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Bank of England, Prudential Regulation Authority and FCA consultation on Risk & Reward: PRA CP15/14/FCA.

Response from the Employment Lawyers Association

27 October 2014

Bank of England, Prudential Regulation Authority and FCA consultation on Risk & Reward

Response from the Employment Lawyers Association

INTRODUCTION

1. 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 courts and employment tribunals. It is not ELA's role to comment on the political or policy merits or otherwise of proposed legislation, rather it is to make observations from a legal standpoint. Accordingly in this consultation we do not address such issues. 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.

2. The Legislative and Policy Committee of ELA set up a sub-committee under the co-chairmanship of Caroline Stroud of Freshfields Bruckhaus Deringer LLP and Stephen Levinson of Keystone Law to consider and comment on the consultation paper from the Bank of England, Prudential Regulatory Authority (***PRA***) and Financial Conduct Authority (***FCA***) published in July 2014 on a new regulatory framework for individuals. Its response is set out below. A list of the members of the sub-committee is in Appendix 1 to this response.

3. Our response is only addressed to those non-policy questions we considered it appropriate to address.

EXECUTIVE SUMMARY

A. Generally in relation to these proposals whilst we entirely understand the objectives and have no intention of questioning the policy objectives it is clear from the detailed observations we make in this paper that we have serious concerns both about the way they will operate and for the potential they have for unintended or unfortunate consequences.

B. Also whilst it is not our role to express a view on the impact that these proposals may have on the attractiveness of the UK as one of the world's most competitive financial centres we consider this must be an important factor to be considered when deciding on the final form of these proposed rules by both the FCA and PRA who should include a review of equivalent rules in other jurisdictions.

C. It seems probable that one of the probable effects of these proposals would be increases in the levels of fixed pay which would run counter to the preferred linking of pay to performance and lead to a lack of flexibility when reacting to times of stress.

D. We do not agree with the principle of introducing a two-level approach for deferral, with longer deferral for senior managers.

E. The absence of a mechanism for the mitigation of a number of these proposals is considered likely to encourage an increase in litigation over pay: a greater degree of flexibility might avoid his risk.

F. We doubt that any of the proposals to ban or restrict buy outs are workable and agree that reliance on clawback is the only practical approach.

G. Generally in relation to clawback we refer to the response we provided on 13 May 2014 to the Bank of England, Prudential Regulation Authority consultation on clawback: CP6/14 and to the extent relevant we incorporate those observations in this paper. For ease of reference a copy of that response is included as Annex 2 to this response.

Question 1: Do you agree with the principle of introducing a two-level approach for deferral, with longer deferral for senior managers?

1) More onerous deferral requirements for senior managers may:

- impact the reward packages for individuals carrying out senior manager functions with a move to increasing the fixed pay component (for those other than non-executive directors who are only able to receive fixed pay); and

- adversely impact the willingness of individuals to be appointed to a SMF, particularly when combined with the new enforcement regime and more stringent clawback terms; and

- create a two-tier work force where the interests of senior managers and other employees is not always aligned.

2) If a two-level approach is adopted, clear guidance will need to be provided on the time from which the new deferral and clawback requirements will apply. Will firms be expected to anticipate the introduction of the new regime in the terms of the awards made in early 2015 (i.e. so that those who are expected to take on SMFs once the regime is effective have a seven year deferral applied for 2015 awards) or is it only those awards made after the regime takes effect which must have the longer deferral period?

3) In addition, how will firms be required to apply deferral to MRTs who become senior managers – will the longer deferral period only apply from the date they take on the senior manager role or is there any expectation that the deferral periods of existing awards would be extended?

4) Consideration should be given to whether it is more effective to fix the minimum percentage deferral for senior managers rather than the deferral period and also whether the extended clawback period makes the longer deferral unnecessary. We have general concerns for the inflexibility of the proposed scheme.

Question 2. Do you agree with extending the deferral period to seven years for senior managers?

5) See also our response to Question 1.

6) It is not clear why an arbitrary period of seven years is appropriate if it is not linked to the relevant time horizon for the risks for which that the senior manager is responsible. It is also not clear why those in senior manager / oversight roles should be held accountable for longer than their direct reports.

7) Consideration would need to be given to the impact on the reward packages for those individuals who take on senior manager roles and whether the longer deferral will devalue that element of the package in the eyes of senior managers, so drive up fixed salary and reduce a firm's ability to manage its remuneration costs in times of business stress. It seems to us that this proposal may

undermine the good/bad leaver terms in many exiting reward schemes and may well be inconsistent with the rules in many other jurisdictions.

Question 3. Do you agree with introducing an additional requirement that no deferred variable remuneration should vest earlier than the third anniversary of award for senior managers?

8) Any minimum vesting period needs to be considered in conjunction with the overall longer deferral period and the clawback period. It effectively operates to penalise individuals for being senior managers.

9) It may allow for greater alignment of employees within a firm to have a five year deferral period with no vesting before year three or a seven year deferral period with vesting pro rata from year one.

