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Preparing the Pay Versus Performance Proxy Statement Disclosure in 2023

With the 2023 proxy season fast approaching, issuers will need to address a number of important considerations in preparing their "pay versus performance" proxy statement disclosures for the first time. More than seven years after announcing its initial "pay versus performance" rule proposal in 2015, the Securities and Exchange Commission (the "Commission") adopted the final rule implementing the disclosure requirements mandated by Section 953(a) of the Dodd-Frank Wall Street Reform and Consumer Protection Act. The final rule introduces Item 402(v) of Regulation S-K, which prescribes disclosure of specified quantitative and qualitative information reflecting the relationship between named executive officer ("NEO") compensation and the issuer's financial performance. Despite the lengthy road to adoption, issuers now must act quickly to prepare the required initial disclosures in their annual proxy statements for 2023.

What issuers are affected?

Item 402(v) applies to all reporting companies other than emerging growth companies, registered investment companies, and foreign private issuers.

By when must issuers comply?

Issuers must comply with these disclosure requirements in any proxy or information statement requiring executive compensation disclosure for fiscal years ending on or after December 16, 2022.[1] Most issuers will need to provide disclosures under the rule for the first time in proxy statements for their annual shareholder meetings in 2023.

What quantitative disclosure is required?

The most significant undertaking for issuers will be to generate quantitative disclosures, which will be contained in a table (the "Pay Versus Performance Table") setting forth certain measures of executive compensation and financial performance. Although constructing the table will be largely a technical exercise, issuers will need to coordinate across their internal finance, accounting, and human resources functions as well as with external advisors, among others, to populate their tables with information not previously required for or otherwise already available from their other compensation-related disclosures or from information reflected in their financial reports.

[1] Issuers are required to disclose executive compensation "if action is to be taken with regard to: (a) The election of directors; (b) Any bonus, profit sharing or other compensation plan, contract or arrangement in which any director, nominee for election as a director, or executive officer of the registrant will participate; (c) Any pension or retirement plan in which any such person will participate; or (d) The granting or extension to any such person of any options, warrants or rights to purchase any securities, other than warrants or rights issued to security holders as such, on a pro rata basis." See Item 8 of Rule 14a-101.

We highlight below the key considerations for issuers making these quantitative disclosures. A copy of the form of Pay Versus Performance Table is included in Appendix A to this memorandum. In completing the table, issuers should consider whether to include additional disclosures to supplement the performance and compensation measures required under the rule.

The final rule allows for a transition period.

Issuers generally will be required to provide this disclosure for their last five fiscal years. However, Item 402(v) allows for a transition period, during which issuers will be required to disclose only their previous three fiscal years in the first applicable filing and an additional year in each of the two subsequent annual filings where disclosure is required.[2]

Four of the eight required columns will restate or be derived from amounts already disclosed by the issuer.

- The "*Summary compensation table total for PEO*" column in the Pay Versus Performance Table simply will restate the amounts in the "Total" column in the already-required Summary Compensation Table for the issuer's principal executive officer ("PEO").
- Similarly, the "*Average summary compensation table total for non-PEO named executive officers*" column will reflect the average (*i.e.*, mean) of the Summary Compensation Table "Total" amounts for the NEOs" other than the PEO.
- The "*Net income*" column will restate the amounts included in the issuer's audited financial statements.
- The "*Total shareholder return*" column will restate the total shareholder return ("TSR") of the issuer for each fiscal year in the table. TSR will be calculated in the same manner as for the performance graph already required pursuant to Item 201(e) of Regulation S-K.[3][4]

In other words, the calculations for these four columns will not require significant additional effort for most issuers. By contrast, the four remaining required columns will require significant effort, as discussed below. Issuers may also include additional columns as supplemental disclosure, if not misleading or presented with greater prominence than the columns required by the rule.

Calculating "compensation actually paid" likely will involve significant input from issuers' internal functions and external advisors.

The amounts in the two "compensation actually paid" columns will be derived from the Summary Compensation Table "Total" amounts but with adjustments for the change in the actuarial present value of defined benefit and actuarial pension plans and the grant date fair values of stock and option awards. These adjustments and certain valuation assumptions must be disclosed in footnotes to the table and generally will require issuers to reflect

[2] Smaller reporting companies ("SRCs") will be required to provide this disclosure for only their last three fiscal years. In addition, SRCs will be required to provide this disclosure for only two fiscal years in the first applicable filing.

