CLIFFORD CHANCE

WELCOME TO THE CLIFFORD CHANCE INCENTIVES SUMMER BRIEFING

With the increased focus on ESG and diversity and inclusion and many economies grappling with a cost of living crisis whilst trying to press ahead with initiatives in the post-covid and post-Brexit era, there's no shortage of incentives, remuneration and employment tax issues to consider as we go into the summer. In this issue we reflect on recent developments and consider future changes and trends to watch in the coming months.

Key issues

- The latest on ESG and Pay in the UK
- Listed company executive pay
- Corporate Governance Code
- How companies are responding to the cost of living crisis and worker shortage in the UK
- Pay transparency and reporting
- Financial Services: Remuneration regulation
- Update on UK tax-advantage schemes
- Resetting Management incentives

ESG and Pay: UK

ESG remained a key theme at this year's AGM season. Companies are under increasing pressure from institutional investors, regulators and other stakeholders to ensure their remuneration arrangements are consistent with, promote and enable management to drive their ESG agenda. The UK's leading institutional investors and proxy advisors all state that ESG metrics should form part of remuneration frameworks in their updated principles and guidelines, and regulators are continually focusing on this area through the issuance of both guidance and mandatory rules.

It's not surprising to see, therefore, a trend away from including ESG metrics only in balanced scorecards as part of a holistic assessment of performance, to the use of standalone ESG metrics as part of the non-financial performance criteria in performance targets, performance modifiers, and/or underpins. Also, whilst ESG metrics have tended to be included in annual bonus and short-term incentive awards (with long-term targets broken down to single year milestones), they are increasingly forming part of long-term incentive awards so that their achievement can be measured over an appropriate time period to reflect the materialisation of ESG risks.

With whatever approach is taken, investor bodies are clear that ESG metrics should be specific to a company's business, industry and pay structures, as well as being stretching and measurable, with the Investment Association stating that ESG measures should not reward "*business as usual*" activity. Investors also note that care must be taken by companies to avoid greenwashing of remuneration disclosures.

Comment

We expect ESG linked pay will continue to be a hot topic throughout 2023 and beyond and recommend that companies continue to review their approach to how best to use ESG metrics in pay to enable the company to deliver on its ESG agenda.

Spotlight on listed company executive pay

Julia Hoggett, CEO of the London Stock Exchange, has called for a "*constructive discussion*" on the approach to executive pay in the UK to retain the attractiveness of companies listing in London. Hoggett's comments come in the context of the FCA's proposals to overhaul the listing regime to make it easier for companies to join the market, as well as Jeremy Hunt's Edinburgh reforms which involve the relaxation of certain rules for the financial services industry. All of these developments may suggest a new era of regulation for the City is on the horizon, and changes in this area should be closely monitored.

Any discussion will have to balance the need to attract key talent to the UK by offering higher executive pay opportunities, with investor expectations for higher returns and only paying for performance and wider shareholder considerations around pay levels for lower paid workers, particularly in the context of the current cost of living crisis.

Overhaul of the Corporate Governance Code

The Financial Reporting Council's ('FRC') proposals to the Corporate Governance Code were published in late May 2023. They are aimed at both strengthening directors' accountability for misconduct, and increasing Board responsibility for reporting.

The key changes to the Code from an incentives perspective are:

- a new requirement to ensure remuneration outcomes are aligned to ESG objectives;
- the remuneration committee to take workforce pay and conditions into account when authorising remuneration outcomes;
- the remuneration policy to ensure outcomes are proportionate and do not reward poor performance; and
- increased reporting around directors' malus and clawback provisions, including the minimum circumstances and period in which they can be used, and their previous use.

The changes are intended to apply to financial years starting on or after 1 January 2025, and the Code continues to operate on a "comply or explain" basis.

The FRC also intends to review its guidance on Audit Committees, Board effectiveness and risk management, internal controls and related financial and business reporting.

Comment

The ESG requirement reflects broader regulatory focus on this area, and may result in companies coming under increased pressure to link executive pay to ESG metrics (in part), or explain why they have not.

On malus and clawback, many companies operate these provisions and disclose their key features so the new requirement should not be too onerous, and it is interesting that the FRC have not introduced minimum trigger events.

The reference to remuneration outcomes being proportionate, not rewarding poor performance and taking workforce pay and conditions into account is aligned with one of the Code's key themes for executive pay to be consistent with that of the wider employee base, and it is hoped this will lead to more tailored disclosures than the current requirement to disclose how the remuneration policy addresses six prescribed factors.

