Professional Perspective

Tips for Registrants Transitioning From EGC Status

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Tips for Registrants Transitioning From EGC Status

Contributed by Brittany A. McCants, Bass, Berry & Sims PLC

Emerging growth companies (EGCs) have five years following IPO to take advantage of the scaled disclosure requirements under Items 402(n) and (m) of Regulation S-K. The scaled disclosure requirements were a component of the Jumpstart Our Business Startup Act of 2012 (JOBS Act) to create inclusive access to markets for smaller companies by extending smaller and newer companies a longer runway transition to the disclosure obligations of a publicly-traded entity.

An EGC is a registrant that meets the following requirements: (i) the registrant has less than $1.235 billion or more of total gross revenue in a consecutive 12 month period, (ii) the company has not issued more than $1 billion in non-convertible bonds within the last three years, and (iii) the registrant does not qualify as a large accelerated filer (i.e., has a public float of less than $700 million). As a registrant gets closer to the expiration of its EGC status, it is critical for the registrant to establish formalized processes to develop data collection and disclosure of their executive compensation scheme. A registrant can also lose its EGC status prior to the end of the first five fiscal years following IPO, if it ceases to meet any one of the aforementioned criteria for EGC qualification.

EGCs making the transition from EGC to smaller reporting company, accelerated filer, or large accelerated filer or EGCs who are experiencing surges in revenue due to market shifts or otherwise should focus on four major areas as issues arise, including data collection and disclosures:

- Additional Named Executive Officers and Additional Covered Years
- New Tabular Disclosures
- Expanded Compensation Narratives
- New Shareholder Votes on Compensation Requirements

This article will outline the key differences between the scaled disclosure requirements for EGCs —and in some instances smaller reporting companies—and the expanded disclosure requirements for accelerated filers and large accelerated filers along with practice points to assist companies in generating an internal checklist for this new process.

Additional Named Executive Officers & Additional Covered Years

Executive compensation disclosure requirements for EGCs limit the number of named executive officers (NEO) to the following:

- The principal executive officer (PEO)
- The two most highly compensated executive officers who were serving as executive officers at the end of the last completed fiscal year
- Up to two additional individuals for whom disclosure would have, based on their compensation, been required to be disclosed had they been serving as an officer at the end of the last completed fiscal year

This rule still applies for smaller reporting companies; however, for accelerated filers and large accelerated filers the NEO group expands to also include the principal financial officer and a third highly-compensated executive officer who was serving at the end of the last completed fiscal year, in addition to those listed in the bullets above.

The larger pool of individuals for consideration can create traps for the unwary. The disclosure must include any individual who was in the role of principal financial officer during a covered fiscal year. So for example, an interim CFO can be picked up in the disclosure requirements irrespective of the size of the CFO's compensation and the fact that such CFO was not in the role on the last day of the relevant fiscal year.

Under this set of facts, it is key to the NEO identification process to separate the CFO from identification of the three additional highly compensated officers. Registrants and their advisors should review the director and officer questionnaires and any executive departures during the covered fiscal year closely to determine if any severance packages push an otherwise excluded officer or former officer into NEO status.

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The expiration of EGC status also results in changes to the summary compensation table (SCT). The SCT will need to cover the prior three completed fiscal years and not just the prior two completed fiscal years—although the two-year requirement will still apply to smaller reporting companies. An additional column detailing pension plan information will also need to be added to the SCT. This expanded disclosure may result in a significant increase in data collection and analysis, so the proxy preparation process should be initiated earlier than usual if EGC status has been or may be lost in the coming fiscal year.

New Tabular Disclosures

Four new tables must be added to the executive compensation section of the proxy following the SCT:

- Grants of plan-based awards
- Option exercises and stock vested
- Pension benefits
- Nonqualified deferred compensation

The rules still permit omission of tables or columns if there has been no compensation awarded to, earned by, or paid to any of the NEOs or directors required to be reported in that table or column in any fiscal year covered by such table.

The primary purpose of these additional tables is to supplement the disclosures in the SCT. The SCT provides a high-level summary of NEO compensation, while the supplemental equity tables focus on the components of the individual awards, outcome of the awards and historical information so that investors and proxy advisors may evaluate the long-term equity scheme in its entirety. The additional tables regarding NEO post-employment arrangements provide contextual information for investors to assess how the value of pension benefits fits into the compensation scheme.

