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At a glance:

EMPLOYMENT & INCENTIVES

Legal Outlook 2023

Happy New Year

All businesses operating in the UK

The future of UK employment law

Brexit and EU Law: Fundamental and long-standing employment rights are up for grabs in 2023 with the Retained EU Law (Revocation and Reform) Bill progressing through Parliament (formerly known as the Brexit Freedoms Bill). The Bill provides that key employment legislation (derived from EU Directives) including TUPE, the Working Time Regulations and protections for fixed term employees and part time workers would automatically expire at the end of the year, unless the government were to act to prevent this. No policy has yet been publicised as to what, if anything, might replace the rights contained in the legislation. Assuming that the Bill is brought into force in its current format, rapid change would follow, together with uncertainty for businesses and employers, and increased litigation to be dealt with by already overburdened tribunals.

For further information, see our blog Goodbye EU Law.

Human Rights: Human rights feature in many important employment law cases. In the recent Employment Appeal Tribunal judgment, *Forstater v CGD Europe*, the right to freedom of expression was a critical consideration in reaching the conclusion that those with gender-critical beliefs were entitled to be protected against discrimination. The Bill of Rights Bill will create a new domestic human rights framework under which employees pursuing employment claims may find their ability to rely on human rights diminished. The Bill is in its early stages and is set to progress through Parliament in 2023.

For further information, see our blog The Bill of Rights: A new era for human rights and employment law?

Industrial action

Transport Strikes Bill: The wave of industrial action continues to build and the government has set up a dedicated unit to respond to strikes in the public sector.

The Transport Strikes (Minimum Service Levels) Bill is expected to come into force in 2023. The Bill will introduce minimum service levels (MSLs) in certain transport services (which will be identified in secondary legislation) during strike action.

The Bill creates a framework for trade unions and employers to negotiate MSLs and enter into minimum service agreements (MSAs). If an MSA is not reached, the Central Arbitration Committee will determine the MSL.

Trade unions served with a work notice by their employers before a strike will be required to take reasonable steps to ensure that specified workers identified in the notice remain on duty during the strike so MSLs are maintained. Trade unions that fail to take reasonable steps to implement the MSL will lose protection from tort action and specified workers who still strike will lose their protection from automatic unfair dismissal.

Agency workers and strike action: There will be a judicial review of the Conduct of Employment Agencies and Employment Businesses (Amendment) Regulations 2022, which repeal the ban on the use of agency workers to replace employees on strike. The unions bringing the challenge claim that the government failed to consult on the Regulations prior to their introduction and that the Regulations are in breach of article 11 of the European Convention on Human Rights, which protects the right to strike.

Financial services

Review of the Senior Managers and Certification Regime (SMCR): As part of a wide package of reforms to the financial sector, the government announced a review of the Senior Managers and Certification Regime in December 2022. The first stage of the review will be a Call for Evidence which will take place in Q1 2023. This will entail gathering information to garner views on the regime's effectiveness, scope and proportionality. It will also seek views on potential improvements and reforms to the regime.

Termination rights

Statutory Code of Practice on Termination and Re-engagement: Following various high profile instances of companies terminating the employment of their workforce and re-engaging on less favourable terms and conditions, the government committed to produce a code of practice on termination and re-engagement. The code is expected to set out guidance on conducting fair, transparent and meaningful consultation on proposed changes to terms and conditions, including practical steps that employers should follow. Tribunals will be required to take the code into account and will have the power to award an uplift of up to 25% of an employee's compensation for an unreasonable failure to follow the code.

Resignation or dismissal: Where an employer exercises a pay in lieu of notice clause, following an employee's resignation, to bring forward the termination date, has the employee been dismissed in law? In *Fentem v Outform EMEA*, the EAT held that there was no dismissal, when it considered this question in February 2022, being bound by its own earlier decision on the point. However, the question will be considered further by the Court of Appeal in early 2023.

