GRG Remuneration Insight 92

Enhanced LTI Disposal Restrictions

James Bourchier & Nida Khoury | January 2017

Introduction

Various stakeholders have for some time held the view that shares acquired under long term incentive (LTI) plans should be retained by executives until 1 to 2 years after they have ceased employment with the company. Recently, there have been sales of LTI shares by CEOs of ASX listed companies that have been poorly received by stakeholders as they occurred prior to the disclosure of information that led to declines in their share prices. Such sales have highlighted apparent deficiencies in the design of LTI plans which allow the sale of LTI shares as soon as they have vested. While in the past this was typically the taxing point necessitating executives to sell equity to pay the tax due on it in order to manage tax risks, this no longer needs to be the case. Accordingly, it seems timely to review this aspect of the design of executive LTI plans.

Purpose of Long Term Incentives

The main purpose of LTIs as a remuneration instrument is to align the interests of executives with those of shareholders over the period they impact shareholder value. This "impact period" does not normally end at the time when an executive leaves the organisation, but continues with a diminishing impact for a time after the executive has left the company.

Other views observed in the market include expectations that:

a) Cessation of employment should not lead to vesting and/or the ability to sell shares because executives should be encouraged to always keep their "eye on the ball" in terms of both business decisions and succession planning,

b) Incentive remuneration should be retained until the impact on shareholder value of executive decisions, including their ultimate departure, have fully flowed through,

c) Executives should not engage in short term trading in company shares as the opportunity for gains from such trading may lead to decisions that are not in the best interests of other shareholders,

d) Executives should observe high standards of conduct such that they will not be involved in or seen to be involved in "insider trading",

e) Executives should be required to remain aligned with shareholders post termination to create a "good behaviour bond", to address issues like moving to a competitor or fraud, and

f) Executives should not take actions such as selling shares that signal that they do not believe in the future prospects of the Company, or are not committed to growing shareholder value.

Retention of LTI Shares

The design of LTI plans typically involve a vesting/performance measurement period of 3 years and the conversion of any rights or options that vest into shares. If disposal restrictions are initially applied to the rights or options and then to the shares acquired on exercise of the rights or options, the taxing point under the current employee share scheme (ESS) taxing provisions, may be deferred until the earlier of the 15th anniversary of the LTI grant and the date of cessation of employment. However, any disposal restrictions applicable to the shares must be included as part of the offer of the rights or options.

If a disposal restriction of until the earlier of cessation of employment and the 15th anniversary of the LTI grant is applied, then it will mean that most LTI shares will not become taxable until cessation of employment, which will go a long way towards retention of LTI shares for the "impact period". When the taxing point is triggered it would be reasonable to allow executives to sell sufficient LTI shares to realise the funds needed to pay tax on the LTI benefit. At the top marginal tax rate this would mean that approximately 50% of the LTI shares should be released from disposal restrictions at the ESS taxing point (date of termination of employment or the 15th anniversary of the LTI grant). This would allow executives to manage the tax risk typically associated with termination, but not necessarily realise any value at the point of termination.

The remaining 50% of LTI shares could continue to be subject to disposal restrictions for a period post cessation of employment. In this regard it should be noted that:

- Executives will not have been able to realise any capital value from the LTI for a substantial period and it would be reasonable to allow some access on cessation of employment as part of their rearrangement of their financial affairs, and
- The impact of decisions and plans made by executives during employment will diminish as the decisions and plans of new incumbents overtake those of the former executives. Accordingly, it would seem reasonable to phase out disposal restrictions over a post-employment period.

A possible approach in relation to the remaining 50% of LTI shares would be as follows:

a) 12.5% to become unrestricted on termination of employment,
b) 12.5% to become unrestricted one year after termination of employment,
c) 12.5% to become unrestricted two years after termination of employment, and
d) 12.5% to become unrestricted three years after termination of employment.

Illustration of Impact of Extended Retention of LTI Shares

To illustrate the impact of enhanced retention of LTI Shares we have undertaken modelling based on the following typical executive total remuneration package.

Remuneration Elements	Target	Mid-point	Stretch
Fixed Pay	100%	100%	100%
STI	40%	60%	80%
LTI	60%	90%	120%

It is also assumed that:

- The total remuneration package does not change,

- The share price does not increase,
- Dividends including franking credits represent a yield of 5%, and
- 3 year vesting period.

The following tables are expresses as percentages of the executive's Fixed Pay. They show three scenarios being that target, stretch or a mid-point of vesting are achieved each year.