Question 4. Do you agree that five years is an appropriate minimum requirement to apply to all other MRTs, bearing in mind the range of roles covered?

10) Although firms may choose to have a uniform deferral period for the sake of simplicity, it may be appropriate to allow flexibility for shorter deferral periods for particular roles (without the need for a firm to apply for a waiver) – in particular where an individual is only a MRT by reference to the level of return.

Question 5. Do you agree with the FCA's proposals to introduce a requirement for minimum clawback period of seven years for all MRTs, in line with the PRA rule?

11) There should be consistency of treatment across both the PRA and the FCA (i.e. not one rule for one and another for the other) in order that there is clarity of treatment that allows employers to understand how to treat its employees.

Question 6. Do you agree with the proposal to introduce a requirement to provide for a possible extension of the clawback period of up to three years for Senior Managers if there are outstanding investigations underway at the end of seven years?

12) From the wording in the consultation paper, it appears that employers are to have a discretion to extend the clawback period rather than it being compulsory. As this is discretionary, employers will need to consider putting in place a robust process for determining when the extension should be applied, but in any event, where there is discretion, there is an increased likelihood of litigation. In addition, the employer can extend the period for "up to three years" meaning that within the discretion to extend there is a further discretion as to the period of time for which it can extend – again this is likely to be challenged by an employee and could create litigation.

13) Further, as this is discretionary, it is not clear what the regulator's involvement will be in this area i.e. will they challenge a Firm's use of discretion when deciding on whether to extend clawback or not?

14) Extending the clawback period leads to a tension about whether the employer is permitted to inform the employee that it is being extended given this may tip off the individual that they are under investigation. However, a carefully drafted clawback provision may get round this issue. Further, any extension of the clawback period could be argued to be a pre-judgment of the employee's guilt of any wrongdoing.

15) It is not clear why the extended period is for three years only. If an individual remains under investigation after the end of the extended period of clawback, there is no mechanism that allows for the employer to extend further. In addition, in relation to malus, the requirement is for an employer to freeze the vesting of all awards until an investigation has concluded.

16) There is a different test for applying the extended clawback period as against an extended deferral (malus) period. The test for the extension of the clawback period appears to be broader than that for extending malus i.e. malus relates to ex-post facto risk adjustment and clawback relates to events that may lead to the application of clawback. It would be helpful if the approach with regard to malus and clawback were consistent as this in turn would then lead to a more consistent approach by employers.

17) A seven year clawback period creates difficulties in enforcement because of the time elapsed and both locating the individual and being able to recover any sums of money from them. To extend this period by a further three years makes the task even more burdensome on the employer.

18) There is a potential for this provision (as well as others that are being proposed) to result in individuals not wanting to take on "Senior Manager" roles.

Question 7: Do you agree with the proposal to make explicit in the remuneration rules the presumption against payment or vesting of any discretionary payments, including entitlements to payment for loss of office and discretionary pension benefits?

19) We agree with the proposal, but note that where there are no grounds to terminate an individual's employment summarily (e.g. for gross misconduct), it will only be possible to terminate employment with immediate effect if the employment contract contains an express provision (usually a payment in lieu of notice (PILON) provision) allowing the firm to do so or if the individual gives her or his agreement. The individual will usually only give her or his agreement if the firm agrees to make a termination payment. We suggest consideration be given to clarifying the position, so that (where appropriate) a firm can make a termination payment under a PILON or, where there is no PILON and no grounds for summary termination, can make an agreed termination payment.

Question 8: What do you see as the advantages and disadvantages of the approaches identified?

20) We consider that the first 3 approaches put forward in the CP to be highly problematic and not only for the disadvantages identified in the consultation paper.

Approach 1. Banning buy outs.

21) As well as having a significant detrimental impact on the competitiveness of UK firms who are subject to this restriction (depriving them of the ability to hire appropriately), a ban would in the short term place the financial "cost" associated with a move on the individual, who is the party least able to bear that cost: an employee who wishes to move for what may be wholly legitimate reasons would be required to forfeit potentially substantial sums of money for the privilege of doing so.

22) The implications of this are:

- Employees may delay moving even when it may be in their best interests to do so;
- Recruiting firms will be under pressure to "make good" any loss suffered by the employee, giving rise to an increase in salaries, guaranteed bonuses, or other fixed benefits.

- Firms will be vulnerable to losing staff to overseas and other UK firms not subject to these rules.

Finally, it would be extremely difficult for the regulator to police such a widespread ban.

23) We did consider whether buy outs should only be banned where the new employer knows or has reason to suspect that the employee is subject to outstanding disciplinary action with the old employer) but concluder this would not assist. If this were the case, and there was sufficient concern about the employee's conduct, then this is something that would be disclosed as part of a regulatory reference and would go to fitness and propriety (meaning that a new employer is unlikely to take that person on).

