While you were sleeping: Invisible buybacks for employee share plans and how to fix them

Report Author:

Martin Lawrence

Ownership Matters

Phone: +61 3 9602 4548

Key Takeaways

- Top 100 companies spent almost $1.63 billion in the most recent financial year buying shares for employees
- These buy-backs, often for insiders such as executives, are largely unregulated
- Many buy-backs reveal confusing or poor capital management

Background

In their most recent financial year, more than a third of S&P/ASX 100 listed entities acquired shares on-market for use in incentive schemes. The total cash cost of these buy-backs was more than $1.6 billion and they occurred with minimal disclosure and no shareholder approval despite a substantial proportion of the cash expended being used to purchase equity for senior company executives.

Purchases fall into two categories – where companies acquire shares on-market to satisfy equity incentives as they vest and where companies establish trusts, managed by third parties, to acquire shares to ensure the trust always has sufficient shares available when vesting occurs.

This situation has arisen because of a regulatory gap, whereby purchases of shares on-market by a company for incentive schemes are not treated as buy-backs under the Corporations Act or the ASX Listing Rules. As on-market purchases of shares do not involve new share issues there is also no requirement under the Listing Rules to provide disclosure when significant quantities of shares are acquired. In some cases, companies have spent significant amounts of cash acquiring shares for executives and other staff while at the same time seeking to conserve cash through other capital management initiatives such as non-payment of dividends and underwriting dividend reinvestment plans. Companies which establish share trusts have also in some cases destroyed value by acquiring shares to be held in the trust in expectation of future vesting only to see share prices fall and no vesting occur. This value destruction is in addition to the inefficient use of franking credits where companies paying franked dividends have seen dividends diverted from shareholders in general to the trust, where they are either retained by the trust or in some cases distributed to staff.

The only insight shareholders have into how much of their cash has been spent on these share acquisitions, and how effectively, is through patchy disclosure in cash flow and equity disclosures in annual financial reports.

The materiality of purchases

At a number of S&P/ASX 100 entities purchases of shares for incentive schemes were significant in the context of the company. In 2012, three entities – Macquarie, Challenger and Lend Lease – acquired more than 1 percent of their issued capital on behalf of employees. In 2012, Macquarie acquired just over 3.5 percent of issued capital on behalf of employees, spending $403 million (total dividends paid to shareholders for the year were $570 million).[1] The Top 100 entities that have in a single year acquired more than 1 percent of shares on issue for employee incentive schemes over the past four years are listed in table 1 below.

[1] Macquarie Group Limited, 2012 annual report, pp. 103 & 124.

Table 1: Share purchases above 1 percent of share capital

Entity	Year[2]	Proportion of shares on issue acquired[3]	Cash spent
Macquarie	2012	3.51 percent	$403 million
Challenger[4]	2012	2.59 percent	$61 million
Challenger[5]	2011	2.19 percent	$51 million
Downer EDI[6]	2009	1.88 percent	$27 million
Macquarie[7]	2011	1.8 percent	$269 million
Challenger[8]	2009	1.57 percent	$26 million
Lend Lease[9]	2012	1.1 percent	$50 million

This list is necessarily incomplete because of the poor disclosure by many companies that acquire their own shares for use in incentive schemes. In the most recent financial year, 22 of the Top 100 companies acquired their own shares for use in incentive schemes but did not disclose how many shares were acquired. This included companies such as Computershare, which in 2012 spent US$22.8 million or nearly 7 percent of operating cash flow, on acquiring its own shares for use in incentive schemes but did not disclose how many shares it acquired.[10]

Computershare is one of three Top 100 companies which in their most recent financial year spent more than 5 percent of operating cash flow acquiring shares for their own incentive schemes.[11] Another, Lend Lease, recorded negative operating cash flow in 2012 but spent $50 million on employee share purchases. Over the last four years, eight S&P/ASX 100 entities have spent more than 5 percent of operating cash flow on incentive scheme purchases. In addition to Lend Lease (which also recorded negative operating cash flow in 2011 while spending $16 million on share purchases), OZ Minerals in 2008, which is the year prior to the sample period, spent $15 million on acquiring its own shares for incentive schemes while posting negative operating cash flow.[12]

Table 2 lists years where purchases of shares for incentive schemes were material to cash flow. At a number of large listed companies purchases

[2] Company financial year.

