SEC adopts rule

Pay vs performance disclosures

November 10, 2023

SEC final rule targets disclosure of the relationship between executive compensation and company performance.

November 2023 update: This newsletter has been updated to reflect recent views communicated by the SEC staff through the date of this publication.

Applicability

- SEC Release No. 34-95607, Pay Versus Performance
- Registrants filing proxy or information statements requiring executive compensation disclosures. Foreign private issuers, registered investment companies, and emerging growth companies are exempted.

Fast facts, impacts, actions

Registrants will provide executive compensation and four specified financial performance measures in a tabular format for the most recent five years and describe key relationships between the two. Registrants will also separately disclose the three to seven most important performance measures used to link such pay to performance in the most recent year.

Pay

Who?

- Principal Executive Officer (individually)
- Other Named Executive Officers (as an average)

What?

- Total compensation as reported in the Summary Compensation Table
- Compensation actually paid (as defined by the rule)

Performance

What?

- Total shareholder return (Registrant TSR)
- TSR of registrant's peer group (Peer group TSR)
- Net income
- Company-selected measure (CSM) (most important financial performance measure used to link pay to performance)

The SEC staff released a series of Compliance & Disclosure Interpretations (C&DIs) covering certain implementation and practical questions related to these new pay versus performance disclosure requirements.

Compliance with the rule will be mandatory for filings related to fiscal years ending on or after December 16, 2022 (see Effective dates and transition).

Background

The Dodd-Frank Act mandates that the SEC issue a rule requiring disclosure of the relationship between executive compensation actually paid and a registrant's financial performance. In January 2022, the SEC revisited a proposed rule it had considered in 2015, reopening the comment period to specifically request feedback on certain changes to the original proposal (e.g. the disclosure of additional financial performance measures). The final rule (issued in August 2022) incorporates the original and incremental feedback received on the proposal.

Reg S-K Item 402(c) currently requires a Summary Compensation Table (SCT) that contains the individual compensation of certain executives. The final rule requires compensation information ('pay') for these executives to be presented alongside financial performance measures ('performance') for each of the five most recent fiscal years in a tabular format (which we call the 'PvP table'), supplemented by additional disclosures. The location of this new information is not mandated by the final rule, although we expect that many registrants may include the new table near the existing Compensation Discussion & Analysis disclosures.

The specific components of the pay and performance measures required to be included in the PvP table are described in the following sections.

Pay – Executive compensation disclosures required

The required 'pay' disclosures in the PvP table comprise specific measures of compensation for a registrant's named executive officers. The two measures required include a new measure of 'compensation actually paid' and the total compensation amount currently required in the SCT ('SCT amount').

Executive officers	SCT amount	Compensation actually paid
Principal Executive Officer (PEO)	Individually	Individually
Other Named Executive Officers (NEOs)	Average for all other NEOs	Average for all other NEOs

If there are multiple PEOs in a given year (e.g. transition year from one PEO to a successor), separate columns for each individual PEO for the relevant years and for both of the required measures of compensation are required.

The definition of NEOs under Item 402 includes a registrant's PEO, principal financial officer (PFO), the three most highly compensated executives (other than PEO and PFO), and up to two additional non-executive highly compensated individuals. The average amounts disclosed for the NEOs exclude the PEO. The individuals comprising this average are included in a footnote disclosure (by year).

Adjustments to SCT to determine compensation actually paid

Compensation actually paid is the SCT amount with the following adjustments to pension benefits and equity awards.

Pension benefits

To better reflect the value 'actually paid' under defined benefit and actuarial pension plans, the SCT amount is to be adjusted as follows.

Start with SCT amount for pension benefits
Deduct • Changes in actuarial present value of benefits when positive, and therefore included in the SCT amount.
Add • Service cost − actuarially determined cost for services rendered by the executive for the year. • Prior service cost − entire cost of benefits granted in a plan amendment (or initiation) during the respective year, that are attributed to services rendered prior to an amendment (or initiation), if any.

These additions are calculated using acceptable US GAAP methods and are made even if the benefits are unvested.

The result of these calculations is that the compensation actually paid amount reflects only the pension benefits earned during the year and excludes the amounts that relate solely to changes in interest rates and other actuarial inputs and assumptions.

The above adjustments to the SCT for defined benefit retirement plans are intended to treat defined benefit and defined contribution plans similarly when calculating compensation actually paid.

