The Executive Remuneration Review

Fourth Edition

Editors
Arthur Kohn and Janet Cooper

Law Business Research

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Fourth Edition

Editors
Arthur Kohn and Janet Cooper

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EDITOR'S PREFACE

Executive remuneration encompasses a diverse range of practices and is consequently influenced by many different areas of the law, including tax, employment, securities and other aspects of corporate law. We have structured this book with the intention of providing readers with an overview of these areas of law as they relate to the field of executive remuneration. The intended readership of this book includes both inhouse and outside counsel who are involved in either the structuring of employment and compensation arrangements, or more general corporate governance matters. We hope that this book will be particularly useful in circumstances where a corporation is considering establishing a presence in a new jurisdiction and is seeking to understand the various rules and regulations that may govern executive employment (or the corporate governance rules relating thereto) with regard to newly hired (or transferring) executives in that jurisdiction.

The most fundamental considerations relating to executive remuneration are often tax-related. Executives will often request that compensation arrangements be structured in a manner that is most tax-efficient for them, and employers will frequently attempt to accommodate these requests. To do so, of course, it is critical that employers understand the tax rules that apply in a particular situation. To that end, this book attempts to highlight differences in taxation (both in terms of the taxes owed by employees, as well as the taxes owed – or tax deductions taken – by employers), which can be the result of:

a the nationality or residency status of the executives;

b the jurisdiction in which the executives render their services;

c the form in which executives are paid (e.g., cash, equity (whether vested or unvested) or equity-based awards);

d the time at which the executives are paid, particularly if they are not paid until after they have 'earned' the remuneration; and

e the mechanisms by which executives are paid (e.g., outright payment, through funding of trusts or other similar vehicles or through personal services corporations).

In addition to matters relating to the taxation of executive remuneration, employment law frequently plays a critical role in governing executives' employment relationships with their employers. There are a number of key employment law-related aspects that employers should consider in this context, including:

a the legal enforceability of restrictive covenants;

b he legal parameters relating to wrongful termination, constructive dismissal or other similar concepts affecting an employee's entitlement to severance on termination of employment;

c any special employment laws that apply in connection with a change in control or other type of corporate transaction (e.g., an executive's entitlement to severance or the mechanism by which an executive's employment may transfer to a corporate acquirer); and

d other labour-related laws (such as laws related to unions or works councils) that may affect the employment relationship in a particular jurisdiction.

The contours of these types of employment laws tend to be highly jurisdiction-specific and therefore it is particularly important that corporations have a good understanding of these issues before entering into any employment relationships with executives in any particular country.

Beyond tax and employment-related laws, there are a number of other legal considerations that corporations should take into account when structuring employment and executive remuneration arrangements. Frequently, these additional considerations will relate to the tax or employment law issues already mentioned, but it is important they are still borne in mind. For example, when equity compensation is used, many jurisdictions require that the equity awards be registered (or qualify for certain registration exemptions) under applicable securities laws. These rules tend to apply regardless of whether a company is publicly or privately held. In addition to registration requirements, it is critical for both employers and employees to understand any legal requirements that apply in respect of executives' holding, selling or buying equity in their employers.

Given the heightened focus in many jurisdictions on executive remuneration practices in recent decades – both in terms of public policy and public perception – the application of corporate governance principles to executive compensation decisions is crucial to many companies. Decisions about conforming to best practices in the field of executive remuneration may have substantial economic consequences to companies and their shareholders and executives. Corporate governance rules principally fall into two categories. The first concerns the approvals required for compensatory arrangements; a particular remuneration arrangement may require the approval of the company's board of directors (or a committee thereof) or even, in certain circumstances, the company's shareholders. The second concerns the public disclosure requirements applicable to executive remuneration arrangements; companies should be aware of any disclosure requirements that may become applicable as a result of establishing a new business within a particular jurisdiction, and in fact may wish to structure new remuneration arrangements with these disclosure regimes in mind.

Finally, we would be remiss in discussing the topic of executive remuneration without highlighting the financial services industry. The global financial crisis has, of course, led to a worldwide effort in recent years to more stringently regulate the manner in

which those working within the financial services industry are paid. We hope that readers find the following discussion of the various tax, statutory, regulatory and supervisory rules and authorities instructive.

Arthur Kohn
Cleary Gottlieb Steen & Hamilton LLP
New York
October 2015

Chapter 20

UNITED KINGDOM

Mahesh Varia[1]

I INTRODUCTION

The 2015 AGM season exposed the full impact of the voting regime for directors' remuneration introduced in 2013. This requires UK-registered companies with equity listed on the main UK market, in another state in the EEA or on NYSE or NASDAQ to put a pay policy to a binding shareholder vote every three years. It seems that effective dialogue between companies and their shareholders has paid off as remuneration policies have generally seen stronger levels of support than in 2014. Deferral and clawback of bonuses and long-term incentives continue to be 'hot topics' with trends from the financial services arena filtering down to other sectors.

This year has been the first in which companies have had to get to grips with online registration and reporting of their employee incentive arrangements. Since 6 April 2014, all companies operating share-based incentives for employees in the United Kingdom have been required to register their arrangements electronically and then submit an online return by 6 July.

