



## SHARE OPTION AND PROFIT SHARING INCENTIVE SCHEMES

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## SHARE INCENTIVE SCHEME GUIDELINES

### **1 INTRODUCTION**

- 1.1 The Association of British Insurers has reviewed the guidelines in the context of developing practice over the years. This document rearranges the existing guidelines in the form of core principles followed by guidance notes, and it is hoped that the new format will be helpful to those involved in following and interpreting the guidelines.
- 1.2 The guidelines are designed to provide a framework which will enable companies to operate the full range of employee share schemes within prudent limits which avoid undue dilution of the interests of existing ordinary shareholders. The concept of requiring that performance criteria are satisfied as a condition of exercise of the option and therefore of the reward, is now widely accepted. Institutional shareholders expect remuneration committees to devise appropriate performance criteria which are clearly linked to sustained improvement in the underlying financial performance of a company. Although the guidelines have been regarded as applicable to schemes which involve the issue of new share capital and are subject therefore to shareholder consent, relating corporate performance to reward should apply regardless of the way in which a scheme is sourced. Section 8 sets out examples of some of the performance criteria that have been adopted by companies.
- 1.3 The principles underlying the guidelines are that participation by employees in share schemes should generate a community of interest between employees and shareholders. There should be reward for success and, as a general rule, that reward should be related to the financial performance of the group as a whole and not solely to the performance of individual parts of the group. The requirements set out in paragraphs 2.1 - 2.13 of these guidelines, outline the restrictions which insurance offices as investors regard as essential under such schemes if excessive dilution of the equity interest of ordinary shareholders is to be avoided. The use of share capital of the parent company for employees or executive share schemes will ensure that benefit received by the employee is available equally to all the other shareholders.
- 1.4 Schemes which are consistent with the spirit of the guidelines should ensure that there will be a real incentive to produce sustained growth in the company's financial performance. The framework of the guidelines will enable such schemes to be available to employees as widely as possible while being adequate to meet all reasonable needs of a company in this context. Consideration will be given to exceptional situations where there are special or transitional circumstances.
- 1.5 **Schemes which are not consistent with these guidelines and where it has not been established that the circumstances justify a departure from the guidelines, are unlikely to be supported and may well be opposed.**

## **2 CORE PRINCIPLES**

- 2.1 A company proposing to adopt a share incentive scheme should have in place a properly constituted remuneration committee which will be responsible for the operation of the scheme, in accordance with the Cadbury Committee's Report on "The Financial Aspects of Corporate Governance".
- 2.2 In order to limit the potential dilution arising from the issue of shares for use in option and other incentive schemes, no more than 10% of the issued ordinary share capital from time to time should be set aside for all the company's schemes in any rolling ten year period.
- 2.3 No more than 5% of the issued ordinary share capital in any rolling ten year period should be used for discretionary/executive schemes. Any options granted in excess of 5% should be in the form of "super-options" (ie the minimum period before exercise is no less than five years and the exercise of the options is subject to demanding performance targets; please refer to Section 9 for further guidance).
- 2.4 All discretionary schemes (executive schemes) whether they are approved or unapproved by the Inland Revenue should require the satisfaction of performance targets as a condition of the exercise of options. The performance criteria should be based on sustained and significant improvement in the underlying financial performance of the group. The remuneration committee of the company will be responsible for setting and explaining the precise criteria.
- 2.5 Sections 8 and 9 of these guidelines sets out the views of the Investment Committee on the matter of performance criteria in the light of publication of the ABI/NAPF Joint Statement 'Share Scheme Guidance' in July 1993. Remuneration committees may wish to have regard to these views when considering the determination of performance targets.
- 2.6 Full details of the performance criteria should be disclosed when the scheme is adopted and thereafter annually in the company's Report and Accounts.
- 2.7 The total market value of all options granted to any one participant under any discretionary/executive scheme involving the issue of shares should not exceed four times (4X) the participant's total annual remuneration (see paragraph 4.2 of the Guidance Notes). Options having a market value of up to a further 4X remuneration may be granted in the form of super-options (see paragraph 4.2 and Section 9).
- 2.8 Replacement options may be granted in certain limited circumstances in place of those already exercised by a participant (see paragraph 4.3).
- 2.9 Shareholders must have the opportunity to vote on schemes at least every 10 years.
- 2.10 Options under discretionary or executive schemes should not be granted at a discount to the mid-market price at the time of grant (see paragraph 4.4).

- 2.11 Options should only be granted over the capital of the parent company except in the case of certain overseas subsidiaries or listed subsidiaries (see paragraph 3.4). Generally, it is undesirable that options are granted over the share capital of joint venture or subsidiary companies.
- 2.12 The prior approval of shareholders should be sought for any ESOP arrangement where the ESOP/ESOT may hold more than 5% of the company's ordinary share capital (see paragraph 7.1).
- 2.13 Further details included in the guidelines are set out in the Guidance Notes, of which these form the core principles.

