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White Collar Defense and Investigations

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Variable Remuneration and Ethical Behavior: A Toolkit for Companies

Governmental authorities in the U.K. and the U.S. want companies to align employment incentives with ethical conduct. In 2022, the U.K. government undertook a consultation on this topic and in May 2022 published a paper — "Restoring Trust in Audit and Corporate Governance" (the Audit and Governance Paper) — that outlined plans to change the audit and corporate governance framework for the U.K.'s largest companies (both public and private). The Audit and Governance Paper discussed subjecting executive directors' remuneration arrangements to strengthened clawback (recovery of remuneration) and malus (withholding of remuneration) provisions to include a wider range of clawback triggers, such as reputational damage and a failure of risk management.

Existing frameworks already seek to do this. For example, the U.K. Prudential Regulation Authority's (PRA's) Senior Managers and Certification Regime (SMCR) is designed to drive good behavior in key functions within companies that the PRA regulates. It aims to hold Material Risk-Takers (MRTs), *i.e.*, senior individuals who materially impact a firm's risk profile, accountable through their pay — including through the deferral of variable pay for a specified period and through the payment of a proportion of their variable remuneration in the form of instruments other than cash and the application of malus and clawback provisions.

The U.S. Department of Justice (DOJ) recently issued guidance indicating that companies must not only punish wrongdoing but also incentivize ethical behavior. Like its enforcement partners in the U.K., the DOJ encourages corporations to include clawback provisions in their compensation structures to enable recovery of remuneration already paid to wrongdoers upon discovery of misconduct. The DOJ also suggests that companies incentivize disclosure of wrongdoing and strengthen compliance programs with protocols to voluntarily disclose such matters to regulators prior to an imminent threat of government investigation. In such instances, companies could be rewarded for self-disclosure in the form of cooperation credit, which can reduce penalties.

Driving Good Behavior in the Workplace

Tools designed to incentivize and ensure ethical behavior in the workplace are often categorized as either "financial" or "cultural."

Financial Drivers of Behavior

Financial drivers align employee remuneration with ethical criteria. These tools include:

- delinking pay from short-term performance metrics to encourage a focus on long-term performance;

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- linking pay to business (rather than individual) performance;
- adjusting share vesting criteria to reward nonfinancial metrics that are of value to the business (for example, metrics driving desired cultural or governance behaviors); and
- using clawback and malus to punish wrongdoing.

Ensuring these tools are clearly expressed in workplace remuneration policies, employment contracts and/or award terms (particularly for influential, highly paid employees) is important. The explicit reference to "clawback and malus provisions in directors' remuneration arrangements" in the Audit and Governance Paper reinforces their importance as tools in responding to poor behavior. The consultation sets out a "list of minimum conditions for malus and clawback provisions" to which remuneration committees could be asked to adhere, and while this list largely reflects what U.K. listed companies are already doing, the consultation's focus on effective use of such provisions is clear. Suggested examples of "minimum conditions" for the application of clawback/malus (in line with existing U.K. Financial Reporting Council guidance) include misconduct, material misstatement of results, material failure of risk management, conduct leading to financial loss and reputational damage and add a broader-ranging "unreasonable failure to protect the interests of employees and customers."

The Audit and Governance Paper, alongside the U.K. Corporate Governance Code (which applies to all companies with a premium listing of their shares in the U.K.) encourages companies to explain more clearly to shareholders and other interested parties what malus and clawback provisions the company has in place and what other remuneration approaches it takes to incentivize positive behaviors in the workplace. The U.K. government acknowledges remuneration committees still need to retain flexibility to design and enforce their own malus and clawback polices so that policies can be tailored to a company's specific circumstances.

The U.K. government has recently proposed plans to eliminate the so-called bankers' bonus cap. The cap, introduced by the EU after the financial crisis of 2008, limited banker bonuses (in cash or shares) at twice the employee's fixed annual salary. As set out in PRA and Financial Conduct Authority rules, the cap was applied to a narrow pool of individuals, affecting senior management and MRTs in banks, building societies and designated investment firms. In the absence of the cap, if U.K. financial institutions were to increase bonuses as a percentage of overall compensation, then malus, clawback, vesting criteria and long-term business performance will be of greater importance when U.K. companies design their compensation structures to ensure compliance with U.S. guidance.

