What is the future of Stock Options in Belgium?

An increased focus on 'say on pay'

Since the Governance Act of April 6th, 2010[1], Belgian listed companies providing variable pay to their top executives must defer 50% of the payout except if a deviation is approved by the General Meeting of Shareholders or if the variable portion of the executive's package does not exceed 25% of the total package. The Governance Act did not fully reach its objective so far, either because most companies in the panel grant variable compensation below the 25% threshold or else request a derogation from the General Meeting.

Great Britain has recently adopted new governance legislation imposing a quorum of 50% of shareholders to approve the remuneration policy for directors of UK listed companies. If the quorum is not met, the company will have no other choice but to call an Extraordinary meeting of shareholders to get said remuneration policy duly approved.

We strongly believe that the UK legislative development will inspire many other jurisdictions and is likely paving the way for yet another strong steps towards more empowerment of the shareholders of listed companies on executive pay policy.

The momentum is there for Remuneration Committees to refresh their strategy not only about their company's executive compensation profile but also about how they engage with shareholders and beyond shareholders with other stakeholders including the media on how they reward their top talents.

The specific Belgian context

The particular circumstances prevailing in Belgium seem to have made stock options the alpha and omega of LTIs for executives. Exemption from social security payments, the low taxation of this benefit[2], and the relatively short vesting schedule imposed by the Governance Act[3], explain -for a large part- the immense prevalence of this type of LTI vehicle in the Belgian market.

It is true that the upfront taxation, even at a low rate, constitutes a risk to the beneficiaries. However, many funding solutions are offered by the market, some without too much risk for the beneficiary[4], and even a choice between taxation at grant or exercise. Still, in terms of perception, for many listed companies, the upfront taxation combined with the social security exemption attached to it is so appealing that many companies opt for this type of unique vehicle to accommodate their LTI strategy. Rightly or wrongly, companies awarding options taxable at grant typically refrain from imposing performance hurdles on those options because they feel that adding a layer of uncertainty (performance hurdles) to a natural layer

---

1 An even strictier framework applies to companies active in the Financial sector

2 The reduced benefit in kind subject to progressive personal tax rates amounts to 9% since 1 January 2012 (with an additional 1% per exercise year beyond year five).

3 A stock option plan awarded on 31 December of year N may be exercised on January 1 of year N+4, i.e. after 3 years and one day.

4 These include the various 'tax swap' solutions by which the beneficiary of stock options receives from a bank the cash flow necessary to pay the tax in exchange for a predetermined percentage of the rise in value of the underlying shares. If the stock options are ultimately not exercised (being underwater) the beneficiary owes nothing to the bank, the latter having undertaken its hedging transactions ex ante.

of uncertainty (payout dependent upon stock market performance) is too much for their executives to bite.

The increased focus on pay for performance that emerged from the financial crisis, coupled with the strengthening of the powers of the general meeting as shown in the UK development, create a strong plea for revisiting the Belgian paradigm on LTI: which LTIs to use, for what purpose and how will these be perceived by shareholders?

An inevitable questioning of the ‘all stock options’ model

In the eighties, the United States were the first to strive for a better alignment between the interests of executives and those of the shareholders. Stock options became part of executive compensation packages, where they took a significant place. Soon, all over the world, governments encouraged this alignment with favorable social security and tax provisions.

The Anglo-Saxon countries were the first to realize that stock options present two major drawbacks. In case of a strong bull market, the pay-out is disproportionate in relation to other elements of the compensation package and not commensurate with the efforts of the executives eligible for stock options. Conversely, a decline in markets penalizes leaders for a fall that is not necessarily their fault while penalizing companies concomitantly by removing the retention element of their LTI strategy.

For this reason Anglo-Saxon LTI practices are evolving towards greater diversity. U.S. companies now award a raft of instruments to their executives. More than half of them award at least three different LTIs. A mix of stock options, performance shares, restricted stock and/or cash-based LTIs is common practice.

In Europe too, new systems have emerged. For example, since 2005 in France, companies have been able to award free shares to their employees. This type of LTI has two main advantages. Executives remain motivated even in the event of a market downturn, and the performance cycle is longer, thereby rewarding more sustainable performances.

Many French groups have moved from 'all options' to a mix of options + free shares. They have also, with a little imagination, extended this practice to executives operating in countries with no specific regulation in this area.

In Belgium, other than in the specific case cited earlier of the executives of French subsidiaries, this type of tool is still not widespread.

Cash-based LTIs + securities -based LTIs: the perfect mix for Belgium?

In the U.S., cash-based LTIs are complementary to the LTIs awarded in the form of securities. Cash-based LTIs present several advantages:

- a fair alignment is maintained with executives' performance, also in bear markets;

- they encourage the performance of executives whose activity does not impact the share price as much as that of the members of the Executive Committee.

Cash-based LTIs are also very flexible. They can:

- be indexed or not to the share price of the company or a basket of shares which serves as a reference for the company;
- be linked to a particular key indicator of the development of the business;
- replicate the characteristics of an option etc.

A cash-based LTI is definitely acquired (vested) at a given date. For tax purposes, it is usually paid at the time of vesting. A such, it does not include an exercise period as does an option plan.

A question arises on the ability of a cash-based LTI to align the interests of executives with those of shareholders through share ownership.

The cash-based LTI can provide for a beneficiary to co-invest in shares of the company up-front. At the time of settlement, the cash-based LTI may be paid in whole or in part in shares of the Company (provided that the shareholders have agreed to set aside a certain number of shares for the settlement of the LTI). Finally, the cash-based LTI may be accompanied by an obligation to reinvest a portion of the cash in shares of the company.

The cash-based LTI may therefore also contribute to a gradual accession of executives to ownership of the company within the limits desired by the latter.

Does this mean that cash-based LTIs will replace securities-based LTIs such as stock options?

Our regular contacts with customers abroad confirm that in any case this topic will be closely examined by the Remuneration Committees.

For Belgium, given the intrinsic qualities of securities-based LTIs (stock options), our opinion is that the market should move towards a mix of securities-based LTIs (stock options) and cash-based LTIs.

This ‘ideal’ combination would have the advantage of better meeting the interests of the shareholders and de facto facilitating communication on the subject in the General Meeting.

This will require careful thought and discussion by Remuneration Committees on the structuring of the cash-based LTIs, the respective weight of each LTI type (cash-based and securities) in beneficiaries' packages and the size of the award depending on the category to which they belong (CEOs, executives, high potentials, experts ...).

The performance conditions are also a key issue in this discussion.

But this is already another story.

Ludovic Wolff* | Director | Human Capital | Talent & Reward
Ernst & Young Tax Consultants