

GRG

Remuneration Review

Options for Non-executive Directors

Remuneration Review No. 6

April 2008

INTRODUCTION

This article discusses the provision of equity units (shares, rights and options) as part of non-executive director (NED) remuneration. This is an area that has started to attract media attention and commentary from various stakeholders. In particular, this article seeks to stimulate more discussion about the use of options as part of NED remuneration.

Recently, there has been comment on the use by NEDs of margin loans to fund investments in the companies of which they are directors. These comments have arisen due to sales of shares as a result of margin calls. Whether NEDs ought to use margin loans is a separate and distinct issue to that of NED remuneration and therefore is not covered in this article.

WHETHER TO PROVIDE OPTIONS

Three Reasons Why Not?

Our research into reasons behind opposition to granting options to NEDs as part of their remuneration identified three main negative points of view as follows:

1. When NEDs hold equity in the companies of which they are directors, their independence may be compromised.
2. NEDs should not participate in executive incentive plans as they may face conflicts of interest, and
3. The leverage aspect of option grants may compromise the decision-making of NEDs.

Each of these is discussed below.

Equity Holdings May Compromise Independence

The first of the three reasons does not appear to be widely supported as indicated in the following:

- The ASX Corporate Governance Council's revised version of its "Corporate Governance Principles and Recommendations" which came into effect on 1 January 2008 is supportive of NED fees being provided in the form of "salary sacrifice into equity". (Principle 8, Box 8.2, Item 1)
- The National Association of Pension Funds (NAPF) in the UK supports NED remuneration being paid wholly or partly in company shares.
- That the Australian income tax laws contain a tax deferral concession that encourages NEDs to sacrifice fees into shares would indicate that the Federal Government is supportive of NEDs holding shares in the companies of which they are NEDs.
- Market practice supports equity holdings by NEDs.

GRG Remuneration Reviews are articles to assist directors and senior executives who have responsibilities in relation to Board and senior executive remuneration and other human resources issues. Their role varies between articles with some aimed at stimulating critical thinking, others updating information and others simply acting as a reminder of principles and approaches where awareness may need to be heightened.

GRG Godfrey Remuneration Group Pty Ltd
ABN: 38 096 171 247
56 Berry Street
North Sydney NSW 2060
Phone (02) 8923 5700
Facsimile (02) 8923 5706

When market practice is examined, it is clear that the overwhelming majority of NEDs feel that it is appropriate for them to hold equity in the companies of which they are NEDs. This is evidenced by the following two tables which have been extracted from the 2008 Top 200 Board Remuneration Report. They show, for companies with market capitalisations of more than \$500 million as at 30 June 2007, the 25th percentile (P25), 50th percentile (P50) and 75th percentile (P75) values of their shareholdings. That the P25 shows a value greater than nil indicates that over 75% of NEDs of companies in each market capitalisation range have shareholdings. It should also be noted that the values of the shareholdings are significant when compared to the P50 of the Chairs' and NEDs' Main Board Packages (total of board and committee fees, superannuation contributions, fee sacrifice share acquisitions and other benefits).

Chair - Value of Shareholding Relative to P50 Main Board Package					
Company Size by Market Capitalisation	Sample Size	P50 MBP \$'000	Shareholder Value \$'000		
			P25	P50	P75
> \$10bn	19	\$519	\$784	\$1,681	\$8,299
\$5bn to < \$10bn	20	\$390	\$639	\$1,330	\$2,139
\$2 billion to < \$5 billion	30	\$294	\$284	\$567	\$4,799
\$1 billion to < \$2 billion	40	\$180	\$115	\$386	\$5,276
\$500 million to < \$1 billion	40	\$148	\$343	\$926	\$6,970

Director - Value of Shareholding Relative to P50 Main Board Package					
Company Size by Market Capitalisation	Sample Size	P50 MBP \$'000	Shareholder Value \$'000		
			P25	P50	P75
> \$10bn	157	\$188	\$140	\$308	\$697
\$5bn to < \$10bn	97	\$158	\$81	\$235	\$388
\$2 billion to < \$5 billion	155	\$115	\$64	\$196	\$798
\$1 billion to < \$2 billion	192	\$87	\$66	\$278	\$962
\$500 million to < \$1 billion	156	\$77	\$52	\$151	\$813

Irrespective of the philosophical arguments for or against NEDs having equity stakes in their companies, it is clear that the majority have voted with their capital by investing in the companies of which they are directors.