[3] The performance graph required by Item 201(e) is a line graph comparing the yearly percentage change in the issuer's cumulative TSR over a five-year period to both: (i) a relevant broad equity market index (such as the S&P 500 or Russell 3000), and (ii) a published industry index, or if none exists, an index of peer companies, as selected by the issuer. The TSR for a particular year is computed by taking the difference between the stock price at the end of the year and at the beginning of the year, adding any dividends paid during the year, and then dividing that total by the stock price at the beginning of the year.

[4] Notably, SRCs will be required to provide issuer TSR disclosure, even though SRCs are not required to provide a performance graph under Item 201(e). However, as noted below, SRCs will not be required to disclose peer group TSR.

new information they do not currently use for other disclosures and may need to be generated for purposes of compliance with the rule.

While the adjustment for the change in pension values will only be required for issuers sponsoring supplemental executive retirement plans and other defined benefit pension plans that cover NEOs,[5] the adjustment to the stock and option award values will impact the vast majority of issuers. The stock and option adjustment also generally will require new fair value determinations for the NEOs' awards on multiple dates over the period covered by the disclosure, and issuers may need to coordinate efforts internally and externally to complete the time-intensive calculations required by the rule.

Specifically, in calculating "compensation actually paid" for a fiscal year covered by the Pay Versus Performance Table, an issuer needs to reflect the following for each NEO equity award granted, vested, or forfeited (or otherwise outstanding and unvested) during the year:

1. For awards granted **during the fiscal year**, fair value as of the vesting date for awards vested during the year and as of year-end for awards outstanding and unvested at year-end.
2. For awards granted **during prior fiscal years**, the change in fair value (positive or negative, relative to fair value as of the previous year-end) as of the vesting date for awards vested during the year and as of year-end for awards outstanding and unvested at year-end, reduced by the fair value as of the prior year-end for any awards forfeited during the year.
3. The dollar value of dividends or other earnings paid (before vesting, if any) during the year and not otherwise included in the Summary Compensation Table "Total" for the year.

All of the above must be calculated for each fiscal year covered by the Pay Versus Performance Table to calculate "compensation actually paid" and may either increase or (if negative) decrease the other components of compensation carried over from the Summary Compensation Table "Total." The values must always be calculated consistent with the methodology used for the issuer's financial statements under U.S. GAAP, except that, for awards vesting subject to performance conditions, the change in fair value as of the fiscal year-end should be calculated based on the probable outcome of the performance conditions as of the last day of the year.

Issuers must carefully consider which peer group to use in calculating peer group TSR.[6]

Similar to issuer TSR, peer group TSR will be calculated in the same manner as for the performance graph already required pursuant to Item 201(e) of Regulation S-K. The extra effort required for this column will be in determining which peer group to use and, depending on the peer group selected, calculating the peer group TSR for each of the fiscal years covered by the Pay Versus Performance Table. Issuers have two options from which to choose: an issuer may use (1) the same peer group used for the Item 201(e) performance graph or (2) a peer group used in its Compensation Discussion & Analysis ("CD&A") for purposes of disclosing compensation benchmarking practices.

In selecting a peer group, therefore, issuers with a compensation benchmarking peer group disclosed in the CD&A may find it useful to calculate peer group TSR for both the performance graph and CD&A benchmarking peer groups to see what the issuer's disclosures would look like for each group. Some issuers may also wish to consider whether the underlying peer groups themselves should change, which may trigger additional disclosures. For instance, if an issuer selects a new performance graph peer group, it must explain the reasons for the change and

[5] Neither the change in defined benefit pension value disclosure, nor the adjustment, is required for SRCs.

[6] As noted above, SRCs will not be required to disclose peer group TSR.

also compare the issuer's TSR with that of both the newly selected peer group and the peer group used in the previous fiscal year.

In addition, issuers should be aware that in future filings, if an issuer changes the peer group used in its pay versus performance disclosure from the one used in the previous fiscal year, under Item 402(v) it only will be required to include tabular disclosure of peer group TSR for the newly selected peer group. However, similar to the Item 201(e) disclosure discussed above, the issuer also must then explain in a footnote to the table the reasons for the change, and compare the issuer's TSR to that of both the old and the new group.

Issuers must carefully consider which financial performance measure to select as the Company-Selected Measure.[7]

The issuer must select a financial performance measure[8] (the "Company-Selected Measure") that represents the most important financial performance measure used in determining compensation actually paid to the NEOs during the most recently completed fiscal year. If the issuer's "most important" measure already is included in the Pay Versus Performance Table, the issuer would select its next-most important measure as its Company-Selected Measure (*e.g.*, an issuer could not present net income, which already is included in the table, as its Company-Selected Measure). Issuers should consider how the selection of the Company-Selected Measure would integrate with other compensation-related disclosures, including the discussion of performance measures in the CD&A.

