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Skadden

If you have any questions regarding the matters discussed in this memorandum, please contact the attorneys listed on the last page or call your regular Skadden contact.

One Manhattan West
New York, NY 10001
212.735.3000

300 South Grand Avenue
Suite 3400
Los Angeles, California 90071
213.687.5000

1440 New York Avenue, N.W.
Washington, D.C. 20005
202.371.7000

SEC Guidance Clarifies Some Issues Regarding Pay-Versus-Performance Disclosure, but Leaves Questions Unanswered

The staff of the Securities and Exchange Commission's (SEC's) Division of Corporate Finance recently issued guidance to address open questions related to the final pay-versus-performance (PVP) disclosure rules adopted in 2022. The 15 new Compliance & Disclosure Interpretations (C&DIs) are the first published guidance from the staff on the PVP rules and cover a broad range of topics. While they are helpful in answering a number of open questions, they also raise additional questions of their own and leave a number of other important issues unresolved. Key takeaways from the C&DIs are summarized below.[1]

PVP Disclosure Outside the Annual Proxy Statement

The SEC staff clarified that PVP disclosure is not required in an annual report on Form 10-K, but it did not address whether PVP disclosure is required in other filings (besides proxy or information statements) where executive compensation information is typically disclosed.

PVP disclosures are not required in Form 10-Ks. The introductory language to Item 402(v) provides that PVP disclosure must be included in any "proxy or information statement" for which the SEC requires executive compensation disclosure pursuant to Item 402 of Regulation S-K. The term "proxy or information statement" does not include an annual report on Form 10-K, and C&DI 128D.01 clarifies that PVP disclosure is not required in 10-K filings.

Remaining Questions:

Is PVP disclosure required in filings for an initial public offering (IPO) or spin-off?

The SEC did not address other filings in which executive compensation disclosure pursuant to Item 402 of Regulation S-K typically appears, such as registration statements on Form S-1 filed in connection with IPOs or registrations statements on Form 10 (with its accompanying "information statement") filed in connection with corporate spin-offs.

[1] The C&DIs covering the PVP disclosure rules, 128D.01-128D.13, 228D.01 and 228D.02, are contained in a larger set of C&DIs for Regulation S-K. The August 2022 adopting release includes the final PVP rules.

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A registration statement on Form S-1 is clearly not a "proxy or information statement" and thus no PVP disclosure is required.

For a spin-off, the registration statement on Form 10 includes what is (unhelpfully) referred to as an accompanying "information statement." However, the August 2022 adopting release for the final PVP rules sheds additional light on whether PVP disclosure is required in such filings. It states that the PVP disclosure rules "will provide shareholders with the pay-versus-performance disclosure (along with all other executive compensation disclosures called for by Item 402 of Regulation S-K) in circumstances in which shareholder action is to be taken with regard to an election of directors or executive compensation."

Elsewhere, it states that "the required disclosure may be most useful to shareholders when they are deciding whether to approve the compensation of the named executive officers ("NEOs") through the say-on-pay vote, voting on the election of directors or acting on a compensation plan." Because a public shareholder vote of any sort is generally *not* required in connection with a spin-off, it would be inconsistent with the purpose of the rules to require PVP disclosure for the spin-off company in a Form 10 (and its accompanying "information statement").

Moreover, if PVP disclosure was required in a Form 10 (and its accompanying "information statement"), it would not be possible to complete column (f) of the PVP table with respect to the company's total shareholder return (TSR), since the spin-off company would not have been publicly traded for any of the years covered by the PVP table.

Further support comes from C&DI 128D.06, which provides that, if a company went public during the earliest year covered in the PVP table, the calculation of the company's TSR and peer group TSR need only begin from the company's registration date and is not required to cover any period prior to that date, when the stock was not publicly traded. This supports the view that PVP disclosure is not required in a Form 10 because, when such a form is filed, no public trading of the spin-off company has yet occurred.

Compensation Actually Paid (CAP) Adjustments

The SEC staff provided guidance on the equity awards to be included in the CAP adjustments, as well as the years to be covered and the level of detail required in the footnote disclosure to the PVP table.

