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Restoring trust in audit and corporate governance

Response from the Employment Lawyers Association

8 July 2021

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INTRODUCTION

1. The Employment Lawyers Association (“ELA”) is an unaffiliated and non-political group of specialists in the field of employment law. We are made up of about 6,000 lawyers who practice in the field of employment law. We include those who represent Claimants and Respondents/Defendants in the Courts and Employment Tribunals and who advise both employees and employers. ELA’s role is not to comment on the political merits or otherwise of proposed legislation or calls for evidence. We 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 and regulation or calls for evidence.
2. A Working Party, chaired by Alistair Woodland was established by the ELA City Regulation Committee to respond to the Department of Business, Energy and Industrial Strategy’s consultation “Restoring trust in audit and corporate governance” (“the CP”). The members of this sub-committee are listed at the end of this paper. Unless otherwise stated, references in this response to questions and paragraph numbers are to paragraphs in the CP.
3. The Working Party has concentrated on responding to question 34 of the CP, which engages employment law issues and on which the sub-committee is best able to comment. For the purposes of this response, we have divided question 34 into two parts as follows:
 - 3.1. 34(A). Are there other conditions that should be considered for the proposed minimum list of malus and clawback conditions? and
 - 3.2. 34(B). What legal and other considerations need to be taken into account to ensure that these conditions can be enforced in practice?
4. References in this paper to the views of ELA are intended to be inclusive of the views of the minority as well as the majority of ELA members. Whilst not exhaustive of every possible viewpoint of every ELA member on the matters dealt

with in this paper, the members of the Working Party have striven to reflect in a proportionate manner the diverse views of the ELA membership.

EXECUTIVE SUMMARY

5. Our response explains that there may be merits in preparing separate lists of malus and clawback grounds, with clawback powers relating only to the most serious situations. We suggest that both lists should include appropriate references to materiality, and that the clawback and malus rules in the FCA Handbook may be instructive.
6. The legal and practical challenges of enforcing clawback are significant. Therefore, malus is likely to be more readily available to employers than clawback, provided that adequate deferral rules (as well as malus and clawback provisions) have been incorporated into variable compensation plans. We suggest that a two year deferral period may be insufficient to facilitate the practical application of these provisions, because the sorts of complex matters which would trigger the application of malus or clawback (including financial misstatement, control function failures) can take years to come to light. Details of other enforceability considerations are set out further below.

QUESTION 1

34(A). Are there other conditions that should be considered for the proposed minimum list of malus and clawback conditions?

INTRODUCTION

7. Notwithstanding the fact that para 5.2.5 of the CP refers only to clawback, for the purposes of our response we have assumed that it is intended to refer to minimum conditions for malus and clawback and that this would be clarified in any final articulation of such minimum conditions.
8. In our view, given the practical and legal challenges of enforcing clawback (see further below), the primary emphasis for any new requirements should be to ensure that companies have appropriate malus powers to enable adjustment both in year (i.e. to adjust annual bonus outcomes) and before vesting of any deferred bonuses or long term awards. Set out below are our recommendations in respect of additional conditions, as well as some drafting comments on the proposed conditions and practical points for consideration.

OTHER MALUS AND CLAWBACK CONDITIONS AND COMMENTS ON THE LIST IN PARA 5.2.5 OF THE CP

9. As a general observation, the proposed list of clawback triggers in para 5.2.5 is broadly drafted. Whilst the proposed list in para 5.2.5 covers a wide range of situations, consistency with the approach to the malus and clawback in the financial services sector (e.g. SYSC 19D.3 of the FCA Handbook) would potentially have benefits: for example, it would allow divergence between grounds for malus and clawback, with clawback powers relating only to the most serious situations.
10. Both sets of grounds should include appropriate materiality thresholds (see below) and arguably should not be "closed" lists (i.e. should give companies some flexibility to deal with unforeseen, yet material, situations). We agree with the proposal in the CP that companies should be able to and should actively consider adding to any prescribed minimum conditions to reflect company-specific or sector-specific circumstances.
11. We would expect malus grounds to include: (i) reasonable evidence of director misbehaviour or material error or culpability; and (ii) where the company or business unit suffers a material downturn in its financial performance; and (iii) where the company or business unit suffers a material failure of risk management.
12. We would expect clawback grounds to be somewhat narrower than those for malus, to include at a minimum (i) reasonable evidence of director misbehaviour or material error; and (ii) where the company or business unit suffers a material failure of risk management. We would not typically expect material downturn in financial performance to be a trigger for the operation of clawback (as opposed to malus).
13. Widening malus and clawback powers will meet resistance from executive directors who - despite employment law constraints on the exercise of discretion - will fear that that variable pay is devalued and at risk of arbitrary remuneration committee decision making. These fears could be addressed to some extent by ensuring that any malus and clawback triggers have appropriate materiality. The wording of the malus and clawback triggers in SYSC 19D.3.63 and 64 are instructive, as are the required considerations for companies set out in SYSC 19.3.64(2). Adoption of similar principles here could require that a company must take into account all relevant factors (including proximity of the employee and their level of responsibility) in deciding whether and to what extent it is appropriate (e.g. in the sense of being *Braganza* non-capricious) to seek recovery/ reduction of some or all vested/ unvested remuneration. This would both offer comfort to executive directors and assist companies in taking decisions on malus and

