An Introduction to Employee Share Trust Services

BWCI

Why create an Employee ShareTrust?

A public company can buy its own shares and hold them "in treasury". However it has limited options as to how it can use those shares. It can

- sell them for cash (but not without first offering them to all shareholders in proportion to their existing holdings);
- cancel them; or
- transfer them "for the purposes of an employees' share scheme".

However, so it can set up an Employee Share Trust ("EST"), for example, to

- grant or satisfy share options or awards;

or

- offer more protection to its employees

As long as the company holds the shares, it will be registered as the owner, but the shares will carry no votes and will attract no dividends.

Also, a public company cannot issue new shares at a price below their nominal value, so it must fund a third party (e.g. an EST) to acquire shares. The EST can then pass them on to employees free of charge.

Key term

An Employee Share Trust (EST) is a specialised form of discretionary trust for the benefit of

- employees (present and/or past); and
- (possibly) their spouses or civil partners

A trust deed sets out powers & duties of the trustee.

A private company, on the other hand, cannot hold its own shares "in treasury": any shares it purchases from existing shareholders are immediately cancelled.

If a private company wishes to warehouse its own shares pending making them available to employees by way of gift or sale (whether immediately or upon the exercise of share options), it must do so through a third party. An EST with a trustee chosen by the company is an ideal vehicle for this.

The proprietors of a private company might be willing to encourage employees to own shares and benefit from the growth in their value for as long as they remain employees. While the Articles of Association or a shareholders' agreement could impose an obligation on an employee-shareholder to offer his shares for sale on leaving the company, this is of no use if there is nobody willing and able to buy them.

An EST can provide the mechanism for repurchasing shares from existing or former employees and enabling them to be redistributed among existing or new employees by the operation of a share scheme. This is known as an "internal market" for shares in a private company.

Advantages of using an EST

An EST can enable a company to "capture" its shares at an advantageous price for subsequent use in one or more share schemes. Any subsequent gain in the value of the shares can then be used to reduce the cost of operating such schemes, or to increase the value of the benefits given to employees under the schemes.

An EST can also be used as a convenient mechanism for holding shares available to be used for the purposes of different types of share scheme tailored to satisfy the varying tax regimes and legal requirements in different jurisdictions.

Legislation for the operation of a Share Incentive Plan (a particular type of HMRC approved all-employee share scheme) actually requires that shares are held via an EST.

If a private company's principal shareholder retires or dies with no children or no obvious successor, an EST can alleviate (or even solve altogether) the problem of succession by itself acquiring a shareholding in the company from the principal shareholder or his estate. If necessary, acquisition can be made over a period of time.

Offshore or Onshore?

An EST could either be established onshore in the UK or offshore in an international finance centre such as Guernsey.

Offshore status can be advantageous as an EST should then be exempt from Capital Gains Tax, as the trust is neither resident nor ordinarily resident in the UK.

Corporation tax relief under Finance Act 2003 should still be available to the company, whether the EST is established offshore or onshore.

Even where an offshore trust cannot be used directly (e.g. for the administration of certain types of share schemes which require an onshore trust), an offshore arrangement could still be used to "warehouse" shares prior to sale to the onshore trust when needed. Such onward sale should be exempt from Capital Gains Tax.

