

GRG

Remuneration Review

Non-executive Director Options Opportunity

Remuneration Review No. 8

September 2008

INTRODUCTION

In "GRG Remuneration Review No 6 Options for Non-executive Directors" which was published in April 2008 it was pointed out that the Australian Securities Exchange (ASX) had been approached seeking clarification of the treatment of share options and other equity units in relation to aggregate fees limits (AFL).

A surprising response has been received. It is detailed in this GRG Remuneration Review and possible implications are canvassed.

BACKGROUND

Two significant developments had taken place which led GRG to seek clarification of the treatment of the value of share option grants to non-executive directors for AFL purposes.

First, was the release of the ASX Corporate Governance Council's "Corporate Governance Principles and Recommendations" which states at Box 8.2 item 1 "Non-executive directors should normally be remunerated by way of fees, in the form of cash, non-cash benefits, superannuation contributions or salary sacrifice into equity". Thus, the scope of "fees" was clearly being expanded beyond cash payments.

Second, in accordance with AASB 2, all forms of equity (shares, rights & options) remuneration need to be valued and both:

- charged as an accounting expense, and
- reported as remuneration in the Remuneration Report section of annual reports

on an amortised basis over their vesting periods.

Given these developments, GRG expected share options grants to be treated as fees using the AASB 2 approach. If this were the case then clarity would be important to avoid inadvertent breaches of AFLs.

Our request for clarification raised two aspects being:

- "1. whether the value of such equity grants are fees when comparing actual fees paid with aggregate fees limits, and
2. is the value of the equity units so granted recognised in the year of grant or over the period of vesting".

Of these, point 2 is specifically mentioned in the ASX's response.

GRG Remuneration Reviews are articles to assist directors and senior executives who have responsibilities in relation to Board and senior executive remuneration and other human resources issues. Their role varies between articles with some aimed at stimulating critical thinking, others updating information and others simply acting as a reminder of principles and approaches where awareness may need to be heightened.

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ASX RESPONSE

The following reproduces the ASX's response which followed a quote of ASX Listing Rule 10.17 – see appendix.

“As a general principle, directors fees payable for the purposes of ASX Rule 10.17 does not extend to include the value of equity grants. As a matter of policy, ASX has not sought to apply the rule to equity grants. Directors’ fees payable for the purpose of listing rule 10.17 and the aggregate limit includes cash payments and their statutory entitlements.

As listing rule 10.17 does not apply to equity grants, the clarification sought in question 2 relating to the time which the equity grants is recognised is not necessary for the purposes of the listing rules.

In circumstances where equity securities are issued to a related party pursuant to the terms of remuneration agreements, and likewise where equity securities are issued in lieu of remuneration outside such arrangements, entities need to ensure compliance with listing rule 10.11 or 10.14. If there were an equity incentive scheme under which a director elected to elect to have part or all of his or her fees devoted to purchasing securities on market, that would seem to be a case where the amount of those fees would have to be counted for purposes of the aggregate fee limit under listing rule 10.17 while the purchase of the securities might not require shareholder approval under listing rule 10.14.”

Note that punctuation and expression errors have been reproduced as contained in the ASX's letter.

IMPLICATIONS OF THE RESPONSE

The ASX's response draws a distinction between two broad components of NED remuneration as indicated in the following table

Broad Remuneration Categories	Whether Fees for AFL Purposes
Cash payments and statutory entitlements e.g. superannuation contributions	Fees but with exceptions such as retirement benefits paid to former NEDs.
Equity grants	Generally not Fees but with exceptions and an example was provided in the ASX's letter.

The example exception was when NEDs make elections to have part of their fees redirected to purchasing securities on market. This exception seems to contain two elements being:

- that an amount otherwise to be paid in cash is redirected, and
- the redirected amount remains a cash payment for the benefit of the NED.

As the ASX's letter did not canvas various other situations we have identified the main situations that could arise and have indicated whether the value of equity units should be regarded as fees for AFL purposes.

