GRG Remuneration Insight 59

Major Changes to the Remuneration Landscape

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INTRODUCTION

There are a number of changes occurring in the key management personnel (KMP) remuneration space that are expected to influence the way executive and director remuneration is designed, governed and communicated. These changes arise from adjustments to documents that govern, regulate and guide KMP remuneration practices, particularly for listed companies. This article raises the most significant changes that remuneration committee members, remuneration professionals and company secretaries should be aware of. It is important to note that most of the changes are currently in draft form and may be altered before being finalised, since public feedback has been sought in several cases.

ASX Corporate Governance Council's Principles and Recommendations

The ASX Corporate Governance Council releases principles and recommendations which, while not legally binding, are generally taken to be requirements relating to the way that ASX listed companies are governed on an "if not, why not" basis. This means that all boards and company secretaries should be ensuring compliance with the recommendations or otherwise are able to articulate logical explanations as to why the recommendations are not followed, as part of the company's remuneration governance statement (note proposed change to the ASX Listing Rules with regard to the content of such statements and where they may be published).

The Principles and Recommendations document was recently revised for a third edition (released 27th March 2014). However, while the draft of this document indicated that there would be a new section addressing clawback, the final version of the document incorporates clawback into a section on policy development and disclosure. This version still calls for a clawback policy to recover overpaid incentives in the case of misconduct or material misstatements.

From a remuneration governance perspective some of the key changes to come out of this revision in relation to KMP remuneration are:

- Recommendation 8.1 (establish a Remuneration Committee) now includes seven sub-recommendations, some of which were covered by the previous 8.2 Recommendation,
- Inclusion of gender-related equity as part of the deliberations of the remuneration committee,
- Stronger focus on aligning executive remuneration with value creation for shareholders, and a stronger focus on transparent communication with shareholders about this,
- Stronger focus on the need for companies to transparently develop explicit policies to govern remuneration practices, and to disclose them (in full),
- The guidelines under policy development in regards to non-executive director (NED) remuneration have been significantly expanded and support the use of securities, as long as they are not performance tested, which GRG has been campaigning on for a number of years – see GRG Remuneration Insight 61 for more information on this aspect, and
- A new separate recommendation regarding the development of a no-hedging policy relating to securities based remuneration.

These changes will affect all ASX listed companies and all directors should review the revised guidelines.

Corporations Act Amendments to Improve Remuneration Governance Disclosure

The draft Corporations Legislation Amendment (Deregulatory and Other Measures) Bill 2014 was recently released and includes a number of changes to the Corporations Act intended to make life easier for both companies and shareholders. Among the changes there are two that should be noted by ASX listed companies being:

- Stronger requirement for companies to develop and transparently disclose their remuneration governance framework (GRG suggests posting on the company website),
    - In GRG's view this should consist of, at the least:
        - A framework document outlining the component policies and practices that constitute the framework,
        - Separate Executive and NED Remuneration Policies,
        - Executive Short Term Incentives Policy and Plan Rules,
        - Separate Executive and NED Securities Based Remuneration Policies and Plan Rules (including covering the no-hedging requirement outlined above),
        - A Securities Trading Policy, and
        - A Remuneration Communication and Disclosure Policy.
- Changes to the disclosure of movements in holdings of options to remove duplication between the Corporations Act and the Regulations.

The remuneration governance framework disclosure change is important as GRG has found that many companies have not adequately documented their KMP remuneration policies and this has been of concern to auditors who need to certify that the Remuneration Report is consistent with company policies – see GRG Remuneration Insight 60 for more discussion of this aspect.

Revised ASIC Prospectus etc. Relief for Employee Share Schemes

Generally when companies offer securities to the public they need to observe Corporations Act provisions relating to product disclosure, licensing, hawking and advertising. These provisions aim to ensure that potential investors are fully informed and not misled when considering making an investment. However when companies offer securities to their executives, and sometimes directors, the circumstances are very different to those that arise in relation to a public offer. Differences include the amount of financial risk, if any, for the participant and the degree of knowledge held by the executive or director due to being an insider at a senior level. Hence, ASIC has provided relief from the Corporations Act requirements for executive and director securities plans either generally via Class Order CO 03/184 and individually by specific grants of relief.

