GRG Remuneration Insight 121

The Equity Holding Trend

Authors: Peter Godfrey, James Bourchier & Nida Khoury

Introduction

One of the hottest trends of recent times is for companies to impose minimum equity holding guidelines on non-executive directors (NEDs) and senior executives. These guidelines are increasingly being formalised into "Equity Holding Policies", but all are not equal, and most fail to include any consequences for failure to comply, or powers of enforcement. This Insight explores some of the key considerations and variables related to the development of such policies, and how some of the emerging practices may be improved.

Scope and Application

There appear to be three distinct categories of roles to which equity holding policies are directed being:

- NEDs who do not participate in variable remuneration plans,
- Chief Executive Officers (CEOs) who typically have significant equity variable remuneration as part of their total remuneration packages, and
- senior executives who typically have some level of equity variable remuneration as part of their total remuneration packages.

All of these roles are expected by various stakeholders to have meaningful "skin-in-the-game" via holdings of equity interests in their companies. These roles are predominantly key management personnel (KMP) but equity holding policies may extend to executive roles not classified as KMP.

The meaning of "skin-in-the-game" seems to have morphed over the last two decades. In the 20th Century it was generally acknowledged that senior executives were provided with "skin-in-the-game" via long term variable remuneration (LTVR) grants of options and/or rights. These days the term seems to mean the value of shares (and possibly equivalents) held by executives in the companies for which they work. Thus, under the newer definition, LTVR grants are not counted as "skin-in-the-game" at least until vested and possibly not until they have been exercised into shares that are retained. Logically, vested rights held by executives prior to exercise should also be counted as "skin-in-the-game" as they are essentially the same as having an interest in shares – arguably an amplified interest since vesting scale ranges tend to vary more than share price ranges. However, whether proxy advisors are of this view remains to be clarified.

When and How is Compliance Measured and What is Included?

Compliance by KMP is usually assessed and reported on annually in Remuneration Reports. How compliance is assessed varies more widely than perhaps any other feature of these types of policies.

Common approaches include:

- recognising all shares held including restricted shares, but nothing else,
- also recognising vested and unexercised rights but not options (i.e. only those things that are equivalent to a Share), or
- more controversially, also recognising unvested rights on the basis that participants have "skin in the game" equivalent to an interest in a share via their holdings of these, and
- also recognising shares held by related parties (family, trusts, self-managed super funds (SMSFs) etc.),

In assessing compliance, the equity must be valued, which may be:

- a volume weighted average price (VWAP) over the whole prior financial year,
- a VWAP over 10-20 trading days following the most recent release of financial results, or
- the closing share price on the last day of the financial year, or a VWAP close to this date.

How Much is Enough?

Typical guidelines (based on our observations so far) are for KMP to hold equity in the companies they work for with a market value of not less than:

- 100% of annual board fees for NEDs – this is almost universal,
- 100% to 200% of Fixed Pay for CEOs, and
- 50% to 100% of Fixed Pay for other senior executives.

Under the old definition of "skin-in-the-game" the higher levels seem conservative in the light of typical LTVR grant values, particularly as these are assessed pre-tax. However, the lower levels seem onerous if the new definition is applied and only listed securities held are counted (usually after tax, which tends to substantially reduce holding values – noting that the Fixed Pay % is a before tax benchmark).

How Quickly?

The most common approach is to allow five years to satisfy the relevant guideline. However, some policies allow for an extension in exceptional circumstances, such as in the case that variable remuneration has failed to be awarded in some or all of the years during the standard period, or if the share price falls resulting in a dip in compliance.

Issues Arising in Relation to Equity Holding Policies

Challenges that may arise in relation to equity holding policies include:

1. Not breaching the insider trading provisions of the Corporations Act.
2. How to fund the acquisition of equity.
3. If and how the policy should be enforced in cases of deliberate non-compliance.

Insider Trading Provisions

The insider trading provisions relate to trading while holding "inside information" which is defined as:

(a) information that is not generally available; and

(b) if the information were generally available, a reasonable person would expect it to have a material effect on the price or value of the equity.

