

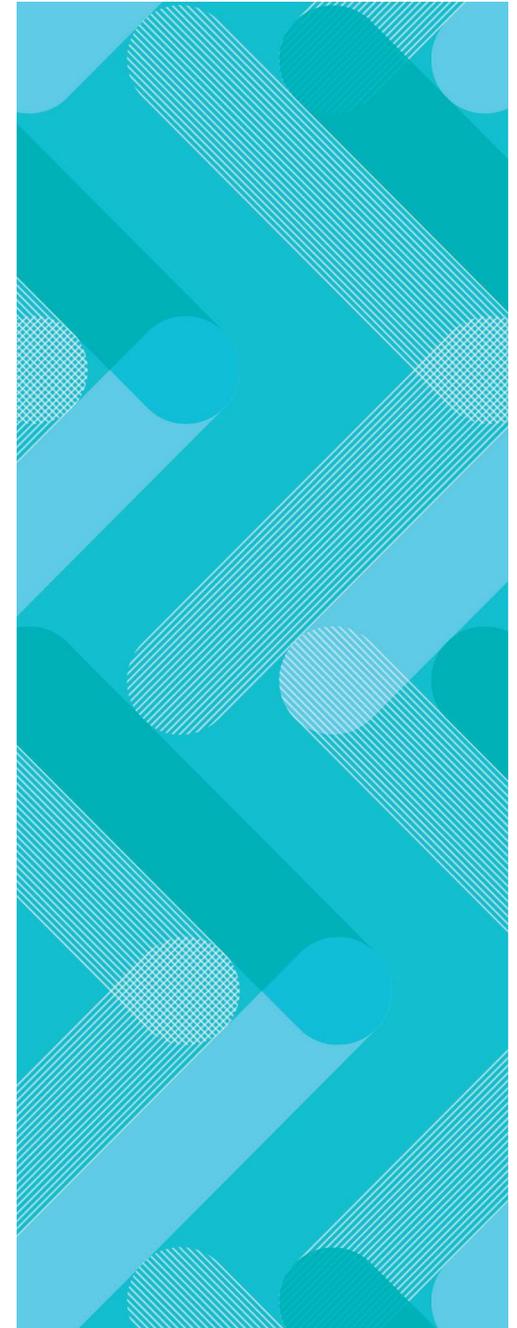


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Malus, clawback and post-employment holding periods

White Paper Conference 2021

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Question:

How do you control - and overcome - difficulties with malus and clawback and implement and enforce post-employment shareholding requirements?

Promoting longer term shareholdings

Regulators, shareholders and the government have encouraged a broad set of inter-connected provisions which includes

- deferral (including deferral into shares)
- post-vesting holding periods
- increased shareholding requirements
- post-employment shareholding requirements
- malus and clawback

Designed to

- promote longer term shareholdings
- lead to greater alignment with the shareholder experience
- discourage short-termism and excessive risk-taking
- promote long-term sustainable growth

Requirements for malus and clawback

Requirements in financial services

- CRD3 / 4 for the largest banks, building societies and investment firms
- PRA's implementation of CRD5 now requires all dual regulated firms (mainly banks and building societies) to implement clawback provisions in relation to their "code staff"
- Implemented through a mixture of malus provisions applying to any remuneration which is in fact deferred, and hard clawback provisions
- Circumstances include:
 - sustainability of the bank
 - a significant downturn in performance or a significant failure of risk management
 - evidence of employee misbehaviour or error

Requirements for malus and clawback

Requirements in financial services

- Asset managers and other investment firms will, by the end of 2021, be subject to the new Investment Firms Prudential Regime
- Consultation on the remuneration aspects is expected from the FCA shortly*
- FCA may enhance malus and clawback, as the PRA has done for banks
- Currently, only the largest asset managers have mandatory malus and clawback requirements under the AIFMD and UCITS V remuneration codes
- No mandatory circumstances or time periods

*Note that, since filming, the FCA consultation has been published at <https://www.fca.org.uk/publication/consultation/cp21-7.pdf>

Requirements for malus and clawback

Requirements outside financial services

- No mandatory provisions for malus and clawback
- UK Corporate Governance Code recommends appropriate withholding and recovery provisions in all variable remuneration arrangements
- No mandatory circumstances or time periods
- FRC Guidance on Board Effectiveness suggests:
 - erroneous or misleading data
 - misconduct
 - misstatement of accounts
 - serious reputational damage
 - corporate failure

Drafting malus and clawback provisions

- Discretion, given under contract, for the board or remuneration committee to apply malus and clawback provisions

How broad can that discretion be formulated whilst still being legally enforceable?

- *Parmar v HSBC* : Court accepted that provided that clauses are drafted widely enough to cover particular circumstances, the exercise of discretion will be upheld absent bad faith, discrimination or perversity
- Risk of contractual provisions become too uncertain if drawn too wide

BEIS White Paper

Restoring trust in audit and corporate governance

- Proposal to strengthen malus and clawback provisions with mandatory clawback triggers and a minimum period of application
- Malus and clawback to promote compliance with directors' statutory duties
- Concern over enforceability from a legal and practical perspective

"if [clawback provisions] are drawn too broadly they become difficult to enforce, but if drawn too narrowly and specifically, they can exclude clawback where it would seem self-evident that action should be taken."

Post-vesting holding periods

- IA guidelines and Corporate Governance Code provide that, for listed companies, a five year vesting and holding period should apply to share-based long term incentive plans
- Delay in delivering the shares to the participant for two years
 - Clawback by malus reduction
 - Easier to operate and enforce
 - Clawback on a gross basis
 - Tax benefit for participant
- Shares acquired need to be held subject to a sale restriction for an additional two years
 - Participant perception
 - Additional costs for the company - dividend equivalents vs real dividend
 - Tax loss on net clawback

Structuring

- Post-vesting holding periods, shareholding requirements and post-employment shareholding requirements
- Shares held in the name of a nominee
 - Subject to any restrictions which are agreed between the company and the individual
 - Nominee refrains from taking any action without clearance from the company
 - Can enforce clawback without action from participant
- Shares delivered in certificated form
 - Holding of share certificate can be outsourced
 - Works for enforcing sale restrictions
 - Power of Attorney in relation to clawback
- More creative solutions?

Legally enforcing sale restrictions and clawback

- Terms should be clearly set out upfront and are understood by the participants
- If referred to in various documents, ensure consistency
- Plan rules - state that, by participating, the participants agree to the terms
- Form of acceptance - refer to the malus and clawback provisions
- Service agreements - agree to sale restrictions, shareholding requirements and malus and clawback provisions
- Inclusion in the shareholder-approved remuneration policy is not enough on its own
- Local advice in relation to non-UK employees (including internationally mobile employees)

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