

THE
EXECUTIVE
REMUNERATION
REVIEW

SIXTH EDITION

Editors
Arthur Kohn and Janet Cooper

THE LAWREVIEWS

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REMUNERATION
REVIEW

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This article was first published in November 2017
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Published in the United Kingdom
by Law Business Research Ltd, London
87 Lancaster Road, London, W11 1QQ, UK
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Enquiries concerning editorial content should be directed
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ISBN 978-1-910813-87-4

Printed in Great Britain by
Encompass Print Solutions, Derbyshire
Tel: 0844 2480 112

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ACKNOWLEDGEMENTS

The publisher acknowledges and thanks the following law firms for their learned assistance throughout the preparation of this book:

ALLEN & OVERY

ALRUD LAW FIRM

BAKER MCKENZIE

BONN STEICHEN & PARTNERS

CLEARY GOTTlieb STEEN & HAMILTON LLP

CREEL, GARCÍA-CUÉLLAR, AIZA Y ENRÍQUEZ SC

GORRISSEN FEDERSPIEL

HANNES SNELLMAN

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J&A GARRIGUES, SLP

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MATTOS FILHO ADVOGADOS

TAPESTRY COMPLIANCE LLP

TRAVERS SMITH LLP

VIEIRA DE ALMEIDA

WOLF THEISS

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UNITED KINGDOM

*Mahesh Varia*¹

I INTRODUCTION

On 29 March 2017, the Prime Minister, Theresa May, gave the European Council formal notification of the UK's intention to leave the EU. Article 50 of the Treaty on European Union was triggered and the two-year window for negotiating the UK's EU exit ('Brexit') began. More than a year after the UK's referendum on EU membership, the relationship that will exist between the United Kingdom and the remaining EU Member States continues to be unclear. As noted in the previous edition of this chapter, as far as executive remuneration is concerned, it is likely that EU anti-discrimination laws and rules to curb excesses in executive pay will be retained by the UK. Prospectus requirements and social security rules may well be affected by Brexit and we will continue to monitor these closely. At the end of August 2017, the government published proposals to reform corporate governance, which include a requirement for companies to publish the ratio of CEO pay to average pay. In the meantime, shareholders have continued to use their existing powers to curb excessive remuneration, with shareholder opposition prompting several high-profile companies to drop or revise proposed executive incentive arrangements in the first half of 2017.

II TAXATION

i Income tax for employees

The rules determining an individual's residence for UK tax purposes are complex and depend on the person's particular circumstances. In the United Kingdom, an individual's liability to tax is determined by whether he or she is resident and domiciled in the country. The underlying principle is that those with the strongest links to the United Kingdom should pay more tax than those with weaker connections.

Historically, the concepts of residence and domicile were not defined by statute, however, this changed significantly from 6 April 2013 when a statutory residence test was introduced and the pre-existing concept of ordinary residence was effectively abolished.²

Broadly speaking, individuals who are UK-resident and domiciled in the United Kingdom are subject to UK income tax on their worldwide income, whereas those who are not pay tax only on income with a UK source. Proposed changes to the domicile rules will mean that individuals who are UK-resident for more than 15 of the past 20 tax years will be deemed to be UK-domiciled for most tax purposes. Further, individuals with a UK domicile

¹ Mahesh Varia is a partner at Travers Smith LLP.

² Finance Act 2013, Sections 218 and 219 and Schedules 45 and 46.

of origin and a UK place of birth will be deemed UK-domiciled for UK capital gains and income tax purposes whenever they are resident in the United Kingdom. Draft legislation to enact these changes has been published and it is expected that this will form part of the second Finance Act of 2017 and, if enacted, will take effect from 6 April 2017.

The rates of income tax for the 2017–202018 tax year³ are as follows:

	Bands	Rate	Tax on band
Basic rate	Up to £33,500	20%	£6,700
Higher rate	£33,501 to £150,000	40%	£46,600
Additional rate	Over £150,000	45%	N/A

In 2015, the government announced measures under which the rates of income tax would not increase during that parliament (known as the Tax Lock).⁴ Technically, that parliament was dissolved and a new parliament begun after the snap election in June. The Tax Lock stays in force for the moment and it remains to be seen whether the government will choose to retain it.

Generally, all compensatory payments are subject to income tax at the rates referred to in the above table. There are, however, certain forms of tax advantaged share plan under which benefits are taxed as capital rather than income, provided specified statutory criteria are met. Capital treatment is more favourable than income treatment for a number of reasons. To begin with, the highest rate of capital gains tax for most assets⁵ is currently 20 per cent. Further, individuals are able to utilise an annual exemption from capital gains tax in respect of gains of up to £11,300 (for the tax year 2017–2018). The tax advantaged plans commonly used for executives are the company share option plan (CSOP) and enterprise management incentives (EMIs). One particular feature of EMIs is that the disposal of shares acquired pursuant to them can benefit from a lower capital gains tax rate of 10 per cent.⁶

Companies have to self-certify their tax advantaged plans as meeting the necessary HMRC requirements. All share incentive arrangements (including those that are non-tax advantaged) must be registered with HMRC and an online annual return filed by 6 July.

