GRG Remuneration Insight 70

Reconsidering Options

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INTRODUCTION

Recent developments may have opened the door for reconsideration of the use of options for executive and non-executive director remuneration purposes. The two most relevant changes are those relating to:

a) the valuation of options, and

b) the taxation of options (proposed amendments to the employee share scheme (ESS) taxing provisions planned to come into effect in relation to grants made from 1 July 2015 onwards).

Companies in the pre-profit early stages of their evolution and companies that are involved in highly speculative activities (e.g. exploration, biotechnology and IT companies) have traditionally preferred to supplement low levels of cash remuneration with grants of options. In this way companies were preserving cash and employees were sharing risks with shareholders.

Over recent years the ESS taxing provisions operated such that there was potential for employees to be taxed on the value of options prior to a benefit, if any, being realised. This situation led to most companies abandoning the use of options. Momentum to this abandonment was added by the proxy advisors and other stakeholders maintaining the view that performance hurdles should be attached to options so as to avoid the possibility of windfall gains when share price growth is driven by market movement rather than company performance.

For clarity when reference is made to options in this GRG Remuneration Insight they are rights with an exercise price usually at or above the share price when the options are granted.

LOWER OPTION VALUES MAKE OPTIONS MORE ATTRACTIVE

Basics

Options tend to be valued using one of the popular option valuation models which include: Black-Scholes, Binomial and Monte Carlo Simulation. In the Black-Scholes Model the main factors are: share price, exercise price, term/life of the option, risk-free rate, volatility and dividend yield. Of these, three seem to have generally moved in directions that lower the value of an option. They are:

Factor	Comment	Impact on Grant Value of Option
Risk-free rate	The cash rate in Australia is at a level that is low compared to the rates that have applied over recent decades and seems to be set to be lowered even further.	Lower risk-free rate reduces the value of options.

Factor	Comment	Impact on Grant Value of Option
Volatility	During calendar year 2014 the ASX All Ordinaries Index indicated less volatility that had applied in prior years which would usually lead to a lower level of forecast volatility than may have been used in prior years. Early 2015 has shown some increased volatility so this impact may need to be monitored.	Lower volatility reduces the value of options.
Dividends yield	For companies that do not pay dividends this aspect is irrelevant. However, for companies that have higher dividend yields than applied in prior years this aspect will be relevant.	Higher dividend yields reduce the value of options.

The value of an option is important as it will influence the number of options that need to be granted to deliver a given value of remuneration, be it salary sacrifice or incentive. For example if an option value were 20% of the share price then five options would be equivalent to a grant of one share. This leverage e.g. 5:1 means that when the share price grows above a certain rate (usually around 10% p.a. compound over a 3 year period) the five options will generate more benefit from share price growth than the full value of a single share.

During recent years the value of options has been high resulting in values often close to 50% of the share price which reduced leverage to around 2:1. This meant that high rates of share price growth were needed for options to produce more benefit than shares.

Considered in isolation the change in option values and leverage may make options worth reconsideration.

Deductibility of Option Benefit and Cost

The value of options granted to employees as a form of remuneration needs to be valued and expensed for accounting purposes. That value is then amortised/expensed over the vesting period if vesting conditions apply or in the year of grant if no vesting conditions apply. The accounting expense does not qualify as a tax deduction for companies.

If on exercise of an option a company simply issues shares to the option holder then there will be no tax deduction at that point. In these circumstances the value of the option should be grossed-up to take account of the non-deductibility of the expense. The gross-up is needed so as to place the remuneration cost of an option on the same footing as other remuneration costs which are tax deductible for the company. The gross-up may be achieved by dividing the option value by (1 – Company tax rate) i.e. (1 – 0.3 = 0.7) or multiplying by 1.43.

Some companies such as those with substantial accumulated losses that are unlikely to be used for some time, if ever, may prefer to ignore the non-deductibility aspect as it may be of little, if any, relevance to the company.

Of course, arrangements can be made for the benefit (share price growth) contained in an option at the point of exercise to be delivered such that it qualifies as a tax deduction for the company. This is a critical point particularly when it is recognised that the amount of the tax deduction can exceed the value of the options that has been expensed/amortised. In cases of

very high share price growth it is possible for the tax saving to exceed the value of the options that have been expensed.

NEW TAXATION OF OPTIONS

The Proposed Changes

The specific new taxing provisions for ESS benefits provided by startup companies will not apply to ASX listed companies unless the definition of startup is changed prior to the draft amendments being passed by Parliament.

However, other proposed amendments will mean, if passed by Parliament, for grants of options made on or after 1 July 2015 that the taxing point may be simply deferred until exercise of the options. All that will be required is that the options be subject to a disposal restriction prior to exercise and the governing rules of the option plan expressly state that Subdivision 83A-C of Income Tax Assessment Act 1997 apply to the plan.

Neither service nor performance vesting conditions will need to be attached to options to defer the taxing point which is currently the case. This change will make the use of options with simple terms much easier.

