28 February 2018

Share Plan Lawyers response to the Consultation by the Financial Reporting Council on Proposed Revisions to the UK Corporate Governance Code closing on 28 February 2018 (the "Consultation")

This response is sent by Share Plan Lawyers ("SPL"). SPL is an organisation for lawyers in law firms advising on employee share plans and, more broadly, in the field of executive remuneration. The group has approximately 250 members representing approximately 70 law firms with a further six specialist practitioners and Counsel. Members include many senior lawyers from all the major City and regional law firms. This response has been produced by a committee of SPL members, but does not necessarily represent the views of individual members of SPL or their firms.

A main purpose of SPL is to meet, consult with and make representations to the Government and other institutions involved in taxation, corporate and other regulatory issues in relation to employee share plans. Members of the SPL advise on the drafting and operation of all types of employee share plans and incentive arrangements. In practice they mostly advise the companies operating these arrangements rather than the employee participants.

Introduction

The Consultation covers some subjects and matters of policy which we consider to be beyond our brief. Accordingly, we respond only on those questions which are relevant to our area of practice. As a body, we have no view on the appropriate quantum of executive pay or whether and how the employee and wider stakeholder voice should be heard in the boardroom. However, we are concerned that UK legislation and voluntary regulation should be relevant, clear, and apply only where appropriate. It should not make the UK an unattractive venue for companies.

Q1. Do you have any concerns in relation to the proposed Code application date?

The final version of Code should be available in Summer 2018 applying to accounting periods starting on or after 1 January 2019. Companies will have a short period of time to arrange compliance with the new Code provisions. Many companies are anxious about having sufficient time, particularly for the provisions relating to employee/stakeholder voice and engagement.

Q2. Do you have any comments on the revised Guidance?

We note the status of the Guidance which is to assist companies in applying the Principles of the Code and to assist in reporting on how the Principles have been applied.

Paragraph 110 – This starts with a reference to "discretion to override formulaic outcomes". This is not, in itself, an unusual feature of plans. Some plans provide for a performance "underpin" precisely to address, in a discretionary manner, some of the examples referred to. In other cases, such as capital variations, it is normal practice for plans to include a power to vary the terms of outstanding awards, where appropriate.

In the final sentence, the paragraph states that "The remuneration committee should consider whether a cap on executive awards is appropriate and be prepared to explain the rationale behind its decision." It is already the case that the shareholder approved remuneration policy is required to include the maximum that may be paid in respect of each component of the remuneration package of the directors, expressed in monetary terms or otherwise (pursuant to paragraph 26(c) of Part 4 of Schedule 8 to the Large & Medium-Sized Companies & Groups (Accounts & Reports) Regulations 2008). Is the cap referred to in paragraph 110 the same as the maximum that may be paid under the policy?

The point arises again in the "Questions for remuneration committees", in the 4th bullet (What is the maximum award we think is reasonable for our executive directors and what will we do in the event the application of the formula produces an outcome in excess of that award?). If the award is in line with the policy, how would the application of the formula produce an outcome in excess of the award?

It is important to distinguish between the grant of long term incentives and cash bonuses. An incentive is not designed to deliver a particular cash amount at a point in the future, but to confer a quantum of equity (or equity-related) participation on grant and to drive behaviours over a vesting period. A shareholder in a high growth company would not expect there to be a limit (especially a discretionary limit) on the value to which his shares might rise.

We refer further to paragraph 110 below in relation to question 14 as it applies to Section 5 Provision 37.

Paragraph 111 – Is it intended to give further guidance on malus/clawback triggers? Members of SPL would be happy to discuss the legal issues surrounding these.

Paragraph 113 – There is a missing word on the final line ("used"?).

Q14. Do you agree with the wider remit for the remuneration committee and what are your views on the most effective way to discharge this new responsibility, and how might this operate in practice?