A person who is in possession of inside information is prohibited from acquiring or disposing of, either directly or indirectly, financial products quoted on a stock exchange. The prohibition extends to arrangements with other parties and to disclosing inside information to persons who may act on it.

Many companies have equity trading policies that restrict the times during the year when KMP may buy or sell equity. While in the past the dominant practice was for short periods of "blackouts", the abundance of conservatism that has emerged regarding insider trading has led to a reduction in these times to very short "trading windows". These times usually follow the announcement of annual and interim results as these are times when the market is best informed and it is least likely that KMP will hold inside information. However, it is a matter of fact as to whether a KMP is in possession of inside information. If KMP hold inside information during the times when trading is permitted under equity trading policies, they still cannot buy or sell equity.

Clearly, the insider trading provisions will apply to on-market acquisitions of shares by KMP, their associates and SMSFs. However, when executive KMP acquire equity it is usually via rights and options that are issued by the company and are not tradeable on a stock exchange. Accordingly, such acquisitions would fall outside the insider trading provisions. From the point of view of ensuring that KMP are not exposed to criticism or legal action in relation to insider trading it would be prudent to use rights that are issued by the company as the means by which KMP acquire equity.

Source of Funds

There are broadly four main potential sources of funds with which KMP may acquire equity:

- Personal assets.
- Superannuation contributions.
- LTVR or deferred short term variable remuneration (STVR) which is retained following vesting.
- Salary sacrifice of Fixed Pay or STVR for executives or fees for NEDs – this only applies if the Company is providing appropriate facilities to NEDs and executives to achieve this, which has been historically uncommon, but is changing.

Personal Assets

Not all KMP are in the same financial position. Some have substantial accumulated wealth while others have modest accumulated assets and are cashflow poor due to family financial commitments including mortgages, private school fees for children and life-style expenses. Thus, for some KMP they may have limited ability to commit significant funds to equity acquisitions and may find it difficult to maintain such holding over long periods.

In any event, using personal assets usually involves the sale of another investment and diversion of the after-tax sale proceeds into the on-market purchase of shares. As illustrated in GRG Remuneration Insight 88 Remuneration Paid in Equities for Non-executive Directors, it is tax inefficient to sell investments and re-invest in an alternative investment. This is because the withdrawal of tax from the investment pool reduces the investment value and in turn reduces future earning opportunities from dividends and growth.

Superannuation Contributions

Many KMP have SMSFs into which the company makes contributions. The SMSFs could be used to acquire equity via:

a) sale of current investments and on-market purchase of shares (insider trading concerns),

b) application of future contributions to on-market purchase of shares (insider trading concerns), or

c) a combination of the above.

As indicated above in relation to Personal Assets the sale of current investments to apply the net of tax sale proceeds to acquire equity is not an optimal approach. It may also result in the SMSF being over weighted in equity in the company which may not be prudent from an investment diversification point of view.

Application of future superannuation contributions to acquire equity is unlikely to result in sufficient equity being acquired quickly enough. This is because contributions at the superannuation guarantee rate of 9.5% will result in around 8% (after-tax) of pay being applied to acquire equity. This would take over 12 years (not three years) to build up a holding of one-times Fixed Pay or Fees.

LTVR or Deferred STVR (for executives only)

Most LTVR and deferred STVR awards are in the form of rights which usually become taxable when vesting conditions are satisfied or when the vested rights are exercised which often occurs soon after vesting. Around 50% of the shares acquired on exercise of rights need to be sold to fund the tax payable and it is not uncommon for more shares to be sold so that executives may realise some cash benefit. Accordingly, it is common practice for LTVR and deferred STVR awards to not result in long term holdings of many shares. A consequence is that under current commonly designed LTVR and deferred STVR plans it is highly likely that equity holding guidelines will not be able to be satisfied via LTVR and STVR deferral plans. This is exacerbated by the fact that LTVR plans have typical measurement periods of three years, meaning that only one or two grants may contribute to the equity holding within the 5 year time horizon commonly used as the maximum period in which to achieve the guideline holdings. As STI deferral typically covers a period of 2 to 3 years (STI measurement period of one year plus one or two years of deferral) there will also be little opportunity for the equity holding guideline to be achieved via deferral of STVR.

