Q4 Commercial Forecast

October 2016

Welcome to the autumn edition of our Commercial Forecast.

Our forecasts help businesses to stay in the know about current and future legal developments which might affect them and the markets in which they operate. The range of topics covered in this edition is typically broad, ranging from the Corporate Governance Inquiry, EU developments in relation to payment services and copyright reform, the comparative benefits of arbitration -v- litigation in the light of Brexit, and the government's proposed apprenticeship levy.

Corporate Governance Inquiry

Last month the Business, Innovation and Skills Committee (BIS Committee) launched an inquiry into corporate governance. A tough stance in this area was a focal point of the Prime Minister's leadership bid and the announcement follows recent failings at BHS and Sports Direct. The Inquiry will examine three key areas: directors' duties, executive pay, and the representation of workers and women in the boardroom.

Directors' duties: The Inquiry will consider a number of aspects of directors' duties, including their clarity and application to private and public companies. The terms of reference include the following questions:

- Is company law sufficiently clear on the roles of directors and non-executive directors?
- Should there be greater alignment between the rules governing public and private companies?
- Should government regulate or rely on guidance and professional bodies to ensure directors fulfil their duties effectively?

Executive Pay: In the wake of a number of shareholder revolts against high pay packets earlier this year, including at BP and WPP, the Chairman of the BIS Committee, Ian Wright MP, asked: "***Can we have any confidence that the current framework for controlling pay is working?***". The Inquiry will examine:

- How should executive pay take account of companies' long-term performance?
- How, if at all, should Government seek to influence or control executive pay?
- Do recent high-profile shareholder actions demonstrate that the current framework for controlling executive pay is effective? Should shareholders have a greater role?

Boardroom Composition: The Inquiry will examine the question of boardroom diversity and will look for evidence as to whether diverse boards perform better. Terms of reference in respect of boardroom composition will also include the following questions:

- How should greater diversity of board membership be achieved?
- Should there be worker representation on boards?

The deadline for written submissions is Wednesday 26th October 2016.

For further information please contact Marie Bates.

Brexit: corporate tax implications

Brexit itself should not trigger changes to UK corporation tax, since (unlike VAT) direct taxes are imposed at nation level. However, this is not the whole story, not least because leaving the EU is likely to prompt a domestic response and also because the UK enjoys the benefits of certain overarching EU Directives which impact corporation taxes. We can therefore expect repercussions, some of which may include the following:

- **Tax incentives**: The UK Government could take short term measures to stimulate inbound investment in the UK (eg. a further reduction in the UK corporation tax rate).
- **Choice of avoidance rules**: Whilst the UK should continue to implement the Base Erosion and Profit Shifting (BEPS) Actions, it is now less likely to adopt further EU anti-avoidance measures (as per the Commission's June 2015 Action Plan for Fair and Efficient Corporate Taxation).
- **Freedom from harmonization**: The UK has never been in favour of the EU-wide harmonization of corporate tax (the so-called Common Consolidated Tax Base). Following Brexit the EU may fast track this policy, perhaps a further incentive for the UK to maintain low corporation tax rates.
- **Withholding on dividends**: The ***Parent-Subsidiary Directive*** eliminates withholding on dividends paid by EU companies to a UK parent or minimum 10% corporate shareholder. In its absence, the relevant Tax Treaty rate would apply (eg. dividend withholding from German companies is up to 15%).
- **Withholding on interest and royalties**: Without the application of the ***Interest and Royalties Directive***, the relevant Tax Treaty rate would apply (eg. royalties paid to Luxembourg companies suffer a 5% withholding).
- **Tax charges on asset transfers**: The ***Mergers Directive*** allows for tax-free cross border reorganisations within the EU. Without it, tax could arise on the transfer of assets to and from UK and EU companies unless domestic reorganisation provisions assist.

For further information please contact Charlotte Black.

Payment services: bringing the regulatory regime up to date

Since the Payment Services Directive (**PSD1**) was originally adopted in 2007, there have been major technological advancements in the retail payments sphere with which the regulatory regime needed to catch up.

A revised directive (**PSD2**) is due to be adopted in the UK in January 2018. It is designed to enhance the protection of consumers when they make payments, improve security and promote the development and use of innovative online and mobile payment systems.

Affected firms should already be considering whether they need to update their customer documentation and security procedures, and planning accordingly.

- **New services**: PSD2 deals with two new services: "***payment initiation services***"; and "***account information services***". Payment initiation services allow users to pay for goods online without needing a credit or debit card, e.g. Paypal. Account information services are online services which collect and consolidate information about a user's different bank accounts which can be accessed via an online login, e.g. ontrees.com. Providers of these services are termed "third party providers" (**TPPs**).

- **Extending geographic scope and currencies**: Historically, PSD1 only applied where the payment service providers (**PSPs**) of both the payer and the payee were in the EEA. However, some PSD2 provisions (primarily transparency and information requirements) apply where only ***one*** PSP is in the EEA. Further, PSD2's transparency and information requirements apply to all currencies, not just the Euro and other Member State currencies.