Prior-year equity awards granted to a first-time NEO must be included in CAP adjustments. C&DI 128D.02 provides that, although equity awards granted to a first-time named executive officer (NEO) in a year prior to their appointment as an NEO are not required to be reported in the Summary Compensation Table, the change in value of such equity awards during the executive's tenure as a NEO must be included in the CAP adjustments and reflected in the PVP table.

Disclosure of CAP adjustments on an aggregate basis is not permitted. C&DI 128D.04 clarifies that the footnote disclosure requirement with respect to "each of the amounts deducted and added" pursuant to any pension value adjustments or equity award adjustments under Item 402(v)(2)(iii) may not be satisfied by providing the aggregate amount of such adjustments. Instead, each amount deducted or added pursuant to the pension value adjustments under Item 402(v)(2)(iii)(B)(1) or the equity award adjustments under Item 402(v)(2)(iii)(C)(1) must be disclosed in the footnote individually, to the extent applicable. However, note that Item 402(v) specifically allows the adjustment items for NEOs who are not principal executive officers (PEOs) to be reported as averages; they do not need to be reported individually for each one of the non-PEO NEOs.

Footnote disclosure of CAP adjustments generally is required only for the most recent fiscal year, except for first-time PVP disclosure. C&DI 128D.03 confirms that Item 402(v)(3) requires separate footnote disclosure for each item deducted and added only for the most recent fiscal year. For earlier years included in the PVP table, footnote disclosure is required only if it would be material to an investor's understanding of the information reported in the PVP table for the most recent fiscal year, or the relationship disclosure required under Item 402(v)(5). However, in a company's first-ever PVP table, the company must provide such footnote disclosure for each of the years presented in the table.

Remaining Questions

What level of detail is required in the footnote to the PVP table pursuant to Item 402(v)(4), which mandates disclosure of any material differences between the valuation assumptions used for purposes of the CAP equity award adjustments and those used to determine the grant-date value of those equity awards?

Examples of assumptions that might have changed include the risk-free interest rate, dividend yield, expected volatility, remaining award term and the company's stock price. Other possible changes could involve assumptions about the probability of achievement of any applicable performance conditions (*e.g.*, changes from threshold to maximum, or vice versa) or the probability of occurrence of a change in control. What kinds of changes constitute materials differences, and the level of detail required in describing those changes, remain unclear.

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Should equity awards with a "retirement vesting feature" allowing for continued vesting following retirement be treated for purposes of the CAP equity awards adjustments as (i) vested when the holder becomes eligible for retirement or (ii)upon the regular vesting schedule?

The SEC staff provided informal guidance in 2014 to the ABA's Joint Committee on Employee Benefits regarding the treatment of awards with a "retirement vesting feature" for purposes of the Outstanding Awards at Fiscal Year-End Table. The staff stated then that these are treated as vesting on the regular vesting schedule (unless the holder has actually retired). However, it is not clear whether or how this informal guidance from 2014 applies to the PVP rules.

How should dividends that are not paid currently in cash prior to the vesting date, but are instead accrued and paid in cash upon settlement of an underlying equity award, be treated for purposes of the CAP equity award adjustments? Are they treated as paid when they are first accrued, with a later negative adjustment if the underlying awards are forfeited and cancelled without payment? Or should they not be reported until the accrued dividends are actually paid out (which may, in the case of restricted stock units, occur after the vesting date)?

Each of these are important topics are subject to a range of differing views among practitioners and advisory firms, and companies would benefit from further guidance from the SEC staff.

Peer Group TSR Disclosure

Contrary to informal guidance that was widely circulated among practitioners and advisors, the SEC staff took a generous approach to the selection of the peer group used for peer group TSR disclosure in the PVP table, saying that companies may use their proxy statement peer group.

Companies may use the peer group that was "actually used to help determine executive pay" even without formal benchmarking. For purposes of calculating the peer group TSR appearing in column (g) of the PVP table, C&DI 128D.05 notes that companies may use a peer group that is disclosed in the Compensation Discussion and Analysis (CD&A) portion of their proxy statement as long as such peer group was "actually used by the company to help determine executive pay," even if such peer group was not used by the company for formal "benchmarking" of compensation under Item 402(v)(2)(xiv) of Regulation S-K. (See C&DI 118.05 for the meaning of "benchmarking.")

