

Best Practice Guidance to Managing Compensation Prior to an IPO

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A global trend is re-emerging: privately held companies are using initial public offerings (IPOs) as a vehicle for raising capital or for an enterprise to shift from government to private ownership through the floating of shares on a stock exchange.

IPOs have been with us for a long time. There is nothing really new about the process, be it in the United States, the United Kingdom, or elsewhere. (See *IPOs: Who Is Doing Them and Where* on page 2.)

What is changing, in general, is the attention organizations give to corporate governance issues. In particular, organizations focus on how to handle executive compensation issues during the IPO process so that they are better prepared to deal with the public scrutiny post-IPO. The period leading to the IPO provides a unique opportunity for an organization to review its compensation programs and to make dramatic changes, if needed, without all the public scrutiny. It is an opportunity that will not occur again.

Why is good governance such an important topic? The standard answer is that "good governance makes for good business." But a more in-depth answer is to think about corporate governance from an investor's perspective. If investors have the choice of buying the equity of two different organizations, how will they make the decision? Most prudent investors will weigh the risk of the investment. Companies with sound governance will have a lower risk profile than those without sound governance. Companies with a lower governance risk profile will also be seen as companies that will provide the returns the investor requires.

As we learn more about specific governance practices, we see that good governance is a cornerstone of trust between investors and the business. Companies with good governance

practices are companies in which people will invest. Companies with questionable practices are those that will suffer by having their share price shaved to reflect a level of market distrust.

Today, good governance is characterized by transparency. Companies that ignore this requirement for essential transparency will spend considerable amounts of money defending themselves from shareholders, from shareholder activist groups, such as Institutional Shareholder Services whose business it is to monitor governance standards on behalf of its institutional members, and/or from government regulators whose prime role is to protect investors and facilitate efficient markets.

One of the key methods investors have to evaluate corporate governance is by scrutinizing a company's executive compensation programs and practices. The following gives some indication of the information that the IPO process puts at their disposal.

In the United States, the initial filing is contained in the Securities and Exchange Commission's Form S-1. That document contains a statement about key executives' and board members' compensation and equity holdings. It is here that an investor's examination of compensation can begin. But it can't end there because this document omits any history of compensation and any statement of intent around compensation.

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IPOs: Who Is Doing Them and Where

The number of IPOs is increasing significantly in Northern Asia, Southeast Asia, and the Middle East with the countries of China and India taking the lead. Typically, four types of organizations participate:

1. Privately held companies that are moving to become publicly traded.
2. Governmentally owned or controlled companies that are becoming publicly traded or “privatized.”
3. Spin-offs: that is, companies that are being separated from their parent and will be free standing publicly traded companies.
4. Boomerangs: companies that were once publicly traded, reverted to private ownership, and will once again be publicly traded companies.

Post IPO, investors gain insight on compensation in the local regulatory filings. During the past several years, reporting through these filings has changed to require greater and clearer disclosure of compensation practices. This increased disclosure is in response to accusations that compensation reporting has been less than candid or written in a way that obscures the meaning for the regular investor. We expect that there will be a continued push to ensure that all compensation is clearly disclosed so that current and prospective shareholders will have a window into compensation governance and the decision-making process.

SIX FACTORS OF SOUND CORPORATE COMPENSATION GOVERNANCE

Achieving “best practice” in compensation governance is fairly straightforward for either organizations looking to privatize or those moving toward an IPO. We recommend the following six key points for your consideration:

- *Listing Laws and Regulations* — Companies moving to a public offering must know and adhere to the standards of the jurisdictions where they will be listed. A discussion

about the different national practices is beyond the scope of this article. (See *Country-Specifics on Executive Compensation: An Overview* on page 4.) However, knowledge of these practices provides the cornerstone for good governance.

At the same time, companies must recognize that national regulatory practices are evolving. As regulators become more comfortable with how well-governed, local companies operate, there will be a willingness to lift some of the restrictions placed on share ownership. Why? Because it is in the best interest of the investors to have as many opportunities to realistically increase share value by increasing the competition for share ownership.

