EMPLOYMENT
LAWYERS
P.O. BOX 353
UXBRIDGE UB10 0UN
TELEPHONE/FAX 01895 256972
E-MAIL ela@elaweb.org.uk
WEBSITE www.elaweb.org.uk

FRC Directors Remuneration Consultation

Response from the Employment Lawyers Association

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INTRODUCTION

The Employment Lawyers Association ("ELA") is a non-political group of specialists in the field of employment law and includes those who represent Claimants and Respondents in the Courts and Employment Tribunals. It is therefore not ELA's role to comment on the political merits or otherwise of proposed legislation, rather to make observations from a legal standpoint. ELA's Legislative and Policy Committee is made up of both Barristers and Solicitors who meet regularly for a number of purposes including to consider and respond to proposed new legislation.

A sub-committee was set up by the Legislative and Policy Committee of the ELA under the chairmanship of Jonathan Chamberlain of Wragge & Co LLP and Paul Harrison of Baker & McKenzie LLP to consider and comment on the FRC's Directors Remuneration Consultation. Its report is set out below. A full list of the members of the sub-committee is annexed to the report.

Our comments are set out against the consultation questions, which we have numbered consecutively from the start of the document.

Q1) **Is the current Code requirement sufficient, or should the Code include a "comply or explain" presumption that companies have provisions to recover and/or withhold variable pay?**

This is a policy question beyond ELA's remit.

Q2) **Should the Code adopt the terminology used in the Regulations and refer to "recovery of sums paid" and "withholding of sums to be paid"?**

Using both terms recovery and withholding would have the benefit of consistency. Also if the Code includes a "comply or explain" provision, requiring companies to comply or to explain non-compliance, then using the same terms in the policy and implementation reports would be sensible. ELA also considers that using both terms would add clarity. .However, terms used in this area are not terms of art. "Clawback" is sometimes used as a generic term to refer to both "recovery" and "withholding" but in the financial services context it generally has a specific meaning and is used in contrast to "malus". For example, in FSA consultation paper 10/19 clawback was defined as "a performance adjustment practice that enables firms to demand payback of all or part of an individual's bonus that has already vested with the individual to take account of developments after vesting" in contrast to malus which meant "a performance adjustment practice that allows firms to adjust the as-yet unvested portion of an individual's bonus to take account of developments after communication of the bonus". Broadly similar definitions were included in the CEBS Guidelines on Remuneration Policies and Practices. We note that the GC100 and Investor Group Guidance states that although recovery and withholding are not defined, they do not align exactly with the way in which the terms "clawback" and "malus" are used and recovery can encompass both clawback and malus. Whichever term is used, the meaning should be

clear and consideration should be given to providing a definition - at least if the Code includes a 'comply or explain' provision.

Q3) **Should the Code specify the circumstances under which payments could be recovered and/or withheld? If so, what should these be?**

Given the wide variety of remuneration schemes and the wide variety of industry sectors which will be covered, it is not possible to be prescriptive about the circumstances when recovery or withholding should apply.. Although there is a degree of prescription in the FCA remuneration code, this applies to one specific sector where there certain factors (e.g. risk management) have been identified as industry specific and there is a high degree of regulation of the way in which remuneration is paid (and in particular the proportion which is deferred). ELA notes that the ABI Principles of Remuneration do not seek to specify any particular factors which should lead to clawback/malus adjustments. The relevant circumstances will therefore have to be fairly generic (e.g. performance/misconduct/misstatement) . However, if from a policy perspective FCA is able to identify certain minimum circumstances where recovery/withholding would be appropriate ELA considers it would be helpful to set them out as this is an area where (outside the financial services context) practice is still developing. If such circumstances are identified, it would be important that the terms used are clear and it should also be made clear which awards might be subject to recovery and over what time period for example would a bonus only be "recovered" if something subsequently came to light relating to the year in respect of which the bonus was awarded, rather than subsequent events.

Q4) **Are there practical and/or legal considerations that would restrict the ability of companies to apply clawback arrangements in some circumstances?**

There are numerous practical and/or legal considerations including, but not limited to, the following:

Recovery of sums already paid (i.e. "clawback")

i. Once a director/employee has "earned" a bonus the courts tend to interpret restrictively any right or discretion for the company to recover it. However, if a clause is drafted clearly enough and is properly drawn to the director's attention from the outset, it is legally possible to have an enforceable obligation to recover. There will often be, however, potential for disputes about whether a repayment is triggered in any particular circumstances.
ii. If a director remains in employment, it will be possible to provide that the recoverable amount be deducted from future payments. For directors who are no longer employed, the Company would have to pursue a claim, ultimately through the courts. If the director had already spent the money, this may make it more difficult to recover legally or practically) and could even encourage profligacy on the part of the director. Given the potential legal costs in pursuing the director and the uncertainty of success it would often not be in the company's best interests to pursue the matter.
iii. It may be considered desirable (in the absence of fraud) for there to be a time period within which payments may be recovered? If so that period needs to strike a balance between fairness to the director and shareholders. An indefinite ability to claw back would mean that the director could never safely spend the money - unless the clawback was limited to extreme circumstances (e.g. serious misconduct) such that the director would know whether he was at risk of having to repay.
iv. At present it is very difficult for the company or individuals to recover tax deducted or NICs paid when sums which have already paid are recovered. ELA is aware of a recent example

where in the case of clawing back enhanced maternity benefits HMRC were very reluctant to permit recovery.

v. If the employment contract of any director is governed by law other than that of England and Wales it needs to be noted that clawback provisions are not enforceable in all jurisdictions.

vi. The Code places a potentially heavy burden on companies and their advisers to draft not merely contracts but all executive remuneration schemes in a way consistent with its provisions. Remuneration may be said to be conditional but with little clarity as to what the conditions are or over what period they remain in force.