## **SHARE INCENTIVE SCHEME GUIDELINES: GUIDANCE NOTES**

### **3 GENERAL**

- 3.1 The rules of each scheme should provide that no more than 10% of the issued ordinary share capital, adjusted for scrip and bonus issues and rights issues, should be utilised for all schemes in any rolling ten year period.

Flow rate controls are designed to spread the potential creation of new shares more evenly over the life of the scheme.

- 3.2 In any three year rolling period, no more than 3% of the issued ordinary share capital should be utilised for all schemes. Where a savings-related scheme is also adopted, up to 5% of the issued ordinary share capital may be utilised in any five year period; the inner limit of 3% in 3 years for the executive and other discretionary schemes should however continue to apply. Further provisions regarding flow rate for replacement options in discretionary schemes are set out in paragraph 4.3 below.

Options should be granted over parent company capital only.

- 3.3 It is generally undesirable for options to be granted over the share capital in a joint venture company.
- 3.4 The grant of options over a subsidiary company should not be made, except in the case of an overseas subsidiary where required by local legislation or in appropriate cases where at least 25% of the ordinary share capital of a subsidiary is listed and held outside the group.

#### Participation

- 3.5 Participation in an executive or discretionary scheme should be restricted to directors or employees who devote substantially the whole of their working time to the business of the company or its subsidiaries.
- 3.6 Non-executive directors should not participate in any form of share incentive or share option scheme in order to avoid compromising their independent status.
- 3.7 For small companies, up to 10% of the ordinary share capital may be utilised for a discretionary/executive scheme, provided the total market

value of the capital utilised for the scheme at the time of grant does not exceed £500,000.

#### **4 DISCRETIONARY SHARE OPTION SCHEMES (EXECUTIVE SCHEMES)**

##### Overall Limits

- 4.1 No more than 5% of the issued ordinary share capital should be used in any ten year rolling period for all option schemes other than savings related schemes. A further 5% may be utilised for discretionary/executive share option schemes provided any options so granted are 'super-options', ie where exercise is dependent on considerably more demanding performance criteria and after a five year period (see Section 9).

##### Personal Limits

- 4.2 For individuals the total value of substantive non-savings related options to subscribe for new capital granted in any ten year period should not exceed 4X annual remuneration. Options with a value of a further 4X annual remuneration may be granted if the further options are 'super-options'.

##### Replacement Options

- 4.3 Options may be granted to replace those already exercised in the following circumstances:
- (i) The maximum level of outstanding options by reference to market value does not exceed 4X remuneration.
  - (ii) No more than 5% of the issued ordinary share capital of the company may be used for all executive and discretionary schemes over a rolling ten year period.
  - (iii) During the first four years the total number of options granted under the scheme and all other executive schemes should not exceed 2.5% of the issued ordinary share capital of the company.
  - (iv) The remuneration committee must, prior to granting options to replace those already exercised, be satisfied that there has been a sustained improvement in the performance of the company over the two to three years preceding the further grant. It is emphasised that this is a subjective test imposed on the grant, not the exercise, of replacement options. In addition, definitive performance criteria as a condition of exercise should be applied as for basic options under an executive scheme.

##### Price and Time of Grant

- 4.4 The price at which shares are issued under a scheme should not be less than the mid-market price (or similar formula) immediately preceding the granting of the shares under the scheme.

- 4.5 Options granted under executive or discretionary schemes should not be granted at a discount to the prevailing mid-market price.
- 4.6 The rules of a scheme should provide that options normally be granted only within a 42 day period following the date of publication of the results of the company.

#### Life of Options and Scheme

- 4.7 No options should be granted under a scheme more than ten years after adoption of the scheme by shareholders.
- 4.8 Options should not be exercisable within three years from the date of grant or, in the case of super-options, within five years from the date of grant; nor later than 10 years after grant.
- 4.9 Where a grantor company is taken over (except where arrangements are made for a switch to options of the offeror company) or in the event of the death or cessation of employment of the option holder, outstanding options may be exercised (or lapse) within one year or, if later, within three and a half years from the date of grant or if later, the last tax relieved exercise. In the case of retirement and takeover, it would be expected that any performance conditions attaching to the exercise of options should normally be fulfilled prior to exercise.
- 4.10 Any options that a company may grant in exchange for options released under the schemes of acquired companies should normally be taken into account for the purposes of the limit on the number of shares issuable under option schemes and the limits on individual participation in any ten year period.
- 4.11 Options should not be granted in the two years preceding the normal retirement date of the participant nor be exercisable within 12 months thereof.

