

Malus and Clawback

Background on the development of regulations on malus/clawback in the financial services sector

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1. Background

Many financial service firms around the world have some form of malus and/or clawback clause. This note provides background to why firms have been adopting them and some of the legal and tax considerations.

Malus and clawback clauses are not limited to financial services, indeed corporate governance codes are increasingly suggesting or requiring them across all sectors for listed companies.

This note sets out the regulatory overview and the overseas legal and tax considerations.

Malus and clawback clauses take many forms, some are drafted only to catch events that happen at the group or subsidiary level, eg financial misstatement, others catch individual or team behaviour, some cover both. When we are drafting and advising on a malus/clawback clause the starting point is to understand what the company wants to achieve, eg, compliance with specific regulatory requirements, achieving corporate governance best practice, achieving minimum global compliance.

2. What does malus and clawback mean?

Malus means a pre-vesting condition which gives the company the right to reduce the amount of an award. The malus clause will state the circumstances which will trigger the reduction. UBS was the first firm to introduce this type of clause in the financial services sector and coined this term. If the malus clause covers a person's behaviour this will be different from and in addition to a 'bad-leaver' clause. The malus clause would be triggered if a person continues to be employed but has behaved in a way which is regarded undesirable. If a person is dismissed for cause then the usual bad leaver clause would apply instead.

Clawback means a post-vesting condition. It does what it says – it claws back what has already been given out. The circumstances would be set out to say what will trigger a clawback. They are usually narrower and cover more extreme circumstances, like financial misstatement and fraud. Clawback clauses are not required by the current financial services remuneration regulations. Countries like the Netherlands have, however, introduced corporate governance regulations which require clawback clauses to apply to the directors of Dutch listed companies across all sectors, the requirement is not limited to the financial services sector.

3. Where can I find the relevant regulations?

If your company is a financial services firm then it is important to consider all the regulations which apply to the relevant businesses. It can be helpful to see how and where the regulations have come from we have therefore set out in this note the background to the regulation in this area:

3.1 Financial Stability Board principles and standards on remuneration

The first iteration of an ex-post risk adjustment was set out in the FSB remuneration principles and standards - FSB Standard 9. It sets out:

'In the event of negative contributions of the firm and/or the relevant line of business in any year during the vesting period, any unvested portions are to be clawed back, subject to the realised performance of the firm and the business line.'

This set out the general principle that there should be clawback if the firm as a whole or the business unit did not perform well. This clearly shows the adjustment is not limited to the individual behaviour.

All G20 member states were expected to implement regulations in line with the FSB principles.

3.2 EU

The next development was the adoption of the ex-post risk adjustment in CRD III:

Annex V, Section 11 Directive 2006/48/EC, point 23 (q)' the variable remuneration, including the deferred portion, is paid or vests only if it is sustainable according to the financial situation of the credit institution as a whole, and justified according to the performance of the credit institution, the business unit and the individual concerned. Without prejudice to the general principles of national contract and labour law, the total variable remuneration shall generally be considerably contracted where subdued or negative financial performance of the credit institution occurs, taking into account [] reductions in payouts of amounts previously earned, including malus or clawback arrangements.'

This considerably expands on the FSB's principle and covers firm and business unit performance and an individual's behaviour.

3.3 EU - CEBS

The CEBS guidelines on remuneration policies and practices added further clarity to what was expected to be implemented by the EU regulators (para 137):

'a. Evidence of misbehaviour or serious error by staff member (e.g. breach of code of conduct and other internal rules, especially concerning risks);

b. whether the institution and/or the business unit subsequently suffers a significant downturn in its financial performance (specific indicators are to be used);

c. whether the institution and/or the business unit in which the staff member works suffers a significant failure of risk management;

d. significant changes in the institution's economic or regulatory capital base.

3.4 UK FSA

The full text of the UK FCA's requirements are set out below for ease of reference. They encompass the requirements set out in the CEBS guidelines but also provides further guidance for example by confirming that in some circumstances, like the start-up of a new venture which is loss-making, no adjustment will be necessary. FCA Handbook (SYSC 19A.3.51. Note the requirement in (c) that an adjustment can be made if there is failure in risk management (there is no reference to the financial performance of the firm).

'A firm must ensure that any variable remuneration, including a deferred portion, is paid or vests only if it is sustainable according to the financial situation of the firm as a whole, and justified according to the performance of the firm, the business unit and the individual concerned.'

(1) A firm should reduce unvested deferred variable remuneration when, as a minimum:

(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 its financial performance; or

(c) the firm or the relevant business unit suffers a material failure of risk management.

(2) For performance adjustment purposes, awards of deferred variable remuneration made in shares or other non-cash instruments should provide the ability for the firm to reduce the number of shares or other non-cash instruments.

(3) Contravention of (1) or (2) may be relied on as tending to establish contravention of the rule on performance adjustment (SYSC 19A.3.51 R).

(1) Variable remuneration may be justified, for example, to incentivise employees involved in new business ventures which could be loss-making in their early stages.

(2) The governing body (or, where appropriate, the remuneration committee) should approve performance adjustment policies, including the triggers under which adjustment would take place. The FSA may ask firms to provide a copy of their policies and expects firms to make adequate records of material decisions to operate the adjustments.'

4. Future developments in the financial services sector

Some new text was added to extend the use of malus and clawback. The new text requires that up to 100% of the total variable compensation is subject to malus and clawback. It also requires firms to be specific on the criteria for their application including where the employee participated in or was responsible for significant losses or failed to meet appropriate standards of 'fitness and propriety'. We will need to see how this requirement is incorporated into the regulations in the EU member states.

Other directives like AIFMD and Solvency II may also contain malus/clawback requirements. They are not yet finalised.

5. Overseas legal and tax considerations

We provide a high level overview of the key issues on a country-by-country basis in our database. (Go to the legal report for any country on any of the plans).

The key issues are:

- Is it illegal to have a malus/clawback clause
- Will it be enforceable, or what circumstances will tend to enable a company to enforce its malus/clawback clauses. We find that some countries require the clause to be very specific and allow no discretions and others require them to be of a general nature allowing discretion, in some countries it may be recommended that the participant consents to or confirms the clause - so some tailoring to local employment laws may be required to increase the effective of the terms.
- Can you set-off other sums due instead of applying malus or clawback. This can be more difficult to achieve and this would need to be considered on exactly what you propose to do.

- Will a malus/clawback clause defer the tax that would otherwise have been payable if you did not have such a clause.
- If tax has been paid and you operate the malus/clawback clause can the tax paid be recovered from the tax authority.

6. Checklist

- **Objectives:** Be clear on why your company wants to introduce a malus or clawback clause:
 - o is it to meet financial services remuneration regulation requirements and if so which regulations apply to you. Your company may have several different regulations that apply and then a decision needs to be taken as to whether there will be a global policy to try and comply with all of them or whether the clauses will be introduced on a country or region specific basis
 - o Is it to meet commercial requirements to promote good and reduce bad behaviour.
- **Global and legal tax considerations:** identify and check whether there will be any local legal or tax issues which may impact on the drafting of the clause.
- **Communication:** communication of the malus/clawback clause is essential. This can significantly impact on its enforceability so consider how this will be best achieved.

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