COVINGTON

SEC Adopts "Pay Versus Performance" Disclosure Rule

August 31, 2022

Corporate and Securities

On August 25, 2022, the Securities and Exchange Commission (the "SEC") adopted a rule that requires public companies to provide new disclosures regarding the relationship between executive compensation and the performance of the company. The new rule will require a table showing the compensation actually paid to the principal executive officer ("PEO"), the average compensation actually paid to other named executive officers ("NEOs") and several measures of the company's financial performance, in each case over a five-year period. The new rule, which was first proposed in 2015, implements Section 953(a) of the Dodd-Frank Wall Street Reform and Consumer Protection Act.

The new disclosures must be included in proxy and information statements that are required to contain executive compensation disclosure under Item 402 of Regulation S-K, and will be effective for fiscal years ending on or after December 16, 2022. Thus, for most public companies, the new disclosures will first be required in their proxy statements for their 2023 annual meetings.[1] The five-year coverage of the new table will be phased in over a three-year period.

Although the pay-versus-performance disclosures will be a new Item 402 requirement, this disclosure will not be required in an annual report on Form 10-K or in Securities Act registration statements that otherwise require Item 402 disclosure. Further, the new pay-versus-performance disclosures may, but need not, be included within the Compensation Discussion and Analysis ("CD&A") section of the proxy statement.

---

[1] The new disclosure requirements will apply to smaller reporting companies, but on a scaled disclosure basis and will be phased in over a two-year period. A smaller reporting company is defined in Rule 12b-2 under the Securities Exchange Act of 1934 and generally means a company with a public float below $250 million, or a company with less than $100 million in annual revenues for its most recently completed fiscal year and either no public float or a public float of less than $700 million. Emerging growth companies, registered investment companies, and foreign private issuers will not be subject to the new rule.

New Tabular Disclosures

New Item 402(v) of Regulation S-K requires tabular disclosure showing the following information for each year covered by the table:

- the total compensation shown for the PEO[2] in the Summary Compensation Table ("SCT"), and as adjusted to reflect the compensation "actually paid";
- the average total compensation shown for the NEOs other than the PEO in the SCT, and as adjusted to reflect the compensation "actually paid";
- the cumulative total shareholder return ("TSR") of the company, calculated in the same manner as under Item 201(e) of Regulation S-K;
- the TSR of the company's peer group, weighted by the respective issuers' stock market capitalization. The peer group must be either the index or group of companies used for purposes of the Item 201(e) performance graph, or the peer companies disclosed as part of the company's CD&A;
- the company's net income; and
- a quantifiable measure (not otherwise required to be disclosed above) chosen by the company that represents the most important financial performance measure the company uses to link compensation actually paid to NEOs to the company's performance for the most recently completed fiscal year (the "Company-Selected Measure"). This measure may be a non-GAAP financial measure, but will not be subject to the requirements of Regulation G and Item 10(e) of Regulation S-K, although a definition of such non-GAAP measure must be provided.

[2] For years with multiple PEOs, companies will be required to include separate disclosures for each PEO.

Below is an example of the tabular disclosure called for by Item 402(v), as provided in the SEC's final rule:[3]

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:		Net Income	[Company-Selected Measure]*
					Total Shareholder Return	Peer Group Total Shareholder Return*		
(a)	(b)	(c)	(d)	(e)	(f)	(g)	(h)	(i)
Y1								
Y2								
Y3								
Y4*								
Y5*								

Relationship Between Pay and Performance

Using the information presented in the table, a public company will be required to clearly describe the relationship, over the period covered by the table, between the compensation actually paid to the PEO and the average of the other NEOs and: (i) the company's TSR, (ii) the company's net income, and (iii) the Company-Selected Measure. In addition, a public company will need to describe the relationship between the company's TSR and the TSR of the company's peer group. The final rule affords companies flexibility to decide how best to show these relationships, including narratively, graphically (such as, for example, with lines plotted to show the change in compensation and the financial performance measures over the relevant period), or through a combination of such methods.

The new rule will also require public companies to provide a list of the three to seven financial performance measures (which must include the Company-Selected Measure) that the company determines are its most important financial measures used to link the compensation actually paid during the last fiscal year to the company's performance. If a company uses fewer than three financial performance measures to link the compensation actually paid during the last fiscal year to the company's performance, it need only list those financial measures it actually uses. A company may, but need not, include non-financial measures in this list if it considers such measures to be among the three to seven "most important" performance measures and it has disclosed its three most important financial performance measures (or all of the financial performance measures, if the company actually uses fewer than three).