What qualitative disclosure is required?

Issuers must use the information in the Pay Versus Performance Table to clearly describe the relationships between compensation actually paid (both to the PEO and to the other NEOs) and each measure of financial performance,[9] as well as between the issuer's TSR and the TSR of its peer group, in each case over the issuer's last five fiscal years. Issuers have flexibility as to the formatting of these descriptions, whether graphical, narrative, or a combination of the two. Issuers also will have the flexibility to decide whether to group any of these relationship disclosures together when presenting their clear description disclosure, so long as any combined description of multiple relationships is "clear."[10] Issuers must thoughtfully determine the most appropriate format for this relationship disclosure, ensuring that it is consistent with CD&A disclosure.

Finally, issuers also must provide an unranked list (the "Tabular List") of three to seven financial performance measures that they determine are their most important performance measures for linking compensation actually paid to company performance.[11] As discussed further in the rule, issuers have flexibility in how to present the Tabular List. Notably, the Company-Selected Measure must be included in (and is not in addition to the three to seven performance measures in) the Tabular List. If an issuer does not use any performance measures for linking

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[7] SRCs will not be required to disclose a Company-Selected Measure.

[8] "Financial performance measures" means measures that are determined and presented in accordance with the accounting principles used in preparing the issuer's financial statements, any measures that are derived wholly or in part from such measures, and stock price and TSR. Disclosure of a measure that is not a financial measure under U.S. GAAP will not be subject to Regulation G and Item 10(e) of Regulation S-K; however, disclosure must be provided as to how the number is calculated from the issuer's audited financial statements.

[9] The disclosure must be provided for the relationship with the Company-Selected Measure and net income, as well as with any additional performance measure the issuer elects to include in the table.

[10] SRCs only must present such clear descriptions with respect to the measures they are required to include in the Pay Versus Performance Table and for their last three, rather than five, fiscal years.

[11] SRCs do not need to present Tabular List disclosure.

compensation actually paid to company performance, it does not have to present a Tabular List or disclose a Company-Selected Measure. Issuers should seek input from their compensation committees in preparing the Tabular List. Issuers should consider if and how these measures are expected to be disclosed in the CD&A and whether additional narrative disclosure would be helpful in explaining the selected measures or in justifying executive compensation decisions in the CD&A.

Are supplemental disclosures permitted?

As noted above, issuers may voluntarily provide supplemental measures of compensation or financial performance (in the Pay Versus Performance Table or elsewhere), and other supplemental disclosures, so long as any such measure or disclosure is clearly identified as supplemental, is not misleading, and is not presented with greater prominence than the required disclosure.

What are the key takeaways?

Given the scope of the information required to comply with the final rule, issuers will need to coordinate both internally and externally to prepare their initial drafts of the newly-required disclosures. Issuers should expect that calculating compensation actually paid will be a time-intensive undertaking requiring multiple sources of input to complete. Issuers also should evaluate which peer group to use in calculating peer group TSR, identify the Company-Selected Measure and their most important performance measures, and consider the interrelationship with other disclosures when selecting the Company-Selected Measure and preparing the Tabular List.

Finally, the flexibility provided under the rules (*e.g.*, with regard to supplemental disclosures) means that issuers will need to carefully consider how to approach and present the various required disclosures. Once an issuer identifies its NEOs for the current fiscal year, it should construct an initial "mock up" of the Pay Versus Performance Table and description of the relationship between the NEOs' pay and the peer group and performance measures to inform the issuer's decisions regarding the content and presentation of the disclosures under Item 402(v).

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If you have any questions about the issues addressed in this memorandum or if you would like a copy of any of the materials mentioned, please do not hesitate to call or email authors Geoffrey E. Liebmann (Partner) at 212.701.3313 or gliebmann@cahill.com; Glenn Waldrip (Partner) at 212.701.3110 or gwaldrip@cahill.com; Mark Gelman (Counsel) at 212.701.3061 or mgelman@cahill.com; Sarah Hernandez (Attorney) at 212.701.3231 or shernandez@cahill.com; or David Fuchs (Associate) at 212.701.3274 or dfuchs@cahill.com; or email publications@cahill.com.

Appendix A

Pay Versus Performance

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		
Y1								
Y2								
Y3								
Y4								
Y5								