

Remuneration Paid in Equities for Non-executive Directors

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Introduction

The generally accepted view is that Non-Executive Directors (NEDs) should have significant equity holdings in companies where they are on the board so that they have “skin in the game”. This aims to ensure strong alignment between the long term interests of NEDs and shareholders. Provision of equity in the company as part of NED remuneration is a tax effective method of building an equity holding without needing to disturb other existing investments held by NEDs nor risking breach of the insider trading provisions of the Corporations Act.

Fee sacrifice equity acquisitions plans are generally supported by proxy advisors and other stakeholders when the total remuneration packages for NEDs are reasonable by reference to market practices in comparable ASX listed companies. Accordingly, all ASX listed companies should consider introducing a NED equity remuneration plan and potentially an equity holding policy, if they currently do not have these.

In this regard it should also be noted that a guideline commonly applied by stakeholders and governance advisors is that NEDs should hold equity of at least the value of one year’s fees and this may be accumulated over a period of the first 3 years in the NED role. Recent research by GRG indicates that the median equity holdings as a percentage of NED board fees ranges between 35% and 67% for companies with market capitalisations of less than \$10 billion. This indicates that more than half of the NEDs in these companies are not complying with the guideline. In larger companies the median is over 100% of fees indicating that NEDs in these companies recognise the merit of NEDs having significant equity stakes in the companies of which they are NEDs.

Funding Share Purchases from Current Assets

A common response when the topic of NED equity remuneration plans is raised is that they should buy shares on the ASX like other shareholders. While this response may seem reasonable at first glance it does not stand up to analysis. Reasons for this include:

- a) Funding of share purchases generally involve the sale of other investments – smart investors know that minimising the frequency of sales maximises the potential for growth. This is because sales trigger Capital Gains Tax (CGT) plus sale and purchase costs which erode the total value that may be reinvested and thereby erodes the potential gain from compounding. If investment in the company of which the person is a NED does not produce better returns than the prior investment, then the person will be better off by retaining the former investment than selling it

to fund the purchase of shares in the company – NEDs should not have to lose investment returns when they take on roles as a NED - See Illustration A below which demonstrate the foregoing point.

- b) Once the person has been appointed as a NED it is often difficult to identify times when shares may be purchased without risk of breaching the insider trading provisions of the Corporations Act. Thus, from a practical point of view purchasing shares with after tax fees may not be an available choice. In any event purchasing shares with after tax fees will result in lower return than using pre-tax fees (salary sacrifice) – See Illustration B below which demonstrates the foregoing point.
- c) Purchasing equity on-market, like selling equity on-market, can be interpreted as a signal to the market as to the company's prospects. NEDs do not wish to be perceived as sending such signals which makes it difficult, if not impossible, for them to purchase shares once the person has accepted the NED role.

Illustration A

The following table shows that when all other aspects are equal, the sale of an investment to buy another investment is a poor investment decision due to the early payment of CGT which reduces the base for growth. If the investment were generating dividend income the sell and reinvestment alternative will produce even worse results as the dividends in the second five years will be from a smaller investment.

Assumptions	
Initial Investment	\$10,000
Growth Rate	10%
Marginal Personal Tax Rate	49%

Aspect		Sale of Investment After 5 Years to Reinvest	No Sale of Investment
Current Investment		\$10,000	\$10,000
Value After - First 5 Years	5	\$16,105	\$16,105
CGT		\$1,496	0
Net Reinvested into Shares in the Company		\$14,609	\$16,105
Value After - Second 5 Years	5	\$23,529	\$25,937
CGT		\$2,185	\$2,409
Net Realised		\$21,343	\$23,529
Advantage of retaining investment compared to selling and reinvesting			10%

Illustration B

The following table shows the advantage of pre-tax/salary sacrifice over after-tax investment in company shares.

Assumptions	
Gross Fees	\$10,000
Less Tax	\$4,900
Net Fees	\$5,100
Growth Rate	10%
Marginal Personal Tax Rate	49%
Dividend Yield After Tax	3%

Aspect		After Tax Investment in Shares	Pre Tax / Salary Sacrifice Investment in Shares
Initial Investment		\$5,100	\$10,000
Gross Value if Sold After - Years	9	\$12,026	\$23,579
CGT		\$1,697	0
Income Tax		\$0	\$11,554
Net Value if Sold		\$10,329	\$12,026
Net Dividends Over 9 Years		\$1,377	\$2,700
Net Value Including Dividends		\$11,706	\$14,726
Advantage of Pre-Tax (Salary Sacrifice) Over Post-Tax Investment			26%

Issues to Consider in Relation to NED Equity Remuneration Plans

In the following table many of the aspects that need to be considered when designing a NED equity remuneration plan are identified and commented upon.

Aspect	Comments
What form of equity should be provided: Shares, Rights or Options?	Taxation and governance considerations generally result in the use of rights instead of shares and options.
How often and when should the equity units be provided?	<p>Generally equity remuneration like other forms of remuneration should be provided after it is earned. Early payment can lead to recovery problems should a NED leave the role early. Provision once per year at the end of the year may disadvantage NEDs if the share price has increased.</p> <p>Shareholder approval of grants of equity units to directors may mean that equity remuneration cannot be provided before the AGM. Regular allocations, say quarterly, may balance competing considerations.</p>
How should the value of the equity units be calculated?	This will depend upon the nature of the equity units being provided. Consistency and fairness are paramount considerations.
What volume weighted average price should be used for the share price?	Many choices are available and will be influenced by the frequency and timing of allocations.
Will shares be issued or acquired by on-market purchases?	<p>New Issues tend to be preferred but on-market purchases may be used.</p> <p>The preferences of a major shareholder that does not wish their relative shareholding to be diluted may be a relevant consideration.</p>
Is there a need for risk of forfeiture to defer the taxing point?	<p>Risk of forfeiture related to performance should not be used.</p> <p>Service based vesting may be used particularly if grants are to be made in advance. External stakeholders generally prefer that there be no vesting or holding conditions.</p>
What form of disposal restrictions should be applied to defer the taxing point?	<p>If share rights or options are used then prior to exercise they should be subject to disposal restrictions.</p> <p>Disposal restrictions may need to be applied to shares acquired by exercising rights or options. This approach is less flexible for NEDs. Share investment rights are more flexible and do not need disposal restrictions to be attached to the shares.</p>

Shareholder Approval

Shareholder approval of NED equity remuneration plans should generally be sought as a matter of good corporate governance. Other factors that may lead to a need or preference for shareholder approval are the ASX Listing Rule 15% annual new issues limit and the financial assistance provisions of the Corporation Act.

Grants of equity units to NEDs will need shareholder approval if new issues of shares will or may be involved. If shares will be acquired by on-market purchase then shareholder approval is not required under the ASX Listing Rules but such approval is desirable from a corporate governance point of view.

As equity grants generally count towards the aggregate fees limit (AFL) or fees cap, consideration may also need to be given to seeking shareholder approval for an increase in the AFL.

Administration

Administration of such a plan is not overly onerous given that in any NED equity remuneration plan the number of participants is small. However, it is important that administration is undertaken by technically competent professionals as some of the details can be complex. Further, given the relationship between the board and management it is preferable that the administration be undertaken by an independent provider.

Conclusion

Boards should give consideration to implementing:

- a NED equity remuneration plan on a salary sacrifice basis, and
- a NED equity holding policy requiring NEDs to accumulate equity stakes with values at least equal to their fees within the first 3 years in the role.

Administration of NED equity remuneration plans is best outsourced to independent professionals who are fully aware of all regulatory and compliance obligations.

GRG can assist with plan design, documentation, shareholder approval and administration.