

# it's our business

## newspad of the Employee Share Ownership Centre

### Gunfight at the OK Bonus Corral

The Governor of the Bank of England has made an unprecedented attack on the bonus culture in the City, in the wake of the continuing world credit crisis.

Mervyn 'Wyatt' King, backed by Confederation of British Industry chief Richard 'Doc' Lambert and Swiss Central Bank boss Jean-Pierre Roth, called on banks and other financial institutions not to offer huge remuneration incentive deals to often inexperienced staff, causing some to take unacceptable risks.

Mr King said: "Banks have come to realise in the recent credit crisis that they are paying the price for having designed compensation packages which provide incentives that are not, in the long run, in the interests of the banks themselves, and I would like to think that would change." So many young people chose working in banks over other careers just because of the high pay on offer, he said. "That is not an attractive position to be in when such a high proportion of our talented young people naturally think of the City as the first place to work in. It shouldn't be. It should be one of the places but not the only one," added the former London School of Economics professor.

The Governor, speaking at a Treasury select committee hearing over his reappointment for a second term, said the sector needed to change if further financial crises were to be avoided. Mr King told MPs that he had been more impressed by the people running small firms across Britain than by London's top financial figures.

However, his comments enraged high street bank bosses and other senior financial executives, provoking fears of an imminent showdown between the two camps over alleged 'excessive' reward levels in the Square Mile. For King has become increasingly vocal in his condemnation of the City, recently blasting the sector for its "hubris".

CBI director general Lambert singled out the bonus culture as one of the main causes of the financial problems engulfing the world's banks. He said bonuses rewarded success but did not penalise failure, and that if bankers had been staking their own capital they might not have taken such big risks. The CBI chief also accused investment banks of being cavalier in their attitude towards risk. He said: "At the heart of many of Wall Street's problems has been a serious misalignment between the interests of managers and shareholders. It's

#### *From the Chairman*

*Less a month now to our 20th European event in Cannes. You can get in the mood on [www.rivieraradio.mc](http://www.rivieraradio.mc) where Henk Potts of Barclays opines wittily and daily. Contact [fhackworth@hurlstons.com](mailto:fhackworth@hurlstons.com) to book. The French and the Germans have at least set out their stall to increase the role of employee ownership. Fatcattery clouds the scene in the UK and US as well as accounting rules, which aim now to quarter our sector; as if hanging and drawing was not enough. Sovereign wealth funds may, like private equity, create a growing impediment. Meanwhile new reports are expected on UK schemes. Does the state get a bang for its buck? Probably not enough unless the requirement to communicate is stepped up. Anybody with a successful scheme will tell you communication is at the heart of it. So why should it be optional?*

**Malcolm Hurlston**

clear a number of investment banks overlooked basic risk controls in their drive to increase profits. "This pattern of behaviour has been exacerbated by a remuneration structure which has encouraged some employees to take spectacular short-term risks, confident that if things work out well they will reap huge rewards, and that if they don't they won't be around to pay the price. If it had been their own equity at risk, things might have played out differently."

Relatively mediocre performers in the UK and US banking industry were multi-millionaires, while top performers earned vast sums. The head of Barclays investment banking, Bob Diamond, was paid £36m last year even though Barclays took a £1.6bn hit from the US sub-prime crisis. Lambert's view of the damage created by the City bonus culture came in his speech at the British Venture Capital Association's 25th anniversary meeting.

Jean-Pierre Roth, the chairman of Switzerland's central bank, donned his gunbelt too, ready to fight alongside King and Lambert. Roth called on the banking industry to eliminate incentives for traders to take reckless risks. He said the turmoil in financial markets raised questions about the efficiency of banking supervision standards, and a rethink of corporate governance rules was crucial to Switzerland's reputation as a financial hub. Banks needed

to "correct the excesses of their remuneration system in a manner that does not put short-term results ahead of the long-term performance", he said in a speech at the Swiss National Bank centenary celebrations. His remarks came after the country's second-biggest bank, Credit Suisse, posted its first quarterly loss in almost five years after writing down £2.6bn of sub-prime losses.

In a move that may foreshadow new compensation legislation in the City and Wall Street, ministers meeting in Washington backed a report, which said banks' compensation structure was partly to blame for the credit crisis. The Financial Stability Forum, a union of regulators, said the current system - in which bankers are frequently paid huge bonuses based on their annual performance - needed urgent reform.