Approach 2. Maintaining existing awards

24) The vast majority of deferred compensation schemes on which we advise contain provisions entitling the employer to forfeit awards for "bad leavers", which often include individuals who leave to join a competitor. Requiring firms to change these sorts of standard provisions would create the following problems.

- Be administratively complex, and may not in practice be possible in respect of existing awards (many schemes prevent disadvantageous amendments to the terms of awards that have already been made).
- Require firms with global plans to treat UK employees in a unique way. This may make these global firms less likely to base key individuals (who they are concerned about losing) in London/ the UK.
- Deprive firms of a legitimate tool which is designed to encourage retention and workforce stability. This could lead to higher staff turnover and increased costs.
- Create significant conflicts of interest, particularly in respect of senior employees who would be financially incentivised to see a competitor perform strongly to maintain the value of deferred compensation (this issue would appear to arise even if the deferred compensation were converted into cash, since the old employer might apply malus if there was a down turn in financial performance of the business as a whole).

Finally, this proposal would not prevent an employer awarding some sort of guarantee to the individual to apply in the event that deferred compensation with the previous employer is lost (such arrangements are not uncommon now where it is not clear whether the old employer will deem the new employer to be a competitor for example). Thus Approach 2 would only really be effective if used in combination with Approach 1 (which itself is problematic for the reasons set out above)

Approach 3. Regulator to apply malus

25) We think there are significant difficulties with the proposal that the regulator should reserve the right to make a malus determination directly and impact the employee.

26) First, it is not clear how such a power would be implemented in practice, the regulator not being a party to the contractual arrangements (for example, a share scheme) that govern the basis on which the buyout is awarded. For example, it is difficult to see how the regulator could enforce a decision to "clawback" compensation already awarded.

27) Secondly, the decision to apply malus to deferred compensation requires an employer to exercise its discretion based on a range of factors which the employer is uniquely well placed to determine. For

example, the question consistency of treatment with other employees, or taking a proportionate approach in light of the position taken in relation to past exercises, is something that only the employer can really determine.

28) Thirdly, firms applying malus decisions typically adopt a formal procedure to avoid any allegation that they have exercised a discretionary power unreasonably. This may involve giving the employee a right of reply, a reasoned decision, and / or a right of appeal against that decision. We do not think it practical to expect the regulator to take the same approach. This could lead to unfairness for the employee and / or expose the regulator to the risk of legal proceedings brought by disgruntled employees.

29) Fourthly, the regulator may be unable to enforce such provisions against employees who live abroad.

Approach 4. Reliance on clawback

30) We see no particular disadvantages in respect of Approach 4.

Question 9 What views do you have on the potential options for addressing the disadvantages of particular approaches?

Question 10 What are the relative merits of pursuing the different approaches and any alternative approaches that might be identified?

31) Taking these two questions together in light of the substantive disadvantages of Approaches 1-3 above, we think Approach 4 is the only realistic option. We can think of no ways in which the risks of approaches 1-3 could be completely mitigated, but if the regulators are minded to adopt any one of them, we suggest that they should only be applied in respect of identified Staff (in line with the rules on malus and clawback).

Question 12. Do you agree that there should be a rule that simple revenue or profit-based measures may not be relied on to determine variable remuneration at aggregate or individual level, except as part of a balanced and risk-adjusted scorecard?

32) We agree with this proposal. However, we note that some firms will have to amend the terms of their incentive arrangements which expressly provide for these performance metrics to be used to determine variable remuneration. Should consideration be given to identifying other factors which firms should include (for the purposes of determining variable remuneration) that can make up a balanced and risk-adjusted scorecard. Examples could include regulatory compliance by an individual and her or his business unit and other individual risk-management related factors.

Question 13: Do you agree that there should be an explicit rule that non-executive directors should not receive variable remuneration in respect of activity carried out in their roles as non-executives?

33) We agree with this proposal. We note that a significant proportion of appointment letters for non-executive directors of UK listed companies only provide for the payment of a fixed monthly fee by way of remuneration and do not provide for any variable remuneration. However, the rule should not prevent an individual who has executive responsibilities in another group company from receiving

variable remuneration (where appropriate and subject to relevant restrictions) in respect of those executive responsibilities.

27 October 2014

APPENDIX 1

Members of the Sub-Committee

Caroline Stroud: Freshfields Bruckhaus Deringer LLP (Co-Chair)
Stephen Levinson: Keystone Law Limited (Co-Chair)
Alice Greenwell: Freshfields Bruckhaus Deringer LLP
Jane McCafferty: 11, KBW Chambers
Julie Morris: Slater & Gordon (UK) LLP
Tom Ogg: 11, KBW Chambers
Andrew Taggart: Herbert Smith Freehills LLP
Alistair Woodland: Clifford Chance LLP

APPENDIX 2

Bank of England, Prudential Regulation Authority consultation on Clawback

Response from the Employment Lawyers Association

INTRODUCTION

1) 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 courts and employment tribunals. It is not ELA's role to comment on the political or policy merits or otherwise of proposed legislation, rather it is to make observations from a legal standpoint. Accordingly in this consultation we do not address such issues. 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.