Peer group TSR must be presented using the CD&A peer group for the applicable year. C&DI 128D.07 provides that, if a company elects to use its CD&A peer group (as opposed to the Form 10-K peer group under Item 201I(1)(ii) of Regulation S-K) for purposes of the peer group TSR disclosure in the PVP table, the peer group TSR for each year covered in the PVP table should be presented using the peer group disclosed in its CD&A for that year, rather than the peer group used in the most recent fiscal year. For example, if the company disclosed the same peer group in the CD&A for 2020 and 2021, but a different peer group in the CD&A for 2022, the peer group TSR must be presented (i) using the 2020-21 peer group for both 2020 (which is a one-year TSR for 2020) and 2021 (which is a two-year TSR for 2020-21) and (ii) using the 2022 peer group for 2022 (which is a three-year TSR for 2020-2022).

Remaining Questions

In this first proxy season of PVP disclosure, will companies be required to explain a change in peer groups from 2021 to 2022, and provide relationship disclosure for multiple peer group TSRs?

Item 402(v)(2)(iv) provides that, if a company uses a different peer group for its peer group TSR disclosure than it used in the immediately preceding fiscal year, the company must (i) include footnote disclosure to the PVP table that explains the reasons for the change to the peer group and (ii) in the relationship disclosure under the PVP rules, compare the company's TSR with the TSR of *both* the newly selected peer group and the peer group used in the immediately preceding fiscal year.

It is not clear from C&DI 128D.07 whether, in the fact pattern described in the C&DI, the additional footnote and relationship disclosure will be required for a change in peer group from 2021 to 2022 in this first year of PVP disclosure.

What constitutes a "different peer group" for purposes of this rule under Item 402(v)(2)(iv)? For example, is a change of one peer company in a CD&A peer group comprised of 18 different companies enough to constitute a "different peer group" from that used in the prior year? If not, what is the maximum amount of turnover that can occur before triggering the extra disclosure requirements under Item 402(v)(2)(iv)?

Alternatively, if the company uses as its peer group the published industry or line-of-business index used by it in the Form 10-K performance graph under Item 201(e)(1)(ii) of Regulation S-K, are changes in the individual companies included in the index made as part of normal adjustments to such index enough to trigger the extra disclosure requirements under Item 402(v)(2)(iv)? Or was the rule was only intended to apply to a change from the CD&A peer group to the 10-K peer group or vice versa, and not at all to changes to component members within one of these peer groups?

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While it seems unlikely that the SEC intends to require onerous additional disclosure due to the minor annual fine tuning of a small number of individual companies in a CD&A peer group or to routine annual or quarterly turnover in the individual companies in a published industry or line-of-business index with many components, the views of SEC staff on these issues are not clear at this time.

Meaning of Net Income

The SEC staff provided clarifying guidance about the net income metric appearing in the PVP table.

GAAP net income must be used. C&DI 128D.08 confirms that in column (h) of the PVP table (Net Income), a company must use the net income or loss under generally accepted accounting principles (GAAP) that Regulation S-X requires to be used in the company's audited financial statements. In the table, a company may not substitute other net income amounts from the audited financial statements, such as income or loss from continuing operations (*i.e.*, excluding any discontinued operations during the applicable year).

Identifying the Company-Selected Measure (CSM)

The SEC staff provided guidance about the selection of the CSM, including a clarification of limits on use of a company's stock price as the CSM (an approach that had been favored by a significant minority of companies).

A CSM may be derived from or similar to net income or company TSR. C&DI 128D.09 notes that the CSM disclosed in column (i) of the PVP table may be the company's most important financial performance measure used by the company to link CAP to performance for the most recently completed fiscal year that differs from the financial performance measures already required to be disclosed in the PVP table (*i.e.*, net income and the company's TSR). Specifically, the CSM may even be a financial performance measure that is derived from, a component of, or similar to the required financial performance measures appearing in the PVP table, as long as they are not exactly the same. Examples of permitted CSMs include (i) earnings per share, (ii) gross profit, (iii) income or loss from continuing operations (compare to C&DI 128D.08 described above) or (iii) relative TSR.

