Board Discretion & LTI Vesting

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INTRODUCTION

In 2013 there was considerable Press coverage and commentary on the decision of the Board of BHP Billiton to exercise discretion to reduce vesting from 100% to 65% in relation to the 2008 grant under its five year Long Term Incentive (LTI) Plan. As shareholders had lost value over the measurement period it is understandable that the Board may have felt that 100% vesting would have been excessive. However, the rationale for the Board selecting 65% vesting in such circumstances was difficult to fathom.

The BHP Billiton situation has led to recognition of four critical questions in relation to Board discretion on LTI vesting. These are:

1. Should Board discretion be a feature of LTI plans?
2. Should all LTI plan participants be treated consistently?
3. When should the discretion be exercised?
4. How should the replacement vesting percentage be determined?

Each of these aspects is discussed in the following.

NEED FOR BOARD DISCRETION

The implications of receiving a "strike" (25% or more negative votes on the Remuneration Report resolution at the AGM) has increased the focus on KMP remuneration and in particular the vesting of LTI grants. Clearly, shareholders are unlikely to look favourably on remuneration practices that result in executives receiving benefits via vesting when they perceive that the return on their investment in the company has been unsatisfactory.

It should also be noted that the need for board discretion has been exacerbated by the nature of the performance metrics that are most often used in Australia. The two most commonly used performance metrics are relative total shareholder return (RTSR) and earnings per share growth (EPSG). EPSG needs Board discretion to be applied to ensure that LTI vesting does not occur when shareholder value has been lost despite EPSG being positive. Similarly, RTSR needs Board discretion to be applied because good RTSR performance may be achieved when there has been a decline in the value of the entire market or a sector or the company.

Given the length of LTI measurement periods it may not be possible to predict in advance the circumstances that will prevail at the time when LTI vesting needs to be determined. Therefore, it would be prudent for Boards to retain discretion in relation to vesting of LTI grants. Such discretion may be prescribed in LTI offers or plan rules.

CONSISTENT TREATMENT OF ALL LTI PARTICIPANTS

Traditionally there have been three main situations when Board discretion in relation to vesting of LTI grants has arisen. These are in relation to:

a) Termination of employment prior to completion of the measurement period,
b) Change in control events, and
c) Events the end of the measurement period.

Of these, a) above can give rise to inconsistency of treatment of former and continuing executives, while b) and c) tend not to. Applying discretion to vesting of LTI grants on termination of employment can give rise to inequitable outcomes such as ongoing executives receiving nil vesting when former executives have received partial or full vesting of their LTI grants. The potential for such inequities plus the default termination benefit limit on vesting that may occur in the event of a termination of employment for executive and managerial officers has led to a change in practice such that vesting is not considered at the time of a termination of employment. The default limit is one times base salary (average of last 3 years) and applies unless shareholders have approved a higher termination benefit. Discretion is now typically only applied at the end of the measurement period for both current and former executives. When discretion is applied at this time it ensures consistency of treatment of current and former executives. Of course, in many termination circumstances all unvested LTI grants will be forfeited with the result that Board discretion becomes irrelevant since it will only apply to LTI grants that have not been forfeited.

WHEN TO EXERCISE DISCRETION

The decision on when to exercise discretion in relation to LTI vesting is not easy or straight forward. Usually the choice to exercise discretion will need to be made each year as measurement periods for different grants will usually end in different years. The decision on when to exercise discretion will become more complex if retesting is available after the end of the initial measurement period. An exception may be when nil vesting occurs at the test date and a subsequent retest is available. In this situation it would generally be inappropriate for the Board to exercise discretion to vest part or all of an LTI grant at the first test.

Broadly there are two situations when Board discretion should be applied to vary the level of LTI vesting that would otherwise apply. They are:

a) If the level of vesting would be higher than is warranted given the actual and perceived investment experience of shareholders over the measurement period (this was the situation faced by the Board of BHP Billiton), and
b) If the level of vesting would be lower than is warranted given the actual and perceived investment experience of shareholders over the measurement period and no subsequent retest is available.

In some situations it will be clear to the Board that a) or b) applies or that neither apply. However, in other situations it will not be clear. In unclear situations and where the Board wishes to ensure that it is seen to have exhibited prudent behaviour it will be necessary to obtain independent professional advice on whether there is a significant discrepancy between the vesting that would apply in the absence of Board discretion being exercised and the actual and perceived investment experience of shareholders.

Determining the perceived investment experience of shareholders is not a simple calculation as many factors need to be considered including:

a) The company's TSR over the measurement period,
b) Market movement over the measurement period,
c) Industry sector movement compared to market movement over the measurement period,
d) The risk free interest rate over the measurement period, and
e) Shareholder expectations at the beginning of the measurement period taking into account the Company's risk profile.

When a discrepancy occurs the next step is to determine the vesting percentage that should apply.

DETERMINING THE REPLACEMENT LTI VESTING PERCENTAGE

Determining a replacement vesting percentage is a challenging task. In the BHP Billiton situation the replacement vesting percentage selected was 65%. However, it could be argued that a more appropriate percentage would have been 0%. Shareholders lost value over the period as BHP Billiton's TSR was negative 9.4%. Also BHP Billiton's TSR Alpha™ (expected return given market movement & risk free rate over the measurement period and the Company's beta as the beginning of the measurement period) was negative 4.4%. Both of these factors would lead to a conclusion that the actual and perceived investment experience of shareholders was not at a level to warrant any level of vesting.

While it may be difficult to understand why the Board of BHP-Billiton selected 65% vesting it is acknowledged that the Board ultimately needed to exercise its judgement and it did so after receiving independent advice.

Conclusion

While Board discretion in relation to LTI vesting is a desirable feature of an LTI plan, the rules need to ensure consistency of treatment of LTI participants. In these circumstances the Board should obtain independent professional advice on when to exercise the discretion and the replacement vesting percentage that should be considered. Such advice would assist the Board to be transparent as to the reasons for the discretion being exercised and the selected replacement vesting percentage. GRG and The KBA Consulting Group can provide independent professional advice to assist Boards in consideration of the application of LTI vesting discretion.

The scope of performance assessment required for independent experts to provide advice to Boards on when discretion should be considered and the extent to which LTI vesting should apply will be discussed in more detail in subsequent GRG Remuneration Insights.