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Compensation Restructuring – UK and Europe

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UK Budget Announcement

The announcement of the UK's 2009 budget on 22 April 2009 introduced a new top rate of income tax. From April 2010, an additional income tax rate of 50 per cent will apply to people earning over £150,000 and the income tax personal allowance will be reduced for those with incomes over £100,000. From April 2011, pension tax relief will also be restricted for those with incomes over £150,000.

Recent Developments in Financial Sector Remuneration Policy

The credit crisis has given rise to severe criticism of remuneration policies both within and outside the financial services sector. A recent report by the Policy Exchange suggests Britain should take the lead in reforming the bonus culture among senior bank employees by introducing less volatile incentive arrangements, and greater protection of shareholder interests. One recommendation, for example, is that shareholders should be invited to approve the appointment of remuneration consultants, as they do the appointment of auditors.

The UK Financial Services Authority (FSA) has also published a draft code of practice on remuneration policy for all FSA regulated firms.

The focus of the draft code is on corporate governance. It emphasizes the need to maintain appropriate corporate governance structures by ensuring the independence of the risk compliance function and of the remuneration committee. Specifically, the report recommends that the risk compliance function should be directly involved in the pay strategy process and report to the remuneration committee. Moreover, the compensation of staff in the risk and compliance functions should be set independently of the business areas. UK subsidiaries of non-UK firms should also have their own non-executive directors.

The draft code rejects the concept of benchmarking as the primary factor in setting pay and urges the use of judgment, taking into account the financial health of the firm concerned.

It is likely that implementation of the code will result in more onerous reporting obligations.

At the European level, the Committee of European Banking Supervisors (CEBS) has also recently published draft principles on remuneration policy. The principles are addressed to financial regulators and the firms they regulate and cover key features of remuneration policy including: the alignment of company and individual objectives; transparency towards stakeholders; performance measurement; and forms of remuneration. The principles will be integrated into new EU guidelines on internal governance which are expected by the end of the third quarter of 2009.

Criticism and public anger over executive remuneration has also sparked some European countries to take more immediate action. For example, France has recently announced a government decree curbing executive bonuses and banning stock options until the end of 2010 for companies that have received state funding (primarily banks) and a limit on bonuses and severance packages at publicly-owned companies.

Changes to Directors' Remuneration Reporting Requirements

New reporting requirements are now in force for UK quoted companies in relation to directors' remuneration during accounting periods beginning on or after 6 April 2009. Quoted companies will now have to explain how pay and employment conditions of the company and other undertakings within the same group have been taken into account in determining directors' remuneration.

Whilst the Combined Code on Corporate Governance (the key source of governance recommendations for UK listed companies) already requires sensitivity in this area, in the current economic climate, remuneration reports are likely to receive increased scrutiny by shareholders. Therefore, remuneration committees should be particularly cautious when preparing such reports.

New UK Pension Obligations

Employers will be required to contribute to workers' pensions under new obligations contained in the Pensions Act 2008.

Currently, UK employers are required to provide access to a stakeholder pension scheme for most employees; however, there is no current obligation on employers to make any pension contributions into employee plans. Under the new obligations, employers will generally be required to contribute a minimum of 3% of workers' qualifying earnings to a pension unless a worker "opts out" of the scheme. Employer contributions will be supplemented by a 4% contribution of qualifying earnings from workers and approximately 1% from the UK government in the form of tax relief. There will be a transitional period in which minimum employer contributions will gradually be increased to 3%. Employers will face civil and/or criminal penalties for breach of the new obligations.

Although the new obligations are not expected to come into effect until 2012, they may have significant cost implications for employers (particularly those who currently do not contribute to employee pension schemes). Therefore, employers should start planning for the changes now. In particular, the cost of future pension obligations should be taken into account when devising current long term incentive packages.

Dealing with Share Incentive Schemes during the Economic Downturn

Google's recent decision to exchange employee share options for new ones at a lower exercise price highlights the problems that many employers operating share option plans currently face. Share options have in the past proved to be a popular tool in recruiting, motivating and retaining employees and executives. However, the current economic downturn and resulting stock market turbulence has in many cases left employees and executives with "underwater" share options (i.e., the price payable on the exercise of the option is higher than the market value of the shares).

Employees and executives are also suffering diminishing returns in respect of share incentive plans (SIPs) – a drop in share prices will directly impact the value of the shares held in the SIP. Furthermore, share awards under Long Term Incentive Plans (LTIPs) (commonly known in the U.S. as "restricted stock plans") may not vest as underlying performance targets are missed.

