

FSC Guidance Note No. 12.00



Executive Equity Plan Guidelines

April 2007

Table of Contents

Introduction and Background

- 1. Scope of Guidelines**
- 2. Summary of Legal and Accounting Obligations**
- 3. Principles**
- 4. Designing Plans**
- 5. Performance Hurdles and Benchmarks**
- 6. Length of Service Hurdles and Timing Related Events**
- 7. Other Restrictions on Equity Incentive and Ownership Plans**
- 8. Transparency and Accountability**

INTRODUCTION

Executive remuneration, including equity incentive and ownership plans, is an important aspect of corporate governance. All shareholders and directors have a major interest in encouraging improved corporate performance and ensuring the equitable sharing of reward between owners and management.

Companies use equity incentive and ownership plans to encourage superior performance by their senior executives and to assist in retaining them. These Guidelines set out principles that companies can use to develop plans and provide guidance on applying those principles. Boards are encouraged to follow these Guidelines when designing such plans and when seeking shareholder approval for them.

The second edition of these Guidelines was published in May 2000. The publication of this third edition is necessary so as to incorporate and reflect obligations under the current law; accounting standards; and generally accepted good practice regarding the composition and disclosure of executive equity plans.

These Guidelines should be read in conjunction with the ASX Corporate Governance Council Principles of Good Corporate Governance and Best Practice Recommendations.¹

¹ 'Principles of Good Corporate Governance and Best Practice Recommendations', Australian Stock Exchange, March 2003.

1 SCOPE OF GUIDELINES

- 1.1 These Guidelines apply to the development of equity plans which act as incentives by rewarding key company executives for superior performance based on appropriate performance criteria.
- 1.2 There are many types of employee share and option plans operating in Australian companies. These Guidelines use the term equity plans to cover all forms of equity and quasi equity, for example: replicated equity; cash or equity settled plans; and options or rights used by Australian companies.
- 1.3 These Guidelines are not intended to unduly restrict companies' flexibility or ability to attract, motivate and retain the highest quality executives that are capable of driving improved company performance.
- 1.4 These guidelines are designed for equity plans in which executive directors participate; they are not intended to apply to equity plans for non-executive directors.

2 SUMMARY OF LEGAL AND ACCOUNTING OBLIGATIONS

- 2.1 The Corporations Act requires listed companies to prepare a Remuneration Report that discusses the policy for determining the nature and amount of remuneration of senior company executives, and the relationship between the remuneration policy and the company's performance.² The remuneration of relevant company officers must be disclosed in accordance with the Corporations Act and the Australian Equivalents to International Financial Reporting Standards.
- 2.2 The Corporations Act and the accounting standards³ require companies to value, disclose and expense any share based payments provided to executives and others. The valuation and the assumptions underlying those valuations for example, including the price of the shares, the exercise price, the term of the equity, the volatility factor and the rate of interest, must be disclosed.

² Section 300A of the Corporations Act, 2001 (Cth), introduced into the legislation as part of CLERP 9 requires companies to prepare a Remuneration Report which must be put to shareholders for a non-binding vote. Note also the disclosure requirements in AASB 124.

³ Refer to the expensing and disclosure requirements contained in the Australian Accounting Standards Board standards AASB 124 and AASB 2.

3 PRINCIPLES

3.1 Executive equity plans (equity plans) are supported as a means of improving company performance and increasing shareholder value by:

- Attracting quality key executives.
- Motivating and retaining key executives.
- Ensuring that some components of key executives' remuneration remain directly aligned with the fortunes of the company over the medium to longer term.

3.2 It is recognised, however, that equity plans are not the only method of achieving these aims and therefore, will not always be companies' preferred approach.