2) The Legislative and Policy Committee of ELA set up a sub-committee under the co-chairmanship of Caroline Stroud of Freshfields Bruckhaus Deringer LLP and Stephen Levinson of Keystone Law to consider and comment on the consultation paper from the Bank of England, Prudential Regulation Authority on Clawback published in March 2014. Its report is set out below. A list of the members of the sub-committee is annexed to the report.

3) Our comments are addressed to seven relevant issues which include the two specific areas set out in the consultation paper.

Executive Summary

A. The grounds for malus and clawback should not be the same. The grounds for clawback should be restricted to circumstances of personal culpability.

B. Enforcement may well prove difficult in the case of departed employees.

C. The potential difficulties of amending contracts and scheme rules in a number of circumstances have been underestimated.

D. Because of the practical difficulties of enforcement (and not any policy issues) clawback should be a last resort. Firms should be given a degree of flexibility in deciding the degree of clawback to be recovered. This would avoid conflict with the Civil Procedure Rules (CPR) that apply to litigation in England & Wales. In particular, (i) a firm should be free to adopt a proportionate approach to litigation (ii) it should only be required to recover the after-tax value of the remuneration; and (iii) it should be able to balance specific factual circumstances in determining the appropriate valuation of non-cash instruments.

E. Also for Remuneration Code Staff based outside the UK a firm should not be obliged to adopt clawback arrangements which are contrary to the laws of the jurisdictions in which the individuals are based outside the UK. This issue is not addressed in the consultation paper but could create considerable difficulties.

F. In our view requiring clawback to apply to variable remuneration awarded before 1 January 2015 but remaining unvested as of that date will clearly result in the employer being put to a disproportionate expense and level of work for something that may not be legally possible or will not affect all those individuals that the award applies to e.g. those who are no longer in employment.

G. Clawback provisions could constitute an unenforceable penalty, but this risk can be minimised with careful drafting.

H. Consideration should be given to the impact of Directors & Officers (D&O) insurance policies on the policy objectives of these proposals.

Issue 1

What is the definition of the conduct or circumstances that should justify clawback ('sufficient malfeasance')

4) The new text that is proposed at section 19A.3.51 of the Senior Management Arrangements, Systems and Controls rules (SYSC) of the UK Financial Services Authority states that a firm must ensure that "any variable remuneration is subject to clawback, such that it is not awarded save where it, or an amount corresponding to it, can be recovered from the individual by the firm in the 6 years following the date on which the remuneration is paid or vests, where the recovery is justified on the basis of the performance of the firm, the business unit and the individual concerned".

5) The new text at SYSC 19A.3.52 (1a) states that: "A firm should recover vested variable remuneration or an amount corresponding to it, where, as a minimum, any of the circumstances described in (1)(a), (b) or (c) arise within 6 years following the date on which the remuneration vested".

6) Paragraphs (1)(a),(b) and (c) provide as follows:

(a) there is reasonable evidence of employee misbehaviour or material error; or
(b) the firm or the relevant business unit suffers a material downturn in financial performance; or
(c) the firm or the relevant business unit suffers a material failure of risk management.

7) At 19A.3.51R a firm must:

(a) Set specific criteria for the application of malus and clawback; and
(b) Ensure that the criteria for the application of malus and clawback in particular cover situations where the employee:

(i) Participated in or was responsible for conduct which resulted in significant losses to the firm; or
(ii) Failed to meet appropriate standards of fitness and propriety.

8) The proposal is that the grounds for applying clawback should be as wide as the grounds for malus.

9) It is our view there should be a distinction between the grounds for malus and for clawback and that it should be made express that malus is expected to be applied first. This reflects the fact that where an employee has left the employer he is likely to have spent the remuneration received and several years will have passed since the conduct now being examined. The practical impact of the time lag will mean that there is more difficulty in establishing evidence as to whether the employee should fall within any of the grounds for clawback and secondly, the employee may not have the money anymore and therefore the negative financial impact on them is far greater.

10) Further, in circumstances where an employee has long left the employer, applying clawback where the business unit suffers a financial downturn and this is not linked to personal conduct appears unreasonably harsh if the employee has had no control over how the employer has been managed subsequently to their departure.

11) We therefore suggest that there should be an express personal culpability to the grounds for clawback in all cases before clawback is applied. This is particularly so in relation to ground 1(b) – material downturn in financial performance.

Issue 2

What are the principles on which the Remuneration Committee decides a senior person's responsibility?

12) It is suggested in the consultation paper that clawback should also be applied where there is no direct failure in relation to a case under 1 (c) involving a material failure of risk management or misconduct where the employee : (a) could have been reasonably expected to be aware of the failure or misconduct at the time but failed to take adequate steps to promptly identify, assess, report, escalate or address it; or (b) by virtue of their role or seniority could be deemed indirectly responsible or accountable for the failure or misconduct, including senior staff in charge of setting the firm's culture and strategy.

