

Equity Incentive Plans

Extending US- and UK-based Plans Across the Pond

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Extending US Incentive Plans to the UK

Overview

- Securities law
- Employment law
- Data protection
- Tax
- Approved (tax-advantaged) plans

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Securities law – prospectus requirements

- A prospectus is required where any transferable securities are offered to the public in the European Economic Area
- Grant or exercise of stock options not an offer of transferable securities
- Awards of free shares, such as restricted stock, would satisfy an aggregate consideration exemption
- Employee Stock Purchase Plans may require a prospectus

Extending US Incentive Plans to the UK *Securities law – prospectus for ESPPs?*

- Exemption if offer made to fewer than 150 persons in **each** EEA country
- Exemption if aggregate consideration over the period of one year does not exceed €5 million
- Partial exemption if company has shares listed on a regulated market in the EEA (may be extended to include US markets in future)
- If no exemption, prospectus will be required – can be short-form, but still substantial document, needing approval from regulator

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Securities law – financial promotions

- The communication of an invitation or inducement to accept or exercise an award must be made or approved by an “authorised person” if no exemption
- Exemption for communications by a group company for the purposes of an “employee share scheme” would cover communications to employees or former employees
- Communications to non-employees (advisers, consultants, non-exec directors) may benefit from exemption for “one-off communications”
- Phantom plans/SARs

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Securities law – regulated activities

- Certain activities in relation to investments may only be done by an authorised person unless there is an exemption
- Generally, activities in relation to share plans will be exempt, but:
 - No exemption for advising on the merits of participation
 - Care needed if awards made to non-employees

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Employment law

- Age discrimination – age-related retirement provisions need caution
- Sex discrimination – treat part-time workers equally
- Restrictive covenants – may not be enforceable in UK
- Exclude implied rights
- Exercise discretions reasonably
- Exclude liability in relation to awards if participant wrongfully terminated?
- Enforceability of clawbacks

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Data protection

- Data protection issues are much broader than just employee stock plans, and companies should have a comprehensive compliance strategy
- Employing companies are likely to be “data processors”, and will therefore need to comply with the Data Protection Act 1998
- Check that registered particulars, and notifications to employees, are wide enough to cover data in relation to share plans
- May be desirable to seek specific consent of employee to transfer of data to US

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Tax (1)

- Usually income tax charge arises when shares acquired
- Restricted stock usually taxed when forfeiture provisions expire, provided no later than five years from acquisition
- PAYE system (employer withholding) applies for listed shares (and in some cases for private companies)
- If PAYE applies, then also social security contributions, including 13.8% employer charge – which can generally by agreement be passed on to participants

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Tax (2)

- Restricted securities election under s431 ITEPA? May be sensible if clawback arrangements apply to shares acquired
- Annual reporting requirements – grant and exercise of non-tax advantaged awards reported on form 42 – by July 6 for year to April 5
- Employing company should get tax deduction for amount that would be employee's income – regardless of whether taxable

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Approved share schemes

- UK legislation provides for generous tax advantages for plans which comply with specific legislative provisions, and have been approved by HMRC – “approved schemes”
- Three types of approved scheme:
 - Company Share Option Plan – CSOP
 - Save As You Earn Option Scheme – SAYE or Sharesave
 - Share Incentive Plan - SIP

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Approved schemes – general

- The scheme needs to be approved by HMRC before first awards made – this will probably move to a self-certification system in 2014
- Only employees of group companies eligible to participate
- Shares must be either:
 - listed on a “recognised stock exchange” (includes NYSE and NASDAQ);
 - in a company not under the control of another company; or
 - (other than CSOP) in a company under the control of a listed company

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CSOPs

- CSOPs are discretionary (i.e. participants may be selected) option plans
- Exercise price must be at least market value at date of grant
- Value of shares which may be under option is limited to £30,000 per person (at date of grant) – not an annual limit
- Exercise after three years (and in certain other circumstances) usually tax free (and no NICs)
- Capital gains tax on sale of shares, but gain will be tax free if falls within annual exemption (currently £10,900 pa)

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SAYE option plans (1)