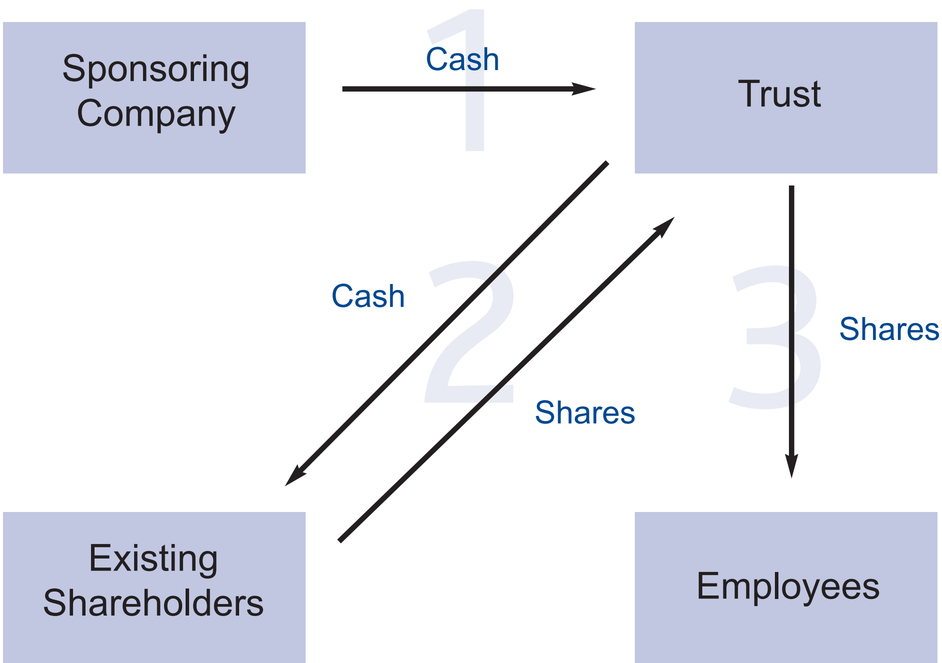
Professional advice should always be taken on the legal and taxation aspects of scheme design and EST arrangements.

Typical holdings of an EST

The holdings of an EST can include

- shares in sponsoring company
- cash
  - against cash elements of Awards
  - to purchase additional shares
- loan facility granted by sponsoring company

How a basic EST works



1. The sponsoring company makes a cash contribution to the Trust. This can either be by way of gift or as a loan.

2. The Trust uses the cash to purchase shares from existing shareholders.

3. The Trust uses the shares to satisfy Awards granted in favour of a class of beneficiaries, which will consist of some or all of the employees of the sponsoring company.

The consequences of this arrangement are:

- cash is transferred from the sponsoring company to existing shareholders via the trust
- shares are transferred from existing shareholders to employees via the trust

Depending on the circumstances the arrangement may offer tax relief as follows:

- Corporation Tax relief for the company in the year shares are transferred to employees
- Capital Gains Tax relief for the existing shareholders on the sale of their shares
- Income Tax relief for the employees through a bona fide employee share scheme

Independent tax advice should always be sought prior to establishing an EST.

The EST work cycle

The operation of different types of share schemes under an EST is driven by the financial year-ends and results of the sponsoring company. The overall profitability of the company is obviously a prime factor in determining the size of the company's overall provision for staff rewards.

So, to this extent, EST administration is cyclical in nature. The company declares its annual results and then

- existing Awards vest wholly or partially (or not at all) depending on terms of the award and the company's performance
- new Awards will be granted
- participants will be advised.

Share Awards

Share Awards will have

- a defined class of beneficiaries, determined by the scheme rules
- a "lifespan" between the grant date and the vesting date, which will normally be 3 years but may vary

Awards may

- be subject to performance conditions, either personal or more commonly corporate
- eventually vest wholly, partially or (if the company's results are particularly poor) not at all.

A typical Award Grant process

Once the decision has been taken to award shares

- The Remuneration Committee ("RemCo") of sponsoring company meets to approve the level of the proposed Awards
- The award schedule is provided to the Trustees, with the RemCo minutes, draft Award Certificate, etc
- The Trustees meet formally to approve the granting of Awards
- Certified copy Award Certificates are sent to participants (sometimes via sponsoring company)
- Awards are normally made from the existing Trust holding of "unallocated" shares
- The Trustees may accept an indemnity from the sponsoring company to provide
    - shares, or
    - funds to purchase them if and when Awards vest
- The Trust records would then show an "overdrawn" position of unallocated shares

Key term

The Remuneration Committee (RemCo) is a sub-committee of the Board of Directors.

Consisting of at least 3 independent non-executive directors, the RemCo will have delegated responsibility for setting remuneration for all executive directors and the Chairman, including pension rights and any compensation payments.

The RemCo should also recommend and monitor the level and structure of remuneration for senior management.

Source: FSA Combined Code on Corporate Governance.

and at the other end of the Award's life:

- The RemCo meets to assess performance against any criteria laid down in the Scheme Rules and the Award Certificate
- The Trustees receive RemCo confirmation of the extent to which Awards are to vest
- The Trustees then
    - agree the schedule of outstanding Awards
    - receive participants' details (addresses, PAYE & NIC rates, vesting choices)
- The Awards (or a scaled percentage of them) vest in favour of relevant participants

Participant choices on Vesting

Scheme Rules and/or the preference of the sponsoring company may not provide for the participants to have much, or indeed any, choice as to what happens to their Awards on vesting.

