Incentives Bulletin

December 2018

Welcome to the December edition of our Incentives Bulletin, updating you on the latest developments in remuneration and share schemes. This month, we look at the new **Investment Association Principles of Remuneration for 2019**, the **ISS 2019 Proxy Voting Guidelines**, the updated **GC100 and Investor Group directors' remuneration reporting guidance**, the **Wates Principles** and the recent **Upper Tribunal decision relating to HMRC's ability to resile from published guidance**. We conclude with a timeline of **key dates in employee incentives** coming up in the near future.

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New Investment Association Principles of Remuneration for 2019

Summary and key practice point: In November 2018, the Investment Association published new Principles of Remuneration for 2019. This included the following key points of relevance to incentives:

- Requirement for a minimum two year holding period to apply post-termination of employment.
- Requirement to set a list of circumstances in which malus and clawback can apply going beyond gross misconduct or misstatement of results.
- New guidelines on the use of restricted share plans, including requirements for performance underpins and five year vesting periods.

More detailed analysis/commentary: The new Investment Association Principles of Remuneration set out new investor expectations and have been updated partly to reflect the new UK Corporate Governance Code. These are also summarised in a *Dear Remuneration Committee Chair* letter, which encourages companies to consider the wider pay context, including adopting new pay ratio reporting requirements for accounts published in 2019.

The Principles recommend that, in respect of the UK Corporate Governance Code's new policy on post-employment shareholding requirements, such requirements should apply for at least two years at a

level equal to the lower of the company's shareholding requirement in force immediately before leaving or the executive's actual shareholding on leaving. Such requirement should be introduced at the earliest opportunity and by the next remuneration policy vote at the latest; and the Remuneration Committee should explain how it will ensure such requirements are enforced/maintained.

In a similar manner, picking up on the revised UK Corporate Governance Code, the new Principles recommend that a more substantial list of circumstances in which malus and clawback could be triggered other than gross misconduct or misstatement of results be specified. The relevant terms should be clearly set out and accepted by the relevant executive director, through a form of acceptance. The Principles further specify that all communications relating to malus and clawback should be consistent with such provisions and that the Remuneration Committee should develop clear processes for assessing whether malus or clawback has been triggered.

The Principles continue to note a reluctance among investors in respect of restricted share plans. They note that investors recognise that they may be appropriate "in certain sectors and businesses" but that in "turnaround" situations, the proposals would still be subject to the same level of scrutiny as normal; and that where a company proposes to switch to restricted share awards, investors may be suspicious if either the current structure appears to work or there is a possibility the proposal is being made only because current structures are not resulting in payment. The Principles set out detailed guidance in respect of their use – in particular, requiring a performance underpin such that the Remuneration Committee confirms that vesting is appropriate; and five year vesting periods with post-vesting and post-employment shareholding requirements applying.

Finally, the Principles also make other changes such as requiring Remuneration Committees to respond to significant dissent against any remuneration resolution; discouraging cash awards; and discouraging retirement as being an automatic good leaver circumstance unless appropriate mitigation provisions are in place.

ISS 2019 Proxy Voting Guidelines

Summary and key practice point: The Institutional Shareholder Services (ISS) announced updates to its proxy voting guidelines for 2019 for countries including the UK on 19 November 2018, to take effect for meetings taking place on or after 1 February 2019. This included the following key points of relevance in relation to incentives:

- Remuneration Policies should state that target bonuses will typically be no more than 50% of the maximum bonus potential; and that share awards should be subject to a total vesting and holding period of five years or more.
- Where there has been a material decline in company's share price, the Remuneration Committee should consider reducing the size of LTIP awards at grant.
- Fees payable to NEDs should not be excessive relative to similarly-sized companies in the same sector.
- Approvals of new or amended LTIPs should state that dilution limits will be in line with Investment Association Guidelines.

More detailed analysis/commentary: The changes made by the ISS seem, in part, to reflect the updated UK Corporate Governance Code.

ISS have said they believe companies have awarded generous bonuses even in cases of mediocre or poor performance, leading to high dissent against remuneration proposals. Their suggested change is intended to provide guidance but not to apply mechanistically – the Remuneration Committee should consider a number of other inputs such as the wider remuneration package and historical pay-performance alignment.