- Participation in an SAYE plan must be offered to all UK employees who have worked for a specified qualification period of up to five years
- Options granted with a three or five year vesting period, and participant agrees to enter into a savings contract, funded by deductions from salary (after tax)
- Savings used to fund exercise price, if option exercised
- Exercise price must be at least 80% of market value at date of grant

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SAYE option plans (2)

- Maximum savings £250 per month – implies maximum value of shares at date of grant of £11,250 for three year options and £18,750 for five year options
- Exercise tax free, possible capital gains tax charge on sale, as for CSOP
- Often used to implement US-style Employee Stock Purchase Plan in UK, although substantial differences
- Operated in conjunction with a bank/administrator (administration costs)

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SIPs (1)

- Share Incentive Plans are flexible and have many tax advantages, but are complex
- Participation must be offered to all employees who have worked for a specified qualification period of up to eighteen months
- Three types of award:
 - Free shares (up to £3,000 per year)
 - Partnership shares (up to £1,500 per year) – purchased from **pre-tax** salary
 - Matching shares – free shares to match partnership shares up to a ratio of 2 to 1

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SIPs (2)

- Shares awarded must generally be held in a specially constituted trust for five years to get full tax benefits
- If so held can be removed and sold with no income tax, no social security contributions and no capital gains tax
- Can be used to replicate Employee Stock Purchase Plan with a combination of partnership shares and matching shares – number of matching shares awarded can replicate 15% discount on price

EXTENDING UK INCENTIVE PLANS TO THE US

Extending UK Incentive Plans to the US

Executive compensation in the US – quick overview

- Base salary
- Annual bonus
- Long-term incentive compensation/equity
- Benefits
 - Retirement (401(k), pension plans)
 - Health (ObamaCare is not national health insurance)
 - Life, Accident, Disability, Severance, Employee Assistance, Employer-Negotiated Discounts, Educational Assistance

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Executive compensation in the US – quick overview

- Public vs. Private Companies
 - \$1 million cap on deduction of compensation for certain officers
 - Code Section 162(m) (Public Companies)
 - Performance-based compensation exception
 - Golden Parachute Excise Tax
 - Private company exceptions
 - Say on Pay, Say on Golden Parachutes (Public Companies)
 - Loan prohibitions (Sarbanes-Oxley – Public Companies)
 - Clawback requirements (Sarbanes-Oxley and Dodd-Frank)

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The use of employment agreements in the US compared to the UK

- At will employment in the US

- Less use of employment agreements
- Confidentiality
- Protection of intellectual property, restrictive covenants
- Other considerations for an employer to use an employment agreement
 - Commission payments
 - Representations and warranties
 - Post-employment cooperation
 - Contractual right to claw back compensation

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Common types of long-term incentive awards stock options

- Options

- Still widely-used, particularly in the case of private companies
- Term is generally 10 years or less
- Good leaver provisions generally not as generous in the UK
- Incentive stock options and nonqualified options
 - Most US public companies do not issue ISOs
- For US tax reasons, exercise price will generally be equal to or greater than the underlying stock's FMV at grant

- Stock appreciation rights

- Equivalent to net exercise of options

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Common types of long-term incentive awards stock options

- Restricted stock
- Stock units
- Phantom stock
- Bonus stock
- Employee Stock Purchase Plans
- Other

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Taxation of awards

- Tax treatment
 - Options
 - Nonqualified options
 - ISOs
 - Stock appreciation rights
 - Restricted stock
 - Section 83(b) elections
 - RSUs, phantom stock
- Ordinary income vs. Capital gains
- Withholding/employment taxes

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Common award provisions

- Vesting: Time vesting
- Vesting: Performance vesting
 - General trend
 - Qualify as performance-based compensation under Section 162(m)
- Cash out (options)
- Clawbacks
- Option term
- Conditions of forfeiture
- Cash/stock payment mix

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Securities law considerations

- Definition of security
 - “Offered or sold”
 - Stock options
 - Restricted stock
 - Deferred compensation
- General rule of registration
 - Considerations
 - Form S-8
 - Prospectus
 - Stock exchange considerations

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Securities law considerations

- Exceptions
 - No sale
 - Rule 701
 - Regulation D
- Regulation S

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Securities law considerations

