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it's our business

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EU regulators launch Prospectus Directive probe

The Centre and the ESO world have been handed an unexpected opportunity to strike back at the European Union's Prospectus Directive (PD), which has wreaked havoc on the share plans of multinational companies listed outside the EU. The Committee of European Securities Regulators (CESR) has launched a formal review into the effectiveness of the Prospectus Directive, which was supposed to have been implemented by all EU member states by July 2005 at the latest.

The CESR is calling for evidence whether the PD is: "really working on the ground, and in particular whether it is contributing to the development of a single market for securities. "Specifically, CESR would like to know whether market participants have found obstacles to the fluid functioning of the passport and/or divergent practices in member states that pose a risk for the proper functioning of the single market. CESR is also interested to know if investors consider that the new Prospectus regime is enlarging the range of investment opportunities and providing an enhanced level of disclosure and protection," it added. This opens the door for Centre members, both ESO service providers and companies, to raise the roof about the way in which the PD is deterring multinationals from issuing new equity grants to employees who work within the EU. The PD can force non EU listed multinationals to issue expensive and time-consuming prospectuses every time they want to issue stock to EU based employees on any significant broad-based scale. The badly drafted directive allows room for different interpretations in different member EU states So there is no guarantee that an exemption from the Directive in one state will be similarly applied in another. There is still confusion about whether certain equity awards to European employees require an expensive prospectus to be issued or not, say practitioners.

"For example, although most EU member states accept that the offer of non-transferable stock options (and the later delivery of shares on the exercise of those options) falls outside the scope of the PD, not every state takes this helpful approach. It is also uncertain whether this approach applies to all types of employee options, in particular US employee stock purchase plan awards," said Kevin Thompson of Clifford Chance. "Another well-rehearsed objection to the PD is the 'home member state trap,' which can unwittingly bind multinationals into having all future EU employee securities filings pre-approved by the first EU state in which that company issued options or shares to employees after December 31 2003," he added.

An open hearing into the failings of the Prospectus Directive is to be held at the headquarters of CESR on January 16 from 2pm –5.30pm (at 11 Ave de Friedland 75008 Paris). In addition, Centre members can present their own evidence on the failings of and obstacles presented by the PD in the sphere of employee share schemes until the 29th of this month. All contributions can be submitted online via the CESR's website under the heading 'Consultation' at www.cesr.eu., with a copy to the Centre. The CESR said that if it decides that only legislative action can put matters right, it will inform the European Commission that major changes are needed.

The PD will come under fire from delegates at the European Centre's eighth global equity pay forum next month in Davos (*see inside*). At last year's event, a senior Commission official was warned that large US parent companies were threatening to terminate all their broad-based employee stock purchase plans within the EU unless the PD was changed or clarified, or both.

From the Chairman

It was good to meet the new team at the Treasury last month - Heather Ridley who is on secondment from Australia and Craig Warwick. Our new ideas on EMI were well received and we expect further collaboration. Following David Pett's success with EMI ideas other members of the steering committee will be looking at other policy issues which need a new look.

William Franklin dropped a bombshell at our joint conference with HBOS last month - expensing options may cost nothing at all! I had become used to the idea there was no certainty but rather "pick a number, any number", but I had never contemplated the possibility of zero. There may be another chance to hear William and we hope to be able to publish his paper with newspad later in the year.

I look forward to seeing many of you at Davos in a few weeks time. It promises to be another outstanding event and there is still some room at the inn.

Malcolm Hurlston

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Sharesave employee bonanzas at M&S and HBOS

Staff at Marks & Spencer are to pocket a £56 million Sharesave windfall after benefiting from a spectacular surge in the retailer's share price. Almost 12,000 employees stand to make profits of between £1,000 and £45,000. Details of the windfall come in the week that M&S announced further recovery under chief executive Stuart Rose. The revival of M&S prompted its share price to surge from 282p three years ago to more than 700p in recent weeks. Staff who saved the maximum £250 over the same period in the Sharesave scheme will have gained more than £20,000 on their original £9,000 investment. Mr Rose said: 'We're delighted that so many of our people have benefited from Sharesave this year and that their faith in M&S and their hard work has been rewarded." M&S has run Sharesave schemes for more than 20 years.

Almost 15,000 staff at banking giants HBOS are set to receive windfalls of between £2600 to £3400 from a five year Sharesave scheme. More than 4000 employees signed up, saving an average £53 a month. At an option price of £5.62 a share and based on the current share price, they stand to make an average gain of more than £3400. A further 10,000 staff joined a three-year Sharesave scheme in 2003. They stand to gain £2600 if they buy the shares at the options strike price of £5.74.

