VARIABLE REMUNERATION IN THE UK

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Fecha de recepción: 24/03/2016
Fecha de aceptación: 23/04/2016

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RESUMEN: Este artículo es una guía práctica sobre los usos de la retribución variable en el Reino Unido. Presenta las diferentes formas en las que la retribución variable puede

estructurarse en este país, teniendo en consideración los bonos en metálico y los planes de acciones y presentando los pros y los contras de varios planes de participaciones con beneficios fiscales. A partir de ahí, pasa a tratar el uso que se hace en varios mercados del Reino Unido, incluidas las organizaciones del FTSE 350. La segunda mitad de este artículo se centra en considerar la normativa sobre retribución variable en el sector financiero y en las organizaciones del FTSE 350, incluido el controvertido «límite de incentivos». Por último, toca algunos problemas legales en torno a la retribución variable en el Reino Unido, incluida la legislación sobre si las bonificaciones tienen carácter contractual o discrecional, temas relacionados con las pagas extra, discriminación, nuevas formas de cobertura y temas relacionados con la gente que deja o vuelve a la compañía.

ABSTRACT: This article is a practical guide to the uses of variable remuneration in the UK. It sets out the various ways variable remuneration can be structured in the UK, considering cash bonuses and share plans and setting out the pros and cons of various tax–advantaged equity plans. It then moves on to discuss the use of variable remuneration in various markets in the UK, including discussion of FTSE 350 companies. The second half of this article then considers the regulation of variable remuneration, in the financial sector and in FTSE 350 companies, including the controversial «bonus cap». Finally, it touches on some legal issues surrounding variable remuneration in the UK, including the law around whether bonuses are contractual or discretionary, holiday pay issues, discrimination, new reporting requirements and issues around leavers and clawback.

PALABRAS CLAVE: Programas de bonificación; impuesto; legislación británica; normativa de la retribución en el sector financiero; límite de bonificación.

KEYWORDS: Bonus schemes; tax; English law; regulation of remuneration in the financial sector; bonus cap.

1. INTRODUCTION

In an increasingly challenging business environment, employers need to ensure that they have a competitive remuneration package to attract, retain and incentivise key employees. In the UK, most employers use some form of variable remuneration to try to achieve this.

Generally UK employers have significant flexibility in structuring their variable remuneration arrangements. For example employers generally have freedom to decide whether the variable remuneration should be discretionary or contractual, the performance conditions that should be applied, the period over which performance should be measured and how leavers should be treated. That said, companies listed on the London Stock Exchange («LSE») and firms in the financial services sector have to take into account the requirements of regulators and the expectations of shareholders; those requirements and expectations affect the structure and timing of variable remuneration and, for banks and certain other investment firms, quantum.

This article provides an introduction to the structure of variable remuneration in the UK and examines current trends in the use of variable remuneration. It also considers a number of legal issues in relation to variable remuneration including its regulation in companies listed on the main market of the LSE («FTSE 350 companies») and banks, the different types of performance conditions and other legal issues relating to bonuses, including how bonuses may become contractual through an employer's conduct and potential issues with discrimination and holiday pay.

2. WHAT IS VARIABLE REMUNERATION

In this article «variable remuneration» means any payments or benefits (including for example cash bonuses, commission and share incentives), receipt of which is dependent on the satisfaction of performance conditions or other contractual criteria such as remaining in employment until a certain date.

European legislation –most notably the Capital Requirements Directive (2013/36/EU) («CRD»)– draws a distinction between «variable remuneration» and «fixed remuneration»[1]. It seems implicit within those definitions that variable remuneration should be used to reward employees for extraordinary performance (i.e. for «going the extra mile» rather than simply doing the job.) In practice, in the UK in many sectors, cash bonuses are an expected element of the employee's remuneration package and, in some circumstances, have traditionally been used to supplement a low base salary.

For companies listed either on the main market or the Alternative Investment Market («AIM») of the LSE, variable remuneration in the form of shares is an essential part of the remuneration package to ensure that the financial interests of employees, particularly senior executives, are aligned with those of shareholders. Most listed companies also operate a share plan for all employees.

We examine the main ways in which variable remuneration is structured in Section 3 below, and the type of performance conditions that may be imposed in Section 7 below.

3. HOW IS VARIABLE REMUNERATION STRUCTURED?

In the UK, variable remuneration is delivered either in cash, in shares or other ownership interests in the employing group, or a mixture of both.

It is a common saying in the UK that «cash is king»! In other words, employees generally favour cash over shares and, when provided with shares, will often seek to sell those shares as soon as they are permitted to do so in order to raise cash.

However,cash bonuses have an immediate effect on the employer's cash–flow. In addition, cash bonuses do not attract any favourable tax treatment, they are subject to income tax and employee and employer social security contributions –known as national insurance contributions («NIC»)– in full when received, in the same way as salary. In contrast, successive governments have taken the view that encouraging equity incentives may improve the general economy. Tax legislation (principally the Income Tax –Earnings and Pensions– Act 2003) contains specific employee share plans that benefit from valuable

1 CRD IV defines: Variable pay as remuneration which reflects a sustainable and risk adjusted performance as well as performance in excess of that required to fulfil the employee's job description as part of the terms of employment; and Fixed pay as remuneration which primarily reflects relevant professional experience and organisational responsibility as set out in an employee's job description as part of the terms of employment.

tax reliefs. Often share plans can be structured so that the growth in value of the shares is subject to capital gains tax (generally at 20% for disposals after 5 April 2016) rather than income tax and NIC. Depending on the level of the employee's income, income tax may be 45% with employee NIC at 2% and employer NIC at 13.8%.

There are a number of other reasons why an employer may want to introduce an employee share plan instead of, or in addition to, a cash plan including:

- Wanting to move towards collective ownership –i.e. giving employees a say in the company going forward; and/or
- Enabling employees to participate in the growth in value of the company; and/or
- Aligning the interests of employees, particularly senior executives,with those of shareholders to consider the best interests of shareholders in their management of the business.