3.3 The basic principles to be applied when developing executive equity plans (some of which are covered by the law) are:

- Equity plans should be clearly linked to performance against appropriate performance benchmarks that should be capable of providing appropriate remuneration outcomes in a variety of economic and market conditions.
- The executive's remuneration as a whole should be reasonable and comparable with industry standards. The structure and level of their remuneration should also take into account the performance objectives set for the executive, their position and responsibilities.
- The individual elements of each executive's remuneration should be clearly identified and disclosed to shareholders. This should include the components of fixed remuneration; variable remuneration; and details of any equity plans designed to promote medium-term and long-term company performance.
- Transparency, accountability and fairness are essential principles that should guide companies when designing equity plans.
- Disclosure to shareholders should be driven by the aim of providing them with the necessary information including in the following circumstances –
 - where shareholder approval of an equity plan is sought (eg for listing rule 7.1 purposes);
 - where shareholder approval is sought for a grant under the plan to an executive director (listing rule 10.14); or
 - where shareholders are assessing the plan within the context of a non-binding vote on the Company's Remuneration Report

- Any share based payments must be valued, with the underlying assumptions and expenses disclosed and expensed in the Income Statement, in accordance with the accounting standards.

4 DESIGNING EXECUTIVE EQUITY PLANS

- 4.1 The Remuneration Committee of the board, consisting of a majority of *independent* non-executive directors, should be responsible for approving the design and all offers made to key executives under equity plans.⁴
- 4.2 Equity plans serve to align the interests of executives with shareholders by providing direct participation in the benefits of future company performance. The structure of these plans as a whole, including the level of entitlement, performance measures and time periods before entitlement to rewards, should be designed to meet the particular needs of the company in terms of driving improved company performance.
- 4.3 Given the varying circumstances of particular companies and the need for equity plans to reflect those circumstances, these Guidelines do not specify particular plan structures that may be appropriate. Rather, the emphasis is on encouraging the development of equity plans that meet the particular needs of the company, and ensure that all aspects of the plans are clearly explained to shareholders.
- 4.4 Entitlements under an equity plan should be reasonable, taking into account the total remuneration package of an executive and reflect that executive's position and level of responsibility. Although equity plan design will vary, the level of reward that an executive may be entitled to if they achieve their performance benchmarks should generally be consistent with equity plans for companies of similar size, industry and complexity.
- 4.5 An equity plan should also take into account the circumstances of the company, including the market place in which it competes, and the executive at the time of the grant.
- 4.6 Where companies provide executive equity plans, all key executives should be entitled to participate. However, it may be appropriate to have different plans and different entitlements for particular executives to enable companies to attract suitably qualified and talented executives for a range of positions with varying responsibilities. It may also be appropriate to consider using an employee share plan.⁵ When designing executive equity plans, companies should also consider how

⁴ See FSC Blue Book, op cit Guideline 5 and 'Remuneration Committees: Good Practice Guide', AICD at page 12 and the ASX Principles, op cit Principle 9 at page 51.

⁵ See the companion set of Guidelines 'Employee Share Plan Guidelines', AEOA, AICD, ASA and FSC [2006].

a particular executive's entitlement to participate in a plan relates to their contract of employment.

- 4.7 Some companies provide share benefits to executives by way of remuneration sacrifice. That is, instead of receiving cash executives elect to receive an equivalent value in shares. This practice can help link the executive's equity to companies' remuneration strategies. Where possible, companies should only offer these benefits by way of on-market purchase and not by way of new issues. This ensures there is an appropriate alignment of the costs and benefits and that shareholders do not suffer the impact of dilution and lower distributable earnings for the same level of reward.