Worker rights

Holiday pay: The Supreme Court will rule on whether a gap of three months or more between holiday pay payments breaks a series of unlawful deductions. This proposition was established in the EAT's decision in *Bear Scotland v Fulton* and has substantially limited the ability of workers to make retrospective claims for holiday pay.

The case of *Chief Constable of Northern Ireland v Agnew & others* is an appeal from the Northern Ireland Court of Appeal. The NI Court of Appeal held that whether deductions constituted a series was a question of fact and that, as a matter of proper construction of the legislation, a series of deductions was not broken by a gap of three months or more.

Tips: The government is backing the Employment (Allocation of Tips) Bill, a Private Members' Bill. The Bill includes provisions to make it unlawful for businesses to retain service charges, ensuring that tips are paid to workers in full. A new statutory code of practice will also be developed to provide businesses and staff with advice on how tips should be distributed. This fulfils a longstanding commitment to introduce legislation to ensure that tips are paid to workers in full.

Working practices

Flexible working: Changes to the flexible working regime are likely to be progressed in 2023. The government has responded to the consultation it conducted in Autumn 2021, confirming that flexible working will become a day one right, with the removal of the "26 weeks" service requirement. In addition, employees will be able to make two flexible working requests in any 12-month period (an increase from one request). Employers will be obliged to respond to requests within a two-month period and must consult with employees before rejecting a request. The requirement for employees to set out how the effects of their flexible working might be dealt with by their employer will be removed. The government is backing the Employment Relations (Flexible Working) Bill, a Private Members' Bill which contains provisions addressing most of these changes.

For further information, see our blog Flexible working: A new regime.

Off-payroll working rules and umbrella companies: One of the headline issues in 2022's largely aborted mini-budget was the repeal of the off-payroll working rules. The widely disliked tax legislation applies to individuals who supply their services via a personal services company (PSC) and make the end-user or client of the PSC responsible for deducting tax and NICs, if it considers the individual would be an employee, absent the PSC. The repeal was reversed shortly after its announcement, leaving a number of major concerns about the operation of the legislation unresolved. In particular, there is concern about the increased use of rogue umbrella companies which replace the PSC, thereby avoiding the application of the rules, but at a cost to the individual, while serving no useful purpose. Scrutiny of the off-payroll rules and consideration of the regulation of umbrella companies is expected in 2023.

Family rights

Protection from Redundancy for Pregnant Workers and New Parents: As long ago as 2019, the government committed to extending protection for pregnant workers and new parents against redundancy. It is now backing the Protection from Redundancy (Pregnancy and Family Leave) Bill, a Private Members' Bill, as a way of fulfilling this commitment. Under the provisions of the Bill, regulations could be made to protect against redundancy during pregnancy and during and after an individual taking maternity, adoption or shared parental leave.

Carer's Leave: Following an announcement in 2021 that it would introduce a new right for unpaid carers to a week of unpaid leave, the government is backing the Carer's Leave Bill, a Private Members' Bill. The Bill will enable regulations to be introduced entitling an employee to one week's unpaid leave each year to provide or arrange care for a dependent with a long-term care need. There will be no service requirement and no requirement to show evidence of how or for whom the leave is used. Employees will be subject to the same protections against detriment and dismissal as other forms of family-related leave.

Neo-natal leave and pay: A new right to neo-natal leave and pay was announced by the government in early 2020. The right would entitle parents of babies requiring neo-natal care to leave and pay for up to 12 weeks. In order to fulfil the commitment the government is backing the Neonatal Care (Leave and Pay) Bill, a Private Members' Bill.

For further information, see our briefing New family friendly rights on the horizon?.

Diversity and Inclusion

Menopause: Workplace legal protections for those experiencing menopausal symptoms were under scrutiny in 2022. Despite the Women and Equalities Committee recommending that the menopause be made a protected characteristic, the government stated that it did not intend to amend the Equality Act 2010. However, progress continues to be made with an increasing number of employers introducing workplace menopause policies. A continued focus on protection is likely to continue in 2023.