13) The principles to be applied in relation to determining a senior person's responsibility for a material failure of risk are not defined. It is suggested that a similar approach should be taken to that set out for malus in Supervisory Statement ss2/13. It will be essential in view of the likelihood that clawback may be considered many years after the events in question have occurred that firms have accurate role descriptions, reporting lines and organisation charts so that determining responsibility for reporting, escalating and deciding on issues in relation to risk is possible. The definition of roles and responsibilities for the most senior roles will link with the senior person's regime which is going to be consulted upon in summer 2014.

14) In addition, as for malus, a clear process for determining culpability, responsibility or accountability should be put into place by firm's including allowing an individual to make representations. Where clawback is being considered, in view of the significant evidential difficulties due to time having elapsed, and the increased practical impact on an individual where the money has been long spent, this is critical. Firm's will need to adapt any process for ex-employees in terms of giving extra time for representations and allowing representations to be made in writing to accommodate the difficulties of communicating with an ex-employee.

15) We view clawback, due to the practical difficulties of enforcement (rather than any policy issue), to be a last resort. Increasing vesting periods against which malus could be applied should be the preferred route for firm's seeking to reclaim remuneration and clawback should be applied in a period measured from the date of the award rather than vesting.

Issue 3

Application of clawback outside the UK

16) Firms are required to apply the Remuneration Code on a group wide basis. Most international firms have Remuneration Code Staff based outside the UK. The contracts of employment of those non UK Code Staff will be subject to local law, and would need to be enforced in the courts of the local jurisdiction. We are aware that in certain jurisdictions (such as France and Germany) a clawback

provision of the type proposed in the consultation paper will not be enforceable. We consider that firms should not be required to include a clawback provision in any contractual arrangement with an employee (or to enforce such an arrangement) where such a provision would be contrary to the law of the jurisdiction in which the individual is based.

Issue 4
In what manner should contracts be amended, particularly for existing but as yet unvested awards?
17) The consultation paper mentions amending employment contracts, we suggest that rules applicable to variable compensation are generally included in stock plan rules (Plan Rules) and therefore, it will be these Plan Rules rather than employment contracts that will need to be amended. In particular, amending employment contracts is not straightforward and something that employers will want to avoid. In particular amending employment contracts will only apply to current employees and not former employees in relation to existing but unvested variable compensation. In addition, where an employment contract has been breached by the employer, an employee may argue that the claw back provision is not enforceable going forward.

Awards granted after 1 January 2015

18) In relation to awards of bonuses going forward, (i.e. awarded 1 January 2015 onwards) including clawback provisions in agreements should be straight forward. When making an incentive award, a condition of payment of such an award should be that the employee agrees to the application of clawback in relation to the award – this will be particularly relevant for the upfront cash element of an award. Such wording could be included in the document outlining the level of the variable compensation e.g. a compensation statement.

19) In relation to the stock element of awards going forward, (i.e. awarded 1 January 2015 onwards) the Plan Rules relevant to the stock element of awards should be amended to include clawback language. As Plan Rules are generally introduced each year for new awards, this amendment can be made unilaterally and be a term of granting the award.

Existing but unvested awards

20) The consultation paper proposes that awards granted before 1 January 2015 that remain unvested as of I January 2015 should be subject to clawback. Generally Plan Rules relevant to stock awards will not be included in employment contracts – only references to the Plan Rules are included. Therefore, it is unlikely that there will be a need to amend employment contracts for existing but unvested awards.

Amending employment contracts

21) However, where employment contracts do contain language relating to the stock element of an award, an employer is required under SYSC TP 3 7(1) to amend the contract where they are "entitled to" amend. It is not clear whether ‘entitled’ means it is just where an employer can unilaterally amend a contract or in other circumstances as well e.g. where employee consent is required. If it is the latter, changes that require consent or are deemed to be detrimental to an employee are likely to be problematic to an employer as it may result in a situation where some employees consent to the change and others do not. Where this occurred, the employer would need to consider whether to include the clawback provisions in the contract of those employees who consented or try to enforce against all employees. Further it may result in the employer looking to dismiss and rehire the employees on the new terms that include a clawback provision (which may result in collective consultation) such an option will be strongly resisted by employers who would argue that they are ‘not entitled’ to amend the employment contract where such steps have to be taken. (Note: this paragraph 21 assessment may also be applicable where an

organisation does not issue compensation statements (as referenced in paragraph 18 above) and therefore is required to amend the employment contract in relation to including clawback provisions for variable incentives awarded from 1 January 2015 onwards to an employee who has an existing employment contract that does not include clawback language.

22) Amending employment contracts will only affect those individuals who remain in employment with the employer who made the award before 1 January 2015 i.e. the awarded but unvested variable compensation of those that have left the organisation will not be subject to claw back.