5 PERFORMANCE HURDLES AND BENCHMARKS

- 5.1 Executive equity plans should be designed to reward superior performance. Companies should develop executive equity plans that provide incentives and rewards based on materially improved company performance in terms of growth in the value of the company and resulting increases in shareholder value. The selection of suitable performance benchmarks are critical to securing this objective and are expected to vary depending on each company's circumstances.
- 5.2 There are many different ways in which companies can design performance hurdles that govern an executive's entitlement under an equity plan. Each company should select performance measures that are most appropriate to measure its materially improved relative performance.
- 5.3 Each company should also clearly disclose these performance hurdles to enable shareholders to evaluate whether they are appropriate. Factors to consider when designing performance hurdles include: the type of company; the size of the company; the volatility of its share price; and its stage in the growth cycle. For these reasons, these Guidelines do not specify particular performance benchmarks as preferred or appropriate for each offer of equity. Rather, these Guidelines emphasise that plans should be carefully designed with a clear link to actual company performance.
- 5.3 Performance hurdles should relate to material improvements in the company's relative performance rather than merely being linked to general market indicators or benchmarks. For example, plans that entitle executives to equity based purely on whether the company's share price reaches a certain level may provide entitlements in a generally rising market regardless of whether the company has materially improved its relative performance. It is recognised that a sufficiently demanding absolute hurdle may be appropriate in certain circumstances (eg in light of the prevailing fixed remuneration), however this should be avoided if possible and the justification for this approach should be disclosed to shareholders.

- 5.4 Without limiting the range of performance measures that may be appropriate for companies, examples of determining improved relative performance include comparing a company's performance with similar companies within a sector or industry over a certain period of time. Other possible measures against which to compare performance include return on funds employed, adjusted earnings per share or total shareholder return. Whatever measures are adopted by companies, they should be capable of providing appropriate remuneration outcomes in periods of both positive and negative economic and market conditions.
- 5.5 Ultimately, the performance measures adopted by companies should encourage materially improved executive performance on an ongoing basis and only reward achievements that are considered appropriate and beyond a base level of performance (eg a level that reflects superior performance). It is important to ensure that the benchmarks provide incentives for executives to materially improve the relative performance of the company.⁶ For example, a poorly performing company may develop a benchmark designed to provide entitlements if there is a major turnaround in the performance of the company. Similarly, a high performing company should select a benchmark that promotes materially improved relative performance and the plan should not provide rewards if the company performance declines relative to its peers.
- 5.6 Where companies develop option plans, the exercise price should not represent a discount to the share price prevailing on or around the day the options are granted.⁷ The methodology for determining the exercise price should be fully disclosed to shareholders. Any costs to shareholders or benefits to executives in the form of share based payments should be valued and disclosed to shareholders. When determining the appropriate exercise price, a company should also consider the overall level of allocation of shares or options and the share price volatility in relation to the proposed performance hurdles.
- 5.7 In the event of a significant decline in the value of the company's shares or negative economic and market conditions, companies should not reset the conditions and/or performance hurdles attached to the issue of options under an executive equity incentive plan without prior shareholder approval.

⁶ The most commonly used hurdle among S&P/ASX 200 companies is a relative Total Shareholder Return (TSR) hurdle, with the company's TSR benchmarked against an index or a group of peers.

⁷ It is acknowledged that in recent years there has been a trend towards more and more use of zero-priced options (commonly called performance rights, performance shares, etc). Such options typically vest based on company performance against a range of indicators, the most common of which is total shareholder return against a peer group of companies.

6. LENGTH OF SERVICE HURDLES AND TIMING RELATED EVENTS

- 6.1 The time period within which executives are entitled to receive shares or exercise options is also an important aspect of executive equity plans.
- 6.2 The plan should incorporate appropriate vesting conditions from the date the relevant securities are granted to the time at which potential entitlements may be received. The vesting conditions should reflect the nature of the plan, performance targets under the plan and the company's performance goals.
- 6.3 Some plans may provide for varying entitlements depending on the level of the executive's performance against the selected performance benchmark. Plans could also provide for rolling entitlements in tranches based on the executive meeting performance targets over a range of time periods.
- 6.4 Some plans may specify certain events (e.g. a person acquiring 20% of the shares in the company) that trigger a vesting of securities. The events that trigger a "change in control" clause and the extent of any vesting (full or partial) should be reasonable and justifiable in the company's circumstances. Companies should disclose the impact, if any, a change in shareholder control would of itself have on the company's executive equity plan(s), specifically in relation to performance based remuneration and the vesting of any rights under the plan.
- 6.5 In the event of early termination of an executive's contract, as a general principle, unless there are extenuating circumstances, it is considered inappropriate for the termination, in itself, to cause a full allocation of unvested rights under an equity plan to arise. Factors influencing the allocation of rights on any early termination would ordinarily include the cause of the early termination, the purpose of the plan and its terms, and applicable laws.

