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## Five Q&A's Regarding the SEC's Pay Versus Performance Disclosure Rules

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On August 25, 2022, the Securities and Exchange Commission (SEC) adopted its long-awaited pay versus performance (PvP) rules mandated by the Dodd-Frank Act of 2010.<sup>1</sup> These rules amend the SEC's existing executive compensation disclosure framework to require public companies to disclose information about the relationship between executive compensation decisions and financial performance.

According to SEC Chairman Gary Gensler, the PvP rules are intended to "help investors receive the consistent, comparable, and decision-useful information they need to evaluate executive compensation policies." However, SEC Commissioner Hester Pierce characterized the rules in her dissent as "unnecessarily complicated," contending that the rules "will elicit costly, complicated disclosure of questionable utility."<sup>2</sup>

Despite the mixed reactions to these intricate new disclosure requirements, most companies must include these new disclosures in their proxy statements for the upcoming 2023 proxy season. Producing accurate and appropriate disclosures addressing these new requirements will be a time-consuming process, involving significant collaboration between internal stakeholders and outside advisors. As a result, impacted companies should start preparing their PvP disclosures now to prevent delays when finalizing proxy materials for distribution next year.

Below are five key questions to assist companies as they begin to prepare disclosures addressing these new requirements.

### WHAT AM I REQUIRED TO DISCLOSE?

New Item 402(v) of Regulation S-K initially requires companies to disclose specified executive compensation and financial performance measures for each of the three most recently completed fiscal years. When fully phased-in, companies must provide these executive compensation and financial performance measures for each of the five most recently completed fiscal years.<sup>3</sup>

Regarding executive compensation, each company must disclose (i) total compensation from the Summary Compensation Table and compensation "actually paid" to its principal executive officer (PEO) and (ii) the average



total compensation from the Summary Compensation Table and average compensation “actually paid” to its other named executive officers (NEOs). Compensation “actually paid” is a new measure specified in the PvP rules that differs from total compensation in the Summary Compensation Table in several meaningful ways, particularly regarding the valuation of outstanding equity awards.<sup>4</sup> Beginning this calculation sufficiently early will be important to avoid delays in finalizing the newly required disclosures for the 2023 proxy season.

Regarding financial performance, each company must disclose the following:

- Total shareholder return (TSR) for the company and the company’s peer group, which can be the peer group used for the company’s performance graph required by Item 201(e) of Regulation S-K or the peer group used by the company for benchmarking compensation in its Compensation Discussion and Analysis (CD&A) disclosure;
- The company’s net income; and
- A “Company-Selected Measure,” which is a financial performance measure chosen by, and specific to, the company that, in the company’s assessment, represents the most important financial performance measure used to link compensation actually paid to NEOs to performance for the most recently completed fiscal year.

Disclosures must be made in the following tabular format<sup>5</sup> and tagged using Inline XBRL:

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		

\* Title of this column will be the actual measure (e.g., Total Revenue, Adjusted EBTIDA, etc.).

Companies must also provide clear disclosure describing the relationship between the compensation actually paid to the PEO and the average compensation actually paid to the NEOs in relation to the financial performance measures included in the table (*i.e.*, TSR, net income and Company-Selected Measure). Each company must also describe the relationship between its TSR and its peer group TSR. In describing these relationships, companies have flexibility regarding how to present the information (*e.g.*, graphically, narratively, or a combination of the two), and may also group any of these relationship disclosures together, provided that the combined description of multiple relationships is “clear”.

In addition to this table, each company must provide a tabular list (the Tabular List) of three-to-seven financial performance measures that it determines are the most important measures for linking compensation actually paid to performance for the most recently completed fiscal year.<sup>6</sup> The Tabular List may include non-financial performance measures, but at least three financial performance measures must be disclosed. Additional measures included in the Tabular List are not required to be ranked or included in the table above, but may include metrics from the table above. For example, if a company utilized TSR, adjusted EBITDA and adjusted net income as financial performance measures linking compensation to performance and selected adjusted EBITDA as its Company-Selected Measure, the company would list TSR, adjusted EBITDA and adjusted net income in the Tabular List, but would not include adjusted net income as part of the above table.



