management Lawyer, Counsel
+1 617 570 1135
jhammons@goodwinlaw.com

Gail Pierce
Counsel
+1 202 346 4382
gailpierce@goodwinlaw.com

Grace L. Wirth
Counsel
+1 202 346 4010
+1 650 752 3144
gwirth@goodwinlaw.com