SLAUGHTER AND MAY

Incentives Bulletin

November 2019

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 **new guidelines** from the Investment Association, ISS and Glass Lewis on **executive remuneration**, the general election **manifesto pledges** from the Conservative, Labour and Liberal Democrat parties, and recent case law developments. We end with a timeline of **key dates** in employee incentives coming up in the near future.

Contents

- New guidelines on executive remuneration
- General election manifesto pledges from the Conservative, Labour and Liberal Democrat parties
- *R Toone v W Ross*: employee benefit trusts payments were unlawful
- *Christa Ackroyd Media Limited v HMRC*: IR35 update
- Horizon scanning

New guidelines on executive remuneration

Summary and key practice point: In anticipation of the 2020 AGM season, the Investment Association (the IA) published its latest "Principles of Remuneration" executive pay guidelines on 5 November 2019. Glass Lewis and Institutional Shareholder Services (ISS) also released updated proxy voting guidelines for 2020 AGMs, on 4 November and 11 November respectively.

As expected, these updates bring their guidance into line with the 2018 Corporate Governance Code (the Code).

The key changes relevant to executive remuneration relate to the following areas:

1. **Pensions:** The IA picks up on the new obligation in the Code for companies to seek to align the pension contributions paid for the benefit of executive directors with the contributions available to the wider workforce. The IA guidelines require that, from 2020, where the pension contributions for existing directors are higher than the "standard employee" rate, the Remuneration Committee is expected to set out in its Directors' Remuneration Report a "credible action plan" to reduce directors' contributions to the "standard employee" rate by the end of 2022. When making this disclosure, the Remuneration Committee should state what the "standard employee" rate is and how this has been derived. Companies should also note that the IA has published guidance to the effect that it sees the non-alignment of executive and workforce pension contribution rates as a voting issue for shareholders when it comes to the approval of the Directors' Remuneration Report.

   Glass Lewis and ISS have followed a similar approach, and recommend that pension arrangements for new joiners be aligned with those of the wider workforce. For incumbent directors, companies should seek to align the contribution rates with the workforce over time. ISS notes that many investors in the UK will expect this to be achieved in the near term.

We note the reports in the press this week that both Lloyds Banking Group and Barclays are set to make significant cuts to the pension packages of their executive directors, following similar moves by Standard Chartered, HSBC and RBS.

2. **General Remuneration Committee considerations:** The IA states that Remuneration Committees should have the discretion to override the formulaic outcomes of the performance metrics applicable to variable pay, in circumstances where it is appropriate to do so, including circumstances that "*impact on stakeholders including the company's workforce, for example if there has been a significant health and safety failure or a poor outcome for clients*". In line with this, Glass Lewis have added the expectation that Remuneration Committees should consider exercising downward discretion where a company has suffered an exceptional negative event, even if formulaic targets have been met. According to Glass Lewis, investors may, for example, expect a Remuneration Committee to reduce a bonus or LTIP grant following a significant decline in share price. ISS has added a new recommendation for Remuneration Committees to disclose how they have taken into account any relevant environmental, social, and governance matters when determining remuneration outcomes. Examples listed by ISS include workplace injuries and fatalities as well as any regulatory fines or sanctions.

3. **Incentive plans:** The IA recommends that any long-term incentive awards granted to executive directors should have, in aggregate, a vesting period and holding period lasting at least 5 years. For the first time, the IA also recommends that companies consider introducing discretion into their incentive arrangements to limit vesting outcomes if a specific monetary value would otherwise be exceeded. In parallel, Glass Lewis has updated its guidelines to emphasise their expectation that all incentive plans should feature clear and transparent award limits, ideally expressed as a multiple of base salary per employee, and to clarify their expectation that LTIPs should allow for no more than 25% vesting for threshold performance. Companies will need to consider carefully how these recommendations could be delivered, balancing the need to avoid negative publicity for delivering remuneration perceived to be "excessive" in certain quarters with the loss of the incentive effect that a cap or threshold may have on management to carry on delivering shareholder value. Companies will also need to consider how to implement a monetary cap without undermining their ability to recruit new executive directors of the right calibre.

4. **Malus and clawback:** The IA's position is that Remuneration Committees should have all the necessary malus and clawback arrangements in place to apply to both unvested and vested variable pay when the situation justifies it. Whilst the IA accepts that the "trigger events" will vary from company to company, it highlights the FRC's guidance that the likely circumstances in which these provisions may apply would include: an error in the relevant performance assessment; misconduct; a misstatement of accounts; serious reputational damage and corporate failure.

5. **Diversity:** ISS will now generally recommend voting against the chair of the nomination committee (or other directors on a case-by-case basis) where there are no female directors on the board of widely-held companies. Mitigating factors include the presence of a female director on the board at the preceding annual meeting and a firm commitment, publicly available, to appoint at least one female director to the board within a year.

6. **Bonus targets:** ISS guidelines on disclosure of bonus targets have been amended to reflect market practice and encourage disclosure to take place immediately following the reporting year. Any company choosing to disclose one or more years in arrears would be viewed sceptically, and the lack of a compelling explanation may attract a negative vote recommendation.

7. **Leavers and notice period:** The IA's view is that shareholders would expect the notice period for executive directors to commence when the individual resigns or when the decision is made that the individual will leave the company (and not at a later date, which has developed as a practice among some companies). ISS's guidelines echo this, stating that formal notice should be served no later than the day on which the departing executive's leaving date is announced. If a company chooses not to serve notice at this time, it should explain its reasoning for this in the subsequent Remuneration Report.

