Equity Compensation: End-to-End Strategies for Private Companies

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Sponsored by:
Speakers

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Symantec
Agenda

- Equity Compensation Strategies
- Equity Compensation Tools
- Avoiding Stock Comp. Issues
- Key Strategies Prior to a Liquidity Event
- Q & A
Equity Compensation Strategies
Start by Identifying Your Stage of Development & Prioritize Accordingly

Radford IPO Compensation Roadmap

- **Startup**
  - First Time Salary and Bonus Benchmarking
  - Consider Creating Systems to Level/Job Match Employees
- **Acquisition Ready**
  - Annual Bonus Assessment/Design
  - Equity Grant Guideline Development and Total Dilution Planning
  - Comprehensive Executive Compensation Review
    - Peer group selection
    - Compensation Philosophy
    - Total pay Competitiveness
- **IPO Event**
  - Public Disclosure and Regulatory Preparation
    - Executive compensation SEC disclosure drafting
    - Equity plan terms audit and funding needs projections
    - Tax & regulatory compliance
    - Executive severance/change-in-control policies and contracts
  - Go Forward Equity Strategy (Share Reserves and ESPP)
  - Ongoing Cash/Equity Program Review and Incorporation of New Roles/Incumbents
  - Equity Holdings Retention and Refresh Assessment
  - Board of Directors Compensation Program
  - Equity Award Valuation Assessment for ASC Topic 718 Accounting

Source: Radford
## Private vs. Public Company Pay Philosophies at a Glance

<table>
<thead>
<tr>
<th></th>
<th>Typical Private Firm</th>
<th>Typical Public Firm</th>
</tr>
</thead>
<tbody>
<tr>
<td><strong>Peer Group</strong></td>
<td>Usually, no specific identified peer list</td>
<td>Usually, a specific group of 15 to 20 identified public peer companies</td>
</tr>
<tr>
<td></td>
<td>Focus is placed on comparative companies similar in size and stage of development</td>
<td>Technology: focus is often on revenue and market cap</td>
</tr>
<tr>
<td></td>
<td>Key metrics include industry, invested capital, revenue, stage of development and employee count</td>
<td>Life sciences: focus is often on market cap, R&amp;D spend, product phase/stage</td>
</tr>
<tr>
<td><strong>Cash Approach</strong></td>
<td>Base salary must be competitive <em>(no longer getting away with low cash)</em></td>
<td>Base salary: 50&lt;sup&gt;th&lt;/sup&gt; percentile</td>
</tr>
<tr>
<td></td>
<td>Annual bonuses a “definite maybe” these days</td>
<td>Annual bonus: 50&lt;sup&gt;th&lt;/sup&gt; percentile or above, emphasizing the at-risk nature of compensation</td>
</tr>
<tr>
<td><strong>Equity Approach</strong></td>
<td>Aggressive award sizes, especially to those risking early entry</td>
<td>50&lt;sup&gt;th&lt;/sup&gt; percentile and up to 75&lt;sup&gt;th&lt;/sup&gt; based on performance</td>
</tr>
<tr>
<td></td>
<td>Vehicles: Stock options dominate</td>
<td>Vehicles: Options, RSUs, performance shares</td>
</tr>
<tr>
<td></td>
<td>Award sizing metric: Ownership percentage</td>
<td>Award sizing metric: Value</td>
</tr>
<tr>
<td><strong>Pay for Performance</strong></td>
<td>Egalitarian: “we’re all in this together”</td>
<td>Pay is targeted to key roles and high performers</td>
</tr>
</tbody>
</table>

*Source: Radford*
# Private vs. Public Company Equity Practices at a Glance

<table>
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<tr>
<th></th>
<th>Typical Private Firm</th>
<th>Typical Public Firm</th>
</tr>
</thead>
<tbody>
<tr>
<td><strong>Award Sizing</strong></td>
<td>&gt; Primarily established by targeting specific ownership percentages; conversion into shares based on TCSO</td>
<td>&gt; Primarily established by targeting specific values; conversion into shares is based on stock price</td>
</tr>
<tr>
<td><strong>New-Hire vs. Ongoing</strong></td>
<td>&gt; Large new-hire grants &lt;br&gt; &gt; Ongoing grants delayed until IPO approaches, or 3-4 years after hire &lt;br&gt; &gt; Ongoing guidelines set anywhere from 25% to 33% of new-hire awards</td>
<td>&gt; New-hire awards are typically 2x ongoing award sizes &lt;br&gt; &gt; Most employees are eligible for ongoing awards after one year of service</td>
</tr>
<tr>
<td><strong>Vehicle Mix</strong></td>
<td>&gt; Stock options dominate <em>(A few notable companies used RSUs pre-IPO; however, cash reserves are needed to address taxes)</em></td>
<td>&gt; Mix of stock options and RSUs, with an emphasis on RSUs as the firm matures &lt;br&gt; &gt; Rising prevalence of performance shares for executives</td>
</tr>
<tr>
<td><strong>Participation</strong></td>
<td>&gt; New hire awards: nearly 100% &lt;br&gt; &gt; Ongoing awards: targeted at key performers and those employees greater than 50% vested (usually 25% to 30% of population at any given time)</td>
<td>&gt; New hire awards: participation drops as companies increases in size &lt;br&gt; &gt; Ongoing awards: broad eligibility is maintained, although awards targeted at top performers (usually 40% to 60% of population at any given time)</td>
</tr>
</tbody>
</table>