[3] Calculated using shares on issue at the beginning of the financial year.

[4] Challenger Financial Group, 2012 annual report, p. 98

[5] See n. 4.

[6] Downer EDI Limited, 2009 annual report, p. 77.

[7] See n. 1.

[8] Challenger Financial Group, 2009 annual report, p. 93.

[9] Lend Lease Group, 2012 annual report, p. 140.

[10] Computershare Limited, 2012 annual report, pp. 46 & 68. In 2011 Computershare spent US$30 million on acquiring shares for incentive schemes.

[11] Banks and other financial institutions were excluded from this calculation although only Macquarie and Challenger recorded purchases above 5 percent of reported operating cash flow over this period.

[12] See n. 9, p. 140; OZ Minerals Limited, 2008 annual report, p. 48 & OZ Minerals Limited, Half-year Report 30 June 2008, p. 9.

were large but not material in the context of cashflow – BHP Billiton, for example, spent US$424 million in 2012 acquiring shares to satisfy equity incentive allocations (and almost US$1.34 billion over the last four years) but this represented less than 2 percent of operating cash flow in 2012;[13] in the 2012 financial year Rio Tinto spent US$103 million on purchases of shares under equity incentive schemes (and US$435 million over the past four years) but this was equivalent to less than 1 percent of cash flow.[14]

Table 2: Share purchases 5 percent or more of operating cash flow

Entity	Year[15]	Shares purchases as proportion of operating cash flow	Cash spent	Where disclosed
UGL[16]	2012	16.22 percent	$18 million	Financing cash flow
Computershare[17]	2011	9.37 percent	US$30 million	Financing cash flow
Downer EDI[18]	2009	8.11 percent	$27 million	Issued capital note[19]
Amcor[20]	2012	6.84 percent	$71 million	Financing cash flow
Computershare[21]	2012	6.83 percent	US$23 million	Financing cash flow
GPT[22]	2009	6.08 percent	$7 million	Issued capital note
Seek	2010	5.92 percent	$5 million	Financing cash flow
UGL	2011	5.63 percent	$8 million	Financing cash flow
Iluka Resources	2010	5.48 percent	$10 million	Financing cash flow

[13] BHP Billiton, 2012 annual report, p. 172; 2011 annual report, p. 164.

[14] Rio Tinto, 2012 annual report, pp. 183-184; 2011 annual report, pp. 171 & 173.

[15] Company financial year.

[16] UGL Limited, 2012 annual report, p. 68.

[17] See n. 10.

[18] The 2009 purchases are not disclosed in Downer EDI's 2009 cash flow note as a separate line item. See pp. 38 & 77 of Downer's 2009 annual report.

[20] Amcor Limited, 2012 annual report, p. 59.

[21] See n. 10.

[22] The 2009 purchases are not disclosed in GPT's 2009 cash flow note as a separate line item. See pp. 94 & 147 of GPT's 2009 annual report.

Entity	Year[15]	Shares purchases as proportion of operating cash flow	Cash spent	Where disclosed
Qantas	2009	5.05 percent	$58 million	Financing cash flow

Disclosure vacuum

There is no regulatory regime for share buy-backs for incentive schemes, regardless of materiality.[23] This regulatory hole is illustrated by Qantas - over the four years to 30 June 2012, Qantas has spent $155 million in cash acquiring its own shares for employees, including $65 million in 2011 but was required to disclose these purchases to shareholders only in half year and full year financial reports, and was not required to disclose the number of shares acquired. Since announcing a formal buy-back on 15 November 2012, as required under the ASX Listing Rules, Qantas has provided notification the day following any purchases and the total price paid. To 24 January 2013 Qantas had spent $25.5 million acquiring almost 17.3 million shares under the formal buy-back. That is, there was greater disclosure of these purchases than much larger purchases in 2009 and 2011 under the buy-back for incentive scheme purposes.[24]