8. **Shareholding guidelines:** The IA emphasises in its letter to Remuneration Committee chairs accompanying the Guidelines its view on the application of share ownership guidelines to executive directors. The IA stipulates that executives should seek to satisfy the relevant guidelines both by share awards vesting and by independent purchases in the market. In accordance with the Code, the Guidelines advocate share ownership guidelines continuing to apply to executives after they have left employment (in the IA's view, for at least two years).

These updates follow the GC100 and Investor Group's updated guidance on directors' remuneration reporting published on 22 July 2019 and covered in our October edition. The update focused in particular on the increased obligations to compare executive remuneration with the wider workforce.

General election manifesto pledges from the Conservative, Labour and Liberal Democrat parties

Summary and key practice point: In the run up to the 2019 general election, the Conservatives, Labour and the Liberal Democrats have published their manifestos. The key remuneration-related proposals are summarised in the table below.

There is a clear focus on remuneration in all manifestos, with Labour and the Liberal Democrats proposing to go significantly further than recent reforms on employee representation and giving the workforce a greater say on executive pay.

Executive Remuneration	**Conservatives**: improving incentives "*to attack the problem of excessive executive pay and rewards for failure*".
Employee representation and share ownership	**Labour**: requiring 1/3rd of boards to be reserved for elected worker-directors and give them more control over executive pay, and giving the workforce a 10% stake in listed companies, paying a dividend of as much as £500 a year to each employee, with surplus funding a Climate Apprenticeship Fund. **Liberal Democrats**: requiring binding and public votes of shareholders on executive pay policies; giving staff in listed companies with more than 250 employees a right to request shares (to be held in trust); requiring all UK-listed companies and all private companies with more than 250 employees to have at least one employee representative on their boards with the same legal duties and responsibilities as other directors, and, for all companies, staff representation on remuneration committees.

Directors' duties and general corporate law	**Labour**: amending the Companies Act, requiring companies to strengthen protections for stakeholders, including small suppliers and pension schemes. **Liberal Democrats**: reforming fiduciary duties and company purpose rules to ensure that all large companies have a formal statement of corporate purpose, including employee welfare, environmental standards, community benefit and ethical practice, alongside benefits to shareholders, and that they report formally on the wider impact of the business on society and the environment.
Equality and pay gap reporting	**Labour**: requiring employers with over 250 (50 by the end of 2020) employees to obtain government certification on gender equality or face further auditing and fines; extending pay-gap reporting to BAME groups and tackle pay discrimination on the basis of race. **Liberal Democrats**: extending the Equality Act to companies with more than 250 employees, requiring them to monitor and publish data on gender, BAME, and LGBT+ employment levels and pay gaps; requiring 40% of female board members in FTSE 350 companies, and implementing recommendations of the Parker review to increase ethnic minority representation.
Tax	**Labour**: launching "*the biggest ever crackdown on tax avoidance and evasion*" and "*reform the inefficient system of tax reliefs*", and ending "*the unfairness that sees income from wealth taxed at lower rates than income from work*". **Liberal Democrats:** taxing income from capital "*more fairly compared to income from work by abolishing the separate Capital Gains Tax-free allowance and instead taxing capital gains and salaries through a single allowance*".

R Toone v W Ross: employee benefit trusts payments were unlawful

Summary and key practice point: In *R Toone v W Ross* [2019] EWHC 2855, the High Court held that certain amounts paid into employee benefit trusts (EBTs) were unlawful distributions of capital.

When a company entered into insolvent liquidation, the joint liquidators claimed that amounts which had previously been paid into two EBTs were unlawful capital distributions, as they were made for the purpose of making tax free payments to the shareholders, who were also employees.

Witness statements from these employees did little to dispel this impression: one employee explained "*with due candour*" that entering into the EBT arrangements "*was believed by us collectively to be clearly more tax efficient than paying salary or dividends*". The judgment also points to the fact that the only employees who were beneficiaries of the trust were the company's shareholders, with payments from sub-trusts paid in proportion of their shareholding.

The court held that the directors, by failing to seek independent legal advice and deciding to take a risk they did not entirely understand in order to secure tax-free distributions, had breached their duties under the Companies Act.

While the decision is not surprising, it serves as a helpful illustration of the limitations placed on the use of EBTs, which should not be treated as flexible tools for indirect remuneration without robust legal advice.

Christa Ackroyd Media Limited v HMRC: IR35 update

Summary and key practice point: In the first IR35 TV presenter case to reach the Upper Tribunal (the UT), the UT upheld on 25 October 2019 the decision of the First-tier Tax Tribunal in *Christa Ackroyd Media Limited* [2019] UKUT 326 (TCC), finding that the intermediaries legislation, known as IR35, applied to a presenter providing services to the BBC via a personal services company (PSC) on the basis that the BBC had sufficient control of the presenter.

The key factor of control justified the conclusion that, had services been supplied directly by the presenter rather than through her PSC, an employment relationship would have subsisted. Accordingly, income tax and NICs should have been accounted for by the PSC.

Horizon scanning

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

10 June 2019	The new SRD II requirements for Directors' Remuneration Reports (such as extending the scope of the report to the CEO and deputy CEO even if not on the Board; comparisons between directors' and workforce pay; and companies being required to explain their decision making process on executive remuneration) will start applying for financial years beginning on or after 10 June 2019
12 December 2019	General election
1 January 2020	UK-incorporated quoted companies must start reporting their CEO pay ratios
6 April 2020	All termination payments above £30,000 threshold will be subject to employer class 1A NICs
6 April 2020	Off-payroll working rules (IR35) come into force for the private sector
5 July 2020	HMRC deadline for filing annual share schemes returns for 2019-2020

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