Transitioning from Emerging Growth Company Status – What Comes Next?

Since its creation as part of the Jumpstart Our Business Startups ("JOBS") Act in 2012, the classification of small technology and life sciences companies as "emerging growth companies," or "EGCs," has been a resounding success, with hundreds of companies taking advantage of its "test the waters" process to conduct an IPO and relaxed reporting requirements as a newly public company. Recognizing the costs and associated burdens of requiring smaller companies to comply with the full panoply of SEC disclosure rules at a time when cash and other resources may be scarce, streamlining the disclosure requirements, including the detailed requirements involving a company's executive compensation program, policies, and practices, enabled many growth-oriented companies to access the public markets for capital while, at the same time, postponing many of the attendant obligations of reporting company status for a brief period of time (such as the shareholder advisory vote on named executive officer ("NEO") compensation. On the other hand, institutional shareholders and their advisors have less visibility into the company's executive compensation philosophy and policies. Consequently, EGC status may be problematic for these constituencies since the availability of limited executive pay information may lead to a less comprehensive qualitative review of the company's executive compensation program in the initial years following its IPO.

Generally, EGCs remain eligible to take advantage of the SEC's "scaled" reporting requirements until the first to occur of:

- the fifth anniversary of its initial public offering;
- its total annual gross revenues equaling or exceeding $1.235 billion;
- issuance of more than $1 billion in non-convertible debt in the past three years; or
- becoming a "large accelerated filer," as defined in the rules under the Securities Exchange Act of 1934.

Achieving large accelerated filer status can sneak up on a company. Under Exchange Act rules, a company becomes a large accelerated filer if it has an aggregate "public float" of $700 million or more (that is, the worldwide market value of the voting and non-voting common equity securities held by its non-affiliates meet or exceed this dollar threshold), it has been subject to the reporting requirements of the Exchange Act for at least 12 months and has filed at least one annual report on Form 10-K, and it does not satisfy the requirements of the revenue test to qualify as a "smaller reporting company" (that is, its annual revenues are not less than $100 million). The "public float" requirement is tested each year as of the last business day of the company's most recently completed second fiscal quarter. For companies with a calendar year fiscal year end, the testing date of June 30, 2023 is rapidly approaching. However, the loss of EGC status does not occur until the last day of the fiscal year in which all of the conditions of the "large accelerated filer" requirement have been met.

This Thoughtful Pay Alert summarizes the expanded executive compensation reporting requirements of companies that no longer qualify as "emerging growth companies." While loss of EGC status will be triggered upon occurrence of any of the enumerated events listed above, we are giving special attention to becoming a large accelerated filer as a result of the size of a company's public float since that is the event that can be most easily overlooked.1

Emerging Growth Company Executive Compensation Disclosure Requirements

In our experience, most technology and life sciences companies that qualify for EGC status take advantage of all or most of the SEC's streamlined disclosure requirements available to present abbreviated information about their executive compensation programs in their Exchange Act reports. These "scaled" disclosure requirements are as follows:

- A Summary Compensation Table (covering only three (rather than five) NEOs (including the Chief Executive Officer, but not necessarily the Chief Financial Officer) and limited to two (rather than three) fiscal years' information;
- An Outstanding Equity Awards at Fiscal Year-End Table; and
- A Director Compensation Table.

While an EGC is not required to quantify the potential payments that would be received by its NEOs in the event of a termination of employment or change in control of the company (see Potential Payments Upon Termination or Change in Control below), they must provide a narrative description of the material terms of each retirement plan that applies to an NEO and the material terms of each contract, agreement, plan, or arrangement that provides for payments to an NEO at, following, or in connection with the resignation, retirement, or other termination of employment, or a change in control of the company or a change in the named executive officer's responsibilities following a change in control of the company.

An EGC also must disclose whether they maintain practices or policies regarding their employees' (including officers) and directors' ability to hedge the economic risk of owning company equity securities.

1. We recommend that companies confer with their legal counsel on their proper filing status.

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Transitioning from Emerging Growth Company Status – What Comes Next? (Continued)

In a recent change to the requirements of the national securities exchanges, beginning in late 2023, EGCs (as well as all other listed companies) will be required to adopt and disclose a compensation recovery ("clawback") policy which requires the recovery of any excess incentive-based compensation paid to its current and former executive officers in the event of a financial restatement resulting from noncompliance with the federal securities laws.

Significantly, an EGC is not required to prepare a Compensation Discussion and Analysis ("CD&A), nor is it required to provide four of the six tabular disclosures otherwise required of accelerated filers and large accelerated filers.

