MANAGING EXEC COMP IN EMERGING GROWTH COMPANIES

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Emerging growth companies (EGCs) are at a unique inflection point in their lifecycle as they transition from a privately-held smaller company to a more mature — and often much larger — public company. (See "What Is an EGC?") This stage presents unique opportunities and challenges, requiring a careful consideration of priorities as companies evolve coming out of the initial public offering (IPO). Fortunately, EGCs enjoy many benefits that provide flexibility to tailor executive pay programs to the company's circumstances and strategy, as well as a transition period that allows for thoughtful implementation of typical public company norms and processes. This transition period can be particularly important given that resources at many EGCs are constrained leading up to, and coming out of, the IPO.

The EGC Pathway

Most EGCs tend to follow a similar path in their evolution.

Private/Pre-IPO Company	Emerging Growth Company	Larger/Mature Public Company
Concentrated ownership	More diversified ownership, but often with a few significant shareholders	Dispersed ownership with significant institutional investor holdings
Pay programs tailored to specific company objectives, often with an eye toward IPO or a liquidity event	Pay programs tailored to company objectives, with varying degrees of responsiveness to external stakeholders like proxy advisors and institutional investors	Pay programs tailored to company objectives but also responsive to external stakeholders' perspectives and the implications for Say on Pay votes
Informal governance and committee processes	Beginning to implement more regular committee processes (standard agendas and meeting cadence)	Formal committee processes
No pay disclosure requirements	Initial, limited required pay disclosures	Robust pay disclosure requirements
Lean internal corporate HR and legal teams	Building corporate HR and legal teams	More robust corporate HR and legal teams

Compensation Implications for an EGC

As with any company, a well-designed executive compensation program in an EGC will support and align with the business strategy, as well as address market pressures by providing competitive levels of compensation. A company's EGC status also often presents a number of unique opportunities.

First, the more concentrated ownership coming out of IPO can often lead to a greater sense of shared strategic priorities. This shared perspective can make it easier to identify the key priorities the pay program should be designed around, including choosing the specific metrics in the annual incentive program or the vehicles and vesting approach in the long-term incentive program.

Second, a newly public EGC has access to equity markets that may not have been available as a private company, and this provides employees with the ability to get liquidity from stock or option grants. This liquidity is often highly anticipated by employees leading up to the IPO and can be long-awaited. But it also requires careful evaluation of employee ownership levels and the retention hold from unvested equity. In some cases, staking grants — either associated with an IPO or shortly thereafter — are an important compensation tool to motivate and retain key talent. In our experience, staking grants can be effective in supporting three objectives:

- Increasing alignment with the company's objectives while reinforcing strategic priorities.
- Ensuring that pay levels are competitive going forward.
- Balancing out any legacy pay issues that may have carried over from when the company was private (such as significant variation in equity values across executives, based on tenure or time of hire).

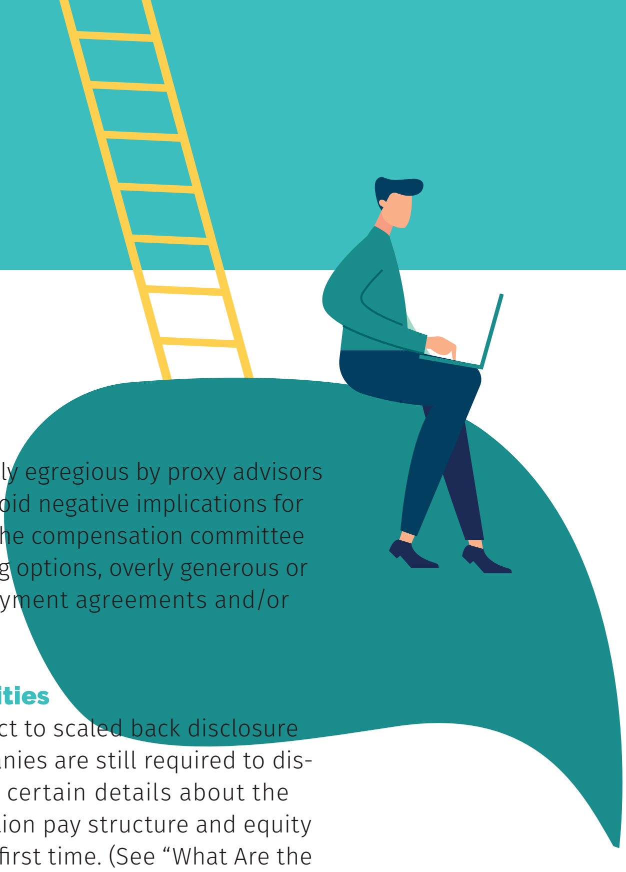
Public markets also bring new, real-time visibility to the company's stock price, which can make the potential value from equity awards more meaningful to employees. The resulting daily visibility employees have on their own personal financial situation can be distracting if not managed thoughtfully. Employee education is critical to make sure awards

