Pearl Meyer

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Option Repricing or Exchanges in Development Biotech



Matt Molberger

MANAGING DIRECTOR

Developing and early commercial biotech companies continue to suffer from the worst industry bear market in recent history. At current prices, many companies are finding that a majority of outstanding option balances are so materially out of the money that employees are not attributing any perceived value to these awards. There is no retention hook. For companies that went public in the last two to three years, this includes all public company grants and in some instances, certain pre-IPO grants as well. Given the recent hiring spree, management teams have raised concerns about retaining large swaths of their organizations, even as hiring in the biotech market is beginning to show signs of cooling slightly.

Throughout Q2, many management teams discussed potential retention strategies and programs with some opting to bring proposals to compensation committees for approval and implementation. Generally, these conversations considered one or more of the following:

- Supplemental cash bonus program;
- Supplemental equity awards;
- Modifying equity grant practices (e.g., pulling forward a future award); and
- An option exchange or repricing program.

The fourth tool is one that has generally been considered out of bounds since the last recession. It is, however, the most powerful and aggressive tool in addressing concerns about retention value.

There are a lot of strong opponents amongst shareholders, board members, and proxy advisors. Concerns typically center around the resulting disconnect between the employee experience and that of shareholders who must bear the entire loss in value. Nevertheless, increasingly more biotech companies are at least starting the conversation.

Depending on the structure of an option exchange, these programs can be viewed as being beneficial to shareholders more broadly. In fact, ISS will support proposals on a

case-by-case basis if they adhere to a set of design parameters, including:

- Program must exclude executives and directors;
- Should exclude options granted within the last one to two years;
- Should exclude options with exercise prices below the trailing 52-week high for the stock price;
- Exercise price should be set at fair market value or a premium;
- Option should remain subject to the original term of the surrendered option; and
- Exchange should be done on a value-for-value basis.

ISS also considers the vesting of the new awards, whether the surrendered options return to the plan for future issuance, the timing relative to a precipitous drop in stock price, and the proxy disclosed rationale for the program and its design.

However, many companies find an issue with adhering to the ISS framework because limiting to these standards may fail to address key objectives for pursuing these programs. Companies wanting to move forward in other ways must do so knowing that they won't receive ISS support or, if the incentive plan permits, do so without shareholder approval.

One point of caution: ISS is adamantly opposed to exchanges or repricings without shareholder approval. It views this as a problematic pay practice and comes down hard on director elections, say-on-pay proposals, and future equity plan proposals. Since a meaningful number of recent IPOs have this flexibility in their plans, this alternative is getting some consideration at internal company meetings.

There have been some early movers with three proxy proposals during this annual meeting season. We saw a mix of compliance and outcome.

Company	Compliance to ISS Standards	Shareholder Vote Outcome
Allogene	No	Pass
Assembly Biosciences	Yes	Pass
Iterum	No	Fail

Straight repricings without approval can fly under the public disclosure radar if executives are excluded. One early example from April of this year was GoHealth, which filed an 8-K

because an executive officer was included in the program.

For companies weighing an exchange or repricing of any kind, the following ought to be considered in the discussion and decision-making process:

Program Element	Sample Alternatives
Purpose of change	• Opportunity to rebuild retention value (intrinsic value) • Replenish share pool • Eliminate overhang • Some combination of the above
Shareholder approval	• Yes • No, if equity plan permits
Importance of ISS	• Design for ISS support • Optimize to meet company objectives
Design	• Exchange • Repricing
Participants	• Executives • Directors • All non-executives • Subset of non-executives (e.g., tenured employees as of a certain date)
Eligible outstanding grants	• Based on exercise price • Based on grant date • Based on award type (new-hire vs. annual vs. other) • Some combination of the above
Vehicle	• Stock options • Restricted stock units (RSUs)
Vesting	• Continue vesting for unvested portions • New vesting for surrendered vested options • Completely new schedule
Term	• Maintain term from surrendered awards • Reset term

It is too early to say that this is a developing trend, but the fact that management teams are willing to seriously consider these types of programs highlights the angst around retention that many leaders are feeling. A prolonged market recovery may only increase interest in the topic, particularly amongst companies that don't have near-term value creating inflection points (e.g., data readouts). As with all retention initiatives, though, management teams and compensation committees must try to gauge how well received the program will be and whether it will actually have the desired retentive effect. The worst result would be to go through the effort, incur the cost, and potentially subject the company to some external criticism, all to find that employees at large don't appreciate or value the program.

About the Author

Matt advises life sciences and technology companies on executive compensation, specializing in benchmarking, incentive design, pay-for-performance alignment, security arrangements, and CD&A disclosure.

About Pearl Meyer

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