The suggested changes to the vesting and holding periods are intended to reflect market practice as well as the UK Corporate Governance Code. The ISS states that market practice is for share awards to have a three year performance period followed by a two year holding period, though the Code itself requires the two periods combined to be a minimum of five years.

The requirement to consider reducing the size of an LTIP award where there has been a material decline in the company's share price derives from the idea that if a constant percentage of salary is used, a greater number of shares may be required to fund the award. The change in respect of NED fees, however, is to provide flexibility to reflect on the magnitude of NED fees within the scope of the remuneration report.

GC100 and Investor Group directors' remuneration reporting guidance

Summary and key practice point: The GC100 and Investor Group published new guidelines for directors' remuneration reporting on 7 December 2018. The guidance has been updated primarily to reflect changes to reporting requirements introduced by the *Companies (Miscellaneous Reporting) Regulations 2018* and includes the following key changes:

- Updating the sections in respect of the annual statement to reflect the new requirement for the Remuneration Committee chairman to include a summary of any discretion exercised in the award of directors' remuneration.
- Expanding guidance in respect of the single total figure of remuneration to provide guidance on the new requirement to disclose, in relation to short or long-term awards, the amount (or estimate of the amount) of the award that is attributable to share price appreciation and, where discretion has been exercised, how the award was determined and whether discretion has been exercised due to share price appreciation or depreciation.
- Adding a new section to incorporate guidance on the new requirement for companies with an average of over 250 employees in the UK to disclose pay ratio tables.
- Adding guidance on the new requirement for the remuneration policy to disclose, in relation to long-term incentives and other awards with performance measured over more than one financial year, an indication of the maximum remuneration receivable, assuming share price appreciation of 50% during the performance period.

More detailed analysis/commentary: The guidance has been updated to reflect changes to reporting requirements that will take effect in respect of financial years beginning on or after 1 January 2019 and is designed to be read in conjunction with the *Companies (Miscellaneous Reporting) Regulations 2018 Q&A*.

While the changes in respect of the annual statement only expand on previous guidance, the guidance in respect of the single total figure of remuneration is newer. The guidance notes that it is uncommon for short-term awards to be attributable to share price appreciation as performance measures tend not to be linked to share price – and that where a bonus is deferred into shares with no additional

performance measures, any increase in value as a result of share price appreciation does not constitute reportable remuneration. However, deferred awards with performance measures and long-term incentive awards with performance shares warrant further consideration. The guidance also states that where the performance measure is satisfaction of TSR or an absolute share price target, it is arguable that the parts of the award subject to those targets is attributable to share price appreciation but that the test remains the difference between vested value and face value at time of grant – companies may wish to make a footnote to note this. Where the share price has depreciated, the guidance suggests that this be acknowledged in the disclosure of long-term incentives vested during the year.

In respect of the new requirement to set out pay ratio tables, the guidance sets out details of what should be disclosed if a company is exempt in certain years, or if their CEO leaves during the year. The guidance contains details in respect of which methodology should be used and notes that the methodology used for calculating the CEO's single total figure should be used for calculating the pay and benefits of the UK employees, while estimates for non-salary components such as bonus should be avoided. The guidance notes that investors will pay close attention to the disclosures and that if a Remuneration Committee considers that the ratio is not consistent with pay, reward and progression policies, the intended necessary actions to address this issue should be disclosed.

Finally, in respect of the new disclosure requirements relating to the maximum remuneration receivable if there is a share price appreciation of 50% during the performance period, the guidance notes that while there is no requirement to include this in the bar chart setting out what directors could receive under the policy, it should at least appear in the same section of the remuneration report. A short description of the basis of calculation should be included but the guidance notes that this could be as simple as *The basis of the calculation of the share price appreciation is that the share price embedded in the calculation for the 'maximum' bar chart is assumed to increase by 50% across the performance period.*

Wates Corporate Governance Principles for Large Private Companies

Summary and key practice point: The Wates Corporate Governance Principles for Large Private Companies were published on 10 December 2018. These are designed to help companies comply with the requirements of the *Companies (Miscellaneous Reporting) Regulations* 2018. Of particular interest to incentives is:

- Remuneration should be linked to the achievement of company strategy.
- Policies may include robust consideration of the reputational and behavioural risks that can result from inappropriate incentives and excessive rewards; and should take account of the broader operating context, including pay and conditions of the wider workforce.
- Boards should consider the benefits of greater transparency – for example, extending to commenting on how executive remuneration reflects general practice within the sector; or voluntary disclosure of pay ratios.
- Boards may wish to consider delegating responsibility for remuneration to a committee and including an independent non-executive director on such committee.
- In the case of subsidiaries, the subsidiary should explain which policy applies to it (if director pay is controlled by a parent) and how it applies.

