GRG Remuneration Insight 46

Share Ownership for Non-executive Directors

Nicholas Jackson and Denis Godfrey | February 2013

Introduction

Previous editions of this publication have discussed the market practice of granting options to non-executive directors (NEDs). We have also provided implementation guidance in that regard (See GRG Remuneration Review No. 6 dated April, 2008 and No. 27 dated March 2011). However, paying NEDs in options remains contentious. For example, a proxy advisor recently recommended against the re-election of NEDs on the basis that they were affiliated to the company because they held options (less than 0.1% of issues shares). This was seen as having the ability to detract from the independence and impartiality of these directors. This edition of the GRG Remuneration Insight seeks to encourage further consideration of options as an element of NED remuneration.

Of course, since 2003 when the first version of the ASX Corporate Governance Principles and Recommendations were released they have contained a guideline that non-executive directors should not receive options. However, the rationale for this guideline has not been explained and is not self-evident.

Current Market Practice

Almost 20% of companies listed on the ASX with market capitalisations over $25 million offered equity (rights or options) to their NEDs as part of their remuneration in 2012 – shares purchased at market value via cash sacrifice are not included in this analysis. The practice of providing equity to NEDs, particularly options, is most evident in the resources sector, less so in the industrial and services sector and appears absent in the financial services sector.

It should be noted that many of the resources companies that provide options do so as a means of preserving cash by paying low fees and compensating NEDs with an opportunity for significant reward should exploration activities prove successful.

Companies with Market Capitalisation > $25 million			
Broad Market Sector	**Total No. of Companies**	**Companies Granting Equity to NEDs**	**% of Total**
Financials	95	0	Nil
Industrial & Services	384	41	10.7%
Resources	397	132	33.2%
Total	**876**	**173**	**19.7%**

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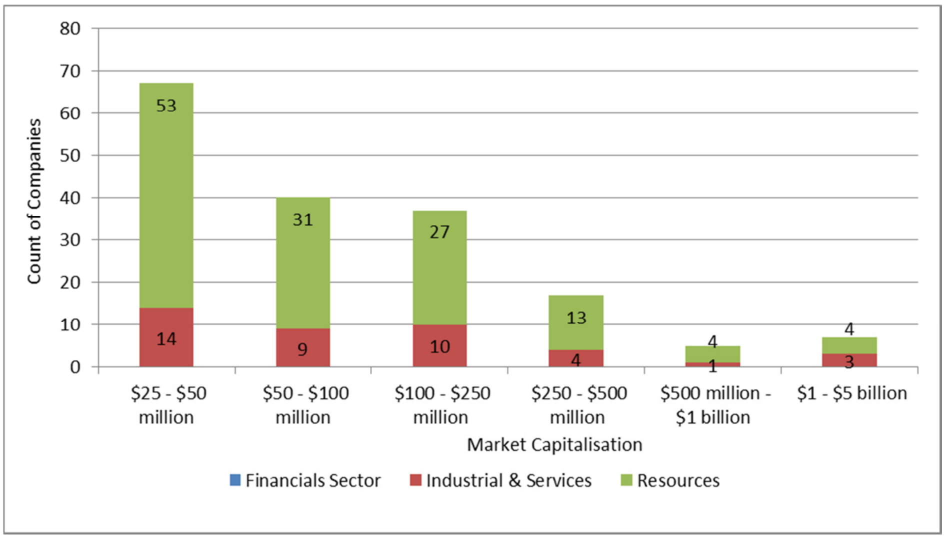
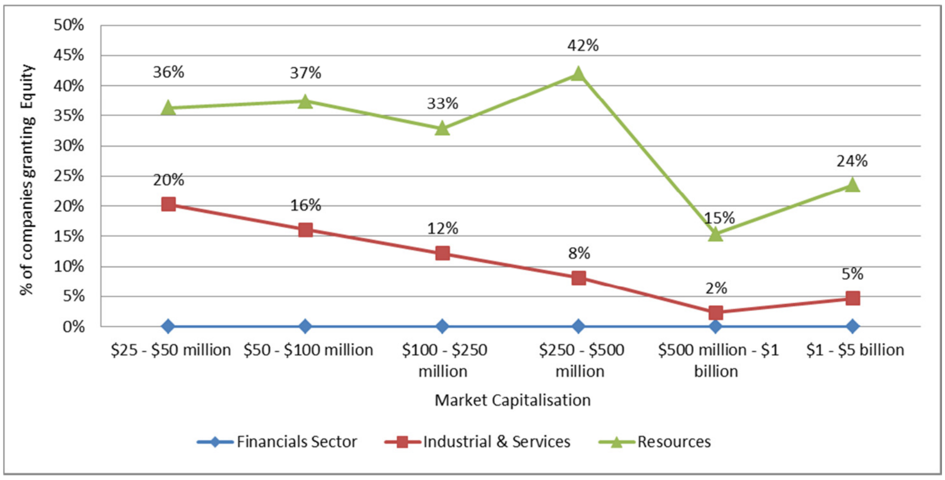
The practice is distributed by market capitalisation as follows.



The following graph displays the percentage of companies granting rights or options by sector and market capitalisation:



The financial sector is the only sector that does not appear to offer equity in the form of Rights or Options to NEDs.

The following tables provide a statistical summary of the value of these grants at the 50th percentile/median.