Since 6 April 2015, new tax and social security rules apply to share-based incentives held by internationally mobile employees. Companies now have to monitor the tax residence status of the participants in their share plans over the 'life' of the relevant award. Finally, the first Conservative government in nearly 20 years has announced that it will consider some fundamental changes to the UK tax system, notably strengthening the rules on false self-employment and looking at the possibility of aligning the income tax and social security regimes.

1 Mahesh Varia is a partner at Travers Smith LLP.

II TAXATION

i Income tax for employees

The rules determining an individual's residence for UK tax purposes are complex and depend on the person's particular circumstances. In the United Kingdom, an individual's liability to tax is determined by whether he or she is resident and domiciled in the country. The underlying principle is that those with the strongest links to the United Kingdom should pay more tax than those with weaker connections.

Although in the past the concepts of residence and domicile have not been defined by statute, from 6 April 2013, a statutory residence test was introduced, and the pre-existing concept of ordinary residence was effectively abolished.[2]

Broadly speaking, individuals who are UK-resident and domiciled in the United Kingdom are subject to UK income tax on their worldwide income, whereas those who are not pay tax only on income with a UK source. In the summer budget of 2015, the government announced changes to the domicile rules from 6 April 2017 which (if enacted) will mean that individuals who are UK-resident for more than 15 out of the last 20 tax years will be deemed to be UK-domiciled for all tax purposes.[3]

The rates of income tax for the 2015/16 tax year[4] are as follows:

	Bands	*Rate*	*Tax on band*
Basic rate	Up to £31,785	20%	£6,357
Higher rate	£31,786 to £150,000	40%	£47,286
Additional rate	Over £150,000	45%	N/A

The government has announced measures under which the rates of income tax will not increase during the current parliament (known as the Tax Lock).[5]

Generally, all compensatory payments are subject to income tax at the rates referred to in the above table. There are, however, certain forms of tax advantaged share plan under which benefits are taxed as capital rather than income, provided specified statutory criteria are met. Capital treatment is more favourable than income treatment for a number of reasons. To begin with, the highest rate of capital gains tax is currently 28 per cent. Further, individuals are able to utilise an annual exemption from capital gains tax in respect of gains of up to £11,100 (for the tax year 2015/16). The tax advantaged plans commonly used for executives are the company share option plan (CSOP) and enterprise management incentives (EMIs). One particular feature of EMIs is that the disposal of shares acquired pursuant to them can benefit from a lower capital gains tax rate of 10 per cent.[6]

2 Finance Act 2013, Sections 218 and 219 and Schedules 45 and 46.

3 Her Majesty's Revenue & Customs (HMRC): Technical Briefing on foreign-domiciled persons changes announced at summer budget 2015, 8 July 2015.

4 The UK tax year runs from 6 April to 5 April.

5 HMRC: Tax Lock: Income Tax, National Insurance contributions and VAT, 8 July 2015.

6 Taxation of Chargeable Gains Act, Section 169I(7A)–(7R).

The government has made significant changes to the rules applicable to tax advantaged plans with a view to both improving and simplifying them.[7] Most of these plans (including CSOP) required advance approval from HMRC before they could be operated. From 6 April 2014, this prior approval process was replaced by a self-certification regime under which tax advantaged plans (including those previously approved by HMRC) must be registered with HMRC online and certified by the company as meeting the necessary statutory conditions. Although this reduces the time within which such plans can be implemented, it is at the expense of the reassurance that prior approval gave. EMIs have always operated on a self-certified basis; however, from 6 April 2014, all EMI plans need to be registered and the grant of awards notified to HMRC online. Annual returns for all share incentive arrangements (including those that are non tax advantaged) for the 2014/15 tax year onwards must be filed with HMRC online and by 6 July.

Plans under which participants own shares from the outset remain popular and can give rise to growth that is taxed as capital. The government continues to be mindful of arrangements that seek to disguise remuneration as capital, and in recent years has introduced a number of anti-avoidance measures to combat them.[8]

The UK income tax rules for non-tax-advantaged stock options, restricted share acquisition plans and restricted stock units are set out in the table below. It should be noted that in the United Kingdom it is common for restricted stock units to be structured as nil cost stock options, as these offer greater flexibility over when income tax becomes payable and enable employers' social security obligations to be transferred to employees.

	Option	*Restricted stock acquisition plans*	*Restricted stock units (structured as a nil cost option)*
Tax treatment upon grant	No tax	No tax if unrestricted market value paid. Otherwise, income tax on discount if election to be taxed on grant is made	No tax
Tax treatment upon vesting	No tax	Income tax may arise on lifting of restrictions if unrestricted market value is not paid or if no election is made to be taxed on grant	No tax
Tax treatment on exercise	Income tax on the difference between market value of shares on exercise and exercise price paid	N/A	Income tax on the difference between market value of shares on exercise and exercise price paid

7 Finance Act 2013, Section 14 and Schedule 2 and Finance Act 2014, Section 51 and Schedule 8.

8 For example, Income Tax (Earnings and Pensions) Act 2003, Part 7A.

Tax treatment upon sale of underlying shares	Capital gains tax payable on difference between share sale price and market value of shares on exercise	Capital gains tax payable on difference between share sale price and market value of shares on acquisition (if no tax paid on vesting)	Capital gains tax payable on difference between share sale price and market value of shares on exercise

On 6 April 2015, changes enacted in the 2014 Finance Act[9] which reform the way in which share-based incentives held by internationally mobile employees are taxed took effect. The changes were made in response to concerns that the existing rules did not always match those applicable to other forms of employment income. The new provisions apply to awards held or awarded on or after that date and will require employers and employees to monitor the award-holder's residence over the 'life' of the award. In the case of a share option this will generally be from the date of grant until the award 'vests'.

