The Materiality of Performance Targets

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The new executive compensation rules were a response to widespread perceptions of serious flaws in executive compensation practices. Those perceptions were fueled by a significant rise in the relative level of executive pay and other benefits, the stock option backdating scandal and incidents of questionable oversight by directors. The Securities and Exchange Commission responded to these developments in part by requiring more extensive executive compensation disclosure.

Companies have spent considerable effort to comply with the new rules. Proxy preparation began earlier last year, and compensation disclosure received significant attention from compensation committees. The growth in blogs, magazines, practitioner groups and seminars addressing compliance with the new rules attests to the effort.

While compensation disclosure has improved with additional detail and analysis, it has been notably less robust in the high profile area of performance targets. While some companies did disclose performance targets in the 2007 proxy season, roughly half of large issuers did not provide disclosure about specific performance target levels.[1] One review of SEC comment letters states that all but one of 23 large companies were asked to provide disclosure and analysis concerning the quantitative and qualitative aspects of performance goals.[2] These statistics suggest that a significant portion of large companies had substantial doubts or concerns about disclosure of performance targets. Some companies may have considered that the disclosure could reveal to competitors information about fine-grained and highly specific internal measures of results, even if it would not demonstrably cause competitive harm and be eligible for confidential treatment under SEC rules. Others may have been concerned about the potential for investor confusion if "target"

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[1] The Corporate Executive, September-October 2007, page 7.

[2] SEC Staff Comment Letters on Proxy Disclosure of Executive Compensation, Frederick W. Cook & Co., Inc. (August 30, 2007), available at http://www.fwcook.com/alert_letters/8-30-07_SEC_Staff_Comment_Letterson_Proxy_Disclosure_of_Exec_Comp.pdf

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results for compensation purposes were inconsistent with routine guidance that they provide about their results.

In many cases performance target disclosure is required by the new rules, but the new rules do not explicitly require performance target disclosure in all cases. Rather the rules are driven by the same considerations of materiality that inform disclosure judgments generally under the federal securities laws. The rules and accompanying preamble repeatedly and unambiguously state that only material information must be disclosed. The fact that the SEC's rules are also principles-based should encourage, not preempt, serious consideration of the circumstances in which performance target disclosure is material, and those in which it is not.

It might seem axiomatic that performance targets are always material, but we believe that careful consideration of the facts surrounding a plan's design and operation sometimes demonstrates the opposite conclusion. As we illustrate below, there are common performance-based bonus arrangements in which the payout is determined by purely objective formulaic criteria, but in which specific performance targets may be irrelevant or otherwise not material to an understanding of a plan or an assessment of the degree of difficulty of obtaining a particular level of payout under the plan.

The SEC has been at pains to emphasize that its rules are not intended to drive behavior, but a staff position requiring performance target disclosure, without regard to considerations of materiality, may do exactly that. Because that result would further neither the interests of investors, nor the objectives of a company's employee incentive programs, it seems prudent to review the role that judgments about materiality may play in responding to the SEC's new rules in this area.

Materiality of Performance Targets in Common Bonus Arrangements

Neither the rules governing the compensation discussion and analysis nor the accompanying preamble explicitly require performance target disclosure. Among the six topics required to be addressed is "how the registrant determines the amount (and, where applicable, the formula) for each element of pay." The rules list 15 examples of information that may be required, including "what specific items of corporate performance are taken into account" and "how specific forms of compensation are structured and implemented to reflect these items of the registrant's performance." By contrast, Instruction 1 to the rules governing the compensation discussion and analysis specifically and unambiguously states that the purpose of the CD&A is to provide investors with "material information that is necessary to an understanding" of a company's compensation arrangements.

The instructions to the rules also explicitly permit a company to omit performance target disclosure if disclosure would demonstrably cause competitive harm.

Many have inferred from this provision that performance targets must be disclosed if the exception is not available. But this inference ignores the focus of the rules and the preamble on material information.

Materiality is necessarily a matter of "facts and circumstances," and it is difficult to reach conclusions of general application. Nevertheless, to illustrate the importance of an inquiry into materiality, we consider below what additional information about compensation arrangements would in fact be conveyed by specific performance target disclosure in three common bonus plan designs.