- *Compensation Standards* — Good governance is a core value that communicates to investors that both the company’s Board of Directors and the executives are looking out for the interests of the shareholder. Good governance begins with the formation of a Compensation committee whose members are independent, non-executive directors. The Compensation committee should have a clearly defined charter that is, in effect, the statement about the compensation issues within the purview of the Compensation committee and policies that the Compensation committee will follow in the management of the executive pay program.
- *Sound Business Practices* — Executive compensation programs should be subject to a continuous process of development and refinement. That means that prior to the listing, the Compensation committee should put in place the procedures, policies, and programs that will sustain sound leadership before, during, and after the listing process. Specifically the committee should:
 - Put the compensation program in place and communicate it to potential investors. Compensation programs should be reviewed and adjusted accordingly before any public disclosures. It is unwise to radically change or increase the pay program post-listing because of the negative message sent to investors about how the company will use their money.

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- Communicate confidence and stability to investors by using equity as a tool for rewards and for enhancing shareholder value.
- **State Your Intentions** — Pre-listing regulatory filings provide opportunities to communicate an organization’s plans for growth, continuity, and executive leadership. When used properly, you can instill confidence in the investor community that there is a direct link between the success of the company, its investors, and the executives.
- **Communicate Success** — On an on-going basis, and in accordance with applicable regulations and statutes, communicate the performance of the company. Most organizations do this at least annually. Companies listed in the United States do this through the annual “proxy filing” while in the United Kingdom it is done through the Annual Report, the vehicle most commonly used to communicate the performance of the business, its values, vision, and mission. Reporting requirements have become more onerous over the years as regulators and investors demand increasing levels of clarity and transparency. Companies should consider going beyond the required minimum disclosures if the minimum disclosures do not adequately explain the company’s activities to shareholders.

- **It’s Not Just About Executives** — Compensation planning during the pre-IPO stage involves more than just thinking about how to compensate and retain executives. It is also about addressing employee equity compensation matters. The issue here is thinking through equity compensation and the needs of the growing organization post-IPO. Companies that fail to adequately plan their equity programs often find that their insider holdings exceed acceptable levels and could create a condition where outside investors face the potential for their holdings to become diluted if additional share authorization is needed. It is better to plan three to five years out and address your growth needs now than be faced with the prospects of having to explain why you failed to properly manage your share program. As part of this planning, consider the following:
 - Equity is used as a recruitment tool, offered to new employees as an inducement to join your company. New employees will accept equity in lieu of cash compensation if they believe the value of the shares will exceed what they could earn through cash compensation.

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Country Specifics on Executive Compensation: An Overview

National listing practices range from listing requirements to who can own the equity, and to the use of employee share schemes. In addition, companies that list in more than one country may be subject to multiple listing requirements.

A case in point is the New York Stock Exchange (NYSE) Listed Company manual that states in Section 303A.8:

“Shareholders must be given the opportunity to vote on all equity-based compensation plans and material revisions thereof ...” Under Swiss law, the Board of Directors is required to vote. Shareholder approval is not required. The NYSE allows certain home company practices to take precedence as long as the company discloses the practice.

One country significantly limits equity ownership by executives. While mechanisms have been identified that allow indirect executive participation, an understanding of these national differences is key to having a sound executive compensation program.

- Equity is the foundation of an Employee Share Purchase Plan (ESPP). These plans offer a limited discount to encourage employees to buy company stock and share in the growth potential of the shares.
- Equity is used as company match for certain benefits programs, such as defined contribution programs (in the United States, a 401(k) program).

Planning equity requirements will address the needs of the business to support its human resources programs not just through the IPO process but also during the several years that the company is going through its initial growth cycle.

READYING YOUR COMPENSATION PROGRAMS AND PROCESSES FOR AN IPO

It is the Compensation committee’s responsibility to ensure that the compensation programs are ready for the public scrutiny that will occur post-IPO? Buck Consultants has worked closely with many organizations and Compensation committees to help them through this process. The questions outlined below should help you begin to formulate your strategy for dealing with the process.