Examples of the main forms of cash and share based variable remuneration commonly used in the UK are summarised below.

3.1. Annual cash bonuses

There are two broad categories of annual cash bonus: a non–contractual or a contractual bonus.

A non–contractual bonus scheme will typically provide that there is no right to a bonus, but that payments may be made entirely at the employer's discretion and on the employer's own terms. The key aim is to avoid placing the employer under any obligation to make any bonus payments. Most employers will prefer to offer a non–contractual bonus as this gives them greater flexibility.

Contractual bonuses are calculated upon whatever basis is set out in the scheme. Annual bonuses are typically expressed as a target percentage of the employee's salary and plans are typically constructed to provide threshold, target and maximum levels of performance which then generate corresponding threshold, target and maximum levels of pay–out.

It is worth noting that many employers, particularly listed companies, may require employees to defer some or their entire annual bonus into shares. This is sometimes accompanied by the promise of receiving free, additional matching shares from the company if performance and continued employment conditions are met.

Legal issues relating to contractual and non–contractual cash bonuses are discussed further in Section 7 below.

3.2. Long–term cash incentive plans

Long–term cash incentive plans are a form of award which is contingent upon the achievement of previously defined performance objectives over a multi–year period (typically at least three years). Again, a long term cash incentive plan may be structured either as a non–contractual or a contractual bonus.

3.3. Phantom share plans

This is a particular type of cash bonus, the value of which is linked to the increase in the value of the company's shares. However, no shares are actually issued or transferred to employees.

Phantom share plans are often used by private companies to grant awards to employees that mirror share options or restricted share plans, in circumstances where using actual shares is inappropriate, for example where shareholders are concerned about the dilution of their shareholdings or control.

3.4. Specific purpose bonus

Some bonuses are awarded for a specific purpose to incentivise the employee to perform a certain objective or for a specific event such as a sign on bonus given to a newly hired employee.

3.5. Commission

Commission is remuneration based on the amount of sales an employee makes and is typically paid as a percentage of those sales. Commission is often used to supplement a low base salary.

There are two basic ways of calculating commission: flat commission and ramped commission. Flat commission is calculated at a flat rate whereas ramped commission increases on the attainment of certain goals or targets.

3.6. Tax–advantaged equity plans

These types of plans can be very tax efficient for both a company and its employees. However, to obtain that tax efficiency there are a number of statutory requirements (regarding for example the company that offers the plan, the shares that can be used, the employees

that can participate and the limits on participation) which must be satisfied. Tax–advantaged arrangements are classified by the employees that are able to participate in them. Some types of tax–advantaged plans have to be made available to all qualifying employees (all–employee plans); whilst under others the company can select the employees who are invited to participate (discretionary plans).

The table 1 below summarises the different types of tax–advantaged plans.

Tax advantaged schemes

Type of plan	Advantages	Disadvantages
Company share option plan Discretionary scheme under which the company grants share options (a right to purchase shares in the future at an exercise price equal to the market value of the shares on the date of grant) to selected employees.	• Any increase in the value of the shares between the grant and the exercise of the share option is free of income tax and NIC, provided the option is exercised at least three years after grant or in certain good leaver circumstances. On the sale of the shares the difference between the sale proceeds and the exercise price is subject to capital gains tax. • Company may select employees to participate. • No upfront financial commitment is required from employees so it is risk free for employees. • Performance targets can be imposed but these must be stated at the time of grant, must be objective and not capable of arbitrary variation by the company at a later date.	• Maximum limit of £30,000 on the value of shares (measured at the date of grant) that may be held under unexercised options. • No upfront financial commitment is required from employees. • If share value falls below exercise price, share options lose their effectiveness as retention and motivating tool. • Certain aspects of the scheme design are restricted by the legislation.

Type of plan	Advantages	Disadvantages
SAYE (save as you earn) option plan All employee scheme under which the company may grant share options (a right to purchase shares in the future at a price which may be discounted by up to 20% of the market value of the shares at the date of grant). The option is linked to a savings contract which requires the employees to save between £5 and £500 per month from their net salary for 3 or 5 years. At the end of the savings period, employees can choose to exercise their option, funding the exercise price from the savings contract or withdraw the savings.	• Rewards only those employees who make a financial commitment. • Risk–free investment because, if the share price goes down during the savings contract, employees still receive their savings and possibly a tax–free bonus. • Any increase in the value of the shares between the grant and the exercise of the share option is delivered free of income tax and NIC, provided options is exercised at least three years after grant or in certain limited good leaver circumstances. On the sale of the shares the difference between the sale proceeds and the exercise price is subject to capital gains tax. • Unlike CSOPs, option exercise price can be up to 20% less than market value at grant.	• Has to be offered to all employees. • Complex administration. • Savings are made from net pay. • Not all employees will choose to participate.

Type of plan	Advantages	Disadvantages
Share incentive plan All employee share plan under which the company may make four different types of share award: free shares, partnership shares (paid for by employees out of pre–tax salary), matching shares (which companies can give to employees who purchase partnership shares) and dividend shares (purchased with dividends from other plan shares).	• Flexible, as the company can decide which elements of a SIP it wishes to implement in any tax year and the level of awards subject to the maximum limits set out below. Each year, the maximum value of shares that: - Each employee can be allowed to buy is £1,800 (or, if lower, 10% of salary). - The employer can give each employee £3,600 worth of free shares. • For those employees who purchase partnership shares, the employer can award matching shares up to a maximum matching ratio of two matching shares for every one partnership share purchased so assuming an employee purchases £1,800 worth of partnership shares, the employer may award £3,600 worth of matching shares. • In addition, dividends from plan shares may be reinvested in further shares. • The tax rules are complex but, if certain conditions are satisfied, such plans may be very tax efficient with no income tax or NIC to pay and no capital gains tax on growth in value while the shares remain in the plan. In addition, the money used to buy partnership shares is taken from gross salary. • Awards of free shares can be subject to a performance target. • If partnership shares are offered, this requires a financial commitment from employees.	• Complex and may have high administration costs, particularly where all four types of award are offered to employees. • Has to be offered to all employees. • Partnership shares are riskier for employees than options or free shares, as they become beneficial owners of shares from the date of purchase and therefore vulnerable to any decrease in the share value.