Plans under which participants own shares from the outset remain popular and can give rise to growth that is taxed as capital. The government continues to be mindful of arrangements that seek to disguise remuneration as capital, and in recent years has introduced a number of anti-avoidance measures to combat them.⁷ During the past year, it is clear that the judicial view of tax-avoidance arrangements has moved with the result that HMRC has won some important cases in this area.⁸ The UK income tax rules for non-tax advantaged stock options, restricted share acquisition plans and restricted stock units are set out in the table below. It should be noted that in the United Kingdom it is common for restricted stock units

³ The UK tax year runs from 6 April to 5 April.

⁴ HMRC: Tax Lock: Income Tax, National Insurance contributions and VAT, 8 July 2015.

⁵ There is an 8 per cent surcharge on disposals of chargeable residential property and receipts of carried interest.

⁶ Taxation of Chargeable Gains Act, Section 169I(7A)–(7R).

⁷ For example, Income Tax (Earnings and Pensions) Act 2003, Part 7A.

⁸ For example, *UBS AG v. HMRC and DB Group Services (UK) Limited v. HMRC* [2016] UKSC 13 and *RFC 2012 Plc (in liquidation) (formerly The Rangers Football Club Plc) v. Advocate General for Scotland* [2017] UKSC 45.

to be structured as nil-cost stock options, as these offer greater flexibility over when income tax becomes payable and enable employers' social security obligations to be transferred to employees.

	Option	Restricted stock acquisition plans	Restricted stock units (structured as a nil cost option)
Tax treatment upon grant	No tax	No tax if unrestricted market value paid. Otherwise, income tax on discount if election to be taxed on grant is made	No tax
Tax treatment upon vesting	No tax	Income tax may arise on lifting of restrictions if unrestricted market value is not paid or if no election is made to be taxed on grant	No tax
Tax treatment on exercise	Income tax on the difference between market value of shares on exercise and exercise price paid	N/A	Income tax on the difference between market value of shares on exercise and exercise price paid
Tax treatment upon sale of underlying shares	Capital gains tax payable on difference between share sale price and market value of shares on exercise	Capital gains tax payable on difference between share sale price and market value of shares on acquisition (if no tax paid on vesting)	Capital gains tax payable on difference between share sale price and market value of shares on exercise

On 6 April 2015, changes took effect that reformed the way in which share-based incentives held by internationally mobile employees are taxed. The provisions require employers and employees to monitor the award-holder's residence over the 'life' of the award. In the case of a share option this will generally be from the date of grant until the award 'vests'.

As a matter of good corporate governance, it is becoming increasingly common for part of a bonus paid to an executive to be deferred, either on a voluntary or compulsory basis. The deferred element of the bonus is usually provided in the form of an option that vests after a period of time. Sometimes executives are given a matching award in the form of a stock option exercisable after two to three years, subject to the satisfaction of performance criteria.

Where remuneration is deferred or waived, care needs to be taken to ensure that an income tax charge is not inadvertently triggered before such deferral or waiver can take place. Charges can arise under the disguised remuneration legislation if a third party, such as an employee benefit trust, earmarks cash or assets to individual executives. The first Finance Act of 2017 included amendments that widened the scope of these anti-avoidance provisions⁹ and further provisions are expected in the second Finance Act of the year.

The use of clawback to recover payments made in the event of misconduct or misstatement is starting to gain popularity and is compulsory for certain companies within the financial sector. In 2014, the Upper Tribunal upheld a taxpayer's claim for tax relief in respect of a bonus that was subject to clawback. HMRC has since published guidance on the circumstances in which individuals can claim income tax relief for amounts clawed back.¹⁰

ii Social taxes for employees

In most circumstances, where income tax is payable, the employer is required to account for tax under the pay-as-you-earn (PAYE) collection system. Failure to recover this tax from

⁹ Finance Act 2017, Section 15, Schedule 6.

¹⁰ *HMRC v. Julian Martin* [2014] UKUT 429 (TCC) and HMRC Employment Income Manual EIM00800-00845.

an employee can lead to additional costs for the employer and further tax liabilities for the employee. To guard against this, it is important that incentive plans contain appropriate indemnities. Where tax is payable under PAYE, social security charges (national insurance contributions (NICs)) will also be due. For the 2017–2018 tax year, employee NICs are charged at 12 per cent for earnings of between £157.01 and £866 per week. Above this threshold, they are uncapped at a rate of 2 per cent. Employers also have to account for NICs at a rate of 13.8 per cent in respect of employees with weekly earnings above £157. These are also uncapped, and create an additional uncertain liability for an employer. In recognition of this, it is possible for employer NICs to be transferred to the employee in certain limited circumstances, such as the exercise of share options.

Many employers are able to reduce their employer NICs by £3,000 every year by applying the 'Employment Allowance', however, this is no longer available for companies where the only employee is the director of that company.

iii Tax deductibility for employers

Under UK law, the general rule is that a corporation tax deduction is available for expenses incurred wholly and exclusively for the purposes of a trade. Generally, employee salaries and associated costs such as employer social security contributions will be deductible under such principles. An exception to this is where the salary is paid more than nine months after the end of the period of account for which the deduction is claimed.¹¹ In such circumstances, any deduction is deferred until the accounting period in which the salary is actually paid.

