Career Shares – a proposed long-term incentive arrangement

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to be read in conjunction with:

"**Executive Pay – a career perspective**",
Hume Occasional Paper, No. 89, June 2011.

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1. Basic proposal:

Long-term incentives to be delivered in the form of "Career Shares" which would be granted on an annual basis and vest after, say, three years with the quantum vesting possibly being dependent on performance over that period. The major differentiating feature between Career Shares and Performance Shares is that, on vesting, the former would prohibit the director from cashing in (transferring ownership) the vested shares until retirement or exit from the company, with the possibility that this restriction would extend until two or more years after exit.

The following diagrams present an illustration of the difference between the two approaches of Performance Shares versus Career Shares:

[1] For a fuller discussion of this proposal see Brian G M Main, "Executive Pay – a career perspective", *Hume Occasional Paper,* No. 89, June 2011. The author is grateful to all those who attended his David Hume Institute seminar on 1 June 2010, and for all of the through provoking comments received.

Figure 1
Conventional vesting pattern (e.g., Performance Shares)

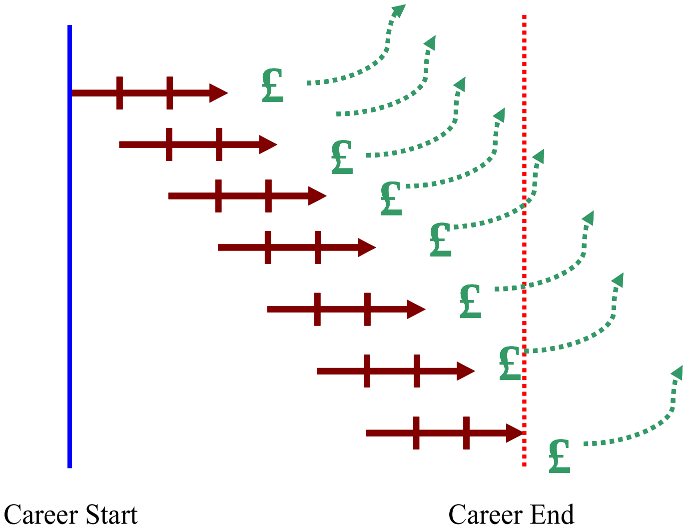
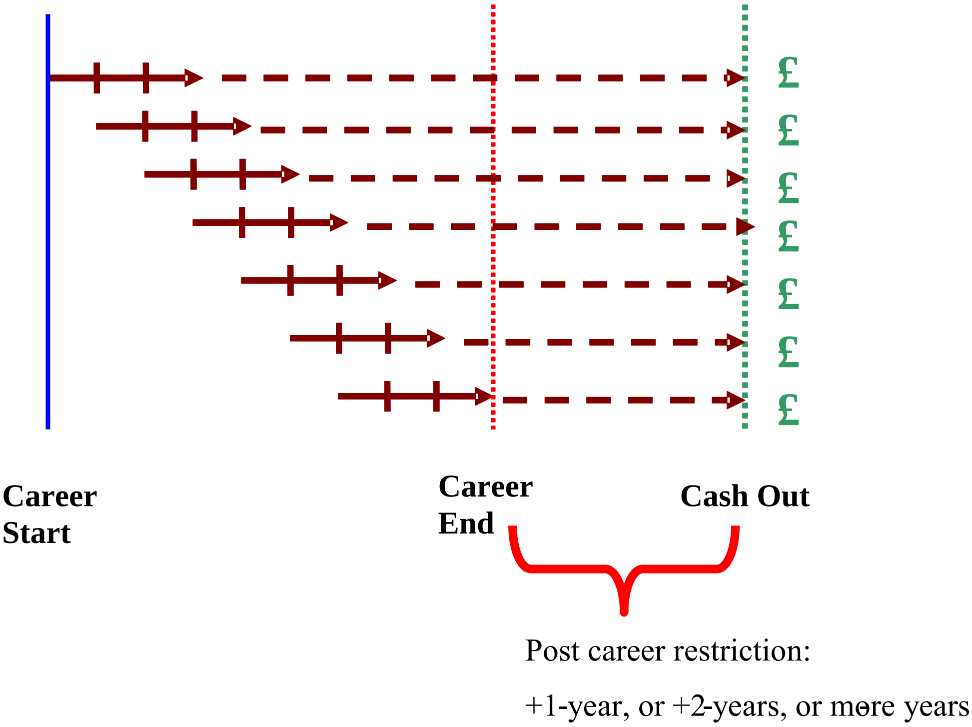