Type of plan	Advantages	Disadvantages
Enterprise management incentives ("EMI") options Discretionary scheme under which the company may grant share options (a right to purchase shares in the future) to selected employees.	• Generous plan – options over £250,000 worth of shares (valued at the date of grant) may be awarded to each individual employee. In broad terms, a company may have no more than £3 million worth of shares (again valued at the date of grant) subject to EMI options at any time. • Very flexible – the exercise price can be less than the market value at grant; performance targets can be imposed and options can be granted to selected employees. Also, subject to the scheme rules, employees can choose when to exercise their options. • Generous tax reliefs – it is possible to structure EMI options so that the only tax to pay is capital gains tax when the shares are sold. In addition, if certain conditions are satisfied, it may be possible to reduce the effective capital gains tax rate to 10% by claiming entrepreneurs' relief. There is no minimum holding period required to obtain the benefit of the income tax and NIC exemptions. • No upfront financial commitment is required from employees.	• EMI options can only be granted by smaller companies (those with gross assets of less than £30 million) which are carrying on a qualifying trade. Certain trades (e.g. financial services) are excluded. • Employees do not have any upfront financial commitment.

3.7. Non tax–advantaged share plans

There are a range of other share arrangements that do not attract any specific tax advantages.

In broad terms, non–tax advantaged plans are structured in one of two ways:

- The employee acquires the shares and becomes a shareholder, from day one. The shares are subject to certain restrictions so that if certain performance conditions and continued employment conditions are not satisfied, the shares are forfeited. Examples are restricted share or performance share plans.
- The employee has a right or promise to acquire shares in the future if certain performance and continued employment conditions are satisfied. Examples are options and conditional share plans.

The advantages of these plans are:

- They are flexible –there are no statutory requirements that need to be satisfied and therefore the terms of the plan can be drafted to suit the commercial needs of the business, taking into account where relevant the requirements and expectations of regulators and shareholders.
- They are capable of providing significantly more value than tax advantaged plans. The detailed tax treatment of non–tax advantaged plans is complex. The general principle is that income tax and employee and employer NIC will be due on gains made by employees when they acquire the shares. With careful planning, however, it may be possible to make these plans tax efficient but this often adds significant complexity.

4. THE USE OF VARIABLE REMUNERATION IN THE UK

The UK variable remuneration market is sophisticated, encompassing a wide range of businesses (from large, listed companies to small private companies and across all industry sectors) with varying approaches. On the one hand, for FTSE 350 companies and those in the financial sector, bonuses and other incentives are a central component of an individual's remuneration package. Annual bonuses are very high, historically well

exceeding annual salary, and senior employees will also expect long–term cash or share incentives. On the other hand, smaller companies tend to focus on cash bonuses, commission schemes or EMI option schemes, and salary is the principal form of remuneration.

4.1. FTSE 350 companies and the financial services

KPMG's 2015 Guide to Directors' Remuneration in FTSE 350 companies[2] («Guide») confirms that variable remuneration remains a key component of directors' overall remuneration.

In 2015, variable remuneration continued to account for more than 50% of directors' total remuneration over all FTSE 350 sectors. The financial sector, unsurprisingly, revealed the most extensive use of variable remuneration, with around 70% of total remuneration for directors in this sector being variable rather than fixed. For directors in FTSE 100 companies, there was a tendency for this remuneration to be long–term rather than short–term incentives, with long–term gains making up 42% of total remuneration against 25% in the FTSE 250.

Nearly all companies in the FTSE 100 and 250 operate annual bonus plans, making them the most common incentive arrangement. In the FTSE 100, the median bonus awarded to Chief Executive Officers («CEOs») was 132% of total salary, equivalent to an average figure of £1,087,000 (€1,388,787). A similar trend showed in relation to bonuses awarded to Financial Directors («FDs») in the FTSE 100, who were awarded an average annual bonus of 122% of salary, or £601,000 (€767,857). Across the FTSE 250 CEOs the median bonus awarded to CEOs was 87% of total salary, equivalent to an average figure of £420,000 (€536,605). Bonuses remained highest as a percentage of salary in the financial services sector.

The Guide reveals that more than 70% of the FTSE 350 companies use three or more performance measures in awarding their annual bonuses, with those companies in the financial services sector leading the way. Only four financial services companies in the FTSE 250 use just one performance measure, and none in the FTSE 100. The most common performance conditions are: profit, personal objective, other financial targets, cash flow and earnings per share. For further details on performance conditions see Section 7 below.

Long–term incentives are also widely used across the FTSE 100, and share performance plans are the most commonly–used vehicle, with median awards made to CEOs under per-

2 https://www.kpmg.com/UK/en/IssuesAndInsights/ArticlesPublications/Documents/PDF/Tax/kpmg–guide–to–directors–remuneration–2015.pdf Page accessed 24/03/2016.

formance share plans being 251% of salary, equivalent to an average figure of £2,049,000 (€2,617,869). Again, FDs were awarded similar figures under share performance plans, with an average of 226% of annual salary or £1,173,000 (€1,498,663). Across the FTSE 250 CEOs, the median performance share plan paid out 178% of annual salary, equivalent to an average figure of £887,000 (€1,133,260).

