CLIFFORD CHANCE

Employee Benefits News

October 2014

Welcome to the October edition of Employee Benefits News which includes a round-up of some of the key recent developments in the share plans and remuneration world.

UK SAY ON PAY: 2014 ROUND UP & PREDICTIONS FOR 2015

With the 2014 AGM season almost over, many companies are assessing the key remuneration issues from 2014 and are beginning to plan for 2015.

A number of UK companies issued clarifications on aspects of their remuneration policy before their AGM during 2014. Based on these and the institutional investor feedback many companies received, the key areas of concern for shareholders in 2014 were:

Recruitment policy

- Concern about the level of flexibility and discretion
- Shareholders want to know when discretion will be exercised and whether there is a limit on that discretion

Discretion

- Shareholder concern about the use of discretion where no business reason provided
- Insitutional investors opposed to broad "emergency" discretion

Pay for performance

- Payments not linked to performance, or made when corporate performance poor, will be scrutinised.
- Lack of retrospective disclosure of bonus targets - with commercial sensitivity usually cited as reason for non-disclosure

So what can we expect in 2015?

More malus and clawback

Most FTSE350 companies already include clawback and/or malus in their bonus and long term incentive plans and we expect those companies which do not have it yet to consider amending their plans. Not only is this now a market norm but also the UK Corporate Governance Code (**Governance Code**) has been amended to provide that malus/clawback provisions should be included in performance-related plans for executive directors and, if they are not, the company must explain why. This change applies to accounting periods beginning on or after 1 October 2014.

As the number of companies that have used their malus and/or clawback provisions increases, we expect companies to be reviewing the scope of their provisions to make sure that they remain fit for purpose.

Holding/retention periods

In recent years, institutional investors have encouraged companies to require executives to hold shares for a further period after the end of the performance period. Many companies already include a retention period in their incentive plans, with 2 years being the most common period. We expect this to become the norm as the Governance Code now provides that remuneration committees should consider requiring directors to hold shares for a further period after the vesting/exercise of an award, including for a period after leaving the company. The Governance Code also suggests vesting or performance periods of more than three years may be appropriate.

Use of discretion

We expect that the exercise of discretion will remain a focus, and it will be more important than ever that remuneration committees can explain and justify decisions made and how discretion has been exercised.

Dealing with shareholder dissent

The Governance Code now provides that if a significant proportion of shareholders vote against any resolution (including a remuneration resolution) then the company must explain what actions it will take to understand the reasons for the result. (Votes withheld are not included when determining whether a significant proportion of shareholders voted against a resolution).

More Government intervention?

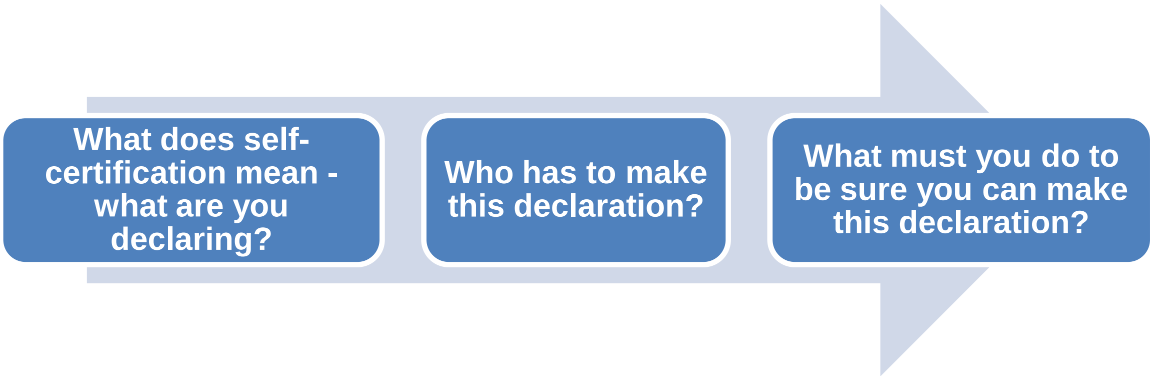
The Business Secretary, Vince Cable, will be reviewing the extent to which the new remuneration reporting regulations have met the Government's objectives, and he has warned that the Government may take further action if companies fail to comply with the spirit and not just the letter of the law.

SELF CERTIFICATION: WHAT SHOULD YOU DO NOW?

Self certification

If you operate tax qualifying plans (which used to be "HMRC approved" plans. We know it's hard to get used to the new name….) now is the time to consider what your company will need to do to self-certify those plans.