IFRS 2 hits pre-tax profit figures

Profits of Britain's top listed firms were ‘cut’ by more than £3.3bn during the last financial year due to the expensing of employee share plans under the new accounting rules, according to a study by actuaries Lane Clark & Peacock. An examination of the accounts of 83 of the top FTSE 100 companies showed that the accounting cost of share plans rose by 27 percent in the 2005/06 financial year from £2.6bn in 2004/5, wiping an average of 2.8 percent off stated company pre-tax profits. These costs are expected to rise by a further ten percent over the next two years, LCP said. Companies facing the heaviest costs from the IFRS2 rule include banking groups Barclays at £338m, HSBC at £315m, drugs giant GSK at £236m and oil company Royal Dutch Shell at £219m. "The rise in equity prices has contributed to the rise in the cost of share plans, but some companies have awarded the same or more share options in 2005 than in the previous year," LCP partner and survey author Matthew Pearlman said. One in five companies has stopped granting share options to employees or has sharply cut them back, choosing to reward staff with shares instead, the survey found.

Treasury review of EMI

The promised Treasury evaluation of the government’s successful Enterprise Management Incentive stock options based scheme is now in its early stages, revealed Centre chairman Malcolm Hurlston. The Centre has presented the Treasury with a paper prepared by David Pett, share schemes partner at Pinsent Masons, and backed by the Centre’s steering committee, calling for EMI reforms. This news emerged from recent correspondence between Mr Pett and Colin Gibson, head of employee share schemes at HM Revenue and Customs. The paper was originally intended for submission to the DTI (who had sought such a note of ways in which the EMI regime might be improved), but now the Treasury has taken up the reins by conducting the review. Although more than 7,000 SME companies have adopted EMI since its inception, a number of problems have held back applicants, including uncertainty as to who qualifies and who doesn't (the exclusion list has grey areas); the cap on the awards limit; conditions surrounding taper relief and access to detailed advice. The Centre’s recommendations are: scrap the independence test, as it is largely redundant and it sometimes produces absurd results (as when shares are held by a corporate trustee); assets held in a fiduciary capacity should not count towards the limit, even if such assets may be required to be shown on the balance sheet; revision of the regulations regarding replacement options; continued taper relief for shares exchanged for loan notes; remove or revise the requirement for a general offer in event of a takeover; centralise the query handling service for EMI and ensure it is handled by staff fully trained in EMI legislation so that companies do not receive conflicting advice depending on their location. Mr Pett added: “It should be made clear to companies that the costs incurred in establishing an EMI plan (e.g. consultants/lawyers fees) are, or should be, deductible for corporation tax purposes.”

Sharesave & D11

The final ruling on the vexed ‘D11’ issue of accounting for Sharesave cancellations by employees could be delayed as late as the fourth quarter of this year, the International Accounting Standards Board has admitted. As reported in last month’s *newspad*, the IASB has already said it wants to force companies to take an accelerated charge against profits for all share options cancelled by employees, thus provoking outrage among Centre members and robust criticism by the UK Accounting Standards Board. But the IASB’s website reveals hesitation in the face of the large number of hostile letters it received during the comment period over the Exposure Draft it published last year. The Board now says that it will extend the D11 project to clarify the definition of performance conditions and the treatment of all non-vesting conditions. The IASB envisages two possible outcomes: publication in the second quarter of a final amendment based on a revised Exposure Draft; **or** the issue of a revised Exposure Draft *before* publishing a final amendment towards the end of the year.

There is a big danger that some companies will see D11 as a damp squib and forget about it rather than seeing it as a time bomb that will create huge fallout for many other companies, said Paul Stoddart, head of new business at HBOS Employee Equity Solutions: “D11 is only a problem in a falling market when a mass exodus of participants is most likely to happen as they jump ship in the hope that the lower price on offer is a better bet. This is not an immediate concern as the FTSE keeps its head above 6000. But has this simply set a timer on the D11 bomb? If the market started to head south, the P&L would be holed by deserters. Some companies are protecting against this possibility by stating all cancelled contracts are to be included in the SAYE £250 maximum savings limit. Should this practice become widespread, it could result in reducing contribution levels as participants pull out of underwater options but face reduced scope to join the next one."