The use of long–term incentive plans is bolstered by an increased need to take risk into account when setting remuneration. For listed companies and the financial services (as discussed later in this article), this is reinforced by legal corporate governance requirements (see further Sections 5 and 6 below). In an environment which is increasingly hostile to highly paid executives, a high proportion of annual bonuses involve the compulsory or optional deferral of some or all of an annual bonus into company shares.

4.2. Smaller private companies

It is generally more difficult to find information on the bonuses awarded by smaller private companies. However, the Chartered Institute of Personnel and Development (the «CIPD») surveys organisations across private, public and third sectors and produces an annual report documenting information on current and emerging practices in UK reward management[3]. This includes an examination of the use of bonuses. Information arising from the 2014–2015 survey reveals that the use of individual bonuses, particularly in the UK's smaller organisations, appears to be falling. Just 49% of the organisations surveyed in the most recent report had performance–related reward schemes for their employees, down on a total of 65% from 2012. Similarly, the percentage of organisations offering sales commission fell by 8% over the same period. Both seem to confirm a downward trend which has lasted for several reporting years. The report cites the financial crisis and the recession as likely contributory factors; businesses perhaps find themselves increasingly unable to offer variable remuneration as part of compensation. However, it also recognises that there are indications that the economy is in recovery, and that a more likely explanation is that UK businesses are choosing to move away from a model of individual performance–driven incentives. It considers that «straight incentive and performance recognition payment arrangements are being downplayed in favour of the more sophisticated pay management of 'base' salaries.»

3 https://www.cipd.co.uk/binaries/reward–management_2014–15.pdf Page accessed 24/03/2016.

5. REGULATIONS OF VARIABLE REMUNERATION FOR BANKS, BUILDING SOCIETIES AND INVESTMENT FIRMS

Irresponsible remuneration policies and practices in the financial services sector which encouraged employees to take higher and higher risks in order to reap bigger and bigger rewards are considered to have been a significant contributory factor to the 2007–08 financial crisis, affecting the reliability and stability of the whole sector. As a result, variable remuneration in the financial services sector has been the focus of wide–ranging EU and UK regulation over the past few years.

The UK regulators –the Prudential Regulation Authority («PRA») and the Financial Conduct Authority («FCA»)– have issued a number of «remuneration codes» regulating the remuneration paid by firms in the financial services sector. The underlying general principle of each of the remuneration codes is that firms must ensure that their remuneration policies and practices are consistent with and promote sound and effective risk management.

This section highlights the key provisions of the «CRR Remuneration Codes»[4] which are relevant to variable remuneration paid by banks, building societies and certain investment firms.

The CRR Remuneration Codes implement CRD IV which took effect in January 2014 and builds on the remuneration requirements under CRD III.

Certain requirements of the CRR Remuneration Codes must be applied on a firm–wide basis (for example, the restrictions on guaranteed bonuses). Other provision only apply to those individuals whose activities could have a significant impact on the risk profile of the firms –referred to as material risk takers («MRTs»)[5]– with the most stringent provisions applying to those MRTs who collectively determine the overall business strategy of the

4 http://www.prarulebook.co.uk/rulebook/Content/Part/292166 and https://www.handbook.fca.org.uk/handbook/SYSC/19D.pdf Pages accessed 24/03/2016.

5 An individual is a MRT if he satisfies one or more of the following criteria:

- Qualitative criteria relating to the role and decision making power of the staff member (for example, a member of the firm's management body or senior management).
- Internal criteria developed by each firm to identify material risk–takers based on the firm's specific risk profile.
- Quantitative criteria based on the individual's remuneration. The quantitative criteria will apply to individuals who satisfy any of the below unless it can be shown that the individual is not in fact a MRT :
- were awarded total remuneration of €500,000 or more in the preceding financial year; and/or
- are within the top 0.3% of staff who have been awarded the highest total remuneration in the preceding financial year; and/or
- in the preceding financial year were awarded remuneration at least equal to the lowest total remuneration awarded to senior management or other risk takers.

Seefurtherhttp://www.eba.europa.eu/documents/10180/526386/EBA–RTS-2013-11+%28On+identified+staff%29.pdf. Page accessed 24/03/2016.

firm –referred to as Senior Managers («SMs»). In some instances, the strict requirements may be relaxed if the total remuneration and variable remuneration paid to an MRT is below a de minimis threshold[6].

For performance periods beginning on or after 1 January 2016, the rules under the CRR Remuneration Codes which affect variable remuneration are:

5.1. Ratio of variable remuneration to fixed remuneration (Bonus cap)

Firms should determine an appropriate balance between fixed and variable remuneration.

Variable remuneration should generally not exceed 100% of an individual's fixed remuneration –or 200% provided at least 66% of the firm's shareholders agree (or, if less than 50% of the total share rights are represented, at least 75% of shareholders).

The bonus cap has had a significant impact in the UK. Traditionally UK financial services firms have paid a low base salary and topped up the base salary with substantial bonuses depending on performance. As a result of the bonus cap, many firms in the UK have substantially increased base pay. The UK government and regulators consider this to be counter–productive – for example the Chief Executive Officer of the PRA described the bonus cap as «bad policy»– as base pay is not dependent on performance and increases the fixed costs of the business.

5.2. Guaranteed variable pay

Firms must not award, pay or provide any incentive guaranteed variable pay to any member of staff unless:

- It is exceptional;
- It occurs in the context of hiring new staff;
- The firm has a strong and sound capital base; and
- It is limited to the first year of service.

To demonstrate whether the guaranteed variable pay is exceptional the firm must consider whether the variable pay is exceptional both on commercial and prudential grounds. Firms should also consider the number of staff to whom they offer guarantees, and should ensure that guaranteed bonuses are not the «norm», but are rare and infrequent.

6 This will be the case if the MRTs total remuneration for the performance year is not more than £500,000 and his variable pay for that performance year is not more than 33% of his total remuneration.