The key questions are:



What are you declaring to HMRC?

When you self-certify your tax qualified plans you declare that the rules of those plans comply with the relevant legislation. HMRC regards this as applying to the plan rules themselves (and the trust deed in the case of a SIP) and to other items such as employee communications.

There are no second chances to self-certify existing tax-qualifying plans. If you miss the deadline (6 July 2015) you will not be able to grant any more tax-qualifying awards. Although existing awards granted under Sharesave and SIP will keep their tax-favoured status, existing CSOP options will lose their tax-favoured status completely.

Who has to make this declaration?

The company secretary will have to sign the self certification on behalf of the company, and is likely to want some comfort to be sure tax qualified plans do comply with the legislation.

What do you need to do to be sure you can make this declaration?

We expect companies will want to review their plan rules and employee communications to be sure they comply with the legislation.

For plans approved before 6 April 2014, HMRC have confirmed they will not "reopen" approval of a plan unless new information comes to light which would have affected the original approval. While this is helpful, there have been changes to the legislation in 2014 and 2013 which apply to existing plans.

Many of the new rules are automatically "read in" to existing tax qualifying plans which means that your plan is read as if you had amended them for the new rules, whether or not you actually change the plan rules. For example, the rules on the exercise of CSOP and Sharesave options following death have changed. In addition, many of the changes made to the legislation last year are also automatically "read in", such as removal of the "specified age". However, some changes are not "read in" (e.g. rules on when CSOP and Sharesave options can be exercised with tax relief on a takeover) and you will need to amend your plan rules to take advantage of these changes.

While the "read in" provisions are helpful, this does mean that what is in your existing rules may not reflect the current legislative position and leaves you at risk of operating your plans according to the written plan rules but in a way that is not in line with the current legislation. This is not the position that you want to be in to self-certify.

We recommend that companies get a legal compliance check of their plans. This involves amending existing rules to reflect the recent changes and giving confirmation that the rules comply with the legislation. A legal compliance check will give the company secretary confidence that he or she can sign the self-certification declaration on behalf of the company. It will also mean that share plans administrators and HR teams can operate existing plans without having to cross refer to the legislation to see how the rules are changed by the "read-in" provisions.

ONLINE FILING FROM 2015

All companies operating share plans (whether tax qualifying or not) must register online with HMRC to make their share plan returns by 6 July 2015. Companies operating tax qualifying plans will need to be registered to be able to self-certify those plans.

We suggest you register online well in advance of the deadline, to give you time to comply with the new requirements.

Through attending meetings and workshops with HMRC, we have a few "top tips" on the new online filing system:

- Each registered plan will be allocated a unique reference number which must be used when submitting your year-end return online. Year-end returns must be submitted by 6 July following the end of the tax year and automatic penalties will apply if you miss this date. The first year-end returns can be submitted online from 6 April 2015.

- You must register each plan separately, including plans of the same type. For example, if you operate two LTIPs each plan must be registered (and, if it is a tax qualifying plan, self-certified) separately and a separate online return filed annually for each plan.

- There does not appear to be any way to correct registration errors, so make sure the full name of the plan and other details are correct. HMRC have said the only way to correct an error is to terminate the registration and re-register with the correct details.

- HMRC is still finalising the templates for online returns (they are meant to be available later this month), and hopefully the templates will be published before the end of 2014 as companies will need time to collate the information or obtain it from their administrators.

FINANCIAL SERVICES SECTOR: CLAWBACK FROM 1 JANUARY 2015

New PRA rules on clawback

Following a consultation earlier this year, the Prudential Regulation Authority (**PRA**) has published amendments to its Remuneration Code (which applies to all PRA-authorised firms) to impose a clawback requirement in addition to the existing malus (pre-vesting adjustment) requirements.

Although the final rules on clawback are less draconian than those set out in the consultation, imposing clawback requirements is a significant change and firms need to consider the new rules carefully. It is also possible that more extensive rules on clawback will be introduced (see below).

Application date

The new clawback requirement applies to **remuneration awarded on or after 1 January 2015**. This is a significant departure from the application date proposed in the PRA's consultation – which included transitional provisions requiring firms to seek to apply clawback to remuneration awarded before that date.

Clawback period

Variable remuneration must be subject to clawback for a period of at least **7 years from the date on which it is awarded**. (The consultation suggested that clawback should apply for 6 years from the **date of vesting)**. The revised requirement is designed to enable firms to adopt longer deferral periods, lengthening the period subject to malus, but reducing the period for which clawback applies.