In addition, an EGC is exempt for a minimum of three years from the shareholder advisory vote on NEO compensation (the "Say-on-Pay" vote), the shareholder advisory vote on the frequency of future Say-on-Pay votes, and the shareholder advisory vote on "golden parachute" compensation. It is also exempt from the "pay-versus-performance" and "CEO pay ratio" disclosures requirements of the Dodd-Frank Act.

Required Executive Compensation Disclosure Following Loss of Emerging Growth Company Status

Once a technology or life sciences company no longer qualifies as an EGC, it's executive compensation disclosure in its annual report on Form 10-K and definitive proxy statement becomes significantly more onerous, requiring expansive narrative discussion regarding a company's executive compensation practices and policies as well as detailed quantitative compensation-related information. This information in turn serves as the basis upon which institutional shareholders make decisions in deciding whether to support a company's compensation practices, as expressed through a Say-on-Pay vote. Accordingly, companies would be well-served to assess their EGC status following June 30th and, if necessary, begin developing their disclosures with a view towards maximizing shareholders' understanding of – and support for – their executive compensation program. Such disclosure must include the following information:

Compensation Discussion and Analysis

The CD&A is the principal narrative discussion of a company's annual executive compensation program and is intended to set the context for and explain the other required executive compensation disclosures. The CD&A should address the objectives and policies of a company's executive compensation program as well as how that program is implemented and the company must tailor the disclosure to its own individual situation. In practice, most companies also provide an "Executive Summary" to their CD&A to provide an overview of their financial performance and executive pay decisions for the last completed fiscal year. To assist in this process, the disclosure requirements provide that the following broad topics be addressed in the CD&A:

- the objectives of the company's compensation programs;
- what each program is designed to reward;
- the different elements of compensation offered by the company;
- why the company chooses to pay each element;
- how the company determines the amount (and where applicable, the formula) for each element;
- how each element and the company's decisions regarding that element fit into the company's overall compensation objectives and affect decisions regarding other elements; and
- how the company has considered the results of the most recent Say-on-Pay vote in determining its compensation policies and decisions and how that consideration has affected the company's executive compensation decisions and policies.

While the company generally must provide detailed information about the performance measures and target levels that it uses in its performance-based incentive compensation plans and arrangements, it may not be required to disclose the specific target levels for these performance measures to the extent that they involve confidential information the disclosure of which would cause competitive harm to the company. However, companies should be mindful that failure to provide this information typically sparks negative commentary from the proxy advisory firms, principally Institutional Shareholder Services (ISS") and Glass Lewis & Co. ("Glass Lewis").

A company is also required to address its equity award grant practices for its executive officers. This disclosure must describe why the company selects particular dates for granting stock options and other equity awards and how it sets an option's terms and conditions, including the option exercise price.

As a practical matter, the CD&A may be the longest single disclosure item in a company's definitive proxy statement (often averaging between six to 10 pages) and over the years has evolved into a combination of narrative and graphic disclosure.

Summary Compensation Table

The centerpiece of the tabular disclosure requirements, the Summary Compensation Table ("SCT") is designed to provide a comprehensive overview of a company's recent executive compensation actions and decisions. This information is intended to enable prospective investors to understand clearly the compensation paid for the prior three fiscal years (expanded from the two years required of EGCs), to evaluate the company's compensation policies and practices in light of its overall performance, and to compare trends in compensation policies and practices between companies.

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Other Required Compensation Tables

There are up to five additional compensation tables that may be required to supplement the SCT once a company loses EGC status:

Grants of Plan-Based Awards Table. The Grants of Plan-Based Awards Table requires disclosure of supplemental information about the incentive and equity awards granted during the last completed fiscal year to each NEO.

Outstanding Equity Awards at Fiscal Year-End Table. The Outstanding Equity Awards at Fiscal Year-End Table requires disclosure of each equity award outstanding at the end of the last completed fiscal year held by each NEO. This table is also required of EGCs.

Option Exercises and Stock Vested Table. The Option Exercises and Stock Vested Table requires disclosure of any exercise of stock options and free-standing SARs and the vesting of outstanding restricted stock and restricted stock unit awards that occurred during the last completed fiscal year for each NEO.

Pension Benefits Table. The Pension Benefits Table requires disclosure of the potential payments and benefits payable to the NEOs under the company's defined benefit pension plans (both tax-qualified and non-qualified plans). Most technology and life sciences companies do not maintain defined benefit pension plans for their employees, so this table is generally omitted.