A statutory corporation deduction is available in respect of employee share acquisitions and the exercise of share options provided certain conditions are met.¹² The conditions relate to the type of business carried on, the nature of the shares acquired and the employee's tax position. Anti-avoidance legislation restricts the availability of corporation tax deductions for contributions to employee benefit trusts to the point at which qualifying benefits or expenses are paid out of the contributions and within certain time limits.

iv Other special rules

A change in control (such as a takeover or share sale) can affect the statutory corporation tax relief available to a company on the exercise of options over its stock. Most plan rules state that options become exercisable following a change of control. One of the preconditions to claiming corporation tax relief in respect of such exercise is that the stock acquired is in a company either listed on a recognised stock exchange or not under the control of an unlisted company. Since an acquisition or takeover by a private or AIM-listed company might mean that this condition ceases to be met, a statutory provision was introduced to give corporation tax relief for a period of 90 days following a takeover by an unlisted or AIM company.¹³

When CSOP options are exercised within three years of grant, they can only receive favourable tax treatment in prescribed good leaver circumstances. These include injury, disability and redundancy, and cessation of employment within a group following a business sale or a sale of the subsidiary for which the individual works. Tax relief is also available when CSOP options are exercised in the event of certain cash takeovers. Some companies have

¹¹ Corporation Tax Act 2009, Section 1288.

¹² *Ibid.*, Part 12.

¹³ *Ibid.*, Section 1016(1A).

historically experienced difficulties with their CSOP options on a takeover as their shares often cease to satisfy the statutory requirements following a change of control. To remedy this, legislation specifically preserves income tax relief where the plan rules permit options to be exercised 20 days either side of a change of control.¹⁴

In the United Kingdom, the tax rules for benefits can be complex. While some are taxable under a statutory regime known as the benefits code,¹⁵ others are subject to their own special rules. Some benefits (such as employer contributions to registered pension schemes, within prescribed limits) are exempt from tax altogether. In the past, payment in the form of benefits in kind has been used as a means of avoiding social security contributions. This is less prevalent now that most benefits attract NICs. Some companies offer their employees a range of benefits from which they can make a selection to suit their particular circumstances. These are known colloquially as ‘cafeteria’ or ‘flex’ schemes, and usually involve the allocation of points or credits that can be spent in purchasing benefits. Under salary sacrifice arrangements, employees are allowed to give up a proportion of their taxable pay in exchange for a tax-exempt benefit such as employer pension contributions or childcare vouchers. These need to be structured carefully to ensure that the desired tax result is achieved. Following concerns that these ‘optional remuneration arrangements’ were being used too widely, the first Finance Act of 2017 introduced measures to restrict the benefits that can attract tax and NICs relief through salary sacrifice to pension, childcare and certain health-related benefits.¹⁶ These apply from 6 April 2017 subject to some transitional provisions for pre-existing arrangements.

Since 6 April 2016, a tax exemption for qualifying business expenses that are paid or reimbursed by an individual’s employer has been available and the dispensation regime (under which employers can agree with HMRC for certain payments to be made to employees free of tax) ceased to exist.¹⁷

Certain forms of termination payment can benefit from a £30,000 tax-free allowance¹⁸ (and escape social security contributions in their entirety). Following a review of the tax and NICs treatment of termination payments legislation is expected to be introduced in the second Finance Act of 2017 to provide that from April 2018, amounts above the £30,000 threshold will be subject to employer social security contributions and all notice pay (whether contractual or otherwise) will be subject to tax and social security contributions.¹⁹

III TAX PLANNING AND OTHER CONSIDERATIONS

An individual coming to work in the United Kingdom who is not domiciled here can claim to be taxed on the remittance basis in respect of his or her overseas earnings. These are broadly earnings with a foreign employer (i.e., one that is non-UK-resident) where the duties of the employment are performed wholly outside the United Kingdom (it should be noted that duties performed in the United Kingdom that are merely incidental to those carried out

14 Income Tax (Earnings and Pensions) Act 2003, Schedule 4, subparagraphs 25A(7A)–(7F).

15 *Ibid.*, Section 63(1).

16 *Ibid.*, Section 69A.

17 Finance Act 2015, Sections 11–14 and 17.

18 Income Tax (Earnings and Pensions) Act 2003, Sections 401–416.

19 HM Treasury/HMRC Consultation Document: 10 August 2016 ‘Simplification of the tax and National Insurance treatment of termination payments’.

abroad are ignored for this purpose). In order to be taxed on this basis, some individuals enter into dual contracts under which their UK and non-UK employments are separated although the circumstances in which the remittance basis of taxation will be available under such arrangements are limited.

Where an individual does not have separate employments, he or she might be able to claim overseas workday relief on his or her non-UK duties. Overseas workday relief is only available to individuals who are non-UK domiciled and based here for fewer than three years.