Amending Plan Rules:

23) If Plan Rules allow for the rules to be unilaterally amended (e.g. where the regulatory environment changes), then it will be possible to amend to take account of clawback. However, it is likely to be difficult to inform all beneficiaries under the Plan Rules as a number of them will be former employees. Where individuals have not been informed of the change and the organisation tries to rely on a purported change, there is a risk of estoppel arguments being raised.

24) Further, if consent is required, it will be almost impossible to obtain each person's consent. It is more likely that only those currently in employment will give their consent. The above two scenarios clearly impact more harshly on those individuals who have remained in employment against those whose employment has terminated.

25) SYSC TP 3 7(2) states that where it is not possible to amend an agreement, an organisation "must adopt specific and effective arrangements, processes and mechanisms to manage the risks raised by the inability of the firm to apply clawback…" It is not clear what such arrangements etc. would be, however, if it relates to amending the Plan Rules or employment contract, the same issues as outlined above will apply.

Conclusion

26) On the basis of the above, whilst we note the view of the PRA in paragraph 3.4 of the consultation paper, in our view requiring clawback to apply to variable remuneration awarded before 1 January 2015 but remaining unvested as of that date will clearly result the employer being put to a disproportionate expense and level of work for something that may not be legally possible or will not affect all those individuals that the award applies to e.g. those who are no longer in employment. Our view is that the PRA should focus on clawback applying to awards of variable compensation made on or after 1 January 2015 only.

Issue 5
Does sufficient malfeasance (the conduct or circumstances justifying clawback) include breach of a restrictive covenant? If so, are there any restraint of trade issues?

27) The proposed wording of SYSC 19A.3.51 (2) states that:

"A firm must ensure that:

(2) any variable remuneration is subject to clawback, such that it is not awarded save where it, or any amount corresponding to it, can be recovered from the individual by the firm in the 6 years following the date on which the remuneration is paid or vests, where the recovery is justified on the basis of the performance of the firm, the business unit and the individual concerned."

28) The wording of SYSC 19A.3.51A (2) and (3) states that:

"A firm must:

(2) set specific criteria for the application of malus and clawback; and

(3) ensure that the criteria for the application of malus and clawback in particular cover situations where the employee:

(a) participated in or was responsible for conduct which resulted in significant losses to the firm; or

(b) failed to meet appropriate standards of fitness and propriety."

29) The proposed wording of SYSC 19A.3.52 (1a) states that:

"(1a) A firm should recover vested variable remuneration, or an amount corresponding to it, where, as a minimum, any of the circumstances described in (1)(a), (b) or (c) arise within 6 years following the date on which the remuneration vested."

The circumstances in 1(a), (b) and (c) are as follows:

"(a) there is reasonable evidence of employee misbehaviour or material error;

(b) the firm or relevant business unit suffers a material downturn in its financial performance; or
(c) the firm or the relevant business unit suffers a material failure of risk management."

30) Although the wording of the relevant provisions is broad enough to cover breach of a restrictive covenant, we consider that it should be a matter for each firm to determine what sorts of restrictive covenants are appropriate (for example depending on the firm's business interests and the ability of those working for the firm to damage those interests) and how it wants to try to enforce any such covenants. Further, we consider that breach of certain restrictive covenants (for example not to disclose or misuse confidential information) may be more relevant in assessing fitness and propriety than breach of other restrictive covenants (for example dealing with clients in breach of a non-deal restriction).

31) If a firm decides to include breach of a restrictive covenant in the specific criteria for the application of clawback (see SYSC 19A.3.51A (2)), the firm should be aware that if a restrictive covenant is unenforceable (for example because it is too broad in terms of duration or scope), it is probable that an English Court would not permit the firm to operate the clawback provision to recover variable remuneration on the grounds of an employee's breach of that restrictive covenant. ELA recommends that any such covenants should be carefully drafted and that the drafting should include appropriate severability clauses so that if certain provisions are unenforceable they do not jeopardise the enforceability of other provisions.

Could the clawback be a penalty?

32) We consider there is a risk the English Courts could decide that a clawback provision is an unenforceable penalty if the trigger event for the clawback is a breach of contract and the amount clawed back is not a genuine pre-estimate of the loss arising from the breach. Given the circumstances in SYSC 19A.3.52 (1) (a) (reasonable evidence of employee misbehaviour or material error) and (c) (a material failure of risk management), the trigger event for the clawback could, in many situations, be a breach of contract. Further, if the requirement is to recover (claw back) all vested variable remuneration (as it

seems to be under the proposed wording of SYSC 19A.3.52 (1a)), this may not be a genuine pre-estimate of loss arising from the breach. PRA should consider whether changes need to be made to the relevant provisions and whether guidance should be given to firms about this risk and how it can be minimised.

33) The basic position is that a provision in a contract which requires party A to pay a sum to party B if party A is in breach of the contract will be an unenforceable penalty unless the sum is a genuine pre-estimate of the loss arising from the breach. Determining whether or not a provision is a penalty first involves assessing whether the trigger event is a breach of contract.