As a matter of good corporate governance, it is becoming increasingly common for part of a bonus paid to an executive to be deferred, either on a voluntary or compulsory basis. The deferred element of the bonus is usually provided in the form of an option that vests after a period of time. Sometimes executives are given a matching award in the form of a stock option exercisable after (typically) three years, subject to the satisfaction of performance criteria.

Where remuneration is deferred or waived, care needs to be taken to ensure that an income tax charge is not inadvertently triggered before such deferral or waiver can take place. Charges can arise under the disguised remuneration legislation if a third party, such as an employee benefit trust, earmarks cash or assets to individual executives.

The use of clawback to recover payments made in the event of misconduct or misstatement is starting to gain popularity and is compulsory for certain companies within the financial sector. It is unclear whether tax paid on such amounts can be recovered from HMRC. In 2014, the Upper Tribunal upheld a taxpayer's claim for tax relief in respect of a bonus that was subject to clawback.[10] Although HMRC announced that it would not appeal the decision, this remains an area of uncertainty.

ii Social taxes for employees

In most circumstances, where income tax is payable, the employer is required to account for tax under the pay-as-you-earn (PAYE) collection system. Failure to recover this tax from an employee can lead to additional costs for the employer and further tax liabilities for the employee. To guard against this, it is important that incentive plans contain appropriate indemnities. Where tax is payable under PAYE, social security charges (national insurance contributions (NICs)) will also be due. For the 2015/16 tax year, employee NICs are charged at 12 per cent for earnings of between £155.01 and £815 per week. Above this threshold, they are uncapped at a rate of 2 per cent. Employers also have to account for NICs at a rate of 13.8 per cent in respect of employees with weekly earnings above £156. These are also uncapped, and create an additional uncertain liability

9 Finance Act 2014, Section 52 and Schedule 9.

10 *HMRC v. Julian Martin* [2014] UKUT 429 (TCC).

for an employer. In recognition of this, it is possible for employer NICs to be transferred to the employee in certain limited circumstances, such as the exercise of share options.

In the Summer Budget of 2015, the government announced that as part of the Tax Lock the upper earnings limit (the point at which employees move from a 12 per cent to a 2 per cent rate of NICs) will not exceed the sum of the 20 per cent income tax limit and the personal allowance for a tax year. Since 6 April 2014, many employers have been able to reduce their employer NICs by £2,000 every year by applying the 'Employment Allowance'. This allowance will rise to £3,000 from 6 April 2016, but will cease to be available for companies where the only employee is the director of that company.

iii Tax deductibility for employers

Under UK law, the general rule is that a corporation tax deduction is available for expenses incurred wholly and exclusively for the purposes of a trade. Generally, employee salaries and associated costs such as employer social security contributions will be deductible under such principles. An exception to this is where the salary is paid more than nine months after the end of the period of account for which the deduction is claimed.[11] In such circumstances, any deduction is deferred until the accounting period in which the salary is actually paid.

A statutory corporation deduction is available in respect of employee share acquisitions and the exercise of share options provided certain conditions are met.[12] The conditions relate to the type of business carried on, the nature of the shares acquired and the employee's tax position. Changes introduced by the Finance Act 2014 have extended the corporation tax deduction so that it is available in respect of overseas employees working for UK companies. Anti-avoidance legislation restricts the availability of corporation tax deductions for contributions to employee benefit trusts to a time when qualifying benefits or expenses are paid out of the contributions in question.

iv Other special rules

A change in control (such as a takeover or share sale) can affect the statutory corporation tax relief available to a company on the exercise of options over its stock. Most plan rules state that options become exercisable following a change of control. One of the preconditions to claiming corporation tax relief in respect of such exercise is that the stock acquired is in a company either listed on a recognised stock exchange or not under the control of an unlisted company. An acquisition or takeover by a private or alternative investment market (AIM)-listed company might mean that this condition ceases to be met. Historically, this has caused difficulties for target companies, a point that was considered in HMRC's review of non-tax advantaged share incentives. Accordingly, in the Finance Act 2014, changes were made under which corporation tax relief will be available for a period of 90 days following a takeover by an unlisted or AIM company.[13]

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11 Corporation Tax Act 2009, Section 1288.

