

SEC Staff Issues Interpretations Relating to the Final “Pay versus Performance” Disclosure Rules

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On February 10, 2023, the Securities and Exchange Commission (the “SEC”) Staff issued a series of Compliance & Disclosure Interpretations (CD&Is) relating to the final “pay versus performance” disclosure rules. These CD&Is cover a range of topics, including use of peer groups, valuation, disclosure of financial performance measures, and presentation of footnotes to the pay versus performance table. As the 2023 proxy season is fast approaching, and calendar-year companies are preparing to finalize initial disclosures, it is important for issuers to review this guidance to ensure no changes need to be made to its draft disclosures.

Overview of Final Pay Versus Performance Rules

On August 25th, 2022, the SEC adopted final pay versus performance rules, now codified in Item 402(v) of Regulation S-K, requiring registrants to disclose information reflecting the relationship between “executive compensation actually paid” by a registrant and the registrant’s financial performance. This rule is intended to provide shareholders with a more clear and digestible understanding of the relationship between “executive compensation actually paid” by a company and the company’s overall financial performance.

A link to Milbank’s original client alert covering the final pay versus performance rules can be found here: <https://www.milbankgeneralcounsel.com/2022/09/sec-releases-final-pay-versus-performance-rules/>

Overview of Topics Covered in the New SEC Staff CD&Is

A summary overview of the CD&I interpretations is set forth below:

- ***Are the new pay versus performance disclosures under Item 402(v) of Regulation S-K required to be included in Form 10-K annual reports?***

- No. The pay versus performance disclosures are only required to be provided in connection with a *proxy or other information statement* for which the SEC requires executive compensation disclosure pursuant to Item 402 of Regulation S-K.
- ***In calculating the equity award adjustments required to determine “compensation actually paid”, are equity awards granted to a first-time named executive officer (“NEO”) in a year prior to (and not otherwise related to) their appointment as a NEO required to be included?***
 - Yes, the change in value of such awards during the executive’s tenure as an NEO will need to be included in the calculation of compensation actually paid.
- ***Is footnote disclosure describing each amount deducted and added as part of determining “compensation actually paid” required to be included for each of the fiscal years presented in the table?***
 - Disclosure for years other than the most recent fiscal year included in the pay versus performance table will only be required if it is material to an investor’s understanding of the information reported in the table for the most recent fiscal year. However, in the table provided in a registrant’s initial pay versus performance disclosure, the registrant will need to provide such footnote disclosure for each of the periods presented in the table.
- ***In satisfying the above footnote disclosure requirements, can a registrant present such amounts (i.e., present the adjustments) in the aggregate, rather than showing each amount added and deducted separately?***
 - No. Registrants will be required to provide footnote disclosure of each amount deducted and added as part of the calculations completed for pension value adjustments and equity award adjustments; however, as described above, other than for the initial year of disclosure, this level of detail will only be required to be provided for the most recent fiscal year.
- ***For purposes of calculating peer group total shareholder return (TSR), can a registrant use any compensation peer group that is disclosed in its CD&A?***
 - Registrants may use a peer group that is disclosed in its CD&A so long as the peer group is actually used by the registrant to help determine executive pay, even if such peer group is not used for formal “benchmarking” purposes. The registrant should present the peer group total shareholder return for each year in the table using the peer group disclosed in its CD&A for such year. For example, if a registrant changed its peer group in 2022 vs. 2021, the registrant would be required to calculate peer group TSR for 2022 using the new 2022 peer group, and disclose the details of the peer group for each year.