The only company to give advance warning of share purchases for incentive schemes is Macquarie Group, which in April or May of 2010, 2011 and 2012 has declared the amount it intends to spend acquiring its own shares under its Macquarie Employee Retained Equity Plan and the period over which it intends to make these purchases before disclosing the average price paid per share when purchasing is completed. This may be due to the sheer size of purchases made by Macquarie under MEREP, spending $403 million in the 2012 financial year, $269 million in the 2011 year, and another $242 million over the six months to 30 September 2012. Even in the case of Macquarie however there has been less disclosure provided of these purchases than under Macquarie's buy-back of up to $500 million shares under the buy-back announced on 27 April 2012.

This lack of disclosure extends to the conduct of buy-backs, as companies are not required to disclose whether share purchases are carried out internally or by an external party, and, if by an external party, under what terms (as the controls around prices able to be paid under Corporations Act buy-backs presumably do not apply to employee buy-backs). Some disclosure can be provided through close perusal of cash flow notes in the accounts. Packaging company Amcor for example in 2012 entered into a $120 million "forward contract to purchase own equity to meet share plan

[23] ASX Listing Rule 3.8A makes reference to an 'employee share scheme buy-back' but this refers to a company repurchasing shares issued to employees under an equity scheme. Buy-back is not a defined term in the Listing Rules.

[24] Over the six months to 31 December 2012 Qantas spent $12 million on its buy-back but $16 million acquiring shares for incentive schemes. See p. 19, Qantas interim report for the six months to 31 December 2012.

obligations" although the identity of the other party to the contract was not disclosed.[25] By contrast Amcor was required to disclose under the ASX Listing Rules that it was Deutsche Securities that carried out the $150 million buy-back undertaken during 2012. Another company, Rio Tinto, notes in its 2011 financial report that vested equity incentives over Rio Tinto Limited shares were satisfied through share purchases made "by a third party on the Group's behalf".[26]

Key concerns over the current disclosure vacuum on incentive share acquisitions are:

- When are shares acquired?
- How many shares are acquired?
- At what price are shares acquired?
- How many shares are held in 'treasury'?
- Who acquires shares?
- Who controls shares held in treasury?

The regulatory confusion over employee incentive scheme acquisitions is also indicated by the accounting treatment of shares held in 'employee share trusts'. These shares are treated as 'treasury shares' despite Australian companies now being prohibited from holding their own shares in treasury after they are repurchased, with shares bought back under formal buy-backs cancelled.[27] Shares held in share scheme trusts, whether held by the company or by an external trustee – in some cases, companies use their share registry as the external trustee – are often not counted in calculating earnings per share and are deducted from equity. There is however no requirement for Australian companies to disclose how many shares they hold in treasury at their reporting dates, or how many shares they acquired during the year, unlike jurisdictions like the UK, where companies may hold their own shares after buy-backs including for use in employee share schemes but are required to provide regular updates on the number of shares held in treasury.

The unusual legal status of shares held in 'treasury' in employee share trusts in Australia also extends to their capacity to be voted and receive dividends, unlike treasury shares in other jurisdictions like the UK. This eligibility for dividends has perverse implications for companies making on-market share purchases for employee share trusts to avoid dilution as shares held in the trust **will receive dividends**, diverting dividends (and attributable franking credits) from shareholders as a whole to either beneficiaries of the trust – normally senior executives – or to punitive taxation as income retained in the trust.[28] In contrast, companies who issue new shares when

[25] See p. 106, Amcor 2012 annual report.

[26] See p. 172, Rio Tinto 2011 annual report.

