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NED Equity: Facilitating More Skin-in-the-Game for Directors

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Introduction

A recent article in the Australian Financial Review (AFR) reported on a proposal by Tanarra Capital that ASX300 companies should adopt a "2 in 2" policy in relation to equity holdings of Non-executive Directors (NEDs). This policy means that within 2 years of appointment, NEDs should hold equity interests in the company with a value of not less than twice the NED's annual fees from the company. Further, Tanarra suggests that the equity interests should be purchased on joining the Board possibly with a full recourse interest free loan provided by the company, to be repaid over 5 years, if the NED is not otherwise able to fund the acquisition. A March article in the AFR also highlights significant problems with NED equity when it is not configured correctly; undermining NED independence through the use of options, and cases of perceived excessive remuneration where too much equity is offered, in some cases on top of cash board fees. This GRG Remuneration Insight discusses these views and related considerations.

Should NEDs Hold Equity?

For many years, a commonly held view was that NEDs should not hold equity in the companies of which they are board members. The rationale for this view was that their equity holdings may influence them to act in their personal interests rather than the interests of shareholders. This view was seen as maximising the independence of NEDs while ensuring that NEDs were not personally financially impacted by the decisions of the Board.

The modern widely held view, which GRG tends to support, is that NEDs should hold equity in the companies of which they are directors so that they will have personal financial interests in the outcomes of the decisions made by boards. This view is seen as aligning the interests of NEDs and shareholders by ensuring that NEDs have skin-in-the-game. These views have gained significant traction partly due to the rising influence of institutional investors and proxy advisors, who seem to generally advocate for this approach.

How Much Equity?

Many ASX listed companies, particularly those in the ASX300, have policies or guidelines requiring NEDs to hold equity in the companies of which they are directors. Such policies often extend to include senior executives. A common policy is for NEDs to be expected to hold equity interests with a value of at least one year's fees within 3 years of being appointed.

The article in the AFR indicated that Tanarra Capital's preference is for 2 times fees and that some directors feel that it should be 3 times fees. Thus, common NED fee holding policies fall well short of this higher expectation.

Timing of Acquisitions

As indicated above, it is common practice to allow up to 3 years for a NED to acquire sufficient equity to meet the company's equity holding policy. Also, as indicated in the introduction, Tanarra Capital's preference was for a higher amount to be accumulated more quickly.

The timing along with the method of acquisition may be an important consideration for those considering a NED role, and could impact the ability companies have to attract and/or retain appropriate talent in the range of circumstances that ASX listed companies face.

What are the Assumed Advantages of the Proposed Approach?

It appears the main benefits arising from the proposed approach are assumed to be:

1. NEDs will have a higher level of alignment than is currently typical, due to the higher fee multiple holding requirement.
2. NEDs will be aligned more quickly because their holding reaches the required level immediately upon appointment.
3. The use of loans, on the face of it, would seem to address potential funding and fairness issues, and ensure that diversity of NED appointments can continue to be supported e.g. in the case of NEDs who rely on board fees for income.

It is worth examining each of these in more detail, as part of the discussion presented below.

Means of Acquisition

There are four main alternatives likely to be relevant to NED equity acquisitions, being:

Means	Comments
1 - Use personal resources to acquire shares	Presumably, sophisticated individuals such as NEDs do not have large sums of cash sitting unutilised rather than invested. As such, this approach is likely to require NEDs to dispose of other shares or investments, paying Capital Gains Tax (CGT) and applying the net sale proceeds to purchase the company's shares on-market. The depletion of the individual's investment pool due to payment of CGT may mean that the individual's investment income will be lower than it would have been had shares not been sold. In these circumstances the NED will be paying a penalty (lower investment earnings) to meet the equity holding guideline.
2 - Use after tax fees to acquire shares	This approach will mean that it will take some years for the required level of equity holding to be achieved. As such, this approach would not meet the requirements outlined in the AFR article. This approach is inefficient from both a tax and timing perspective.
3 - Use pre-tax fees to acquire shares	This approach is the most tax effective approach and will minimise the time required for NEDs to acquire the desired level of equity holding. However, given that the AFR article was calling for equity holdings to be a multiple of annual income, pre-tax cash board fees would need to be mostly or entirely exchanged for equity that was subject to long-term tax deferral to meet this objective within 2 years. This approach can defer tax for up to 15 years if properly constructed, using Restricted Rights that turn into Restricted Shares within a short period of being granted.
4 - Borrow the funds required to fund the acquisition of the shares	Borrowings may be from the company or an independent source. If borrowings are from the company in the form of a limited recourse loan then the purpose of up-front acquisitions, feeling the pain of losses, will be lost as NEDs will not be responsible for any loss in value below the acquisition price. If borrowings are from the company and interest free then the company will, in effect be providing additional remuneration via the interest saving and Fringe Benefits Tax (if FBT applies) which may be an unintended consequence.

	If borrowings are not from the company then the individual will be responsible for interest costs and will be exposed to changes in value of the equity. These may erode the net value of the fees being received as a NED. If the 5 year repayment period proposed by Tanarra were to be applied to a loan of two times fees, then 40% of the fees would need to be applied to repay the loan each year. At a tax rate of 30% this would take up to 57% of gross fees and at a 47% tax rate would take up 75% of gross fees, leaving the NED with minimal cash flow from the fees. Thus, the proposed loan approach is unlikely to provide much relief for NEDs who rely on board fees for income.

Of these approaches, GRG is of the view that pre-tax fees are the better alternative in most circumstances because it presents the least cost and can provide "ESS tax deferral" advantages through an appropriately structured NED fee sacrifice equity plan.