Companies' response to the cost of living crisis and worker shortage in the UK

The cost of living crisis and worker shortage has dominated the headlines and will continue to be an area of great focus for companies, not least because of the anticipation of interest rate rises further throughout the remainder of 2023.

Cost of living crisis and worker shortage in the UK

- More than a quarter (27%) of businesses with 10 or more employees were experiencing worker shortages in May 2023*
- Growth in employees' average total pay (including bonuses) was 6.5% and growth in regular pay (excluding bonuses) was 7.2% in February to April 2023**
- Growth in total and regular pay fell in real terms (adjusted for inflation) on the year in February to April 2023, by 2.0% for total pay and 1.3% for regular pay**
- CPI and RPI are currently 8.7% and 11.3% respectively***

* Office for National Statistics, business insights and impact on the UK economy: released 15 June 2023

** Office for National Statistics, average weekly earnings in Great Britain: released 11 June 2023

*** Office for National Statistics, consumer price inflation, UK: released 21 June 2023

What are companies doing in response to the crisis?

The table below provides examples of the short, medium and long term measures companies have been taking.

Short-term measures	Medium-term measures	Long-term measures
• One-off cash bonuses, with particular focus on the lower paid • Increase to basic wages, in particular, increases geared towards the lower paid and that are in line with the National Living Wage • Increased opportunities for overtime and the rate of overtime pay, which addresses both the cost of living and worker shortage in some sectors • Short-term employee loans within the tax-free exempt amount	• Staff discounts, vouchers and loyalty schemes • Enhanced flexible benefits packages • Revised and enhanced travel and subsistence policies • Hybrid and flexible working arrangements • Access to financial advice, wellbeing courses and counselling • Short to medium-term retention awards, including RSUs, joining awards and free shares under a SIP (or similar)	• Recruitment and retention awards over cash and/or shares to a broader base of employee, including: – RSUs – LTIPs – EMIs – CSOPs • All-employee share awards under SIP and SAYE • New technology and efficiency drives to help counter wage cost inflation and worker shortage

Comment

In our experience, employers have on the whole been very responsive and creative in the ways they have sought to tackle the cost of living crisis and worker shortage. There remain, however, significant challenges to achieving the correct balance for businesses, particularly as they grapple with the increasing cost of wages and the impact that has elsewhere on their business and finances. We expect there to be no let-up in the long-term drive for cost savings, efficiencies and the push towards greater productivity.

Pay transparency and reporting

On 24 April, the European Council adopted new rules to combat pay discrimination and help close the gender pay gap within the EU. Member States have until 7 June 2026 to transpose the rules into national law.

Key pay transparency measures include:

- disclosure obligations on employers at the pre-employment stage;
- the right for employees to request information from their employer (irrespective of size) on their individual pay level and on the average pay levels, broken down by sex, for categories of workers doing the same work or work of equal value;
- companies with at least 150 employees initially (reducing to 100 employees by 7 June 2028) to report information on their gender pay gap; and
- a requirement for employers to carry out a pay assessment, in cooperation with workers' representatives, where pay reporting reveals a gender pay gap of at least 5% which cannot be justified on the basis of objective gender neutral factors.

Measures will be introduced to enhance access to justice for victims of pay discrimination.

Comment

Many EU (and global) jurisdictions already have measures in place to combat pay inequality. In this fast-evolving area, organisations with EU operations should consider what additional obligations will be placed on them by these new rules, including how the relevant data will be collated, kept up to date and stored, what their gender pay gap looks like and any consequential changes required to their internal policies and processes.

The new rules will not apply to UK companies (outside of their EU operations), where gender pay gap reporting has existed for some time. The UK could, however, strengthen its existing rules by, for example, extending its current rules to employers with 50+ employees and introducing ethnicity (and possibly disability) pay gap reporting.

Financial Services: Remuneration regulation

Further change is on the horizon for banks and other CRR firms in the UK with the regulators having finished their consultation on:

- removing the so-called 'bonus cap'; and
- enhancing the remuneration proportionality framework by increasing both the threshold for determining which firms can benefit from proportionality and the remuneration rules which can be disapplied by them.

The PRA's consultation on these proposals closed on 30 May, and the FCA's consultation closed on 9 June. The changes are anticipated to apply to performance years starting on or after Q4 2023, so for calendar year-end firms this will be the 2024 performance year.

