CLIFFORD

CHANCE

WELCOME TO THE CLIFFORD CHANCE INCENTIVES SPRING NEWSLETTER

With the Covid-19 pandemic still evolving and a busy AGM season, there's no shortage of incentives, remuneration and employment tax issues to consider this Spring. In this issue we reflect on the start of the year and consider future developments and trends to watch in the coming months.

Topics covered:

- The latest on Covid-19 and pay
- Corporate governance - Round up of 2020/21 AGM season and trends to watch
- Update on Brexit and employee incentives
- Employment tax news
- Financial Services: Remuneration regulation
- Pay transparency and reporting

Covid-19 and pay

Companies continue to work through challenging issues around pay, including pay cuts and freezes, reduced or forfeited bonuses and delivery of variable pay in shares, rather than cash. Proxy advisers have been particularly focused on the impact of Covid-19 on executive pay in UK listed companies, increasing their focus on effective disclosure and exercise of remuneration committee (RemCo) discretion in this area.

- Investment body statements on pay have reminded RemCos that executives should not be insulated from the impact of Covid-19 and that broader stakeholder interests, including those of shareholders and the workforce, should be considered in making decisions. Since the beginning of the pandemic it's been clear that where a company takes government aid or cancels its dividend, these steps should be appropriately reflected in pay decisions. Generally, companies that haven't done so have faced increased criticism from the press and stakeholders during AGM season, with shareholders voicing their disapproval by voting against directors' remuneration policies and reports.
- In terms of performance-related pay, proxy advisers have discouraged companies from adjusting performance conditions of "in flight" annual bonuses or long term incentive plan (LTIP) awards. Care should also be taken when setting performance conditions for new awards and in particular, companies will need to be mindful of any risk of windfall gains. Disclosures on the determination of any performance conditions, grant value and the calculation of the number of shares to be granted have also been subject to particular scrutiny.
- As the Covid-19 pandemic continues to evolve, further statements and guidance will no doubt follow. Ensuring companies have enough flexibility and discretion in bonus and LTIPs to increase or decrease payouts in the future will continue to be key. Windfall gains are likely to continue to be an area of focus and censure if not addressed by RemCos.

Our full briefings on Covid-19 and pay can be found **here**, **here** and **here**.

Corporate governance: Round up of 2020/21 AGM season and trends to watch

As well as the obvious challenges presented by Covid-19 and executive pay, we're also seeing some key trends emerging during the 2020-21 AGM season that are set to continue into 2021-22.

ESG and pay

The 2020/21 AGM season has shown that global events like the pandemic, the climate emergency, economic uncertainty and social and racial justice are causing companies to accelerate changes to their ESG priorities. A recent ISS survey of global companies found that the inclusion of ESG metrics when setting executive pay has doubled since 2018, with businesses seeking to ensure an ever closer alignment between these issues and their long term corporate strategies.

Although companies have included ESG targets for executive pay in the UK for some time, this has commonly been within a 'balanced scorecard' type framework, to be taken into account as part of a holistic assessment of performance, rather than having standalone ESG measures. ESG measures are now becoming a more significant part of bonus and LTIP award determination. Proxy advisers and other bodies have issued guidance in the area. Where some advisers are cautious in their views, others like Cevian are on the front foot, actively pushing for more ESG targets to be adopted.

This can be a tricky area to navigate:

- Where ESG measures are used in incentive and bonus plans, most tend to be industry focussed, like health and safety measures in the manufacturing sector and carbon emissions goals in the energy industry. Increasingly, environmental concerns are being addressed across sectors, by both regulators and shareholder bodies, reflecting the urgency of the climate crisis and the growing demands by investors for greater disclosure of companies' plans for transitioning to a net zero economy.
- Shareholders will often view strategic measures as 'soft' and are wary where higher pay outs are achieved, as against 'harder' or purely financial metrics. Careful planning is therefore needed on the weightings, achievement and calibration of ESG measures, with shareholders paying particular attention to these areas. Companies will need to ensure that the measures are sufficiently stretching and are not simply 'part of the day job'. As with any other target, tying measures to clear, reported and audited numbers is likely to be more palatable to shareholders and other stakeholders.

Our full global briefing on ESG and pay can be found **here**.

Restricted share plans

We've seen an uptick in the introduction of restricted share plans (RSPs) during the 2020-21 AGM season. These are plans where performance is assessed before awards are granted and awards vest after a vesting period, typically subject to an overall consideration of performance and the appropriateness of vesting by the RemCo but no formal performance conditions applying. This could signal a longer-term trend away from LTIP awards or may simply reflect the current period of increased financial uncertainty and volatility as RSPs tend to give more certainty of payout.

- RSPs continue to receive a mixed reaction from shareholders. Investors assess RSPs on a case-by-case basis, paying close attention to the disclosures on the context and the strategic rationale for the plans.
- Typically, shareholders will react favourably where the RSP has a performance underpin with appropriate RemCo discretion on vesting amounts, in particular so that windfall gains can be avoided. Longer vesting periods and a reduction in award level (in both cases versus an LTIP award) are also expected by the market and investors. The amount of reduction will of course depend on context, including the features of the RSP, but proxy advisers like the Investment Association are of the view, especially given the wider context of the pandemic, that this should be at least 50% and that grant levels should not be allowed to creep up over time.

