## NEW DISCLOSURE REQUIREMENTS FOR THE 2023 PROXY SEASON

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### Introduction

Looking ahead to the upcoming 2023 proxy season, the U.S. Securities and Exchange Commission ("SEC") has adopted new compensation disclosure obligations that will require significant thought, preparation, and lead time. These obligations can be found in new Item 402(v) of Regulation S-K, which implements Section 14(i) of the Exchange Act.

Congress added Section 14(i) through the Dodd-Frank Act.[1] Section 14(i) directed the SEC to adopt rules requiring public companies to provide a clear description of the relationship between executive compensation actually paid and the company's financial performance, or what is commonly referred to as "pay-versus-performance." At their core, the new disclosure requirements involve a comparison of executive compensation against the company's total shareholder return, net income, and a company-selected measure, along with insight into the company's use of financial performance measures when setting executive compensation. The SEC's 233-page release is available here. The SEC has also issued a press release and a brief fact sheet.

Item 402(v) applies to all reporting companies (including business development companies) except foreign private issuers, registered investment companies, and emerging growth companies. As explained below, smaller reporting companies ("SRCs") are only partially subject to Item 402(v). The new executive pay-versus-performance compensation disclosures will be required beginning in 2023 for companies with a calendar-year-end fiscal year. However, the disclosures are only required in proxy and information statements.[2] Item 402(v) has three major components, each of which is summarized below.[3]

### Pay-Versus-Performance Disclosure Table and Footnotes[4]

Item 402(v) requires the following pay-versus-performance disclosure table, with the asterisked items indicating portions of the table from which SRCs are exempt:

Much of this table can be derived from or is related to other Regulation S-K requirements.[5] When selecting a peer group, a company should choose either the same peer group used for purposes of Item 201(e) of Regulation S-K or a peer group used in the Compensation Discussion and Analysis to disclose the company's compensation benchmarking practices.

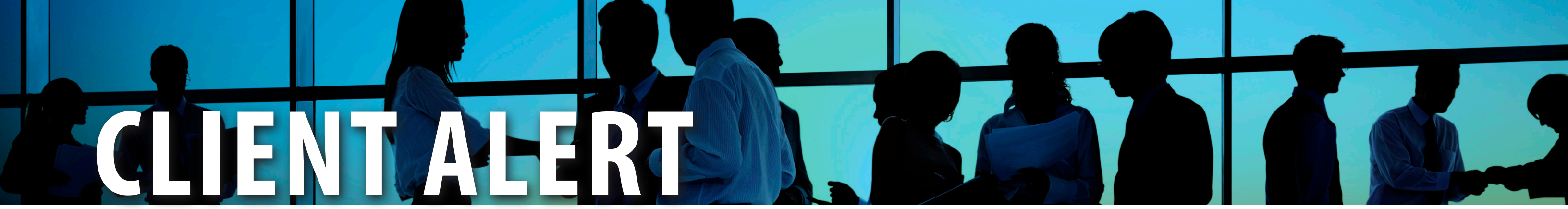
As the SEC explained in its guidance, if the peer group is not a published industry or line-of-business index, the identity of the issuers in the group must be disclosed in a footnote. A company that has previously disclosed the composition of issuers in its peer group in prior filings with the SEC would be permitted to comply with this requirement by incorporation by reference to those filings. Finally, suppose a company changes the peer group used in its pay-versus-performance disclosure table from the one used in the previous fiscal year. In that case, it will only be required to include tabular disclosure of peer group total shareholder return ("TSR") for that new peer group (for all years in the table). Still, it must explain, in a footnote, the reason for the change and compare the company's TSR to that of both the old and the new group.

Calculating executive compensation actually paid will likely be the most time-consuming step in preparing the table.[6] The calculation begins with the total compensation reported in the Summary Compensation Table ("SCT"), followed by three adjustments:

- For *pension benefits*, companies that are not SRCs must (1) deduct from the SCT amount the aggregate change in the actuarial present value of the executive's accumulated benefit under all defined benefit and actuarial pension plans and (2) add back the aggregate of the service cost and prior service cost.[7]
- For *equity awards*, companies must deduct the equity award amounts reported in the SCT and then include a specially calculated amount.[8]
- Executive compensation actually paid must also include *above-market or preferential earnings on deferred compensation* that is not tax-qualified.

