# SEC Adopts Pay Versus Performance Rule on Executive Compensation

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**Background** In the years following the banking and financial crisis of 2008, there was a particular focus by the media and lawmakers on CEOs and other executives collecting hundreds of millions of dollars in compensation. In response, the Dodd-Frank Wall Street Reform and Consumer Protection Act ("Dodd-Frank Act") sought to "strengthen the transparency and quality of executive compensation disclosure to investors."[1] The Dodd-Frank Act mandated that the Securities and Exchange Commission ("SEC") adopt rulemaking that would require public companies to disclose information regarding the relationship between executive compensation and the company's financial performance. The SEC first proposed pay versus performance rules in 2015 as part of their Dodd-Frank Act rulemaking mandates, but the rules remained in proposed form for seven years. In January 2022, the SEC reopened the comment period for the rules that were originally proposed in 2015. Now, well after a decade following the 2008 financial crisis, the rules are taking effect.

**Pay Versus Performance Rules**

On August 25, 2022, the SEC adopted pay versus performance disclosure requirements as directed by the Dodd-Frank Act.

The new rule requires that public companies provide a table that discloses specified executive compensation and financial performance metrics for their five most recently completed fiscal years. Companies are required to report:

- Total shareholder return ("TSR")
- The TSR of peer companies chosen by the company (which must be the same index or peer group used for the purposes of Item 201(e) of Regulation S-K for its stock performance graph or, if applicable, the peer group used for purposes of the compensation and analysis disclosures)
- Net income of the company
- A financial performance measure chosen by the company and specific to the company that, in the company's assessment, represents the most important financial performance measure the company uses to link compensation actually paid to the company's named executive officers to company performance for the most recently completed fiscal year

In addition, companies must describe the relationship between the financial performance measures included in the table and the executive compensation paid to the CEO and, on average, the other named executives for the previous five fiscal years, along with a description of the relationship between the company's TSR and its peer group TSR. Companies are required to identify three to seven financial performance measures they deem most important. Non-financial measures may be included if they are among the most important measures.

The pay versus performance rules are just one piece of the compensation disclosure and regulatory regime that the Dodd-Frank Act sought to enact and implement. Public companies have been subject to "say on pay" stockholder votes for over a decade and are also generally already required to disclose their "CEO pay ratio," which is (i) the median total compensation of all the employees of the company, excluding the principal executive such as the CEO, (ii) the CEO's total compensation, and (iii) the ratio between those two amounts. The company must also include a narrative regarding the methodology used to determine the median employee.

**Effective Date**

The rule will become effective 30 days after publication in the Federal Register. Companies subject to the rule will need to include this information in their proxy statements for fiscal years ending after December 16, 2022. For a company subject to the rules with a calendar year end fiscal year, this information must be in its 2023 proxy statement. For the first proxy statement, companies must provide the information for the previous three years, adding another year of disclosure in each of the two subsequent annual proxy filings. The pay versus performance disclosure also must be tagged using Inline XBRL.

**Smaller Reporting Companies and Applicability**

Smaller reporting companies are subject to scaled disclosure requirements and must only provide the previous two years in the initial proxy statement, adding an additional year of disclosure in the subsequent annual proxies. They also only need to provide disclosures for the previous three years rather than five and need not provide peer group TSR or any company-selected measure. Smaller reporting companies also need not provide the information in Inline XBRL until the third filing in which they provide pay versus performance disclosures.

The rules are not applicable to foreign private issuers, registered investment companies, or emerging growth companies.

**Preparation and Liability Considerations**

While there has been increased interest in the connection between executive compensation and financial performance and a number of companies have already been pushed toward additional disclosures more explicitly linking business performance to executive compensation, the new rules require companies to go further and tie compensation actually paid to their executive officers to specific financial performance and metrics. Accordingly, while much of the information may be based on information that a company otherwise discloses, the calculations and presentation must conform to the SEC rules. Consequently, we recommend companies discuss and review these new requirements with their legal and compensation advisors, determine when such disclosure will become required for them, and begin the process of planning and adopting procedures to gather and present such information.

Further, the new disclosures will be subject to potential SEC review and comment and are subject to liability under Rule 14a-9 and other liability provisions under U.S. federal securities laws under which proxy disclosures are subject. Failure to comply with the new rules could result in SEC comments, shareholder litigation, and reputational damage, among other actions.

[1] Statement on Final Rule Regarding Pay Versus Performance by SEC Chair Gary Gensler.

**Public companies should prepare to comply with the new rules. For more information, please contact a member of Benesch's Labor & Employment Practice Group or Corporate & Securities Practice Group.**

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