*Source: Radford*
Ask Yourself: Where Are There Retention Gaps?

- **A snap-shot of current private company equity models:**
  - Large equity grants are made at the time of hire, typically with 4-year vesting
  - Refresh grants *may* occur in year 3 or 4, often set to 25% of new-hire grant levels
  - Refresh grants are *usually* offered only to top performers and critical roles (~25% of employees at any given time)
  - Employees are often very heavily vested by the time of an IPO, creating post-IPO retention concerns

<table>
<thead>
<tr>
<th>Parameter</th>
<th>Time of Hire</th>
<th>Year 1</th>
<th>Year 2</th>
<th>Year 3+</th>
<th>IPO at $12.00</th>
</tr>
</thead>
<tbody>
<tr>
<td>Equity Grant</td>
<td>400,000</td>
<td>-</td>
<td>-</td>
<td>100,000</td>
<td>-</td>
</tr>
<tr>
<td>Exercise Price</td>
<td>$0.25</td>
<td>-</td>
<td>-</td>
<td>$6.00</td>
<td>-</td>
</tr>
<tr>
<td>Vested Shares</td>
<td>-</td>
<td>100,000</td>
<td>200,000</td>
<td>300,000</td>
<td>400,000</td>
</tr>
<tr>
<td>Unvested Shares</td>
<td>400,000</td>
<td>300,000</td>
<td>200,000</td>
<td>100,000</td>
<td>100,000</td>
</tr>
<tr>
<td>Vested Paper Value</td>
<td>NA - no market until IPO</td>
<td></td>
<td></td>
<td></td>
<td>$4.7MM</td>
</tr>
<tr>
<td>Unvested Paper Value</td>
<td></td>
<td></td>
<td></td>
<td></td>
<td>$600K</td>
</tr>
</tbody>
</table>

*Source: Radford*
Equity Compensation Tools
### The Long March of Equity...
Your IPO is Just the Start

<table>
<thead>
<tr>
<th>Long-Term Incentive Vehicles</th>
<th>Startup</th>
<th>Mid-Cap/ Growth Market</th>
<th>Mid-Cap/ Mature Market</th>
<th>Lg. Cap/ Mature Market</th>
<th>Objectives/Implications</th>
</tr>
</thead>
<tbody>
<tr>
<td>Stock Options Only</td>
<td></td>
<td></td>
<td></td>
<td></td>
<td>&gt; Provides focus on absolute stock price growth and future upside potential</td>
</tr>
<tr>
<td>Restricted Stock or RSUs Only</td>
<td></td>
<td></td>
<td></td>
<td></td>
<td>&gt; De-emphasizes stock price growth</td>
</tr>
<tr>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td>&gt; Supports employee retention and ownership; especially at slower growth companies</td>
</tr>
<tr>
<td>Mix of Options and Restricted Stock or RSUs</td>
<td></td>
<td></td>
<td></td>
<td></td>
<td>&gt; Combines stock price growth incentives with greater emphasis on employee retention and ownership</td>
</tr>
<tr>
<td>Performance Shares</td>
<td></td>
<td></td>
<td></td>
<td></td>
<td>&gt; Allows companies to introduce specific performance-based contingencies into equity awards</td>
</tr>
<tr>
<td>Long-Term Cash</td>
<td></td>
<td></td>
<td></td>
<td></td>
<td>&gt; Requires maturity and cash reserves, and often the ability to select metrics/set goals over time (e.g., 3 years)</td>
</tr>
<tr>
<td>Relative Total Shareholder Return</td>
<td></td>
<td></td>
<td></td>
<td></td>
<td>&gt; Reflects institutional investor perspective (portfolio performance)</td>
</tr>
<tr>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td>&gt; Maturity of market required for reliable comparator group/index</td>
</tr>
</tbody>
</table>