The SCT amount already includes contributions or other allocations to vested and unvested defined contribution plans for the applicable fiscal year. Therefore, no adjustment for these amounts or plan types are required to calculate compensation actually paid.

Equity awards

Equity awards are reported in the SCT based on their fair value on the grant date (consistent with the amount measured for US GAAP that is ultimately recognized in profit or loss over the relevant attribution period).

The calculation of compensation actually paid under the final rule requires a different amount to be included for equity awards. Instead of the grant date fair value in the SCT amount, compensation actually paid includes the change in fair value of outstanding equity awards each year, beginning when an award is granted through to its vesting. The SEC stated that this approach will better align the compensation disclosure with when the award is actually 'earned' by the executive.

Equity awards with market conditions [*Updated 11/10/23*]

The final rule requires compensation actually paid to include changes in the fair value of awards through their vesting date. Questions arose about what periods should be included in the PvP table for equity awards with market conditions, because a market condition is not considered a vesting condition under Topic 718. As a result, compensation cost may be recognized over a derived service period prior to the market condition being met (or not met) and prior to the awards being exercisable by the recipient.

However, the Compliance & Disclosure Interpretations indicate registrants should consider a market condition similarly to a vesting condition for purposes of complying with the PvP table disclosures and other executive compensation disclosures under Reg S-K.

Therefore, the change in fair value of equity awards with market conditions would be included in the PvP table until the market conditions have been satisfied.

Accordingly, the final rule requires the amounts related to equity awards in the SCT amount to be replaced with the following in the calculation of compensation actually paid.

Compensation actually paid – equity awards
• Year-end fair value of any equity awards granted during the respective year that remain outstanding and unvested at the end of that year • Year-over-year change in fair value as of the respective year-end for equity awards granted in a prior year that remain outstanding and unvested at the end of that year • Change in fair value from the prior year-end to the vesting date for equity awards granted in a prior year that vested during the respective year • Fair value as of the vesting date for any equity awards granted and vested within the respective year • Reduction for the fair value as of the end of the prior year for any equity awards granted during that prior year that failed to vest (e.g. were forfeited) during the respective year [*Updated 11/10/23*] • Value of any dividends or other earnings paid on equity awards prior to vesting date that are not otherwise included in the fair value of the award or other reported compensation amounts

The fair value at each year-end and at the vesting date will now be estimated under the final rule. Registrants may use a valuation technique that differs from the one used to determine the grant date fair value of equity-classified awards, as long as the valuation methodology used would be permitted under Topic 718.

Methodologies and assumptions that are not consistent with Topic 718 are not permitted. For example, an entity cannot use a 'shortcut approach' to determine the expected term assumption to value options. Similarly, the entity cannot use the 'simplified method' to determine the expected term when the options do not meet the criteria to be considered 'plain vanilla' at the remeasurement date. [*Updated 11/10/23*]

Footnote disclosure is required for all adjustments and assumptions (e.g. valuation model inputs) used to determine equity award fair value estimates that are materially different from those disclosed in the financial statements (related to share-based compensation expense).

In the release adopting the final rule, the SEC clarified that registrants are not permitted to remove signing, severance or other one-time payments and bonuses in the disclosure of compensation actually paid for each year.

Further, under the final rule an award requiring exercise (e.g. options) would be considered actually paid during its vesting period, not post-vesting or at the time the award is exercised.

Once the award is vested, the employee can control how and when the award is monetized. The SEC provided a view that changes in the fair value of an equity award after vesting generally reflect investment decisions made by the employee as opposed to companies' compensation decisions.

Performance – Measures and related information required to be disclosed

The following summarizes the four financial performance measures (FPMs) required to be disclosed in the new PvP table.