Figure 2
Career Shares Vesting and cashing-in pattern



2. Key features:

- The Career Shares form of long-term incentive arrangement would, upon vesting prohibit any cashing-in or divesting or hedging until a given number of years after the individual has left the company (whether through retirement or for other reasons).

- The post-exit holding period could range from one year all the way up to four years. Normally it would be expected to be set at 2-years. This delay in cashing-in is the essential novelty of the Careers Shares approach, namely separating vesting and transferability, to provide a truly long term incentive.

- At all times, from the granting of the incentive award, through the vesting event, and until the end of the restriction period, the quantum of shares under award would be increased in direct proportion to the dividend yield enjoyed by shareholders, with effect at each ex-dividend date.

- To meet any tax liability upon the executive resulting from a successful vesting event, a proportion of the realised reward would, exceptionally, be allowed to be cashed in for this purpose.

- In order to appraise shareholders of the cumulative effect of this arrangement, the Directors Remuneration Report should contain a cumulative valuation of those shares whose transferability continues to the restricted under the Career Shares arrangement. This would be separated from information regarding any other beneficial holding of shares by that executive.

- In addition to the holding of Career Shares, the cumulative total remuneration realised by the executive throughout the time in post (as a boardroom director) would also be reported. This would include salary, cash bonuses received, the cash value of pension contributions made by the company, the cash equivalent of other payments received, and the cash value realized on the sale of any performance shares or share options that had been cashed in (including for reasons of meeting tax liabilities, as mentioned above).

3. **Discussion of technical issues:**

3.1 Restriction on transferability - during the period of employment

During the period of employment, qualitatively this would be similar to restrictions that currently apply in many board-room incentive schemes such as mandatory deferral of bonus, and an early form of this arrangement can be found in the recent HSBC proposed Group Performance Share Plan

Directors are usually prohibited[2] from making any investments that would offset or hedge the effect of the Career Shares type of incentive. For example, for companies whose shares trade on the Main Market of the London Stock Exchange, the legal situation is governed by Listing Rule 9.2.8 of the FSA Handbook[3] and the Model Code[4] in Listing Rule 9, Annex 1. This places significant restrictions on the ability of directors to deal in shares or other securities (including financial derivatives[5]) of their own company. Prior clearance must first be obtained from the Chairman of the company and approval must be refused in certain circumstances.

> "A director (other than the chairman or chief executive) or company secretary must not deal in any securities of the company without first notifying the chairman (or a director designated by the board for this purpose) and receiving clearance to deal from him."

3.2 Restriction on transferability – subsequent to the period of employment

Once the contract of employment has terminated, further restriction on transferability of vested shares becomes subject to the common law public policy doctrine[6]. The

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[2] I am indebted to Professor Hector MacQueen and David Cabrelli of the Edinburgh University School of Law for guidance in these matters.
[3] http://fsahandbook.info/FSA/html/handbook/LR/9/2
[4] http://fsahandbook.info/FSA/html/handbook/LR/9/Annex1
[5] Including "entering into a contract (including a contract for difference) the purpose of which is to secure a profit or avoid a loss by reference to fluctuations in the price of any of the securities of the company;" and "the grant, acceptance, acquisition, disposal, exercise or discharge of any option (whether for the call, or put or both) to acquire or dispose of any of the securities of the company".
[6] See "A Law and Economics look at Contracts against Public Policy", Harvard Law Review, March 2006, Vol. 119 Issue 5, p1445-1466, 22p.

benefit to the company brought about by the restriction is required to be weighed against the negative impact on the owner of the shares on which the restriction bears. As in areas of employment law pertaining to the length of gardening leave or the length and scope of non-compete clauses, the courts are likely to take an unfavourable view of anything that smacks of an overt restraint of trade. As such, any attempted extension of the restriction period to as long as two years following the termination of employment may be challenged in court.