Section 5 Provision 33 (expansion of Remuneration Committee role):

We note the following concerns:

- The Consultation (paragraph 85) and the Guidance (paragraph 104) make clear that responsibility for overseeing workforce policies can be delegated to a committee other than the Remuneration Committee. We support that choice as, given the reference in the expanded remit to "remuneration *and workforce* policies and practices", we believe that the time implications will frequently be too great for Remuneration Committees consisting of non-executive directors. In addition, it would be appropriate for executive directors to input into determinations of wider workforce pay. We do not feel that paragraph 85 and paragraph 104, which suggest delegation to a separate committee and coordination with the Remuneration Committee, are consistent with Provision 33 which states that the Remuneration Committee **should** oversee workforce remuneration.

- Existing provision D.2.3. which effectively provides that the Remuneration Committee should not determine non-executive director pay has been deleted. New Principle Q and the Guidance (paragraph 107) set out that no director should be involved in deciding his or her own remuneration outcome and that the Remuneration Committee should have responsibility for determining remuneration for executive directors. It might assist clarity to state in paragraph 107 that the responsibility for non-executive directors' fees remains with the Board and shareholders.

Section 5 Provision 36 (promoting long-term shareholdings)

It should be clear that, where an executive receives shares under an award, they may sell some of those shares to pay any related tax and social security contributions, even during the holding period. This could perhaps be referred to in the Guidance. If this is not clarified, increased holding periods may act as a deterrent to the actual holding of shares (on release of an award or exercise of an option). This is because companies might be inclined to defer the vesting of the share awards, and option holders might defer the exercise of their options, so as to defer the tax liability until the end of the extended holding period when a sale can be effected.

We are unclear why there are references to 7 years in the Guidance (paragraph 109) when Provision 36 refers only to "at least 5 years". Should the Guidance be aligned?

Section 5 Provision 37 (Discretion to override formulaic outcomes):

As mentioned earlier, in relation to Paragraph 110, many companies already include in their performance conditions and/or incentive plan rules Board/Remuneration Committee discretion to determine that the overall performance of the company warrants lesser vesting, notwithstanding performance conditions having been met, which provides protection against “formulaic” outcomes.

It is not clear whether a broader discretion than this is helpful (indeed, we think that it may raise legal issues which we would be happy to discuss with you further) or that this is necessarily the intention of the proposed provision. It would be helpful to clarify statements such as that in paragraph 110 of the Guidance which suggests that awards should be adjusted if they do not deliver “policy intentions”. Is this a reference to the shareholder approved directors' remuneration policy? Could this be clarified? It is important to understand that incentive plans are established to drive positive performance. They are not designed to deliver a particular quantum. If a plan delivers significant rewards due to outperformance of the relevant metrics by which management performance is measured, that is unlikely to be contrary to the underlying policy. It would be unusual, in our view, for a company only to wish to reward management for growing the share price or turnover or return on capital, or whatever is the relevant measure, up to a certain fixed point, and Remuneration Committees could apply the "underpin" discretion referred to above (in our response to Q2) to adjust outcomes where external factors, such as Government policies or changes in tax rates, inflate performance.

Is there a reason why the provision refers to a Board discretion rather than a Remuneration Committee discretion?

Section 5 Provision 40 (consideration of the range of possible values of awards to directors to be identified and explained at the time of approving the policy):

We believe that this provision should be reviewed once the Statutory Instrument on LTIP outcomes referred to in the response to the Green Paper on Corporate Governance Reform published by BEIS has been published otherwise there is a risk of inconsistencies.

Q16. Do you think the changes proposed will give meaningful impetus to boards in exercising discretion?

There is a significant body of law relating to the exercise of discretion, in particular in the context of employment relationships. We would be happy to discuss these further with you. Whilst the revisions to the Code provide helpful context in relation to remuneration, we believe the focus should be on the design and grant of appropriate incentives rather than relying on broad discretions to amend outcomes with hindsight. Where award outcomes are subject to broad discretions, this may lead to larger initial grants to counter the risk (and so loss of incentive effect) inherent in the possible exercise of discretion.

Other

The revised Code should avoid references to share *options* and share *option* schemes (eg Section 2 Provision 15 and Section 5, Provision 34) where the intention is for the Code to apply to all share based incentives. References to share awards or incentives and share incentive plans would clarify that a more limited scope is not intended.

Share Plan Lawyers Corporate and Regulatory Committee
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