Supplemental disclosures, including additional financial performance measures, may be included as part of the pay-versus-performance disclosures, so long as the disclosure is clearly

[3] Smaller reporting companies, which are not required under current rules to prepare a stock performance graph under Item 201(e) or a CD&A, are not required to disclose the items marked with an asterisk.

identified as supplemental, not misleading, and not presented with greater prominence than the required disclosure.

Calculation of Compensation "Actually Paid"

Compensation actually paid will be determined by adjusting the amount of total compensation, as reported in the SCT, to better reflect the value of pension benefits and equity awards actually realized by the executives during the year. The final rule requires disclosure of the amount of such adjustments for each year in a footnote to the table shown above.

Pension amounts will be adjusted by deducting from total compensation as shown in the SCT the change in pension actuarial value and by then adding back (i) the actuarially determined service cost for services rendered during the applicable year and (ii) the actuarially determined cost of benefits changed during the year that are attributed to periods prior to the change. In both cases, these service costs are to be calculated using the same methodology as used for the company's financial statements.

To reflect the fair value of equity awards actually realized during a year, the new rule calls for a series of adjustments to be made to the amounts reported in the SCT for grant date fair value of stock awards and option awards. These adjustments will subtract from total compensation, as shown in the SCT, the grant date fair value of awards made during the year and then will add back adjustments to reflect the fair value of awards actually realized, such as, for example, the year-end fair value of unvested awards granted during the year and the change in fair value of unvested awards granted in previous years. To the extent that assumptions used to determine the fair value of awards on their vesting date differ materially from assumptions used in determining grant date fair value as disclosed in the company's financial statements, the company will be required to disclose such different assumptions with footnotes to the pay-versus-performance disclosures.

Phase-in

Public companies other than smaller reporting companies will be required to phase in the new pay-versus-performance disclosures over the course of three years. In their first year of being subject to the rule, such companies will have to provide the disclosures for the three-year period ending in the most recent fiscal year. In the second year, the disclosures will have to cover the preceding four-year period. In the third year, disclosures by these companies must provide the required disclosure for the full five-year period contemplated by the rule.

Smaller reporting companies are only required to provide the disclosures for a three-year period and will phase in their disclosures over the course of two years. In the first year of being subject to the rule smaller reporting companies will be required to provide the information for the two-year period ending in the current fiscal year. In the second year such companies will be required to provide disclosure for a three-year period.

XBRL Tagging

Companies will be required to include an exhibit in which the required pay-versus-performance information has been tagged in an interactive data format using XBRL. This requirement will be phased-in for smaller reporting companies, so that they will not be required to comply with the tagging requirement until the third annual filing in which the pay-versus-performance disclosure is provided.

Next Steps and Observations

The new rule represents a significant and highly technical new disclosure obligation for many public companies. It will require companies to come up with new compensation data that are not required under the SEC's already-extensive executive compensation disclosure regime and that differ in meaningful ways from the supplemental information that many issuers provide in their C&DAs to illustrate the linkage between pay and performance in their executive compensation programs.

Companies will need to be prepared to discuss in the accompanying narrative disclosure and in their CD&As any data in the new table that might appear to show a misalignment of pay and performance. In addition, the mandated peer group disclosures may highlight information that is not comparable across the entire peer group. Peer groups are selected based on a variety of criteria that are not necessarily focused on producing a group with comparable financial results. Companies should consider whether the new table will impact the company's discussions regarding the peer group with investors, particularly if the company's TSR does not align with its peer group.

If you have any questions concerning the material discussed in this advisory, please contact the following members of our Securities and Capital Markets practice group:

Kerry Burke	+1 202 662 5859	kburke@cov.com
Mellissa Campbell Duru	+1 202 662 5659	mduru@cov.com
David Engvall	+1 202 662 5307	dengvall@cov.com
Matt Franker	+1 202 662 5895	mfranker@cov.com
Andrew Klimek	+1 202 662 5327	aklimek@cov.com
David Martin	+1 202 662 5128	dmartin@cov.com
Charlotte May	+1 202 662 5732	cmay@cov.com
Brian K. Rosenzweig	+1 212 841 1108	brosenzweig@cov.com