

Designing a Worldwide Program of Stock Settled Appreciation Rights (SSARs)

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Roche

Basel, Switzerland
Founded in 1896
Healthcare

- Pharmaceuticals
- Diagnostics

65'000 employees
Approx. 150 countries
Majority holdings in Genentech and Chugai


Roche equities

Bearer shares (voting stock)
Genussscheine (non-voting equity securities)
Liquidity of voting shares - Pooled rights on > 50%
Unable to issue new Genussscheine under Swiss law
Listed on Swiss Exchange (not listed in US or EU)
American Depository Receipts in US

Background

Previously, 2 main equity-based LTI plans at Roche


- **Cash-settled SARs** (Stock Appreciation Rights) in North America
 - Similar to an option but only receive cash value of gain – no stock
 - Granted over Roche ADRs, not Genussscheine (GS)
- **Roche Option Plan** (used outside of North America)
 - Granted over Roche GS



Need for change (1)

Align rewards more strongly with Roche's "Winning for the Future" strategies


- Positive feedback for option plan, but less direct linkage through C-SARs
- No opportunity to receive stock from C-SARs
- Desire to retain simplicity in design
- Gearing of LTI awards



Need for Change (2)

Reflect Roche as a global company in the way we reward people


- Previous differences in options and C-SARs
 - Underlying stock
 - Grant dates, vesting and life
 - Award methodologies



Need for Change (3)


Improve how we account for and control our long-term incentive costs

- Requirement to settle awards with existing not newly issued stock
- Complexity of hedging ADR movements
- Fluctuating charges from cash settled plan
- Accountability of businesses/affiliates for LTI costs
- Joint HR and Finance project to address IFRS2 changes and LTI plan design



Need for Change (4)

Respond to US legislation where current plan was no longer feasible



Roche Long Term

Outcome


Roche Long Term

- **Stock-settled SARs**
- **Options still used if more effective**

Common program – same:

- Underlying stock
- Award terms
- Award methodology





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Design aspects - Agenda


Working with Roche
History of existing plans
Review methodology
Initial design
Tax problems in the US
Solutions to US problems
General lessons to be learnt

Working with Roche

It started as a typical LTIP review
It needed consultants on the ground in the US and Europe
It seemed straightforward at the time
There is a very high level of expertise inside the client company


History of existing plans

Parent company option plans only introduced in this century
US subsidiary had a much longer history of using LTIPs to attract and incentivise staff in a highly competitive market for talent
Roche shares not registered with the SEC so not possible to grant options – cash settled SARs used instead




Review methodology

Standard procedure followed:
Review existing plans and corporate objectives,
Interview key business executives to get their perceptions of existing plans and areas for improvement
Benchmark awards with global and local competitors
Undertake trends analysis
Present findings, conclusions and recommendations in two day design meeting in NJ



Initial design

Basic design of option/SAR met the needs of the company and supported corporate growth strategy
However, the cash settled SARs created major problems with budgeting when the company did well
AJ throw away line – that's easy to solve following IFRS2 – lets spend time on the hard bit and get the design right



Initial design

The key to the solution – stock settled SARs met US needs and Swiss requirements and satisfied US securities laws and reduces P&L charges by up to approximately US\$140m a year

We needed to set out strategy to US securities lawyers, US benefits lawyers and Roche and KPMG
After meeting in Basel with Finance, Tax, Treasury and KPMG we got full sign off.



Initial design – harnessing IFRS2

Cash settled SARs are a liability and cost amount of gain – varied from \$0 to \$195m

Stock settled SARs are equity instrument and cost is market value at date of grant – about \$55m

Expense over 3 year vesting period



Tax problems in the US

Life is never that easy

George Bush signed the American Jobs Creation Act 2004 in October creating a new 20% tax charge + penal interest rate (6% a year)

Clear statement from Treasury and IRS that the act applied to SARs but not Stock Options– reasons given

The 20% tax penalty killed our design



Solutions to US problems

Back to the drawing board
US has the biggest executive population but Roche has participating executives in 55 countries
SAR with fixed payout schedule should avoid the new charge -Less flexibility but acceptable to the US
Two strategies – 1 lobby Treasury and Congressmen to show inconsistency of the proposed treatment – 2 flesh out SAR with fixed payout schedule in case strategy1 failed

Solutions to US problems

Launch of new program in early 2005
Needed separate US rules and communication materials
Treasury and IRS published guidance on 20 December 2004
Lobbying won – exemption for stock settled SARs when shares listed on recognised overseas exchange
One program was all that was needed

General lessons to be learnt

You do not always know what all the issues are until they suddenly emerge
Expensing of options has given a real opportunity to add value when SARs are used by companies for US employees
Lobby in the US – it can work!



Technical Issues Arising from the Implementation of a Worldwide Program of Stock Settled Appreciation Rights (SSARs)

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Key Issues

- Less prescriptive legislative systems
 - No specific tax rules for equity plans
 - Even if some rules (for eg options), authorities unfamiliar with SSARs
 - How should SSARs be treated - as options, cash SARs or share awards?
- Recent legislative changes
- Recharges and corporation tax deductions
- Use of Genussscheine rather than 'ordinary' stock
- Securities Laws

Uncertainty of Tax Rules

Ireland

- Are SSARs regarded as:
 - an 'option'; or
 - an award of shares that takes place at the time of exercise?
- Income tax charge is the same and no social security due
- However reporting obligations differ and tax must be paid at an earlier time if options
- Treated as options - the most prudent approach and also consistent with the language used elsewhere in the plan.