It is not possible to avoid UK tax simply by providing services through a personal services company. Legislation exists²⁰ that deems payments made to service companies to be employment income if, were it not for the existence of the service company, the relationship between the client and worker would be one of employment. If the worker is within the charge to UK income tax, these anti-avoidance rules apply wherever the company is incorporated or resident. The UK government has recently modified the rules applicable to agencies and in Finance Act 2017 introduced anti-avoidance legislation applicable to off-payroll workers in the public sector.²¹

The United Kingdom has a wide network of double taxation treaties, most of which are based upon the OECD Model Convention. These usually include a tie-breaker clause to determine the residence of an individual, and articles dealing with taxing rights over employment income and the avoidance of double tax. In circumstances where there is no double taxation treaty, UK domestic law can give unilateral relief for overseas tax as a credit against the individual's UK tax liability.

Since 1 September 2013, an additional form of employment status, 'employee shareholder', has existed.²² An individual adopting such status exchanges certain employment rights for tax advantaged shares in the business for which he or she works. The tax reliefs given to such status were, however, reduced with effect from 17 March 2016²³ and were removed completely for shares acquired in consideration of employee shareholder agreements made on or after 1 December 2016.²⁴

IV EMPLOYMENT LAW

i Non-competition covenants

In the United Kingdom, the use of non-competition covenants in employment contracts for executives is commonplace. While historically their value has tended to be as a form of deterrent rather than as an enforceable right, in recent years the courts have perhaps shown a greater willingness to uphold non-competition covenants. In each case, the courts will look carefully at whether the covenant in question is necessary to protect the relevant business. Covenants are only enforceable to the extent that they go no further than is necessary to protect the legitimate interests of the person's employer.

20 Income Tax (Earnings and Pensions) Act 2003, Part 2, Chapter 8.

21 Finance Act 2017, Section 6, Schedule 1.

22 Growth and Infrastructure Act 2013, Section 31 and Finance Act 2013, Section 55 and Schedule 23.

23 HM Treasury: Budget 2016 Paragraphs 1.126 and 2.193.

24 Finance Act 2017, Sections 12–14.

ii Non-solicitation covenants

Non-solicitation covenants are more likely to be successful if they relate to existing rather than potential customers. Other relevant factors will be the individual's role in attracting the business in question, his or her level of seniority, whether the individual had previously dealt with the particular customers in question and the loyalty of customers within that particular sector. As regards poaching employees, although there is no prohibition on an employee choosing to follow a former colleague, the courts have held that there are circumstances in which an employer has a legitimate interest in maintaining a stable workforce.²⁵

iii Enforceability of restrictive covenants

Generally, the courts will also consider the geographical reach and time duration of restrictive covenants to ensure they go no further than is necessary. In light of the increasing globalisation of business, courts are perhaps more willing to enforce covenants with a wider geographical reach provided this is necessary to protect the business's interests.²⁶ There is no set time period, as in each case it is necessary to look at how long is needed to protect the particular business; however, six to 12 months is generally regarded as the upper limit of enforceability. If the employee in question is placed on gardening leave (i.e., he or she is retained as an employee during his or her notice period, but not required to come into the workplace), this will affect the period of restriction the court is prepared to enforce. Recent case law has demonstrated that account will be taken of the time taken on gardening leave when determining how long a post-termination covenant can last.²⁷

Restrictive covenants in documents, such as share acquisition agreements and shareholders' agreements, are subject to the same rules on restraint of trade as those that appear in an employment contract. The courts are sometimes more willing to enforce broader restrictions contained in commercial documents that have been negotiated at arm's length. Any payments made to individuals for entering into restrictive covenants outside the terms of the employment contract are taxed as employment income. Usual practice is to allocate a specific proportion of any consideration to the restrictive covenant rather than leave it for the UK revenue authorities to attribute a larger sum.

iv Termination of employment

Where an executive's employment is terminated, there are a number of claims that he or she might bring against his or her former employer. A claim for wrongful dismissal can be made where the employer terminates a contract in breach of its terms. Usually this happens where an employer does not give adequate notice of termination. If an employer amends an employee's contract without his or her consent or otherwise fundamentally breaches the contract, the employee might be able to resign and claim that he or she has been constructively dismissed.

An employee who has been unfairly dismissed may be able to bring a statutory claim either instead of or in addition to any claim for wrongful dismissal. In most cases, the employee must have worked for a minimum period of time to be eligible for such remedy, although

25 See *Dawney Day & Co Ltd v. D'Alphen and others* [1997] IRLR 285, where a one-year non-solicitation covenant in an employment contract applicable to directors and senior employees was held to be enforceable.

26 See, for example, *Egon Zehnder Ltd v. Mary Caroline Tillman* [2017] EWHC 1278 (Ch). The covenant in that case was later declared invalid by the Court of Appeal on different grounds.

27 *Tullett Prebon plc and others v. BGC Brokers LP and others* [2010] EWHC 484 (QB).

there are exceptions. A claim must usually be made within three months of the dismissal, and the levels of compensation are in most cases limited by statute. Currently the compensation limit is the lower of £80,541 and a year's gross salary, plus a 'basic award' of up to £14,670 (giving a maximum limit of £95,211), although this is revised every year.

An executive who has been singled out for whistle-blowing or because of their sex, age, race, religion, belief, sexual orientation, gender reassignment, marital status, pregnancy or maternity or disability could also have a claim in respect of which there is no limit on the compensation that can be awarded.