Bonus Based on Performance Formula ("Matrix Plan")

Company X has an annual bonus plan for the CEO. The amount of the bonus is equal to a multiple (ranging from zero to 2.5) of the CEO's base salary determined pursuant to a matrix that takes into account X's earnings and return on equity ("ROE"). X first determines separate factors for the earnings and ROE portions of the bonus, which are then added together to determine the multiple that is used to calculate the bonus. The following tables dictate the factors, with the factors for performance between the indicated levels determined by linear interpolation:

EARNINGS

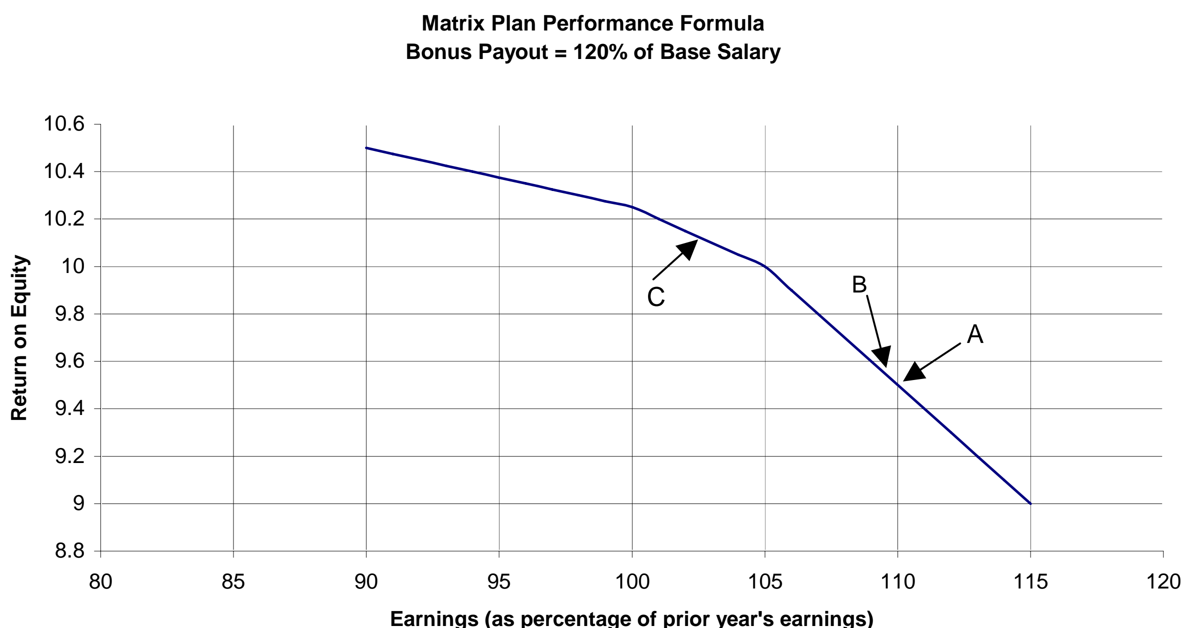
Current Year Earnings Compared to Prior Year Earnings	Bonus Factor for Earnings
Less than 90%	0%
90%	40%
100%	50%
150%	150%

ROE

Current Year ROE	Bonus Factor for ROE
Less than 9%	0%
9%	40%
10%	60%
11% or greater	100%

Assume that in designing the Matrix Plan for 2007, X's Compensation Committee targeted earnings growth of 10% and a constant ROE (compared to the prior year) of 9.5%. If targets were achieved, the CEO's bonus would be equal to 120% of his base salary. In plans with this design, the disclosure of these performance targets may, or may not, aid investors' understanding of the "degree of difficulty" inherent in achieving any particular payout level under the plan, depending on the facts and circumstances.

The relative difficulty of achieving the 120% payout under the Matrix Plan is a function of the plan's formulas. These formulas may be illustrated, in part, by the following graph.



The curved line on the graph corresponds to values of earnings and ROE (i.e., levels of performance for those two performance criteria) that would result in a payout of the targeted bonus amount of 120% of the CEO's base salary. Point A corresponds to the point at which the Compensation Committee's performance targets were set. Since there are many combinations that could result in the targeted payout, identifying point A does not necessarily aid an investor's understanding of the degree of difficulty of achieving the targeted payout of 120% of base salary. That payout would be achieved by performance corresponding to any other point on the line. Point A may turn out to be easier or harder to achieve than points B or C, or any other point on the line, but the bonus payout will be exactly the same regardless of where on the line performance happens to fall. Members of X's Compensation Committee and management will likely have different perceptions of the easiest and hardest combination of values for earnings and ROE that would achieve the 120% payout level. The bonus plan could operate exactly in the same manner as described above without the Compensation Committee designating any particular level of earnings growth or ROE as "target" values in the plan's formula.