Obligation on firms

Firms are required to make "**all reasonable efforts**" to exercise clawback, whereas the consultation would have imposed a mandatory requirement to recover vested variable remuneration. This change is intended to address concerns that it may not be possible to exercise clawback in every circumstance (for example, if the individual is insolvent, or in a jurisdiction in which clawback is unenforceable).

Firms should seek to recover "**an appropriate amount corresponding to some or all vested variable remuneration**", whereas the consultation appeared to require all vested variable remuneration to be recovered. The change to the Remuneration Code goes on to state that firms must "take account of all relevant factors…in deciding whether and to what extent" clawback should be exercised.

Clawback circumstances

The circumstances in which clawback should be operated are also narrower than in the consultation. Under the final rules, clawback should be exercised where there is reasonable evidence of employee misbehaviour or material error, or where the firm or relevant business unit suffers a material failure of risk management. Where the rationale for clawback is a failure of risk management, the PRA confirms that firms should take account of the individual's proximity to, and responsibility for, the failure in deciding what level of clawback should apply, if any. The firm's approach to clawback should be set out in its internal policies.

PRA/FCA consultation paper

The PRA and the Financial Conduct Authority (**FCA**) have also issued a joint consultation (which runs until the end of October) on further changes to their respective Remuneration Codes. The consultation proposes a number of amendments based on the recommendations of the Parliamentary Commission on Banking Standards (**PCBS**).

If implemented, the changes to the Remuneration Codes will apply to awards made for **performance periods commencing on or after 1 January 2015**. So, for firms operating a calendar performance year, the first annual bonus round to be impacted would be in early 2016, in respect of 2015 performance.

The material changes proposed include:

Deferral

The **minimum deferral period** should be extended for all "Material Risk Takers" (MRTs) (the new term for Code Staff). It is also proposed that there should be a two level approach, under which Senior Managers (to be identified under the **new Senior Managers Regime**, on which the FCA and PRA are also consulting) are subject to a longer deferral period than other MRTs.

In addition, Senior Managers would be subject to **minimum deferral of 7 years**, with the first vesting no earlier than the third anniversary of the award and vesting thereafter no faster than *pro rata*. Other MRTs would be subject to **minimum deferral of 5 years**, with the first vesting no earlier than the first anniversary of the award and vesting no faster than *pro rata*.

Clawback

The FCA is playing catch-up with the PRA and is consulting on the revised clawback rules which the PRA has already introduced (see above). In addition, both the PRA and the FCA are proposing a further amendment to the new clawback rules. For Senior Managers, it is proposed that there should be an option to **increase the new 7 year clawback period by up to a further 3 years** (i.e. to 10 years in total) in certain circumstances, including where there are outstanding investigations underway at the end of the 7 years.

Buy-outs and guarantees

The PCBS identified the practice of new employers buying out deferred compensation as undermining the purposes of malus by "wiping the slate clean" for the employee. The consultation therefore proposes various options to address this issue. The options range from banning buy-outs altogether (although the consultation recognises this would be detrimental to the competitiveness of UK-regulated firms) to leaving the current position unchanged, relying on the new clawback provisions to provide a means of redress against former employees.

Once responses to the consultation have been published later this year the PRA and the FCA expect to each publish "at a later date" a separate policy statement containing their respective final remuneration rules and related guidance. We will update you further once these have been released.

SHARE PLANS AND INTERNATIONALLY MOBILE EMPLOYEES: NICS UPDATE

New rules governing the UK tax treatment of share plan awards granted to internationally mobile employees (**IMEs**) come into force on 6 April 2015. These rules will apply to existing options/awards as well as any future awards.

A consultation paper has been published on aligning the NICs rules with the new income tax rules, although full alignment will not be possible due to the way in which international social security agreements operate.

Under the proposed new NICs rules, an IME will not have to pay NICs for a period when he or she was not resident or present in the UK or was subject to the social security system of another country as a result of EU law or an international social security agreement. This period will be calculated on the same basis as for income tax.

As with the changes for income tax, there are potential winners and losers from this change. Under the current rules, an IME only has to pay NICs on vesting/exercise of an award if he or she was within the UK social security system when the award was granted. Under the new rules:

- ✔ IMEs who were within the UK social security system on grant of an award but cease to be within it before vesting may not have to pay NICs on part of their award.
- ✘ IMEs who were not within the UK social security system on grant of an award but come within it before vesting may have to pay NICs on part of their award.

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