- **Encouraging competition**: To facilitate competition amongst PSPs, PSD2 requires banks and other PSPs to allow customers to make payments via a TPP, and to share information with TPPs providing account information services so that customers can have a consolidated view of all their accounts via a single online login.

- **Security**: Sharing this data raises serious security issues and therefore PSD 2 has new security requirements. Most PSPs must update their current reporting and authentication procedures and must in particular apply "***strong customer authentication***" procedures for online account users. They must use two or more of the following to validate the user or transaction:

    1. ***knowledge***: something only the user knows, e.g. a PIN;
    2. ***possession***: something only the user possesses, e.g. a card; and
    3. ***inherence***: something the user is, e.g. a fingerprint.

- **Liabilities and Direct Debit refunds**: PSD2 reduces the liability cap for unauthorised payment transactions to €50 (from €150) except in the case of fraud or gross negligence, and enhances payers' Direct Debit refund rights.

- **Limiting exclusions**: PSD2 restricts some of the exclusions currently available, as the Commission believes that Member States have been applying them inconsistently and beyond their intended scope. For example, the exception for limited networks of service providers such as department store or petrol station cards has been significantly limited.

Member States (including the UK) must transpose PSD2 into domestic law by 13 January 2018.

HMT, which is responsible for amending the Payment Services Regulations to incorporate PSD2 intends to issue a consultation shortly. Following that consultation the FCA intends to consult on the effect of the PSD2 changes to its handbook.

For further information please contact Grania Baird.

Apprenticeship levy: draft regulations published

The apprenticeship levy, which the Government intends to impose from next April, will require larger employers to pay a levy to the government to fund new apprenticeships.

The scheme is intended to support the Government's commitment to increase the quantity and quality of apprenticeships, and will be charged at a rate of 0.5% of an employer's total pay bill where this exceeds £3 million a year. For these purposes, an employer's pay bill is the amount of their payroll on which secondary Class 1 National Insurance contributions are payable (including salary amounts falling below the secondary threshold). As such, the levy will only be paid by the largest 2% of employers.

Draft regulations have now been published setting out how the levy will operate. The regulations will amend the Income Tax (PAYE) Regulations 2003, and provide that those employers for whom the levy is payable will need to report to HMRC the amount of the levy for which they are liable on a monthly basis. The reporting requirement is also extended to those employers whose pay bill (again, based on the amount of their payroll on which secondary Class 1 National Insurance contributions are payable) exceeded £2.8 million in the last tax year or who consider that their pay bill will be over £3 million during the current tax year, on the basis that even if they are not currently required to pay the levy they may well be required to do so in the near future.

The draft regulations also set out details of how the annual £15,000 allowance to offset the levy payment will operate on a monthly basis, providing that any unused allowance can be carried over to subsequent months, and deal with apportionment of the allowance between difference PAYE references.

The apprenticeship levy is controversial, as some larger employers in sectors where apprenticeships are not common feel that it is unfair that they should be required to pay a levy from which they will not benefit. However, imposition of the levy is intended, amongst other things, to increase the incentive for such businesses to offer more apprenticeships, and in so doing advance the government's social mobility agenda.

The draft regulations are subject to consultation, and responses should be provided by 14 November 2016. The regulations and the consultation can be accessed here:

https://www.gov.uk/government/publications/draft-legislation-regulations-for-the-calculation-payment-and-recovery-of-the-apprenticehip-levy/draft-legislation-regulations-for-the-calculation-payment-and-recovery-of-apprenticeship-levy#the-consultation-process-how-to-respond

For further information please contact Alice Cave.

Update on EU copyright reform

On 14 September 2016 the European Commission published far reaching proposals for the modernisation of EU copyright as part of its Digital Single Market Strategy.

The proposals include (i) a **draft Directive** on copyright in the Digital Single Market and (ii) a **draft Regulation** to facilitate online transmissions and retransmissions of television and radio programmes. They represent part of the Commission's drive to update EU copyright rules for the digital age and, ultimately, to improve integration and harmonisation of copyright across the EU.

Included in the draft legislation are:

- rules to facilitate wider access to content (including television and radio programmes, audio-visual and "***out of commerce***" works) online and across borders - these are the provisions which are designed to facilitate easier rights-clearance and licensing models to enable cross-border use of such content on online services;

- new copyright exceptions for certain uses of copyright works for education, research and cultural heritage – these are part of the Commission's aim to create a level playing field for particular uses of copyright works across the EU in view of the advancement of digital technologies; and

- measures aimed at creating a "***fairer online environment for creators and the press***" - this includes a new "neighbouring" right for publishers, labelled by some as the "***google tax"*** on snippets.

Whilst the proposals have been welcomed by press associations, rights holders and others, some of the draft measures are not without their critics. The proposed introduction of the "neighbouring" right for press publishers in relation to the use of their works online - particularly by search engines - and further controls on the use of content on video sharing platforms have proved particularly controversial; these rules are aimed at reinforcing the position of right-holders and giving them a right to be separately remunerated for such uses of content. However, opponents have labelled the measures a win for "old media".

