GRG Remuneration Insight 122

Enforcing “Skin-in-the-Game”

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Introduction

Except for salary sacrifice equity acquisition, GRG’s experience indicates that properly structured and weighted long term variable remuneration (LTVR) is the best and fairest way to facilitate executives to have more “skin-in-the-game”. However, the way that most LTVR plans are structured neither assists nor compels executives to retain the equity earned. This Insight examines practical approaches that can be used to achieve more “skin-in-the-game” for senior executives through optimisation of LTVR plans to facilitate longer term holding of equity interests. Many of the same principles can be applied to short term variable remuneration (STVR) deferral also, if applicable, however previous research has shown that the introduction of STVR deferral has reduced LTVR’s weighting in the remuneration mix for executives, which can undermine shareholder alignment.

The Current Landscape

The most common design features of LTVR plans utilised by ASX listed companies include:

a) annual grants of rights,

b) performance and service measurement period of 3 years,

c) vesting based on performance over the measurement period,

d) no exercise restrictions on vested rights and in some cases automatic exercise of rights when they vest, and

e) either no disposal restrictions on shares acquired when vested rights are exercised or short disposal restriction periods of 1 or 2 years.

In Australia, tax becomes payable on equity acquired during employment at:

- **vesting** if disposal restrictions do not apply to the vested rights,
- **exercise** if not taxed at vesting and disposal restrictions do not apply to the shares acquired on exercise of vested rights (must be set at the time of granting of rights), or
- **cessation** of disposal restrictions applicable to shares acquired on exercise of vested rights, if there has been no earlier taxing point.

The taxing event almost invariably triggers executives to sell shares to generate the necessary funds to pay the tax due, which in turn reduces the “skin-in-the-game” by around 50% for most executives. Moreover, when executives decide to sell shares to cover the tax liability, they seem to go beyond the sufficient amounts to cover the tax and also sell the reminder of the shares on which tax is payable, which often results in no shares being held beyond the vesting period.

In view of the foregoing, the key to more “skin-in-the-game” is to delay the taxing point, which in turn will delay the trigger to sell shares.

Context of Executive Tenure

In 2017 Korn Ferry conducted a study of the average tenure of CEOs and other C-suite executives in the top 1,000 US companies by revenue, which indicated that average tenure was 8 years for CEOs and 5 years or less for other C-suite executives. A 2018 study by Equilar on CEO tenure in S&P500 companies came up with similar results; and other less comprehensive studies in Australia have produced comparable results to the USA studies.

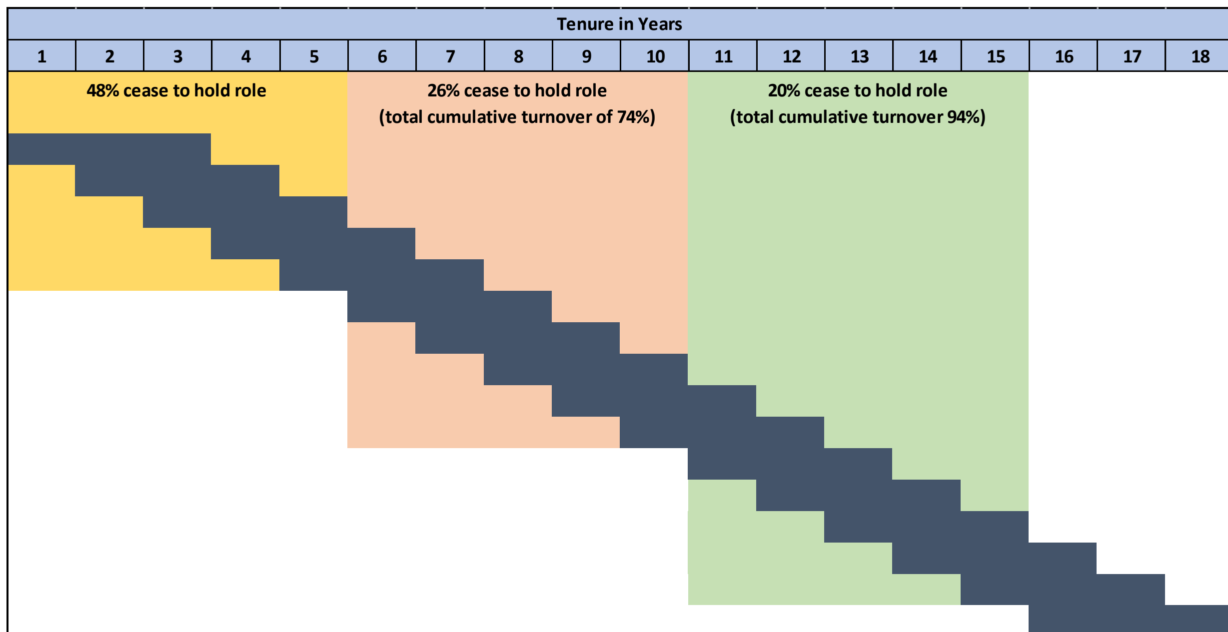
The results of the tenure studies are presented in the following graph along with the over-lapping cycles created by typical LTVR plans utilised in Australia – the blue marked periods of 3 years. Observations in relation to the graph include:

a) for around half of the CEOs with tenure of less than 5 years, up to 2 LTVR grants will have a chance of vesting before they cease employment which means that, to the extent both of these grants vest, they will need to be retained for the full period of tenure if these CEO's are to have any meaningful "skin-in-the-game",

b) for the 26% of CEOs with tenure finishing between 5 and 10 years, up to 7 LTVR grants would be tested for vesting,

c) For the 20% of CEOs with tenure finishing between 10 and 15 years, up to 12 LTVR grants would be tested for vesting, and

d) For around 6% of CEOs with tenure finishing after 15 years, more than 12 LTVR grants would be tested for vesting during their tenure.



Holding Period Considerations

When looking at holding periods they tend to be expressed as periods following the end of the measurement period which gave rise to vesting. Given that the maximum tax deferral in Australia is until the earlier of the elapse of 15 years from grant or cessation of employment, when a 3 year measurement period applies for vesting then the maximum holding period would be an additional 12 years.

Other considerations when setting holding periods include:

- insider trading prohibitions,
- company securities trading policy,
- stakeholder perceptions of share sales by senior executives, and
- the preference of executives to be able to access accrued vested LTVR benefits within a reasonable period of vesting.

Holding periods are generally achieved by either:

a) the application of exercise restrictions which delay the exercising of rights, which is also the better way to facilitate malus/clawback, or

b) the application of disposal restrictions to shares which are enforced by a trust, which is more common since it allows access to dividends and voting.

Alternative Holding Approaches

Five alternative approaches to facilitating holding beyond the vesting period are raised for consideration but, of course other variations may be considered.

Alternative	Comments
1. No Holding Requirement	Executives are not compelled to hold vested rights. Leave it up to them to achieve or not achieve the requirements of equity holding guidelines as they see fit. Manual exercise can be used to encourage executives to delay exercise and taxation, however this will come at the cost of dividends if the company is a dividend payer.
2. Minimum Holding Period Policy	Require vested rights or shares to be held for 3 years after a measurement period of 3 years (i.e. total period of 6 years). Assuming that target vesting is achieved and its quantum constitutes the typical 20% to 40% of annual fixed pay, then holdings of between 60% and 120% of fixed pay should be achieved over no more than 6 years. This policy is likely to achieve equity holding guidelines for the 50% of executives with more than 5 years of service, particularly if nil vesting has not occurred in any of the prior 6 years. Exercise restrictions or restricted shares held in trust can be used to achieve this outcome.
3. Medium Holding Period Policy	Require vested rights or shares to be held for 7 years after a measurement period of 3 years (i.e. total period of 10 years). Assuming that target vesting is achieved and its quantum constitutes the typical 20% to 40% of annual fixed pay, then holdings of between 140% and 280% of fixed pay should be achieved over no more than the 10 years. This policy is also likely to achieve equity holding guidelines for the 50% of executives with 5 years or more of service, however, given that it is likely that 74% of executives will have ceased employment before the 10 year period is completed it follows that the actual holding period will be until the end of their period of service. Exercise restrictions or restricted shares held in trust can be used to achieve this outcome.
4. Maximum Holding Period Policy	Require vested rights or shares to be held for 12 years after a measurement period of 3 years (i.e. total period of 15 years). Again, this policy is likely to achieve equity holding guidelines for the 50% of executives with 5 years or more of service, however given that it is likely that 94% of executives will have ceased employment before the 15 year period is completed it follows that the actual holding period will be until the end of their period of service. Exercise restrictions or restricted shares held in trust can be used to achieve this outcome.
5. Flexible Approach	This alternative applies approach 2, 3 or 4 to grants of LTVR, until the holding policy is met, with grants made after that point being unrestricted or subject to elective restrictions.