[27] Section 259C of the Corporations Act specifies a narrow set of exemptions over when a company may hold its own shares, usually in cases where it is acting as a trustee on behalf of investment or insurance funds. The Australian Securities & Investment Commission (ASIC) is able under the Act to give relief from the prohibition on a company holding its own shares and these exemption notices are regularly filed by insurers and banks.

[28] This will not occur at companies which acquire shares on-market only when vesting actually occurs rather than attempting to 'hedge' by acquiring shares via a share trust. This exposes the company to the risk of having to expend more cash than expected to acquire shares if more

vesting occurs dilute existing shareholders after issue but do not divert dividends (and franking credits) from shareholders as a whole to employee share trust shares held for executives that are yet to vest.

Leakage can also occur in other ways such as through rights issues. For example, in 2010 Downer EDI conducted a renounceable entitlement offer and executives who were beneficiaries of shares held in the employee share trust were eligible to receive the premium – paid by current and new Downer EDI shareholders - received by shareholders who chose not to take up their rights. AGL point too??

Capital destruction

The lack of information available to shareholders on incentive plan share purchases has also meant shareholders have limited oversight over what is effectively a form of capital management. If a company is pursuing a buy-back that shareholders consider ill-advised they are able to obtain immediate information and bring their concerns to the company's board and management. In the case of incentive share purchases shareholders are only able to discover partial information after (often long after) the purchases have occurred. This is despite evidence emerging of companies frequently making poor or contradictory purchasing decisions, as the examples below show:

- **Qantas:** The company in the interests of cash conservation ceased paying dividends at the end of the 2009 financial year and has continued to pay no dividend – although it did commence a $100 million share buy-back. Despite this, Qantas spent $65 million in the six months to December 2010 acquiring its own shares for use in incentive schemes after spending $58 million acquiring its own shares for incentive schemes in the six months to December 2008.
- **QBE Insurance:** In February 2012 QBE announced a placement and share purchase plan to raise $600 million in capital to pay down convertible debt after the Australian Prudential Regulation Authority (APRA) indicated this debt may no longer be considered as regulatory capital. The company nonetheless spent US$30 million during the year acquiring its own shares to satisfy equity incentives.
- **OZ Minerals:** In the last six months of 2008, a period which ended with the company being unable to roll over its debt as its cash reserves were rapidly depleted and commodity prices fell, the company spent $14.3 million acquiring its own shares for delivery under its equity incentive plan.

Other companies such as Fairfax Media, Telstra, Aristocrat and Downer EDI spent considerable sums in past years acquiring shares for share trusts ahead of major share price declines. These companies now, while they have no need to acquire new shares to satisfy vesting of incentive grants, have sat on substantial cash losses from past share acquisitions for many years. At Telstra for example, as at 30 June 2007 the average price of the shares held in the Telstra Growthshare Trust was $5.56 and the number of shares held in the trust increased by 24.649 million at an average price per share of just under $4.60 per share. This came after Telstra spent $129 million in the first six months of the 2008 financial year acquiring its own shares for employee share plans. The company's share price only returned to those

vest – or if the share price is high - but protects shareholders from capital leakage through holding shares in trust eligible for dividends to satisfy incentives that never vest.

levels early in 2013, rendering the 10 million shares allocated out of the trust over the four years to 30 June 2012 more costly to Telstra shareholders than issuing new equity – which would not have attracted dividends over that period – or simply acquiring the shares on vesting.

In the absence of management explanations for why companies chose to acquire their own shares for use in incentive schemes it is hard to evaluate how company's view these purchases in the context of overall capital management – if at all. One of the few companies to over time explicitly explain its decisions in regards to sourcing employee equity scheme allocations has been Macquarie which has clearly viewed and described its decisions over employee equity allocations as part of overall capital management.[29] On a related issue it is unclear whether APRA requires the listed entities that it regulates to obtain approval prior to acquiring their own shares for use in incentive schemes given its requirement as prudential supervisor of banks and insurers for these entities to obtain its approval prior to undertaking a formal buy-back or other form of capital return.[30]

Fixing the problem

The present surreptitious buy-backs under incentive schemes raise two concerns: firstly, a lack of information over when, why, how and how many shares are acquired and held by a company for incentive schemes and, secondly, the 'insider problem', given the lack of controls over equity scheme allocations under Australian regulation.