Whether or Not Equity Grants are Fees for AFL Purposes

Type of Remuneration	Fee Sacrifice	Additional to Fees
Shares purchased on market	Fees. Part of what would have been cash fees and cash payments made for the benefit of NEDs.	Unclear but probably fees. Not part of agreed fees but additional cash payments to purchase shares for NEDs.
New issue of shares	Unclear but probably not fees. Part of what would have been cash fees but no cash payments made for the benefit of NEDs.	Not fees. Not part of agreed fees and no cash payments made as shares issued.
Rights which when exercised give rise to market purchases of shares	Unclear but probably not fees. Part of what would have been cash fees but no cash payments when rights granted. Subsequent cash payments are to satisfy obligations to holders of rights.	Not fees. Not part of agreed fees and no cash payments when rights granted. Subsequent cash payments are to satisfy obligations to holders of rights.
Rights which when exercised give rise to new issues of shares	Unclear but probably not fees. Part of what would have been cash fees but no cash payments when rights granted. Also, no subsequent cash payments as obligations to holders of rights satisfied by issue of shares.	Not fees. Not part of agreed fees and no cash payments when rights granted. Also, no subsequent cash payments as obligations to holders of rights satisfied by issue of shares.
Options which when exercised give rise to market purchases of shares	Unclear but probably not fees. Part of what would have been cash fees but no cash payments when options granted. Subsequent cash payments are to satisfy obligations to option holders.	Not fees. Not part of agreed fees and no cash payments when options granted. Subsequent cash payments are to satisfy obligations to option holders.
Options which when exercised give rise to new issues of shares	Unclear but probably not fees. Part of what would have been cash fees but no cash payments when options granted. Also, no subsequent cash payments as obligations to option holders satisfied by issue of shares.	Not fees. Not part of agreed fees and no cash payments when options granted. Also, no subsequent cash payments as obligations to option holders satisfied by issue of shares.

The cells highlighted in yellow would be the most frequently occurring as it is common practice for companies to offer fee sacrifice share purchases or option grants to supplement low fee levels. The cell highlighted in green is, perhaps, one that should be considered by companies wishing to supplement fees with equity grants that do not need shareholder approval and fall outside the AFL.

POSSIBLE APPROACH TO SUPPLEMENTARY EQUITY GRANTS

It is common practice for top executive remuneration packages to have Base Packages around the median of market practice and for the total remuneration packages including incentives to be pitched around the 75th percentile of market practice for superior performance. However, in the same companies, the remuneration of NEDs tends to be pitched at the median of market practice and does not contain an opportunity to achieve more competitive remuneration when superior performance is achieved. Thus, there is inconsistency in the remuneration treatment of top executives and NEDs.

NED remuneration needs to be a fixed sum (ASX Listing Rule 10.17.2 – see appendix). Market practice clearly shows that grants of shares, right and options can be made as they constitute part of fixed sums. However, by providing remuneration in the form of equity such as options a variable performance element is introduced into NED remuneration. Such a situation will be in the interests of shareholders provided that the equity grants are not so excessive that they could lead to self interested behaviour to the detriment of shareholders. Given the quantum of NED remuneration in Australia and the approach discussed below, the size of the equity grants would be most likely to support a performance focussed culture from the Board down.

A means of addressing this situation would be for fees to continue to be pitched at the median of market practice and for a supplement to be provided in the form of grants of options or rights. The annualised value of the supplement would be calculated by reference to the excess of the P75 over the P50 of market practice for main board packages (total of board and committee fees, superannuation contributions, benefits, fee sacrifice share acquisitions and other equity grants). The supplement could be provided at 3 yearly intervals. Thus, options or rights would be granted each 3 years. The value of the grant would be 3 times the annual excess. The numbers of options or rights to be granted would be calculated by dividing the three year supplement value by the value of the option or the right, as appropriate.

