GRG Remuneration Review

Checklist for Reviewing Long Term Incentive Plans

Remuneration Review No 19

October 2009

INTRODUCTION

Legislation Slow to Emerge

2009 has been a challenging year in relation to executive long term incentive plans due to uncertainty around the taxation treatment of employee share scheme (ESS) benefits. The uncertainty started with an announcement in the 2009 Federal Budget on 12 May 2009 that the ESS provisions would be substantially changed. The impact of the announced changes would have been to penalise executives who received part of their remuneration in the form of grants of shares, rights or options. Following the Budget announcement there was considerable reaction from the business community and the Government then modified its position.

Rather than amend the previous legislation, the Government has decided to replace it with new provisions. Exposure drafts of the new ESS taxing provisions have been released and feedback from interested parties has been provided. However, the Government has still not finalised the new provisions and has not submitted them to Parliament. Parliament is scheduled to sit for sixteen (16) more days this year with eight (8) days in October commencing on 19 October and eight (8) days in November commencing on 16 November 2009. Thus, it is possible that the legislation may be delayed until 2010 even though it is to apply to grants made after 30 June 2009.

Interim LTI Arrangement Have Been Adopted by Companies

This delay in finalising the legislation has meant that companies have been forced to adopt interim arrangements in relation to 2009 long term incentive (LTI) grants which needed shareholder approval at 2009 annual general meetings (AGMs). Most AGMs take place in October and November each year and notices of meeting needed to be sent out earlier. Thus, companies could not wait for the legislation to be finalised before making LTI grants to executives.

More Changes to Come

Even after the new ESS taxing provisions are passed by Parliament there will remain several aspects where further change may be expected because the Board of Taxation is to make recommendations to the Government by 28 February 2010 on:

- how best to determine the market value of ESS benefits, and
- whether shares and rights under an ESS at a start-up, R&D or speculative focused company should have separate tax deferral arrangements.

LTI Plans Need to be Reviewed

Once the new ESS taxing provisions and the new limit on termination benefits that may be paid to executive and managerial officers without shareholder approval have been enacted, all companies will need to review their LTI plans. Both of these aspects have serious implications for LTI plans. So as to help companies with the LTI review process, GRG has developed a checklist of the main aspects of LTI plans that need to be considered and provided comments to assist with that consideration.

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.

GRG Godfrey Remuneration Group Pty Ltd
ABN: 38 096 171 247
56 Berry Street
North Sydney NSW 2060
Phone (02) 8923 5700
Facsimile (02) 8923 5706

www.godfreyremuneration.com

LTI PLAN CHECKLIST

Aspect	Comments
Participants	Participation should be limited to those executives who have roles that can have an impact on the longer term performance of the company. These would typically include the Managing Director, Direct Reports and other selected key executives. Lower levels of employees may participate in equity plans that assist with retention and promote shareholdings among employees. These plans may complement and/or be extensions of LTI plans.
Award Type	Broadly, there are four main types of awards that may be offered under an LTI plan. These are: • shares, • rights (options with a zero exercise price), • options, and • cash (including when cash may be converted into shares). Although cash LTI plans have not been widely used in the past it may be expected that they will grow in usage as indicated by comments below.
Grant Frequency	Annual is standard practice and recognises that LTIs form part of the current year's remuneration but with subsequent conditions for vesting.
Award Opportunity	The award opportunity should be calculated on a consistent basis for each group of employees. As the amount is part of the current year's remuneration it should be calculated as a percentage of Base Package e.g. the target LTI may be say 20% of the Base Package. The stretch award opportunity should be higher than the target so as to recognise that the vesting conditions lessen the chance of vesting.
Performance Period	Three (3) years is the well established measurement period for LTI plans. It represents a reasonable balance between not being too long so as to become irrelevant for executives and not being too short so as to not reflect longer term performance. There are variations from as short as two years or less and as long as five years or more. It should also be noted that with new award opportunities being offered each year and each of those having a three year performance period, the cumulative impact is to produce a genuine focus on long term performance.
Performance Measures	Performance measures need to: • relate to growth in shareholder value, and • be durable over the measurement period recognising that detailed business plans may change and that individuals may change roles during the measurement period. The most often used performance measures in order of frequency of use are: • relative total shareholder return (TSR), • growth in earning per share (EPS), • absolute TSR, and • period of service. It should be noted that offers may be divided into tranches with a different performance measure applying to each tranche. Some stakeholders prefer both TSR and EPS growth to be used. Relative TSR may be combined with a threshold condition of TSR needing to be positive.

