EQUITY INCENTIVES UPDATE

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INTRODUCTION

Welcome to issue 1 of our Equity Incentives Update, dedicated to keeping companies informed about legal and regulatory developments affecting share-based incentives.

In this issue we cover:

- Reporting of share-based compensation under the proposed Gender Pay Gap Reporting Regulations which will apply from April 2017 to all employers with 250 or more employees;
- Dealing restrictions and disclosure requirements for employee share schemes under MAR;
- New HMRC guidance on how employees may "make good" tax arising in relation to share incentives to avoid a double tax charge;
- Data privacy issues for share scheme operators;
- A new HMRC tax interpretation which will impact listed companies which operate post-vesting holding restrictions; and
- Brexit considerations for share schemes.

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GENDER PAY GAP REPORTING

REGULATIONS AND THE REPORTING OF SHARE INCENTIVES

The Equality Act 2010 (Gender Pay Gap Information) Regulations 2017 (**"Regulations"**) will come into force on 6 April 2017. They will apply to all employers with 250 or more employees on 5th April in any given year.

The Regulations require annual public reporting of (amongst other things) the differences between mean and median (i) hourly rates of pay (including "bonus pay") for male and female employees in the employer's pay period in which 5th April falls; and (ii) bonus pay paid to male and female employees in the 12 months ending on the 5th April.

"Bonus pay" includes any remuneration in the form of securities, securities options or interests in securities. For this purpose, these types of remuneration are treated as paid to an employee at the time, and in the amounts in respect of which, the securities, securities options and interests in securities give rise to taxable employment income. This means that the amounts relevant for gender pay gap reporting will depend on the type of security or interest in security.

The regulations are likely to give rise to some issues for employers, including:

- securities options do not result in taxable employment income until the option is actually exercised. However, employees are generally able to choose when they exercise options (subject to certain backstop dates). An employer's gender pay gap indicated in its annual report may therefore be skewed depending upon when male and female employees choose to exercise their options. Since the hourly rate of pay calculation has to take into account bonus pay, and as that calculation focuses only on a single pay period (most likely the month of April, for an employer that pays its staff on a monthly basis), only options exercised in that period will be taken into account in reporting. A male executive exercising an option in April would count towards the average hourly pay calculation – but a female executive holding an identical award which she chooses to exercise the month afterwards would not be. Similar issues may arise when calculating the bonus pay differential for the full 12 month period;
- when calculating "bonus pay" for the purposes of reporting average **hourly rates of pay**, the value of the relevant award is pro-rated across all periods to which the award relates. Accordingly, it seems that a share option granted with a three year vesting period but exercised on April 5th will not result in the full value of the award being taken into account when calculating the employee's hourly pay rate – only a proportion of the value of the award will be. This seems sensible. However, pro-rating does not seem to be available when determining the **"bonus pay"** differential **for the full 12 month period.** This could again lead to skewed results. An individual receiving shares worth £100 in a particular year (but which vested, and so were earned, over a 2 year period) will seem to be better paid for the purposes of the Regulations than someone who received £50 of shares in that year but had already received £50 of shares in the previous year;
- where tax-advantaged securities options (EMI, CSOP and SAYE) do not give rise to a tax charge on exercise, it seems that the amount of the option gain is not an amount which is reportable under the Regulations; and
- for direct share acquisitions, there will be no taxable employment income unless the employee pays less than market value for the shares, so no report is required under the Regulations of such acquisitions. This applies even if, for example, one gender is given the opportunity to acquire more shares (albeit at market value) than the other.

DEALING RESTRICTIONS AND **DISCLOSURE REQUIREMENTS UNDER MAR**

The EU Market Abuse Regulation (No 596/2014) (**"MAR"**) has direct effect in the UK. It took effect from July last year and establishes a new regulatory framework for preventing market abuse and enhancing investor protection. MAR has relevance to employee share plans, most notably in respect of (i) the restrictions on dealings by persons discharging managerial responsibility or "PDMRs" (a concept which now also applies to AIM companies) during a closed period, and (ii) the notification obligations which apply to PDMR dealings. Companies will need to be aware of how the grant, vesting and exercise of awards, and the subsequent delivery of shares, are affected and ensure compliance with notification deadlines.

Key points to note include:

- new closed periods apply during which a PDMR is prohibited from entering into any "transaction on its own account". The new closed periods are 30 days prior to the announcement of the company's interim/half yearly report and 30 calendar days before the announcement of the company's year-end report. ESMA has clarified its interpretation of the application of closed periods around preliminary results, confirming that where a company releases preliminaries containing all the key information relating to the financial figures expected to be in the year-end report, the 30 day closed period will end immediately prior to that announcement. This gives AIM companies which release full preliminaries a longer window than previously in which to grant awards under share plans whilst still complying with institutional guidelines on grant windows. Previously, AIM companies had to wait until publication of the annual report before the closed period ended;
- there are very limited exemptions from the PDMR prohibition on dealing in closed periods – much more limited than, for example, under the Model Code which previously applied to main market companies;
- an extended range of financial instruments is caught by the restrictions on dealings and notification obligations. Debt instruments and derivatives are covered, including phantom stock options where the amount payable is linked to the company's share price; and
- changes in relation to notification of dealings include:
  - a requirement for PDMRs to notify dealings to the FCA as well as to the company (notification to the FCA must be done using a specified online form);
  - new notification deadlines – both the PDMR notifications and the company's announcement of dealings to the market must be made within three business days of the dealing.

