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Share Plans and Executive Remuneration

July 2016

As the dust settles, we consider the impact of Brexit on share plans and executive remuneration in the short, medium and long term.

Short term

Outcomes skewed by volatility

In the short term companies' share prices will be influenced by market and currency volatility. This has the potential to skew annual bonus outcomes and LTIP vesting levels for 2016. This will lead to some companies paying out more than shareholders would expect and some paying out less than executives might expect. Shareholders will expect remuneration committees to ensure that pay outcomes appropriately reflect company performance, and therefore remuneration committees will need to take account of any risk that the outcome will not be seen as "right" by stakeholders when approving 2016 bonuses and LTIP vestings based on a formulaic application of performance conditions.

Equally, if executives feel that their remuneration outcomes are lower either because of a remuneration committee exercising their discretion, or because performance metrics have been missed due to events outside their control, this may lead to retention issues.

Existing targets

There is also the possibility that companies may want to amend targets attached to existing awards but this would be very controversial and while no doubt some will at least try to do so, they will be the exception. Remuneration committees may well take the view that they should leave the targets untouched partly because of the difficulties associated with changing them and partly because of the uncertainty surrounding how the political and economic situation will develop and its impact on markets and company performance over the next 12 to 18 months. They may decide to consider the suitability of performance conditions as and when awards vest in light of prevailing circumstances. Management may, however, be nervous about the uncertainty inherent in such an approach.

All-employee grants

At an all-employee level, for those companies that have granted sharesave options, or are planning to do so over the summer, share price movements may lead to the options very quickly (or immediately in some cases) being underwater. This will have a negative impact on how employees view their participation and so companies will need to consider whether to launch a second invitation this year in response to any significant post-referendum fall in share price.

Medium term

Knock-on effects of 2016 decisions

Brexit-influenced 2016 remuneration committee decisions will likely have long term consequences given that most main market companies will go to shareholders for approval of a revised directors' remuneration policy next year (this being 3 years after the first set of policies were approved in 2014). As such, any decisions related to pay for 2016 which shareholders do not like have the potential to colour how shareholders approach the vote on the new policy.

Combined with the ongoing review of executive remuneration commissioned by the Investment Association, the renewed focused on boardroom pay generally and continued "anti-establishment" sentiment, the skewing of pay outcomes as a result of Brexit-related volatility has the potential to significantly complicate the work of company secretaries/ reward directors/ remuneration committees over the next 6 to 9 months.

2017 targets

The effect of the uncertainty within markets will potentially make performance target setting for 2017 more challenging. This will be true of annual bonus and LTIP awards. Remuneration committees will need to be very careful not to be seen to dilute future performance targets in a way that unduly benefits management and/or has the potential to provide windfall gains in the event that the market remains buoyant in the early to middle part of next year (and beyond).

If any companies are considering adjusting their performance targets downwards for future awards this will in itself require a shareholder vote if softer targets are not permitted under their existing remuneration policy.

Shareholders are also likely to be resistant to such changes, particularly given that there remains a view that the softening of targets (particularly in relation to bonus) following the 2009 financial crisis led to remuneration levels being too high in the year that followed relative to the performance levels that were achieved.

Long term

As yet, there are no clear indications of what the UK's post-exit relationship with Europe will be, and it is the structure of this relationship which will drive the form of long term legislative changes. However, there are certain areas where the current UK regime is particularly reliant on European law.

Prospectus Directive

Overseas companies operating their share plans in the UK currently have to comply with legislation implementing the Prospectus Directive. Given the UK government's policy of promoting employee share ownership, it may well decide to ease the restrictions on employee offers, possibly by broadening the employee share schemes exemption to cover all employee offers, or extending the current share scheme exemption to cover shares listed on certain third country exchanges, such as the NYSE and NASDAQ.

There is generally agreement among EU Member States that offers of free shares and options fall outside of the Prospectus Directive. However, UK companies operating share purchase plans such as the partnership share element of a SIP or a share matching scheme will likely currently be relying on the employee share schemes exemption in the Prospectus Directive when they operate these plans in the EU and it is unclear whether this exemption will remain available. However, if the proposed new Prospectus Regulation retains its current form, UK companies will be able to continue to make offers into the EU with the publication of a summary document once this new regulation comes into force.

Company relocations

There has been speculation in the media that some companies will re-domicile to remain within the EU. Whilst the main draw of remaining in the EU would be access to the single market, there are likely to be counter-balancing legal and non-legal factors making the decision more complex. From a share plans perspective the legal issues arising from re-domiciling could be resolved by a comprehensive compliance review of the requirements of the new host country. Whether or not re-domiciling would make it easier for such companies to continue to operate their share plans across the EU as compared to the position if they remained in the UK will depend upon how UK-headquartered companies are treated for securities law purposes following Brexit. Some companies may decide to remain in the UK, but move certain business units into the EU. In the short term this would likely significantly increase the size of their IME population, with the cost and administrative burden that entails.

Financial services

The current Remuneration Codes derive much of their current form from European regulations such as CRD IV. In turn they have influenced domestic requirements such as the clawback and malus provisions in the Investment Association's principles of remuneration. Given that the current requirements track the uncontroversial policy goals of discouraging risk and rewarding performance, it is difficult to see the UK government diverging significantly from the current structure (or shareholders being prepared to accept this). Many commentators have suggested that the UK may scrap the bonus cap, which it initially opposed and which it sought to overturn in the European Courts. Although there may be an economic argument for doing so, within the current political climate it is hard to see the political impetus for this.

Directors' dealings

The Market Abuse Regulation ("MAR") came into force on 3 July 2016. Given that in practice the MAR regime does not differ greatly from the Model Code, it is difficult to see that Brexit will result in major changes in this area.

A final thought

This time last year few imagined the UK would vote to leave. The contingency planning many companies undertook in the run up to the Brexit referendum is now paying off, although many involved did not believe that their plans would ever be acted upon. Even though it is not yet clear what the UK's new relationship with Europe will be, time spent now thinking through the various possible implications for share plans and executive remuneration will maximise the chances of a smooth transition to the next regime, whatever form it takes.

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