Multi-year measurement periods are not permitted for the CSM. C&DI 128D.11 provides that a multi-year financial performance measure may not be used for the CSM, even if the multi-year period includes the most recent fiscal year in the PVP table. Because the CSM must represent the most important financial performance measure (that is not otherwise required to be disclosed in the PVP table) used by the company to link CAP to performance *for the most recent fiscal year*, the CSM must be presented with a single-year measurement period. For example, if the company uses a three-year relative TSR metric for its performance-based equity awards, the three-year relative TSR may not be used as the CSM, but the one-year relative TSR may be used. Presumably, the multi-year TSR may be used as an additional performance measure under the tabular list of the company's most important performance measures.

The use of a company's stock price as its CSM is limited. C&DI 128D.10 clarifies that the company's stock price may not be used as the CSM if the company did not use its stock price to directly link CAP to performance (*i.e.*, as a performance metric used to determined compensation earned or vested) during the most recent fiscal year, even if the company's stock price has a significant impact on the value of outstanding equity awards held by the NEOs as reported in the PVP table. However, if, for example, the company's stock price is a market condition applicable to a performance-based equity award that was outstanding during the most recent fiscal year, or is used to determine the size of a bonus pool for the most recent fiscal year, the company may include its stock price as its CSM.

A CSM may be the financial performance measure used to determine a bonus pool where individual bonuses are determined based on other factors. C&DI 128D.12 addresses the case of a company that uses a "pool plan" to determine its annual bonus awards, where the bonus pool is (i) available for payout only upon achievement of a financial performance measure or (ii) scaled based upon the extent such financial performance measure is achieved, but (iii) individual bonuses out of the pool are allocated using different criteria not tied to that financial performance measure.

The SEC staff's response clarifies that, because the size of the bonus pool is determined based on the financial performance measure, the company is using that measure to link CAP to performance within the meaning of the PVP disclosure rules. Therefore, the measure may be used as the CSM. And, if that is the only financial performance measure employed by the company during the most recent fiscal year, it *must* be used as the CSM and be listed among the company's most important financial performance measures for the most recent fiscal year.

Relationship Disclosure for Multiple PEOs in the Same Fiscal Year

Although the PVP disclosure rules require that columns be added to the PVP table when a company has multiple PEOs in a single year covered by the PVP table, the SEC staff was more lenient in the context of the relationship disclosure.

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Aggregating multiple overlapping PEOs for purposes of the relationship disclosure is permitted. To the extent the presentation will not be misleading to investors, C&DI 128D.13 states that the staff will not object if a company aggregates the compensation of multiple PEOs serving during a single reporting year for purposes of the disclosure of the relationship between CAP and the company's TSR, net income and CSM.

Implications

Companies will need to review and become familiar with these new C&DIs and incorporate them into their 2023 proxy season disclosures. The PVP disclosure rules and new C&DIs raise many complex and sometimes unresolved questions, and companies should consult counsel when applying them.

Contacts

Page W. Griffin
Partner / New York
212.735.2108
page.griffin@skadden.com

Shalom D. Huber
Partner / New York
212.735.2483
shalom.huber@skadden.com

Regina Olshan
Partner / New York
212.735.3963
regina.olshan@skadden.com

Joseph M. Penko
Partner / New York
212.735.2618
joseph.penko@skadden.com

Erica Schohn
Partner / New York
212.735.2823
erica.schohn@skadden.com

Joseph M. Yaffe
Partner / Los Angeles
213.687.5516
joseph.yaffe@skadden.com

Berit R. Freeman
Counsel / New York
1.212.735.2112
berit.freeman@skadden.com

Michael A. Wiseman
Counsel / New York
212.735.2662
michael.wiseman@skadden.com

Loren Koles
Associate / New York
212.735.3671
loren.koles@skadden.com