

11KBW Business Law Group

Deferred Variable Remuneration

Julian Wilson

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DEFERRED VARIABLE REMUNERATION



SETTING THE SCENE

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- Key principles
- Legal issues arising
- Scope and effect of the Rules

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Sources

- Capital Requirements Directive (*2006/48/EC and 2006/49/EC*) (CRD 3) – proposed provisions on remuneration practices
- Committee of European Banking Supervisors' Consultation Paper on Guidelines on Remuneration Policies and Practices (CEBS CP42)
- Financial Services Act 2010
- FSA Remuneration Code Consultation Paper 10/19
- Draft Remuneration Code Rules (Appendix 1 to 10/19)

Most of you will already be familiar with the FSA's proposed revisions to its Remuneration Code (due to come into effect in January 2011) to take on board remuneration rules required by the Capital Requirements Directive (CRD 3) and the Financial Services Act 2010. Many of you will also have read the Committee of European Banking Supervisors' Consultation Paper on Guidelines on Remuneration Policies and Practices.

Although we had expected the final text of the new Remuneration Rules to be available by now, the FSA has postponed publication pending CEBS final paper because some of the proposed rules result from matters of interpretation by the FSA of the CRD 3 remuneration provisions. The final text of the Rules is not expected until mid-December even though the Rules are due to take effect from 1 January 2011.

The intention of this Seminar is not so much to explain the changes themselves –you will all know of them by now- but to identify the potential legal issues to which they might give rise in future once the **key principles** behind the changes are implemented.

So this is “crystal-ball gazing” - asking whether there will still be room for bonus litigation in cases covered by the Code in the future from the perspective of the bonus litigation there has been to date (in which Members of 11KBW have prominently featured).

So what are the **key principles**?

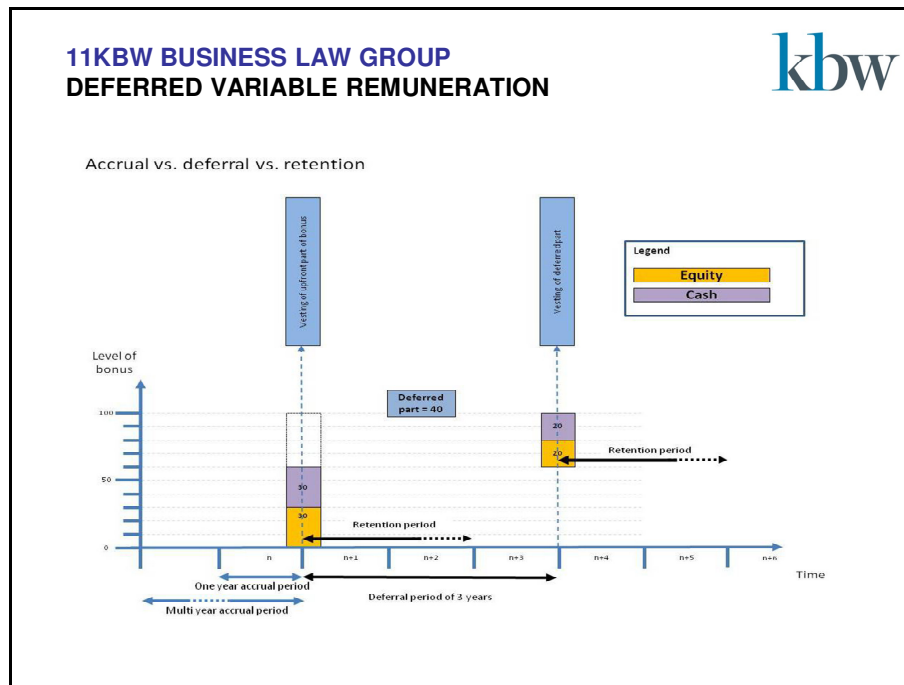
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Key Principles

