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it's our business

newspad of the Employee Share Ownership Centre

Davos debate on future of Eso and executive reward policy

A wide-ranging debate on the future of employee share schemes and executive reward is set to take place at the World Centre's tenth global employee equity forum in Davos on Thursday February 5 and Friday February 6.

Several speakers have hinted that they are ready to go into the trenches to defend the 'right' of company remuneration committees to offer whatever level of executive reward packages shareholders and the market will stand.

This is despite signals from both the US and the European Union member states that tough new regulatory controls on types of executive reward packages will strike about the time the forum takes place. It looks odds-on that the major mainland European states will collectively ban golden parachute payments and punish companies who reward executives - with incentive equity or cash bonuses - even when they have failed to deliver increased genuine profits and sales. Incentive clawbacks are set to operate when bumper 'profits' are later shown to be nothing of the kind.

Meanwhile, a study by lawyers Norton Rose LLP suggests that more than 75 percent of FTSE 100 companies' SAYE-Sharesave employee options are currently worthless, leaving at least one million participating employees out of the money. Whereas the majority of three-year SAYE schemes which matured last year still paid out (because the 2005 launch strike price was low), the same will not be true for 60 percent of the three-year SAYE schemes which are due to mature this year, concluded the survey. But the real crisis could come next year when three year SAYE contracts launched in 2007 mature, suggested the survey. Up to 80 percent will be underwater unless stock markets revive dramatically during the next 18 months.

This alarming scenario is exercising the minds of speakers and delegates who will gather at the five-star Steigenberger Belvedere Hotel early on Wednesday evening February 4, in readiness for the informal pre-conference dinner. Advisers are wondering how employee commitment to Eso will be maintained unless plan-sponsoring companies are allowed to let deeply underwater SAYE options wither away and replace them with new more realistically priced option schemes. However this would raise expense accounting and regulatory issues.

"The silver lining is that employees can abandon worthless options and keep saving so as to pocket the tax-free bonus on the linked savings contract, (though the bonus interest rate is diminishing by the month). The more fortunate will also get the opportunity to apply for new cut-price options," said David Cohen, head of employee benefits at Norton Rose.

Two major open forum sessions are scheduled in the programme in order to discuss these and other issues. Sarah Pickering of Alvarez & Marsal Taxand LLP and Martin Osborne-Shaw of Killik Employee Services will mediate these sessions.

To date more than 30 people have registered to attend. Other speakers in Davos are: Paul Stoddart (HBOS Employee Equity Solutions), Jean-Nicolas Caprasse (Riskmetrics Group); Kevin Lim (RBC Corporate Employee & Executive Services); Euan Fergusson (White & Case LLP); Alan Judes (Strategic Remuneration); Peter Mossop (Sanne Group); Sara Cohen (Lewis Silkin); John Pymm & Julie Withnall (Watson Wyatt); Dale Giedd and Ulrich Semmler (UBS); David Pett (Pinsent Masons); Rosemary Marr (Investec) & Grant Barbour (Bedell Group) and Marcus Wallman (Al Tamimi & Co).

Please email Fred Hackworth fhackworth@hurlstons.com and Holly Bruce hbruce@hurlstons.com to register for this event. Members receive generous discounts.The programme can be downloaded from the Centre website at: www.hurlstons.com/esop and see the events page.

From the Chairman

Who would have thought that George Bush would choose for his swansong the control of executive salaries in the motor industry? Esops started in order to spread the wages of capital and it was never in the script that ceos would scoop a growing proportion of the pool. In this, as in so much of late, the market has proved imperfect.

Davos will be a good place to plan for the new world and I hope many of you will take the opportunity to join us there, having digested the news and much more over Christmas.

Malcolm Hurlston

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TREASURY TO LOOK AT CENTRE COMPLAINT

Lisa Griffiths of the Treasury Banking Reform group has told Centre chairman Malcolm Hurlston that the Financial Services Authority is consulting on “possible further reforms” to the Financial Services Compensation Scheme, including whether the £50,000 deposit compensation limit should also apply to “financial products other than deposits.” This came after the chairman wrote to the Chancellor decrying apparent state-backed discrimination against employee SAYE-Sharesave participants who keep their plan savings in the same bank as their personal savings. The chairman asked Mr Darling to remove the anomaly whereby any amount deposited with a bank or building society via a SAYE scheme counts towards an individual's compensation limit with that bank or building society.

BUSINESS AS USUAL?