clawback lawfully, reducing litigation risk which is often inherent in such determinations.

QUESTION 2

34(B). What legal and other considerations need to be taken into account to ensure that these conditions can be enforced in practice?

14. To date clawback powers have not been widely used, often because the contractual matrix introduced by companies was inadequate (for example, a company may not have express consent of recovery of previous payments and/or to off-set sums from other remuneration due) and concerns that recovery of remuneration granted before the introduction of clawback would not be permitted by the terms of awards. Other barriers to clawback include the inability to enforce it in some jurisdictions (creating an unlevel playing field) and lack of clarity about the ability to recover tax on cash and share awards (see further below).
15. It should be noted that malus and clawback rules typically only apply to variable pay. Thus, as it is extremely rare for variable pay awards to be made to non-executive directors to receive variable pay, enhancement of malus and clawback powers will not have a material impact on them. Successful operation of malus powers is generally dependent on companies having adequate deferral rules in their variable compensation plans.
16. In our view, there are a number of issues which may prevent the employer exercising these provisions in practice:-
 - 16.1. Firstly, we think that it may amount to an unenforceable penalty to require individuals to repay the gross amount received by them (rather than the net) amount. A practice has developed in the banking sector (the PRA included a clawback requirement in the Remuneration Chapter of the PRA Rule Book for CRR Firms in January 2015) of only requiring an individual to repay the net amount received (and to co-operate in seeking repayment of tax from HMRC).
 - 16.2. The two year malus/clawback period may limit the practical application of these provisions, because the sorts of complex matters which would trigger the application of malus or clawback (including financial misstatement, control function failures) can take years to come to light (and the time required to investigate and apportion responsibility for them can take even longer). Contrast the PRA requirement which is seven years from the date of award. There would be a logic, in our view, to tying in the malus/clawback period with the current UK Corporate Governance Code requirement that share awards to promote long term shareholdings

by executive directors should subject to total vesting and holding period of five years (Part 5 Paragraph 36).

- 16.3. In the financial services context, UK regulators have provided guidance on the circumstances in which firms should actually operate the malus and clawback provisions. Without the equivalent of this in regulatory guidance, it might be more difficult for an employer to justify the exercise of discretion to apply malus/clawback in practice (an increased scope for employees to challenge the unlawful exercise of discretion by their employer). For example:
 - 16.3.1. in circumstances where directors were not personally involved or culpable; or
 - 16.3.2. in relation to compensation awarded in years other than those in which the wrongdoing occurred.
- 16.4. That said, we also have sympathy for the view that the government should be cautious about imposing more strictures on exercise of discretions than the Supreme Court does. Such viewpoint may militate against the provision of further guidance on malus and clawback in this context.
- 16.5. Without the equivalent of the PRA rules which require subsequent employers to replicate malus and clawback provisions in respect of "buy outs", there is a risk that employees who become aware of facts which might lead to the application of malus and clawback will leave the employer where such facts arose to join another employer who will buy out their existing awards (that is, the risk of rolling bad apples).
17. In addition it should be noted that remuneration committees of listed companies have been extremely cautious about operating clawback for continuing directors given their public reporting obligations, in particular the need to disclose how any discretion has been exercised (i.e. unless a director has already left or is being dismissed in connection with the issue in question, companies will not want to make public disclosures which infer serious misconduct or accountability failings of executive directors).
18. As a closing remark, we note the focus in the CP on clawback powers in the context of corporate failure, and the Thomas Cook example given in para 5.2.3. It should be noted that, upon the insolvency of a company, insolvency practitioners rather than remuneration committees may find themselves responsible for making determinations in respect of malus and/or clawback. The wrongful trading regime under the Insolvency Act 1986 may give additional

recourse against directors (or shadow directors) pursuant to which they may be required to contribute to a company's assets in the event of an insolvency.

Members of ELA Working Party

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Anna Greenley	Devereux
Jean Lovett	Linklaters LLP
Tom Ogg	11KBW
Kate Pumfrey	Freshfields Bruckhaus Deringer LLP
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