Amid a raft of other recommendations, including an overhaul of the way ratings agencies work and a beefing up of the Basel rules on banks' accounts, the FSF said remuneration should be tied to performance over credit cycles, which last five or more years. This raises the prospect of bankers having to wait many years for bonuses, or even being forced to forfeit them if the bank's performance later disappoints. But City finance houses pointed out that they have been quick to take their own remedial action and do not need yet more expensive and performance clogging regulation. UBS, which so far has written off £19bn due to the credit crisis, is now paying its bankers more stock and less cash. Even for top deal-makers, the cash amount paid is being capped at around £380,000. UBS said in an internal report that some of its staff had been paid for the amount of gross revenue they generated, rather than actual profit. They had received big immediate bonuses and not enough longer-term incentives, such as deferred shares. Some of the methods used to assess the sub-prime securities they had traded were flawed. "No formal account was taken of the quality or sustainability of those earnings," admitted UBS, which has completely overhauled its remuneration systems. At JPMorgan, which escaped the worst of sub-prime, some bankers are being made to wait longer for their deferred stock to vest - 18 months - instead of a year, or three years instead of two.

The Association of British Insurers has climbed onto the bandwagon too. It is to review executive pay structures at Britain's banks following concerns raised by shareholders in the wake of the credit crisis. Scottish Widows and Schroders, two of the City's largest fund managers, have now called for bonuses to be better aligned with shareholder returns as well as long-term financial performance. Other institutions are privately backing the call and hope to use the fallout from the current crisis as an opportunity for change. Peter Montagnon, director of investment affairs at the ABI, said: "Our guidelines have always made it clear that there should be a strong link between executive pay and shareholders' interests. In light of the credit crunch, we will look to see whether that link is being maintained." Although shareholders have no say on staff bonuses, they hope that pressure for reform at executive level would filter through to investment

banking. Richard Buxton, fund manager at Schroders, said: "We have argued for years that the banks need to have incentive structures not based on earnings growth as that encourages taking risks with the balance sheet. You could argue that those fears have now been borne out. "We think bonuses should be based on total shareholder return and paid largely in shares that vest over three years. Share ownership is preferable to share options, which have no downside risk. All this can permeate right through the company. Incentives further down should be based on one- and three-year criteria."

Another leading fund manager suggested bonuses be "held in shares for three years as that would help directors live with the consequences of their actions." Institutions have been dismayed by the banks' urgent cash calls - a £12bn rights issue at Royal Bank of Scotland and £4bn at HBOS - and deep dividend cuts just months after insisting they were in a stable position. James Clunie, fund manager at Scottish Widows, said: "People really need to pay attention to remuneration. At the moment the incentive is to take risks as you get a large bonus if you get it right and you don't suffer if you get it wrong - your client does. I'd like to see some kind of medium-term bonus structures with clawback. Remuneration should be risk-adjusted." Shareholders' decision to join the debate is significant because insiders believe they will have more influence than regulators.

#### SHARE SCHEMES REVIEW ALMOST COMPLETE

A report arising from the government's review of the Share Incentive Plan is likely to be made public within the next few months, the Centre has learned. The report of the SIP review is largely complete, but needs to be circulated around key Whitehall departments before being published, according to an insider. It will include a section on the effectiveness of the other main HMRC approved employee share scheme - SAYE Sharesave.

#### MOBILE EMPLOYEES TRAPPED IN UK TAX NET

David Ogden of BDO Stoy Hayward reports that legislative changes to mobile employees' eligibility criteria for all-employee schemes will mean that many companies will have to change their SIP and Sharesave plan rules and get HMRC to confirm that the plan remains approved in its amended form. The changes will take place once Royal Assent is granted (expected July). HMRC indicated that there will be some flexibility over the timing for making changes if companies have not realised/managed to get it done in time - but it will expect the necessary changes to be made by the year end.

Prior to 6 April, employees classed by HMRC as Resident but Not Ordinarily Resident (RNOR) from a tax perspective were not subject to some of the charging provisions contained in Part 7 of the Income Tax (Earnings and Pensions) Act (ITEPA) 2003 - i.e. certain provisions only applied to employees who were resident and ordinarily resident in the UK, explained the latest issue of Clifford Chance's bulletin Employee Benefit News. These charges included Chapter 5 (taxation of securities options) and Chapter 2 (taxation of restricted

securities). In addition, RNORs were excluded from the scope of Chapter 3 (taxation of convertible securities) and Chapter 4 (taxation of post-acquisition benefits). Certain other charging provisions under Part 7 (such as Chapter 3C (securities acquired for less than market value)) already applied to RNORs. However, under the proposed changes outlined in the Finance Bill 2008, employees who are RNOR will in principle be subject to all of the tax charges in Part 7 on the same basis as resident and domiciled UK employees. The changes will mean that, for example, an employee who is RNOR on the grant of a securities option will now be taxable under Chapter 5 at the time of exercise of the option rather than under Chapter 3C (the Chapter 3C tax charge would not have arisen, broadly, until the time the shares were sold).