- mandatory **deferral** of 40% of variable pay (rising to 60% where variable pay is > £500,000) for no less than three years "vesting" pro rata over that period
- "malus" **adjustment** (i.e. reduction or forfeiture) of the deferred amounts by reference to risk, performance, misbehaviour or material error; material downturn or failure of risk management
- 50% of variable pay to be awarded in share or non-cash instruments also subject to deferral or **retention**

So the maximum percentage of the bonus payable in cash at the payment date is 30% - which you can see from the graphic at Annex 3 to CEBS CP42



The key principles behind the proposed revisions are to subject the bonuses of affected senior employees (being those in affected firms exercising a Significant Influence Function; Senior Management; Staff in the same remuneration bracket as Senior Management; and Risk Takers (but not de minimis earners earning < 500k and bonus <33%)):

to **deferral** of 40% - 60% of the award. The Code is clear that the deferral intended is not postponement of payment but postponement of vesting so that the employee's rights will be conditional contractual rights rather than proprietary in nature:

to subject the deferred elements of the award to so-called "malus" **adjustment** (that is reduction or forfeiture) of the deferred awards by reference to risk, performance, misbehaviour or material error; material downturn or failure of risk management.

This form of adjustment of deferred awards is called ex post risk adjustment (i.e. after the event of award) adjustment for post accrual events in contrast to the ex ante (i.e. before the event) adjustment to the bonus pool prior to the making of individual awards.

Terminology

- **Deferral** – postponed vesting of earned amounts
- **Retention** – vested stock restricted from sale
- **Adjustment**
 - Ex-ante – adjusting for risk and costs in calculating income when bonus pool set
 - Ex-post risk - adjusting deferred unvested awards for subsequent risks and adverse developments
- **Vesting**- point property passes to employee
- **Malus**- ex-post risk adjustment which prevents vesting
- **Clawback**- demand repayment of all or part of vested amount as a result of developments after vesting (e.g. fraud or misleading information)

The ex post risk adjustment mechanisms are a matter for firms and may be formulaic (referable to performance criteria or financial ratios) or discretionary (in the judgment of management) or a mixture. Obviously, discretionary adjustment will be subject to the law's existing control mechanisms for discretions (*Horkulak*) subject to the effect of the Code.


Concepts

The Regulators' reasons for invoking the principles of deferral and ex post risk adjustment are well understood. The operations of banks and financial services firms these days are so complex that it is not easy for them to say what the profit receivable from the transactions entered into during the performance year are or will be. Working out its present value for bonus purposes is fraught with difficulty so that only by postponing part and adjusting it as the future unfolds can risks be contained. Markets are volatile and the capital needs of banks must take precedence.

But deferral in this context and in particular the subjecting of deferred amounts to after the event adjustment is, I would suggest, unnatural in that:

- bonuses in this sector are backward looking –they reward past performance during the prior year in which they were at least notionally earned. They are historically assumed to have accrued due. Contrast Incentive Schemes which pay out by reference to future performance.

- Whilst it is natural for an Incentive Scheme to involve conditional cash or share awards which remain unearned and conditional (so do not vest) until, the Performance Condition has been satisfied, it is far less natural to subject a backward looking “earned” award to conditionality and to postpone its vesting.

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Legal Issues Arising

- Deferral Mechanism?
 - Implied trust?
 - Contractual or equitable rights in deferred amounts?
 - Any fiduciary obligations of the holder?
- Interaction with express and implied terms, particularly Trust & Confidence term
- Deferred Amounts
 - Conditional entitlement or accrued rights?
- Long duration of deferral of large percentage:
 - Is the economic disincentive to move employment a Restraint of Trade?
 - Will an “in employment” condition for the long deferral period amount to a Restraint?
 - Necessity for Leaver Provisions – exacerbates usual problems
- Ex post risk adjustment
 - In or out of scope of Penalty Doctrine?
- Clawback
 - In or out of scope of Penalty Doctrine?
- Do RoT and Penalty doctrines give way to policy behind Code?