Also, in circumstances of poor performance when vesting does not occur, particularly over multiple years, STVR and LTVR may contribute nothing to equity holdings. In these cases, it can be very challenging for executives to comply with holding policies. Therefore, it is important for holding policies to make allowances for these circumstances, or for the Company to offer other facilities to enable compliance in a low-cost manner.

Salary Sacrifice

From a personal investment point of view, salary sacrifice of Fixed Pay, STVR or Fees is the most tax effective way to acquire equity and at the same time not be exposed to insider trading concerns. Bearing in mind that the one times

Fixed Pay or Fees minimum holding generally needs to be acquired over 3 to 5 years it follows that at least 20% to 30% of Fixed Pay or Fees would need to be sacrificed to acquired equity each year in the absence of any other contribution to holdings. Of course, compared to using after-tax Fixed Pay or Fees the 30% salary sacrifice (15% after tax equivalent for many executives) is much lower than the percentage of gross Fixed Pay or Fees that would need to be used to acquire an equivalent value of equity which could be up to 57% of gross Fixed Pay or Fees (57% gross - 47% tax = 30% net).

Given the foregoing comments in relation to alternatives other than salary sacrifice it seems clear that salary sacrifice is the only viable and fair alternative by which equity holding guidelines may be achieved within a 3 to 5 year time-frame.

A small number of GRG's clients have already introduced compulsory equity components of fixed pay of between 10% and 30% of Fixed Pay, for the CEO and selected direct reports. While this may not be a voluntary sacrifice, it is equivalent to a salary sacrifice. Some clients are considering providing future Fixed Pay increases in the form of equity only, for this purpose, until the target level of equity in the Fixed Pay package is met.

Enforcement

Most equity holding policies do not include any consequence for a failure to comply or any opportunity for enforcement. Obviously, it is not possible to compel someone to buy shares, however, under STVR and LTVR plan terms that are written to harmonise with holding policies it is possible to:

- give the Board the power to defer additional amounts of STVR awards into equity for executives,
- give the Board the power to apply long disposal restrictions on LTVR or even deferred STVR until the holding policy is met, so that there is no compulsion to sell down to pay tax – this can accelerate holding value increases by up to 50%, and
- it is becoming more common to apply disposal restrictions while the position of NED is held, to defer tax for up to 15 years.

Conclusions

Equity for Executives

For executives to comply with equity holding guidelines will generally require Boards to facilitate such acquisitions via salary sacrifice or similar equity acquisition plans and/or adjustments to the terms of LTVR and deferred STVR plans. In relation to LTVR and deferred STVR the most critical point to achieve is deferral of the taxing point so that earned equity is not halved due to having to sell shares to fund tax liabilities. The second point is to ensure that executives retain equity by imposing disposal restrictions that enforce compliance with equity holding guidelines.

Similarly, unless a Company is compulsorily deferring STVR into equity and offering substantial LTVR with a high likelihood of vesting, it may be prudent to offer executives tax effective salary sacrifice equity acquisition opportunities via one of the unlimited equity acquisition plans that GRG has developed.

Equity for NEDs

While it is possible for NEDs to acquire equity via fee sacrifice through executive variable remuneration plans, if the plan design permits such acquisitions, it is generally seen a good governance for NEDs to not participate in plans designed for executives. Accordingly, a separate NED Equity Plan that facilitates pre-tax acquisitions and long tax deferral is becoming common market practice in the companies that are adopting holding policies. This typically allows NEDs to meet their holding obligations twice as quickly as companies that do not offer equity plans, with long term tax deferral (up to 15 years or cessation of being a NED).

Setting up and operating a NED Equity Plan can involve some costs however the amounts involved are generally not significant for the company. Therefore, cost would be unlikely to be a sufficient reason to not introduce a NED Equity Plan.

Similarly, unless a Company is compulsorily deferring STVR into equity and offering substantial LTVR with a high likelihood of vesting, it may be prudent to offer executives tax effective salary sacrifice equity acquisition opportunities via one of the unlimited equity acquisition plans that GRG has developed.