Thus, there may be a basis to conclude that specific performance targets are not material to an understanding of the Matrix Plan, although the ultimate disclosure judgment would require further analysis of all the facts and circumstances surrounding the plan design. Information that bears on that judgment may include, for example: (i) whether the likelihood of particular performance outcomes is significantly greater than the likelihood of other performance outcomes; (ii) whether the Compensation Committee focused on particular outcomes, to an extent greater than merely using the particular outcome as a starting point or a reference point, in constructing the payout curve; and (iii) whether there are particular business factors that motivated the Compensation Committee to construct formulas to result in a payout curve that is steep or flat at particular points.

However, the mere fact that specific values for earnings growth and ROE were designated as the "target" values under the Matrix Plan for a particular year does not seem to require a conclusion that knowing those values is material or necessary to an understanding of the plan. The specific targets may represent only a starting point around which the Compensation Committee designed the plan formulas, without any determination that the targets represent something more fundamental to the plan design. Plans such as the Matrix Plan are typically designed to include a range of performance points at which the targeted payout amount would be paid and to include a smooth schedule of payout amounts for performance that is incrementally above or below the values at which the target payout amount would be paid. This is because "cliffs," or discontinuities, in the payout or performance schedules tend to create bad incentives. That is, management may be motivated to take actions harmful to the business in order to achieve the next most generous bump in the payout schedule. There must be a starting point for constructing the smooth schedules, and the "targets" under a plan may represent just that.

That a company communicates performance targets to plan participants also does not by itself make the targets material or necessary to an investor's understanding of the plan. The communication of specific targets to participants is often for illustrative purposes, and the illustrations typically include more than one set of values. At the same time, participants in a plan of the same type as the Matrix Plan are typically also provided with the plan's formulas, which gives them the information that is necessary to an understanding of the plan because it tells them how their bonus payments would be affected if they achieved performance levels other than those in the illustrations, as will almost certainly occur.

Accordingly, it seems that the disclosure of specific performance targets in the case of a plan structured like this Matrix Plan may or may not be "material" or "necessary" to an understanding of the degree of difficulty inherent in the plan. Identifying one set of values that would lead to a payout of some particular amount provides virtually no information about the relative difficulty of obtaining that payout when there are an infinite number of sets of values that would achieve the same payout level and there is no special

significance to any particular set of values. In that context, any values that may have been used to construct the matrix cease to constitute "targets" in a meaningful sense. In graphic terms, identifying a single point that forms part of a payout line on a graph such as that set forth above may tell investors virtually nothing about the shape of the payout line, which may be the key to understanding the plan. Indeed, where no set of payout values has particular significance, focusing on a single set of payout values may be misleading.

In those cases in which specific performance targets set under a Matrix Plan would not enhance an investor's understanding of the degree of difficulty inherent in the plan, what other information could provide that context? We suggest that there are four key items that best serve this purpose: (i) matrix information of the type set forth above; (ii) the target bonus payout amount, (iii) the actual bonus payout amount and (iv) a historical presentation of performance trends. In other words, information about how much bonus the Compensation Committee expected to pay the CEO, how X performed, what amount of bonus was actually paid and how it was determined.

Bonus Based on Relative Total Shareholder Return ("TSR Bonus Plan")

Company Y has a three-year bonus plan for the CEO. The amount of the bonus is equal to a multiple (ranging between zero and 1.75) of the CEO's base salary for the final year of the plan based on the total return (stock price plus dividends) to Y's shareholders ("TSR") compared to the same measurement for 50 competitors, as indicated in the following table, with the multiple for performance between the indicated levels determined by linear interpolation:

Relative TSR	Multiple of Base Salary
Bottom half of comparator group	0%
Between the 25th and 26th companies in the comparator group	50%
Better than the best of the comparator group companies	175%

This illustration highlights the importance of understanding what the term "target" means when discussing a particular plan. Does it mean the level of performance that the Compensation Committee would like to see, or the performance level that the Compensation Committee reasonably expects to see? If "target" means what is reasonably expected, then in many cases the best basis for those expectations is prior performance and the best disclosure would be along the following lines: "In the past five three-year

performance periods, our relative TSR has been at the following percentiles for the comparator group – AA for Year 1; BB for Year 2; CC for Year 3; DD for Year 4; and EE for Year 5." Since Y will have no control over, and the Y Compensation Committee will not have any special knowledge about, the likely three-year TSR of the companies in the competitor group, disclosure of the Compensation Committee's predictions about Y's performance relative to the comparator group would not seem material or necessary to an investor's understanding of the plan in many circumstances. Of course, as with the Matrix Plan, if the Committee attaches special significance to a particular performance level, breakpoint or range of levels, that may cause that level, breakpoint or range to be material to an understanding of the plan.