The following provides an example assuming a share price of \$10.00, annual dividends of \$0.50, term of option of 5 years, exercise prices of \$10.00 for options and nil for rights, risk free rate of return of 6% and volatility of 30%. The value of the option calculated using a Black-Scholes model would be \$2.00 and the value of the right would be \$8.50.

The number of options and rights to be granted assuming that the 3 year supplement was \$60,000 (\$20,000 x 3 years) would be calculated as follows.

Number of Options	=	3 Year Supplement Value ÷ Option Value
e.g.	=	\$60,000 ÷ \$2.00
	=	30,000 options

Number of Rights	=	3 Year Supplement Value ÷ Right Value
e.g.	=	\$60,000 ÷ \$8.50
	=	7,059 rights

The options or rights would vest after 3 years of service. If termination occurred earlier, then pro-rata vesting would apply having regard to the completed portion of the 3 year service period.

Performance vesting conditions would not apply. This would help distinguish the NED equity plan from executive long term incentives. If performance vesting conditions were to be applied, then the option and right values would be lower than indicated with the result that more options or rights would need to be granted.

Whether rights or options are granted would be influenced by factors such as:

- whether emphasis is to be placed on performance improvement – options would be suitable, or
- whether the emphasis is to be placed on encouraging NEDs to build their equity stakes in the company – rights would be suitable, or
- whether or not the company preferred to seek shareholder approval of the grants:
 - needed for options if when exercised they will result in a new issue of shares, and
 - not needed for rights if when exercised they will be satisfied with a market purchase of shares,
- whether the company wishes to obtain a tax deduction for the value of the shares provided when rights and options are exercised – market purchases result in tax deductions for the amount expended,
- whether the company wishes to operate a general employee share plan so that tax deferral may apply to equity grants to NEDs – no need for a general employee share plan if rights or options are used but a general employee share plan is required when shares are provided.

In the current environment when many shareholders have seen the values of their shareholdings fall, it may be appropriate for Boards to defer increases in their cash fees and to supplement their fees with option or right grants which will clearly align their interests with those of shareholders and demonstrate that they have confidence in the futures of the companies of which they are directors.

MARKET PRACTICE

The following table which has been compiled from GRG's database of NED remuneration practices shows the incidence of share and options plans for NEDs among the top 336 ASX listed companies (those with market capitalisations above \$250 million).

Share & Option Plans Analysis			
Market Capitalisation	Total No of Companies	% With Share Plan	% Where Directors Have Received Options
> \$10 billion	27	74%	0%
\$5 billion to < \$10 billion	32	50%	3%
\$2 billion to < \$5 billion	47	32%	6%
\$1 billion to < \$2 billion	57	21%	18%
\$500 million to < \$1 billion	70	26%	33%
\$250 million to < \$500 million	103	17%	38%
Total	336	29%	23%

Thus, even though the ASX Corporate Council has indicated that NEDs should not be provided with options it is clearly a common practice and one that, in the author's view, should increase.

APPENDIX – ASX Listing Rule 10.17

ASX Listing Rule 10.17 provides as follows.

An entity must not increase the total amount of directors' fees payable by it or any of its child entities without the approval of holders of its ordinary securities. This rule does not apply to the salary of an executive director. However, an executive director's salary or director's fees must not include a commission on, or percentage of, operating revenue.

10.17.1 The notice of meeting must include the amount of the increase, the maximum amount that may be paid to the directors as a whole, and a voting exclusion statement.

10.17.2 If a non-executive director is paid, he or she must be paid a fixed sum.

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GRG Contacts

GRG is well positioned to assist boards in reviewing their company's remuneration strategies, incentive plans and employment contract terms. Many of the top Australian listed companies are among our substantial client base.

GRG maintains databases on director and executive remuneration. We capture all the aspects required to be covered in Remuneration Reports and therefore provide an authoritative source of advice in relation to market practices and emerging trends.

Please feel free to call any of the following consultants on **02 8923 5700**

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More information on GRG may be obtained from our website:

www.godfreyremuneration.com