Association for Financial Markets in Europe

Consultation Paper Response

Consultation Paper / CP 6/14

Clawback

13 May 2014

The Association for Financial Markets in Europe (AFME) welcomes the opportunity to comment on the Bank of England's recent consultation paper on clawback. AFME represents a broad array of European and global participants in the wholesale financial markets. Its members comprise pan-EU and global banks as well as key regional banks, brokers, law firms, investors and other financial market participants. We advocate stable, competitive, sustainable European financial markets that support economic growth and benefit society.

AFME is the European member of the Global Financial Markets Association (GFMA) a global alliance with the Securities Industry and Financial Markets Association (SIFMA) in the US, and the Asia Securities Industry and Financial Markets Association (ASIFMA) in Asia.

AFME is listed on the EU Register of Interest Representatives, registration number 65110063986-76.

We summarise below our over-arching response to the discussion paper, which is followed by a section with more detailed thinking around some of the main topics and questions asked.

Over-arching Comments

AFME and its members believe that in line with FSB principles, remuneration should be aligned with the success of firms and their constituents' businesses. We also believe that remuneration practices including deferral and clawback should foster sound risk management and avoid incentives for excessive risk taking and short-termism.

While we clearly support the overall objective, we are concerned that some of the proposals outlined in the Consultation Paper do not provide correct incentives for firms to continue to develop remuneration policies that are consistent with effective risk management. Whilst clawback provisions are undoubtedly important in the overall risk management strategy of remuneration policy, the use of such provisions should be considered as a last resort, given that firms can take action both earlier and more easily against employees in a number of other ways, such as the reduction of current year remuneration, or a malus adjustment of unvested deferred compensation.

We note that the consultation suggests (at paragraph 3.5) that the clawback requirement 'could lead to longer vesting periods of executive remuneration, which could discourage short-termism'. AFME and its members believe that the proposal as drafted could in fact discourage firms from awarding remuneration with terms in excess of minimum requirements. For example, if the required clawback period commences at the end of the deferral period, firms may not be encouraged to adopt longer deferral periods or to pay a greater proportion of remuneration in a deferred form. As they stand, the rules envisage clawback for six years post vesting. Thus, an award which vests in full after three years will be at risk for a total of nine years (three deferral and six clawback).

The global coordination of clawback arrangements will be very important, and the proposal should be considered also in relation to the impact it would have on firms' being able to offer competitive remuneration terms within the UK, EU and globally. Whilst AFME and its members recognise and support the desire of the PRA to set appropriate standards, a significant departure from globally-recognised principles could threaten the attractiveness of London as a global financial centre.

It is likely that firms would not be able to enforce clawback terms in some jurisdictions, including for example Germany and France, and that staff would be incentivised to choose to work in jurisdictions where extensive clawback terms do not apply. Other practical considerations include the possibility that firms will not be successful where clawback needs to be enforced in the courts or where the costs of legal action to seize assets and funds from individuals exceeds the amount that might be recovered. Our members are particularly concerned that the breadth of the proposed clawback (mirroring malus guidance) will lead to cases being lost due to a lack of direct involvement by the employee in the event triggering clawback or indeed any fault at all on the part of the employee. The wide provisions and potential application to employees uninvolved in events leading to clawback will be subject to the same action as those directly involved. This creates a significant risk for the UK (and UK firms operating outside of the UK) if these provisions are implemented in isolation from other jurisdictions. We would point to and endorse the view of the Parliamentary Commission on Banking Standards (Volume II paragraph 883) which recommended only that:

In the most egregious cases of misconduct….the regulator examines whether there is merit in further powers to recover remuneration received or awarded.

We would also require confirmation that the clawback requirements are subject to applicable law.

In our and our members' view, the timing of the proposals should be moved back to coincide with the implementation of the UK Senior Managers' Regime. Most employees covered by the Remuneration Code will be Senior Managers, and our members should not be exposed to the costs and the staffing risk of having to renegotiate employment contracts twice in less than twelve months.

Further detail/responses to questions

The proposal that the grounds for applying clawback should be as wide as the grounds for malus

AFME and its members agree that it is important for firms to align employees remuneration with performance and reduce it in circumstances where appropriate. Firms have the ability to do this through a variety of mechanisms including the reduction or non-payment of bonus awards, the operation of malus clauses and disciplinary action and termination of employment. Each of these actions would usually be taken before seeking to clawback awards because of the complexities and potential significant cost involved in pursuing clawback. We suggest therefore the clawback clause should be limited to financial misstatement of the firm or egregious cases of misconduct by the employee. The term 'clawback' as currently drafted is very wide and can be applied to individuals even if they were not at the firm when the incident creating the issue occurred. Subjecting employees to the threat of clawback in respect of events for which they have no responsibility, for example market-wide financial shocks, is unlikely to discourage excessive risk-taking. By contrast, in respect of firms competing for global talent, it may lead to greater demand from the market for more remuneration to be delivered as fixed rather than variable, thereby reducing ability to reduce costs at times of financial stress.

The wordings in paragraph 2.6 of the Consultation Paper "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" and "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" – should be made more specific.

In discussions with employment lawyers our members are seriously concerned that clawback provisions are not only unenforceable in certain jurisdictions, but that application to enforce could in turn leave firms open to counter arguments by employees, for example that it could be challenged on the basis that it is a penalty clause and as such would be void and un-enforceable. We understand that many of the major law firms will be responding to this consultation, and would suggest that PRA consider specialist advice on the employment law implications of the exercise of clawback before proceeding with any new regulation.