For further information, please ask for our MAR brochures: AIM Companies – Impact of MAR on Employee Share Plans, and Main Market Companies – impact of MAR on Employee Share Plans.

“MAKING GOOD” PAYE AND NIC LIABILITIES TO AVOID DOUBLE TAX CHARGES IN RELATION TO SHARE INCENTIVES

Recent revisions to HMRC’s employment income manuals indicate a sensible relaxation of approach to “gross up” issues that can arise where an employee (knowingly or innocently) fails to reimburse his employer for certain PAYE liabilities.

PAYE charges arise in respect of so called “notional payments” made by employers – essentially non-cash benefits arising, for example, on the exercise of a share option. As a notional payment does not involve the transfer of money, the employer is unable to deduct tax in the usual manner. Nevertheless, it is required to account for the tax as if it had done. Section 222 Income Tax (Earnings and Pensions) Act 2003 imposes further tax charges if the PAYE liability is not reimbursed to the employer within 90 days of the end of the relevant tax year. As anyone who has encountered section 222 will know, this charge frequently proves to be extremely punitive. Often it is triggered because the parties did not appreciate that a PAYE liability had arisen in the first place – and, crucially, is not avoided (or capable of being reclaimed) when the employee later goes on to reimburse their employer.

So what has changed? A section 222 liability only arises where a PAYE liability is not “made good” by an employee in time. Historically, HMRC would in essence only accept that an employee had “made good” their tax if the relevant amount had actually been paid by them. Thankfully, and contrary to the view they have previously taken, HMRC have now confirmed that a liability can nevertheless be treated as “made good” for the purposes of section 222 if it is the subject of a bona fide indemnity given by the employee.

Of course, if a PAYE liability is known to have arisen, the mere existence of an indemnity will not prevent HMRC applying section 222 if an employer simply chooses not to enforce it for a time. But it should prevent a charge where (for example) an employer did not appreciate that a PAYE liability crystallised on the exercise of options by employees if, once discovered, the employees reimburse their PAYE liability pursuant to indemnities given under the terms of their share awards. That will be the case even if the reimbursement is not made until after the period required by section 222. The giving of the indemnity itself counts as the underlying PAYE liability having been “made good”. **This reinforces the importance of ensuring proper indemnities are contained in documentation granting any type of share incentive**.

DATA PROTECTION, THE GDPR AND EMPLOYEE SHARE SCHEMES

Establishing and operating an employee share scheme involves the processing of the participant's personal data and may also involve the transfer of personal data to a non-EU country, for example where there is a UK employer but the parent company granting an award and issuing shares is outside the UK.

In the UK, the processing of data, and its transfer to a non-EU country, are (amongst other data protection matters) currently governed by the Data Protection Act 1998 (**"DPA"**). With effect from 25 May 2018, the DPA will be replaced by the General Data Protection Regulation (**"GDPR"**) which brings with it new legal rights for individuals, increased responsibilities for data controllers and data processors, and substantial changes to the enforcement regime, including potential fines of up to 4% of a group's turnover.

Key points to note and prepare for in a share schemes context include:

- the GDPR will apply to data processing even where that does not take place in the UK, if either it relates to the activities of an EU-based entity, or relates to the grant of share awards to individuals who are in the UK. In the latter case, the data controller or processor will have to designate a representative in the EU;
- there has always been a risk in an employment context in relying on individual consent to data processing as a means of being compliant with the DPA. The use of consent to avoid a breach of the GDPR will be even harder. Consent to processing must be clear, specific and unambiguous, and consent to third country data transfers will only be effective if the individual has been informed of the possible risks of such transfer of data, and advised what safeguards have been put in place and how the individual can obtain copies of them. Share plan provisions around consent will have to be reviewed and data controllers transferring data outside the EEA will need to have appropriate safeguards in place. One possibility may be an agreement between the relevant group entities incorporating the standard contractual clauses approved by the European Commission;
- an emphasis on much greater transparency means that considerably more information must be given to individuals about the manner and purposes for which their data is being used, and that this information must be provided in a clear, prominent and user friendly way. Again, this is likely to require an amendment to award grant documentation, and in some cases may mean that the required "data protection notice" is provided to participants in a separate document to the award agreement; and
- trustees of employee trusts and share plan administrators who are data processors rather than data controllers have, for the first time under EU data protection law, direct responsibilities under the GDPR, including a requirement to keep a record of processing activities. In addition, there must be an agreement in place between the data controller and data processing which includes certain obligations. Data processors can be directly liable for GDPR breaches.