12 Corporation Tax Act 2009, Section 1288.

13 Corporation Tax Act 2009, Section 1016(1A).

When CSOP options are exercised within three years of grant, they can only receive favourable tax treatment in prescribed good leaver circumstances. These include injury, disability and redundancy, and cessation of employment within a group following a business sale or a sale of the subsidiary for which the individual works. Tax relief is also available when CSOP options are exercised in the event of certain cash takeovers. Some companies have historically experienced difficulties with their CSOP options on a takeover as their shares often cease to satisfy the statutory requirements following a change of control. To remedy this, changes introduced by the Finance Act 2014 preserve income tax relief where the plan rules permit options to be exercised 20 days either side of a change of control.[14]

In the United Kingdom, the tax rules for benefits can be complex. While some are taxable under a statutory regime known as the benefits code,[15] others are subject to their own special rules. Some benefits (such as employer contributions to registered pension schemes, within prescribed limits) are exempt from tax altogether. In the past, payment in the form of benefits in kind has been used as a means of avoiding social security contributions. This is less prevalent now that most benefits attract NICs. Some companies offer their employees a range of benefits from which they can make a selection to suit their particular circumstances. These are known colloquially as 'cafeteria' or 'flex' schemes, and usually involve the allocation of points or credits that can be spent in purchasing benefits. Under salary sacrifice arrangements, employees are allowed to give up a proportion of their taxable pay in exchange for a tax-exempt benefit such as employer pension contributions or childcare vouchers. These need to be structured carefully to ensure that the desired tax result is achieved. The taxation of benefits was the subject of a government-sponsored review and Finance Act 2015 contains provisions that will introduce a number of simplifying measures including a tax exemption for qualifying business expenses that are paid or reimbursed by an individual's employer. This new exemption is due to take effect from 6 April 2016 at which point the current dispensation regime (under which employers can agree with HMRC for certain payments to be made to employees free of tax) will cease to be available.[16]

Certain forms of termination payment can benefit from a £30,000 tax-free allowance[17] (and can escape social security contributions in their entirety). Where taxable payments are made after the issue of form P45, the employer has to apply the '0T' tax code. The practical effect of this is that one-twelfth of each tax band is applied to the payment, which could result in a proportion of it becoming taxable at the higher and additional rates, although any overpayment of tax can be reclaimed. On 24 July 2015, HMRC published a consultation document setting out proposals to simplify the tax and NICs treatment of termination payments.[18] The government is considering abolishing

14 Income Tax (Earnings and Pensions) Act 2003, Schedule 4, subparagraphs 25A(7A)–(7F).

15 Income Tax (Earnings and Pensions) Act 2003, Section 63(1).

16 Sections 11–14 and 17 of Finance Act 2015.

17 Income Tax (Earnings and Pensions) Act 2003, Sections 401–416.

18 HMRC: Simplification of the Tax and National Insurance Treatment of Termination Payments.

the existing exemptions (including the £30,000 allowance) and replacing this with a new statutory exemption that would be linked to statutory redundancy.

III TAX PLANNING AND OTHER CONSIDERATIONS

An individual coming to work in the United Kingdom who is not domiciled here can claim to be taxed on the remittance basis in respect of his or her overseas earnings. These are broadly earnings with a foreign employer (i.e., one that is non-UK-resident) where the duties of the employment are performed wholly outside the United Kingdom (it should be noted that duties performed in the United Kingdom that are merely incidental to those carried out abroad are ignored for this purpose). In order to be taxed on this basis, some individuals enter into dual contracts under which their UK and non-UK employments are separated. In January 2014, HMRC published revised guidance on the subject.[19] HMRC has historically scrutinised dual contracts, and legislation was introduced in the Finance Act 2014 limiting the circumstances in which the remittance basis of taxation will be available under such arrangements.

Where an individual does not have separate employments, he or she might be able to claim overseas workday relief on his or her non-UK duties. This area of the law has undergone change as a result of the new statutory residence test that was introduced from April 2013. Overseas workday relief is only be available to individuals who are non-UK domiciled and based here for fewer than three years.

It is not possible to avoid UK tax simply by providing services through a personal services company. Legislation exists[20] that deems payments made to service companies to be employment income if, were it not for the existence of the service company, the relationship between the client and worker would be one of employment. If the worker is within the charge to UK income tax, these anti-avoidance rules apply wherever the company is incorporated or resident. The UK government has recently modified the rules applicable to agencies and has announced that it also intends to take further steps to guard against instances of 'false self-employment'.[21]

The United Kingdom has a wide network of double taxation treaties, most of which are based upon the OECD Model Convention. These usually include a tie-breaker clause to determine the residence of an individual, and articles dealing with taxing rights over employment income and the avoidance of double tax. In circumstances where there is no double taxation treaty, UK domestic law can give unilateral relief for overseas tax as a credit against the individual's UK tax liability.

19 HMRC Restrictions on the remittance basis – dual contracts: www.hmrc.gov.uk/international/dualcontracts.pdf.

20 Income Tax (Earnings and Pensions) Act 2003, Part 2, Chapter 8.

21 HMRC Intermediaries Legislation (IR35): Discussion document – 17 July 2015.

On 1 September 2013, a new form of employment status, 'employee shareholder', was introduced.[22] An individual adopting such status exchanges certain employment rights for tax advantaged shares in the business for which he or she works.