The changes have certain consequences for the timing of any tax charge and employers will need to understand these changes in order to properly operate PAYE/NIC. In principle, the changes should simplify the current regime and will provide some advantages. For example, a RNOR employee will no longer be subject to a risk of UK tax on the grant of an option with an exercise price below market value. In addition, the employer will in principle, be able to transfer to the RNOR the employer's NIC liability on the exercise of an option chargeable under Chapter 5 (the NIC transfer facility is not available for Chapter 3C charges). Nonetheless, the overall effect of the changes may be to bring more individuals who are internationally mobile within the scope of the UK tax net

#### MOVING THE GOALPOSTS

Some FTSE 100 companies have been asking their institutional shareholders to back the scrapping of existing incentive reward packages and their replacement with less demanding ones because their share prices had tumbled so far down during the past year that senior executives had little chance of getting any benefit from them. Several ceos are in a worse position because the share price of their companies is lower than it was when they were appointed, perhaps a year or 18 months ago. Although the UK stock market recovered somewhat last month it was still ten percent down on May 1 from its peak last July.

"Many leading companies are addressing this issue and if they are not, they should be," said one remuneration consultant. Alliance & Leicester has changed its senior executive reward schemes, otherwise bonuses and stock awards could no longer be made, due to a large fall in its share price in the wake of the poisoned mortgage debt crisis. Moving the goalposts to keep leading executives incentivised, doesn't please everyone: small shareholders tend to believe that if the share price has dived and if dividends are low, then the company's top brass should bear some of the pain too. But what to do when share prices have fallen, not because of poor corporate performance, but due to the savage global sub-prime credit crisis? Richard Lapthorne, chairman of Cable & Wireless, said: "Incentive plans in this environment can be a problem but, as ever with arguments about pay and incentives, there are no easy answers. It's not black and

white. If you revalue incentive schemes on the way down in difficult markets, then people can counter and say that when packages go up because of higher share markets, then you should start re-adjusting to exclude the help from a following wind." Hewitt New Bridge Street director David Tankel said: "Institutional shareholders don't like Long Term Incentive Plans if they focus too much on share price growth, because if the markets go up, the executives do well regardless of whether they have improved the business or not." A recent Hewitt NBS report said that last year the average FTSE 100 ceo received a total reward package of £2.5m from a base salary averaging £780,000. What price peer group quartiles?

Meanwhile, some US consultants are arguing that share awards are worth more than the market value because shares give the holder the benefit from future growth in value. They calculate this extra value by estimating the expected future growth in the shares and discounting the growth to present value. The consultants suggest the enhanced share value should be used when assessing the number of awards being made, rather than be used for the accounting fair value. "While I've only heard of this trend second hand, as long as the concept does not spread into accounting, it may not do too much harm," said William Franklin of Pinsent Masons. "However the approach of increasing the value of a share above its market value seems illogical as in theory the share price ought already to take into account expectations of future share price growth."

#### EMI: HOW TO BEAT THE AWARD LIMIT

Some SME company executives may be making far more out of the Enterprise Management Incentive scheme than the government originally intended. For Centre member Bird & Bird revealed in a recent client employees incentives e-bulletin how to get round the government's limit on the value of qualifying EMI options which any individual can hold – which was increased from £100,000 to £120,000 in the Chancellor's recent Budget. The qualifying amount is measured by counting the unrestricted market value of option shares on the grant date (after taking into account any outstanding CSOP options).

Additional option grants to any individual are prevented within three years but the rule only applies if the employee has been granted qualifying options with a total unrestricted market value of £100,000. "Well-drafted plan rules usually prevent the application of the three-year rule by specifying a limit of £99,999 per employee on the value of shares which may be subject to qualifying options," said Bird & Bird. "If your plan rules include a £99,999 limit, the rules will need to be amended to allow options to be granted up to the new limit, which should itself be expressed as £119,999 for the same reason. Fortunately, the limit is being increased by Treasury order and HMRC have chosen not to amend the legislation in order to block the loophole, which prevents the application of the three-year rule.

# it's our business

## CONFERENCES

Turbulence in world stock markets has led an increasing number of companies to opt for Sharesave instead of SIP, it was revealed at the recent Capita share plans summit at Vintners Hall. A few employees have even asked share scheme promoters how safe Sharesave contributions are in light of Northern Rock, even though their accumulated savings are safe right up to the moment when (or if) their options are exercised. Some under water Sharesave plans have been quietly closed in order to make way for new ones, at a lower options strike price - but there has been very little change in overall SIP contribution levels, delegates were told.