5.3. Discretionary variable remuneration

The amount of the discretionary pay pool should be based on profit, adjusted for current and future risks, and take into account the cost and quantity of the capital and liquidity required.

5.4. Deferral

At least 40% of variable pay awarded to relevant individuals who do not satisfy the de minimis concession must be deferred over 3 to 7 years depending on the nature of the employee's role taking into account the business cycle, the nature of the business, its risks and the activities of the individual in question. Where the variable pay is particularly high (generally £500,000, but it may be lower in certain circumstances), at least 60% must be deferred.

5.5. Payment in shares or ownership instruments

For MRTs who do not satisfy the de minimis concession, 50% of both that part of the bonus which is immediately payable and that part of the bonus which is deferred should be paid on a net of tax basis in the form of shares or equivalent ownership interests or, where possible, capital instruments which adequately reflect the credit quality of the firm as a going concern.

Any shares, ownership interests, and non–cash instruments used should also be subject to a retention policy to ensure that the incentives are aligned with the longer term interests of the firm. Generally a six month retention period on a net of tax basis is acceptable.

5.6. Performance adjustment

Firms should ensure that variable remuneration is subject to «performance adjustment». In particular this means that firms must ensure both the upfront and deferred portions of variable remuneration awarded to MRTs who do not satisfy the de minimis threshold are only paid or vest if it is sustainable according to the financial situation of the firm and justified on the basis of the performance of the firm, business unit and individual.

A malus arrangement –under which unvested variable remuneration is subject to adjustment– should be applied to variable remuneration (including any element to be paid in non–cash instruments) where: (1) there is reasonable evidence of an employee's misconduct or material error, (2) the firm or relevant business unit suffers a material down-

turn in its financial performance, or (3) the firm or the relevant business unit suffers a material failure of risk management. This includes circumstances where the staff member participated in, or was responsible for, conduct which resulted in significant losses to the firm or failed to meet appropriate standards of fitness and propriety (or both).

A clawback arrangement –under which firms are required to recover amounts that have been paid to employees– should operate for a minimum period of seven years from the date of award if: (1) there is reasonable evidence of employee misconduct or material error, or (2) the firm or the relevant business unit suffers a material failure of risk management. For SMs the clawback period should be extended for an additional three years if the firm starts an internal investigation or it is notified that a regulatory investigation has been started that could potentially lead to the application of the clawback (were it not for its expiration after seven years).

5.7. Future developments

On 21 December 2015 the European Banking Authority («EBA») published its final guidance on sound remuneration policies under CRD IV[7], effective for performance periods beginning on or after 1 January 2017. On the same date the EBA also issued its opinion addressed to the European Commission, Parliament and Council on the application of the principle of proportionality to the remuneration requirements under CRD IV.

The principle of proportionality allows a firm to implement the CRD IV remuneration requirements in the way and to the extent that is appropriate having regard to the firm's size and internal organisation and the nature, scale and complexity of its activities.

Applying the principle of proportionality, the UK regulators categorise firms into three proportionality levels based on their total assets. Broadly, the more significant the firm and the greater potential risk that the firm's activities pose to financial stability, the higher the firm's proportionality level.

Proportionality level 3 firms (firms whose total assets are less than £15 billion), the lowest risk category, are exempt from the bonus cap. In addition, such firms are generally not obliged to apply the «pay out process rules», namely deferral (although it is considered best practice to operate some form of deferral), payment in shares or other instruments or operate performance adjustment.

The EBA's approach differs from the UK regulators in a number of areas particularly in relation to the principle of proportionality. The EBA considers that all firms subject to CRD IV should apply the bonus cap and that the proportionality principle does not

7 http://www.eba.europa.eu/documents/10180/1314839/EBA–GL–2015–22+Guidelines+on+Sound+Remuneration+Policies.pdf Page accessed 24/03/2016.

allow a firm to disapply any of the CRD IV requirements in their entirety, although the EBA have recommended that specific exemptions from the pay–out process rules are introduced for certain «small and non–complex» and for staff who receive «low levels» of variable pay, irrespective of the size and activities of their firm. The UK regulators have confirmed [8]that they will continue with their current approach in relation to the bonus cap (effectively meaning that proportionality level 3 firms will still not be obliged to apply the bonus cap) but that firms should comply with all other aspects of the EBA's guidelines.

6. REGULATION OF VARIABLE REMUNERATION – FTSE 350 COMPANIES

Companies listed on either the main market or the AIM of the LSE must ensure that their variable remuneration arrangements, particularly shares incentives, comply with various regulatory requirements. The regulatory requirements stem not only from legislation but also from best practice and the expectations of shareholders.

This section summarises the requirements and expectations in relation to the structure of variable remuneration set out in the UK Corporate Governance Code[9] («Code») and the Investment Associations («IA») Principles of Remuneration 2015[10] («IA's Principles»). In a number of areas the requirements or expectations for FTSE 350 companies are similar to the requirements for firms within the financial services sector. In other words, the restrictions which apply to firms within the financial service sector are «trickling down» to other sectors and ultimately are affecting the way in which those sectors structure their variable remuneration.

The Code is the key source of corporate governance recommendations for FTSE 350 companies listed on the main market of the LSE. It consists of principles of good governance, most of which have their own set of more detailed provisions. The Code sets out best practice for executive remuneration and incentives, and includes factors to be considered when setting performance conditions, as well as recommendations concerning how bonus payments should be structured.

8 http://www.bankofengland.co.uk/publications/Documents/news/2016/037.pdf Page accessed 24/03/2016.
9 https://www.frc.org.uk/Our–Work/Publications/Corporate–Governance/UK–Corporate–Governance–Code–2014.pdf Page accessed 24/03/2016.
10 https://www.ivis.co.uk/media/11101/Principles–of–Remuneration–2015-Final.pdf Page accessed 24/03/2016.