Removal of the bonus cap

Under the proposal, the limit on variable pay of one times fixed pay (or up to two times with shareholder approval) will be removed for material risk takers of UK headquartered banks and overseas firms in the UK, except for any of their EU material risk takers.

Firms will still have to set their own "*appropriate ratio(s)*" between fixed and variable pay with the fixed component allowing for "*a fully flexible policy*" on variable pay with the possibility of paying none.

Comment

We expect changes to pay structures as a result of the removal of the bonus cap to evolve gradually within the industry rather than significant changes to happen immediately. Firms will need to work through the impact of the change on their internal pay models, external markets in which they operate, and employment law considerations, including the impact on:

- *any fixed allowances operated and the feasibility of amending these;*
- *shareholder resolutions which limit variable pay and the practicality of changing this limit;*

- *remuneration structures used to benefit from preferential valuation for bonus cap purposes;*
- *any changes to remuneration structures given a rebalancing of pay in favour of the variable element (e.g. shorter deferral periods on graded basis for different pay ratios);*
- *internal policies and processes; and*
- *remuneration reporting and disclosure.*

We expect UK regulators will be considering what other changes they might make to the remuneration rules (e.g. perhaps the length of deferrals and / or the requirement that at least 50% of non-deferred variable pay must be delivered in instruments) in order to complement the removal of the bonus cap to enable firms to better implement the changes.

Increase to the total assets threshold for small CRR firms

The regulators are also proposing to increase the total assets threshold for determining a 'small CRR firm' from £13bn to £20bn, and allowing those firms (under this expanded definition) to disapply the malus, clawback and PRA buyout rules for their material risk takers (in addition to the rules on deferral, non-cash instruments, discretionary pension benefits, and establishment of a remuneration committee as is currently the case).

Comment
This will be a welcome change especially for those firms who ceased to be 'small CRR firms' following the changes to proportionality brought in by CRD V, and will reduce a lot of the admin burden and cost of complying with all of the remuneration rules incurred over the last 2 years.

Firms who have between £13bn and £20bn of total assets should calculate whether they would be classified as a 'small CRR firm' under this proposal, and if so, the consequential changes they would make to their pay policies and practices and how these would be implemented. Likewise, existing small CRR firms should consider the impact of the disapplication of the malus, clawback and PRA buyout rules on their pay arrangements.

Further changes?

The PRA has stated it will consult on changes to remuneration disclosures for small CRR firms in the "near future". Given the EBA is no longer reporting UK data, we may also soon see UK regulators revisit the approach to High Earners and benchmarking disclosures.

MIFIDPRU Remuneration Reporting

Most UK investment firms will have completed their first performance year under the FCA's new prudential regime for MIFID investment firms ('IFPR'). These firms will have completed their MIFIDPRU Remuneration Report (MIF008) and will now be focusing on completing their remuneration disclosures under MIFIDPRU 8.6, self-assessment RPS template (or equivalent) and material risk taker table. In addition, firms should:

- update their material risk taker lists for 2023 and notify those individuals identified;
- consider if any amendments to their remuneration policies and practices are needed to reflect practice;
- determine if board and/or remuneration committee training on the IFPR is required to keep these bodies up-to-date on regulatory requirements; and
- ensure internal audit's (or alternative where there is no internal audit) annual IFPR compliance review is undertaken with the findings acted upon.

Comment
As firms prepare their remuneration disclosures and look ahead to this year's pay decisions, it's a great time to reflect on learnings from the first year of IFPR and determine whether any changes should be made to their pay policies and practices going forward.

Tax-advantaged plans

Changes to tax-advantaged Company Share Option Plans ("CSOPs")

Significant changes have been made to the CSOP legislation effective 6 April 2023. These changes should increase the availability and attractiveness of CSOPs for both private and listed companies.

Key headline features of a CSOP

- A CSOP is a discretionary employee share option plan
- CSOP options may be granted over ordinary shares in a company that is either listed on a recognised stock exchange (e.g. the LSE but not AIM) or is not under the control of another company
- The exercise price must not be less than the market value of a share at the time of grant
- No tax on the grant or exercise of a CSOP option provided the option is exercised 3 or more years from the date of grant (exemptions are also available where options are exercised early by 'good leavers' and on certain corporate events)
- The gain realised on the sale or disposal of CSOP shares will be subject to capital gains tax, subject to the availability of the CGT annual allowance and other reliefs

The changes announced provide, as follows:

1. *Increase to maximum individual limit.*

   The maximum aggregate market value of shares (at grant) over which qualifying CSOP options may be granted to and held by an eligible employee has doubled, increasing from £30,000 worth of shares under option to £60,000 worth of shares.