34) If the trigger event is not a breach of contract, the provision will not be a penalty . If the trigger event is a breach of contract then determining whether or not the provision is a penalty involves assessing whether the payment is a genuine pre-estimate of the loss arising from the breach or whether the payment is in effect designed to deter a party from breaching the contract. If the payment is a genuine pre-estimate of loss, it should be enforced by the English Courts, but if it is designed to deter a party from breaching the contract it will be a penalty and it will not be enforced by the English Courts (although the injured party may still claim damages for breach of contract).

35) Although the case authority has developed since Dunlop, for example in Murray v Leisureplay plc [2005] IRLR 946 and Cavendish Square Holdings BV v Makdessi [2013] EWCA Civ 1539, the basic position remains the same.

36) Depending on how a firm drafts clawback provisions in, for example, variable remuneration scheme rules, a provision requiring an individual to repay a bonus if he or she is in breach of the employment contract could be unenforceable as a penalty clause.

37) However, we consider that it should be possible to minimise the risk of clawback provisions being challenged by employees on the grounds of being unenforceable penalties by drafting the relevant provisions carefully, so that they are not triggered, for example, by an employee's breach of the employment contract. Award, payment, vesting and retention of variable remuneration could be conditional upon certain circumstances and factors, including (but not necessarily limited to) the specific criteria envisaged by SYSC 19A.3.51A (2). By way of example, the conditionality wording could include the employee in question not having participated in or been directly or indirectly responsible or accountable for conduct which resulted in significant losses to the firm and the employee upholding appropriate levels of fitness and propriety as well as the firm not suffering a significant downturn in performance in all cases at any time within the 6 years following the vesting or payment of the variable remuneration.

38) Whether and, if so, to what extent clawback should be applied to an employee's variable remuneration will normally be a matter for a committee within the firm. We are of the view that those committees should always give careful consideration to any decision to apply clawback, including how to communicate and document that decision so as to minimise the risk of litigation from current and former employees and third parties.

Issue 6

What issues arise from the scope of the claw back obligation

The requirement to "recover" vested variable remuneration

39) The new proposed text at SYSC 19A.3.52 E (1a) states that: "A firm should recover vested variable remuneration, or an amount corresponding to it, where, as a minimum, any of the circumstances described in (1)(a), (b) or (c) arise within 6 years following the date on which the remuneration vested" (emphasis added).

40) We do not consider it appropriate to require a firm to recover vested variable remuneration: whether or not such recovery is possible may be outside the firm's control. There may be practical considerations (such as the individual no longer having the funds available to make the repayment) which mean a firm unable to recover vested variable remuneration in practice. Therefore we suggest that a firm's obligation should be limited to it taking reasonable steps to recover vested variable remuneration, taking account of the issues set out below.

The amount to be recovered

41) The new proposed text at SYSC 19A.3.52 E (1a) does not appear to leave any discretion for a firm to seek to recover some (but not all) of the vested variable remuneration in question. This gives rise to a number of issues. By contrast, under the evidential provision at SYSC 19A.3.52 E (1) of the existing Remuneration Code, firms are expected to "reduce unvested deferred variable remuneration" (emphasis added) in the equivalent circumstances. Therefore under the proposed drafting it appears that, if the circumstances described in SYSC 19A.3.52 E (1)(a), (b) or (c) arose, a firm would be expected to recover all of an individual's relevant vested variable remuneration, but would have discretion over the appropriate reduction to any unvested deferred variable remuneration.

42) The absolute nature of the obligation removes the ability of a firm to vary its approach depending on the particular circumstances in question. Under the current "malus" provision, a firm can determine the percentage reduction to be applied to unvested deferred variable remuneration depending on, for example, the degree of culpability of the individual or the level of the downturn in financial performance. We consider that this is a sensible approach, which should be extended to the new "clawback" provision.

43) We also suggest that in exercising its discretion to seek to exercise "clawback", a firm should be entitled to take account of (a) any reduction in the variable remuneration to be awarded to a current employee for the current performance year; and (b) any exercise of "malus" in respect of an individual's unvested deferred variable remuneration, in each case arising out of the same circumstance that would trigger the exercise of "clawback". As stated above we consider that it would be appropriate for a firm to treat "clawback" as its recourse of last resort, to be exercised only in those situations where it is has already exercised discretion to reduce any variable remuneration award for the current performance year and/or to reduce unvested deferred variable remuneration under the "malus" provision.

44) Litigation. In bringing any enforcement proceedings in England and Wales, a firm would be bound to comply with the Civil Procedure Rules (CPR), including the "Overriding Objective" at Part 1. Under the CPR, parties are required to help the court to further the overriding objective, including to deal with the case in a way that is proportionate to issues including the amount of money involved and the financial position of each party (CPR 1.1(2)(c)). If only for the avoidance of doubt, we consider it should be recognised that the proposed amendments to the Remuneration Code do not require a firm to conduct any enforcement proceedings in a manner that is disproportionate or otherwise puts the firm in breach of its duties under the CPR (for example, if the amount of vested variable compensation is de minimis having regard to the cost of enforcement). A firm should be free to settle any litigation arising out of the enforcement of the Clawback provision (requiring them to recover all of the vested compensation would seemingly prevent the firm from reaching any compromise agreement with the employee).