CO 03/184 has been the subject of some confusion and criticism as it fails to recognise certain commonly arising circumstances and is insufficiently specific in some of its descriptions regarding when relief may apply.

A new draft class order is being drafted (see ASIC consultation paper 218) which addresses many of these concerns, in particular:

- Difficulty obtaining relief in relation to securities offered to non-executive directors,
- The use of instruments that may have features that appear to be derivatives as part of remuneration, and
- The use of non-securities based instruments,
- Offers to "related bodies corporate",
- The use of stapled securities,
- The use of trust arrangements, and
- How rights, rather than options, are to be treated.

In GRG's view the draft class order hits the mark in most cases and has made a submission regarding some suggested changes. It is expected that when the final revised class order is released it will significantly improve opportunities to optimise the use of securities-based remuneration, and will have implications for most ASX listed companies.

ATO Draft Ruling on Employee Share Trusts

The ATO recently released a draft ruling (ATO TR 2014/D1) regarding the use of employee remuneration trusts (ERTs) which include employee share trusts (ESTs). While it is common practice for companies to use a trust as part of their arrangements for securities based remuneration, particularly long term incentives, some companies have been pushing the limits of the regulations. In many cases the arrangements companies have set up directly contradict the intention of the law, often by obtaining private tax rulings. The ATO has indicated that it will no longer support such practices and that private tax rulings to facilitate them will not be provided going forward.

It is important to note that this ruling is not expected to effect the vast majority of ESTs, where shares are obtained at the point of vesting and remain in the trust for a reasonably short period between vesting and release to participants. The ruling appears to be focussed on structures where the EST obtains and holds securities prior to vesting, for long periods, and may not hold the securities for any particular participant. The ATO is arguing that in this case the EST is actually undertaking investment activities and should be taxed on its capital gains as any other commercial investment entity would be.

It is also important to note that this tax ruling is intended to be retrospectively applied, except where a private tax ruling was previously obtained.

GRG supports these changes, as it seeks to eliminate the divergent treatment of companies that obtain private tax rulings to provide advantages to their executives, and everyone else who is acting in alignment with the intention of the law. In our view the practices that were emerging were tax fiddles and should not have been facilitated by the ATO.

See GRG Remuneration Insight 58 for more discussion of this aspect.

Potential ESS Tax Laws Changes May Have Implications Beyond Start-ups

The current employee share scheme (ESS) taxing provisions specify that securities offered as part of remuneration will be taxed up-front, on the date of grant, unless a real risk of forfeiture applies. Start-up companies have struggled with this since they have seen the hurdle to be met as being whether the company is successful and eventually realises some kind of value, rather than meeting performance conditions like relative TSR or EPS growth which are commonly used by established companies (measures which GRG is also critical of due to poor alignment with shareholder benefit). Start-ups tend to prefer vanilla options which don't impact on their cash reserves and only have value if the company is eventually successful, but these would be taxed up-font even if the likelihood of any future being realised is low. Treasury is currently reviewing the ESS taxation provisions, and the proposed changes are likely to have implications for all companies, not just start-ups. The primary argument is that securities should be taxed when some benefit is realised rather than up-front (unless subject to risk of forfeiture).

GRG's primary concern with the proposed review is the focus on start-ups, since the problems with the current ESS taxing provisions are not limited to start-ups and it is likely that any attempt to restrict the changes to start-ups will be fraught with challenges around defining and regulating who is and who is not a start-up and when they cease to be classified as such. At the heart of it, there does not appear to be any particular logic behind treating start-ups differently than other entities. While start-up companies have been vocal about the problems of the current ESS taxing provisions, the problems equally apply to other companies.