### **5 SHARE OPTION SCHEMES: SAVINGS-RELATED SCHEMES**

- 5.1 Options may be granted under an Save-As-You-Earn scheme at a price of not less than 80% of the middle-market price of the company's shares.
- 5.2 The maximum amount that may be contracted for savings by individuals under an SAYE scheme should not exceed £250 per calendar month.
- 5.3 Paragraphs 4.6 (timing of grants), 4.9 and 4.10 (takeovers and cessation of employment) will apply and options must be exercised within 12 months of death except where rollover, for example on an acquisition, applies.

### **6 PROFIT-SHARING SCHEMES**

- 6.1 The total amount of the share capital that may be issued under profit-sharing schemes should not in any one year exceed 1% of the share capital on the day preceding the appropriation of profits for the scheme.

- 6.2 Appropriation of profits should be made once only in any financial year after announcement of the final results for the accounting period. The funds should be paid over to the trustees as soon as possible.
- 6.3 The price at which shares are subscribed should be the middle-market price of the shares shortly prior to appropriation of profits.
- 6.4 Funds received by the trustees should be used as soon as possible in the subscription or purchase of shares and allocation as soon as possible to the individuals eligible under the scheme. The trustees should obtain the instructions of the individuals to whom shares have been appropriated and exercise voting rights accordingly.

## **7 EMPLOYEE SHARE OWNERSHIP TRUSTS**

- 7.1 An employee share ownership plan or trust should not be used as an anti-takeover device. It is desirable that such plans should first be submitted for prior approval to shareholders and in any event where the ESOP or ESOT would be capable of holding more than 5% of a company's issued ordinary share capital at any one time.

## **8 PERFORMANCE CRITERIA**

- 8.1 There is a growing acceptance, and it is considered important, that the benefit arising from the exercise of options, particularly under discretionary option schemes, should be linked to the underlying financial performance of the company. The Association of British Insurers (ABI) and the National Association of Pension Funds (NAPF) published a joint paper in July 1993, in which it was emphasised that the responsibility for setting performance criteria relevant to a particular company should be a matter for the remuneration committee of that company.
- 8.2 Initially, attention focused on performance criteria showing real growth in normalised earnings, however, a number of other criteria have subsequently emerged. The circumstances of each individual company will vary, and there is a reluctance therefore on the part of institutional investors to indicate a general preference for any particular measurement. On the other hand, a considerable number of companies have stated that they welcome indications of the sort of formulae that are considered to be acceptable.
- 8.3 The following are examples of criteria which have evolved and which have been adopted. It may well be that other formulae will emerge. It is felt that remuneration committees should have discretion to select the formula which is felt to be most appropriate to the circumstances of the company in question. Nevertheless, as the Joint Statement made clear, it is important that whatever criterion is chosen as a condition of the exercise of options, the formula should be supported by or give clear evidence of, sustained improvement in the underlying financial performance of the group in question.

### **8.4 Absolute Measures or Targets**

Normalised earnings per share measured by reference to a percentage margin, for example 2% per annum growth, in excess of inflation over a 3 year period. It is important that the figures for earnings be smoothed where appropriate to avoid distortions arising from one-off

extraordinary or exceptional items included within the FRS 3 definition of earnings per share.

## 8.5 Comparative Measures

Outperformance of an index or of the median or weighted average of a pre-defined peer group in the case of basic options: or the achievement of top quartile performance in the case of super-options:

(i) Normalised earnings per share

Outperformance of the median or weighted average rate of increase in normalised earnings of a peer group.

(ii) Net Asset Value per Share

Net asset value per share measured, for example against a predefined peer group or index.

(iii) Total Shareholder Return (ie share price performance plus gross dividend per share)

Where total shareholder return is used this should be based on exceeding the relevant benchmark within a predefined peer group but, as this formula relies substantially on share price, attainment of the criterion should also be supported by a defined secondary criterion validating sustained and significant improvement in the underlying financial performance.

(iv) Comparative Share Price

Comparative share price relative to a peer group would be an acceptable alternative to total shareholder return, conditional in the same way on a secondary performance criterion validating sustained and significant improvement in underlying financial performance over the same period. The price achieved should be averaged over a period of a few weeks to eradicate the influence of short term market influences.

## 9 SUPER-OPTIONS

- 9.1 Where discretionary options are granted exceeding 5 per cent of issued Ordinary share capital in a ten year period or which exceed 4 times annual emoluments for any individual it is important that performance criteria governing their exercise should be considerably more demanding than for basic options. It is recommended that a comparative approach only should be adopted, requiring top quartile performance within a pre-defined peer group over a five year period using such earnings, asset growth or total shareholder return measure (validated by a secondary measure in the same way as for basic options where this is required) as remuneration committees shall think most suitable.

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