An employer seeking to effectively settle statutory claims brought by an employee can do so by entering into a settlement agreement. This is a binding agreement between the parties that has to meet certain statutory requirements, including a condition that the employee has received independent legal advice in relation to the agreement.

Companies incorporated in the United Kingdom might need to obtain shareholder approval in respect of termination payments made to directors. Such approval is also required where the payment is in connection with a transfer of the company's business or a takeover. There are exceptions for payments made pursuant to existing legal obligations or as damages, so these provisions generally apply to payments that are *ex gratia*.

Representative bodies of institutional shareholders, such as the Investment Association, produce guidelines on best practice for listed companies in respect of severance payments. Such companies will generally take these guidelines into account, as they can influence the way in which key shareholders will vote.

UK-incorporated companies whose shares are listed on the London Stock Exchange are subject to additional requirements in respect of termination payments. The Companies Act 2006 (see Section VII) requires quoted companies to submit their policies on termination payments to a shareholder vote at least every three years. Any payments subsequently made in accordance with this policy must then be announced to the market.

V SECURITIES LAW

UK securities rules need to be taken into account when structuring share-based executive remuneration, and can primarily be found in the Financial Services and Markets Act 2000 (FSMA 2000) and the Prospectus Rules, which form part of the Financial Conduct Authority's (FCA) Rules and Guidance.

i The Prospectus Rules

The Prospectus Rules were introduced to implement the Prospectus Directive²⁸ in the United Kingdom. Under these Rules, it is unlawful for a company or firm, wherever incorporated or registered, to make an offer of transferable securities to employees in the United Kingdom unless a prospectus approved by the FCA (or the competent authority of another EEA state) has been published, or an exemption applies.

The starting position is the same for both private and publicly traded entities. In particular, transferable securities are defined as those that are negotiable on the capital market. 'Capital market' is not defined and is given a broad interpretation.²⁹

28 Directive 2003/71/EC.

29 For further information see the published non-binding guidance of the European Commission (in the form of questions and answers) on the interpretation of the Markets in Financial Instruments Directive, which

In the United Kingdom, the grant and subsequent exercise of an employee share option will not generally give rise to an obligation to publish a prospectus. This is because the FCA takes the view that employee share options (whether nil cost or otherwise) that cannot be assigned or transferred by the employee to a third party (as is usually the case) are not negotiable on the capital market and, therefore, are not transferable securities. The FCA also considers that the exercise of an employee share option is not an offer of the underlying shares to the public. Whether private company shares are negotiable on the capital market is a matter of fact, depending on the rights of the shares in question.

There are a number of exemptions from the need to file a prospectus. For example, an offer currently falls outside the requirements of the Prospectus Rules if the aggregate consideration payable under the offer across the whole of the EEA is less than €5 million calculated over a period of 12 months,³⁰ or if the offer is made to fewer than 150 people in each EEA Member State.³¹ The consideration threshold may change under the new Prospectus Regulation (see below) as Member States will be able to exempt offers from the prospectus requirement where the consideration is between €1 million and €8 million.

Even where none of the above exemptions are available, a prospectus will not be needed for an offer made to employees provided certain conditions are met.³² Instead, an employee information document will have to be made available to employees receiving the offer that contains information on the number and nature of the securities offered, and the reasons and details of the offer.³³ The exemption for offers of securities to directors and employees applies to all companies with a head office or registered office in the EEA, and to non-EEA companies with securities traded either on an EEA regulated market or a non-EEA market that is deemed by the European Commission to have an equivalent legal and supervisory framework.³⁴

In June 2017, the EU adopted the Prospectus Regulation,³⁵ which will introduce directly applicable rules that repeal and replace the Prospectus Directive. In most cases, these new rules will take effect on 21 July 2019, although certain provisions will apply from an earlier date. One key change for employee incentives is that from 21 July 2019, the exemption for offers made to directors and employees will no longer be limited to companies with EEA head offices or registered offices and non-EEA companies with securities traded on EEA regulated or equivalent markets.

ii The Financial Promotion Regime

The Financial Promotion Regime governs the circumstances and manner in which a company or firm can communicate an invitation or inducement to engage in investment activity to the public (including employees) in the United Kingdom. In particular, unless an exemption from the regime is available, any such communication must be made by a person authorised by the

contains further discussion of the definition of transferable securities.

30 Article 1(2)(h) of the Prospectus Directive and paragraph 9 to Schedule 11A of FSMA 2000.

31 Article 3(2)(b) of the Prospectus Directive and Section 86(1)(b) of FSMA 2000.

32 Article 4(1)(e) of the Prospectus Directive, Prospectus Rules 1.2.2R(5) and Section 85(5)(b) of FSMA 2000.

33 For further guidance on the contents of the information document, see paragraphs 173–176 of the ESMA/CESR guidance on the consistent implementation of Commission Regulation (EC) No. 809/2004 implementing the Prospectus Directive.