More than 50 delegates so far have registered for the European Centre's 20th anniversary conference at the Majestic Hotel, Cannes, on Thursday June 5 and Friday June 6. The Centre has only a few rooms left in the Majestic (as part of the conference package deal) and so delegates are advised to register asap to avoid being sent to a different Cannes hotel. Details of the speakers, their presentation topics and admission prices etc are to be found on the Centre website at: [www.hurlstons.com/esop](http://www.hurlstons.com/esop) and click onto the 'events' tab. Download the conference brochure. E-mail the name(s) of your delegate(s) to Fred Hackworth at: [fhackworth@hurlstons.com](mailto:fhackworth@hurlstons.com)

The next Centre-STEP Channel Islands conference, held in association with the Society of Trust & Estate Practitioners, will take place on Friday, July 11 at the Royal Yacht Hotel, St Helier. This conference, for which a few speaking slots are still available, will focus on: the impact of recent and upcoming regulatory/legislative changes on Eso trustees (e.g. IASB, CGT, Jersey company law etc) and other issues for trustees of EBTs of private equity owned companies.

The annual Centre-Institute Of Directors conference for SMEs will take place on Wednesday, September 17 at One Whitehall Place SW1. This conference, entitled 'Transforming your business through employee share ownership,' features a strong line-up of Centre member speakers who will cover tax and accounting issues, the range of choices, exit planning, employee benefit trusts and relevant legislative/regulatory changes. The brochure is now available from the Centre and from the IoD conferences department. All enquiries about speaker roles and/or delegate attendance at Jersey and attendance at Centre-IoD to Joel Lewis at Centre head office: Tel +44 20 7436 9936 and by email to [jlewis@hurlstons.com](mailto:jlewis@hurlstons.com)

## RUSH TO THE EXIT TO BEAT CGT CHANGES

The owners of Coffee Nation, the coffee vending machine group, rushed through a sale of the business to enable staff and shareholders to escape being hit by changes to the Capital Gains Tax regime. This sale was another example of entrepreneurs and company directors offloading holdings ahead of the Government's abolition

of taper relief on CGT, which increased the tax rate by 80 percent - from ten to 18 percent. The new regime came into effect at the start of the new fiscal year last month. Coffee Nation operates vending machines in 550 sites across the UK and has an annual turnover of £20m. Primary Capital, a small private equity firm that acquired Coffee Nation as part of a £4m management buyout in 2000, agreed a deal to sell the business to fellow private equity firm Milestone Capital and Coffee Nation's management. The £25m sale allowed management and staff to offload their shareholdings at the lower tax rate of ten percent. Scott Martin, ceo of Coffee Nation, called the tax changes "ridiculous."

Insurance company owner Peter Cullum sold a slice of his Towergate Partnership ahead of the CGT changes to US hedge fund Och-Ziff, gaining £100m for himself and other directors, whilst 2500 staff picked up between £500 and £1,000 each. Shareholders collectively saved £8m in extra tax by beating the April 5 deadline. In the final week, directors' share deals tripled in value to £120m, compared with the previous year. Sir John Craven, chairman of Lonmin, sold £2.17m worth of shares in order to save £170,000 in CGT liabilities. Chris Wright, the major shareholder in Chrysalis saved almost £1.8m by transferring most of his 25 percent stake in the music group into a trust for his wife Janice.

## COMPANIES

ING Group NV issued 1,734,638 ords to meet obligations to its share plan participants. ING employees are granted conditional shares, which become unconditional after three years if the employee remains in post. Of the newly issued shares ING bought back 1,042,546 at the opening price €23.50 at 31 March for the delta hedge book, which is used to hedge employee options, from employees who wished to sell their shares immediately. The delta hedge position is adjusted periodically, in accordance with regulatory requirements and ING's policies to prevent market manipulation. The hedge book currently holds 33.5m (depository receipts for) ING ords, representing 1.5 percent of the total shares outstanding.

## ON THE MOVE

Colin Kendon took over as head of the Bird & Bird UK incentives and benefits team on May 1. Beatrice Chivers, a chartered tax adviser, joined in March from Ernst & Young. The team, based at New Fetter Lane, London EC4, recruited two tax lawyers internally in March who will split their time between tax and incentives. Contact details are [colin.kendon@twobirds.com](mailto:colin.kendon@twobirds.com) and Tel: +44 20 7905 6312 (Beatrice at +44 20 7982 6519). Guy Abbiss left the firm on April 30 to set up his own practitioner business - Abbiss Cadres.

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