IV EMPLOYMENT LAW

i Non-competition covenants

In the United Kingdom, the use of non-competition covenants in employment contracts for executives is commonplace. While historically their value has tended to be as a form of deterrent rather than as an enforceable right, in recent years the courts have perhaps shown a greater willingness to uphold non-competition covenants. In each case, the courts will look carefully at whether the covenant in question is necessary to protect the relevant business. Covenants are only enforceable to the extent that they go no further than is necessary to protect the legitimate interests of the person's employer.

ii Non-solicitation covenants

Non-solicitation covenants are more likely to be successful if they relate to existing rather than potential customers. Other relevant factors will be the individual's role in attracting the business in question, his or her level of seniority, whether the individual had previously dealt with the particular customers in question and the loyalty of customers within that particular sector. As regards poaching employees, although there is no prohibition on an employee choosing to follow a former colleague, the courts have held that there are circumstances in which an employer has a legitimate interest in maintaining a stable workforce.[23]

iii Enforceability of restrictive covenants

Generally, the courts will also consider the geographical reach and time duration of restrictive covenants to ensure they go no further than is necessary. In the light of the increasing globalisation of business, courts are perhaps more willing to enforce covenants with a wider geographical reach provided this is necessary to protect the business's interests. There is no set time period, as in each case it is necessary to look at how long is needed to protect the particular business; however, six to 12 months is generally regarded as the upper limit of enforceability. If the employee in question is placed on gardening leave (i.e., he or she is retained as an employee during his or her notice period, but not required to come into the workplace), this will affect the period of restriction the court is prepared to enforce. Recent case law has demonstrated that account will be taken of the

22 Growth and Infrastructure Act 2013, Section 31 and Finance Act 2013, Section 55 and Schedule 23.

23 See *Dawnay Day & Co Ltd v. D'Alphen and others* [1997] IRLR 285, where a one-year non-solicitation covenant in an employment contract applicable to directors and senior employees was held to be enforceable.

time taken on gardening leave when determining how long a post-termination covenant can last.[24]

Restrictive covenants in documents, such as share acquisition agreements and shareholders' agreements, are subject to the same rules on restraint of trade as those that appear in an employment contract. The courts are sometimes more willing to enforce broader restrictions contained in commercial documents that have been negotiated at arm's length. Any payments made to individuals for entering into restrictive covenants outside the terms of the employment contract are taxed as employment income. Usual practice is to allocate a specific proportion of any consideration to the restrictive covenant rather than leave it for the UK revenue authorities to attribute a larger sum.

iv Termination of employment

Where an executive's employment is terminated, there are a number of claims that he or she might bring against his or her former employer. A claim for wrongful dismissal can be made where the employer terminates a contract in breach of its terms. Usually this happens where an employer does not give adequate notice of termination. If an employer amends an employee's contract without his or her consent or otherwise fundamentally breaches the contract, the employee might be able to resign and claim that he or she has been constructively dismissed.

An employee who has been unfairly dismissed may be able to bring a statutory claim either instead of or in addition to any claim for wrongful dismissal. In most cases, the employee must have worked for a minimum period of time to be eligible for such remedy, although there are exceptions. A claim must usually be made within three months of the dismissal, and the levels of compensation are in most cases limited by statute. Currently the compensation limit is the lower of £78,335 and a year's gross salary, plus a 'basic award' of up to £14,250 (giving a maximum limit of £92,585), although this is revised every year.

An executive who has been singled out for blowing the whistle or because of their sex, age, race, religion, belief, sexual orientation or disability could also have a claim in respect of which there is no limit on the compensation that can be awarded.

An employer seeking to effectively settle statutory claims brought by an employee can do so by entering into a settlement agreement. This is a binding agreement between the parties that has to meet certain statutory requirements, including a condition that the employee has received independent legal advice in relation to the agreement.

Companies incorporated in the United Kingdom might need to obtain shareholder approval in respect of termination payments made to directors. Such approval is also required where the payment is in connection with a transfer of the company's business or a takeover. There are exceptions for payments made pursuant to existing legal obligations or as damages, so these provisions generally apply to payments that are *ex gratia*.

Representative bodies of institutional shareholders, such as the Association of British Insurers, produce guidelines on best practice for listed companies in respect of

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24 *Tullett Prebon plc and others v. BGC Brokers LP and others* [2010] EWHC 484 (QB).

severance payments. Such companies will generally take these guidelines into account, as they can influence the way in which key shareholders will vote.

UK-incorporated companies whose shares are listed on the London Stock Exchange are subject to additional requirements in respect of termination payments. The Enterprise and Regulatory Reform Act 2013 (see Section VII, *infra*) requires quoted companies to submit their policies on termination payments to a shareholder vote at least every three years. Any payments subsequently made in accordance with this policy must then be announced to the market.

V SECURITIES LAW

UK securities rules need to be taken into account when structuring share-based executive remuneration, and can primarily be found in the Financial Services and Markets Act 2000 (FSMA 2000) and the Prospectus Rules, which form part of the Financial Conduct Authority's (FCA) Rules and Guidance.

i The Prospectus Rules

The Prospectus Rules were introduced to implement the Prospectus Directive[25] in the UK. Under these Rules, it is unlawful for a company or firm, wherever incorporated or registered, to make an offer of transferable securities to employees in the United Kingdom unless a prospectus approved by the FCA (or the competent authority of another EEA state) has been published, or an exemption applies.