WHAT IS AN EGC?

A company can retain EGC status following IPO until the earliest of:

- The end of the fiscal year containing the fifth anniversary of the IPO;
- The end of the fiscal year in which revenue is at $1.07 billion;
- The issuance of more than $1 billion in non-convertible debt over a 36-month period; or
- The date on which the company qualifies as a large accelerated filer (generally meaning the company has public float above $700 million).

Source: *2012 JOBS Act*



and potential opportunities are understood, while also serving as a reminder for participants that stock compensation is most effective when viewed as a multiyear and long-term compensation vehicle.

Third, EGCs are allowed a transition period post-IPO during which they are subject to less rigorous evaluation by proxy advisors and are not required to have a "Say on Pay" vote. Accordingly, these transition rules allow EGCs to evolve pay program designs and committee processes toward public company norms over time, rather than immediately upon IPO.

Effectively navigating the transition through the EGC period can take a variety of forms. Whatever the circumstances, it is important for all EGC companies to establish effective and consistent pay- and governance-related practices as they lay the groundwork to transition out of EGC status. Such practices may include using a peer group to provide competitive context to compensation decisions or establishing an annual compensation committee meeting calendar and agenda items.

The flexibility during the transition period also allows EGCs to tailor incentive plan designs to support and align pay to key objectives during the critical time following IPO, without having to feel immediately compelled to adhere to institutional investor or proxy advisor preferences. For example, EGCs may utilize more discretion in annual incentive plans or postpone implementing performance-based equity if there is not a compelling business reason — actions that could, down the road, have a negative impact on "Say on Pay" votes. However, it remains important to avoid any pay practices considered particularly egregious by proxy advisors or shareholders to avoid negative implications for directors who sit on the compensation committee (for example, repricing options, overly generous or non-standard employment agreements and/or tax gross-ups).

Determining Priorities

While EGCs are subject to scaled back disclosure requirements, companies are still required to disclose pay levels and certain details about the executive compensation pay structure and equity grants, often for the first time. (See "What Are the Exec Comp Disclosure Requirements for an EGC?") While an EGC is not required to have a "Say on Pay" vote, the company will be subject to an initial — but less rigorous — evaluation by proxy advisors if it is a member of any large stock index (such as the Russell 3000) and has institutional investors as part of its shareholder base. As a result, basic hygiene on the executive compensation program is critical to avoid any unanticipated or embarrassing outcomes related to the required pay program disclosure. Many of these items are required for any company going through an IPO, but an EGC is afforded more time to implement many of them.