- Do you have the right alignment of your compensation strategy and business strategy? The Compensation committee should reference its clearly articulated compensation philosophy when assessing the appropriateness of every compensation decision. When organizations have not been in the public eye, many have taken a more ad-hoc approach to compensation decisions and have not developed a formalized philosophy. As soon as they believe an IPO is likely, the Committee should take steps to define the organization’s compensation philosophy. This includes not only determining what the philosophy will be but also ensuring that it aligns with, and stays aligned with, the organization’s business strategy.
- Do you have your Comp committee/Board engaged in the process of managing pay? Gone are the days where the Compensation committee and Board members could claim that they did not know about a compensation issue. The Committee should formalize the process of keeping the Board informed about compensation issues and decisions. In preparation for an IPO and the public disclosure needed as a public organization, summary sheets of total remuneration (tally sheets) paid to all executives should be provided to the Compensation committee and Board.
- Are the rewards structured in a manner that pays for performance? The increased scrutiny around compensation in public companies increases the need for organizations to assure a strong link between an executive’s incentive pay (cash and equity) and the organization’s performance. Prior to going public, incentive compensation programs should be redesigned to ensure performance metrics are relevant to the industry and understandable to shareholders. The Committee should take steps to compare the organization’s performance to a broad industry index or comparable companies when setting performance goals. This ensures that shareholders will see and understand the link between pay and performance. Equity programs are increasingly designed to reward performance. In fact, designing these programs with additional performance hurdles is becoming more common.

The Committee should formalize the process of keeping the Board informed about compensation issues and decisions.

- Is the economic value of the compensation consistent with the creation of that value? The Committee should model incentive and equity program payments under various performance scenarios. In many situations, it is not okay to set stretch goals that pay rewards for over achievement where the economic value provided to the executive is greater than the value created.
- Do the equity programs lock in key executives post-IPO? The significant wealth that key members of management accumulate in their equity programs often becomes available to them shortly after an IPO. The Committee should assure that executives have a portion of their equity/wealth that is unvested at the point of an IPO so as to ensure executives' post-IPO retention. Although there are several approaches the Compensation committee can take, the choice of a specific executive retention approach will likely depend on how far away the organization is from the actual IPO.
- Do the executives have an ownership stake in the organization? Many organizations have recently adopted ownership guidelines for executives, especially as they introduce full-value equity share programs such as restricted stock. Adopting ownership guidelines helps the organization justify to shareholders why the executive will retain awards that are not performance based. Although it is not yet a common practice, wouldn't it be best for the Committee to adopt such guidelines before the executive has cashed out his/her wealth?
- Are your equity program documents flexible enough to meet the changing types of equity awards? Do they meet the new standards and are there enough shares reserved to carry you for two years post-IPO? The design of equity

programs is rapidly changing. When shareholder activist groups weigh in each year on their most pressing issues, it forces companies to adopt new policies or face the possibility that shareholders will not approve their organization's request for a new plan/shares. Several years ago an organization's equity overhang was a pressing issue for shareholders. Then equity burn rates and linking a CEO pay with performance became pressing issues. Recent changes in the United States requiring expensing of options has focused these groups on the stock option plan's share counting and vesting schedules. In response, companies are rethinking their strategies for the type of equity awards.

- Are employment agreements in place to protect the executives in the event of termination without cause or in the event of a change of control? To the extent an organization already had employment contracts in place, the level of payments in the event of termination should be reviewed. Shareholders are increasingly demanding that organizations reduce the level of severance under these arrangements. In the past it was common for many executives to receive severance pay of three times base pay and bonus and a gross-up to keep them whole from taxes. However, severance packages at this level may now only be provided to the CEO. Lastly, the Committee should take steps to review all incentive plan documents for consistency of terms with the employment agreements and intent in the event of a change of control.

The Committee should assure that executives have a portion of their equity/wealth that is unvested at the point of an IPO so as to ensure executives' post-IPO retention.

BEST PRACTICE STANDARDS

There are hundreds of examples of “worst practice” executive compensation practice. On virtually any day of the week, some national or local newspaper runs an article about one example or another. It is rare to read an article about good practice, though it is sometimes reported.

Our advice to our many global clients heading to an IPO is to approach executive compensation with confidence. While this is a complex and evolving arena, your Compensation committee will be able to successfully navigate the issues by following the guidelines discussed here.

Buck Consultants has developed a best practices database for executive compensation. This database addresses both “big picture” practices, such as model “Compensation Committee Charters” and the refinements that support best practice, such as the frequency of meetings, recordkeeping, how and when the Chief Executive Officer is involved, and the management of compensation for executives below the CEO level. These standards are available in return for an organization agreeing to contribute to the database. Periodically, Buck publishes its *InsightOut* white papers, which describe key trends and changing standards.

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