45) We therefore suggest that firms should be expected to take reasonable steps to recover vested variable remuneration, and that in considering what steps are required firms should be permitted to take account of (a) the amount of variable vested remuneration in issue; (b) the likely costs of bringing enforcement proceedings; and (c) the prospects of success in any such proceedings. Further, we consider

that firms should not be required to include a "clawback" provision in any contractual arrangement with an employee where such provision would not be enforceable under the law of the relevant jurisdiction.

46) Gross or net amount? The current state of the law in the United Kingdom is unclear as to whether an individual would be able to recover income tax and national insurance contributions paid on remuneration which the individual is subsequently required to repay pursuant to a contractual obligation. While the law may be clarified following the outcome of the appeal in Martin v Commissioner for HMRC (TC/2010/2791) there will continue to be situations both within the UK and in jurisdictions outside the UK where there will be uncertainty as to the ability to recover these sums. We consider that it would be unduly penal to require an individual to repay the pre-tax value of the remuneration in circumstances where the individual is unable to recover the tax amount from the revenue authorities. Consequently, ELA suggests that a firm’s obligation to clawback vested variable remuneration should be limited to recovering the after tax value of the remuneration, unless the tax and any social security contributions payable on the remuneration are recoverable by the firm or the individual.

47) Recovery of variable remuneration delivered in shares. SYSC 19A.3.47 requires a substantial proportion of variable remuneration to consist of shares or other non-cash instruments. The value of such instruments is likely to fluctuate over time and it therefore raises the question of what is the appropriate method for determining the value of the remuneration in order to determine the value to be clawed back.

48) Putting to one side the question on whether the amounts are pre or post tax (see above), there are the following principal approaches:

(a) Value the instruments at vesting. However, this may not accurately reflect the value that the individual derived from the instruments. For example, if they were not sold immediately and have since increased in value, the individual may have in fact realised more value than is clawed back, in which case the clawback may not have the penal impact it is presumably intended to. Conversely, they may not have been sold but may be worth materially less than they were originally, in which case this alternative might be considered unduly penal.

(b) Value the instruments at the date of the clawback. Again, this may not accurately reflect the value that the individual derived from the instruments. This might also encourage individuals to retain the instruments until the end of the clawback period. However, in those circumstances, reflecting the tax uncertainty outlined above, it may be preferable to hold the instruments subject to a deferral period so that they only vest at the end of the period (i.e. so that they are subject to malus rather than clawback). ELA also notes that even if an employee retains the instruments, he or she may not simply be able to hand them back to the firm to satisfy a clawback obligation as there may be corporate law issues which preclude the firm from receiving or holding those instruments.

(c) Clawback the value the individual received. Under this approach, a firm would be able to look at the value that an individual had derived from the instruments and determine the quantum accordingly. For example, if an employee had sold the shares he or she received on vesting, the clawback would be calculated by reference to the value received for the shares under the sale. If they had been retained then it would be calculated by reference to the value at the date of clawback. This route does pose some practical issues as a firm may not be able to ascertain the value for which shares have been sold by an individual.

49) We consider it likely that route (a) would encourage the immediate sale of the instruments (which, subject to any holding requirements, would undermine the purpose of a non-cash instrument) and (b) would encourage the retention of the instruments (and thereby prevent employees from being able to utilise the value of their pay). Accordingly, we would welcome guidance from the PRA which made

clear that the firm would be obliged to seek to recover either (a) the shares themselves (if still held by the individual); or (b) the value actually received by the individual on sale of the shares (to avoid a situation in which the individual was being asked to replay more than they had received.

Issue 7

Directors & Officers Insurance

50) We suggest finally that consideration be given to the possible impact on the effectiveness of the policy underlying these proposals of the existing terms (and potential development of new terms) in Directors and Officers insurance policies both in the UK and elsewhere. This is a dynamic and expanding market and whilst regulatory terms exist that prevent the recovery by means of insurance of a financial penalty imposed by a regulator (FCA/GEN/6/1) it seems improbable that this could apply to an employer seeking to take action against a director for 'employee misbehaviour or material error'.

51) If a market develops to provide cover expressly for such risks two possible consequences may occur. First it will mitigate against the culture these proposed regulations seek to inculcate and secondly the demand for such cover from senior executive is likely to become universal and given potential risk levels a considerable additional expense for businesses.

Offer of further assistance

52) It is apparent that these proposals raise a number of potentially complex and difficult issues. If we can assist further by meeting with officials from the PRA we are pleased to offer to do so. We frequently do this in connection with proposed legislation and new regulations. If this is of interest contact should be made with Lindsey Woods our Head of Operations at lindseyw@elaweb.org.uk.

13 May 2014