Earned but unvested

Will the courts give any recognition to the “earned” nature of the award? Query whether any equitable right is created by deferring earned awards?

What happens to the deferred amounts? If they have not vested, property has not passed and there is no express trust created by deferral but if the sums are earmarked in recognition of the fact that the contractual rights will result in a future transfer of property, is an implied trust created. Will firms owe any fiduciary duties in their stewardship of the deferred sums?

The FSA’s current Code applies to the largest banks, building societies and broker dealers. However, CRD3 will bring over 2,500 firms within the scope of the Code. These include all banks and building societies, asset managers, hedge fund managers, UCITS investment firms as well as some firms that engage in corporate finance, venture capital, the provision of financial advice and stockbrokers. Obviously, within those classes, there are a lot of different remuneration structures. Hedge Funds, for example, are generally structured very differently from the banks. Most comprise LLPs which distribute their profits to their Members. It is not

consistent with their character to hold unvested funds in a deferred pot. They defer vested sums into a Trust structure subject only to adjustment for member's liabilities.

Why do the FSA and CEBS contemplate that deferred awards must be unvested. Is this based on an assumption that the Penalties doctrine does not apply to unvested rights? Is that a safe assumption in law?

Room for operation at the T&C term?

What, if any role, will the overarching implied term of trust and confidence have? In a case in which I appeared for the Claimant in 2006- *Takacs-v-Barclays*, I managed to show that a claim based on the implication of "anti-avoidance" and "cooperation" terms into a detailed conditional bonus scheme had real prospects of success. May such implied terms act to limit the application of "malus" adjustment provisions of the new schemes? If 40% of my award is deferred for 3-5 years and subject to potential ex-post risk adjustment during deferral for material downturn in my business unit, how far does the implied term of cooperation operate to preclude my employer from disbanding my business unit or ignoring the effect of it being disbanded?

Deferred Awards and Employment Movement

Employment in this sector has historically been flexible. Any scheme deferring benefits for 3 to 5 years has to contemplate the possibility of employment coming to an end during the deferral period and the employee taking up alternative competitive employment. It is usual for deferral schemes to impose Leaver Provisions containing onerous terms on voluntary termination or in the event of competitive dealings. Longer deferral may exacerbate the usual problems of Leaver Provisions - *Micklefield* clauses, the need for clear words: *Levett, Brand*, the *contra proferentem* rule and the principle that a contract should not be construed in a manner which would permit a party to it to take advantage of his own wrong.

The longer the employee has remained in employment the greater the balance he will have in his "deferred" account. If there are onerous terms arising on voluntary resignation or there is an "in employment" condition to vesting, will the resulting large economic disincentive to move employment amount to a Restraint of Trade?


Scheme rules commonly provide that even vested rights to deferred stock will be forfeited in the event the employee takes up competitive employment. In a case I was involved in 2007 – *Curran –v- Dresdner Kleinwort-* the Claimant held vested rights in many £ms in shares due for payment between 2008 and 2011, which would be forfeit if he obtained or attempted to obtain

employment with a competitor during the deferral period. Do such terms engage the Restraint of Trade doctrine or not?

There are currently conflicting approaches in the relevant first instance decisions as to whether the type of restraint that operates by deterrent of financial penalty engages the doctrine. In *Peninsular*, the EAT held that an economic disincentive to move employment was not a restraint of trade. Only a bar on competitive working was. It was followed in *Tullet*. But compare *Stenhouse*, *Bull*, *Wyatt*, *Sadler*, *NM Financial*, *Prudential-v-Rodrigues (NZ)*, *Greig*, *Greck*, *Finnegan* Is *Peninsular* good authority or is the correct position that a restraint may be found in a condition which has the practical effect of diminishing prospects of competitive employment as much as in a promise not to compete. If the doctrine does apply, will the court prefer the countervailing policy behind the Code?