34 Prospectus Directive Amending Directive Instrument 2012 (FSA 2012/29).

35 Regulation (EU) 2017/1129.

FCA or the Prudential Regulation Authority (PRA), or the contents of the communication must be approved by a person authorised by the FCA or the PRA. Breaching the Financial Promotion Regime is a criminal offence.³⁶

Communications to employees regarding the acquisition or sale of shares, and the grant or exercise of options, are likely to be caught by the application of the Financial Promotion Regime. There is, however, a fairly broad exemption for participation in employee share schemes.³⁷ In particular, the restriction on financial promotions does not apply to any company or firm (or any member of the same group as such company or firm) where the communication is for the purposes of an employee share scheme.³⁸ As such, particular care must be taken to ensure that this exemption is available, and advice should be sought, especially when third parties (including in the context of a takeover) wish to communicate with employees of an unconnected company or firm regarding their share-based remuneration arrangements.

VI DISCLOSURE

This section summarises the requirements for disclosure of share dealings by directors and senior employees in the context of share-based executive remuneration. It should be read in conjunction with Sections VII and VIII.

i Private companies

For companies (wherever incorporated) whose shares are not admitted to trading on the Main Market of the London Stock Exchange or AIM, there are no requirements under English law for the disclosure of directors' or senior employees' interests in their shares. Companies may, however, be required to make certain disclosures in the directors' report forming part of their annual report and accounts, and the level of detail will depend on the accounting standards being used as well as the size of the company concerned.

ii Listed companies

The Listing Rules are published by the FCA and set out the minimum requirements for securities listed on the Official List. Chapter 9 of the Listing Rules was amended to remove unnecessary overlap with the new statutory rules regarding remuneration reports (see Section VII). Chapter 5 of the Disclosure Guidance and Transparency Rules within the FCA Handbook provides that at the end of every calendar month during which an increase or decrease in the issued share capital of the company takes place, the company must disclose to the market the total number of shares in each class that it issues.

The EU Market Abuse Regulation³⁹ (EU MAR) came into force on 3 July 2016 and has had direct effect in the UK from that date. EU MAR has replaced the United Kingdom's civil law rules on insider dealing (although not the criminal offence). It also prescribes when certain individuals may deal in a company's securities and imposes disclosure requirements on such individuals and those closely associated with them. Although in broad terms the principles of disclosure and insider dealing remain very similar, EU MAR is wider in scope

³⁶ Sections 21 and 25 of FSMA 2000.

³⁷ Paragraph 60 of the Financial Services and Markets Act 2000 (Financial Promotion) Order 2001.

³⁸ See paragraph 60(2) of the Financial Services and Markets Act 2000 (Financial Promotion) Order 2001 for a definition of employee share schemes.

³⁹ Regulation (EU) No 596/2014.

than the previous regime and applies to AIM-listed companies as well as those whose shares are admitted to trading on the Main Market of the London Stock Exchange. The introduction of EU MAR necessitated changes to existing UK rules and legislation. Most significantly, the Model Code (previously set out in the Listing Rules) was considered to be incompatible with EU MAR and has ceased to apply. Further, the Disclosure Rules within the FCA Handbook have been renamed 'Disclosure Guidance' to reflect the fact that the FCA no longer has the power to make rules in this regard, and now contain signposts to the relevant articles of EU MAR.

Article 19(1) of EU MAR requires all PDMRs (defined in the same way as FSMA 2000) and persons closely associated with them (PCAs) to notify both the company and the FCA of all transactions in the company's securities or financial instruments conducted on their own account or for the account of a third party. The notification must be made within three business days of the transaction and the company must announce the transaction within the same time limit. This differs from the previous regime under which a PDMR or connected person was only required to notify the company, which in turn had until the end of the business day following receipt of that information to inform the market. Under EU MAR, companies must tell PDMRs about their disclosure obligations and keep a list of both the PDMRs and their PCAs. PDMRs must, in turn, notify each of their PCAs in writing of their disclosure obligations.

EU MAR imposes additional restrictions on when PDMRs can and cannot deal in shares and securities. One change brought about by EU MAR is that there is no longer a requirement for companies with shares on the Official List to have a dealing policy. As a matter of good practice, most companies are, nevertheless, choosing to have such a policy to ensure PDMRs and their PCAs comply with their obligations under EU MAR.

PDMRs of companies whose shares are admitted to trading on the Main Market of the London Stock Exchange by way of standard listing must comply with EU MAR, however, the requirements of Chapter 9 of the Listing Rules do not apply to standard-listed companies.

Companies whose shares are admitted to trading on AIM must, as well as complying with EU MAR, comply with the AIM Rules for Companies. In light of EU MAR, the AIM Rules have been amended slightly to remove specific dealing restrictions but impose a requirement for AIM companies to have a 'reasonable and effective dealing policy'.

VII CORPORATE GOVERNANCE

The UK corporate governance regime comprises a mixture of statutory rules, codes and investor guidelines. The extent to which these apply to a company will often depend upon where the company is incorporated, whether it is a quoted company, the size of the company and, in some cases, the type of activity undertaken by it.

i Statutory controls

The Companies Act 2006 sets out rules that apply to UK-incorporated companies, including requirements that:

- a details of directors' remuneration are disclosed in the company's annual report and accounts;⁴⁰

⁴⁰ Companies Act 2006, Section 412.