Timing Issue

The requirement for the NED to acquire a multiple of annual board fee income within 2 years from appointment is likely to be problematic for boards that are in flux due to significant mismanagement, compliance or regulatory issues, or because of a falling share price. In such circumstances, presumably NEDs replacing a failed board will need time to guide the company through the necessary changes to restore shareholder confidence and value. As such, a requirement for what is effectively immediate investment in the company's equity that is likely to continue to lose value for a period may be a hurdle to appointing appropriately qualified NEDs with the capability to guide the business out of trouble. If for example it took 12 months to improve the company's outlook, there would only be 12 months remaining to acquire 2 times board fees, which would require external resources to accomplish.

Insider Trading and Company Securities Trading Policy

Both insider trading restrictions in the Corporations Act and company securities trading policies can significantly impact a NEDs ability to purchase company shares. These provisions will also impact a NED's ability to comply with the company's equity holding policy. Of the various approaches to acquiring equity outlined, the use of pre-tax remuneration can avoid problems with insider trading and securities trading policies when shares are acquired via new issues or an employee share trust which has previously acquired shares in compliance with the insider trading laws and the company's securities trading policy.

Company Policy or Guideline

The first decision each board needs to address is whether or not to require NEDs to hold equity in the company. If a new policy is to be introduced, then consideration will also need to be given to its application to current NEDs. Will there be a drop-dead requirement, a transition arrangement or will the new requirement only apply to future NED appointments?

Whether the NED equity holding requirement is structured as a policy or a guideline is of little consequence. What matters is the consequence of non-compliance. If non-compliance means that the NED may not be appointed or must resign or may not submit themselves for re-election at the end of their current term then that may lead to loss of talent; to the detriment of the board and shareholders. If non-compliance has no consequence, then the policy may have some effect by at least encouraging NEDs to acquire and hold equity in the company. A middle-ground may be to allow the Board to determine that future fees will be paid to the NED in equity only (no further cash fees) until the holding requirement is met.

Any policy needs to relate to ongoing holdings of equity rather than holdings at a particular point in time. Holding shares at the end of the year and then selling them would defeat the purpose of the policy.

The other matter to consider is share price volatility. If a NED acquires sufficient shares to satisfy the equity holding policy they may subsequently fail to meet the equity holding policy if the share price

declines (most policies are expressed as a value of shares relative to the value of annual fees). It would not make sense for NEDs to have to step down due to a fall in the share price. Equally it may be unfair to expect NEDs to buy more shares when the share price has fallen i.e. to make up the shortfall in the value of shares held relative to the equity holding policy level. GRG recommends that policies specify a "make-good" period when this circumstance arises.

Consequences of Having a Minimum Equity Holding Policy

For those individuals with substantial financial resources a minimum equity holding policy may be of little consequence. In addition, for such individuals the holding of equity in the company may be a minor part of their personal financial resources with the result that having skin-in-the-game may not impact their decision making in the way expected by those proposing that NEDs have equity holdings of 2 to 3 times annual fees.

For NEDs with modest financial resources, the requirement to hold significant equity may be an impediment to them accepting appointments as NEDs. It is now common, particularly on boards seeking diversity, for professionals to take up NED roles mid-career before they have had the opportunity to accumulate significant financial resources. This cadre of NEDs, as opposed to the traditional NED being an older retired senior executive, has many benefits, including diversity and freshness of opinions, and should be encouraged rather than discouraged by placing an equity holding barrier to becoming NEDs.

A view presented in the article is that individuals who need the income they earn as fees and therefore may not be able to afford to acquire significant equity holdings probably should not be appointed as NEDs because their reliance on the fees for income may taint their ability to fulfil their fiduciary responsibilities. GRG does not see a lot of merit in this view.

Conclusion: A Prudent Way Forward, Balancing Stakeholder Needs

Considering the foregoing discussion, a prudent way forward may be to introduce a policy under which say 30% of board fees are compulsorily paid on a pre-tax basis in equity and NEDs are required not to dispose of equity while they hold the office of NED. If done on an ongoing basis, holdings can be expected to exceed even the proposed new higher levels, in a more sustainable and fairer manner. This approach means that NEDs will not have to divert existing investment into company shares and will not need to borrow to fund share acquisitions.

Ignoring share price volatility, NEDs would accumulate equity with a value of 90% of board fees after three years, 180% after 6 years and 270% after 9 years. Assuming a properly structured arrangement, tax would be deferred until the earlier of cessation of disposal restrictions and the elapse of 15 years after the equity was acquired. Also, assuming the equity transitions into shares soon after it is acquired, the NEDs will receive dividends on the full amount of equity held. Assuming a ~50% tax rate they will also reach the desired minimum shareholding twice as fast as traditional approaches. A challenge for NED equity plans has been the use of plans designed for executives, which typically creates a trigger for NEDs to be taxed and thus forces them to sell into the market. With up to 15 years of tax deferral on the shares received, NEDs will not be forced to sell into the market to pay tax under GRG's proposed approach, unless they exceed current typical term limits. For governance and independence reasons, NED equity plans should always be operated as a separate and discrete plan from any other plan, in any case.

GRG's proposed approach balances the needs of various stakeholders by:

1. Accelerating holding accrual compared to current typical approaches.
2. Ensuring NEDs are not financially disadvantaged.
3. Providing tax advantages through Employee Share Scheme (ESS) tax treatment.
4. Ensuring that there are sufficient cash funds in the NED remuneration mix to support diversity.
5. Facilitating holding requirements that will accrue to a level or multiple of board fees that far exceeds current standard approaches, in a sustainable and fair manner over time.
6. Avoiding point-in-time issues to do with the circumstances of a NEDs appointment.

Given the favourable treatment available under new equity plan frameworks, and the requirement for all equity plans to be amended or replaced to comply with the Corporations Act from 1 March 2023, now is a great time to think about NED equity plan optimisation.