NEDs Equity grants at P50

Market Capitalisation	Industrial & Services	Resources	All Sectors
$25 - $50 million	$2,477	$48,263	$39,869
$50 - $100 million	$30,635	$65,884	$56,813
$100 - $250 million	$28,000	$44,561	$35,559
$250 - $500 million	$26,299	$61,551	$61,551
$500 million - $1 billion	n/a	$233,193	$233,193
$1 - $5 billion	$6,425	$434,697	$407,520

Board Chair Equity grants at P50

Market Capitalisation	Industrial & Services	Resources	All Sectors
$25 - $50 million	$16,212	$89,043	$71,881
$50 - $100 million	$33,071	$77,000	$70,628
$100 - $250 million	$44,486	$57,149	$47,419
$250 - $500 million	n/a	$103,311	$88,368
$500 million - $1 billion	n/a	$408,452	$408,452
$1 - $5 billion	$11,801	n/a	$83,745

Reasons for granting options to NEDs as part of their remuneration

On the face of it, a director's incentive to ensure that the company performs well should increase with his or her shareholding. This is not to say that NEDs would not also be motived by a desire to enhance their reputation or more altruistic factors, but why not add the financial incentive of sharing in the benefits of effective company stewardship along with the shareholders they represent?

Australian research in 2010 found a sizeable positive relationship between NED share ownership and company performance. More specifically, companies with a NED with a substantial shareholding (as deemed by the ASX definition of substantial) perform 29.7% better than otherwise. [Is Company Performance Dependent on Outside Director 'Skin in the Game'? Serkan Honeine and Peter L. Swan, Australian School of Business, University of New South Wales, Draft: November 26, 2010].

As indicated earlier, resources companies engaged in exploration activities have for many years provided low cash fees and then compensated NEDs with grants of options. In addition to compensating the NEDs for low cash fees the options also reflected the risks and challenges associated with being a director of a low capitalisation and high risk company.

The Independence Issue

The ASX Corporate Governance Council's Corporate Governance Principles and Recommendations identify being a substantial shareholder of the company [i.e. holding at least 5% of the voting capital of the entity] as one of the relationships that could be viewed as affecting the independence of a director. This ownership relationship and percentage is also identified in the corporate governance policies of companies such as NAB, BHP Billiton and Rio Tinto as a 'watch-point' with respect to director independence.

The NYSE has taken a different approach to classifying independent directors than the ASX. "As the concern is independence from management, the Exchange does not view ownership of even a significant amount of stock, by itself, as a bar to an independence finding." Likewise, NASDAQ does not see share ownership as a barrier to independence, unless the director sits on the audit committee. Even then, the independence threshold is twice that of the ASX at 10%.

AICD policy on the Remuneration of NEDs is that options should not be granted to NEDs unless there are special circumstances. These special circumstances presumably include those of a company that is cash-poor such as a start-up. The allocation of options in these circumstances is seen as reasonable as long as appropriate hurdles are used to minimise the possibility of immediate windfall gains through market price movements. Options with holding periods of 3 years would satisfy this requirement. Also other forms of equity such as rights could be used.

But Why Only in Special Circumstances?

One argument against share ownership by NEDs is that it can create a vested interest in a company's near-term share price. This could therefore impair the judgement of a director facing a proposed action such as an acquisition that is in the best long-term interest of the company but likely to adversely influence share price in the short-term or medium term. If this is a real risk, it can be mitigated by designating a holding period for options to insulate the recipient from short-term variations in share price as envisaged by the AICD policy.

A related argument against share ownership by NEDs is that it could create a financial incentive to mislead the market so as to bolster share price. Clearly vesting shares over time is no guarantee against such fraud. In reality no remuneration policy can be expected to provide proof against fraud. Legal sanctions, ethical standards, professional codes and clawback provisions (see proposed amendments to the Corporations Act) are required to carry that weight. Nevertheless, it would be prudent in our view to have a guideline as to the percentage of personal wealth that a NED may invest in the company to remain viewed as an independent NED. This is a more meaningful consideration than the percentage of voting capital per se held by a director.

Retention of NEDs

GRG has had feedback from key shareholder representatives that they prefer any equity granted to NEDs, particularly in small resources companies, to not have a long vesting period. The concern is that the NEDs may be encouraged to hold on to their NED roles so as to maximise vesting of equity grants and their value. While this can be a positive influence for companies that find it difficult to attract and retain high calibre NEDs there can be situations where it may be in the interests of shareholders for NEDs to relinquish their roles to allow refreshment of the board's talent pool. In these circumstances delayed vesting may become an impediment to achieving a better performing board. However, short vesting periods combined with longer holding periods may provide a way forward. A short (one year) vesting period tied to service would be sufficient to defer taxation without creating a golden handcuff and the holding lock would ensure that no windfall gains occur as the result of short term changes in the share price. Multiple overlapping grants would also ensure that there is no incentive to focus on a particular date related to the exercising of options.

Taxation Considerations

The current employee share scheme (ESS) taxing provisions represent a minefield to be negotiated when seeking to accommodate various stakeholder preferences. Nevertheless, various forms of options, rights and shares can be used with taxation being deferred until NEDs may sell shares without breaching the insider trading provisions of the Corporations Act. One approach is to combine a short e.g.1 year, vesting period with a longer holding period that ceases on retirement of a NED.

Conclusion

While recognising the potential risks, options provide a powerful incentive for NEDs that should enhance their preparedness to act independently of management and in the best long-term interest of shareholders at large. It should therefore be possible to effectively communicate and explain them to shareholders as an appropriate element of board remuneration policy not just for start-ups but for all ASX listed companies. However, in the current environment this may represent a significant challenge for most companies.