# To Disclose or Not to Disclose: Performance Targets and the SEC

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One of the most ambiguous and controversial aspects of the SEC's expanded proxy rules is the disclosure of specific performance targets that are tied to annual and long-term incentive awards. The agency has made clear it considers such information to be key to its goal of providing investors with a better understanding of the level and structure of executive compensation programs.

However, after one year of filing experience and with subsequent guidance provided by the SEC, there remains uncertainty about the manner and extent to which such metrics should be considered material and therefore disclosable and reported. In fact, inadequate reporting of performance targets was the issue most commented on by the SEC staff in its initial review of proxies filed under the new rules. In early 2008, the staff continued to give strong indications that companies will be held to a high standard of disclosure of material targets. Studies of the first season of proxy filings under the new SEC reporting rules by Pearl Meyer & Partners and other firms have concluded that fewer than 50% of filers, regardless of their methodologies, provided full disclosure with respect to specific performance targets or metrics.

Questions about performance targets remain at the forefront of discussions among directors and independent experts. This article presents practical guidance on determining whether and how companies should disclose performance measure details.

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**Director Summary:** This second year of proxy disclosures under the new SEC rules brings with it high expectations of compliance, particularly in disclosing relevant performance targets tied to incentive awards. The authors outline reporting requirements and present six steps for determining the need to disclose, with particular emphasis on competitive harm arguments.

## The Basics

The SEC has stated that the Compensation Discussion and Analysis (CD&A) is intended to provide *material* information that is necessary to an understanding by shareholders of a company's compensation policies and decisions. Among the mandatory items that the SEC wants addressed is how the amount of compensation and the formula (where applicable) was determined. If the formula included a performance target, it must be disclosed, with certain exceptions, to the extent it was materially relevant to compensation policies, decision-making and amounts.

The SEC has put forward the following concepts in regard to the disclosure of performance targets:

- If a target is immaterial to executive compensation policies, it is not subject to disclosure.
- Companies cannot rely on the "competitive harm" standard if the target was disclosed previously.
- If a disclosed target is a non-GAAP measure, the company must also disclose how that number is calculated from the audited financial statements.
- A material target is exempt from disclosure if it would result in competitive harm, but the company must then explain the difficulty of achieving the target and be prepared to explain to the SEC, (if questioned), why it would result in competitive harm.
- Boilerplate language such as "targets are stretch goals" is insufficient.
- Current or prior year information (including performance targets) should be discussed if it adds to an understanding of compensation in the last fiscal year.

Despite these guidelines, the rules and instructions surrounding disclosure of performance targets remain complex and far from clear-cut.

## Six Steps to Determining the Need for Disclosure

*1. Is the performance data material to the*

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***compensation decision-making process?***

The disclosure rules generally offer little guidance as to what is and what is not material. Following the first proxy season, the SEC staff indicated that it generally considers performance targets to be material. Understanding incentive plan payouts is predicated on understanding the metrics or performance hurdles required to earn those payouts. Companies can assume that the more formal the performance plan, the more likely that its metrics and measures would be considered material and subject to disclosure.

The question of materiality might be posed as, *"Is the data essential in order for an investor to understand the basis for the award?"* In contrast, awards that are purely discretionary may not have any material underlying metrics or criteria that need be disclosed, although the company would ultimately be required to disclose how compensation decisions were made. It should be kept in mind that providing a rationale to shareholders for discretionary awards is a sensitive issue and may prove difficult, given the increased governance focus on "pay for performance" standards. At the same time, however, companies whose programs are based on purely formulaic or quantitative measures may feel burdened by an obligation to disclose every last detail of the plan—a disclosure Catch-22, if you will. Many plans contain an array of measures, a large percentage of which might not significantly affect generation of the award. Some of the measures in these plans may not be material to understanding the plan and a complete disclosure could ultimately be contrary to the SEC's goals of clarity and transparency.

***2. Have the measures or values been previously disclosed?***

If the company has previously disclosed a performance measure in filings or in guidance to "the Street," it cannot cite the competitive harm exception. If the measure is similar but is structured differently from the measure that had been disclosed, an argument might be made that the specific measure was not previously disclosed. However, the filer should be prepared to articulate how the performance measure differs from the same or similar measure that was previously disclosed.

***3. What about disclosure of previous and current performance targets?***

The rules require disclosure of plans and actions taken in years previous to or following the fiscal year covered by the proxy if they are material to an understanding of compensation paid during the fiscal year covered by the proxy. Many companies either did not understand that this rule could be prospective in nature or chose to provide a minimal discussion of the prospective plan or none at all. Most companies did not reveal performance targets for 2007 in their 2006 proxy. However, some of the comment letters, as well as informal comments made by the staff in 2008, revealed that going forward, the SEC expects current targets (i.e., 2008 targets for 2007 proxies) to be disclosed to the extent that they were material to understanding the compensation program as a whole, not just as they relate to 2007 plans or payouts.