New legislation and changes in financial reporting obligations combined with zero tolerance of corporate governance breaches have led to a dramatic increase in the demand for expertise in the market for stock plan administration and related consulting services, reports Centre member Global Shares. Meanwhile, the FSA is looking at the circumstances behind David Ross's secret pledging of shares in Carphone Warehouse, National Express, Big Yellow and Cosalt as collateral against £100m worth of loans he took out to back other ventures. His sale of 15m (two percent) of his Carphone stake on June 19 to the company's employee share ownership trust (ESOT) at £2.17 per share (netting him £32.6m) is now in the spotlight, as shareholders seek explanations. The shares were trading at around 93p at Xmas.

REMUNERATION: MOVING THE GOAL POSTS

As bombed out stock prices and profits disrupt companies' incentive reward plans, many firms are considering extra emergency measures to reward employees. A survey of 151 US companies by Deloitte Consulting found nearly three-quarters had implemented or were considering such measures, including stock awards or special bonuses. Respondents said they were worried about keeping key workers and wanted to boost morale in the turbulent economy. UK based store chain Debenhams is intending to remove sales targets from its executive compensation scheme. Such a move would almost certainly see bonuses increase. Executive directors at the chain, who were granted a 2.5 percent increase in their base salaries in the last financial year, have agreed to take a salary freeze this year in the light of tough trading conditions on the high street. However, they could more than make up any shortfall through the proposed bonus changes. Bonuses for the last financial year were calculated on profit, net debt and like-for-like sales targets but Debenhams' remuneration committee has suggested that only pre-tax profits and net debt targets should now be used. The move could allow directors including ceo Rob Templeman and finance director Chris Woodhouse to secure bigger bonuses despite the downturn on the high street. Templeman received a 19 percent pay rise this year as the retailer proposed beneficial changes to executive compensation, despite the consumer downturn. Debenhams said it was proposing the changes to ensure that "compensation arrangements remain competitive and drive performance in the current challenging economic environment." The maximum potential bonus under the executive compensation scheme is equivalent to 100 percent of salary. The remuneration committee paid out a 20 percent bonus last financial year after Debenhams hit only its net debt targets. Head office staff and store managers will see their pay frozen while remuneration for shop floor employees will increase in line with inflation.

Industries that rely heavily on stock and bonus compensation -- such as technology and financial services -- may have been harder hit by the meltdown than others. Some companies can't afford to give extra rewards, even if they want to give them. The Deloitte survey found that more than two-thirds said earnings declined or were flat over the past year, and 58 percent predicted their bonus plans would pay out less than their targeted amount; ten percent were expecting no bonus payouts at all. Almost two-thirds of companies that granted stock options said half or more of their grants from the past five years were now underwater, or could only be redeemed at prices that were above current market prices. Many surveyed companies said they were thinking of tweaking bonus plans to increase their chances of paying out, and modifying long-term incentive programmes to improve the value for workers. Nearly a third said they were considering additional programmes to keep key employees -- often special payments to supplement regular bonus pools. Some companies are considering swapping underwater options for stock, or for options with lower exercise prices. Such swaps can hurt earnings, and often require shareholder approval, which make them tough to do. Compensation-tracker Equilar Inc. unmasked more than 20 companies that implemented option exchanges in 2008, including home builder Toll Bros Inc and software company VMware Inc. Pharma company MannKind corporation in July offered many of its 600 employees the chance to exchange two stock options for one share of restricted stock and 83 percent agreed to do so.

A plan by Credit Suisse to base bankers' bonuses on the performance of troubled assets responds to calls to link risk and reward, and other banks will likely adopt similar structures, investors and consultants said. They welcomed the new system having -- alongside regulators and politicians -- criticised the bonus culture, which they say has encouraged the kind of reckless risk taking that spurred the world's worst financial crisis in decades. "This scheme is definitely better than giving executives cash," a corporate governance head at a large British fund house said. The plan will cut Credit Suisse's risk exposure by linking most of its top executives' bonus payouts to some $5 billion in illiquid and often opaque assets such as mortgage-backed securities, which have tumbled in value.

