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Clawback of Bonuses: UK PRA's Banking Proposals Cast Six-Year Shadow for Bad Actors and Their Supervisors and Line Managers

On 13 March 2014, the Prudential Regulation Authority (PRA), the U.K. regulator responsible for prudential supervision of banks, insurers and large broker-dealers, issued a consultation paper on bonus clawback (CP6/14). The PRA paper can be found here.

The consultation is the latest proposal to align employee reward in the banking sector with the interests of shareholders and other bank stakeholders and remove the perception of payment for failure. There is clear political enthusiasm for measures to regulate bankers' access to their annual bonuses, but the PRA's proposal, which would allow the clawback of vested variable remuneration, will place strain on contractual agreements, employment relationships and tax rules. Employees in the U.K. have free-standing rights under both their existing contracts and employment law.

Assuming implementation of the proposals, all "Level 1" and "Level 2" PRA-authorised banks and investment firms will be required to amend employment contracts of "code staff" to ensure vested bonus awards can be clawed back for a period of up to six years from the date of payment or vesting. In line with PRA Remuneration Code provisions, the requirement will also apply to the employment contracts of "Code Staff" employed by non-U.K. branch offices and subsidiaries.

A firm would be required to clawback vested variable remuneration in any situation where:

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

Employees subject to such clawback are potentially a large group:

- those directly culpable of malfeasance; or
- those who could have been reasonably expected to be aware of the failure or misconduct at the time but failed to take adequate steps to promptly deal with it; or
- those who 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.

Any existing awards that have been paid or vested before the expected 1 January 2015 implementation date will be grandfathered. However, the rules would apply to any awards made after that date (requiring employers to amend contracts of employment in many cases) and the PRA expects firms to take "all reasonable steps" to amend employment contracts to apply clawback to awards made prior to that date that vest subsequently.

Therefore, the PRA proposes to apply clawback retrospectively to awards which have been freely negotiated and awarded in good faith. The PRA proposals will be a significant issue for current "Code Staff" employees and a particular concern for those affected employees who plan to retire after 1 January 2015 and whose retirement arrangements assume that paid bonuses will not subsequently be clawed back.

Employing firms' ability to operate the required clawback provisions will be subject to U.K. employment law. Employees have free-standing employment rights, which include:

- the terms of their individual contracts of employment. Any change to an employee's contract will require the employee's consent. An employer would need to dismiss and re-engage the employee on new terms if they do not agree to the proposed change to their bonus entitlement, with attendant risk of unfair dismissal claims;
- a prohibition on deductions from wages (which includes in this context bonus and other cash payments) unless the employee has agreed, in writing, to the deduction before the relevant deduction is made. If employers want the ability to clawback the amount from future wages (as a practical alternative to a separate repayment) they will need to review existing deduction provisions in their contracts to ensure that a clawback is explicitly covered; and
- even in cases where the employee has agreed to a deduction or that the payment can be repaid, the clawback may not be enforceable if it is regarded as a penalty clause: the terms of the clawback would need to be well-drafted and the clawback should be limited to a genuine estimate of the employing firm's loss as a result of the employee's conduct.

Given the onerous nature of a clawback provision, an affected employee's contract will require explicit wording and firms will need to include clear provisions in their contracts for new hires to enable them to clawback any remuneration.

In practice, senior individuals' employment contracts are usually structured so that (i) each bonus award is wholly discretionary and, accordingly, (ii) the employer may impose conditions when the award is made. Provided there is a degree of flexibility in current contracts it should not, therefore, be too difficult from a U.K. perspective to impose clawback provisions on future grants to existing affected employees. However, this will not necessarily be the case for affected employees who are based in non-U.K. jurisdictions and whose employment contracts are subject to other local laws.

However, the position in respect of awards made *before* 1 January 2015 that will vest after that date is more problematic. In such cases it is very unlikely that provision for clawback would have been included in the conditions of the award. Therefore, unless the affected employee agrees to amend his or her contract to include a clawback provision, the firm will be unable to do so. Other than a formal request of its affected employees, it is difficult to envisage what "reasonable steps" the PRA expects firms to take in such a scenario. In practice, therefore, the firm's duty in this respect may prove somewhat light. It is possible that the PRA recognises this, because the proposed transitional arrangements state that where employment contract amendment is not possible, firms must put in place specific and effective arrangements, processes and mechanisms to manage the risks raised by their inability to apply clawback.

Tax also has to be considered. In keeping with other recent regulatory proposals, the consultation paper does not immediately offer a mechanism to mitigate any consequences of clawback under U.K. tax law. Vested bonuses in cash or securities are very likely to be taxed either when awarded or, if later, vested. The employer also will suffer national insurance costs at that point, too. However, it is not clear that subsequent clawback creates the right post-tax result under existing U.K. tax law, as was debated in a 2013 case (*Julian Martin v HMRC [2013] UKFTT 040 (TC),* still under appeal). Clawback of cash bonuses might, as in that case, create "negative earnings," which are deductible, but there are limits to carry-back (12 months, plus the new limit of £50,000 or 25% of income on reliefs) if not absorbed by certain other income in the clawback year, and the relief must be claimed within a certain timeframe. Equity that is clawed back gives rise to even greater complexity and in many cases may never give rise to a useful deductible item for income tax purposes, given the relevant statutory wording currently in force.

Given that the intention of the proposals is to curb excessive risk-taking and short-termism, as opposed to anything punitive, the PRA may be obliged to discuss these proposals with HMRC, as indeed happened with the FCA's 2013 implementation of AIFMD remuneration requirements.

The consultation period concludes on 13 May 2014. Affected firms should consider the impact of these proposals from both a legal and an HR perspective and respond to the PRA either directly or through an industry group before that date.