The inability of the Compensation Committee to project based on special insight or with particular confidence the payout under the TSR Bonus Plan does not mean that the plan is poorly designed. The compensation objectives of such a plan would typically include a desire to focus the CEO on medium-term stock performance and to be responsive to the imperatives of the market for CEO talent given the increasing use of these types of plans. Investors can decide how they feel about these objectives without a prediction about Y's future performance relative to the comparator group.

Bonus Based on Roll-Up of Business Unit Performance ("Roll-Up Bonus Plan")

Company Z has 20 operating facilities, all producing roughly equal revenue. The performance of each facility is measured in a variety of ways, including the following five criteria: earnings, revenue, return on investment, customer satisfaction and employee safety. Z has an annual bonus plan for the CEO. The amount of the bonus is based on a roll-up of the results for each of the five performance criteria for each facility, weighted by revenue per facility. The roll-up is calculated so that a score of 100% is given for performance equal to the prior year's results for each factor. The CEO's bonus is equal to his base salary multiplied by his score.

That the Roll-Up Bonus Plan includes 100 performance targets weighted roughly equally means that no target individually is material to an understanding of the arrangement. Is an understanding of the targets, considered together, material to an understanding of the arrangement, so that disclosure of each target should be required? There is, of course, a practical concern that substantially affects the answer to this question. Disclosure of information sufficient to provide useful color about the targets would require discussion of the five performance criteria at each of the 20 facilities. It is hard to imagine that this could be accomplished succinctly with the detail and analysis that is expected under the new rules. It is likewise doubtful that the additional disclosure would further the staff's objective of making executive compensation disclosure accessible to the average investor.

In light of the practical concern, the obvious question is whether there is a better way, and the answer is, in many circumstances, yes. As clearly stated in Instruction 1 to the CD&A rules, the disclosure standard under those rules is not whether disclosure of particular information would be sufficient to convey an understanding of a plan, but rather whether it is "necessary." In plans with designs that are similar to the Roll-Up Plan, disclosure about the payout schedule, the amount of the bonus payout if target levels of performance are achieved, the actual payout and the performance of Z, as a whole, should give investors information sufficient to assess the degree of difficulty inherent in the plan, so that disclosure and analysis of the 100 performance targets is not necessary. Furthermore, many of these types of plans are based on extensive budgeting processes. A description of the budgeting process could provide further color.

Although the example of a bonus plan including 100 targets is hypothetical, it is not exaggerated. Many companies do structure their bonus payout formulae in a highly nuanced and granular manner. A principal purpose of these designs is to closely associate the bonus arrangements of senior executives with those of lower level managers who are more directly responsible for particular elements of performance deep within the organization, and whose bonus opportunities reflect that responsibility. The design seeks to avoid a situation in which the bonus payments for senior executives are based on higher-level criteria – such as TSR or ROE – and do not correlate with the performance at the micro level. Investors can, of course, assess the prudence of such a design for a particular business without knowing the specifics of the performance targets under the particular plan.

Conclusion

Performance target disclosure is appropriate in many circumstances. As these illustrations demonstrate, however, performance target disclosure may not always be material or necessary to an investor's understanding of a company's compensation program. More importantly, the examples also demonstrate that judgments about performance target disclosure must flow from a careful assessment of all of the facts and circumstances related to a plan's design and operation. Such assessments can lead to disclosure that is accessible to investors, while not undermining other important objectives of a company's employee incentive programs and its external communications about its results and prospects.

As noted above, it seems likely that a presumption by the SEC staff that performance targets are always material will lead many compensation committees to consider changes to plan design with a view to avoiding performance target disclosure that, although not demonstrably harmful from a competitive perspective, may have other adverse implications. The principles underlying the executive compensation rules do not warrant that result.

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