- Form S-8
 - Available to companies whose stock is already registered
 - All required reports during the preceding 12 months have been filed
 - Can only be used in connection with an “employee benefit plan”
 - Prospectus + registration statement (Form S-8)
 - A prospectus must be provided
 - Prospectus must be retained by the employer for five years after they are last used
 - Annual report

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Securities law considerations (cont'd)

- Rule 701 – Compensatory Plan Exception
 - Shares must be provided under the terms of a written plan or contract
 - Each participant must receive a copy of the plan
 - Not available to a company that is subject to the reporting requirements of Sections 13 or 15(d) of the Securities Exchange Act of 1934

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Securities law considerations (cont'd)

- Rule 701 – Compensatory Plan Exception (continued)
 - Aggregate sales price or amount of securities sold in reliance on Rule 701 during any 12-month period must not exceed the greatest of:
 - \$1,000,000
 - 15% of the total assets of the issuer; or
 - 15% of the outstanding amount of the class of securities being offered and sold in reliance on Rule 701
 - A copy of the plan or contract must be provided to the grantees

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Securities law considerations (cont'd)

- Rule 701 – Compensatory Plan Exception (continued)
 - **Additional Disclosure:** If the aggregate sales price or amount of securities sold during any consecutive 12-month period exceeds \$5 million, issuer must provide the grantees with the following a reasonable time before the sale date:
 - A copy of the SPD, if the plan is subject to ERISA (usually not the case)
 - If the plan is not subject to ERISA, a summary of the material terms of the plan
 - Information about the risks associated with an investment in the securities
 - Financial statements with a reconciliation to US GAAP

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Securities law considerations (cont'd)

- Rule 701 – Compensatory Plan Exception (continued)
 - When must disclosure be provided: Within a reasonable time prior to the purchase; in case of options, within a reasonable period of time before the date of exercise
 - State blue sky laws must be considered
 - Rule 701 does not cover a grantee's later sale of the securities received
 - If Rule 701 applies, no filing with the SEC required
- State securities may still apply but many states' securities laws contain a similar exemption to Rule 701

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Securities law considerations

- Regulation D – Additional Exemptions

- Rule 504

- Sales of up to \$1 million (certain sales must be aggregated for the limit, but no aggregation with Rule 701 sales)
 - Only applies to private employers
 - No limit on number of purchasers
 - Regulation D disclosure rules do not apply; Purchasers receive “restricted securities”

- Rule 505

- Sales of up to \$5 million in any 12-month period
 - No more than 35 purchasers who are “accredited investors”
 - Purchasers receive “restricted securities”

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Securities law considerations

- Regulation D – Additional Exemptions

- Rule 505 (continued)

- Non-Accredited investors must receive substantial disclosure
 - Accredited Investor
 - Includes directors and executive officers
 - Individual whose individual or joint net worth exceeds \$1 million (not including personal residence)
 - Individual who had individual income in excess of \$200,000 or joint income of \$300,000 in each of the two most recent years and a reasonable expectation of reaching the same level in the current year

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Securities law considerations

- Regulation D – additional exemptions
 - Rule 506
 - No monetary cap on sales
 - No more than 35 purchasers who are not “accredited investors”
 - All non-accredited investors, either along or with an advisor, must be sophisticated
 - Same disclosure requirements as under Rule 505 for Non-Accredited Investors
 - Purchasers receive “restricted securities”
 - All Regulation D Exemptions: Must file a Form D with the SEC

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Securities law considerations

- No sale exemption
- Regulation S
- State “Blue Sky” Securities Law
- Dispositions by grantees
 - Rule 144

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Section 409A

- Section 409A of the Internal Revenue Code
 - Broad scope
 - Exceptions
 - Restricted stock
 - Options and stock appreciation rights
 - Issuer stock
 - Modifications
 - Application to stock units and phantom stock
 - Short-term deferral exception
 - Compliance

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Additional tax law considerations

- Foreign bank account reporting
- FACTA
- Code 457A
- Use of trusts
- Withholding/payroll taxes
- Applicable law

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Plan administration

- Documentation of awards
 - Employee signature/acknowledgement?
- Employee communications
- Brokerage accounts
- Liquidity

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Other issues

- US expatriates
- Mobile executives
- Clawbacks
- Choice of law
- Deferred comp plans for US executives may constitute securities too
- A few other traps for the unwary

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Thank you