Withholding of sums to be paid (malus)

i. Malus/withholding is generally less problematic. The provision would still need to be clearly drafted and communicated to a director, but the issues of practical enforcement, the tax issues and the ability of the director to know when he can spent the amount are addressed (assuming the amounts are not subject to recovery/clawback once vested).

Q5) Are changes to the Code required to deter the appointment of executive directors to the remuneration committees of other listed companies?

This is a policy question beyond ELA's remit

Q6) Is an explicit requirement in the Code to report to the market in circumstances where a company fails to obtain at least a substantial majority in support of a resolution on remuneration needed in addition to what is already set out in the Regulations, the guidance and the Code?

This is a policy question beyond ELA's remit

If yes, should the Code:

- **set criteria for determining what constitutes a 'significant percentage';**
- **specify a time period within which companies should report to the market and, if so, by what method; and/or**
- **specify the means by which companies should report to the market and, if so, by what method?**

Are there any practical difficulties for companies in identifying and/or engaging with shareholders that voted against the remuneration resolution/s?

Assuming the response to the opening question is "yes", these questions raise policy or practical issues to which we are not best placed to respond. However, from a legal perspective, in respect of the first bullet point we consider that it would be helpful if the Code does set criteria for determining what constitutes a 'significant percentage'. This is needed to ensure that there is sufficient clarity for all involved. Failure to set criteria for determining what constitutes a 'significant percentage' in circumstances where there will be obligations upon a company arising from a failure to secure this level of support is likely to result in unnecessary and avoidable disputes between companies and shareholders on this point and inconsistent practice.

Q7) **Is the Code compatible with the Regulations? Are there any overlapping provisions in the Code that are now redundant and could be removed?**

We note that there are provisions of the Code which overlap with requirements of the Regulations. We have set out the main examples below:

Code requirement	**Regulations requirement**
The annual report should identify the chairmen and members of the board committees. (Provision A.1.2)	The annual remuneration report must name each director who was a member of any committee which considered matters relating to the directors' remuneration for the relevant financial year. (Paragraph 22(1)(a) of Schedule 8 to the Regulations)
Where remuneration consultants are appointed, they should be identified in the annual report, and a statement made as to whether they have any other connection with the company. (Provision D.2.1)	The annual remuneration report must state whether any person provided any advice or services to the committee in their consideration of matters relating to directors' remuneration, and name any person that has done so. (Paragraph 22(1)(b) of Schedule 8 to the Regulations) In the case of any such person, the report must state the nature of any other services that that person has provided to the company during the relevant financial year, and whether and how the committee has satisfied itself that the advice received was objective and independent. (Paragraph 22(1)(c) of Schedule 8 to the Regulations)
Upper limits on annual bonuses should be set and disclosed. (Schedule A)	The directors' remuneration policy (in the future policy table) must set out the maximum that may be paid in respect of each component of the remuneration package, including annual bonus. (Paragraph 26(c) of Schedule 8 to the Regulations)

However, despite these areas of overlap, we do not suggest that the provisions of the Code noted above are "redundant" or should be removed. This is for two reasons:

- Some of these provisions in the Code apply more widely than their counterparts in the Regulations, which are restricted to the executive remuneration context. For example, Code Provision A.1.2 applies to all board committees, not just the remuneration committee.

- The application of the Code is wider than to the Regulations, in terms of which companies are within their scope. The Regulations only apply to companies incorporated in the UK, whereas the Code applies to all companies with a Premium Listing, regardless of whether they are incorporated in the UK or elsewhere.

We therefore suggest that the overlapping provisions are retained. However we also suggest that a section should be added to Schedule B of the Code ("Disclosure of corporate governance arrangements"), and to the Appendix ("Overlap between the Disclosure and Transparency Rules and the UK Corporate Governance Code") to explain the relevant requirements of the Regulations and their overlap with the Code, in the same way as is done currently for the Disclosure and Transparency Rules and the Listing Rules.

Q8) Should the Code continue to address these three broad areas? If so, do any of them need to be revised in the light of developments in market practice?

In respect of the first question, whether or not the Code should continue to address these three broad areas is a policy issue and as such is not the principal focus of our response. In respect of the second question, we have focussed only on the first bullet point (i.e. aspects of performance-related remuneration for executive directors) as this is the area upon which we are best qualified to comment in our role as employment lawyers. Assuming that the answer to the first question is "yes", we do not believe that developments in market practice require changes to the Code.

ELA Sub-Committee Members

Jonathan Chamberlain, Wragge & Co LLP – **Co-chair**
Paul Harrison, Baker & McKenzie – **Co-chair**

Greg Campbell, Mishcon de Reya Solicitors
Clare Fletcher, Slaughter and May LLP
Sarah Gadd, Latham & Watkins
Alan Jones, Averta Employment Lawyers LLP
Stephen Levinson, Keystone Law
Jane McCafferty, 11 KBW
Eilidh Wiseman , Dundas & Wilson CS LLP