Options googly

In an attempt to maintain the incentive value of its employee stock options, Google is set to become the first Silicon Valley company to make all of its options freely transferable. The plan, due to take effect in April, will let Google's employees sell their options to a group of banks that will be free to bid for them. By creating a market value for the options, this would make it clear to employees that their holdings are worth something, even if the company's shares had not risen since they were issued, executives said. Google will take an undisclosed charge to reflect the greater value of company options under the scheme. Transferable options combine the leverage of options, as their initial value can multiply over time, with the ability to understand the tangible value in a tradable stock, experts said. Employee options account for roughly two percent of Google's outstanding shares on a fully diluted basis. Once an employee's options are vested, he or she can look for bidders in the private auction. Employees can set a minimum price at which to sell. However, the plan could backfire if it encouraged employees to cash in their options early rather than hold them for the full ten years. Financial institutions meeting certain criteria will be able to participate as a bidder through a website. "This is great for Google employees because it means their options are much more valuable than they would otherwise be," said James Angel, associate finance professor at Georgetown University. Microsoft two years ago offered all employees the chance to cash in their options, many of which at the time were underwater. Since then, it has issued only restricted shares to employees rather than options. Google, by contrast, said all options issued since it went public at $85 a share in August 2004 would be covered by the plan, and that all the options it issues in future will be transferable.

Executive pay guidelines

The Association of British Insurers (ABI) has updated its guidelines on executive remuneration. The guidelines have not changed significantly although they have been re-written and re-formatted to make them clearer and more direct, said Centre member **Deloitte**. There are some additions and changes in emphasis. Previously the guidelines have required justification for an *above* median base pay policy, but this has been expanded to include policies which are *at* median, emphasising the concern around benchmarking and the dangers of upward ratcheting. Remuneration committees should have the ability to reduce or reclaim bonuses if these have been paid as a result of inaccurate performance returns and should consider legal redress where this is the case. New guidance states that pensions paid on early retirement should be subject to abatement and that remuneration committees should identify, review and disclose any arrangements that guarantee pensions with limited or no abatement on severance or early retirement. These provisions would not be considered acceptable if included in new contracts. New provisions cover the granting of options or other share-based incentives over the share capital of a joint venture or subsidiary company. None of the five key principles is new, said **Pinsent Masons.** "They can be summarised as: remuneration policies should promote long-term value creation and should be aligned to corporate objectives: remuneration committees must oversee remuneration practices and should engage with shareholders on such matters: remuneration levels should retain and motivate but benchmarking should be treated cautiously to avoid ratcheting effects: remuneration arrangements should be performance linked, promote alignment with shareholders' interests and be clearly understandable. Payments for non-performance should be avoided. ABI's members would prefer remuneration committees to disclose their remuneration policy. Another change is about the need to justify salaries benchmarked to a median level. In the 2005 guidelines, only salaries above median levels required justification; now justification is required for salaries *at or above median*. The ABI thinks rem.comms should analyse, when benchmarking salaries, whether a median (or above median) salary is appropriate, rather than it being the default position. The ABI and its members are keeping their focus on annual cash bonuses, particularly as maximum bonus levels continued to rise sharply last year. There is new guidance that, where bonus levels increase, there is an expectation that correspondingly more stretching performance measures will apply. The revised guidelines encourage a contractual link between variable pay and performance. By making such a link, this would limit the ability of companies to make discretionary bonus payments where performance targets had been missed.

Fatter cattery

Robert Nardelli, ex ceo of US retailer **Home Depot** has walked off with a £108m severance package after years of lacklustre share price performance. Mr Nardelli's pay since taking office in 2000 has been valued at £123m, including generous stock options. Did this reward align his interests with those of shareholders? "Alignment with or without options is anyway a pipedream," claimed John Plender of the *Financial Times*. "Myth number two is that CEO pay determination is a market process. The reality is that the nomination and compensation committee members who secured the services of Mr Nardelli after his failure to win the top job at General Electric were a bunch of nervous, over-awed pussy cats. A rewards-for-failure system sends dangerous incentive signals. If CEOs know that they win regardless of performance, what does it do to their strategic judgment? If CEOs are highly rewarded for failure, it follows that they have a huge incentive to bet the corporate ranch," wrote Mr Plender. "A final myth is that stock options have no cost. They do. It consists of the amount the company gives up by not selling the options to outside investors. Accountancy is finally recognising this reality. Lucian Bebchuk and others at Harvard have shown that the cost has been very significant in relation to profits. There are wider costs, which include the demotivation of the workforce. The least bad solution is to engage shareholders and give them a UK-style vote on CEO pay. Investor activism may help, said Mr Plender. "We also need to recognise that pay consultants' methodologies rely heavily on total shareholder return, which can reward people with windfalls, and earnings per share, a malleable number to which Home Depot shifted when it suited its book."

