SLAUGHTER AND MAY

Incentives Bulletin

November 2018

Welcome to the November edition of our Incentives Bulletin, updating you on the latest developments in remuneration and share schemes. This month, we look at a **High Court decision on the application of a malus clause**, key measures from the **Autumn Budget** of relevance to share schemes, and points of interest in the **letter sent by the PRA to Remuneration Committee Chairs** and in the latest **bulletin on employment-related securities issued by HMRC**. We conclude with a timeline of **key dates in employee incentives** coming up in the near future.

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High Court dismissed claim that use of a malus clause was unfair where ex-employee had been accused of evading taxes

Summary and key practice point: The High Court has granted summary judgment against an employee in respect of his claim relating to the effect of exclusion clauses, in share plan rules and in a settlement agreement, on his unvested stock and deferred cash awards (*Parmar v HSBC Private Bank (UK) Limited*).

Facts: The claimant, P, was dismissed by HSBC in 2013 after being identified in US legal proceedings as an "unindicted co-conspirator" in a criminal conspiracy to defraud the US Inland Revenue Service. At the time P was potentially entitled to the benefit of unvested stock and deferred cash awards. Both benefits were expressed to be discretionary both in the Share Plan and in the contract of employment.

An exclusion clause in the settlement agreement between the parties also gave the bank absolute discretion to amend, reduce or cancel the award of any shares and deferred cash and provided that P would have no claim against the bank arising out of any such amendment, reduction or cancellation. The Share Plan rules and P's contract contained a malus provision operable if P brought the business into disrepute and the rules provided that he waived any right to compensation if the bank failed to exercise a discretion in his favour under the Share Plan.

In 2016, the bank's Remuneration Committee determined that P should receive a nil discretionary variable pay award for 2011 and that 100% malus was appropriate in relation to the unvested awards. P brought a

claim for more than £1.8m in unpaid bonuses and damages, based on the bank's "arbitrary, perverse and capricious conduct".

The bank sought summary judgment on the claim on the basis that P had no realistic prospect of success and that he faced an insuperable bar in the form of the exclusion clauses in the Share Plan and in the settlement agreement.

Decision: The High Court granted summary judgment against P. The exclusion clauses were wide enough to cover the claims advanced in unambiguous terms, both in isolation and combination (albeit they would not exclude liability on the part of the bank in the event of bad faith or something akin to it, such as discrimination or perversity, despite the Share Plan rules suggesting they would). P had no realistic prospect of succeeding with his claims.

The High Court considered the case on its merits and again concluded that there was no realistic prospect of success and no prospect of showing bad faith, or anything akin to it, to defeat the operation of the exclusion clauses. There was no evidence that the bank was guilty of arbitrary, perverse and capricious conduct. P had sufficient material to enable him to respond to the allegations against him and it was fair for the bank to rely on his failure to do so.

The regulatory background was highly material to the exercise of the bank's discretion. It was required to ensure that its remuneration policies promoted sound and effective risk management and that variable remuneration was paid or vested only where justified and that unvested awards were reduced where there was evidence of misbehaviour.

More detailed analysis/commentary: The summary judgment reflects the fact that, as the Court put it, the bank's process and decision were "entirely unimpeachable". By contrast, in the recent *Daniels v Lloyds Bank Plc* case, the High Court granted summary judgment to two former directors who were claiming that the bank had wrongfully withheld shares due to them under an LTIP by unlawfully applying a malus clause. The High Court decided that the bank did not have the power to amend the terms of existing awards under the LTIP, or to reduce awards where shares had already vested. The effect was that the bank was liable to pay nearly £3m to the two former executives.

Budget 2018

Summary and key practice point: The Chancellor, Philip Hammond, delivered the Autumn 2018 Budget on 29th October 2018. This included the following measures of relevance to share schemes:

- The qualifying holding period for entrepreneurs' relief for acquisitions of shares through enterprise management incentives (EMI) options will be increased to two years.
- Where individuals are required to hold at least 5% of share capital and voting requirements to qualify for entrepreneurs' relief, they must now also be entitled to 5% of the distributable profits and net assets of the company.
- Individuals whose shareholding is diluted below the 5% qualifying threshold for entrepreneurs' relief as a result of a new share issue will still be able to benefit from the relief in certain circumstances, except where such dilution occurs due to the exercise of options by employees.

It was confirmed that the income tax personal allowance will be increased to £12,500 and the higher rate threshold to £50,000 in April 2019 – a year earlier than the manifesto promise.

More detailed analysis/commentary: For disposals of shares on or after 6 April 2019, entrepreneurs' relief will only be available to EMI optionholders who sell shares two years or more after the date of grant of the option. This measure is intended to support longer-term business investments. However, this change will not apply where the company whose shares are under option ceased to be a trading company or a member of a trading group before 29 October 2018; the one-year holding period will continue to apply.