Table A shows the LTI shares that would be held by the executive on a cumulative basis.

Table B shows the value of unvested LTI grants that could vest for a Good Leaver but would typically be forfeited by a Bad Leaver.

Table C shows the combined values of Table A and B for a Good Leaver.

Table A

Year	Value of Shareholding - Available to Good and Bad Leavers		
	Target	Mid-point	Stretch
1	0%	0%	0%
2	0%	0%	0%
3	0%	0%	0%
4	60%	90%	120%
5	120%	180%	240%
6	180%	270%	360%
7	240%	360%	480%
8	300%	450%	600%
9	360%	540%	720%
10	420%	630%	840%

Table B

Unvested LTI - Available to Good Leavers		
Target	Mid-point	Stretch
60%	90%	120%
120%	180%	240%
180%	270%	360%
180%	270%	360%
180%	270%	360%
180%	270%	360%
180%	270%	360%
180%	270%	360%
180%	270%	360%
180%	270%	360%

Table C

Total Available to Good Leavers		
Target	Mid-point	Stretch
60%	90%	120%
120%	180%	240%
180%	270%	360%
240%	360%	480%
300%	450%	600%
360%	540%	720%
420%	630%	840%
480%	720%	960%
540%	810%	1080%
600%	900%	1200%

It is important to remember that the executive will also receive dividends in respect of their LTI shareholdings. The following table shows the amount of dividends receivable each year including dividend imputation credits.

Year	5% Dividends		
	Target	Mid-point	Stretch
1	0%	0%	0%
2	0%	0%	0%
3	0%	0%	0%
4	3%	5%	6%
5	6%	9%	12%
6	9%	14%	18%
7	12%	18%	24%
8	15%	23%	30%
9	18%	27%	36%
10	21%	32%	42%

Evident from the above table is that although realisation of the vested value of LTI benefits is deferred, the executive does receive significant regular additional income via the dividend stream. In the above illustration, dividends add between 21% and 42% to the executive's Fixed Pay in year 10.

Implementation

Implementation of enhanced disposal restrictions may not be undertaken on a retrospective basis. This is because if the disposal restrictions are added or extended to an LTI grant after it has been made then the taxing point will not be delayed. Accordingly, implementation would need to occur in relation to future LTI grants. This would, in effect, represent a phasing in for those executives with existing unvested LTI holdings that will not be subject to disposal restrictions following vesting.

Alternatives

The LTI disposal restrictions outlined above may be modified if considered too onerous. Less onerous alternatives could include:

a) Applying the foregoing disposal restrictions to say 50% of shares acquired under the LTI plan and allowing the remaining 50% to be treated as they typically are at present, or
b) Applying a 3 year disposal restriction period to Shares following vesting of LTI grants thereby ensuring that executives will hold:
   i. 3 years of unvested LTI grants, and
   ii. 3 years of vested LTI awards (except for cessations of employment when at least 50% would be available for sale to cover tax, but with the remainder being required to be held following termination until the restriction ceases which may be in line with the 12.5% each release from disposal restriction outlined earlier),

   but allowing executives with longer tenure to be able to access LTI benefits prior to cessation of employment,
c) Applying this foregoing treatment to the amount of equity required to be held by an executive under the Company's KMP equity holding policy, but not to any excess (typically equivalent to one-year's Fixed Pay).

Any additional vested shares would be unrestricted and may be sold.

Conclusion

Implementation of enhanced LTI disposal restrictions may require many companies to reconsider the mix of STI and LTI as part of total remuneration packages. Clearly there needs to be a balance between deferred LTI shares and cash flow from Fixed Pay and STI which needs to be adequate to meet the living expenses of executives. This may also involve reconsideration of STI deferral. Arguably STI deferred into Equity should be treated no differently to LTI in terms of disposal restrictions. This would be particularly the case when STI deferral implementation was funded by the reduction of LTI and increasing of STI.

The approach outlined in this GRG Remuneration Insight represents a radical shift from current typical LTI practices. It has been presented to stimulate consideration of an important matter. It would clearly be preferable if Boards took the initiative rather than wait to be pressured by proxy advisors and other stakeholders. Retention of LTI Shares would go a long way to addressing emerging concerns regarding short-termism, truly long-term alignment of executives (instead of extending LTI measurement periods) and the risks associated with terminations, fraud and misconduct. As such, this is a matter that should be considered by Risk Committees as well as Remuneration Committees.