GRG Remuneration Insight 135

STVR Deferral
An Essential Ingredient in the Remuneration Mix

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INTRODUCTION

What is Short Term Variable Remuneration (STVR)?

Short Term Variable Remuneration (STVR) is an element of remuneration that is variable in nature and rewards performance in relation to key outcome metrics identified in the company's annual business plan. Performance is typically measured over 1 year and the outcome metrics are often a combination of financial, operational and strategic indicators.

Why is deferral an important ingredient of STVR

STVR remains an important part of remuneration structures. For many years it was paid entirely in cash. This approach tended to promote short-termism without regard to longer term consequences for shareholder value and created problems for companies with cash flow constraints, particularly when service testing of Long Term Variable Remuneration (LTVR) meant that many executives did not value other variable remuneration components. The form of delivery of STVR awards has been evolving over recent years, alongside other significant remuneration governance changes. This GRG Remuneration Insight canvasses the developments and future best practice, including how STVR deferral can support long term alignment, equity holding policy requirements, and "skin in the game".

BACKGROUND

In the Productivity Commissions Report No. 49 of 19 December 2009 on Executive Remuneration in Australia it was suggested that consideration should be given to part of STVR awards being deferred into equity that is subject to holding locks (see page 382). This suggestion was seized upon by institutional investors, proxy advisors and indeed boards; particularly those of larger ASX listed companies, and resulted in part of STVR awards being delivered in Rights (entitlement to a share or the value of a share). At the time, but no longer the case, for the taxing point to be deferred on Rights it was necessary for there to be a real risk of forfeiture which was usually applied by vesting the Rights after an additional period of service, typically 1 to 3 years. The appropriateness of service vesting of Rights that had already been earned through performance was questionable and this risk of forfeiture led to a lot of push-back from executives, often leading to a reduction in long term at-risk remuneration, and an increase in short term opportunities, to compensate – further increasing the risk of short-termism. Linking deferred STVR to continued service rather than sustaining the performance that gave rise to the STVR award was also less than ideal in terms of managing short termism.

GOVERNANCE AND REGULATORY DEVELOPMENTS

Taxation

In FY2016 changes were made to the employee share scheme (ESS) taxing provisions to allow tax deferral on Rights without the need for a real risk of forfeiture, if certain other conditions were met. Also, cessation of employment is not an ESS taxing point in relation to grants of Rights made from 1 July 2021 onwards.

Holding Policies, Skin-in-the-Game, Malus and Clawback

Two growing policy requirements of executives are:

a) Minimum equity holding guidelines which require executives to hold shares and vested Rights to a minimum value such as:
   i. 100% of Fixed Pay for CEOs, and
   ii. 50% of Fixed Pay for Direct Reports, and
b) Holding vested Rights for a period so that they are a reservoir for clawback (recovery of overpayments) should the need arise, as well as empowering malus policies (adjusting realisable remuneration downward in response to stakeholder management concerns).

These requirements should be governed by appropriate policies and procedures that are formally adopted by the company and published on the company's website

LTVR NOT SUITABLE FOR MEETING MINIMUM EQUITY HOLDINGS OR PROVIDING A RESERVOIR OF EQUITY FOR CLAWBACK

Because LTVR plans typically use equity instruments it may initially appear that LTVR plans would be an abundant source of equity to meet minimum equity holdings requirements and provide a reservoir for clawback, however this is generally not the case. LTVR plans typically have 3 to 5 year measurement periods which include an ongoing service condition for that full period (note: GRG recommends 1 year service testing on LTVR when granted annually to address a range of issues that otherwise arise). This structure means that no vesting will occur until year 4 or later. When the average tenure for executive roles of 5 years is overlaid on the LTVR measurement period it becomes obvious that little, if any, meaningful holdings of equity will arise from LTVR plans for most executives and most grants will be forfeited due to the antiquated practice of service testing during the whole performance measurement period.

While for some longer serving executives the LTVR may eventually result in equity holdings that can count toward minimum equity holding guidelines, they generally would not be suitable for clawback even following vesting, because there is generally no requirement to continue holding the Shares, and they are typically sold to pay tax. In order to clawback such instruments the employer would typically have to seek recovery in court. It should also be noted that most stakeholders clearly prefer executives to achieve the minimum equity holding within 3 years, not 4 to 6 years – an unfair requirement if equity is not vesting to the incumbent and they are expected to acquire shares on-market thereby risking insider trading and using after tax money (in the absence tax deferred unlimited salary sacrifice equity plans that are now available).

On balance GRG's view is that LTVR cannot be relied upon to achieve either minimum equity holdings or reservoirs of equity for clawback.

STVR deferral on the other hand can be used to build equity holdings that count towards minimum equity holdings and provide reservoirs for clawback after 1 year of service.