**Source:** Radford
## Pros/Cons Equity Compensation Types

<table>
<thead>
<tr>
<th></th>
<th>Pros</th>
<th>Cons</th>
</tr>
</thead>
<tbody>
<tr>
<td><strong>Stock Options</strong></td>
<td>• No immediate dilution • Employee controls tax event</td>
<td>• No retention value for underwater options • Complex valuation</td>
</tr>
<tr>
<td><strong>Restricted Stock</strong></td>
<td>• Ownership in stock from time of grant • No underwater issues</td>
<td>• Tax at vesting • Higher comp expense (than option) • Immediate dilution</td>
</tr>
<tr>
<td><strong>Restricted Stock Units</strong></td>
<td>• May settle in cash or shares • No underwater issues</td>
<td>• Tax at vesting • Higher comp expense (than option) • Possible liability accounting</td>
</tr>
<tr>
<td><strong>Performance Awards</strong></td>
<td>• Goal-based behavior • Shares only issued if performance met</td>
<td>• Tracking targets • Probability accounting • Changing targets = modification</td>
</tr>
</tbody>
</table>
Avoiding Stock Comp. Issues
Avoiding Cheap Stock Issues

- **Cheap stock charges**
  - Results from the issuance of private company share-based payment awards with exercise prices below the fair value of the stock
  - Typically arises in connection with employee stock options

- **Potential consequences**
  - Employee tax penalties
  - Administrative challenges
  - Higher stock-based compensation expense
  - Disqualified ISO status
  - SEC scrutiny during IPO process
Avoiding Cheap Stock Issues (cont’d)

- **Recommendations**
  - Obtain 409A valuations
    - At least once per year & more often with significant events
    - Should be contemporaneous
    - Best when prepared by independent valuation specialist
  - Document estimates of FV at each major grant date
  - Limit the number of grant dates in a given year

- **Tips**
  - Consult your auditors for 409A valuations specialists
  - Refer to AICPA Practice Aid on valuing private company stock
  - Obtain 409A at each major grant in the year leading up to IPO
Caution: Modifications

- **Modification by definition** (ASC 718-20-35-3)
  
  A modification of the terms or conditions of an equity award shall be treated as an exchange of the original award for a new award.

- **Recognizing modifications**
  - Repricings
  - Exchange of equity awards (e.g. options for RSUs)
  - Extension of time to exercise post termination
  - Acceleration of vesting
  - Change in performance-based metrics
  - Changes in employment status (e.g. consultant to employee)
  - Adding “change of control” provisions
Caution: Modifications (cont’d)

- **Modification implications**
  - Additional stock-based compensation expense
  - Possible tax consequences
  - Potential loss of ISO status

- **Tips & Suggestions**
  - Understand accounting and tax implications prior to board approval
  - Ensure equity software calculation is correct
  - Document all modification accounting
Priority #1 – Data Integrity

Key Questions

1. Are awards granted reconciled to board minutes at least once per quarter?
2. Have all recipients been properly identified in the system and either employee or non-employee?
3. Are employees notified of their awards on a timely basis?
4. Is the paperwork kept in a single location and is it complete?
5. If performance-based awards were granted, who is assessing probability?
6. Has the accounting department been notified of all award modifications?
7. Are taxes withheld for all exercises of non-qualified stock options?
8. What process is in place to ensure that employee terminations are entered into the system promptly?
ASC: 718 vs. IFRS 2

- Classification
  - Equity vs. Liability

- Grants
  - Grant Date Definition
  - Employee vs. Non-Employee

- Attribution
  - Straight Line or Tranche by Tranche

- ESPP
  - Non-Compensatory or Compensatory

- Income Tax Accounting
  - Deferred Tax Asset Measurement

- Payroll Tax Liability
Key Strategies Prior to a Liquidity Event
Thinking About Pre-IPO Equity Compensation...
There’s a lot to Consider

- Defining your post-IPO equity pool size
  - Evergreen provisions?
  - Employee Stock Purchase Plans?
- Awarding Equity in a Fair and Appropriate Manner as an IPO Approaches
- Transitioning Programs and Employees From Private to Public Environments
  - % of Ownership Becomes Value
  - Stock Options Often Become RSUs
  - Share Counts Often Decline
  - Award Frequencies Change
- Lock-Out Periods and Employee Communication
- Plan Administration
## Common Equity Program Modifications at IPO

