GRG Remuneration Insight 61

Green Light for NED Share Rights

Denis Godfrey and James Bourchier | May 2014

INTRODUCTION

For some years GRG has been espousing the provision of part of non-executive director (NED) remuneration in the form of company securities. GRG's stance was in contrast with the views of various stakeholders who took the opposing view but were generally unable to provide sound reasons for opposing all grants of securities to NEDs. See GRG's website www.godfreyremuneration.com for copies of earlier GRG Remuneration Insights 46 and 47 and GRG Remuneration Reviews 6, 8, 18 and 27.

The 3rd Edition of the Corporate Governance Principles and Recommendations published by the ASX Corporate Governance Council (the Council) indicates a significant shift in the attitude of the Council to the provision of securities to NEDs as part of their remuneration.

Commentary on Recommendation 8.2 includes the following guideline:

> "*Equity-based remuneration: it is generally acceptable for non-executive directors to receive securities as part of their remuneration to align their interests with the interests of other security holders. However, non-executive directors generally should not receive options with performance hurdles attached or performance rights as part of their remuneration as it may lead to bias in their decision-making and compromise their objectivity*."

This revised guideline opens the door for securities to be provided to NEDs as part of their remuneration. This is a good change provided that it is applied on a sound, reasonable and rational basis. This is discussed below.

No Performance Based Vesting Conditions

It has long been acknowledged that NEDs should not participate in incentive plans designed for executives. The reason for this has been that if NED and executive incentives were to be subject to performance conditions then they should be the same performance conditions. It would not be rational for NEDs and executives to be provided with incentives to achieve difference outcomes in relation to a single company. If NED incentives were to be subject to the same performance conditions as executives then the NEDs would clearly be conflicted in setting the performance targets as they would be personally affected.

Thus, if variable (as to value that may be realised by recipients) remuneration is to be provided to NEDs it should not contain performance targets.

Service Vesting and Dealing Restrictions

Securities may be provided such that NEDs are taxed on the securities' value at the date of grant or when both vesting conditions are satisfied and dealing restrictions cease to apply (limits apply to period of tax deferral). Of these two approaches the dominant, if not exclusive, market practice is to offer securities with a deferred taxing point.

If securities are to be provided to NEDs as part of their remuneration then a vesting condition will need to be part of the offer if the taxing point is to be deferred. A vesting condition that is not performance related is service. Provided that the service period required to be completed before vesting occurs is at least 12 months from the date of the grant of the security the taxing point would be deferred provided that other relevant employee share scheme (ESS) taxing provisions are also satisfied.

The taxing point may be deferred beyond the vesting date by including as part of the offer a dealing restriction which could apply so as to defer the taxing point up to the earlier of 7 years from the date of grant and termination of employment with the company. A long period of dealing restriction may be seen as a desirable feature as it aligns the interests of NEDs with those of other shareholders and ensures that NEDs will have a long term interest in returns to shareholders.

Termination Benefits

If securities granted to NEDs are subject to vesting conditions and a NED leaves the company prior to vesting then if early vesting is triggered or accelerated by the termination then the value of securities that vest will be counted as part of the termination benefit and will be subject to the one times base salary limit unless shareholders have approved a higher termination benefit. This aspect needs to be addressed as part of the design of the NED securities plan.

Shares, Rights or Options

The types of securities that may be offered to NEDs include shares, rights and options. Except in high risk companies such as startup companies it is the authors' view that options should generally not be offered to NEDs. The reason for this view is that the nature of options (benefit only arises from share price increases and no loss for option holder if the share price falls) may provide an incentive for option holders to expose the company to additional risk which may not be in the best interests of shareholders. In this regard it is acknowledged that if moderate grants of options were to be used it would be unlikely that NEDs would be influenced to expose the company to excessive risk.

For companies that are not high risk ventures it will generally be preferable to offer shares or rights to NEDs. Of these alternatives the most simple to administer is rights as they only give rise to share acquisitions if they vest and do not involve residual administration and taxation implications if they do not vest.

Securities as Part of Remuneration

It is difficult to envision a situation where a company would wish to offer securities to NEDs in their capacity as NEDs other than by way of remuneration. Therefore, offers of securities, if they are to be made, should constitute part of a reasonable remuneration package for the NED. The mix of cash, superannuation and securities needs careful consideration and may take into account company cash flow, the company's policy for minimum security holdings by NEDs, current security holdings of NEDs, impediments to on-market purchases such as insider trading prohibitions and the boards desire to demonstrate to other security holders that they are committed to the future success of the company by investing part of their remuneration in the company on a long term basis.

Provision of securities as a variable component of NED remuneration may facilitate better alignment between the policies for executive and NED remuneration. Executive remuneration is typically composed of fixed and variable components with the fixed element set by reference to market practice for fixed remuneration and the variable element designed to achieve a target market outcome for the total remuneration package. Similarly, NED remuneration could be composed of two components being fixed and variable components. The fixed component would be composed of fees and superannuation while the variable component would be via grants of securities. The fixed component could be set by reference to market practice for fixed remuneration and the variable component could be set so that the total remuneration achieved a desired market positioning for the total remuneration package.

As occurs with the variable element of executive remuneration, offers of securities to NEDs should be on an annual basis representing part of the remuneration for the year of the offer. Larger grants to cover several remuneration years generally give rise to administration problems and challenges when trying to maintain internal equity particularly for NEDs appointed after multi-year grants have been made.

Shareholder Approvals and Communication

Shareholder approvals may be required of:

a) Offers to NEDs if they involve or may involve a new issue of shares on vesting - offers that will not involve an issue of shares because on-market purchases must be used if shares are to be acquired, do not need shareholder approval, and

b) The plan if considered good corporate governance or to preserve the 15% annual limit on new issues that may be made without shareholder approval or the trustee of the employee share trust (EST) is a related party.

Thus, some plans and offers will need shareholder approval and others will not.

In any event shareholders will need to be fully informed as to the details of the NED securities plan and offers made to individual NEDs. This will arise mainly via the Remuneration Report which, of course, is the subject of a vote at the annual general meeting (AGM). As Remuneration Report voting at the AGM can give rise to a "strike" if at least 25% of votes are against the resolution, it will be important for the NED securities plan and the offers to be based on sound principles and within the range of both reasonable remuneration and the shareholder approved aggregate fees limit (fees cap).