Many institutional investor bodies publish their expectations for executive remuneration policies and practices, most notably the IA which represents the interests of investment managers. The IA's Principles are most influential for FTSE 350 companies but AIM companies are encouraged to observe them as «best practice». Whilst the IA's Principles are not binding, FTSE 350 companies ignore them at their peril –shareholders are likely to vote against variable remuneration which is out of line with the IA's Principles.

Particular points to note from the Code and the IA's Principles are:

- Complexity is discouraged. Shareholders prefer simple and understandable remuneration structures; simplicity can be improved by limiting variable remuneration to an annual bonus and one long term incentive scheme.
- Companies should determine an appropriate balance between fixed and performance–related, immediate and deferred remuneration. Performance conditions, including non–financial metrics where appropriate, should be relevant, stretching and designed to promote the long–term success of the company. Remuneration incentives should be compatible with risk policies and systems.
- All variable remuneration should include malus and clawback provisions.
- For share–based remuneration the remuneration committee should consider requiring directors to hold a minimum number of shares and to hold shares for a further period after vesting or exercise, including for a period after leaving the company, subject to the need to finance any costs of acquisition and associated tax liabilities.
- In normal circumstances, shares granted or other forms of deferred remuneration should not vest or be paid, and options should not be exercisable, in less than three years. Longer periods may be appropriate and shareholders would generally prefer longer performance periods. The use of additional holding periods is now commonly expected by investors, so that in total the performance and holding period should cover a period of at least five years.
- Grants under executive share option and other long–term incentive schemes should normally be phased (i.e. awarded each year) rather than awarded in one large block.
- Only basic salary (i.e. not variable remuneration) should be pensionable.

Another issue to bear in mind is that FTSE 350 companies are required to prepare an annual directors' remuneration report («DRR») covering long term incentive plans and other elements of remuneration.

The DRR must include a directors' remuneration policy, which is subject to a binding vote at least every three years, and an annual report on remuneration in the financial year

being reported on, and on how the current policy will be implemented in the next financial year, which is subject to an annual advisory vote.

It is important to ensure that any variable remuneration is consistent with the DRP as any obligation to make a non–compliant payment will have no effect and the employee will not be able to enforce it. In addition, any non–compliant payment actually made will be held in trust for the company and either the directors (on behalf of the company) or the shareholders are able to bring an action to recover the payment.

7. WHAT PERFORMANCE CONDITIONS MAY BE IMPOSED?

The key to the success of any variable remuneration arrangements is ensuring that the performance conditions (or pre–set targets) which must be met before the employee can benefit from the arrangements are well–drafted and in line with business strategy. This is essential to ensure that the employees are motivated to achieve the intended objectives of the business and/or carry out the desired behaviour. Arrangements where bonuses are awarded to all employees regardless of performance, or arrangements where the performance conditions are unrealistic and therefore are unlikely to be satisfied, so will have limited success in achieving an employer's goals.

The performance conditions imposed vary significantly depending on the employer, whether the employer is listed on the LSE, industry sector and the type of variable remuneration. Performance conditions may relate to personal and/or corporate performance and the level of the potential benefit from the variable remuneration will often depend on the extent to which the performance conditions have been met or exceeded.

Personal performance conditions may be financial (for instance, to reach a sales target) or non–financial (such as to reach a certain performance grade in an annual appraisal or complying with company policies and procedures).

Corporate performance conditions may be based on the performance of the team, the employing company and/or the overall group. The performance conditions may be set on an absolute basis looking at the performance of the company itself over a performance measure period or on a relative basis, comparing the performance of the company with a group of similar companies or a financial index.

Corporate performance measures fall into three main categories:

- Financial measures such as profit growth or earnings before interest, taxes, depreciation and amortisation or in the case of long–term equity incentives growth in earnings per share or return on equity;
- Operational or non–financial measures such as improved market share, product service quality levels; inventory level, safety records; and
- In the case of equity incentives, market–based performance conditions designed to measure the increase in the value of the business to investors. The most common market–based performance condition is total shareholder return which measures the increase in the company's share price together with dividends paid.

For smaller private companies the performance condition may relate to the achievement of a specific event for example achieving an exit such as a sale or flotation.

Under the CRR Remuneration Code firms are required to assess performance on a combination of the performance of the individual, the business unit and the firm's overall results. A significant part of an individual's assessment should be based on non–financial criteria, with emphasis on risk management, regulatory compliance and adherence to the firm's values. The UK regulators consider that Earnings Per Share and Total Shareholder Return are not properly adjusted for long–term risk, and should only be used as part of a balanced scorecard which gives credible weight to non–profit based measures.

FTSE 350 companies are required under the Code to impose challenging performance conditions reflecting the company's objectives on all incentive plans.

In addition, major shareholders will not vote in favour of arrangements that do not contain adequate performance conditions. The IA's Principles sets out investor expectations for performance conditions stating:

«Performance measures and vesting conditions should be fully explained and clearly linked to the achievement of appropriately challenging financial performance which will enhance shareholder value ... Shareholders have a clear preference for financial measures linked to value creation. Performance criteria should be linked to the Company's long–term strategy and targets reflect an appropriate balance between the shorter– and longer–term.»

There are a number of detailed recommendations in the IA's Principles regarding performance conditions which are beyond the scope of this article. Particular points to note include the following recommendations/expectations:

- Sliding scales and graduated vesting profiles are a useful way of ensuring that performance conditions are genuinely challenging. They generally provide a better motivator for improving corporate performance than a 'single hurdle'.

- Full vesting should reflect exceptional performance and so be dependent on achievement of significantly greater value creation than that applicable to threshold vesting.
- Awards should not vest for less than median performance.

8. OTHER LEGAL ISSUE

8.1. Discretionary or contractual bonus

Bonuses may be contractual, i.e. guaranteed under contract or guaranteed dependent on achievement of set goals, or discretionary. They may also be a combination of the two.