For further information, see our briefing Menopause in the Workplace.

We will monitor developments in all these areas and keep you updated throughout 2023 in our monthly “At a glance ” publication.

UK Listed companies

Directors' pay

2023 marks the triennial point for many FTSE companies when they will be presenting new policies for shareholders' binding vote. They previously presented policies for a vote in 2020, during the Covid pandemic, amid investor clamour about quantum and performance conditions disclosure. These concerns persist as executive pay largely recovered in 2021/22 to pre-pandemic levels.

Issues for companies preparing their 2022 remuneration reports and policies and planning for 2023, mostly arise from the guidance and expectations of the FRC proxy advisors and investors looking for fairness in executive pay. And the war in Ukraine, energy prices, high inflation, the soaring cost of living and post-Brexit issues are all contributing to continued economic uncertainties. It is clear that remuneration committees will need to navigate carefully decisions on 2022 pay outcomes, remuneration setting for 2023 and (where relevant) preparing new policies. They also need to ensure, more than even, that they have full information on what's expected as well as full powers to carry out their functions.

The 2022 AGM season saw comparable levels of shareholder dissent to 2021 (which in turn had much higher dissent levels than in 2020). Up to the end of October 2022, ten FTSE 350 companies received a substantial vote of 20% or more against the remuneration policy. 27 FTSE 350 companies received between 20% and 49.9% vote against their implementation report and three lost the vote. The 2023 AGM season is also likely to be challenging.

Key areas to consider are as follows:

Pay restraint

Calls for executives to "share the pain" of the pandemic's impact have evolved into a general message that directors' pay should be commensurate with the experience and expectations of employees, suppliers, shareholders and wider society. Remuneration committees need to guard against unjustifiably high levels (or potential levels) of pay, and show restraint on overall quantum. Proxy advisors and investors are focussing on:

- **Salary increases:** The message is that increases should be kept low and ideally lower proportionally than general increases across the broader workforce. This is the case even where low-paid employees receive a significant pay increase due to the cost-of-living crisis. Directors should not receive, as a matter of course, the same pay increase as the general workforce.

> **Windfall gains – vesting and grant sizes:** There was a concern that the 2020 share prices dip would result in LTIP awards over higher numbers of shares. Companies were urged to take action *at grant* to prevent windfall gains if and when prices recovered. Where grant sizes have not been scaled back, investors expect remuneration committees to consider exercising discretion to reduce vesting levels so participants do not benefit from having been granted significantly more shares. It is becoming clear that companies should routinely consider the risk of windfall gains and explain what action they have (or have not) taken, at grant and subsequently.

Non-executive directors' (NED) fees

Perhaps because of the warning on salary increases for executive directors, the Investment Association have expanded their guidance on NED fees. They recognise that fees have not always reflected the increased complexity, time commitment and skillset required for the role. They state that NED fees should reflect all these and the expectations of the board and shareholders. But the reasons for any fee increase should be properly explained. Any fee increase, whatever its size, will clearly be closely scrutinised. Companies will have to navigate this carefully where they wish to reward NEDs appropriately, so as not to be seen to simply increase fees due to e.g. high inflation.

Discretion, malus and clawback

There has been an expectation for some years that companies have the ability to reduce payouts through malus, clawback and/or other discretion. Remuneration committees therefore need to consider whether a reduction is appropriate as a standard part of the performance assessment process.

The FRC say (in their Review of Corporate Governance Reporting against the Code in 2021 reports) that companies should state whether or not the remuneration committee has used its discretionary powers in determining final pay outcomes. Reasons given by companies in the FRC's random sample for cancelling or reducing awards included fines, targets not being met and overall industry and company performance, but unlike 2020, the pandemic was not a dominant factor.

The FRC would like companies to avoid general statements and clearly explain why discretion had to be used, set out the factors taken into account and details of the adjusted outcome.