### HOW DO I DETERMINE THE COMPANY-SELECTED MEASURE?

As noted above, the “Company-Selected Measure” must be a financial performance measure that, in the company’s assessment, represents the most important financial performance measure linking compensation actually paid to its NEOs to financial performance for the most recently completed fiscal year. This determination will necessarily be based on the specific metrics and process used by each company to set its compensation levels and targets. However, initial candidates for the Company-Selected Measure will be the financial performance measure that the company most heavily weights when setting payouts under its annual, short-term and long-term incentive plans. We expect other financial performance measures used in evaluating annual, short-term and long-term incentive plans will serve as starting points for the other performance measures required to be disclosed in the Tabular List.

### DOES THIS DISCLOSURE REQUIREMENT OVERLAP WITH THE EXISTING CD&A AND EXECUTIVE COMPENSATION DISCLOSURES?

While some disclosures required by the PvP rules overlap with existing CD&A and executive compensation disclosures, the PvP rules are intended to supplement existing disclosure requirements. Telling a complete and comprehensive story about pay versus performance will likely go beyond existing disclosures for many public companies. The SEC acknowledged this fact in its adopting release, stating that “[e]xisting disclosures generally provide the necessary components to make these comparisons, including data required for calculations that aid in these comparisons, but [completing the actual comparisons] may be time-consuming and costly.”<sup>7</sup> As a result, significant, original disclosure will be required, particularly with respect to the initial set of PvP disclosures.

### WHERE DOES THIS DISCLOSURE GO?

Companies must include the PvP disclosures in proxy statements and information statements that are required to include Item 402 executive compensation disclosure. However, companies have flexibility to present the new PvP disclosures as desired in the context of the overall executive compensation discussion.

In the adopting release for the PvP rules, the SEC specifically considered and rejected the idea of requiring that these PvP disclosures be included within CD&A.<sup>8</sup> Accordingly, similar to disclosures in response to the CEO pay ratio rules, we expect companies will not include the PvP disclosures within existing CD&A disclosure.

### WHEN IS THIS RULE EFFECTIVE?

The PvP rules become effective 30 days following publication of the release in the *Federal Register*. Once effective, companies must provide the required PvP disclosures in proxy statements and information statements for fiscal years ending on or after December 16, 2022. This means that companies whose fiscal year ends on December 31, 2022 will be required to comply with the PvP rules for the upcoming 2023 proxy season.



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- <sup>1</sup> The SEC's final rules are available [here](#) (the Adopting Release) and the SEC's accompanying press release and fact sheet are available [here](#) and [here](#), respectively.
  - <sup>2</sup> SEC Commission Hester Pierce's dissenting statement is available [here](#).
  - <sup>3</sup> Smaller Reporting Companies will initially be required to provide the information for two years, adding an additional year of disclosure in the subsequent annual proxy or information statement that requires PvP disclosure.
  - <sup>4</sup> See Item 402(v)(2)(iii) for requirements regarding the calculation of compensation "actually paid".
  - <sup>5</sup> Companies may supplement this table, "so long as any additional disclosure is clearly identified as supplemental, not misleading, and not presented with greater prominence than the required disclosure." Adopting Release at 25.
  - <sup>6</sup> To the extent that less than three financial performance measures are used to link compensation "actually paid" to performance for the most recent fiscal year, companies must only include those measures used and should note that no additional measures were considered.
  - <sup>7</sup> Adopting Release at 9.
  - <sup>8</sup> See Adopting Release at 24 (noting that "mandating registrants to include the disclosure in the CD&A may cause confusion by suggesting that the registrant considered the pay-versus-performance relationship in its compensation decisions, which may or may not be the case").