- b shareholder approval is obtained for certain termination payments made to directors;⁴¹
and
- c service contracts lasting longer than two years are approved by shareholders.⁴²

UK-registered quoted companies⁴³ are subject to an additional requirement to produce an annual report on their directors' remuneration which is subject to a shareholder vote. Since 1 October 2013, the directors' remuneration report has been split into two parts. The first part comprises the policy report. This sets out the company's current and future policy on executive remuneration, and is subject to a binding vote (i.e., 50 per cent approval is required) at least every three years. The second part of the report sets out how the policy has been implemented during the year and is subject to an annual advisory vote. If the implementation report is not passed, a vote on the policy report is required at the next AGM. The company's approach to exit payments needs to be included in the remuneration policy, and is therefore subject to a binding vote.

ii Regulatory controls

The Financial Reporting Council (FRC)⁴⁴ publishes the UK Corporate Governance Code (the Code), which sets out standards of good practice in relation to board behaviour including remuneration, accountability and its relationship with shareholders. The Code is technically voluntary; however, all companies with a premium listing of equity shares in the UK, whether or not incorporated in this country, are required to report on whether they have applied the Code and explain areas of non-compliance.⁴⁵

The UK Corporate Governance Code requires executive directors' remuneration to be designed to promote the long-term success of the company. It states that the performance-related elements of directors' remuneration should be 'stretching' and applied rigorously and, where appropriate, companies should consider using non-financial performance metrics, such as customer satisfaction, as well as financial measures. It also includes a requirement that performance-related plans for executive directors include provisions that enable the company to recover sums paid or withhold the payment of any sum (i.e., *malus* and clawback) but leaves it to the remuneration committee to determine the circumstances in which this should apply.

The FRC has announced plans to undertake a fundamental review of the Code in autumn 2017 taking account of its recent work on corporate culture, succession planning and the issues raised in government papers published in November 2016 and August 2017.⁴⁶

41 Ibid., Section 217.

42 Ibid., Section 188.

43 Broadly, those whose equity share capital is included in the FCA's Official List, officially listed in an EEA state or admitted to dealing on the New York Stock Exchange or NASDAQ. This does not include companies traded on AIM.

44 The FRC is the independent regulator in the UK with responsibility for promoting good corporate governance.

45 A company with a premium listing on the Official List must meet the most stringent standards.

46 Department for Business, Energy & Industrial Strategy: Corporate Governance Reform – Green Paper: November 2016/Financial Reporting Council PN 8/17 16 February 2017 'FRC to Review the UK Corporate Governance Code'; Corporate Governance Reform: The Government response to the Green Paper consultation, August 2017.

iii Institutional investor guidelines and the Stewardship Code

Shareholders of listed companies are encouraged to use their voting powers to ensure good corporate governance. Institutional investors (such as pension funds and insurance companies) are represented by investment committees many of which publish guidelines for best practice on share-based remuneration. The guidelines issued by the Investment Association, the Pension Lifetime Savings Association and the Pensions and Investment Research Consultants Ltd are often considered.

The Stewardship Code was first published by the FRC in 2010 and sets out good practice for institutional investors when engaging with companies listed in the United Kingdom. The principles within the Stewardship Code apply on a comply-or-explain basis, and state that institutional investors should have a clear policy on voting and should vote all the shares they hold. The FRC is keen to encourage overseas investors holding shares in UK-listed companies to comply with the Stewardship Code, and for UK institutional investors to apply it to their overseas holdings.

iv The Listing Rules

The Listing Rules provide that certain forms of incentive arrangement require prior shareholder approval before they can be implemented. These include employee share schemes involving the issue of new shares, and long-term incentive plans in which directors are entitled to participate.⁴⁷

v AIM companies

Companies with securities traded on AIM do not need to comply with the Listing Rules, but have their own rules and their own source of corporate governance guidelines, for example, the Corporate Governance Code for Small and Mid-Size Quoted Companies published by the Quoted Companies Alliance, the Corporate Governance Policy and Voting Guidelines for Smaller Companies published by the Pension Lifetime Savings Association, the Institutional Shareholder Services UK and Ireland Proxy Voting Guidelines 2015 and the European Corporate Governance Guidelines. The London Stock Exchange has expressed the view that AIM companies should aspire to the standards set out in the UK Corporate Governance Code and UK institutional shareholders often expect it.

VIII SPECIALISED FINANCIAL SERVICES REGULATORY REGIMES

The United Kingdom has seen similar trends to many other developed countries in the scrutiny and the regulation of remuneration in the financial services sector. These have been heavily shaped by EU legislation. Generally, the strictest and most well developed regulations have been applied first to systemically important banks, with similar provisions gradually extended to the wider financial services sector. From 2013 onwards, there has been a significant increase in the number of different remuneration codes applied by the FCA and PRA to different types of financial services firms, reflecting the implementation of various EU regimes and the separation of responsibility between the two regulators. The current set of codes is shown below:

⁴⁷ Listing Rule 9.4.1.