Where remuneration committees do not have discretionary powers to adjust outcomes (or they are not wide enough), they could consider using malus or clawback. Remuneration committees need to look carefully at the terms of the malus and clawback provisions to ensure that they are wide enough to allow the reduction, as companies are expected to disclose how they intend to enforce malus and clawback if necessary. Having these powers just in the remuneration policy will not be enough; the contractual terms of the bonus/LTIP award need to permit any contraction of potential payouts.

ESG risks and climate change

The Code states that remuneration committees should consider risk mitigation in designing pay policies, and the FRC are encouraged to see an increase in material ESG metrics for bonuses and/or LTIPs. In response to growing focus and expectations from investors, there is increasing use of environmental and social measures in incentive plans: For bonuses, social measures (mostly diversity and inclusion, health and safety, and employee engagement) are common, and environmental measures such as emission reduction are becoming prevalent. Governance measures are usually risk-related metrics. LTIPs also include environmental measures which are inherently long-term, such as decarbonisation and energy reduction.

Investors expect that ESG metrics are quantifiable and the method of performance measurement is clearly explained, suitably stretching, and clearly linked to implementing company strategy. They should not reward executives for 'business as usual' activity or be used as a way to increase overall quantum. Where companies are still considering how to reflect any ESG corporate strategy in variable pay this should be fully explained (including how the approach will evolve in future years).

The government had announced that certain firms (initially asset managers, regulated asset owners and listed companies) would be required to publish climate transition plans on moving to a low carbon economy. To help to develop a "gold standard" for these, the government also set up a Transition Plan Taskforce. The Taskforce is consulting on new guidance to help companies prepare for climate transition plans disclosure. It is proposed that, as part of the accountability element of the disclosure, companies should describe whether and how they have implemented arrangements to align remuneration and incentive structures with the stated objectives and priorities in their transition plans. This includes information on factoring "transition plan-related considerations" into executive remuneration and the proportion or number of individuals with pay linked to progress against the transition plan objectives and priorities.

The transition plans may be required during 2023 but the exact timing is unknown.

Pensions contribution rates

Investors have been demanding for a number of years that companies comply with the Code requirement that pension contribution rates for directors align with those for the workforce. Since 2019 this was expected for new directors' contribution rates, and existing directors' rates were to align by the end of 2022. Investors and proxy advisors will generally oppose pay policies or remuneration reports where there is no such alignment. However, some will still accept a cogent reason for any delay in alignment, or a commitment to do so in the near future.

Alternative incentive structures

Investors have been encouraging companies to consider whether alternative remuneration structures to LTIPs would align better with their strategy. At the same time they have been weary of such plans, saying for example that companies wishing to introduce **restricted share plans** (RSP) need to strongly demonstrate the long-term strategic rationale, and that grant sizes should be reduced by at least 50% compared to conventional LTIP awards. And lower share prices (e.g. more than 20% drop) may require greater reduction to prevent windfall gains.

Proxy advisers clarify that remuneration committees must have power to exercise discretion at RSP vesting, to ensure that outcomes reflect executive performance and guard against payment for failure. Legal & General Investment Management also require meeting a climate target for companies in the sectors with greatest impact on climate change.

The **combined incentive (omnibus) plan** is now in focus. Here performance is assessed for the full award after a short time period, a portion is paid out, and the rest is deferred subject to time-vesting or other performance restrictions. There is resistance to companies moving to this single incentive plan structure, which usually means reducing the pay element linked to the long-term performance and any deferred element becoming guaranteed pay. Proxy advisers want such plans to have some strategic rationale and to meet certain conditions including vesting and holding periods of at least three years, underpins for any deferred awards and reduced grant sizes (compared to any replaced LTIP).

Code changes and increased regulator scrutiny

Following the government response on proposed audit and corporate governance reforms, the

FRC will consult (in Q1 of 2023) on developing the malus and clawback regime in the Code. They aim to deliver greater transparency and to consider a broader range of trigger events. The revised Code is intended to apply to financial periods starting from 1 January 2024.