The proposal to limit the application of clawback to a period of six years from the point of vesting

In setting the length of the period for which remuneration remains at risk, we believe there should be a balance struck between the need to allow sufficient time for latent problems to emerge and the impact on employees of being subject to an indefinite threat of having to pay back remuneration already earned. However, a clawback period of six years from the period of vesting seems unnecessarily long, especially as the grant may have occurred three to five years prior to vesting, therefore exposing the employee to a period of between nine and eleven years at which their award is 'at risk'.

We believe that the rules should recognise that forfeiture of an award prior to the end of the deferral period and the clawback of a delivered award achieve the same objective and should be viewed together. We would therefore suggest that a total period during which an award is at risk (or the deferred period if longer) is considered. Using a six year rule as an example, an award could be subject to malus or clawback for six years. If the deferred period is three years with cliff vesting, this would mean the award being subject to malus for three years and clawback for three years. An award deferred for five years with cliff vesting would be subject to malus for five years and clawback for one year. An award deferred for longer than six years would simply be subject to malus but no further clawback. This ensures a consistent minimum period over which any award is at risk. This approach is also more likely to encourage your goal of longer deferral periods as firms weigh up the greater ease of recovery through malus versus clawback.

Our members and the employment lawyers to whom we have spoken do not understand the rationale for the six year period, and as a practical matter, we believe that a clawback period linked to the current deferral rules in the Remuneration Code would be the most logical approach. Those rules require deferral of three to five years, and we would suggest clawback should be required for a maximum of five years from award. When combined with malus this means that any award of variable compensation is subject to malus or clawback for five years from award.

We would also ask that you consider defining 'vesting' in your rules. Some organisations consider the term vesting to mean the period over which any deferred award is earned and not necessarily the period of deferral until an award is converted or delivered to the employee. It seems likely that you are referring to the conversion or delivery of an award to an employee rather than the point at which future service is no longer required to earn an award.

As an example:

- A three year deferred award could be said to vest and convert at the third anniversary of the grant. Vesting and conversion are coincident with each other. We would understand that the employee needed to complete three years of employment with the firm from the point of award to receive the award. The award would be cancelled on leaving before three years.
- Alternatively a three year deferred award could be considered to be immediately vested but convert on the third anniversary of the grant. Vesting and conversion are not coincident and the employee would receive the award at the third anniversary of grant whether he or she stayed with the firm or left service.

Further Comments

We mentioned earlier the likelihood of the costs of legal action to seize assets and funds from an individual exceeding the amount that might be recovered. A possible way of mitigating this risk might be through the introduction of firms being able to establish de-minimis levels, whereby they may determine not to pursue an individual given the likely cost and the likely success of legal recovery, given the amounts involved. It should be noted that firms may still lose an enforcement action in the courts and be subject to the loss of costs.

We have concerns about applying the proposed standards retrospectively. As a general matter, employees should be entitled to expect that the terms of bargains negotiated with their employers and set out in legally binding contracts are not subject to amendment by subsequent regulation of which the employee had no notice at the time the bargain was made. In addition, we believe it is doubtful that such retrospective amendments would be enforceable. It would be far more practical if the clawback framework is implemented prospectively.

Attempts to obtain employee consents to a retrospective change could lead to the odd situation where employees within the same firm are treated differently, some having consented to change and some not. In reality we expect that employees will not voluntarily agree to a retrospective change to their contracts. Even where contracts of employment have been amended to permit clawback the likelihood is that few employees (or former employees where this is more likely to be applied) would voluntarily repay amounts which would mean resorting to the courts in order to recover amounts due.

Section 3.4 of the consultation paper, mentions that the PRA does not expect the costs associated with amending employment contracts, including the need to renegotiate terms with staff, to be significant. AFME and its members believe the costs are likely to be significant:

- for the clawback to have reasonable chance of enforceability in the UK and elsewhere it is likely that employee consent will be required to the clawback term (to avoid the risk of it being challenged on the grounds of unlawful deduction);
- It is likely that firms will need to either vary employee contracts and to do so firms are likely in many cases to have to pay for legal advice that their employees would seek and/or change the award process to require employee consent to an award (currently many firms grant awards without requiring any consent or acknowledgement)
- There are also very significant practical barriers, including the need to allow staff a three month consultation period, in seeking to have contracts amended by January 2015.

The consultation has also not considered the very significant time and effort (in addition to the potential costs noted above) involved in taking legal action to effect a clawback. The costs both implicit and explicit, involved in applying clawback will be significant. Our member firms can attest to this as a result of the work done to date in applying malus to unvested remuneration. The amount of management time involved in these activities should not be underestimated.

Additional practical considerations that might need to be considered in the context of the operation of clawback, could include:

- the valuation of awards, particularly where these have been granted in the form of shares or options, together with the treatment of gains or losses made;
- situations where awards have been transferred to third parties, e.g. family members, trusts or charities;
- whether and how clawback might be applied to the estates of deceased persons and the attendant inheritance tax considerations; and,
- whether and how clawback might be applied to a portion of vested awards.

Lastly, it will usually be the case that tax and social security is payable when remuneration is delivered. In the UK and some other tax systems employers and employees cannot claim back that tax if the relevant remuneration is subsequently clawed back. It seems counter-prudential that a firm should suffer tax on remuneration that it subsequently claws back and unfair that employees should have to pay tax on remuneration the benefit of which they never ultimately enjoy. This issue could be addressed in two ways. The PRA could work with the tax authorities to agree a sensible mechanism for employers to claim back tax paid in respect of remuneration subsequently clawed back. In addition firms should only be required to claw back from employees the net amount of remuneration paid or delivered after taxes. Firms may indeed only be able to enforce clawback in respect of net rather than gross amounts.

We believe that appropriately calibrated clawback rules, reflecting the concerns expressed in this response, will enhance the safety and soundness of firms operating in the United Kingdom and enhance its reputation as a place to do business.