EQUITY INCENTIVES LIMITED

# Setting up a share or share option plan: an introduction

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# Introduction

There are a variety of share and share option plans available to companies seeking to reward their employees, and the design and implementation of each will obviously differ. However, there are some issues which will always need to be taken into account when introducing an equity incentive plan, and certain steps will be common to each. This briefing sheet aims to give introductory guidance to setting up a share or share option plan.

# Step 1: what are your objectives?

You will need to clarify your objectives before selecting a plan or selection of plans. What do you want your plan to achieve?

- involve all employees, or concentrate on key managers?
- reward current employees for past performance or future performance?
- recruit new employees or retain existing employees?
- create a strong company culture?

Your objectives may be met by the introduction of one type of plan. If your aims are more complex, you may need to put in place a variety of complementary equity incentive arrangements.

# Step 2: what sort of plan?

- Tax advantaged, or unapproved? A plan that is "approved" by the Inland Revenue will benefit from tax advantages, but generally lacks flexibility as certain rules will need to be followed. You will need to check if your company qualifies for an Inland Revenue approved plan or other tax advantaged plan – for example, if your company is a wholly-owned subsidiary, you may not be able to implement your own plan; you will have to use parent company shares. An "unapproved" plan is not, as the term may suggest, illegal or improper in any way. It is a valid plan but it does not benefit from additional tax advantages. Generally, it is much more flexible than an approved arrangement and does not require prior approval from the Inland Revenue.
- **All employee or discretionary?** Again, all-employee plans can benefit from tax advantages. However, a discretionary plan may have some tax advantages in any case, and allows better targeting of key employees or managers; it will also allow a higher level of reward for individuals.
- **Options or shares?** Granting options means that you can require a certain period of time to pass, or certain performance conditions to be met, before shares pass into the hands of participants. Awarding shares means that participants become shareholders immediately, which may include all the normal rights of shareholders such as voting rights (although these rights can be excluded in certain circumstances).

# Step 3: designing the plan

Your choice of plan will have an effect on how flexible you can be when it comes to the detailed design of the plan. Issues you can consider include:

- If the plan is for all employees, on what basis will shares or options be awarded, eg length of service; salary?
- Should there be performance conditions attaching to either the award of shares or vesting of options?
- What percentage of share capital do you want to use? Will you comply with investor protection (eg ABI) guidelines?
- When should options become exercisable? For example, will they all become exercisable at the end of a set period of time, or in tranches?
- Should employees have to pay for their shares or options, or would you prefer to use nil-cost options or free shares?
- What happens if employees leave, or are made redundant, or die?
- Will the shares used in the plan be a different class from other shares in the company – e.g. will they have voting rights; will a dividend be paid?

# Step 4: company law issues

Before implementing the plan, you will need to check certain company law issues, looking specifically at the company's Memorandum and Articles, and any shareholders' agreements that exist. Particularly important issues include:

- Do the Articles give the directors the power to allot shares under the plan?
- Is there sufficient unissued share capital in the company?
- Will the share capital need sub-dividing?
- Is there a need to create a new class of shares?
- Are there any compulsory transfer provisions in existence? If not, should they be introduced?
- Are there pre-emption provisions in the Articles and if so should they be disapplied?

# Step 5: implementing the plan

Once the detailed rules of the plan have been agreed and drafted, the plan can be established and implementation take place. Certain steps will be common to the implementation of any type of share or option plan, but some have additional requirements. For example, approved plans require prior approval from the Inland Revenue before awards of shares or options can be made. Furthermore, if the company is quoted on a recognised stock exchange, there will be additional requirements under the Listing Rules. The following are just some of the steps that you may need to take:

- Obtain shareholder approval
- Adopt plan in board meeting
- Communicate the Plan to employees – in some cases, the Inland Revenue will want to see your communication documents before they will grant formal approval
- Submit rules of plan and associated documentation to Inland Revenue for approval, if necessary
- Establish a trustee company to hold shares on behalf of employees if required
- Arrange bank or building society accounts if employees will be saving money to buy shares in the future
- In the case of a large complex plan involving many employees, consider using a professional administrator to run the plan on your behalf. Alternatively, if the plan is to be run in-house, could specialised software packages increase efficiency?
- If appropriate, comply with the Stock Exchange Listing Rules where there is an issue of new shares
- If the company is not listed on a recognised Stock Exchange, obtain a valuation of the shares from the Inland Revenue Shares Valuation Division
- Make awards under the plan
- Record details of all option grants or issue of shares to participants
- Notify Inland Revenue of option grants or other awards
- If a public company, ensure that awards to directors are disclosed in the annual report and accounts
- Ensure that the correct accounting treatment is followed
- Make any necessary filings at Companies House e.g. notify the Registrar of any changes to the Company's Articles of Association.

# Step 6: ongoing procedures

Once the Plan has been implemented and share options have been granted, or shares have been awarded, there are various ongoing procedures which must be followed.

- **Administration issues**: You will need to keep track of (amongst other things):
    - who has been granted awards?
    - when were awards granted?
    - how many awards were granted and over which type of share?
    - what was the share price at date of grant?
    - when will options lapse?

- when will options become exercisable?
- were performance targets set and, if so, how are they to be measured?
- when were options exercised?
- what was the exercise price?

- **Inland Revenue annual returns**: The Inland Revenue requires companies to fill in an annual return for option schemes whether approved or unapproved at the end of each tax year. This process should be straightforward provided you have kept a good record of award events.

- **Company books**: once options are exercised, the employee shareholders must be issued with a share certificate, and the shareholders' register must be updated. A stock transfer form may need to be completed if shares are transferred, say, from an employee trust to the employee.

- **Companies House notification**: this will be needed for the issue of new shares.

- **Future grants**: future grants must also be recorded, with care taken to record different exercise prices, different performance targets, vesting periods, etc.

- **Amending the Plan**: however carefully designed a share or option plan may be, it should be reviewed on a regular basis to ensure it still meets the changing needs of the company, the marketplace and the employees. If the plan is approved, the changes may require Inland Revenue approval.

# Who are we?

Equity Incentives has substantial experience in all aspects of employee benefits, including equity incentives. The Managing Director, Graeme Nuttall, is a member of the HM Treasury advisory group which helped the Inland Revenue introduce new share schemes including EMI and SIP. He drafted the Employee Share Schemes private member's Bill which came into force as the Employee Share Schemes Act 2002. Through membership of the **Global reward plan group** we implement international share schemes.

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