Aspect	Comments
Performance Measures (continued)	In exploration companies it is common practice to use options with exercise prices that represent a premium to the share price at the time of grant of the options. This premium is, in effect, a performance measure and no other performance measures have been applied to these options in the past. However, in the future it may be necessary to combine them with a service performance measure if the premium is not high enough to produce a nil or minimal taxable value for the options.
Retesting	While retesting it not favoured by many stakeholders, it does make sense particularly for measures such as TSR which are strongly influenced by share price movements and therefore may produce distorted results when measured at a single point in time. A compromise can be to only apply retesting when nil vesting occurs at the first test date.
Change in Control (CIC)	CIC events include takeovers and are watershed events that warrant vesting having regard to performance up to the date of the CIC.
Termination of employment **(This will be a future problem area for executive and managerial officers.)**	Taxation provisions which trigger taxing of unvested benefits on termination of employment have been and will continue to be a strong influence on the design of share, right and option plans. This influence has resulted in plans being designed so that vesting and lapsing occur on termination so that the ESS benefits that are taxed on termination are only the ones that have vested. From a plan design point of view it would be preferable to lapse that portion of award opportunities that should be forfeited due to the nature of the termination e.g. dismissal and resignation, or the shortened period of service and for the remainder, if any, to roll forward as if the termination had not occurred. Then both former and current employees may be treated consistently in terms of the vesting that arises based on performance. Cash plans, including those that may be converted into shares, can be structured such that vesting is not triggered or accelerated by the termination of employment. This will have a two fold effect of: • no tax being triggered by the termination of employment, and • the benefit not being a termination benefit and therefore not being subject to the one times base salary limit on termination benefits that applies to executive and managerial officers.
Bonus Issues, rights Issues and Capital Reconstructions	The provisions dealing with these aspects should ensure that participants are neither advantaged nor disadvantaged, compared to shareholders, by any changes to issued capital.
Tax Deduction for Company	If companies issue shares for nil consideration or for the exercise price of an option then the company will not be entitled to a tax deduction for the value of the benefit provided to LTI plan participants. All LTI plans should provide for cash to be paid out by the Company equal to the value of the LTI benefit being provided. This amount may be paid to the LTI plan participants via payroll or to an employee share trust (EST). By structuring the payment in this way the company will obtain a tax deduction for the amount paid.
Cash Flow	If the company pays the benefit amount to an EST and the trustee applies the funds to subscribe to a new issue of shares then the cash flow will be neutral except for the tax saving from the tax deduction for the payment of the benefit value to the EST. However, if the EST makes an on-market purchase of shares then there will be a cash outflow equal to the cash payment less the tax saving. The same cash flow position will apply to direct payments to executives via payroll.

Aspect	Comments
Taxation of Executives **(The new taxing provisions are problematic and tend to discourage the use of share, right and option grants as the LTI.)**	If shares, rights or options are provided then they will be taxed on the earlier of: 1. grant, if there is no real risk of forfeiture, 2. if a real risk of forfeiture applies then a. elapse of seven (7) years, b. termination of employment, c. when both the real risk of forfeiture and any dealing restrictions cease to apply, d. on exercise of rights or options except in the unlikely event of a real risk of forfeiture applying to the shares in which case 2a, 2b and 2c will apply to the shares. From a practical point of view this will generally mean that the taxing point will be soon after the shares, rights or options vest. If the LTI provides a cash benefit then payment may be deferred indefinitely including after termination of employment. The taxing point will be when the payment is made. Irrespective of when or in what form (cash or shares) the payment is made, the executive will be taxed on the full value of the benefit received.
Shareholder Approvals	Shareholder approval should not be required except when new issues of shares are involved in relation to directors.
Accounting Charges	When shares, rights or options are used or when the company may choose to pay cash awards in either cash or shares then the LTI is accounted for as a share-based payment.
AFSL & PDS Requirements	Generally an Australian Financial Services License and product disclosure statements are not required in relation to LTI plans but legal advice should be obtained particularly if the award offered may be construed as a derivative.

OBSERVATIONS

When the proposed new ESS taxing provisions and the limit on termination benefits are taken into account it would appear that for many companies the LTI plan for executive and managerial officers should be in the form of a cash share plan i.e. cash awards which are delivered at the company's discretion in cash and/or shares. This is a significant but necessary change to provide certainty to executives and not expose them to unreasonable risk from participation in a LTI plan. The risk exposure can arise from several perspectives including:

- Executives being taxed on the benefit value at a time when shares may not be sold due to insider trading restrictions, if the share price subsequently falls before they may be sold then executives may realise less than the value that has been taxed,
- If executives retain options that have been taxed on their notional benefit value and the share price falls below the exercise price and therefore executives do not exercise the options then there will be no refund of the tax payable on the notional option benefit,
- If shares, rights or options vest on termination of employment then they will be taxable but may not be able to be received or sold until shareholder approval is obtained. The share price could be lower with the result that the benefit that has been taxed cannot be realised.

An appropriately structured cash share plan would only deliver shares at a point in time when they may be sold by the executive to realise sufficient cash to cover their tax liability. Thus the taxing and realisation points would coincide. Also an appropriately structured cash share plan would not vest benefits on termination of employment and therefore would not be subject to the one year's base salary limit on termination benefit that may be paid without shareholder approval.

Of course, each company will need to determine the appropriate LTI plan for their particular circumstances.

ooooo00000ooooo