- ***What time period is a registrant required to use for its cumulative total TSR and peer group TSR when the registrant went public during the earliest year included in the pay versus performance table? What about when a company emerges from bankruptcy?***
 - If a registrant's securities were registered under Section 12 of the exchange act 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 such registration date. Similarly, if a registrant emerges from bankruptcy and a new class of stock is issued under the bankruptcy plan, the registrant may present cumulative TSR and peer group TSR using a measurement period that starts when its new class of stock starts trading.
- ***What measure of "net income" is required to be included in the pay versus performance table?***
 - For purposes of the pay versus performance table, registrants are required to include net income or loss as required to be disclosed in the registrant's audited GAAP financial statements under Regulation S-X.
- ***May a registrant provide a Company-Selected Measure that is derived from net income or TSR (such as earnings per share, gross profit, income or loss from continuing operations, or relative total shareholder return), even though such metrics are derived from net income and TSR as presented in the pay versus performance table?***
 - Yes, the Company-Selected Measure can be any financial performance measure that differs from the financial performance measures otherwise required to be disclosed in the table, including measures that are derived from, or are similar to, those measures.
- ***Can a registrant use its stock price as its Company-Selected Measure if the only link between compensation actually paid and stock price is the value of equity compensation awards?***
 - No. If the only impact of stock price on a NEO's compensation is through changes in the value of share-based awards, the registrant could not include its stock price as the Company-Selected Measure. However, if, for example, the registrant's stock price is a market condition applicable to an incentive plan award or is used to determine the size of a bonus pool, it may be included as a registrant's Company-Selected Measure.
- ***Can a registrant use a multi-year measure to present or calculate its Company-Selected Measure?***
 - No. The Company-Selected Measure must relate to the most recently-completed fiscal year.
- ***If a registrant uses a financial performance measure to calculate an overall bonus pool, but the individual payouts are based on factors other than financial performance***

measures (such as committee discretion), may the registrant omit the “Tabular List” and the Company-Selected Measure, and the related relationship disclosure(s)?

- No; in this scenario, the registrant would still be considered to have used the financial performance measure to link executive compensation actually paid, and therefore would still need to incorporate that measure into the relevant disclosures.
- ***If a registrant has more than one PEO in a fiscal year, may the registrant aggregate the compensation of such PEOs for the given year for purposes of the narrative, graphical or combined relationship disclosures?***
 - To the extent the presentation will not be misleading to investors, the Staff clarified that it will not object if a registrant aggregates the PEOs’ compensation for purposes of the narrative, graphical, or combined comparison between compensation actually paid and TSR, net income, and the Company-Selected Measure.

Milbank Observations

A number of interpretive questions were left open by the text of the final pay versus performance rule following its adoption in August. Given the fairly short period of time provided to registrants to comply with the new rule, practitioners have been awaiting additional interpretive guidance from the Staff ahead of the 2023 proxy season. Some of these interpretive questions have been clarified by the new CD&Is.

Perhaps the most universally relevant piece of guidance provided in the CD&Is is clarification as to what level of detail is required to be included in the footnotes to the pay versus performance table, in connection with the calculation of “compensation actually paid”. The text of the adopting release left open a question as to whether the pension plan adjustments and equity award adjustments for a given fiscal year could be reported in the aggregate (versus disclosing each “bucket” of additions or subtractions). The CD&Is clarify that all of the components of the adjustments must be individually disclosed for all relevant fiscal years for the registrant’s first year of disclosure; in subsequent years, registrants will generally be permitted to only include this level of detail in respect of the most recent fiscal year.

The CD&Is also clarify that registrants are permitted to calculate peer group TSR using any peer group it discloses in its CD&A for purposes of determining executive compensation. At the time the final rule was adopted, there was a question as to whether registrants could only use its CD&A peer group to the extent the registrant used that peer group for formal “benchmarking” purposes. The CD&Is provide registrants with some more flexibility in what peer group it can use for this purpose; however, the CD&Is state that a registrant would be required to re-calculate its peer group TSR if its CD&A peer group has changed from one year presented in the table to another. As a practical matter, using a CD&A peer group may create more work for registrants than would otherwise be required if a line of business or industry index (used to satisfy the performance graph requirements of Item 201(e)) were to be used.

Also of note is the fact that the CD&Is clarified that a company cannot use stock price as its Company Selected Measure unless stock price is actually used to directly determine compensation (for example, if

equity awards vest based on achievement of different stock price hurdles). However, the CD&Is provide some flexibility on what Company Selected Measures can be used by clarifying that registrants can use metrics such as earnings per share, gross profit, or income or loss from continuing operations, despite the fact that such metrics are “derived from” or related to net income and cumulative total shareholder return.

Companies should continue to review and refine their pay versus performance disclosures with this interpretive guidance in mind and contact Milbank for any related questions or guidance.

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