Caution When Used for Executive LTI or Non-executive Directors

Executive LTI

When options are used as a long term incentive (LTI), proxy advisors and other stakeholders expect performance related vesting conditions to be attached to them. Provided that the requirements for tax deferral outlined in the previous section are complied with, the taxing point for options will be the latter of exercise, cessation of performance vesting conditions and for shares acquired by exercising options, cessation of disposal restrictions, provided that these times are no later than the earlier of the date of termination of employment or the 15th anniversary of the grant of the options.

Many directors hold the view that the nature of options means that they are performance related. This is because a benefit only arises if the share price grows to exceed the exercise price which in some cases is set at a premium to the share price when the options are granted. However, proxy advisors do not hold this view and in any event feel that performance conditions need to be attached to options so as to avoid the possibility of windfall gains from share price increases driven by stock market movement rather than company performance.

At a practical level it may be said that performance vesting conditions are essential for companies that need the support of proxy advisors or major shareholders who hold views similar to those held by proxy advisors, but not so for other companies.

Non-executive Director Options

Reference should be made to commentary under Principle 8 of the 3rd edition of the Corporate Governance Principles and Recommendations which is published by the ASX Corporate Governance Council for guidance on the use of options for non-executive directors.

On page 31 it states:

"When setting the level and composition of remuneration, a listed entity needs to balance …the need to ensure that the incentives for non-executive directors do not conflict with their obligation to bring an independent judgement to matters before the board".

On page 33 it also states

"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."*

These quotations indicate that performance vesting conditions should not be attached to grants of options to non-executive directors.

While they also indicate that options without performance vesting conditions would be acceptable for non-executive directors there are some stakeholders who prefer rights or shares to be used in relation to non-executive directors as they are concerned that the nature of options may undermine their independence.

DILUTION

It should be noted that larger numbers of options than rights or shares need to be granted to deliver a given LTI value. Particularly for companies with low share prices and relatively small numbers of issued shares, the number of options to be granted each year may lead to excessive dilution of current shareholder interests in the company.

As a guide GRG suggests that total LTI grants in any year not exceed 2% of issued shares. Even this level is in excess of the 5% over 3 years limit in ASIC Class Order 14/1000 which applies to grants that rely on the class order for relief. Offers of options to senior managers generally would not need to rely on such relief.

RISK AND MOTIVATION

The nature of options and the gearing they involve needs to be considered from corporate risk and employee motivation points of view. With options, executives do not suffer any loss if the share price declines. Thus, there is no incentive to avoid risk as there is no penalty for failure except in rare catastrophic situations where they may lose their jobs.

On the other hand, there is strong incentive to maximise share price growth as the higher the share price growth the greater the benefit for option holders. This may lead to risks being taken that exceed to board's normal risk appetite or attempts to influence the market to look more positively on the company prospects or at worst manipulation of accounts to present a more optimistic view of the company than is warranted.

Clearly small grants of options are unlikely to have much impact on risk taking etc. but the larger the grants the greater the impact. LTI grants would be expected to have a significant impact on the recipients otherwise there would be no point to the grants.

GRG VIEW

GRG is of the view that performance rights will remain the most favoured form of executive LTI. They are not overly dilutive, they do not encourage excessive risk taking, they do reward performance as measured by reference to performance vesting conditions and are not tax inefficient when the value of the benefit provided is structured to qualify as a tax deduction. Nevertheless, some companies may find options an attractive form of incentive and may use them either as the sole form of equity grant or in combination with performance rights.

OPTIONS THAT ARE RIGHTS

Rights are in effect a form of option but one where the exercise price is nil. The foregoing comments do not relate to rights. However, it should be noted that the proposed ESS taxing change which will make options worth reconsidering are also likely to affect the use of rights. For example:

a) STI deferral into rights has been accompanied by service vesting conditions so as to defer the taxing point. The new ESS taxing provisions will mean that it will no longer be necessary to apply any vesting conditions which will make STI deferral much more acceptable to executives who have earned the STI awards with short term performance.

b) Providing part of non-executive director remuneration in the form of rights on a fee sacrifice basis virtually disappeared since the ESS taxing provisions were changed back in 2009. The purpose of the proposed amendments is to reverse most of the 2009 amendments. Consistent with this purpose the opportunity to sacrifice fees into rights will again become available.

c) Similarly salary sacrifice into equity for executives has also disappeared. From 1 July this will be available through the use of rights.

PLAN & BE PREPARED

Given the proposed amendments to the ESS taxing provisions and the recently released ASIC Class Order 14/1000 it will be important for Boards to:

a) receive professional advice on changes to STI and LTI plans that should be considered,

b) decide on the changes to be made,

c) have relevant plan documentation updated to reflect the changes,

d) discuss the proposed changes with proxy advisors and major shareholders to gain their support,

e) prepare to communicate the changes in Remuneration Reports, and

f) prepare resolutions and explanations to obtain shareholder approval as needed.

Those Boards that start the review process now and plan ahead will be well prepared and will not find adapting to the new environment a challenge.