For further analysis on the 2021 AGM season, please access the Clifford Chance briefing **here**.

Corporate governance reform

In response to the large-scale corporate failings of companies like Carillion, BHS and Patisserie Valerie, the UK government is proposing an overhaul of the audit and corporate governance regime.

- Changes are being proposed to director pay as part of the government's white paper. Company directors may face fines, suspensions and the clawback of two years' worth of variable pay in cases of serious misconduct, inaccurate accounts or a company suffering reputational damage.
- Directors will also be expected to take much greater responsibility for the accuracy of company accounts, recalling similar changes introduced in the US after Enron under the Sarbanes-Oxley rules. Insufficient cash reserves will mean a prohibition on paying dividends and executive bonuses.
- The consultation on the white paper will close in July 2021.

Cross border social security

The Trade and Co-operation Agreement set out a protocol for social security co-operation in the EU/UK which is relevant for companies with internationally mobile employees. It maintains the principle that only one state's legislation for social security applies at a time so that, for example, someone working in the UK and in an EU member state, should only pay social security in one country and not in both. This broadly preserves the status quo for the time being and all EU member states have now opted in to the protocol.

Further detail on Brexit and incentives can be found in our briefing **here**.

Brexit & employee incentives

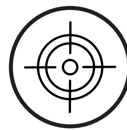
The EU and UK Trade and Co-operation Agreement was agreed in December 2020, shortly before the end of the Brexit transition period. Broadly speaking, it is good news as far as incentives are concerned, at least in the short term.

GDPR

The transfer of data from the EU to UK remains an open issue for the moment under EU GDPR. As a third country, the UK has to demonstrate that it has an "adequate" framework for personal data protection for these purposes. The European Commission has assessed the UK's approach and found that it offers an 'essentially equivalent level of protection'. This will need the green light from a committee of Member States before the Commission will proceed to adopt. The transfer of data from the UK to the EU does not present an issue under the UK GDPR rules.

Prospectus Regulation and Market Abuse Regulation

A number of amendments were made running up to the end of transition to make sure that these regimes 'work' following transition, so no immediate changes are needed arising directly from Brexit. The UK and EU rules may of course diverge in future.



Employment Tax news

Off-payroll working

- The extension of the IR35 or "off-payroll working" regime to the private sector came into effect on 6 April 2021, having been delayed in 2020 due to the pandemic. The off-payroll working rules are designed to ensure individuals who are providing services through an intermediary, but are 'deemed' to be employees for tax purposes, pay income tax and national insurance contributions.
- This signals a significant change for large and medium-sized companies which are clients or 'end users' in a supply chain, as responsibility for determining the employment status of, and paying any tax in relation to, impacted individuals will now rest with them. Impacted companies, to the extent that they have not already done so, should review their supply chains, the terms of any third party contracts and any internal procedures and processes.
- The new regime applies to payments made for services provided on or after 6 April 2021. HMRC has helpfully confirmed that it will focus on ensuring compliance with the new rules, rather than investigating past arrangements, and that it will not open new compliance enquiries into tax years before 6 April 2021 in most circumstances.

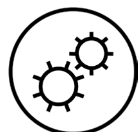
Disguised remuneration

- In the medium-term, HMRC continues its consultation into the effectiveness of the disguised remuneration regime. The next steps will see HMRC increasingly using its

investigatory powers to tackle deliberate non-compliance and strengthening its approach to asset recovery. HMRC is also currently consulting on how to clampdown further on the promoters of tax avoidance schemes (consultation closes in June 2021).

Capital Gains Tax (CGT)

- In the longer term, HMRC is considering an overhaul of the CGT regime. In November 2020, following a call for evidence, the Office of Tax Simplification (OTS) published its first report on CGT simplification. The first OTS report focuses on policy design and principles and makes recommendations on CGT rates, a closer alignment of CGT to income tax, annual exempt amounts, capital transfers and reliefs and losses. A further report is to be published later this year and will explore key technical and administrative issues.



Financial Services: Remuneration regulation

The combined impact of the recent regulatory changes introducing CRDV, the ongoing impact of Covid-19 and the end of the Brexit transition period, mean that remuneration continues to be an area of focus for financial services firms.