8.1.1. Contractual bonuses without performance criteria

In some cases, an employee may have a clear contractual guarantee that a bonus will be paid in its entirety. Examples of guaranteed contractual bonuses which are not dependent on performance criteria and do not include any element of uncertainty would be:

- A sign–on bonus; and
- An annual cash bonus which is guaranteed for the first two years of an employee's employment to incentivise them to join the company.

In these cases, the employee will have an unqualified contractual right to receive the bonus, and the employer will have a contractual obligation to pay it. In the event that it is not paid, the employer may pursue a claim of unlawful deductions from wages or a breach of contract claim, without being required to prove anything other than that the employer has not paid the bonus.

8.1.2. Contractual bonuses with performance criteria

A contractual bonus may also be subject to certain performance criteria being met. These criteria may relate to the individual employee, the business as a whole, or a business unit. In this case, where the criteria are met the bonus will again be payable as a matter of contractual right to the employee. Where the criteria are formulaic, the employee retains

a greater degree of certainty under a bonus structure compared to a discretionary bonus. Examples of formulaic criteria would be:

- a 20% bonus for a business development manager if an employer's client base increases by 5% by a certain date;
- a fixed–figure bonus provided an employee reaches a target number of hours worked, or a target figure of income generated; or
- a variable bonus directly relating to the percentage of income over target which the employee's department generates over the course of a year.

Again, if an employer failed to pay such a bonus where the performance criteria had been fulfilled, an employee would be able to bring a claim for full payment without being required to prove that the employer had acted unreasonably, provided they could show that the requirements of the bonus had been met.

However, where there is a greater degree of subjectivity in the performance criteria, particularly where the employer is required to form an opinion, there will be more room for dispute. Some examples of situations where an employer is required to form an opinion in the award of a bonus would be:

- a bonus relating to personal performance which does not specify any tangible and measurable targets;
- a bonus relating to unit performance which states that bonuses will be awarded where a unit has «substantially» increased its productivity levels; or
- a bonus which is awarded «according to company performance.»

Where an employer is required to form an opinion as part of its contractual obligation, it must do so reasonably and in good faith under English law. An employee who does not receive their bonus under such a contractual provision will therefore have to prove not only that they have not received the bonus they should have, but that the employer did not act reasonably and in good faith in failing to award that bonus. An employer may find it difficult to show that it acted reasonably where grounds are not specified in the contract, or where it has historically always paid out a particular bonus.

8.1.3. Non–contractual bonuses

Most bonuses will be wholly or partly discretionary. The wording for a wholly discretionary bonus will typically provide that there is no right to a bonus, and that payments

may be made entirely at the employer's discretion. An employer who successfully includes such wording in their contracts in principle has no obligation to pay any bonus. However, employers should be aware that their behaviour may lead to a court concluding that there is an implied contractual right to a bonus where it has been paid regularly (see below for further discussion).

Where a bonus is discretionary, an employer will not be required to show that they have acted reasonably (as they do with contractual bonuses where employer's opinion forms part of a performance criteria) in deciding whether and what to pay an employee. They will, though, not be able to withhold a discretionary bonus «arbitrarily, capriciously or unreasonably.» However, this is a very low standard to meet as evidenced by case law.

A recent case[11] confirmed that an employer's obligation to show that they have not acted unreasonably in choosing whether to award a discretionary bonus is not a high hurdle. A claimant sought to argue that he was entitled to receive a bonus (which was explicitly stated to be «at the absolute discretion of the company») on the basis that colleagues in similar roles received guaranteed bonuses. The High Court struck the claim out, as it found there was no reasonable prospect of the employee's claims succeeding at trial. It found that the employer's decision to award different levels and structures of bonus to different employees was entirely rational and reasonable, on the basis that some employees are more desirable and thus require higher levels of incentive. It reiterated that it would require an «overwhelming» case to persuade a court that a failure to award a certain level of discretionary bonus was irrational or perverse. This case reaffirms the wide freedom employers are given in determining pay–out under discretionary bonus schemes. Employers may therefore prefer such wording to contractual bonuses.

8.1.4. Uncertainty over whether a bonus is contractual or discretionary

Sometimes the line between contractual and discretionary bonuses can be blurred. Even where a bonus scheme is stated to be wholly discretionary, if an employee has been paid bonuses on a regular basis they may argue that they have an implied contractual right to receive them according to the employer's custom and practice. A court will consider all relevant information in such a case, including a practice of making payment over previous years, when deciding whether «discretion» is to be construed as having contractual elements. Cases where a bonus has been found to be contractual in spite of wording to the

11 Paturel v DB Services (UK) Ltd [2015] EQHC 3659; [2015] EWHC 3660 (QB).

contrary include one where an employee received a bonus for five years running, although the terms surrounding the award of the bonus were never put into writing. When the employee resigned, his employer failed to pay him the bonus and asserted that it was entirely discretionary. However, the Employment Tribunal held that the bonus had, by custom and practice, become contractual, and since the employee had not been informed that the circumstances had changed he had a reasonable expectation of being awarded it and a right to receive it.

8.2. Holiday pay and bonuses

A recent string of English cases deals with the issue of what aspects of remuneration constitute «normal pay» and, as a result, need to be included in an individual's holiday pay. The principle focus of the litigation has been on overtime and on commission. The Employment Appeal Tribunal's judgment in *Bear Scotland and others v Fulton and others* [2014] UKEAT 0047/13/0411 held that payment for compulsory and regular overtime should be considered normal pay for the purposes of calculating holiday pay. *Lock v British Gas* (Case C–539/12) [2014] ICR 813 recognised that payment for tasks which are not always required by the employer but are required only now and then is not likely to constitute normal pay for the purposes of calculating holiday pay.

These cases pose the question of whether bonus payments must be included in the calculation of holiday pay. While it seems highly unlikely that a discretionary bonus could be described as normal pay, a bonus which is contractual either under the contract or by interpretation may be held to be normal pay, and an employer may potentially be required to take them into account when calculating holiday pay.