Companies should consult Item 402(v) for footnote disclosure requirements related to these calculations.[9]

| 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* | | |
| (a) | (b) | (c) | (d) | (e) | (f) | (g) | (h) | (i) |
| Y1..... | ................ | ................ | ................ | ................ | ................ | ................ | ................ | ................ |
| Y2..... | ................ | ................ | ................ | ................ | ................ | ................ | ................ | ................ |
| Y3..... | ................ | ................ | ................ | ................ | ................ | ................ | ................ | ................ |
| Y4*... | ................ | ................ | ................ | ................ | ................ | ................ | ................ | ................ |
| Y5*... | ................ | ................ | ................ | ................ | ................ | ................ | ................ | ................ |






## Tabular List of Financial Performance Measures[10]

In addition to the pay-versus-performance disclosure table, companies (but not SRCs) are also required to disclose an *unranked*, tabular list of at least three, and up to seven, financial performance measures, which in the company's assessment represent the most important financial performance measures used by the company to link compensation actually paid to the company's NEOs, for the most recently completed fiscal year, to company performance. Companies can disclose a single tabular list or multiple lists broken down across (1) the PEO and the remaining NEOs or (2) the PEO and each NEO. The tabular list may also include nonfinancial measures if the company considers them among the most important.

The number of performance measures is capped at seven. A company that considers fewer than three financial performance measures when it links executive compensation paid during the fiscal year to company performance will be required to disclose only the number of measures it actually considers.

The company-selected measure included in the pay-versus-performance disclosure table must be a financial performance measure from this tabular list. In the company's assessment, it represents the most important financial performance measure that is not otherwise required to be disclosed in the table, and is used by the company to link compensation paid to the company's NEOs for company performance for the most recently completed fiscal year, to company performance. The company-selected measure can be updated from one filing to the next. Companies that do not use any financial performance measures to link executive compensation actually paid to company performance or that only use measures already required to be disclosed in the pay-versus-performance disclosure table would not be required to disclose a company-selected measure or its relationship to executive compensation actually paid. Companies are not required to provide the methodology used to calculate the measures included in the tabular list or the methodology used to calculate the company-selected measure.

## Graphical or Narrative Relationship Descriptions[11]

Using the information in the pay-versus-performance disclosure table, companies are required to provide clear descriptions of two key relationships. First, companies must provide a clear description of the relationship between the executive compensation actually paid to the PEO and the average of the executive compensation actually paid to the other NEOs and the company's (1) cumulative total shareholder return, (2) net income, and (3) company-selected measure. Second, companies must clearly describe the relationship between the company's TSR and that of the company's peer group. The description of these relationships must cover the company's five most recently completed fiscal years.

Companies may elect to provide this information in graphical form, in narrative form, or a combination of the two. The SEC encourages companies to use the format that most clearly provides information to investors about the relationships, based on the nature of each measure and how it is associated with executive compensation actually paid. For example, the SEC noted that the required relationship disclosure could include a graph providing executive compensation actually paid and change in the financial performance measures (e.g., TSR, net income, or company-selected measure) on parallel axes and plotting compensation and such measures over the required time period. Alternatively, the required relationship disclosure could include narrative or tabular disclosure showing the percentage change over each year of the required time period in both executive compensation actually paid and the financial performance measures, together with a brief discussion of how those changes are related.

## Transitional Relief[12]

Companies must generally provide three years of the required information in the first proxy or information statement in which they provide the disclosure. After that, companies will add another year of disclosure in each of their two subsequent filings, thereby bringing the total to five. SRCs may provide only two years of this information in their first proxy or information statement, adding an additional year of disclosure in the subsequent proxy or information statement.

## KEY CONTACTS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[1] Dodd Frank Act § 953(a).
[2] The new disclosures are not mandated in other filings where disclosure under Item 402 is required, such as Form 10-K or a registration statement under the Securities Act. Item 402(v) disclosures will also not be deemed to be incorporated by reference into any filing under the Securities Act or the Exchange Act, except to the extent a company chooses to do so.
[3] SRCs should consult Item 402(v)(8) to understand the more limited application of Item 402(v).
[4] *See* Item 402(v)(1)-(4).
[5] For example, the term "PEO" refers to the company's principal executive officer, which is defined in Item 402(a)(3) along with the term "named executive officer" ("NEO"). Likewise, total shareholder return is defined in Item 201(e). The company-selected measure is discussed below.
[6] *See* Item 402(v)(2)(iii).
[7] These amounts should be calculated in accordance with U.S. GAAP, including FASB ASC Topic 715.
[8] *See* Item 402(v)(2)(iii)(C)(1)(i)-(vi).
[9] *See* Item 402(v)(3)-(4).
[10] *See* Item 402(v)(6).
[11] *See* Item 402(v)(5).
[12] *See* Instruction 1 to Item 402(v).