The issue may be worth testing however, as the voiding of post termination restrictive covenants (those restrictions on an employees actions that are intended to bind after employment has ceased) is based on the view that they are anti-competitive and in restraint of trade. The locking up of a director's capital does not fall so clearly under this heading as might, say, a restriction on choice of employer (in a non-compete clause). This is particularly true in the sense that the very accumulation of the capital would not have been possible (or so readily made available) had it not been possible to design the contract in this very manner (as in Career Shares). As such, it may well be possible to justify the "reasonableness" of the arrangement. There would remain the right to property protocol in the European Convention of Human Rights[7]:

> "No one shall be deprived of his possessions except in the public interest and subject to the conditions provided for by law and by the general principles of international law.
> The preceding provisions shall not, however, in any way impair the right of a State to enforce such laws as it deems necessary to control the use of property in accordance with the general interest or to secure the payment of taxes or other contributions or penalties."

Once again, however, it may well be possible to satisfy the implied restrictions of Career Shares on the grounds of general interest and proportionality.

[7] Aida Grgić, Zvonimir Mataga, Matija Longar and Ana Vilfan (2007) "The right to property under the European Convention on Human Rights. A guide to the implementation of the European Convention on Human Rights and its protocols, Human Rights Handbook No. 10, European Council.

3.3 *Dividend payments*

After the initial post-Greenbury[8] flurry if adoption of Performance Share plans, remuneration committees became aware of the bias such arrangements would have on decisions relating to dividends (owing to directors having claim to the delivery of company shares at the end of a three-year period). The share price is, obviously, likely to grow more if the maximum possible earnings are retained within the company rather than disbursed through dividend payment. Performance metrics such as total shareholder return are generally neutral to whether shareholders enjoy capital gains in the share price or enhanced dividend yields. Those dependent on healthy dividend yields (pension funds and others) were therefore alarmed at the perverse incentive that Performance Shares might create to restrain or even diminish dividends payment.

To remedy the situation, it soon became standard practice to augment the quantum of target shares available to the director so as to exactly reflect the dividend yield awarded in the relevant years. This essentially made the director the recipient of dividends during the unvested period of the award. As an example, the following extract is taken from the details of Kingfisher's Performance Share Plan:

> "Holders of awards of forfeitable shares will have certain shareholder rights, except that they will be required to waive their right to receive dividends.
>
> Participants will receive a payment (in shares), on or shortly following the vesting of their awards, of an amount equivalent to the dividends that would have been paid on the shares (assuming reinvestment in shares on the relevant ex-dividend dates) that vest between the granting of the awards and their vesting."

It is proposed here that under the Career Shares arrangements a similar approach is adopted. Once Career Shares have vested then dividends would be paid to the director in shares, and prior to vesting the quantum of the award would be adjusted pro-rata with the achieved dividend yield.

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[8] Greenbury, Sir Richard (1995). "Directors' Remuneration. Report of a study group chaired by Sir Richard Greenbury". London: Gee Publishing Ltd (July). A report which did much to move directors remuneration arrangements away from a reliance on share option plans and towards the use of Performance Share Plans.

3.4 Tax liabilities

With unapproved schemes (the type in use for boardroom directors), the employee is liable for income tax and employee national insurance contributions on the gains realised at the point when the options are exercised or when conditional shares vest. Employer national insurance contributions are also due (and by prior agreement may also be the responsibility of the employee).