- For larger firms and banks subject to CRD/CRR, although the changes introduced under CRDV may not have required a complete re-write of their policies, it has meant a significant amount of planning and implementation work. For level 3 firms especially, this has meant preparing for the impact of a bonus cap on material risk taker (MRT) variable pay for the first time. For all firms, the technical changes to the MRT identification rules means an ongoing review of internal identification procedures to ensure that methodologies are up to date, as well as working through changes to the de minimis MRT thresholds and the lifting of the minimum deferral period to 4 years.
- For other investment and advisory firms, PE houses and portfolio managers, the EU's new regime under IFD and IFR will take effect in June 2021. In the UK, the FCA's proposals for a new prudential regime for MIFID investment firms (IFPR) remain work in progress, and will likely come into force for performance periods beginning on or after 1 January 2022. A Consultation Paper covering new remuneration rules has now been published by the FCA (April 2021) with a number of key changes for firms (consultation period will close on 28 May 2021). Timings are tight for what will be a more fundamental change for many affected firms. For those investment firm groups operating across both the UK and EU, diverging approaches will now need careful thought and planning.
- The PRA's updated position on pay and Covid-19 will have been a welcome reprieve for CRD/CRR firms. The PRA had formerly advised against shareholder distribution and bonuses in 2020. However the regulator relaxed its position somewhat in December 2020, allowing distributions to shareholders to restart, within certain parameters or 'guardrails', and the payment of cash bonuses to senior staff, including MRTs, provided that a 'high degree of caution and prudence' is exercised.
- In terms of Brexit, specific issues arise for UK headquartered firms that have reorganised their structures as part of Brexit planning, moving operations from the UK to an EU member state. We're seeing firms give careful thought to the impact of internal reorganisations on remuneration governance and pay structures.
- In the longer term, many of the measures relating to financial services remuneration design are of course derived from EU law. Following Brexit, the UK has indicated that it may revisit certain measures, such as a more relaxed approach to the bonus cap. With the advent of new rules, codes and regimes, the regulatory landscape is likely to become more complex as the UK and EU rules diverge

Our briefing on the FCA's IFPR remuneration proposals can be found **here**.

Pay transparency and reporting

- New proposals to shake up pay transparency have been published by the European Commission, affecting companies with operations in the EU. The changes proposed are likely to be significant. Key enhancements include pay information disclosure for job candidates and a prohibition on the disclosure of a candidate's pay information, a harmonised EU-wide approach to gender pay

gap reporting and enhanced access to justice for impacted individuals. The proposals have been sent to the European Parliament and the Council for approval and EU member states will have two years from adoption to transpose into national law.

- As the EU proposals were introduced post-Brexit, the UK is not part of the reform. Nonetheless, pay reporting remains a hot topic in the UK. Gender pay gap reporting has of course been in place in the UK for some time and this may be extended in due course to employers with 50+ employees. It is also likely that ethnicity (and possibly disability) pay gap reporting will be introduced. It remains to be seen whether the UK will follow suit in strengthening its rules on pay transparency in other areas as indicated in the EU proposals, particularly at the pre-employment stage.

For further information, our EU pay transparency briefing can be accessed **here**.

HMT and HMRC have issued a number of incentives and employment tax related delays in reporting deadlines, most notably:

- The new Fifth Anti-Money Laundering Directive ('5MLD') extended the requirement to register trusts on the Trust Registration Service (TRS) to many non-tax paying trusts that were otherwise excluded. HMRC has announced that, due to delays in updating the TRS system, the registration deadline of March 2022 has been delayed. Further updates will follow from HMRC, but trustees and agents are expected to have 12 months from the date that the TRS system is updated to register; and
- Companies with more than 250+ employees now have until 5 October 2021 (previously 5 April 2021) to provide their gender pay gap report.

CONTACTS

Sonia Gilbert
Partner

T: +44 207006 2041
E: sonia.gilbert@cliffordchance.com

Andrew Patterson
Partner

T: +44 207006 6160
E: andrew.patterson@cliffordchance.com

Catrin Wright
Head of Practice Development: Incentives

T: +44 207006 2920
E: catrin.wright@cliffordchance.com

C L I F F O R D

C H A N C E

This publication does not necessarily deal with every important topic or cover every aspect of the topics with which it deals. It is not designed to provide legal or other advice.

www.cliffordchance.com

Clifford Chance, 10 Upper Bank Street, London, E14 5JJ

© Clifford Chance 2021

Clifford Chance LLP is a limited liability partnership registered in England and Wales under number OC323571

Registered office: 10 Upper Bank Street, London, E14 5JJ

We use the word 'partner' to refer to a member of Clifford Chance LLP, or an employee or consultant with equivalent standing and qualifications

If you do not wish to receive further information from Clifford Chance about events or legal developments which we believe may be of interest to you, please either send an email to nomorecontact@cliffordchance.com or by post at Clifford Chance LLP, 10 Upper Bank Street, Canary Wharf, London E14 5JJ

Abu Dhabi • Amsterdam • Barcelona • Beijing • Brussels • Bucharest • Casablanca • Delhi • Dubai• Düsseldorf • Frankfurt • Hong Kong • Istanbul • London • Luxembourg • Madrid • Milan • Moscow • Munich • Newcastle • New York • Paris • Perth • Prague • Rome • São Paulo • Seoul • Shanghai • Singapore • Sydney • Tokyo • Warsaw • Washington, D.C.

Clifford Chance has a co-operation agreement with Abuhimed Alsheikh Alhagbani Law Firm in Riyadh.

Clifford Chance has a best friends relationship with Redcliffe Partners in Ukraine.

2104-001403