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Client Alert
News Flash

Latham & Watkins Executive Compensation, Employment & Benefits Practice

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SEC Issues New "Pay Versus Performance" Guidance

The SEC provides much-needed guidance on the new pay versus performance disclosure requirements that will be applicable to the current proxy season.

On February 10, 2023, the Staff of the Securities and Exchange Commission (SEC) issued new compliance and disclosure interpretations (C&DIs) providing much-needed guidance on the new pay versus performance disclosure requirement under Item 402(v) of Regulation S-K. For a full summary of the disclosure requirement, please refer to the discussion of the rules in this Latham Client Alert.

The SEC issued 15 new C&DIs in all. This Client Alert summarizes the guidance that will likely be applicable to most companies:

- **Pay Versus Performance Disclosure Not Required in Part III of Form 10-K.** The pay versus performance disclosure is not required to be incorporated by reference into Part III of Form 10-K. It is only required to be provided in connection with proxy or information statements that require disclosure under Item 402 of Regulation S-K. As a result, Item 402(v) disclosures are not incorporated by reference into Securities Act registration statements.

- **Footnote Disclosure of CAP Adjustments Requirements Clarified.**

  - Footnote disclosure of each amount deducted and added pursuant to Item 402(v)(2)(iii) to calculate compensation actually paid (CAP) is required. Aggregate disclosure of the adjustments is not permitted.

  - Footnote disclosure of each amount deducted and added pursuant to Item 402(v)(2)(iii) to calculate CAP is required for all fiscal years presented in a company's first pay versus performance table (e.g., a company that includes its first pay versus performance table in its 2023 proxy statement must include this footnote disclosure for each of fiscal years 2020, 2021, and 2022). In subsequent years, this disclosure is only required for the most recent fiscal year in the table (unless the prior year adjustments are material to an investor's understanding of the information in the table for the most recent fiscal year or the relationship disclosure). Following the initial year of presentation, most companies likely will elect to limit this footnote disclosure to the most recent fiscal year.

- **Using Compensation Peer Group Permissible for Peer Group TSR Calculation.**
  - For purposes of calculating peer group total shareholder return (TSR), companies may use any compensation peer group that is disclosed in its compensation discussion and analysis (CD&A) as a peer group actually used to help determine executive pay, even if the peer group is not used for "benchmarking" within the meaning of SEC guidance.
  - Companies that elect to use their CD&A peer group for this purpose should present the peer group TSR for each year in the pay versus performance table using the peer group disclosed in its CD&A for such year, rather than using the 2022 peer group for all three years.
  - Despite this clarification, many companies likely will decide to use their industry or line-of-business index included in the performance graph under Regulation S-K Item 201(e) to avoid the additional disclosure obligations if the company's CD&A peer group changes (i.e., disclosing the reason for the change and comparing the company's cumulative TSR to the cumulative TSR of both the old and new peer groups).
- **TSR Calculation Starting Point for Newly Public Companies Clarified.** For companies that went public during the earliest year included in the pay versus performance table, the "measurement point" for purposes of calculating TSR and peer group TSR should begin on the date of registration under Section 12 of the Exchange Act. This is consistent with the calculation of TSR under Item 201(e) of Regulation S-K.
- **GAAP Net Income Required.** The net income or loss measure that must be disclosed in column (h) of the pay versus performance table is the number required to be disclosed in the company's audited GAAP financial statements (per Regulation S-X). Companies may not deviate from this calculation, such as by excluding material discontinued operations or by disclosing net income attributable only to the company's controlling interest in non-wholly-owned subsidiaries.
- **Choosing a Company-Selected Measure.**
  - The company-selected measure (CSM) in the pay versus performance table is a financial performance measure selected from the tabular list included in the pay versus performance disclosure. The CSM can be a measure that is derived from, a component of, or similar to the financial performance measures otherwise required to be disclosed in the pay versus performance table. For example, earnings per share, gross profit, income or loss from continuing operations, and relative total shareholder return are permissible CSMs, even though they are derived from or similar to GAAP net income and TSR. However, the CSM may not be measured over a multiyear period that includes the applicable year as the final year. Thus, for example, relative TSR that is measured over multiple years is not a permissible CSM, but relative TSR that is measured annually is permitted.
  - Stock price may not be used as a CSM if the only impact of stock price on CAP is through changes in the fair value of equity awards in the calculation of CAP. Stock price is only a permissible CSM where it is used by the registrant to link CAP to company performance, such as where it is a market condition applicable to payout levels under an incentive plan award, or where stock price is used to determine the size of a bonus pool. As a reminder, if a company did not use any financial performance measures in connection with its executive compensation program in the last completed fiscal year, or if the company only uses financial performance measures that are already included in the pay versus performance table (i.e., TSR and/or GAAP net income),

the company is not required to include a CSM in the table, or to describe a CSM in the narrative and/or graphical relationship disclosure to the table.

 - If a company's bonus pool is available for payout, or the size of the bonus pool is determined, based on a financial performance measure, the measure is eligible to be a CSM, even if allocations of payouts from the bonus pool are in the discretion of the Compensation Committee and not tied to any financial performance measure. If this is the only financial performance measure used by the company in setting executive compensation, the company may not take the position that it does not have a CSM and must use this measure. As a reminder, if a company determines that it does not use any financial performance measures in setting executive compensation, it should note this in the pay versus performance disclosure.

- **Combining CAP for Multiple PEOs.** If a company has multiple principal executive officers (PEOs) in a fiscal year, it may aggregate the PEOs' CAP for purposes of the narrative and/or graphical relationship disclosure showing the correlation between CAP and the financial performance measures, but only to the extent that the presentation will not be misleading to investors.
  - Companies will still need to show the total compensation of the PEOs from the Summary Compensation Table for the applicable year and each PEO's CAP separately in the Pay Versus Performance table.
- **Equity Awards Granted Prior to Becoming a NEO Must Be Included in Compensation Actually Paid.** In calculating the change in the fair value of equity awards in determining CAP, equity awards granted in a year prior to the year an individual became a named executive officer (NEO) must also be captured in the CAP calculations.

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