Uncertainty of Tax Rules

Switzerland


- Regulations cover stock options, stock purchase plans and stock appreciation rights but no specific rules for SSARs
- Regarded in the same way as cash settled appreciation rights – tax charge at exercise

New Legislation

- In addition, possible new legislation for stock options announced in November 2004 can reduce taxable gain when options exercised
- But unclear on whether would this apply also to SSARs

Expatriates


- Different cantons have different rules on taxation of stock options for expatriates (Cantons also changing their approach!)
- Draft legislation in Nov 2004 proposed harmonisation



Uncertainty of Tax Rules

Netherlands

- Is the SSAR regarded as a stock appreciation right or an option?
 - If an option, CT deduction possible at vesting, based on a valuation formula;
 - If a SAR, CT deduction at exercise based on the amount that's taxable on the employee
- In either case, not necessary to make a recharge in order to obtain the CT deduction (although if no recharge, capital taxes implications for Dutch entity)
- Further complication as this advice based on proposed legislation which was due to come into effect from 1 Jan 2005



Uncertainty of Tax Rules


Belgium

Tax Point

- Deloitte Belgium advised that, on strict technical interpretation, SSARs taxable at vesting
- However, anticipated that tax authorities would expect tax at exercise – this may well be preferable for Roche
- Consider seeking ruling but expected that authorities would insist on tax at exercise

Social Security


- Social security due if recharge (not intended) or Belgian entity 'intervenes' in decision-making process
- Unclear what is regarded as 'intervention' – 'suggesting' names of employees for awards could be sufficient



New Legislation

USA


- Previously tax charges would arise on exercise of the SSARs
- But confusion arose due to American Jobs Creation Act published in Autumn 2004
- Meant that tax charge may instead have arisen at vesting
- However, following publication of Treasury regulations, SSARs will continue to give rise to tax charge at exercise rather than vesting



New Legislation

Mexico

- New legislation for stock options due to come into effect from 1 Jan 2005
- Unclear if applies equally to SSARs but anticipated that it would do so
- If legislation applies, would fundamentally alter taxation of SSARs
- In old regime, employee would be taxed on the amount recharged at time of recharge
 - If no recharge, no tax until sale
 - However, in Mexico, was hoped to make recharge at grant – therefore potential up front tax charge for employees (based on amount recharged)
- In new regime, options taxed at exercise - would this apply for SSARs?




New Legislation

Uruguay

- Currently no system of income tax in Uruguay
- However, new Government came into power on 1 March 2005
- Anticipated that new income tax regime to be implemented – but many unknown items
 - what form this might take
 - when it would come into effect

Greece

- Previously, if no recharge, withholding not due
- But recent ruling from Ministry of Finance suggests withholding due even if no recharge



Recharges and Corporation Tax Deductions

- Asked to consider if Corporation Tax deduction would be possible for local entity
 - If so, on what basis/when?
 - Would recharge be required?
 - How would this impact taxation of SSARs for employee?
- Roche not generally intending to operate recharge between parent and local entity unless values exceeds a threshold
- If recharge were made, would be up-front based on IFRS 2 valuation

Recharges and Corporation Tax Deductions


- Rules on CT deductibility not often clear (unlike eg UK)
 - Often, deduction available on paid basis if recharge made (and agreement in place)
 - but could then give rise to up-front tax charge for employee (eg Mexico)
 - However, in eg China, deduction may be possible - but would not be available until exercise
 - Alternatively, in eg Brazil, if recharge made get deduction for amount taxable on employee – not necessarily the amount paid under recharge

Use of Genussscheine

- Genussscheine (GS) are a dividend bearing, non-voting equity security listed on the Swiss Exchange (SWX) in Zürich and traded on virt-x Exchange Limited in London
- Can affect whether CT deduction is available – eg in **Germany**, intended to operate recharge – CT deduction available in this case as 'market purchase'
- Can also affect Securities Laws – eg in **Australia**, what Securities Laws implications/exemptions might arise depends on whether stock is market purchase or newly issued – more onerous requirements for market purchase

Securities Laws


- In some countries, Securities Laws might arise for vanilla options – typically as employee have to pay an amount to exercise option
- However, with SSARs, employees don't have to actually pay any money on exercise.
- Therefore unclear on whether, and to what extent, Securities Laws will apply
- Securities Laws differ from country to country



Securities Laws

Pakistan

- Would the Public Companies (Employees Stock Option Scheme) Rules, 2001 apply to SSARs?
- Possible additional administration
- But, more importantly, would be necessary to make an accounting charge for the 'fair value of the options'
- Approached the SECP on a 'no-names' basis but no ruling given




Securities Laws

Venezuela

- Previous rulings suggested that there could be "Public Offer" for Securities Laws purposes if options granted to more than 1 person
- Would this apply equally to SSARs? Employees not required to 'invest' any funds to acquire Genussscheine

New Zealand

- Similarly, would award of SSARs be 'an offer of securities to the public'?
- Awards of free shares not included if no 'consideration' from employee
- If plan does fall within disclosure regime, would the plan fall within one of the exemptions which are available



Questions?

Thank you for your participation

