Granting nil-cost share awards to employees and directors

The QCA Share Schemes Expert Group has produced this briefing note on the issues that small and mid-size quoted companies should think about when they consider granting nil-cost share awards to employees and directors.

I. Background

The reasons why a company may opt to grant nil-cost share awards, which serve as share-based incentives and reward to employees and directors, include:

- Encouraging loyalty and retention of staff, thus reducing recruitment related costs;
- Increasing productivity of the workforce and potential business growth; and
- Reducing remuneration costs.

For AIM companies these types of plans commonly include safeguards such as a limit on the number of shares that might be issued – commonly 10% of issued share capital from time-to-time measured over a ten year period – and require achievement of performance conditions to enable the employee or director to share in the growth rather than simply extract existing value from shareholders.

However, granting nil-cost share awards (which often take the form of nil-cost share options) can have three impacts:

1. Where the share awards use new issue shares, existing shareholders' holdings are diluted and the value of their holding and influence in the company is reduced to the extent of the dilution.
2. Participants receive value, and if they are either an employee or a director, the employer company is normally liable to operate PAYE and incur employer's secondary national insurance contributions – 13.8% for the 2017/18 tax year. Sometimes, this NIC liability can be passed to the employee or director with their consent.
3. The fair value of the share-based remuneration is an expense identified in the profit and loss account and therefore influences the profit, in accordance with FRS 102 (and IFRS 2).

Existing guidance published by the Quoted Companies Alliance

Although the current AIM Rules for Companies do not currently require shareholder approval or set limits on employee share plans, small and mid-size quoted companies are encouraged to review:

II. The QCA Remuneration Committee Guide for Small and Mid-Size Quoted Companies[1]

Our Remuneration Committee Guide assists the members of the remuneration committees and those who support them in setting pay for executive directors and senior management in a fair and reasonable manner. It includes the following advice:

- **Share ownership –** Companies should cultivate a culture of long-term share ownership, in order to allow all employees to share in the success of the company. Implementing an incentive scheme for senior employees enables companies to take back an appropriate proportion of the shares in the event of financial misstatement or misconduct involving that person or early termination of employment.

- **Long-term incentive awards –** Companies should carefully consider the various advantages and disadvantages of share options and performance share plans before selecting the most appropriate arrangements for their business.

- **Base salary –** Remuneration committees should avoid overpayment in recruiting for any position and consider the multiplier effect on overall pay when other elements, such as bonuses, long-term incentives and pension contributions, are linked to base salary.

- **Communicating with shareholders –** Companies should collect feedback from their top 5-20 shareholders when establishing or renew a share-based incentive plan.

III. The QCA Corporate Governance Code[2]

As the industry standard for growing companies which are not obliged to apply the UK Corporate Governance Code, the QCA Corporate Governance Code helps companies put into place appropriate corporate governance arrangements and encourages positive engagement between companies and shareholders.

It includes the following advice:

> *"On occasions, where performance-related remuneration is under consideration, it should be proportionate, shareholders must be consulted and their support obtained. It is recommended that remuneration plans that may lead to significant dilution of holdings of investors are pre-brokered with investors."*

What should your company consider before issuing nil-cost option shares to employees and directors?

We advise small and mid-size quoted companies to consult with shareholders – either informally or formally – and, if appropriate, seek approval for all new share-based remuneration arrangement involving the issue of new shares at the next available opportunity.

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[1] http://www.theqca.com/shop/guides/118376/remuneration-committee-guide-for-small-and-midsize-quoted-companies-2016-downloadable-pdf.thtml

[2] http://www.theqca.com/shop/guides/143861/corporate-governance-code-2018-downloadable-pdf.thtml l