With the removal of service testing, executives should no longer be seeking compensation for the increased risk of loss of income, since the only risk is related to malus and clawback, and "ESS" tax treatment can be expected to produce a financial benefit equivalent to paying nil capital gains tax as demonstrated in the following table, making it an attractive choice:

Aspect	Variables	After Tax Investment and CGT Treatment	Salary Sacrifice Investment (ESS Tax Deferral)
Gross Amount		$25,000	$25,000
Tax	47%	$11,750	$0
Investment in Company Shares		**$13,250**	**$25,000**
Value at End/Sale		$26,500	$50,000
CGT Tax Paid		$3,114	$0
ESS Tax		$0	$23,500
Net Benefit		$23,386	$26,500
Advantage from ESS Tax Deferral			$3,114
Financial Advantage Ignoring Extra Dividends			**13%**

Note: under the approaches GRG uses neither STVR deferral nor salary sacrifice is limited in terms of obtaining ESS tax deferral.

HOW MUCH STVR TO DEFER AND FOR HOW LONG

The following formula provides a means by which to determine the period for which part of STVR awards should be deferred. The example used is for an executive with a Fixed Pay of $200,000 pa, a Target STVR award opportunity of 25% of which 50% is paid in cash and 50% is deferred.

Deferral Period = Min Equity Value Holding ÷ STVR Deferral at Target

= $100,000 ÷ $25,000

= 4 years

Where

Min. Equity Holding Target = Fixed Pay x Holding %

= $200,000 x 50%

= $100,000

STVR Deferral at Target = Fixed Pay x Target STVR Award Opportunity x Portion of STVR to be Deferred

= $200,000 x 25% x 50%

= $50,000 x 50%

= $25,000

The outcome of 4 years would be appropriate for many executive roles as the assumptions reflect common market practice. However, typical deferral periods tend to be for 1 or 2 years and not the 4 years indicated by the formula. Of course, some of the assumptions may vary for some companies for example:

- Some companies may have minimum equity holding requirements greater than the 50% used in the example – lower levels would be unlikely to be seen as reasonable by many stakeholders,
- Some companies may have either higher or lower target STVR award opportunities as 25% is around the middle of market practice,

- The portion of STVR awards to be deferred rarely exceeds 50% on a compulsory basis (but often on an elective basis), so some companies may use lower STVR deferral levels.

The foregoing comments would lead to the conclusion that current practices in relation to minimum equity holding levels may be achieved via STVR deferral. Again, if service testing is removed and executives can resign while retaining their deferred equity interests (including continued holding requirements to give effect to ongoing malus and clawback requirements) then there should be little, if any, concern about the length of the deferral. This also supports alignment of executives with long term shareholder interests even post termination.

EXERCISE RESTRICTIONS VS DIPOSAL RESTRICTIONS

Rights are typically used as the equity instruments to effect STVR deferral. This is because there are more onerous conditions to be satisfied for tax deferral when shares are used. With Rights there are two methods that may be used to ensure longer term equity holdings. These are:

- Exercise Restrictions which stop rights being exercised into shares for a specified period – this approach is flexible as exercise restrictions may be released by the board at any time but suffers the disadvantage of Rights not carrying entitlements to dividends; this can be addressed via the valuation of the Rights to account for the loss of dividends, or provision of dividend replacement payments as part of plan rules, and
- Disposal Restrictions which stop shares from being sold for a specified period – this approach is inflexible as disposal restrictions may only be released in special circumstances.

Under both approaches the taxing point is deferred.

In most circumstances the better approach is to use Exercise Restrictions because the taxing point is not triggered by the cessation of the Exercise Restrictions (cessation of Disposal Restriction triggers a taxing point); it is triggered by exercise of the Rights which may be selected by the Participant at a time when they are not at risk of insider trading, and are ready to give up the benefit of ESS tax deferral on growth, up to 15 years after grant of the Rights.

APRA REGULATED ENTITIES

The recently released final version of Prudential Standard CPS511 contains provisions requiring deferral of a significant part of variable remuneration (60% for CEOs and 40% for other affected roles) for significant periods (4 - 6 years for CEOs, 4 - 5 years for senior managers and executive directors and 2 - 4 years for other roles) for specified roles. It also appears to require that executives continue to have that skin in the game on the same terms as continuing employees even post termination of employment, which is logical if the aim is to reduce short-termism. Given the need for executives to have "skin-in-the-game" it would seem to be appropriate for much of the deferral required by CPS511 to be undertaken via STVR plans.

EXECUTIVE PERSPECTIVE

While executives may initially be disappointed by having more STVR deferred and for longer periods, they should soon realise that malus and clawback events will be a relatively rare occurrence (assuming good conduct on ESG and other responsibilities) and that the deferral has provided an opportunity for them to accumulate a significant asset that may be accessed in due course and which will generate a strong income stream via dividends, if the company declares dividends.

CONCLUSION

Current market practice in relation to STVR deferral would be unlikely to support minimum equity holding guidelines or to provide a significant reservoir for clawback. Accordingly, many companies will need to review their policies in relation to deferral of part of STVR awards, the equity instruments used to effect STVR deferral and the provisions which are used to ensure that equity is held for a reasonable period.