One of the conditions for entrepreneurs' relief (save in relation to EMI shares) is that the individual has at least 5% of the ordinary share capital and voting of the company. In order to tackle identified abuse, since 29 October 2018, shareholders are now required also to be entitled to at least 5% of the distributable profits and net assets of a company to claim the relief.

The Government intends to legislate in the Finance Bill 2019 to allow individuals whose shareholding is diluted below the 5% qualifying threshold for entrepreneurs' relief as a result of a new share issue to obtain relief for gains up to that time. The measure will have effect for shares held at the time of fundraising events which take place on or after 6 April 2019. However, this extension of the relief will not be available where dilution occurs due to employees exercising options.

PRA Remuneration compliance for Level One firms

Summary and key practice point: On 18th October 2018, the Prudential Regulatory Authority (PRA) published a Dear Remuneration Committee Chair letter, outlining an update in the way it supervises compliance with the Remuneration Part of the PRA Rulebook by proportionality Level One firms, in advance of its annual review of firms' remuneration policies and practices.

With effect from the 2018/19 remuneration review, the PRA will no longer provide a "non-objection" statement to the proposed communication or distribution of variable remuneration awards by Level One firms (banks, building societies and certain investment firms, with total assets exceeding £50 billion).

More detailed analysis/commentary: The PRA says that this reflects a change in approach - increasingly, it will draw on the principles for governance set out in the senior managers and certification regime. There will be greater emphasis on how remuneration committees carry out their independent challenge and oversight role in accordance with the PRA's Remuneration Rules and how the chairs of those committees (or, where applicable, other senior management functions) discharge their responsibilities under the SMCR. The FCA has sent a similar communication to firms.

PRA supervisors will continue to engage with Level One firms throughout the year as part of its review of firms' remuneration policies, practices and processes. Where relevant, the PRA will provide feedback to these firms following the annual remuneration round, to draw attention to issues to be addressed. The PRA expects Level One firms to submit a remuneration policy statement and quantitative data tables three months ahead of the firm's preferred final feedback date (previously referred to as the "non-objection date"), with an update of the figures at least two weeks before the final feedback date.

HMRC ERS bulletin: non-statutory clearance for share scheme queries and tax-advantaged "catch all" rules

Summary and key practice point: HM Revenue & Customs (HMRC) published employment-related securities (ERS) bulletin 30 on 2 November 2018. Key points of interest are as follows:

- The ERS bulletin notes that most of the requests submitted to HMRC since 2014, when the system of obtaining HMRC prior approval for tax-advantaged employee share schemes was replaced with the self-certification regime, fall within the scope of the general non-statutory clearance procedure. It therefore requests that in future, where advice is sought from HMRC about changes to share plans or proposed transactions affecting share plans, these are submitted through the non-statutory clearance procedure. If the company has an allocated Customer Relationship Manager (CRM), all non-statutory clearance requests should be sent directly to them.

- Where companies operate a main share scheme with a sub-plan to operate a tax-advantaged share scheme, that sub-plan must meet the specific requirements of the relevant legislation to qualify for favourable tax treatment. The sub-plan should clearly identify which rules of the main plan will apply. HMRC warns that use of a "catch all" rule may result in the plan being viewed as non-qualifying.

More detailed analysis/commentary: Since the pre-approval regime was replaced with self-certification, HMRC has continued to respond to queries concerning the statutory requirements which must be met for favourable tax treatment under the CSOP, SAYE and SIP legislation to apply (albeit with much more limited resources). In the future, these requests should be submitted using the non-statutory clearance procured, via the company's CRM if possible. This means it will no longer be possible for advisers to raise queries on a "no names" basis.

It is not clear whether the non-statutory clearance procedure should be used only for queries relating to self-certified CSOPs, SAYE plans and SIPs, or for all queries (other than EMI plans, for which a separate system applies).

Horizon scanning

What key dates and developments in employee incentives should be on your radar?

Date	Development
31st December 2018	Applications for postponing the disguised remuneration loan charge to be made by this date
1st January 2019	Revised UK Corporate Governance Code due to take effect Associated legislation due to come into force - including to require listed companies to report annually the ratio of CEO pay to the average pay of their UK workforce
29th March 2019	European Union (Withdrawal) Act 2018 to take effect

4th April 2019	Gender pay gap reporting deadline
6th April 2019	Extension of holding period to qualify for entrepreneurs' relief extended to two years from disposals made on or after this date
April 2019	Annual updates to employment rates and limits

Jonathan Fenn
T +44 (0)20 7090 5025
E Jonathan.Fenn@slaughterandmay.com

Padraig Cronin
T +44 (0)20 7090 3415
E Padraig.Cronin@slaughterandmay.com

Phil Linnard
T +44 (0)20 7090 3961
E Phil.Linnard@slaughterandmay.com

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