The starting position is the same for both private and publicly traded entities. In particular, transferable securities are defined as those that are negotiable on the capital market. 'Capital market' is not defined and is given a broad interpretation.[26]

In the United Kingdom, the grant and subsequent exercise of an employee share option will not generally give rise to an obligation to publish a prospectus. This is because the FCA takes the view that employee share options (whether nil cost or otherwise) that cannot be assigned or transferred by the employee to a third party (as is usually the case) are not negotiable on the capital market and, therefore, are not transferable securities. The FCA also considers that the exercise of an employee share option is not an offer of the underlying shares to the public. Whether private company shares are negotiable on the capital market is a matter of fact, depending on the rights of the shares in question.

There are a number of exemptions from the need to file a prospectus. For example, an offer falls outside the requirements of the Prospectus Rules if the aggregate

25 Directive 2003/71/EC.

26 For further information see the published non-binding guidance of the European Commission (in the form of questions and answers) on the interpretation of the Markets in Financial Instruments Directive, which contains the relevant definition of transferable securities.

consideration payable under the offer across the whole of the EEA is less than €5 million,[27] or if the offer is made to fewer than 150 people in each EEA Member State.[28]

Even where none of the above exemptions are available, a prospectus will not be needed for an offer made to employees provided certain conditions are met.[29] Instead, an employee information document will have to be made available to employees receiving the offer that contains information on the number and nature of the securities offered, and the reasons and details of the offer.[30] The exemption for offers of securities to directors and employees applies to all companies with a head office or registered office in the EEA, and to non-EEA companies with securities traded either on an EEA regulated market or a non-EEA market that is deemed by the European Commission to have an equivalent legal and supervisory framework.[31] In February 2015, the European Commission published a consultation paper seeking views on whether the exemption should be extended to private companies in non-EEA countries.[32]

ii The Financial Promotion Regime

The Financial Promotion Regime governs the circumstances and manner in which a company or firm can communicate an invitation or inducement to engage in investment activity to the public (including employees) in the United Kingdom. In particular, unless an exemption from the regime is available, any such communication must be made by a person authorised by the FCA or the Prudential Regulation Authority (PRA), or the contents of the communication must be approved by a person authorised by the FCA or the PRA. Breaching the Financial Promotion Regime is a criminal offence.[33]

Communications to employees regarding the acquisition or sale of shares, and the grant or exercise of options, are likely to be caught by the application of the Financial Promotion Regime. There is, however, a fairly broad exemption for participation in employee share schemes.[34] In particular, the restriction on financial promotions does not apply to any company or firm (or any member of the same group as such company or firm) where the communication is for the purposes of an employee share scheme.[35] As

27 Article 1(2)(h) of the Prospectus Directive and paragraph 9 to Schedule 11A of FSMA 2000.

28 Article 3(2)(b) of the Prospectus Directive and Section 86(1)(b) of FSMA 2000.

29 Article 4(1)(e) of the Prospectus Directive, Prospectus Rules 1.2.2R(5) and Section 85(5)(b) of FSMA 2000.

30 For further guidance on the contents of the information document, see paragraphs 173 to 176 of the ESMA/CESR guidance on the consistent implementation of Commission Regulation (EC) No. 809/2004 implementing the Prospectus Directive.

31 Prospectus Directive Amending Directive Instrument 2012 (FSA 2012/29).

32 European Commission: Consultation Document: Review of the Prospectus Directive, 18 February 2015.

33 Sections 21 and 25 of FSMA 2000.

34 Paragraph 60 of the Financial Services and Markets Act 2000 (Financial Promotion) Order 2001.

35 See paragraph 60(2) of the Financial Services and Markets Act 2000 (Financial Promotion) Order 2001 for a definition of employee share schemes.

such, particular care must be taken to ensure that this exemption is available, and advice should be sought, especially when third parties (including in the context of a takeover) wish to communicate with employees of an unconnected company or firm regarding their share-based remuneration arrangements.

VI DISCLOSURE

This section summarises the requirements for disclosure of share dealings by directors and senior employees in the context of share-based executive remuneration. It should be read in conjunction with Sections VII and VIII, *infra*.

i Private companies

For companies (wherever incorporated) whose shares are not admitted to the Main Market of the London Stock Exchange or AIM, there are no requirements under English law for the disclosure of directors' or senior employees' interests in their shares. Companies may, however, be required to make certain disclosures in the directors' report forming part of their annual report and accounts, and the level of detail will depend on the accounting standards being used as well as the size of the company concerned.

ii Listed companies

UK incorporated companies whose shares are admitted to trading on the Main Market of the London Stock Exchange by way of premium listing must comply with the Disclosure and Transparency Rules (DTRs)[36] and the Model Code of the Listing Rules (Model Code).[37]

DTR3 requires all persons discharging managerial responsibility (PDMRs) and their connected persons to disclose to the company in question all transactions conducted on their own account in the shares or securities of the company, and the company must then make an announcement to the market via a regulatory information service (an RIS announcement) as soon as possible, and in any event by no later than the end of the business day following receipt of that information. DTR5 provides that at the end of every calendar month during which an increase or decrease in the issued share capital of the company takes place, the company must disclose to the market the total number of shares in each class that it issues.