GRG's view is that Alternative 1 is the least supportive of equity holding guidelines as it is unlikely to result in adequate equity being held by executives with more than 5 years of service. Of the others, it is clear that Alternatives 2 and 3 should be considered if a company requires most of its executives with more than 5 years of service to meet equity holding guidelines but does not wish to apply onerous holding policies on very long serving executives. In this regard it should be noted that a holding policy that covers 6 or 10 years will not necessarily result in executives wanting/having to sell after 6 or 10 years particularly if a taxing point is not triggered by the elapse of the 6 or 10 years (e.g. in the case of manual exercise following a restriction period).

GRG tends to favour Alternative 3 (or the flexible approach using 3 as its basis) as it is less likely to result in share sales during employment which may attract adverse commentary from stakeholders and adversely affect the reputations of the executives and the board.

Delaying the Taxing Point

Disposal Restrictions

Subjecting rights granted and shares to be acquired on exercise of rights to disposal restrictions delays the taxing point until the disposal restrictions cease. Based on the foregoing discussion the disposal restriction attached to the shares could be until the 6th, 10th or 15th anniversaries of the grant of rights depending on the alternative chosen and board preferences.

The other advantage of this approach is that the executive ends up holding shares and therefore can receive dividends and vote the shares.

However, the main problem with this approach is the inflexibility resulting from being unable to change the disposal restriction period once it is set when the rights are granted. Thus, if for some reason it becomes desirable or necessary for an executive to sell shares before the end of the disposal restriction period then the executive will not be able to make the sale unless they resign to trigger a cessation of employment event to have access to their locked up equity benefits. To counter this problem and avoid compelling executives in genuine need to access their equity to resign, exercise restrictions can be utilised as explained below.

Exercise Restrictions

When rights are granted and are subject to disposal restrictions, the taxing point will be when the vested rights are exercised (which may be backdated to an earlier cessation of employment) or the elapsing of 15 years. To ensure that executives continue to hold vested rights which are akin to shares, an exercise restriction may be placed on vested rights that are subject to disposal restrictions.

The advantage of exercise restrictions over disposal restrictions is that the board may release exercise restrictions without impacting tax deferral, but may not release disposal restrictions relied upon for tax deferral (if a board can release disposal restrictions then the restrictions will not be effective in deferring the taxing point). Thus, if an executive needed to exercise vested rights and sell the shares then the board could release the exercise restrictions. This would help avoid the possibility of an executive leaving a company to access the benefit accrued in deferred vested rights.

This comes with the added benefit of enabling malus/clawback clauses – it is much harder to recover a vested share, than it is to cancel an unexercised Right.

The disadvantage of holding vested rights subject to exercise restrictions instead of shares subject to disposal restrictions is that the holder of the rights would not be entitled to receive dividends. Accordingly, to not disadvantage executives who hold vested rights they would need to be compensated for the dividends and franking credits not received. There are several ways by which this may be achieved and which GRG can advise on.

Conclusions

If companies wish to ensure that equity holding guidelines are observed or prefer executives to maintain "skin-in-the-game" then LTVR plans (and possibly deferred STVR grants) need to be adjusted to impose holding policies in relation to either vested rights or shares acquired on exercise of vested rights. The optimal holding period seems to be 7 years following vesting of rights although shorter and longer periods could also be considered.

Such holding policies may be enforced via either disposal restrictions on shares acquired by exercise of vested rights (often referred to as restricted shares) or exercise restrictions on vested rights (often referred to as restricted rights). Of these alternatives, exercise restrictions allow maximum flexibility in terms of executives being able to sell shares, subject to board approval, should the need arise. It also allows executives to retain vested rights after the exercise restriction period has ceased and continue to defer the taxing point, subject to the maximum tax deferral period of until the elapse of 15 years or earlier cessation of employment, when manual exercise is applicable.