Short title	Basic scope	Location	Applied from
CRR Firms Remuneration Code	Banks, building societies and PRA-designated investment firms. Previously, these firms were covered by the IFPRU Remuneration Code	Remuneration Part of the PRA Rulebook for CRR firms	2015
IFPRU Remuneration Code	IFPRU investment firms	SYSC 19A in the FCA Handbook	2014 (but successor to FSA Remuneration Code)
AIFM Remuneration Code	Managers of alternative investment funds (AIFMs)	SYSC 19B in the FCA Handbook	2013
BIPRU Remuneration Code	BIPRU investment firms	SYSC 19C in the FCA Handbook	2014 (but successor to FSA Remuneration Code)
Dual Regulated Firms Remuneration Code	Banks, building societies and PRA-designated investment firms. Previously these firms were covered by the IFPRU Remuneration Code	SYSC 19D in the FCA Handbook	2015
UCITS Remuneration Code	Management companies of undertakings for collective investment in transferable securities (UCITS)	SYSC 19E in the FCA Handbook	2016
Remuneration and Performance Management of Sales Staff	MiFID investment firms and firms benefitting from the Article 3 MiFID optional exemption	SYSC 19F in the FCA Handbook	Will apply from 2018
* Senior Management Arrangements, Systems and Controls			

PRA-regulated insurers that are subject to the Solvency II Directive must comply with remuneration rules in the Solvency II Delegated Regulation, but as these are directly applicable, they have not been transposed into the PRA Rulebook.

i General principles

Broadly, the general principle of the codes is that firms should establish and maintain remuneration policies and practices that promote sound and effective risk management. Some firms may find that they are subject to more than one code.

The codes are generally divided into a number of principles, some of which apply to the whole firm and others of which apply only to staff whose activities have a material impact on the firm's risk profile (known as Code Staff). In certain cases, other requirements attach to senior managers and groups.

Although many of the requirements in the different codes are similar and reflect broadly correlative EU standards across industry sectors, there are nonetheless key differences between them which may make applying some codes more onerous. For example, the CRR Firms Remuneration Code, the IFPRU Remuneration Code and the Dual-Regulated Firms Remuneration Code each contain a specific 'bonus cap' requirement derived from the CRD IV Directive. This requires that the variable remuneration of Code Staff must not exceed 100 per cent of fixed remuneration or 200 per cent if shareholder consent has been obtained. The other codes do not apply a hard numerical cap of this nature.

The new SYSC 19F code relating to the remuneration of sales staff is designed to implement the MiFID II remuneration requirements in the UK.⁴⁸ It is considerably shorter than the other codes and contains provisions that are generally less prescriptive. Broadly, it imposes an overarching obligation on relevant firms to ensure that when they are providing MiFID investment services to clients, they do not remunerate or assess the performance of staff in a way that could create a conflict with the duty to act in the client's best interests.

⁴⁸ Directive 2014/65/EU.

Despite its title, the code does not only apply to sales staff, but also to other individuals, including senior management, to the extent that their remuneration could create a conflict encouraging them to act against the interests of clients.

From time to time, European regulators issue guidance on the EU legislation underpinning certain codes, which may require the FCA and PRA to reassess the UK domestic implementation of those rules. For instance, the European Banking Authority (EBA) issued guidelines in 2015 which emphasised that ‘role-based allowances’ (which a number of British banks had paid as fixed remuneration to avoid the bonus cap) must be considered to be variable remuneration unless they meet strict criteria to be classified as fixed remuneration under rules implementing CRD IV.

Where a firm breaches an applicable remuneration requirement, the FCA or PRA (or both) may take appropriate enforcement action.

ii Proportionality

Not all firms have to give effect to the remuneration requirements in the same way and to the same extent. Each of the codes (with the exception of the new SYSC 19F code) contains the concept of proportionality, under which the firm must comply with the requirements in a manner and to the extent that is appropriate to its size, internal organisation and the nature of its activities. The FCA and PRA have produced guidance for many of the codes explaining the relevant factors in determining how proportionality applies. Firms of greater significance and posing the greater risk to financial stability fall within the highest proportionality level and will have the greater levels of compliance.

Proportionality is a key political issue, as in February 2016, the FCA and PRA refused to apply the EBA’s interpretation of proportionality under the CRD IV regime to relevant UK firms. The EU is seeking to clarify the application of proportionality under the CRD regime in its proposed CRD V Directive, which, if adopted as drafted, will introduce defined quantitative criteria for these purposes. It will also contain an exhaustive list of which remuneration principles can be disapplied on the grounds of proportionality, which will not include the bonus cap. This would represent a significant change from the current UK approach.

iii Remuneration policies, record keeping and reporting

Firms must ensure that their remuneration policies and practices are clear and well documented and that proper records are kept to evidence compliance with the applicable codes. Certain firms may also be required to report remuneration details to the FCA or PRA on an annual basis for comparison and benchmarking purposes.

IX DEVELOPMENTS AND CONCLUSIONS

With the government’s focus firmly on Brexit negotiations, it is difficult to predict potential developments in executive remuneration over the next year. Significant changes in legislation seem unlikely, however, the public mood is very much against excessive levels of pay and gender inequality. Shareholders seem more prepared than ever to question the rewards given to the most senior employees and the courts have demonstrated an inclination to find against pay schemes that they regard as abusing the tax system. All these factors put together emphasise the importance of careful planning and effective communication for any company seeking to introduce executive incentive arrangements in the UK.

Appendix 1

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Strategic Research Sponsor of the
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ISBN 978-1-910813-87-4

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