Some of these and related questions will be addressed by our other Speakers shortly:

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- **Code's interaction with express and implied terms:**
Dan Oudkerk QC
- **Adjustment and Clawback, Vesting and the Penalty Doctrine:**
Simon Devonshire QC
- **Deferral and Restraint of Trade:** Alistair McGregor QC

But the starting point to answer these questions has to be the **Scope and Effect of the Rules** themselves beginning with their **statutory status as delegated legislation**

Statutory status of the Remuneration Code

- Section 6 Financial Services Act 2010: *Rules made by FSA about remuneration*: In the Financial Services and Markets Act 2000, after s.139 insert—
 - “139A General rules about remuneration
 - (1) The Authority must exercise its power to make general rules so as to make rules requiring each authorised person (or each authorised person of a specified description) to have, and act in accordance with, a remuneration policy.
 - (9) General rules may—
 - (a) prohibit persons (or persons of a specified description) from being remunerated in a specified way;
 - (b) provide that any provision of an agreement that contravenes such a prohibition is void; and
 - (c) provide for the recovery of any payment made, or other property transferred, in pursuance of a provision that is void by virtue of paragraph (b).

Rules = Senior Management Arrangements Systems and Controls (Remuneration Code) (No 2) Instrument 2010 (SYSC)

- **Application (19.1.3):** Remuneration:
 - awarded/due/paid on or after 1/1/11
 - awarded for 2010 but not paid before 1/1/11
- **Current contracts (19.1.5):**
 - A firm must take reasonable steps to amend or terminate non-compliant provisions in contracts entered into before 29/7/10 at the earliest opportunity

Mandatory rules for deferral and guarantees

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- **Guaranteed Bonuses (19.3.38) :**
 - A *firm* must not award, pay or provide guaranteed variable *remuneration* unless it:
 - (1) is exceptional;
 - (2) occurs in the context of hiring new *Remuneration Code staff*, and
 - (3) is limited to the first year of service.
 - **19.3.39** (1) (b) is subject to appropriate performance adjustment requirements.
 - **19.3.40** is subject to the same deferral criteria as other forms of variable *remuneration* awarded by the *firm*.
- **Minimum Deferral (19.3.46)**
 - A firm must not award, pay or provide a variable remuneration component unless a substantial proportion of it at least 40% is deferred over a period which is not less than 3 to 5 years

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Effect of the Code

- Statutory force of SYSC as delegated legislation but scope of interference?
 - Impact on contracts?
 - Impact on exercise of discretion?
 - Impact as evidence of a public policy?

Impact on Contracts

- FSA only proposes to exercise its s.139A (b) power in relation to:
 - Guaranteed bonuses: 19.3.38R,
 - Minimum 40% deferral :19.3.46R
 - Replacing payments recovered as void: SYSC 19 Annex 17R
- Other contractual provisions contravening Code are not void or unenforceable: s.151 (2)
- An employee can invoke a *contractual* right against the employer, even if performance by the employer would place it in breach of the Code.

Impact on bonus discretion

Impact on discretion

- Code dictates considerations which must be taken into account at ex-ante, ex-post, and clawback stages
- So Code narrows the parameters of discretion
- But within the constraints of the Code, how the employer exercises discretion will still be subject to common law principles

Rule on ex post risk adjustment
Evidential Provision

- 19.3.49 E (1) A firm should reduce unvested deferred variable remuneration when, as a minimum:
- (a) there is **reasonable** evidence of employee misbehaviour or material error;
 - (b) the firm or the relevant business unit suffers a **material** downturn in its financial performance;
 - (c) the firm or the relevant business unit suffers a **material** failure of risk management.

Impact as evidence of a public policy

- Enforcement of contract terms can be constrained by public policy
- Doctrines of Restraint of Trade and Penalty are public policy
- Balancing exercise: would they give way to the policy behind the Code?