In order to discuss the remaining two reasons for not providing NEDs with options it may be helpful to use an example to bring the discussion to life.

Example for Discussion

The main aspects of the example raised for discussion are as follows:

1. The Board would determine an annual dollar value of NED fees to be provided in equity. The amount could be set at say \$40,000 pa.
2. 3 years' of equity would be granted to NEDs simultaneously, thus providing equitable treatment of NEDs. New appointments may either receive a pro-rata interim grant covering the period remaining to the next grant or they may wait until the next grant to receive their allocation.
3. The number of options to be granted would be determined by dividing the amount to be provided in equity by the value of the options. One of the accepted option valuation models would be used for this purpose. Assuming a share price of say \$15.00 and an option value of say \$5.00 the grant would be of 24,000 options (3 years x \$40,000 pa ÷ \$5.00).

4. The options would have an exercise price equal to the share price at the date the options are granted and would have a term of say 5 years.
5. The options would be structured such that they vest 3 years after grant but if an individual ceased to be a NED earlier, then vesting would be on a pro-rata basis reflecting the portion of the vesting period worked.
6. Vested options may be exercised at any time up to their expiry date even after termination of employment.
7. The grant of the options would require shareholder approval under Rule 10.14 or 10.15 of the ASX Listing Rules.
8. Shareholder approval of the NED option plan should be considered in the interests of transparency and other considerations such as the 15% new issue limit under the ASX Listing Rules.
9. Normal provisions dealing with adjustments to options in cases of bonus and rights issues and other capital reconstructions would apply.

NEDs Should Not Participate in Executive Incentive Plans

The ASX Corporate Governance Principles and Recommendations state in Principle 8, Box 8.2 Item 2 that: “Non-executive directors should not receive options or bonus payments.” Unfortunately, the ASX Corporate Governance Council has not provided reasons for its view.

If a NED option plan were to be introduced then it would be governed by separate plan rules to those which govern the executive share, right or option plan. Thus, it would be a separate plan. Further, the vesting conditions that apply to NED options would be clearly distinguishable from those that would apply to executives. NED options would vest based on service whereas executive options would vest based on performance typically measured by reference to total shareholder return.

Thus, if a NED option plan were to be introduced on terms similar to the example plan, then it would be a separate plan with separate vesting conditions. Accordingly, the guideline that NEDs “should not normally participate in schemes designed for the remuneration of executives” (Principle 8, Box 8.2, Item 1) would be fulfilled even though NEDs would receive options.

In this regard, it should be noted that when NEDs receive shares under a separate NED share plan with no vesting conditions other than service, it is clear, and well accepted, that NEDs are not participating in executive remuneration schemes.

Whether equity is provided in the form of shares or options, any potential conflict of interest that may arise when NEDs exercise discretions in relation to vesting under executive incentive plans, would be avoided by having a separate plan as discussed in the foregoing. Also, adoption of an external performance measure for the vesting condition of executive incentive plans further reinforces their separation from a NED equity plan

Options May Compromise NED Decision-making

In the UK, the NAPF has indicated that it is against the provision of options as they may result in NEDs’ decision-making becoming compromised. This would clearly be the case where a NED had a major shareholding in the company and interests in firms with which the company trades as a supplier or customer. However, such special situations are outside the scope of this paper.

In the previous example, a total of 24,000 options over \$360,000 of shares would be granted to NEDs each 3 years. Such a grant of options, when considered in the context of the value of shares typically held by a NED, the amount of cash fees that would be earned by the NED and the NED’s personal assets, would be unlikely to in any way compromise the decision-making of NEDs.

Even if larger proportions of NED fees were to be converted into option grants, the quantum of fees available to be converted into options would be unlikely to generate sufficient option leverage to compromise NED decision-making. Thus, in Australia, the proposition that converting fees into

options would be likely to compromise the decision-making of NEDs would seem to have little, if any, relevance.

The following table, extracted from the 2008 Top 200 Board Remuneration Report, shows the incidence of use of share and options plans among large Australian companies. There is approximately equal use of share (30%) and option (30%) plans among companies in the \$500 million to \$1 billion market capitalisation range. However, option plans are less frequently used among larger companies.