<table>
<thead>
<tr>
<th>Practice at IPO</th>
<th>Technology</th>
<th>Life Sciences</th>
</tr>
</thead>
<tbody>
<tr>
<td>New Equity Plan Adoption (% of companies)</td>
<td>89%</td>
<td>88%</td>
</tr>
<tr>
<td>Prevalence of Full Plan Evergreen (% of companies)</td>
<td>70%</td>
<td>83%</td>
</tr>
<tr>
<td>Median Evergreen Funding Rate (% of post-IPO total common)</td>
<td>4.0%</td>
<td>4.0%</td>
</tr>
<tr>
<td>Immediate Funding w/ Evergreen (% of post-IPO total common)</td>
<td>6.6%</td>
<td>6.4%</td>
</tr>
<tr>
<td>Immediate Funding w/o Evergreen (% of post-IPO total common)</td>
<td>10.0%</td>
<td>11.4%</td>
</tr>
<tr>
<td>Adoption of ESPP Offering (% of companies)</td>
<td>32%</td>
<td>62%</td>
</tr>
</tbody>
</table>

*Source: Radford*
Option-Only Approaches Still Dominate the pre-IPO Landscape

- Equity portfolio practices rarely shift until after an IPO

<table>
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<tr>
<th>Employee Level</th>
<th>Pre-IPO Technology</th>
<th>Public Technology</th>
</tr>
</thead>
<tbody>
<tr>
<td></td>
<td>Options Only</td>
<td>RS/RSUs Only</td>
</tr>
<tr>
<td>Executive</td>
<td>95%</td>
<td>1%</td>
</tr>
<tr>
<td>Management</td>
<td>95%</td>
<td>1%</td>
</tr>
<tr>
<td>Professional</td>
<td>95%</td>
<td>1%</td>
</tr>
<tr>
<td>Support</td>
<td>96%</td>
<td>1%</td>
</tr>
</tbody>
</table>

Source: Radford, 2012 Global Technology and Pre-IPO/Venture-Backed Surveys
Pre-IPO Firms Focus on Time-Based Vesting Ahead of Liquidity Events

<table>
<thead>
<tr>
<th>Employee Level</th>
<th>Pre-IPO Technology</th>
<th>Public Technology</th>
</tr>
</thead>
<tbody>
<tr>
<td>Executive</td>
<td>80%</td>
<td>20%</td>
</tr>
<tr>
<td>Non-Executive</td>
<td>100%</td>
<td>0%</td>
</tr>
</tbody>
</table>

- Please note prevalence data may not add up to 100%, as companies may have multiple types of equity awards in place at the same time.
- Investor pressure, media scrutiny and increased disclosure requirements have forced public companies to improve pay/performance links via true performance contingent vesting – but usually only for executives.

Source: Radford, 2012 Global Technology and Pre-IPO/Venture-Backed Surveys
Change in Control

- Definition typically requires change in more than 50% of the voting power of stock
  - Definition in documents will most likely cover a merger, acquisition or IPO event
  - Conform definitions across equity plans

- Accelerated Vesting
  - Single-Trigger
    - Retention Strategies
    - Most common if no conversion
  - Double-Trigger
    - Employment Agreements
Section 409A

- **Section 409A issues:**
  - Stock Options granted at a discount
    - Stock Option cannot be an ISO if not granted below fair market value
  - RSUs
    - RSUs can be used to delay recognition of income tax
    - Note that FICA due at vesting

- **Distributions on a Change in Control**
  - Section 409A definition is technical and thresholds (which are adjustable upward) will need to be reviewed
  - Double-Trigger may provide more flexibility for the definition of Change in Control, as distribution occurs at the separation
  - Exemptions
    - Short-Term Deferral
    - Separation Pay
Section 280G

- Excess Parachute Payments may be subject to penalty
  - 20% excise tax to the individual
  - No compensation deduction to the company
- “Parachute Payment”
  - Compensation paid contingent upon a Change in Control
    - Includes accelerated equity vesting
  - If payment is greater than 3x average base compensation over past five years, “excess” above the base compensation amount is the parachute payment
- Private company exemption if shareholder approved
Securities Laws

- **Federal**
  - Private: Rule 701
    - $5M rule
  - Public: Form S-8
  - JOBS Act

- **State**
  - Blue Sky Laws (most incorporate Rule 701 by reference)
  - California has specific laws apply (See 25102(o))

- Executive Compensation Table
  - Grant date fair value of equity awards + other compensation
  - Individual grant details (shares, price, etc.)

- Compensation Discussion & Analysis
  - Compensation strategies & philosophies for equity awards
  - Note: JOBS Act exemption for emerging growth companies

- Beneficial ownership table
  - Aggregate of direct and indirect ownership
  - Significant shareholders (5%+)
  - Executive officers and board members
Public Disclosure Provisions (cont’d)

- Notes to Financial Statements
  - Plan summary / roll-forward
  - Stock-based compensation information
  - Details of equity awards by grant date in year prior to IPO

- Disclosure of Material Compensatory Arrangements
  - Material compensation plans, contracts or arrangements, or material amendments and modifications
  - Four business days to file, unless exception applies
Questions?

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