Registrant TSR	• Substantially similar to the definition of TSR in Reg S-K Item 201(e) • Disclosure is cumulative (Y1: one-year TSR, Y2: cumulative two-year TSR etc.) • Measurement period is from the last trading day prior to the first fiscal year presented (the measurement point) through the end of each covered fiscal year • Amount disclosed is based on a fixed investment of $100 at the measurement point
Peer group TSR	• Registrant's peer group is either (1) the peer group used for Reg S-K Item 201(e), or (2) the peer group used to benchmark executive compensation in the Compensation Discussion and Analysis (CD&A) disclosure in the Proxy Statement • Peer group TSR applies the same calculation as Registrant TSR but is weighted according to market capitalization at the beginning of each period
Net income	• Registrant's net income as defined under US GAAP The SEC staff has clarified that the net income performance measure in the PvP table is net income from the registrant's audited GAAP financial statements; other net income amounts, such as net income or loss attributable to controlling interests or net income or loss from continuing operations, may not be used. [C&DI 128D.08]
Company-selected measure (CSM)	• The single most important FPM that is used to link compensation actually paid to NEOs to company performance for the most recently completed fiscal year • If the most important FPM is already disclosed (e.g. Registrant TSR or net income), then the next-most important; if there are no other FPMs used, the CSM disclosure may be omitted • Required disclosure includes the numerically quantifiable performance of the Registrant under the CSM for each covered fiscal year. For example, if the CSM has been identified as total revenue for the most recently completed fiscal year, the disclosure would quantify total revenue for each covered fiscal year • If the CSM is a non-GAAP financial measure, required disclosure includes a reconciliation from the audited financial statements

Description of relationship

In addition to presenting the pay and performance measures described above in the PvP table, the final rule also requires a registrant to clearly describe the following in a format such as a graphical or narrative style, or a combination of the two:

- the relationship of the Registrant TSR, net income, and CSM to the executive compensation actually paid to the PEO and to the average of the executive compensation actually paid to the remaining NEOs for the five most recently completed fiscal years; and
- the relationship between the Registrant TSR and the peer group TSR for the five most recently completed fiscal years.

List of most important measures

The final rule also requires a tabular list (separate from the PvP table) of the most important FPMs used by the registrant to link executive compensation actually paid to company performance for the most recently completed fiscal year.

- A registrant discloses at least three, but no more than seven FPMs, although it is permissible to disclose fewer than three FPMs if it uses fewer (if no FPMs are used to link executive compensation actually paid to company performance, the tabular list may be omitted).
- A registrant may also include non-financial performance measures (NFPMs) in the tabular list if such measures are among their most important performance measures. However, there must be at least three FPMs (or fewer if it only uses fewer) and a maximum of seven performance measures in total.
- There are three options for the tabular list disclosure; one list for all of the NEOs, two separate lists for each of the PEO and the remaining NEOs, or separate lists for the PEO and each individual NEO. If a registrant elects to disclose multiple lists, each list must include at least three and up to seven FPMs (or fewer if it only uses fewer).
- There is no requirement to rank the tabular list.
- There is no requirement to provide the methodology to calculate the FPMs unless necessary to prevent the information from being confusing or misleading. However, if the FPM is a non-GAAP measure, disclosure must be provided as to how the number is calculated from the audited financial statements.
- Determination of the most important FPMs is based only on the most recently completed fiscal year.
- The CSM must be included in the tabular list.

Permitted additional disclosures

A registrant is permitted to provide additional disclosures as long as they are not misleading, do not obscure and are not more prominent than the required information, and are clearly labeled as supplemental. For example, in addition to the four required FPMs, other performance measures (FPMs or NFPMs) or additional fiscal years may be included in the PvP table if they are considered to be important, could warrant quantitative disclosure, or would help an investor understand the information provided. All performance measures included in the PvP table are subject to the requirement to describe their relationship to the actual executive compensation paid to the PEO and the average of the executive compensation actually paid to the remaining NEOs.

XBRL requirements

The final rule requires registrants to separately tag each value in the tabular disclosure and the footnote disclosure and block-text tag the footnote and relationship disclosures using Inline XBRL.

Smaller Reporting Companies (SRCs)

The requirements under the final rule are scaled for SRCs in the following ways:

- only three years of information (instead of five years);
- disclosure of the peer group TSR, CSM, and the separate tabular list of performance measures are not required;
- disclosure of amounts related to pensions for purposes of compensation actually paid is not required; and
- Inline XBRL tagging is not required until the third filing subject to the pay versus performance disclosures.

Effective dates and transition

The final rule became effective October 11, 2022. Compliance with the final rule is required in proxy and information statements that require executive compensation disclosures (under Item 402) for fiscal years ending on or after December 16, 2022.

The final rule requires five years of pay versus performance disclosures in a tabular format. However, for purposes of transition, registrants will only be required to include information for the three most recently completed fiscal years in the first year of compliance (only two years for SRCs), with an additional year of information required in each following year to phase-in to the full five-year (or three-year for SRCs) tabular disclosure.

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Updates

This newsletter was originally published on September 1, 2022. It was updated on February 17, 2023, and November 10, 2023, to reflect continuing SEC developments.

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