Underwater Share Options

Employees with underwater options may not be

as motivated to perform well or even remain with the employer in the short term. Nevertheless, the rationale for granting share options is to align the interests of employees and executives with those of the shareholders. Where a company fails and its share price drops, employees and executives (whose decision-making may partly have caused the failure) should arguably suffer just as the shareholders of the company suffer. However, where underwater options arise due to external factors beyond the control of employees – such as a stock market collapse - employees and executive are likely to expect some sort of replacement incentive.

Employers face the challenge of balancing the demands of disgruntled employees with those of their shareholders who are unlikely to want to improve employee incentive plans, or to provide replacement compensation, in such tough economic times.

What can Companies do to Mitigate Underwater Options?

- ***Adjust other elements of the remuneration package.*** Companies concerned about the possible departure of disgruntled senior employees might consider establishing a "phantom" share option (bonus) plan under which employees would receive an option over a number of notional shares at current market values. On exercise of the option, the option holder would receive a cash sum equal to the growth in value of the notional shares over which the option was held. However, it may not be viable for many companies in the current economic climate to offer such additional cash payments.
  - An alternative approach may be to introduce an LTIP under which free shares are granted to employees and executives subject to achievement of performance criteria. The advantage to an LTIP for employees and executives is that there will always be a gain, even if the share price falls. The advantage for the company is that the incentive for the employee to perform well is maintained because vesting is subject to performance targets over a performance period (typically three years).
  - Again, shareholders are unlikely to welcome any restructuring of compensation packages, particularly where senior executives are concerned.
- ***Alter performance targets.*** The most commonly used performance criteria – total shareholder return and earnings per share – may now demotivate executives who feel they have little or no control over the performance measure. Companies and shareholders may now wish to consider alternative criteria.
- ***Grant new options keeping existing options in place.*** The Association of British Insurers (ABI) recommends that public companies make annual grants of options to reduce the risk of successive tranches of options going underwater. Companies can therefore grant options with exercise prices fixed at the bottom of the market value, so providing the potential for increased profits on the options in the future as the share price recovers.
- ***Replacement of options.***
  - Most plan rules permit the surrender of underwater options and the re-grant of new options at the lower current market value – although the ABI view is that the surrender and re-grant of options is not appropriate.
  - An alternative approach is to re-price the options. Re-pricing involves adjusting the option exercise price of the underwater option to the current lower market value. Re-pricing of

options is unusual in the UK because: option plan rules generally do not permit it; HM Revenue and Customs will not permit re-pricing of tax-approved options; and because institutional shareholder guidance published by the ABI does not support it. Companies listed on the Main Market of the London Stock Exchange would need to satisfy themselves that re-pricing an option after it has been granted is not a breach of Listing Rule 9.4.4 (which requires prior shareholder approval of the grant of any discounted option over newly issued shares).

- AIM-listed companies have greater flexibility to alter performance targets under share plans, and do not require shareholder consent to adopt new, or to amend existing, share incentive plans.

Can Employees do anything when faced with Underwater Options?

There is little employees can do. However, for share option schemes involving the use of a savings arrangement set up with a bank to fund the exercise price of an option (known as Save As You Earn or sharesave schemes (SAYE)), the underwater SAYE options need not be exercised; instead, the SAYE option holders may elect to pocket the proceeds of the savings arrangement with the bank together with a tax-free bonus.

Impact of the Economic Downturn on SIPs

As mentioned above, a fall in the share price of a company will affect the value of shares held in a SIP. What this means for companies offering SIPs is that the number of matching shares needed will increase significantly. If free shares are offered by the company based on a monetary value, the number of shares required will also increase. The company will therefore need to bear in mind dilution limits when dealing with free and matching awards.

Mitigating LTIPs

Where the vesting of shares under a LTIP is subject to the satisfaction of performance targets, the company could consider varying the performance targets so that they could more easily be met in the current economic climate. However, any material changes to performance targets or criteria would need to be reviewed and approved by shareholders, who are going to be concerned to avoid rewarding executives for failure.

Conclusion

Employers need to ensure that share and other incentive plans continue to deliver both for the employer and for employee participants. If share option plans are underwater, companies might consider altering the terms of those plans, or introducing new “recovery” plans. Alternatively, employers may simply grant more options – since the potential for gain in recovering businesses may now be significant. It is also important to review performance targets, with institutional shareholders, to ensure that targets are appropriate for the relevant groupings of employee participants and are effective in aligning the employee and shareholder interests.

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