The FRC will also initiate a remuneration reporting pilot on a voluntary basis as a pre-cursor of the extension of its Corporate Reporting Review powers. They will use the pilot's findings to formulate their regulatory approach for when they have statutory powers over the whole annual report.

This means that the FRC will be able to request information on and require changes to remuneration reports. It is not clear how this would operate in practice with the mostly qualitative information in such reports. But it is clear that ever greater scrutiny is here to stay.

Directors' remuneration report guide – Our online tool to help companies put together their annual directors' remuneration report has been updated for the 2022 reporting season and 2023 AGMs.

US clawback compensation rule: impact on US-listed companies

Companies (wherever incorporated) with securities (including debt) listed on a US national stock exchange need to review their clawback policies and plan for complying with a new SEC clawback rule. They will also have to make specific disclosures to the SEC when the policy is triggered.

This will apply from November 2023 at the latest, possibly earlier, depending on the US exchange where the company's securities are listed.

The SEC rule mandates only one clawback trigger: where a company is required to prepare an accounting restatement. The clawback requirement applies to any pay (cash or incentive award) whose receipt is subject to a "financial reporting measure performance goal". The company has to calculate the amount of gross pay of current or former executive officers that would have been payable during a three-year clawback period, based on the accounting restatement, and recover any overpayment. "Executive officer" is not limited to executive directors, and role or conduct are not relevant.

The only permitted exceptions are where the company decides that it would be impracticable to recover pay. It can only do so if the expense would exceed the recovery, if clawback would violate home country law, or recovery would cause a tax-qualified retirement plan to violate the US Internal Revenue Code. In each of these there are additional conditions.

The SEC clawback rule is detailed and prescriptive and has potentially onerous consequences for companies, with no (or very little) room for manoeuvre and no discretionary powers. This is quite different from the way companies have so far considered and applied their malus and clawback powers. Careful planning is required to ensure that companies are ready to apply the rule when it comes into force in 2023.

For further information, see briefings on:

US-listed companies will soon be required to adopt compensation clawback policies

FRC 2022 review of corporate governance reporting: executive pay

The Investment Association: updated executive pay guidance for 2023

Glass Lewis 2023 UK Proxy Voting Policy Guidelines: executive pay provisions

Executive pay proposals in the government response on audit and corporate governance reforms

How to produce accurate and robust climate transition plans

Financial sector pay

Banks

CRD V has now been in force across the EU and in the UK for two years and made significant changes to the remuneration rules applying to banks and banking groups. There are particular challenges with: apportioning material risk takers' (MRT) pay for between global and UK roles, identifying MRTs in UK branches/subsidiaries of overseas banks, the remuneration committee's role at group and local level in setting and adjusting bonus pools, application of the prohibition on paying dividends and distribution on deferred pay and the Pillar 3 disclosure rules.

Following Brexit, the PRA indicated that they intend to reform remuneration standards for banking. This would take a more global view, and aim to make the rules more accessible and user-friendly. As part of this, the PRA are now consulting (until 31 March 2023) on the **removal of the "bonus cap"** which limits the variable pay of MRTs to 100% of fixed pay (or 200% with shareholder approval). Firms will still be required to set an appropriate internal ratio (along the same lines as already apply under IFPR to investment firms). This will apply for performance years starting after the date the rules are amended (expected during Q2 2023). So for most banks this is likely to be the performance year starting in 2024. The consultation does not however address issues around: (1) shareholder approval where the cap was increased to 200% of fixed pay, and (2) for banks that wish to do so, reducing or removing role-based allowances.