The key issues covered by the review include:

- Reducing administrative burden,
- Examining the valuation and communication of securities, and
- Examining the appropriate taxing point and how securities should be taxed.

The original consultation was begun by the previous government and has been superseded by a new initiative under the Abbott Government, though both share the same name. Additional information can be found at the Treasury website under Consultations and Submissions "Employee Share Schemes and Startups".

Should the review result in changes to the ESS taxing provisions they may have a significant impact on the way all companies design and implement their securities-based remuneration.

ASX Listing Rules Update

The ASX has been considering an update of the ASX Listing Rules through public consultation. On 21 February the latest draft of proposed changes to the Rules was released and has been open for additional commentary before finalisation. Many of the changes are refinements but other are more substantial. Proposed changes to note from a KMP remuneration perspective include:

- A new Rule which provides greater flexibility to companies to make their corporate governance disclosures either in their annual report or on their website. In the latter case it must also include in the annual report the URL of the page of the website where the corporate governance statement may be found.
- That grants of securities to directors do not need shareholder approval has been retained. It has been made clear that where on-market purchases will be used to supply shares when options and rights are exercised there is no need for shareholder approval of the grant, if on-market purchases of shares are required by the terms of the employee incentive scheme.
- Rule 10.17 has been amended to clarify which elements of non-executive director remuneration fall within the aggregate fees limit. The requirement for non-executive director fees to be a fixed sum has been removed.
- A new Rule (4.10.22) which will require details to be disclosed in annual reports of securities purchased on–market in relation to employee incentive schemes.

Superannuation Penalties Reduced for NEDs on Multiple Boards

Although this change to the superannuation provisions occurred in 2013 it has come to our attention that some NEDs may not be fully conversant with the changes and their implications. Therefore, the changes are briefly discussed below.

The previous problem for NEDs had been that if they participated in, for example, five boards, each paying them say $100,000 then each company would have had an obligation to pay $9,000 (9% superannuation rate that applied in prior years) in superannuation contributions, even though the concessional contribution limit would be exceeded in aggregate as a result. Prior to the change the excess contributions were taxable at the 15% contributions tax rate within the superannuation fund and at a 31.5% excess contributions tax rate for the NED. The NED could then withdraw from the superannuation fund the amount necessary to pay the excess contributions tax.

The disadvantage for NEDs did not arise from a tax perspective as NEDs would generally have been paying the top marginal rate of income tax of 46.5% which equals the combined 15% tax payable by the superannuation fund and the 31.5% excess contributions tax payable by the NED. The disadvantage arose from being forced to contribute more to superannuation that would have occurred if the NED’s total income had been earned form one employer and not being able to retrieve the excess contributions (other than to pay the excess contributions tax) from the superannuation fund.

Since 2013 excessive contributions are taxed as income of the NED at the NED’s marginal tax rate and a credit is received for the 15% contributions tax paid by the superannuation fund. Also the NED may withdraw 85% of the excess contributions. A charge may also be applied to negate any advantage the NED may receive from paying tax on excess contributions later than would have occurred had PAYG been deducted monthly during the year. The NED may continue to be disadvantaged if not able to withdraw from the superannuation fund, contributions that fall between the SGC rate and the concessional contributions maximum amount.

Conclusion

Despite the fact that many of the changes outlined are at the consultation or draft stage, it is clear that the executive and director remuneration landscape is going to change significantly during 2014, and both market practice and best practices will change as a result. GRG will be keeping a close eye on developments as they occur and we will do our best to keep our readers up to date with the final changes and how they are influencing the market as we observe it.

In order to assist directors to stay on top of such issues, GRG has started a LinkedIn group called “Remuneration Committee Matters” where updates can be logged and directors can discuss the key issues with each other. GRG invites you to join this LinkedIn group and to contribute to discussions that will improve the effectiveness, governance and outcomes of Remuneration Committee deliberations.