Non-qualified Deferred Compensation Table. The Non-qualified Deferred Compensation Table requires disclosure of information about each non-qualified defined contribution plan or other non-qualified deferred compensation plan or arrangement in which an NEO participates. Many technology and life sciences companies do not maintain non-qualified deferred compensation plans for their executive officers, so this table is generally omitted.

Potential Payments Upon Termination or Change in Control

While the subject of potential payments upon a termination of employment or change in control is not a new disclosure category for a company upon losing EGC status, the nature of the information required expands from the previously required disclosure (regarding the material terms of each contract, agreement, plan, or arrangement that provides for payments to an NEO at, following, or in connection with termination and change in control scenarios) to require disclosure describing the specific circumstances that would trigger payments or the provision of other benefits and quantifying the estimated annual payments and benefits that would be provided to all of the NEOs in each covered circumstance (that is, terminations of employment with or without cause, termination of employment following a change in control, etc.).

Other Required Compensation-Related Disclosure

Shareholder Advisory Votes on NEO Compensation. Subject to one exception (as noted hereafter), once a company is no longer an EGC, it must conduct a Say-on-Pay vote (either every one, two, or three years as recommended by the board of directors and voted on by shareholders on an advisory basis), the shareholder advisory vote on the frequency of future Say-on-Pay votes (if one has not been previously conducted), and the shareholder advisory vote on "golden parachute" compensation (in connection with a merger or acquisition transaction). Currently, the vast majority of technology and life sciences companies hold annual Say-on-Pay votes. In the event that an emerging growth company loses its EGC status within two years of its initial public offering, the company may conduct its initial Say-on-Pay vote at any time prior to the third anniversary of its IPO.

Pay-Versus-Performance Disclosure. A company must provide certain pay versus performance disclosure, including a multi-year table disclosing the SCT compensation and compensation actually paid to its NEOs, as well as a description of the relationship between the compensation actually paid to its NEOs and the company's financial performance. (*See our Thoughtful Pay Alert, SEC Adopts New Rules for "Pay-Versus-Performance Disclosure Requirement (Nov. 8, 2022)).*

CEO Pay Ratio Disclosure. A company must provide disclosure of the median of the annual total compensation of all its employees (except for its Chief Executive Officer), the median of the annual total compensation of its Chief Executive Officer, and the ratio of these two amounts. (*See our Thoughtful Pay Alert, Complying with the CEO Pay Ratio Disclosure Requirement (Sept. 29, 2017)).*

Hedging Disclosure. As in the case of EGCs, a company must disclose whether they maintain practices or policies regarding their employees' (including officers) and directors' ability to hedge the economic risk of owning company equity securities. (*See our Thoughtful Pay Alert, SEC Issues Final Hedging Disclosure Rule (Jan. 18, 2019)).*

Compensation Recovery ("Clawback") Policy. Beginning in late 2023, all listed companies (including EGCs) will be required to adopt and disclose a compensation recovery policy which requires the recovery of any excess incentive-based compensation paid to its current and former executive officers in the event of a financial restatement resulting from noncompliance with the federal securities laws. (*See our Thoughtful Pay Alert, SEC Adopts Compensation Recovery ("Clawback") Policy and Disclosure Rules (Nov. 8, 2022)).*

Observations

This enhanced disclosure typically leads to more fulsome review of a company's executive compensation policies and practices by institutional shareholders and their advisors (such as ISS and Glass Lewis). As a result, this increased scrutiny tends to shift concerns about executive pay (and potential "Against" vote recommendations) from the re-election of director (particularly compensation committee members) to the Say-on-Pay vote except in egregious cases. As a result, we recommend that

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companies encountering their first CD&A and the attendant tabular and other disclosure start preparing for these requirements earlier than when they were an emerging growth company since the stakes will be increasing exponentially.

Need Assistance?

Compensia has extensive experience in helping companies draft the executive compensation disclosure in their annual reports on Form 10-K and proxy materials for their annual meetings of shareholders and analyze the potential impact on the disclosure requirements for emerging growth companies. If you would like assistance in preparing your executive compensation disclosure, or if you have any questions on the subjects addressed in this Thoughtful Pay Alert, please feel free to contact Jason Borrevik at 408.876.4035 or jborrevik@compensia.com, Mark A. Borges at 415.462.2995 or mborges@compensia.com, or Hannah Orowitz at (332) 867.0566 or horowitz@compensia.com.

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