Because with conventional conditional share awards (such as Performance Shares), it is the vesting or transfer of ownership of shares to the director gives rise to a tax charge on the value of the shares at that point, this tax charge can be deferred by vesting nil-price options at that stage. The life of the option (usually a further seven years) then allows the director to delay the tax charge.

The two arrangements (share awards versus nil-price options) are not exactly equivalent, of course. The eventual tax charge (and the company's national insurance tax liability) will depend on the final value realised when the nil-price options are exercised. For the company, this potential national insurance tax liability is partly off-set by corporation tax relief[9].

The accumulation of substantial amounts of claims to shares under such an arrangement would require the company to manage the accounting of such an overhang with care –to avoid infringing the dilution limits in force. An alternative is to budget for the liability through use of open market purchases of shares by making use of market-purchased shares held by an employee benefit trust .

By using longer life nil-price options (or executive share options) it would be possible to further delay the tax event. But 10 years is the usual maximum in such arrangements. Indeed, IVIS Guidelines(2009) declare:

> "7.2 Shares and options should not vest or be exercisable within three years from the date of grant. In addition, options should not be exercisable more than 10 years from the date of grant."

[9] Indeed, the employer national insurance contributions due my be recovered from the employee if the transfer of shares in involved.

So, with directors enjoying long boardroom careers (and, recall, that the typical CEO is in post for only 4.5 years) there will be a need for a tax recognition of any accumulated gains and, in this case, a partial release of funds sufficient to meet the resulting tax expense (currently 50% income tax, 2% employee Nics, and 13.8% employer Nics).

3.5 Cumulative reporting

Both in terms of providing key information to the shareholders or other stakeholders and as a reminder to the directors themselves, it is proposed that the *Directors Remuneration Report* provide a cumulative record of the income received by each director over the period to date that they have spent in post[10]. This could follow current reporting practice but with the addition of an extra line providing the cumulative outcome. It would be necessary to value the current holding of vested and unvested shares in the company.

Set against the cumulative company performance over the same period, this would provide a much closer reflection of the link between pay and performance than is currently available when annual company results are offered along side what is a snapshot of a single year's remuneration. The DDR currently does a poor job at providing a single figure to capture the reward of any particular director. Under current practice, a list of pay components is provided, not all of which are capable of being readily summed together (e.g., salary reported in £ but the award of performance shares in the form of units of shares). Equally there is a blurring of pay awarded (as in the previous example) versus pay realised (where the focus would be on the value of performance shares vesting rather than the number of performance shares awarded).

[10] There is scope for debate over what best constitutes the definition of a post in this context. One view would hold that all time as a director should be continuously viewed as a 'post' (in the legal sense that a director is a director is a director). Alternatively moves between Finance Director and CEO might constitute distinct 'posts'.

4. <u>Conclusion:</u>

A Career Shares approach to long term incentives offers considerable advantage over the current practice of annual awards of three-year incentives that are free to be cashed in as soon as they vest. The advantage of Career Shares would be that they both encourage and allow the director to take a longer term perspective in the delivery of strategy. Early promise that is not sustained is no longer rewarded, as Career Shares bring with them an automatic claw-back facility. Equally, if the restriction on cashing in can be maintained for a year or two after exit from the board, each director is given a clear interest to ensure that the succession process delivers sustained good company performance.

There are, of course, some practical considerations that need to be confronted before a Career Shares approach can be implemented. These include:

- Enforcing the prohibition against any cashing-in, or divesting, or hedging of Career Shares until a given length of time after the individual has left the company (whether through retirement or for other reasons).

- The adjustment of the quantum of Career Shares in direct proportion to the dividend yield enjoyed by shareholders, with effect at each ex-dividend date.

- Cashing in of a proportion of vested shares to meet tax liabilities would be necessary, although share plan design could reduce the empirical impact of this effect.

- Reporting in the Directors Remuneration Report should be improved to provide the cumulative value of Career Shares held by each director (both vested and unvested). In addition, these holdings should be placed in perspective by similarly reporting the cumulative reward enjoyed by the director from all other sources of company remuneration.