7 OTHER RESTRICTIONS ON EQUITY INCENTIVE AND OWNERSHIP PLANS

- 7.1 A reasonableness test should apply to the number of shares or options issued under executive equity plans. The number of shares or options that will be reasonable to issue will vary according to the individual circumstances of a company.
- 7.2 When determining what is reasonable, companies should consider the nature of their business, competitive situation, industry standards, their existing capitalization and the maximum number of shares or options issued under all employee and executive equity plans. For example, in the case of a start-up or venture capital company, it is likely that a higher level of executive and employee ownership would be considered reasonable compared to the level that would be appropriate for an established listed public company with a large number of employees.
- 7.3 Executives who receive options under an equity plan should not be allowed to participate in rights issues, or bonus issues, or any other preferential equity raising.

However, the exercise price of any options issued under an equity plan should be adjusted to reflect the issue of any new shares.⁸

- 7.4 Ordinary shares issued under an equity incentive and/or ownership plan, or as a result of the exercise of options, should rank equally with shares owned by existing investors.

8 TRANSPARENCY AND ACCOUNTABILITY

- 8.1 All executive equity plans, and other forms of executive remuneration and share based payments, must be fully disclosed and justified to shareholders in accordance with requirements under the Corporations Act. Companies must comply with all relevant laws including taxation and accounting standards and the ASX Listing Rules when designing, implementing and administering executive equity plans.⁹
- 8.2 Companies should also provide shareholders with meaningful information on the application of the board's remuneration policies in respect of all executive equity plans in order to assess whether to approve the plans. Shareholders should be presented with sufficient information to determine whether the plans appropriately reward performance. The plans should be reasonable and clearly linked to appropriate performance benchmarks which measure relative company performance. The elements of plans to be disclosed include: levels of entitlement, performance hurdles, vesting requirements and any restrictions on disposing of shares received as a result of plans. It may be helpful to illustrate in graphical form the relevant performance criteria required to be achieved before executives are entitled to rewards.
- 8.3 Companies should have a written and published policy covering the period before and after the vesting of securities where executives might seek to acquire and/or trade in financial products issued over the company's securities by third parties which operate to limit the economic risk of the equity plan.
- 8.4 Pre-vesting hedging activities should be prohibited, particularly where the company has informed the market that a portion of executives' remuneration is 'at risk'.
- 8.5 The company's policy should also require executives to disclose any post-vesting hedging activities to the company. Any breaches of company policy should be treated seriously, and where material, disclosed to the market.
- 8.6 Shareholders need to assess the cost of plans and whether the possible equity dilution and expenses resulting from the plan is commensurate with the overall benefits of improved company performance.

⁸ Refer to ASX listing rules 6.19 and 6.20.

⁹ See in particular Sections 300(1) and 300A of the Corporations Act and AASB 124.

- 8.7 Therefore, to assist shareholders in determining whether the proposed equity plans are appropriate in the context of the company's overall executive remuneration, the company should disclose the full cost of executive equity incentive and ownership plans to the company and shareholders including:
- the methodology and assumptions used to calculate the cost of the plans¹⁰;
 - the value of share based payments; and
 - the timing and method of purchase or issue of shares or options.

Other Reference Material

FSC Blue Book

AICD 'Remuneration Committees: Good Practice Guide'

AICD 'Remuneration Committees – Issues for Smaller Companies'

AICD Issues Paper 'Executive Service Agreements'

ASA Position Statement 'Equity Based Incentive Schemes'

¹⁰ Institutional investors are particularly interested in the magnitude of any discount applied to take account of the possibility that the options or rights may lapse (eg due to performance hurdles not being satisfied).