CONFERENCES

Benchmarking international plans

The Centre and BT are offering plan issuer members the chance to swap notes on the performance of their all-employee share plans across international borders. A working lunch has been scheduled to take place at the BT Centre, opposite St Paul's tube station, on **Tuesday Jan 23** from 12.30pm until 2pm. Many quoted companies find it difficult to assess accurately the performance of their employee plans, especially those which operate across borders. The Centre and BT are engaging companies who are prepared to look at sharing experience and developing best practice in this area. The discussion is expected to cover: share plans offered, sourcing of international share plan advice, demand for and take-up of the plans, cost-benefit ratios, relationships with works councils, international HR issues, communication, especially translations, and tax guidance If you are interested in participating, please contact Joel Lewis for more details at jlewis@hurlstons.com or call (020) 7436 9936. This event is free to Centre members**.**

Davos: Fifty people have registered for the **European Centre's** eighth annual global equity forum in the deluxe Steigenberger Belvedere Hotel, Davos Platz, on **Thursday Feb 1 and Friday Feb 2.** Return flights from Heathrow to Zurich can be had for *under £80,* correct at time of writing, including surcharges, using Centre member BA. Delegates' paid-for bed nights in the Belvedere are Jan 31 and Feb 1. See the Centre website: www.hurlstons.com/esop for details, or email fhackworth@hurlstons.com. The discounted room rates apply to those who arrive early and stay up to Saturday morning. *Snow levels in Davos average 110 cm on the upper slopes. The Daily Telegraph said on January 6: "New snow in Davos, fantastic skiing"*

Cannes: The European Centre is building the agenda for its 19th annual conference, which will take place in the Majestic Hotel on the seafront, **July 5 and 6**. Prospective speakers are invited to suggest presentation topics – which can be either for solo slots or joint speaking slots with clients - to fhackworth@hurlstons.com. Speakers obtain substantial reductions on the package deal, which includes two nights accommodation in the Majestic.

Gordon the ESO saint

Chairman Malcolm Hurlston told the joint Centre-HBOS share schemes conference last month that the UK had never had a Chancellor who had been so supportive of employee ownership for so long: "Gordon Brown's starting point was acceptance that ESO did work by improving productivity, but he has showed a bias towards the direct ownership of shares and a bias against options," he said. "It is curious therefore that, of the two new share plans which have emerged during his watch, the one which has been successful beyond doubt is the Enterprise Management Incentive, which is based entirely on options. The story goes that Gordon Brown was not keen on EMI and rather grudgingly let it through. EMI has certainly never been properly promoted, but it has joined the select band of products close to my heart which have succeeded through consumer pull rather than marketing push." He was concerned that Sharesave, which had proved successful, would end up not merely the object of benign neglect, but disadvantaged: "Where are we now? – Of course Sharesave has been buffeted not only by the following wind for the SIP; it has been dealt hammer blows by the insensate actions of the international accountants. The Centre took the lead in opposing the plans to expense options, but we hit a closed door and were told: '*Nothing to do with us Guv*' Even today only Charlie McCreevey, the European Commissioner who was formerly Gordon Brown's Irish oppo, has truly grasped the magnitude of the issue." Mr Hurlston asked whether had the ESO community had lost the spirit of it all? Had it communicated too little the importance of being a shareholder and enjoying the rights as a co-owner of a company? "The what-ifs of our scenarios in employee communications focus on the numbers; we have neglected the transformatory effects on the mind," he added. Helen Hatton, the Jersey regulator, raised eyebrows when she gave details of the three disciplinary procedures used against offenders in Jersey, in a speech which underlined the world lead of her jurisdiction. William Franklin astounded the audience by using a new financial model to demonstrate that, under certain conditions, SAYE options can even be granted at zero cost. The Centre hopes to make his findings available to members through an *occasional paper*. If you missed this outstanding event and would like to another opportunity to attend, contact jlewis@hurlstons.com

COMPANIES

ASDA is off to the High Court to try and recover £600,000 it says it mistakenly paid in tax on behalf of former ceo Allan Leighton. ASDA wants back the money it paid in tax on Leighton's share options when he left the firm in 2000. Leighton - now chairman of Royal Mail and BHS - believes he paid the bill himself. German luxury carmaker **BMW** said it planned to buy back 800,000 of its own shares, which it would use for employee share schemes. Employees of **Icelandair Group Holdings** now own more than a six percent share in the company after 35m shares were reserved for them in the recent share offer.

The Employee Share Ownership Centre is a members' organisation which lobbies, informs and researches on behalf of employee share ownership. It is operated by staff of Hurlstons Corporate Consultancy Ltd.