In the UK, On-Line plc's board repriced 1.4m outstanding executive share options, some dating back to 2003 reported The Sunday Times. Rethinking remuneration packages is on the agenda at almost every big business. The fear is that if incentives are too far under water, top talent could walk out of the door. In the UK shareholders must be won over if bosses are to be given fresh incentives for options are meant to pay out if a company performs well rather than guaranteed regardless. "It doesn't feel to me that many companies are going to give (repricing) a try here," said Luc Vandevelde, chairman of Vodafone's remuneration committee. "Those who do will be severely criticised." When jobs are being cut, companies know that they must tread carefully when feathering managers' nests. In October, the Financial Services Authority sent out a ‘Dear ceo’ letter, cautioning banks over excessive bonus schemes it thinks may have contributed to the financial crisis. "If we have suffered, it feels right directors should suffer too," said one fund manager. Compared to the last recession, a greater proportion of incentives are based on total shareholder return, measured against a list of comparative firms. For those to pay out performance is still relative. Revised packages linked in part to earnings per share maturing in 2010 and 2011 are now worth very little. Nil-cost options awarded in September 2007 with a face value of £6m to Michael Grade, ITV's chairman, are worth £1.9m today and he may not qualify for many of them at the end of this year. Failing to achieve total shareholder return is down to management, but revenue-growth targets look impossible in a steep advertising downturn. ITV, whose shares have fallen 59 percent in a year, has said it will not make changes to its long-term incentive scheme, which runs until 2011. However, Grade's options that fail to vest in 2009 can be rolled over and retested in 2011.Vodafone made big changes after introducing a restricted stock-award plan that encourages directors to buy shares to qualify for long-term bonuses. "The problem the companies have is that no-one in this market knows what good performance is," said one ceo.

Eyebrows were raised at the golden goodbye awarded at the loss-making nuclear holding group BNFL. David Bonser, director of HR and a key figure in the development of BNFL's troubled Thorp reprocessing plant, received £1m ‘compensation’ for ending his employment last November, on top of an annual salary and bonuses worth £575,000 for the 12 months to March. Two other directors left with well over £1m each as the company was wound down.

TAX CHANGES AND ESO PLANNING

In its latest edition of Employee Benefits News, lawyers Clifford Chance warned of recent developments that may affect employee share plans and other incentive arrangements and which may require action. These include reviewing plan design in order to avoid the future income tax/NIC rises announced in the recent Pre Budget Report and reviewing incentives in light of the FSA's recent views on ‘good’ and ‘bad’ remuneration policies. There are changes that may need to be made to some company compliance practices - the need to review PAYE and NIC compliance procedures for share plans to avoid the new penalty regime. There were very significant announcements for the longer-term in relation to income tax and NIC. Although these changes are not specifically targeted at gains made from employee share plans, they will prompt companies to re-visit the design of their plans. The Chancellor’s long-term proposals for income tax and NIC include the following, both of which will take effect from April 2011: Income over £150,000 will be liable to tax at 45 percent and Class 1 NIC (employer and employee) is to be increased by 0.5 percent. Based on current rates, this means that employers’ NIC will be increased to 13.3 percent and the additional employee rate of 1 percent above the NIC earnings cap will be increased to 1.5 percent (the standard employee NIC rate on income up to the earnings cap will increase to 11.5 percent). In light of these proposed changes, companies are likely to increase the use of their tax-approved arrangements, both discretionary plans (company share option plans and EMI) and all-employee plans (SIP and Sharesave plans), as these will in future provide greater savings in income tax and NIC. More importantly many companies will be considering how best to modify their plans generally and/or adopt new plans to maximise tax efficiency. This may involve, for example, accelerating compensation payable under existing arrangements so that it is received before April 2011. Alternatively, plans may be amended to provide for shorter vesting periods followed by a post-vesting longer holding period. Income tax/NIC would be accelerated to the end of the (shorter) vesting period but shareholders should nonetheless still be happy if there is then a holding period (possibly with performance conditions still continuing to apply) before the shares can be sold.

In addition, some plans (by using e.g. restricted or “hurdle” shares) may be structured so that shares are immediately acquired at the outset (with any income tax/NIC arising at that time), with any gains made after acquisition being then subject to CGT rather than income tax and NIC. Similar ideas to these have been pursued in the past, particularly where possible changes in government have been anticipated, although arguably those plans (which tended to be more complex than e.g. share option plans) became less attractive following the abolition of the ten percent rate of CGT taper relief earlier this year. Now, however, a bigger gap between the new CGT rate of 18 percent and the impending new top income tax rate of 45 percent means that these ideas will be back on the agenda. MM & K Ltd made a similar point in its latest client newsletter: “There will be increased pressure to compensate via shares taxed as capital gains. Many companies use employee trusts and we foresee greater usage of such arrangements. If you are not already doing this, do contact us. Executives will want to make the maximum use of the UK HMRC approved tax effective schemes. The annual maximum for SIPs is £7,500 worth of shares, and £3,000 for SAYE options. CSOPs have a maximum award value of £30,000 at the date of grant. Such amounts are not life changing, but prudent executives will want to maximise their tax planning opportunities," said director Nigel Mills.