Expanded Compensation Narratives

Compensation Disclosure & Analysis

One of the most onerous new requirements for an accelerated filer or large accelerated filer is the compensation discussion and analysis (CD&A). The CD&A is an in-depth disclosure detailing the registrant's compensation framework and its underlying components.

Registrants are required to explain what the compensation program is designed to reward, identify each element of compensation and expound on:

- why each element was selected;
- how the registrant determines the amount of compensation; and
- how each element fits within the overall objective of the registrant's compensation program.

Registrants are also required to explain whether and how the results of the most recent shareholder advisory vote on executive compensation impacted compensation policies and decisions. Among other items, this disclosure must provide investors with information regarding the allocations between long-term and short-term incentives, cash and non-cash compensation, and performance-based and service-based vesting incentives. In sum, the CD&A provides all of the material information utilized to set a registrant's compensation policies and decisions regarding the NEOs.

Registrants who do not qualify as EGCs are also required to include a number of additional factors and details such as benchmarking, peer group selection, and the impact of accounting and tax treatment on the various compensation elements in their compensation disclosures. Depending on the composition of the shareholder base, registrants utilize this disclosure to highlight the strengths of its compensation program to appease proxy advisory firms and to demonstrate responsible use of its equity compensation to investors.

Registrants provide this information in both narrative and graphical disclosures and the typical length of a CD&A is 10 pages on the shorter end and more than 20 pages for more extensive disclosures. Given the volume of new information and its complexity, registrants should coordinate early and often with their legal counsel and compensation consultant to develop this disclosure.

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CEO Pay Ratio

Accelerated filers and large accelerated filers also need to include CEO pay ratio disclosures. The CEO pay ratio disclosure requires registrants to disclose the following:

- The median annual total compensation of all employees other than the PEO.
- The annual total compensation of the PEO.
- The ratio of these amounts.

Though the components of the disclosure are deceivingly simple, computing the median annual total compensation can be a challenging exercise depending on the size of a registrant's employee basis, locality of its employees, and the components of compensation that must be used to apply a "consistently applied compensation measure" to compute annual compensation.

Also, the disclosure around the methodology, assumptions used, and adjustments made due to local laws and certain exclusions and groupings presents a wide array of issues that must be addressed in a way that is both compliant and minimizes risk for the registrant.

Pay Versus Performance

Loss of EGC status also means the new pay versus performance (PVP) disclosures are part of the required executive compensation disclosures. The PVP disclosure requires the following:

- Tabular disclosure (1) comparing SCT total compensation and compensation actually paid (CAP) of any person who served as the registrant's PEO and the average of the other NEOs for the covered fiscal year, (2) comparing the registrant's total shareholder return (TSR) and the registrant's peer group TSR, (3) listing the registrant's net income, and (4) identifying the most important performance measure linking pay to performance (company selected measure or CSM).
- A table identifying three to seven of the most important performance measures used to link pay to performance.
- Narrative disclosure detailing the relationship between CAP and performance.

Smaller reporting companies may take advantage of scaled disclosure requirements and omit the following: peer group TSR and the CSM from the table, the table identifying the three to seven most important performance measures, and the narrative disclosure. This disclosure presents complex challenges in the computation of CAP, selection of the appropriate peer group for the TSR disclosure, and identification of the most important performance measure.

The nuances involved in this disclosure and volume of new computations necessitate additional time to collect, analyze, and review the requisite data. Additional coordination with the registrant's compensation consultant may also be needed for purposes of clarifying the benchmarking data and syncing the PVP disclosure with the CD&A disclosure.

New Shareholder Votes on Compensation Requirements

Loss of EGC status also requires two new shareholder vote requirements: say-on-pay vote and say-on-pay frequency. The say-on-pay vote extends investors the opportunity to approve the compensation of its NEOs as disclosed in the proxy. The say-on-pay frequency vote is an advisory vote on how often a say-on-pay vote should occur, which must be at least every three years. Say-on-pay frequency is a non-binding vote that must occur at every six years.

The say-on-pay vote must be held within one year following the expiration date of the registrant's EGC status. The say-on-pay vote frequency is required as soon as the first annual shareholder meeting following loss of EGC status.

Conclusion

As a registrant nears the expiration of its EGC status and makes the transition to a smaller reporting company, accelerated filer, or large accelerated filer, these four areas will be important areas of new disclosure and should be planned for accordingly. While additional time and resources are required, the investment is worthwhile to avoid costly compliance missteps as the company grows into its next phase.

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