The Listing Rules are published by the FCA and set out the minimum requirements for securities admitted to the Official List. Chapter 9 of the Listing Rules requires a premium-listed UK incorporated company to make certain disclosures in its annual report and accounts, known as the remuneration report, giving prescribed details of directors' remuneration (including both cash and share-based remuneration). Chapter 9 has recently been amended to remove unnecessary overlap with the new statutory rules regarding remuneration reports (see Section VII, *infra*).

36 See the Disclosure and Transparency Rules sourcebook that forms part of the FCA Handbook.

37 See Chapter 9 of the Listing Rules and the Model Code annexed to Chapter 9.

The Model Code imposes additional restrictions on when PDMRs can and cannot deal in shares and securities.

PDMRs of companies whose shares are admitted to trading on the Main Market of the London Stock Exchange by way of standard listing must comply with the DTR3 requirement to disclose dealings by PDMRs to the company in question, and then the company must disclose those dealings to the market via an RIS announcement; however, the requirements of Chapter 9 of the Listing Rules and the Model Code do not apply to standard-listed companies.

Companies whose shares are admitted to trading on AIM must comply with the AIM Rules for Companies requiring the disclosure of dealings by directors to the company in question, and then by the company to the market by way of an RIS announcement.[38]

VII CORPORATE GOVERNANCE

The UK corporate governance regime comprises a mixture of statutory rules, codes and investor guidelines. The extent to which these apply to a company will often depend upon where the company is incorporated, whether it is a quoted company, the size of the company and, in some cases, the type of activity undertaken by it.

i Statutory controls

The Companies Act 2006 sets out rules that apply to UK-incorporated companies, including requirements that:

a details of directors' remuneration are disclosed in the company's annual report and accounts;[39]

b shareholder approval is obtained for certain termination payments made to directors;[40] and

c service contracts lasting longer than two years are approved by shareholders.[41]

Quoted companies[42] are subject to additional requirements. These have recently undergone significant change (discussed below). Regulations made under the Companies Act 2006 previously provided that quoted companies had to produce an annual directors' remuneration report on which shareholders have an advisory, non-binding vote. Under regulations introduced in 2013 (see subsection vi, *infra*), the information to be disclosed in the remuneration report has altered so that it is more accessible to shareholders. In addition, quoted companies need to put a remuneration policy to a binding shareholder vote at least every three years.

38 Paragraph 17 and Schedule 5 of the AIM Rules for Companies.

39 Companies Act 2006, Section 412.

40 Companies Act 2006, Section 217.

41 Companies Act 2006, Section 188.

42 Broadly, those whose equity share capital is included in the FCA's Official List, officially listed in an EEA state or admitted to dealing on the New York Stock Exchange or NASDAQ. This does not include companies traded on AIM.

ii Regulatory controls

The Financial Reporting Council (FRC)[43] publishes the UK Corporate Governance Code, which sets out standards of good practice in relation to board behaviour including remuneration, accountability and its relationship with shareholders. The UK Corporate Governance Code is technically voluntary; however, all companies with a premium listing of equity shares in the United Kingdom, whether or not incorporated in this country, are required to report on whether they have applied the Code and explain areas of non-compliance.[44]

The UK Corporate Governance Code requires executive directors' remuneration to be designed to promote the long-term success of the company. It states that the performance-related elements of directors' remuneration should be 'stretching' and applied rigorously and, where appropriate, companies should consider using non-financial performance metrics, such as customer satisfaction, as well as financial measures.

Following a recent review of the Corporate Governance Code, the FCA has introduced a requirement for schemes of performance-related remuneration for executive directors to include provisions that would enable the company to recover sums paid or to withhold the payment of any sum (i.e., *malus* and clawback) but leaving it to the remuneration committee to determine the circumstances in which this should apply. This change applies to financial years commencing on or after 1 October 2014.

iii Institutional investor guidelines and the Stewardship Code

Shareholders of listed companies are encouraged to use their voting powers to ensure good corporate governance. Institutional investors (such as pension funds and insurance companies) are represented by investment committees many of which publish guidelines for best practice on share-based remuneration. The guidelines issued by the Investment Management Association (now known as the Investment Association and incorporating the Investment Affairs division of the Association of British Insurers), the National Association of Pension Funds, and the Pensions and Investment Research Consultants Ltd are often considered.

The Stewardship Code was first published by the FRC in 2010 and sets out good practice for institutional investors when engaging with companies listed in the United Kingdom. The principles within the Stewardship Code apply on a comply-or-explain basis, and state that institutional investors should have a clear policy on voting and should vote all the shares they hold. The FRC is keen to encourage overseas investors holding shares in UK listed companies to comply with the Stewardship Code, and for UK institutional investors to apply it to their overseas holdings. The Code was revised on 28 September 2012 with effect from 1 October 2012.

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43 The FRC is the independent regulator in the UK with responsibility for promoting good corporate governance.