Fixing the information problem is relatively simple:

- The ASX should amend the Listing Rules to include incentive share plan purchases under its buy-back disclosure requirements; and/or
- The ASX should require listed companies to disclose on a monthly basis how many shares had been acquired on-market for use in incentive schemes and through what mechanism; at what average price; why the company had decided to acquire rather than issue and how many shares were held as 'treasury' shares under incentive schemes at month end; and
- ASIC should provide guidance to companies on the required disclosures in contributed equity and reserves notes to ensure the number of shares acquired for use in incentive schemes; the number held in treasury as at balance date and the amount spent on incentive scheme buy-backs were all disclosed.

The above proposals would pose minor disclosure burdens on listed companies.

Attempting to give Australian shareholders a measure of control over how much equity may be allocated under equity incentive schemes, either through on-market purchase or new share issues is likely to be more difficult given it is likely to encounter significant opposition from groups representing the management of listed companies.

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[29] See, for example, Macquarie Group Limited, 'Result announcement for the half year ended 30 September 2009: Presentation to Investors and Analysts', 30 October 2009, p. 32 or p. 25 of the 2012 results announcement on 27 April 2012.

[30] See for example Australian Prudential Regulation Authority, 'Prudential Standard APS 110: Capital Adequacy' and 'Prudential Standard GPS 110: Capital Adequacy'.

At present the only limitation on allocations under incentive schemes is ASX Listing Rule 7.1 which limits new equity issues – including options – to 15 percent of shares on issue over any rolling 12 month period if issued without preemptive rights. ASIC Class Order 03/184 is often interpreted as imposing a limit on issues under incentive schemes to 5 percent of shares on issue but this limit exempts issues to persons located offshore and anyone considered to be a 'sophisticated' investor, a group likely to include most listed company senior executives. This reflects the Class Order's purpose of exempting companies from having to prepare a prospectus for share plan issues.

The only other limit on new share issues is if they are made to directors under ASX Listing Rule 10.11 or 10.14 (although since 2005 if shares are acquired on-market under an incentive scheme and transferred to a director no approval from shareholders is required).[31]

There does not appear to be any limit on the number of shares a company would be able to acquire on-market for use in incentive schemes, other than any specific limits that may be imposed by regulators such as APRA. The 10 percent limit over any 12 month period for a buy-back without shareholder approval under the Corporations Act does not appear to apply, given the other requirements relating to a buy-back do not apply to incentive plan acquisitions.

The existing regulatory environment privileges the acquisition of shares on-market for incentive schemes given the absence of any meaningful disclosure requirements, shareholder approvals or limits. A potential solution is as follows:

- Amend the Listing Rules to **require** shareholder approval for the allocation of equity under incentive schemes for the forthcoming year;
- Require the approval to specify the maximum number of shares able to be allocated under incentive schemes over this period and the number allocated over the prior period; [what about pre-approval of a dollar amount so shareholders know what the capped liability would be?]and
- Specify whether the shares would be acquired on-market or newly issued, and disclose the number acquired and the number issued over the prior period.

This would give companies the flexibility of being able to ask shareholders for as many or as few shares for employee share plans as required, remove the regulatory preference for share acquisitions over new share issues under incentive plans and give shareholders better visibility and actual control over dilution or potential misallocation of capital through incentive share plans.

[31] In some cases the on-market exemption for purchases for directors has given rise to perverse outcomes. UGL, for example, at the end of its 2009 financial year chose to issue 560,000 new shares under incentive plans to be held until vesting in December 2011 but acquired at a similar time 43,205 shares for its managing director as a 'succession incentive'. By acquiring the shares UGL was able under Listing Rule 10.14 to avoid shareholder approval for this allocation to its CEO, Leupen.