Certain executive compensation topics should be given higher priority than others during the EGC stage of a company's lifecycle, acknowledging other items can be addressed down the road as a more mature public company. The urgency and timing to address these items is driven by the company's growth trajectory and how quickly the company

Highest priority	Medium priority	Lowest priority
Avoid egregious pay practices (such as repricing options, overly generous or non-standard employment agreements and/or tax gross-ups).	Establish a consistent committee process (such as setting agendas and calendars).	Implement governance-related practices (such as stock ownership guidelines and/or clawbacks).
Establish a peer group to understand comparative practices.	Establish a clearly articulated pay philosophy and approach to govern pay programs.	Establish a shareholder outreach strategy related to executive compensation.
Set reasonable and defensible pay levels (for example, informed by peer group); avoid outsized pay packages without sufficiently disclosing the rationale.	Test pay and performance relationships.	Enhance disclosure of programs, being more consistent with the traditional requirements of a Compensation Discussion & Analysis (CD&A).
		Implement programs responsive to large shareholders' perspectives (e.g., "performance-based" long-term incentives).

WHAT ARE THE EXEC COMP DISCLOSURE REQUIREMENTS FOR AN EGC?

An EGC is subject to scaled-back disclosure requirements, consistent with those for a smaller reporting company. EGCs are *not* subject to the following:

- "Say on Pay" or "Say on Pay Frequency" votes;
- Disclosure of the Compensation Discussion & Analysis (CD&A), including information regarding peer groups used in setting compensation levels;
- Grants of plan-based awards table, providing information on equity and formulaic annual incentive awards in the prior fiscal year;
- Option exercise and equity vesting table, providing amounts with respect to each in the prior fiscal year;
- Discussion of the value of payments upon a change in control or termination of executive's employment; and
- Pension and nonqualified deferred compensation arrangements table.

The disclosure requirements for these companies *do* include:

- Compensation of three (rather than five) executive officers, consisting of the CEO and two other most highly compensated executive officers (i.e., not automatically the CFO);
- Summary compensation table and related narrative disclosure, reporting full compensation for up to the last two (rather than three) completed fiscal years (the narrative disclosure can be more limited than that of a typical public company);
- Outstanding equity awards at fiscal year-end table;
- Director compensation table;
- Additional narrative disclosures (such as material terms of retirement plans, termination payments and change in control arrangements); and
- Two years' worth of financial statements (rather than three).

ISS COMPENSATION POLICY FOR EGCS

The ISS Compensation Policy includes:

- An evaluation of directors up for election and individual director voting recommendations;
- The creation of a peer group to use for pay-for-performance evaluations (despite not issuing a "Say on Pay" voting recommendation), with certain quantitative tests not performed until multiple years of data are available;
- May include a qualitative commentary on the pay-for-performance alignment and other observations regarding the pay program; and
- May issue negative director recommendations based on egregious pay practice or pay levels.

will lose EGC status, as a "Say on Pay" vote will be required once the company is no longer an EGC.

Company-specific circumstances related to its shareholder base, including whether it remains controlled or has diversified institutional ownership, and the board's preferences for a robust process for executive compensation decision-making, are also very influential on the pace of change and prioritization.

Additionally, a lot of EGCs are fast-growing companies where the growth often stretches the resources of corporate support functions like Human Resources and Legal. Often, executive compensation can take a backseat to other priorities required to support growth, such as recruiting, system implementation and other more immediate concerns related to acquisitions or new business opportunities. Despite these resource constraints, a deliberate approach focused on the highest priorities in executive compensation design and decision-making processes can help pave the way for future programs.

Positioning for the Next Step on the Journey

An EGC can capitalize on its unique position between a private company and a more mature public company by thoughtfully managing, designing and administering the executive compensation program and associated compensation committee governance items. The EGCs newly-public status also presents opportunities to thoughtfully design and communicate equity compensation programs in order to get the most value out of those programs. Careful consideration of priorities, particularly in light of the company's growth trajectory and shareholder base, are critical to the most effective executive compensation programs. Finally, despite operating in an environment with stretched internal resources and competing priorities, it is important to act early to lay the groundwork for executive compensation design and committee processes to position the company well to manage the transition out of EGC status. Despite these competing priorities, our experience indicates that the companies that lay the groundwork for robust executive compensation programs and compensation committee processes are best positioned to head toward the next step on their journey. **WS**

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