For further information about the GDPR in relation to share plans, or in relation to your business generally, please refer to our guidance booklets at https://www.dlapiper.com/en/uk/focus/eu-data-protection-regulation/home/ or contact James Clark (james.clark@dlapiper.com)

LISTED COMPANIES AND POST-VESTING HOLDING RESTRICTIONS: NEW HMRC TAX INTERPRETATION

Many listed companies, and particularly those in the financial services sector, now operate post-vesting holding restrictions on their director and senior executive share plan awards. These reflect institutional demands for greater alignment of senior executives' interests with shareholders' and that executives should build up significant shareholdings. Typically, a post-vesting holding restriction will require the executive to continue to hold his vested share awards for a period of two years following vesting, though normally sales to cover tax arising on vesting are allowed.

Companies have historically applied income tax and national insurance contributions to the full gain arising on vesting of an award or (in the case of an option) exercise of an option following vesting. However, HMRC have now advised that they would normally expect these types of holding restrictions to reduce the value of the shares on vesting/acquisition of the shares. This means that unless a "section 431 election" is entered into, (i) tax is being paid on the wrong value on vesting/acquisition and (ii) additional income tax and NICs may be due on the subsequent disposal of the shares.

Where a company applies post-vesting holding restrictions, it will be important therefore, going forward, for section 431 elections to be entered into at the appropriate time. HMRC's approach to existing arrangements where section 431 elections have not been entered into (and it is too late now to do so) may depend on the amount of tax in question.

BREXIT IMPLICATIONS FOR EMPLOYEE SHARE PLANS

Brexit may affect employee share plans in a number of ways, including:

- **prospectus rules.** As with all other EEA countries, the UK has implemented the EU Prospectus Directive. This requires that a prospectus is published in relation to (i) the offer to the public of securities, and (ii) the admission of securities to trading on a regulated market, unless an exemption or exclusion applies. An offer of securities to employees constitutes an offer to the public for these purposes. The Prospectus Directive allows for a number of exclusions and exemptions in an employee share schemes context, although companies based outside the EEA may not be able to rely on these exemptions, depending on the value of the employee offer and the number of employees to whom it is made. Some relaxations to the Prospectus Directive are proposed by the EU Prospectus Regulation which is expected to come into force in 2019. In particular:

  (i) the employee share schemes exemption which currently applies to companies with a head office or registered office in the EEA, or securities admitted to trading on a regulated market in the EEA, is to be extended to **all** companies. This means that a prospectus is not required in relation to an offer or allotment of securities to existing or former directors or employees by their employer or an affiliated undertaking provided that a document is made available containing information on the number and nature of the securities and the reasons for and details of the offer or allotment; and

  (ii) countries will be able to permit companies to make an offer of securities with a total consideration of up to €8 million (currently €5 million) without a prospectus being required (it will be for each country to specify the maximum offer value up to that limit, subject to a minimum of €1 million).

  Currently, the Prospectus Directive also allows for the "passporting" of prospectuses across Europe.

  Whilst passporting of prospectuses between the UK and Europe may become more difficult post-Brexit, in practice, it seems unlikely that the UK will wish to make it harder for companies to access UK markets and so it is reasonable to assume that the UK will adopt the Prospectus Regulation or measures similar to it even if it is no longer an EU member;

- **the application of MAR.** As noted, MAR is directly applicable in the UK. It has replaced the Model Code and AIM Rules provisions applicable to dealings in closed periods, and this means considerably curtailed exemptions from the prohibitions on dealings in closed periods which were formerly available in relation to share plans. It is possible that, consistent with a policy of encouraging access to UK markets, the UK may choose not to adopt MAR in UK law post-Brexit and that we instead revert to the previous Model Code and AIM Rules provisions;

- **data protection.** Our article above explains how the General Data Protection Regulation (GDPR) will affect share plans. The GDPR will have direct effect in the UK from 25 May 2018 and the Government has indicated that it is likely to remain the standard for data protection compliance in the UK post-Brexit, not least because negotiations for our exit will want to prioritise European Commission agreement that the UK has adequate safeguards in terms of data protection to enable the on-going transfer of personal data between the UK and the EU; and

- **EU social security rules.** The EU social security rules are currently applied to determine in which EEA country an employee is liable to be insured and pay contributions where he works concurrently in more than one country or moves between member states. These EU social security rules also apply equally in relation to earnings from share incentives (including gains deemed realised on the exercise of share options). Following Brexit, unless the UK agrees to be part of the EU system, workers may in some circumstances be liable to double social security contributions in both the UK and the EU member state in which they are working.

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