44 A company with a premium listing on the Official List must meet the most stringent standards.

iv The Listing Rules

The Listing Rules provide that certain forms of incentive arrangement require prior shareholder approval before they can be implemented. These include employee share schemes involving the issue of new shares, and long-term incentive plans in which directors are entitled to participate.[45]

v AIM companies

Companies with securities traded on AIM do not need to comply with the Listing Rules, but have their own rules and their own source of corporate governance guidelines. These are the Corporate Governance Code for Small and Mid-Size Quoted Companies published by the Quoted Companies Alliance, the Corporate Governance Policy and Voting Guidelines for Smaller Companies, the ISS UKI Proxy Voting Guidelines 2015 and the European Corporate Governance Guidelines. The London Stock Exchange has expressed the view that AIM companies should aspire to the standards set out in the UK Corporate Governance Code and UK institutional shareholders often expect it.

vi Recent changes

Since 1 October 2013, the directors' remuneration report of UK-registered quoted companies has been split into two parts. The first part comprises the policy report. This sets out the company's current and future policy on executive remuneration, and is subject to a binding vote (i.e., 50 per cent approval is required) at least every three years. The second part of the report sets out how the policy has been implemented during the year and is subject to an annual advisory vote. If the implementation report is not passed, a policy report is required at the next AGM. The company's approach to exit payments needs to be included in the remuneration policy, and is therefore subject to a binding vote.

VIII SPECIALISED REGULATORY REGIMES

The UK has seen similar trends to many other developed countries in the scrutiny and the regulation of remuneration in the financial services sector. Generally, the strictest and most well developed regulations have been applied first to systemically important banks, with similar provisions gradually extended to the wider financial services sector. In 2009, the Financial Services Authority (FSA), the then regulator, issued the Remuneration Code as part of its regulatory response to the banking crisis. From 1 January 2011 this code was substantially amended and increased in its scope. A new code was introduced in 2014 by the PRA and the Financial Conduct Authority (FCA) (which replaced the FSA) and applied until 1 July 2015. There are now five remuneration codes as follows:

45 Listing Rule 9.4.1.

Short title	*Scope*	*Location*
CRR Remuneration Code	Banks, building societies and PRA-designated investment firms	Remuneration Part of the PRA Rulebook
IFPRU Remuneration Code	IFPRU investment firms and relevant overseas firms (formerly the 2014 Remuneration Code)	SYSC 19A(which is part of the FCA Handbook)
AIFM Remuneration Code	Managers of alternative investment funds (AIFMs). Implements the remuneration requirements of the Alternative Investment fund Managers Directive	SYSC 19B
BIPRU Remuneration Code	BIPRU investment firms authorised by the FCA. This is the same as the code applicable from 1 January 2011 referred to above	SYSC 19C
Dual regulated firms Remuneration Code	Banks, building societies and PRA-designated investment firms	SYSC 19D

Of these, the CRR Remuneration Code, the Dual-Regulated Firms Remuneration Code and the IFPRU Remuneration Code are new codes (the New Codes).

i Regulation for banks, building societies and investment firms currently in force

Broadly, the general principle of the codes is that firms should establish and maintain remuneration policies and practices that promote sound and effective risk management. Some firms may find that they are subject to more than one code.

The codes apply, potentially, to all staff (including employees, secondees from non-UK group companies and consultants), however, the implications of for such individuals will depend on whether or not they are 'material risk takers' (known as 'Code Staff').

The codes generally set out rules on how remuneration should be structured and the levels of remuneration. One important rule is the ratio of variable pay to fixed pay. Since 1 January 2014, under the CRD IV directive, variable pay of Code Staff should generally not exceed 100 per cent of fixed pay. This 'bonus cap' led to the controversial use of role-based allowances which, it was argued, amount to fixed pay. The European Banking Authority gave its opinion in October 2014 that such allowances should be regarded as variable pay unless they meet stringent criteria. Performance adjustment of variable remuneration is another area that has seen recent development. *Malus* provisions (under which unvested awards can be reduced) have been required by both the PRA and the FCA but with effect from 1 January 2015, the PRA requires clawback (the repayment of vested awards) to apply to variable remuneration for a minimum period of seven years from the award date. The FCA is to introduce the same clawback rule for performance periods beginning on or after 1 January 2016.

ii Proportionality

Not all firms have to give effect to the remuneration requirements in the same way and to the same extent. The New Codes and BIPRU Remuneration Code are applied proportionately with three proportionality levels based on the firm's total assets. Firms of

greater significance and posing the greater risk to financial stability fall within the highest proportionality level and will have the greater levels of compliance.

iii Record keeping

If a firm is within one of the New Codes it will be expected to ensure that its remuneration policies and practices are both clear and well documented. Further, the firms have to complete an annual Remuneration Policy Statement to record these procedures and to assess their compliance with the code(s). For each member of Code Staff, a record must be kept in respect of every performance year. Such individuals must also be kept aware of what their status means.

IX DEVELOPMENTS AND CONCLUSIONS

The new government appears to be in favour of supporting employee share ownership however it has made it clear that it will not tolerate abuses of the tax system. The next 12 months will be an interesting time for those providing their services through consultancy arrangements as we wait to see how the government intends to tackle instances of 'false self-employment'. If the proposals to change the tax and NICs treatment of termination payments and to align tax and NICs more closely are followed through then this would be one of the most fundamental changes to the UK tax system in many years.

Appendix 1

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