Clifford Chance said that the backdrop of continued market uncertainty had to be borne in mind. One potential disadvantage of such arrangements was that an income tax / NIC charge may be crystallised when the shares are acquired (at a time when the employee cannot realise any gain) but the income tax / NIC paid is not recoverable if the share price then falls. This contrasts with share options, where the employee risks nothing until he decides to exercise the option (at which point he is generally able to realise any gain). In short, there is a classic trade off between high risk/low tax (shares) and low risk/high tax (options) and all arrangements should be viewed in that context.

ON THE MOVE

Global Shares, a leading global share plan administrator and consultant, announced the appointment of Mr. Andy Rogers to the board of Global Shares plc. Andy is chairman of The European Marketing Group and principal of Rogers Associates Ltd, director of VGC Group Ltd and is also an Associate Director of Elior UK. He worked for Bank of Ireland for 38 years; a career equally divided between Ireland and the UK

COMPANIES

Eircom has been put up for sale and its distressed Australian owner has appointed the investment bank UBS to find a buyer. The company is among assets in Europe that Babcock & Brown (B&B) put on the block as part of a sweeping restructuring plan. BCM, the listed fund that holds the majority stake in Eircom and is partly owned by the parent company in Australia, has agreed to buy itself out of the parent company and seek a sale of Eircom, which could fetch €2bn. Any buyer is likely to create a parent company to avoid disturbing a €4bn debt package that Eircom has in place. The Eircom ESOT, which has a 35 percent stake in Eircom, would then inject itself into the structure.

Centre member MM & K Ltd has granted options to employees so that all employees with more than one year's service and directors either own shares, have options or both. The options granted were tax effective EMI options with ten-year life vesting after three years. MM & K's objective is to incentivise and reward employees and allow them to share success.

New Star Asset Management was forced to cede control to a group of banks in a £240m deal that hits employee shareholders, including founder and chairman John Duffield, hard. The falling to earth of New Star (death star?) has been a stunning blow to the reputation of Mr Duffield, who founded the business in 2000. He sold his previous business, Jupiter, launched with £150,000 of his own money, to Germany's Commerzbank for £680m. But there is concern among employees, who fear they could collectively face a tax bill of about £8m on loans from an employee benefit trust to pay for shares. The value of the shares has dived and should New Star become insolvent, employees might have to pay tax on the value of the benefit at the time the loans were made.

Of the scores of jams and conserves sold under the Tiptree brand of Wilkin & Sons, the most remarkable are made from fruit grown within yards of the company's factory in the Essex countryside. Its best-known products may be Tawny marmalade and Little Scarlet strawberry jam, but devotees seek out mulberry, greengage and damson jams or jellies made from crab apple, quince and medlar. Employees now own 48 percent of Wilkin & Sons through an employee benefit trust and this will eventually increase to 50 percent. "The biggest thing we've got is that we're family owned," a board member said. "The Wilkin family could have sold out and gone to the Bahamas, but our chairman, Peter Wilkin, sees himself as custodian of the company."

LOBBYING: An employee should be entitled to set up a personal Share Incentive Plan if his employer has not yet introduced the SIP and has no plans to do so, said Centre member Gavin Oldham of the Share Centre. His idea was warmly received by the Centre's steering committee. The employee should be able to go it alone via a provider ie a personal SIP. It would be capable of being merged in later if the company started one and in the meantime would give the employee access to tax breaks related to the scheme. The chairman is raising the issue with Downing Street. "I like the idea of empowering the individual," said Mr Hurlston. On the Daily Telegraph's campaign wish list SOS – Save Our Businesses : Reduce thresholds for the Fringe Benefits Tax to allow greater flexibility for employee incentives.

CENTRE-STEP EVENTS

A working party comprising Malcolm Hurlston, David Harvey ceo of the Society of Trust & Estate Practitioners (STEP) Worldwide, Rosemary Marr chairman of STEP Worldwide and Centre staffer Anna Burgess is considering whether more joint STEP/Esop Centre events can be held in future. David Harvey said that STEP is polling its members to see which countries they have an interest in. Possible locations for new events include: Hong Kong, BRIC countries, Cayman Islands, British Virgin Islands, Bahamas, Barbados and Trinidad & Tobago. The results of the poll are expected by the end of this month (Jan).

The Employee Share Ownership Centre Ltd is a members' organisation which lobbies, informs and researches on behalf of employee share ownership.