8.3. Potential discrimination issues

Although employers generally pay bonuses for good reasons, it is easy for discrimination to creep into a bonus system. A clear example is a bonus which relies on attendance or productivity, both of which may be indirectly discriminatory under the Equality Act 2010. Bonuses which reward time spent at work, whether directly through hourly targets or indirectly through other performance criteria, have the effect of placing part–time workers at a disadvantage. As these roles are predominantly carried out by women, such schemes could be indirectly discriminatory. Similar issues could also arise in relation to employees' disability or their religion.

Employers should be conscious of providing a fair and transparent bonus scheme,

ideally with written reasons for any formula applied and for the award of bonuses. The English courts have seen cases of women bringing sex discrimination claims when they were awarded lower bonuses than male comparators in which the employer was unable to provide justification for this. As the bonus in a discrimination claim is on the employer to disprove a claim, it is important that an employer in such a situation can evidence its fair process and the fair reasons for awarding a particular bonus to a particular individual.

8.4. Gender pay gap reporting

Measures requiring companies to report on their gender pay gap are due to come into force on 1 October 2016 under the Equality Act 2010, the UK's primary piece of equality legislation. Draft legislation is currently open for consultation at the time of writing and is due to be concluded by 11 March 2016. Under the draft Regulations, companies with more than 250 employees will have to publish reports stating the difference between the average pay of their male and female employees, this will include bonus payments. Employers will be required to publish on their website the following information relating to bonuses:

- The difference in mean bonus pay between male and female employees during a 12 month period; and
- The proportion of male and female employees who received bonus pay during a 12 month period.

Bonuses are one of the biggest drivers of gender pay gap discrepancies, particularly at senior levels, as they can be among the least transparent forms of pay. Requirements cover public sector as well as private and voluntary sector employees, so it is clear that a large proportion of companies in the UK will find themselves subject to these new reporting requirements. By forcing companies to publicly declare their statistics, the hope is that businesses will be encouraged to analyse the causes of any gender–based pay and bonus gaps and factors influencing the salary progression of women.

8.5. Leavers

It is important to ensure that variable remuneration arrangements contain well–drafted provisions setting out the consequences if the employee's employment terminates before the bonus is paid or the shares are transferred.

In the UK it is permissible for an employer to provide that an employee will forfeit his awards of variable remuneration if his employment terminates or he gives or receives notice at any time during the performance period or before payment of the variable remuneration, irrespective of the reason for the termination of his employment.

That said, variable remuneration arrangements often contain «good leaver» provisions under which an employee will usually be allowed to keep his awards (subject to the satisfaction of performance criteria) on the termination of his employment. Such awards are normally paid on a pro rata basis depending on the length of time that the employee has continued as an employee during the performance period.

The meaning of the terms «bad leaver» and «good leaver» is key. There is a variety of definitions that could be used. For example a bad leaver could be defined as an employee who voluntarily resigns or is dismissed for gross misconduct or could be limited to those employees whose employment is terminated other than by reason of redundancy or ill–health.

For FTSE 350 companies, the IA's Principles state:

- Where individuals resign before the end of the performance period, or in the event that employment is terminated for cause, any unvested awards should normally lapse.
- In other circumstances of cessation of employment, some portion of the award may vest, to the extent of the performance period that has been completed, but subject to the achievement of relevant performance criteria. In general, the originally stipulated performance measurement period should continue to apply. However, where in the opinion of the company, early vesting is appropriate, or necessary, awards should vest by reference to performance criteria achieved over the period to date. Such circumstances may include disability, ill health, redundancy, retirement or analogous reasons for departure of a 'good leaver' nature.

8.6. Clawback

There are a number of issues to be considered in designing clawback for variable remuneration. Two of the main issues are summarised below.

- *How to give effect to clawback*. If the employee is a continuing employee, this can sometimes be achieved by reducing other amounts due to the employee, such as bonuses or awards under other schemes. Often, though, the employee will have been dismissed, in which case it may be very difficult in practice to recover an-

ything from him. It is illegal for an employer to receive a payment from an employee unless the employee has given prior written consent (so there needs to be a procedure under the plan whereby the employee signs an agreement to make clawback payments).

- *Whether clawback is gross or net of tax*. If the employee has paid tax on the award it is arguably fair that the clawback should apply only to the net amount he actually benefitted from but this will leave the employer «out of pocket» for an amount equal to the tax and NIC. If the employee is obliged to repay the gross amount, it may not be possible for him to recover the tax from the UK tax authorities.

9. POTENTIAL IMPACT OF BREXIT

If the UK votes to leave the EU in the referendum on 23 June 2016, it will have a significant impact in a number of areas. The nature of the impact will depend on the model that the UK adopts post–Brexit for example whether the UK seeks to join the EEA or whether the UK seeks to agree independent Free Trade Agreements. As a general principle, however, it is likely that the UK would seek, as far as possible, to deregulate and reduce EU regulation particularly in relation to remuneration in the financial services industry.

10. CONCLUSION

The consequences of the financial crisis show what can happen when variable remuneration incentivises the wrong behaviour. Yet equally, seeking to cap the amount of variable remuneration has also had negative unintended, consequences in the UK.

Employers are required to «navigate a minefield» to ensure that the variable remuneration arrangements incentivise and encourage the right behaviours and provide the right rewards taking into account the requirements of regulators and expectations of shareholders as appropriate.

Given the increasing disparity between the highest paid senior executives and the workforce generally in the UK, one might hope that this would provide employers with an

opportunity to offer other, perhaps non–financial incentives to their senior employees. However, it is clear that variable remuneration is, and will remain a key element of remuneration packages paid by UK companies, and that a shift away from financial reward particularly for senior executives will not be forthcoming and is probably less likely to be less forthcoming in the event of Brexit.

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