***4. What about non-Generally Accepted Accounting Principles (GAAP) measures?***

If non-GAAP measures were used in determining compensation (assuming they are material and not within the competitive harm exception), the company must disclose how the number was calculated from the company's audited statements. Most proxies in the first year apparently failed to provide such an explanation, prompting SEC comment letters requesting further explanations of such formulas. As a reminder, among GAAP items are earnings per shares and net income, while typical non-GAAP financial measures include EBITDA, EBIT, and derivatives of cash flow, operating income, margin and net income, assuming the adjustments are not GAAP compliant.

***5. If the metrics are confidential and they are not going to be disclosed, what is required?***

If a company establishes confidentiality through the competitive harm clause, it must explain the difficulty of achieving the award based on the undisclosed measure. Many proxies that took a competitive harm position responded to this question by simply stating that "the targets were stretch goals." Not surprisingly, the SEC deemed such explanations to be boilerplate, unhelpful and unresponsive and asked those companies for further information and clarification. One way to come closer to satisfying this requirement is to disclose, if possible, historical levels of achievement as compared to historic targets.

***6. Will the disclosure cause competitive harm to the company?***

The rule underlying the competitive harm exception has been in existence for some time. The agency's instruction clearly states that both target measures and metrics must be disclosed, unless they are either i.) confidential trade secrets or ii.) confidential commercial and financial information, and the disclosure of such information

would result in competitive harm. Most companies that failed to provide full disclosure in the last proxy season neglected to state that the targets were withheld based on the confidential harm exception and did not adequately address the degree of difficulty in achieving the targets as an alternative disclosure. A company relying on the competitive harm rule should be prepared with a written explanation supporting its decision to make available to the SEC upon request.

Determination of competitive harm is the responsibility of the committee and the board. Whether the targets are financial, operational, retrospective, or prospective, the test is based on the facts and circumstances, and the company must be prepared to explain to the staff, if questioned, the context for the competitive harm argument. The justification should be more easily established for the current year's annual incentive plans, as compared to plans for the last fiscal year, where performance is known by the time of filing. In assessing the potential for competitive harm, companies should consider if disclosure of the target may change the behavior of others; how competitors might change their business strategy; and how customers, suppliers, or other third parties might change pricing or negotiating strategies.

## Solidifying a Competitive Harm Argument

Based on the SEC's reaction to performance target disclosure in the first proxy season, a company that strongly believes that certain data falls within the competitive harm standard should act now to put mechanisms in place to secure such treatment:

- Review the competitive harm clause and exclusions (i.e., Instruction 4 to Item 402(b)), Securities Act Rule 406, Exchange Act Rule 24b-2, Exemption 4 of the Freedom of Information Act and Rule 80(b)(4) thereunder, and Staff Legal Bulletin No. 1 (July 11, 2001)
- Have a one- or two-page document available in the event of an SEC inquiry that details how disclosure would result in competitive harm.
- Mock up a detailed explanation of the difficulty of achieving the target.
- Seek legal counsel to review the argument, the support document, and the pro-forma disclosure and assess its viability from a common sense standpoint.
- Consider arranging (or having counsel arrange) a call with SEC's staff designee and securities counsel to discuss the issue(s) with respect to the upcoming filing.
- Provide the finalized package and conclusions to the compensation committee with respect to why the competitive harm exception should apply.

If it is determined that a competitive harm argument

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is not applicable, the following general action tips should be considered in preparing 2008 disclosures:

- Plan on including an adequate discussion of the metrics underlying any awards, their specific values, and how those values were/are tied to the level of payout(s).
- Plan on disclosing the link between the payment/performance and business strategy for each element of incentive compensation.
- Plan on adequately discussing whether the measures or the rationale used for the rewards (including retrospective and discretionary awards) were sufficiently linked to actual performance and performance expectations.
- Plan on providing, for discretionary plans, the same level of rationale as to what the specific values or metrics were that justified the award and how the award was in fact determined.
- Ensure that disclosures are sufficiently robust to effectively link decisions and the resulting compensation with performance outcomes (past or prospective).
- Remember that disclosure of material individual targets is just as important as disclosure of the overall related company goals
- Be prepared to not only explain individual targets, but also how they influenced or drove the compensation decisions for the specific underlying awards.

## Conclusion

The SEC's response to the first season of filings under its expanded disclosure rules has illuminated the circumstances and means by which companies should report their use of performance targets in executive compensation programs. However, it remains an issue demanding particularly close scrutiny and careful judgment by boards and management. ■

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