Investment firms

The Investment Firms Prudential Regime (**IFPR**) came into force on 1 January 2022, with new pay rules applying for performance periods starting on or that date, for all UK investment firms. Firms have since been navigating round complex rules and some challenging issues, including the following:

- **Scope:** Identifying MRTs on the basis of qualitative criteria only, particularly those based outside the UK and the impact on their pay, and treatment of UK branches of third party firms;
- What does "**risk adjustment**" mean in relation to bonus pools, the process involved and the FCA's likely approach to assessing remuneration practices; and

- **Pay-out structure:** Appropriate deferral periods, regulatory and HR impacts of setting a high fixed/variable pay ratio, using parent company shares for the non-cash instruments requirement and alignment, and treatment of severance pay.

The first **public disclosures** under IFPR will be due in 2023, when firms publish their financial statements after the end of the first performance period to which IFPR applied. The level and details of disclosure required depend on firm classification: all SNI firms must publish a summary of their remuneration approach and governance and the key characteristics of their remuneration policy. Non-SNI firms and large non-SNI firms must include further information including on MRTs, risk adjustment, malus and clawback, deferral, and using exemptions.

In addition, firms will need to submit their first report to the FCA, within four months of the end of the financial period (form MIF008 and guidance notes). Again, the larger the firm, the more information it will be disclosing, and the greater the level of detail.

All these issues will continue to be addressed during 2023 as the rules bed down. Experience of similar issues which banking groups have had to deal with in the context of the CRD regime will no doubt be of some assistance.

ESG factors

The **EU** continues the process of ensuring that firms properly factor in climate and other environmental risks, for themselves and their investee companies. But the regulatory impact on remuneration remains relatively light with a focus on disclosure rather than substantive changes to remuneration policy. (This may change: Members of the European Parliament have proposed amendments to the current draft texts of CRD6 and CRR3 to mandate that at least 50% of variable pay be based on ESG measures. This provision may of course not survive the complex and drawn-out EU legislative process.)

Under the Sustainability-related Disclosures in the Financial Services sector Regulation (SFDR), the remuneration policies of financial market participants and financial advisers have, since 2021, had to demonstrate how they are consistent with the integration of their own "sustainability risks", and publish this on their website. The EBA's report on the management and supervision of ESG risks for CRD V and IFD firms goes further and recommends that firms incorporate ESG risks into their remuneration arrangements, but does not specify how that might be done. The EBA's Roadmap on Sustainable Finance (December 2022) indicates that it may update its Remuneration Policies Guidelines to elaborate on aspects related to ESG risks.

In relation to investee companies, Regulatory Technical Standards issued in April 2022 under SFDR:

> Require "investment strategies" of financial market participants to describe "the policy to assess good governance practices of the investee companies, including with respect to . . . remuneration of staff"; and
> Include "excessive" CEO pay ratios amongst possible adverse sustainability impacts. Firms may struggle to gather this information about their investee companies as, depending on their location, they may not have to compile it themselves or may have done so in ways which differ so much from each other as to make any aggregation meaningless.

Similarly, in the **UK**, the FCA, when setting out its future ESG priorities suggests ensuring accountability for ESG claims and promises through remuneration and incentives. But the FCA's long-awaited consultation paper CP22/20 on sustainability disclosure requirements (SDR) regime and accompanying investment labels does not contain any remuneration-related issues. Unlike the EU's SFDR which was envisaged as a disclosure-based regime, the FCA's SDR proposals are explicitly envisaged as a "labelling" regime with financial products being assigned one of three sustainability labels.

A PRA paper (October 2022) on its supervision of climate-related financial risks approves of firms embedding climate risk factors into senior remuneration targets, especially for any Senior Manager Function with responsibility for the financial risks from climate change.

For further information, see briefings on:

Preparing for public disclosure under the Investment Firms Prudential Regime

Greening Finance: A Roadmap to Sustainable Investing

FCA outlines draft ESG disclosure rules for UK financial services

SFDR RTS: application delayed to 1 January 2023

European Commission adopts final RTS under SFDR

Sustainable Finance Sources: survival guide

Toolkit: CRDV & IFD remuneration rules

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