Of course, the long term impact in the UK of changes in copyright at EU level is currently uncertain in the wake of Brexit. However, with the UK digital sector currently estimated to be worth £118 billion a year, and with roughly 43% of UK digital exports going to the EU, amendments to EU copyright rules will continue to be of central importance even after the UK has formally left the Union.

Having said that, alongside the publication of this EU-wide draft legislation the UK Government has launched a Select Committee inquiry into the impact of Brexit on the Digital Single Market (Inquiry into the impact of Brexit on the Creative Industries, Tourism and the Digital Single Market) and it will be interesting to see if, and with what conviction, there is appetite to engage with a disentanglement in this area. We suspect it could be quite soft.

For further information please contact Paul Jones.

Arbitration: a more attractive option post-Brexit?

Our Q3 edition (issued immediately after the referendum decision) noted the uncertainty around whether, post-Brexit, it will be more difficult to enforce English court judgments in the EU.

Arbitral awards are less susceptible to these concerns because a successful party's right to enforce them isn't derived from EU legislation; it comes instead from the 'New York Convention' – an international treaty to which the UK will remain a party post-Brexit.

A knock-on effect of the uncertainty is that contracting parties are paying closer attention to boilerplate provisions which deal with jurisdiction, and weighing up whether it's preferable to specify that disputes should be resolved through arbitration instead of the English court.

It's important to consider the question carefully in the context of the particular background facts but, by way of introduction, here's an overview of the key factors:

- In most cases, the arbitration and litigation processes are very similar, involving exchanges of statements of cases, disclosure, witness statements, expert evidence, and a final hearing followed by a binding decision.

- **Confidentiality**: in broad terms, arbitration is confidential but litigation is not. If a dispute with the other side could raise sensitive issues which are better not ventilated in public, the privacy afforded by arbitration may be preferable.

- **Tailored procedure**: arbitration is more flexible and can allow the parties to select arbitrators and tweak the procedure to reflect the quirks of a particular dispute. In most cases, however, the procedure bears a striking resemblance to litigation.

- **Cost**: arbitration can be more expensive than litigation because the fees payable to the arbitrator will exceed those of the court. It can be a disproportionate means of dealing with very small disputes. But, if the procedure is tailored, the process can become more efficient and cheaper overall.

- **Range of powers**: the court has greater powers than an arbitral tribunal. For example, it can quickly issue interim injunctions or freezing orders, and take action against third parties who didn't sign up to the contract containing the arbitration clause. However where the arbitrators need this additional support, they can call upon the court to assist.

- **Access to the decision maker**: smaller procedural decisions are taken more quickly by arbitrators, over email or conference call. The formality of the Court process means that accessing the judge takes longer and can cost more.

- **Ease of appeal**: the grounds on which an arbitral award can be challenged are narrower and it's less likely that a dispute will be prolonged through a series of appeals. This adds commercial certainty to the outcome, but it can work against the losing party who would rather have another bite at the cherry.

- **Enforcement**: An arbitral award may be easier to enforce outside the UK than a court judgment. This was already the case in some jurisdictions (eg Russia) but post-Brexit this may also be true of EU countries.

For further information please contact Kate Allass.

Software resellers may now have rights under the Commercial Agents Regulations

The High Court has recently ruled that the Commercial Agents Regulations did apply to a situation where an agent was selling commoditised software on behalf of its principal (in ***The Software Incubator Ltd v Computer Associates Ltd [2016]***).

The Regulations are designed to enhance and protect the position of commercial agents in relation to their principals, and entitle agents to commission for post-termination sales and compensation, regardless of the reasons for the termination of the underlying agency agreement.

It had been previously thought that such arrangements were outside the scope of the Regulations (which only apply to agents who supply goods on behalf of their principal, not services), save in situations where software was bundled in with hardware. In coming to this conclusion, the judge held that the modern interpretation of a software product that is licensed on a perpetual basis should allow it to be treated as a good, albeit that it is not tangible.

This could have significant implications for software resellers who may, if now protected by the Regulations, be entitled to significant compensation if the agency arrangement breaks down. It may also have ramifications for other agency arrangements not previously thought to have been caught by the Regulations.

Software providers who use resellers with the authority to negotiate and conclude contracts on behalf of their principals for the sale of unlimited licences for software products should carefully assess the basis upon which the reseller is engaged to determine whether the Regulations apply and, if they do or might do, the implications arising. If they do not, then they could be stung by the no-fault automatic compensation mechanisms provided for in the Regulations.

As such, now may be the time for software providers to review their reseller agreements and consider whether any changes to the 'consequence of termination' provisions are necessary in light of this judgment.

For further information please contact David Copping.

Tell me more...

If you'd like to discuss any of these issues further, please contact the authors or speak to David Fletcher on **020 3375 7117** or email him at david.fletcher@farrer.co.uk.