Where there is a choice, the Trustees will contact participants 2 to 3 weeks prior to the vesting date to ask what option they wish to take. The available options are normally as follows:

Option 1: Sell all

Here, the Trustees sell sufficient of the vesting shares to cover the participant's liabilities to PAYE & NIC (or international equivalents) at the rates advised by the sponsoring company. This can either be done as a market transaction or as an off-market transaction whereby the Trustees purchased participants' "tax" shares at the agreed vesting price. In an on-market transaction, the sale would also cover brokerage costs.

Proceeds of the tax sale would normally be remitted to the sponsoring company, which would then account to the relevant tax authorities.

The Trustees would also sell the balance of the vesting shares and account to the participant for the proceeds.

Option 2: Transfer all

Here, the participant undertakes to settle the personal tax liability direct (normally via the sponsoring company's payroll system).

The Trustees will transfer all of the vesting shares to the participant or as the participnat directs.

Option 3: Part sell, part transfer

The Trustees sell sufficient shares to cover the participant's liabilities to PAYE & NIC (or international equivalent), plus costs if it's an on-market transaction, and remit the proceeds to the sponsoring company as before.

The Trustees then transfer the remainder of the vesting shares to the participant or to his nominated beneficiary or nominee account

What if a participant leaves?

If a participant leaves the company during the lifespan of an Award, the effect on that Award of their departure will depend on

- the circumstances of the departure; and/or
- the Plan Rules.

The participant may be termed a "good" leaver (redundancy, retirement) or a "bad" leaver (dismissal, resignation).

The outstanding Award may then

- lapse partially, when the participant will receive a proportion of the Award (normally related to the proportion of its lifespan for which he has been employed), either immediately or at the original vesting date;
- lapse wholly, in which case the participant will not receive any proportion of the Award; or
- be released in full, either immediately or at the original vesting date

BWCI's Participant and Award Data System

BWCI operates a dedicated participant and award data system, known as "EBS", for the administration of its EST clients.

Summary of features

Simplified data handling processes

Particularly in the area of bulk transactions

- new Award grants
- Award vestings

A two-way process involves clients who can furnish BWCI with updated data for automated re-import into EBS.

Improved reporting capabilities

For client:

- list of all outstanding Awards under however many different schemes, either in summary or full detail
- quarterly movements schedule
- summary of Awards, detailing total numbers of shares & participants covered by outstanding Awards

For individual participants:

- details of each outstanding Award in their name
- Award & vesting statements
  - generated automatically at the time
  - readily replaceable if and when necessary

Automated documentation

System can be tailored to generate standard documents, e.g.

- on an Award grant, Award statements for all concerned
- on a vesting, a statement detailing how each participant's Award has been dealt with plus
- covering letters to all participants

Other Client reporting

Quarterly Administration Report

- Trust documentation
- Loan facility
  - Facility agreement
  - Maximum facility available
  - Current balance
- Status of preparation of financial statements
- Activity during the quarter
- Outstanding issues at quarter-end
- Award data reports from EBS

Quarterly Net Assets Statement

- Valuation of assets held at quarter-end
- Summary of movements during the quarter
- Breakdown of
  - bank balances
  - debtors and creditors
- Annual Financial Statements
  - Audited or not as required by client
  - Balance Sheet
  - Fund Account (equivalent to profit & loss account)

Company profile

The BWCI Group was established in 1979. We are the largest firm of actuaries and consultants in the Channel Islands, employing over 100 staff in Guernsey and Jersey.

We are an independent firm, providing a broad range of employee benefits, investment and insurance consultancy services to corporate and institutional clients based in the Channel Islands, the UK and internationally.

We are also a leading provider of specialist administration services for:

- pension plans
- **employee share plans**
- life assurance companies

These complement our consultancy services and enable us to offer complete solutions to our clients.

BWCI is the Channel Islands member firm of **Abelica Global,** the international network of firms providing actuarial and consulting services around the world. Our **Abelica Global** links enable us to provide a global service to our clients, while still retaining our independence as BWCI.

For further information

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