Share & Option Plans Analysis			
Market Capitalisation	Total No of Companies	% With Share Plan	% Where Directors Have Received Options
> \$10 billion	27	74%	0%
\$5 billion to < \$10 billion	32	50%	3%
\$2 billion to < \$5 billion	45	33%	11%
\$1 billion to < \$2 billion	53	25%	15%
\$500 million to < \$1 billion	61	30%	30%
Total	218	38%	15%

PERFORMANCE LINKAGE

By delivering part of fees in the form of shares, right or options, a performance linkage is introduced into NED remuneration. The performance linkage would be different to that which applies to executives who generally need to satisfy challenging goals for incentive remuneration to be earned. In the case of the NEDs, the value they may ultimately access is influenced by overall company performance as recognised by total shareholder return.

The three types of equity units have different degrees of performance linkage as discussed below:

Equity Unit	Performance Linkage
Shares	<ul style="list-style-type: none"> • Fewest number of equity units required to replace a given quantum of fees. • Longer term performance linkage via share price movements. Some value will arise for shareholders provided the shares have value. • Annual performance linkage via participation in dividends, if any.
Rights	<ul style="list-style-type: none"> • Slightly more rights than shares, if a dividend paying company, required to replace a given quantum of fees. • Longer term performance linkage via share price movements. Some value will arise for rights holders provided the shares have value. • No annual performance linkage as there is no participation in dividends.
Options	<ul style="list-style-type: none"> • Significantly more options than rights or shares are required to replace a given quantum of fees. • Longer term performance linkage via share price growth. No benefit arises for option holders if the share price does not increase. • No annual performance linkage as there is no participation in dividends.

Fee sacrifice share acquisition plans using market purchases have been popular but have the potential to either breach the insider trading provisions or to run into administration problems due to needing to defer share acquisitions until periods when NEDs have no inside information. Rights

and options, which involve new issues of shares when they are exercised, do not suffer from these problems but do need shareholder approval of grants.

The following table shows the outcomes of three equity alternatives to \$40,000 of fees given three share price growth scenarios. In relation to the shares and the value of the rights, it has been assumed that dividends apply at the rate of 75 cents per share.

Equity Units	Value of Equity Unit	Number Granted in Lieu of \$40,000 of Fees	Benefit After 3 Years if \$15.00 Share Price Grows by		
			0%	10%	25%
			\$15.00	\$19.97	\$29.30
Shares	\$15.00	2,667	\$46,006	\$59,261	\$84,136
Rights	\$12.75	3,137	\$47,055	\$62,646	\$91,904
Options	\$5.00	8,000	\$0	\$39,760	\$114,375

NB: The foregoing does not take account of taxation. Subject to the NED making a tax election, the net benefit from options should generally be greater than from shares or rights as options should qualify for the 50% CGT concession.

OTHER CONSIDERATIONS

The following points should be noted in relation to options:

1. For tax deferral to apply to options, there is no need for a general employee share plan to be in place to satisfy the “75% test” which is satisfied when 75% of full-time and permanent part-time employees with 3 or more years of service have received an offer under an employee share scheme. In any event, most NEDs ought to elect to be taxed on the tax value of options in the year they are received so that they may qualify for the 50% CGT concession when the options or shares acquired by exercising the options are subsequently sold, having been held for at least 12 months.
2. Unlike on-market purchased shares, option grants to directors need shareholder approval. However, such approval can cover grants of options for a period of three years, thus reducing the frequency of needing to seek shareholder approval.
3. A potential problem that could arise with option grants is when the value of the options should be taken into account for aggregate fees limit (AFL) purposes. If the accounting charge approach were to be used then:
 - a. if no vesting condition is attached to the options then they would be charged in the year of acquisition, or
 - b. if a vesting condition applies then the value of options granted would be spread over the vesting period and the value to be amortised would depend upon whether:
 - i. a market (share price related including TSR) vesting condition, or
 - ii. non-market vesting condition such as service, attached to the options.

GRG has written to the ASX seeking clarification as to whether the accounting charge or some other approach should be used to take the value of options into account for AFL purposes but at the time of writing this article the ASX has not responded.

0000oooo0000

GRG Contacts

GRG is well positioned to assist boards in reviewing their company's remuneration strategies, incentive plans and employment contract terms. Many of the top Australian listed companies are among our substantial client base.

GRG maintains databases on director and executive remuneration. We capture all the aspects required to be covered in Remuneration Reports and therefore provide an authoritative source of advice in relation to market practices and emerging trends.

Please feel free to call any of the following consultants on **02 8923 5700**

- ◆ Denis Godfrey
- ◆ Allan Vernon
- ◆ Tony Santiago
- ◆ Jeff Smith
- ◆ Ross Parker
- ◆ Meg van Koeverden Brouwer

More information on GRG may be obtained from our website:

www.godfreyremuneration.com