More detailed analysis/commentary: The Wates Principles provide large companies with a framework for complying with the new requirements of the *Companies (Miscellaneous Reporting) Regulations 2018*,

which apply to accounting periods beginning on or after 1 January 2019. They reflect an ongoing review into corporate governance.

In respect of the sphere of incentives and remuneration, the Principles suggest that a system similar to the one that applies to listed public companies should be employed. There is also a noticeable emphasis on comparing executive remuneration with the wider workforce and inhibiting excessive pay, in line with scrutiny increasingly being applied in respect of large listed companies.

Upper Tribunal holds that taxpayer had legitimate expectation that HMRC would not resile from published guidance

Summary and key practice point: In *R(Vacation Rentals (UK) Ltd) v HMRC [2018] UKUT 383*, the Upper Tribunal overruled HMRC's decision not to apply its published VAT guidance. While the case was about exemptions from VAT card handling services, the case has wider significance as it demonstrates that HMRC cannot resile from published guidance if that guidance is clear, unambiguous and unqualified.

Facts: The claimant was a booking agent between holidaymakers and property owners. As part of its role, the claimant would collect payment from the holidaymakers for the property owners. If payment was made by credit or debit card, the claimant would charge an additional fee. It treated such fee as exempt from VAT, based on HMRC guidance *BB 18/06*, which had been published following a case known as Bookit. This stated that a VAT exemption would apply in card handling supply if it involved: (i) obtaining the credit or debit card information with the necessary security information from the customer; (ii) transmitting that information to the card issuers; (iii) receiving the authorisation codes from the card issuers; and (iv) transmitting the card information with the necessary security information and the card issuers' authorisation codes to the intermediary bank that liaises between the card issuer and the taxpayer. BB18/06 specifically stated that if an agent, acting for the supplier of goods or services, made a charge to the customer over and above the price of the goods or services, for a separately identifiable service of handling payment by credit or debit card, and that service included the fourth component listed above, the charge would be exempt from VAT.

HMRC refused to apply *BB 18/06* to the claimant and issued VAT assessments. HMRC held that as the facts in Bookit had been different (in particular, that in Bookit, the agent was required to obtain the authorisation code first whereas here, the intermediary bank had obtained the authorisation code first) and so the guidance and law did not exempt the claimant from VAT. The claimant applied to the Upper Tribunal for judicial review of this decision. The Upper Tribunal overturned this decision.

More detailed analysis/commentary: The Upper Tribunal held that the point relied on in Bookit by HMRC was not, in fact, the crucial aspect of the Bookit judgment and that there had been a later case in which the intermediary bank had received the relevant codes first which had benefited from the exemption. As the guidance had not drawn a distinction between the two cases, this suggested that HMRC did not regard it as essential that the agent obtain the codes first. The Upper Tribunal also noted that guidance is not to be construed in the same manner as legal statute but by reference to a "fair reading by an ordinarily sophisticated taxpayer".

In considering whether the guidance gave rise to a legitimate expectation, the Upper Tribunal found that it would do so if it was clear, unambiguous and unqualified. In this particular case, the Upper Tribunal found that the guidance was so clear, unambiguous and unqualified, and that the distinction

HMRC had tried to draw between who first received the codes was of no material significance to the real question of whether the claimant's actions brought about a transfer of money from the intermediary bank to the claimant. Consequently, there was a legitimate expectation that the guidance would apply and HMRC had not established an overriding interest to justify the frustration of the expectation.

Although the decision related to VAT, the key principle is that HMRC can resile from published guidance but only where such guidance is not clear, unqualified and unambiguous. As there is plenty of guidance relating to share schemes published by HMRC, this is an important principle to bear in mind when perusing the guidance and considering whether a course of action is acceptable to pursue.

Horizon scanning

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

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 (*Companies (Miscellaneous Reporting) Regulations 2018*) 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

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