2. *Relaxation of the types of shares over which CSOPs may be granted.*

   For companies that have more than one class of ordinary share, it is no longer necessary for the shares over which CSOP options are granted to be either 'employee-control shares' or 'open market shares'.

Comment
Doubling the maximum individual limit on CSOP options and introducing the ability to grant over a different class of share (e.g. growth shares) should make CSOP options more attractive as an incentive and retention tool.

This good news is however slightly tempered by the fact that the CGT annual allowance reduced from £12,300 to £6,000 p.a. effective 6 April 2023 and is expected to further reduce to £3,000 p.a. with effect from 6 April 2024. This will increase the total amount of CGT paid when CSOP shares are disposed, though given the current rate at which CGT is charged (20%), CSOPs remain a tax efficient means of delivering shares to employees.

Tax-advantages alone should not be the sole determining factor for granting CSOPs. In particular, share usage (far fewer shares are needed to deliver the same value under an award with no exercise price), accounting costs, performance conditions and expected future share price growth should also be considered. CSOPs only deliver value to the extent that there is share price growth, whereas awards with no exercise price can still provide value to employees regardless of share price growth. As a result a company with low expected levels of future share price growth may be better sticking with other forms of award.

Sharesave ("SAYE") and Share Incentive Plan ("SIP") changes

Following changes to CSOPs which were largely praised in the market, HM Treasury has published a call for evidence on ways to improve and simplify tax qualified SAYE plans and SIPs, with the aim to boost business growth. The consultation closes on 25 August 2023.

This presents an excellent opportunity for companies and industry experts to help shape the future of these valuable all-employee plans.

We are looking forward to hosting a session organised by ProShare with the HM Treasury team running the consultation on 19 July 2023.

Updated SAYE bonus calculations

HMRC has updated its mechanism for calculating bonus rates for SAYE participants with effect from 18 August 2023. The bonus rate will be calculated by reference to the Bank of England base rate and any new rate will apply to SAYE invitations sent out 15 days or more after the base rate is announced. It is expected that this updated mechanism will result in a bonus being provided to new participants for the first time since 2014.

Resetting management incentives

Both private and publicly listed companies are reviewing their management equity plans ('MEPs') and long-term incentive plans ('LTIPs') respectively to ensure they remain appropriate in the current economic climate.

Various approaches can be taken to reset a MEP as set out in our 'Resetting Management Equity' flyer here and discussed here.

Comment

The most suitable approach (or approaches) will depend on the individual circumstances of the company. Some of the key questions that companies should consider when considering how to re-incentivise key personnel are:

- *Is a comprehensive overhaul of the economics required?*
- *Is a targeted approach for select mangers needed or can all managers be treated in the same way?*
- *Are there any restrictions in the company's articles of association and/or shareholders agreement (e.g. who needs to approve the changes)?*
- *What is the timeframe for effecting the change?*
- *What should be the position if actual performance far exceeds expectations on an exit event, and how should the mechanics of an exit event be worked through?*
- *Is manager consent required and what is the likelihood of obtaining this if so?*
- *Is dilution acceptable?*
- *What is the tax treatment?*

Resetting an LTIP often involves similar considerations to MEPs reset mechanisms and can involve:

- amending performance conditions;
- granting new awards based on current and/or revised future market conditions;
- deferral of awards to align with business conditions;
- changing quantum of awards;
- exchanging underwater options; and
- applying discretion to the extent permissible on vesting of awards.

There is also the possibility of putting in place restricted share plans or value creation plans to overcome any incentivisation and retention concerns from LTIP awards no longer providing meaningful value.

Comment

Investors are generally opposed to resetting LTIPs for listed companies and so early and transparent engagement with key shareholders and relevant investor bodies will increase the likelihood of them being supportive of the proposal. Other implications that need to be considered in connection with any of these options, include for example:

- *the terms of the directors remuneration policy;*
- *whether shareholder approval or participant consent is needed;*
- *the impact on share dilution;*
- *disclosure requirements; and*

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