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The First Year of Say-on-Pay for Life Science Companies: How to Plan Ahead

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Many life science companies that have gone through an IPO over the past 10 years have filed as an Emerging Growth Company (EGC) under the Security and Exchange Commission's (SEC) Securities Act. This designation provides for certain scaled-back SEC disclosure requirements and includes forgoing a non-binding advisory vote on compensation in your proxy statement that is otherwise required for other public companies. This advisory vote is commonly known as "say-on-pay."

The EGC designation can last for up to five years, but may end earlier if a company gets to a certain financial or market size. An exit from EGC status can have significant meaning for the company overall in terms of SEC reporting requirements across a number of areas, including compensation. Perhaps one of the most common unknowns is what to expect entering the first year of say-on-pay.

A Short History of Say-on-Pay

Say-on-pay was mandated for public companies subject to proxy rules as part of the 2010 Dodd Frank Wall Street Reform and Consumer Protection Act. The rule requires that companies include in their proxy statement a non-binding advisory vote on the company's executive compensation program. It is a simple yes or no vote intended to reflect support for or opposition to the compensation program and actions taken as they are described in the compensation disclosures of the proxy statement. In spirit, it is intended to be focused on the compensation program for the top few executives that are required to be disclosed (the "named executive officers" or "NEOs"), but experience tells us that the vote often serves as a referendum on a host of items such as overall company performance, governance, and director compensation.

Related to say-on-pay is a "say-on-frequency" vote, also advisory in nature and intended to set the frequency in which a company will hold its say-on-pay vote. This vote is held once every six years, and shareholders vote on whether the company should hold its say-on-pay every year, other year, or third year. A vast majority of companies simply and proactively recommend to shareholders an annual say-on-pay vote, and that is what shareholders overwhelmingly support. Therefore, most companies exiting EGC status will have a say-on-pay vote each and every year thereafter.

What to Expect: Planning

One of the key planning activities for management teams and compensation committees is to get ahead of the decisions and disclosures on these two votes early on. Companies will know, at the latest, by July 1st of a given year if they will be required to hold a say-on-pay vote and say-on-frequency vote in the upcoming proxy statement, so adding this topic to the agenda for discussion and agreement in late summer or early fall is a good governance practice. This is also a good time to discuss what new reporting requirements will be necessary in the coming proxy statement.

For companies exiting emerging growth status that are becoming an accelerated filer, the level of compensation disclosure increases significantly, primarily through a new Compensation Discussion & Analysis (CD&A) section and increased tabular disclosures for executive compensation. It may be the case that your company is exiting EGC status but not considered an accelerated filer so we recommend checking with the legal team to understand your company's new reporting requirements.

Nonetheless, the quality of the disclosure becomes more important regardless of your new filing status, as the disclosure will be the primary way that shareholders will evaluate your compensation program and vote on say-on-pay.

What to Expect: Proxy Advisory Firm Analyses

The proxy advisory firms will issue their annual report for most every public company once the proxy statement has been filed with the SEC, but before the annual meeting of shareholders. The two most influential proxy advisory firms are Institutional Shareholder Services Inc. (ISS) and Glass Lewis & Co. Their reports cover vote recommendations on any proxy proposal, as well as other information and analysis they believe are important to their clients. Not surprisingly, both firms have a common set of areas and benchmarks that they use for companies to evaluate their compensation program for say-on-pay vote recommendation purposes. In emerging growth life sciences companies, practices and features can differ meaningfully from what ISS and Glass Lewis typically advocate. Therefore companies should be aware of some common criticisms, but it is also important to note that these criticisms reflect firm policy guidance and not necessarily what is competitive in a particular industry or size of company. Notable examples include:

- **Discretion in Bonus Plans:** Many emerging growth companies, particularly those that are pre-commercial, structure their annual cash incentive plan to include some level of discretion or subjectivity in arriving at a final bonus funding level. We see this most often when placing partial credit on certain goals for meeting some aspects of a particular objective. Similarly there is often discretion used in providing credit above 100% for outperformance against a particular goal. The advisory firms prefer incentives to be based entirely on quantitative, measurable goals, and will be critical of companies that make use of discretion without proper documentation and rationale for doing so.
- **Performance-Based Equity:** Both proxy advisory firms prefer for a majority of long-term incentives to be considered performance-based. Performance-based in this case means that the award must be earned by achieving certain performance hurdles. The advisory firms do not consider awards that vest on the passage of time, even stock options, to be performance-based. In the emerging growth life science space, many companies still use time-based stock options for good reason, but the proxy advisors will criticize this practice in their reports.
- **Share Ownership Requirements:** Both proxy advisory firms prefer that a company have a policy requiring that executives hold certain levels of company stock, often denominated as a multiple of an individual's base salary. While this is a sensible practice, it is not commonly put in place at emerging life science companies given their focus on stock options, which are typically not considered forms of real ownership. These policies can also add administrative complexity and burden for companies that are trying to keep operations and administration streamlined.

Additionally, companies can also find that these firms have identified a pay-for-performance disconnect. This most often occurs for a few reasons:

- The peer groups that are used in their models differ from the company's own selected peer group;
- Their models focus on long-term incentive values based on their accounting cost (i.e., grant date fair value) and not based on the actual intrinsic (i.e., "in the money") value to the individual; and
- Their models also use financial measures in part to define performance, which can become problematic when the company is pre-commercial and has no consistent revenue or profit from products.

These items can result in companies being considered to have a poor pay and performance alignment when in reality that alignment may be quite good.

To mitigate the potential for criticism, we advise clients to focus on providing clear and concise compensation disclosures in the proxy statement that help the reader understand why the compensation program and decisions made were right for your company.

What to Expect: Proxy Advisor and Shareholder Vote Outcomes

Over the past ten years, proxy advisors and shareholders have overwhelmingly supported company say-on-pay proposals. Almost nine out of 10 companies receive a positive vote recommendation from a proxy advisor, and similarly, approximately nine of every 10 shares that are voted are a "yes" on say-on-pay. That said, companies may inevitably receive a negative vote recommendation from either or both advisory firms, and in a few cases, may fail to receive shareholder support on say-on-pay.

To avoid surprises, we recommend that a company research its investor base to understand how their top shareholders typically vote on say-on-pay for other investments, and what level of influence proxy advisor vote recommendations have on their actual votes. Additionally, companies can analyze in advance whether or not they expect to have any issues with proxy advisor firm recommendations based on their policy guidance. To the extent the vote is in question, prepare to engage with shareholders early to understand their perspectives on your compensation program and proactively provide your companies rationale for the compensation design.

Proper planning with the compensation committee in terms of education, understanding, and action as appropriate is important to mitigate the chance of having any surprises come proxy voting season.

About the Author

Terry Newth is a managing director at Pearl Meyer. He consults on the design, development, and assessment of executive compensation programs that support each organization's business objectives, long term business strategy, and organizational culture. His clients range from Fortune 500 organizations to pre-IPOs to private and family-owned companies in a wide range of industries. Terry's areas of expertise include pay strategy and philosophy development, market-based pay studies, incentive plan design, severance and CIC arrangements, outside director pay, transaction-related compensation, CD&A and supporting table disclosures, corporate governance, and share plan

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