Companies that adhere to the U.K. government guidance will also reap benefits with U.S. authorities. In a September 2022 memorandum, the DOJ announced changes to its corporate criminal enforcement policies that seek to shift the costs of corporate misconduct to individual wrongdoers instead of the company's shareholders. The DOJ memo instructs that, when evaluating a corporation's compliance program, "prosecutors should examine whether compensation systems are crafted in a way that allows for retroactive discipline, including through the use of clawback measures, partial escrowing of compensation, or equivalent arrangements."

Helpfully, contractual provisions addressing clawback and malus can be phrased broadly to cover a spectrum of misbehavior and offer companies a versatile safeguard against harmful behaviors. In a similar way, companies have for some time applied metrics to performance-based remuneration that are focused on longer-term performance of the business, with awards vesting over a period of years linked to long-term business performance, to increasingly discourage executives, management and MRTs from making short-term decisions that may be harmful to the business. We anticipate that the financial services sector will start using these types of provisions more widely for both new hires and for existing employees. To the extent the terms of bonus and incentive plans are contractual and not discretionary, changes to existing terms and conditions of employment for U.K. employees would require employee consultation and consent. If a company's bonus arrangements are discretionary, it may be able to amend bonus terms to include these types of provisions without employee consent. In either case, we typically expect companies to ensure a uniform approach for both existing employees and new hires, even if this might require existing employees to consent to any changes.

Cultural Drivers of Behavior

In addition to financial incentives, companies also have cultural tools available to promote and encourage compliance. Companies should employ these tools to ensure that the cultural environment (*i.e.*, what employees see, hear and experience day-to-day) aligns with the ethical standards that the organization espouses and to make sure that there are clear repercussions for those who do not behave in accordance with expectations.

Cultural tools can take multiple forms, including:

- regular ethics training;
- clear, thoroughly implemented ethics policies;
- ethical role models; and
- clear feedback channels.

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Used together, cultural tools can improve the acceptance, normalization and effectiveness of behavioral standards. They are an important complement to financial tools. The U.K. Bribery Act 2010 (the U.K. Bribery Act) introduced failure to prevent bribery as a corporate offence. Section 7 of the act makes an organization guilty of that offense if an "associated person" (*e.g.*, an employee or agent) bribes another person with the intention of gaining business or a business advantage for the organization. But the U.K. Bribery Act also sets out in Section 9 that if a commercial organization can show it had "adequate procedures" in place to prevent such bribery, then it may have a defense to its liability. Guidance from the U.K. government on what comprises "adequate procedures" reveals that cultural factors matter greatly. These include articulation of the benefit of rejecting bribery, regular training, a "tone from the top" signaling "zero tolerance" of bribery, risk-based compliance policies, transparency in transactions and information disclosure, good communication and frequent review of prevention policies, and internal and external commitment to bribery prevention. The guidance reaffirms that organizations that invest in the fundamentals of their corporate culture and messaging stand to benefit.

Similarly, U.S. regulators strongly encourage companies to foster a culture of compliance that will prevent instances of misconduct and support the disclosure of wrongdoing when it does occur. In particular, company policies that encourage disclosure of misconduct will signal to the DOJ that the company takes seriously its compliance obligations. The DOJ's recent revisions to its Corporate Enforcement Policy[1] make clear that only immediate reporting of corporate misconduct, prior to even internal investigations, will afford companies the chance for a declination from the DOJ for wrongdoing. Efficient reporting mechanisms within companies subject to DOJ enforcement are therefore essential. Corporate policies favored by the DOJ also include whistleblower exceptions to nondisclosure agreements, carve-outs in NDAs for reporting criminal activity, anonymous hotlines to encourage whistleblowers to report and anti-retaliation policies to protect those that do. Like its U.K. counterparts, the DOJ advocates implementation of cultural tools such as ethics training, policies and procedures that communicate and establish ethical norms, and efficient and trusted mechanisms by which employees can report misconduct.

A culture of accountability, then, is critical — but should be accompanied by clear messaging on compliance responsibilities, along with tailored or supplementary training for high-risk employees and supervisory employees alike. In instances in which company policies call for employees at different levels of seniority to take different approaches, employees need to understand their position in order to comply. Since the introduction of the SMCR, some firms have increased their deployment of harsh disciplinary sanctions against senior individuals deemed to have not behaved in a "fit and proper" way. In the financial services sector, employers are showing decreased tolerance for senior employees accused of improper conduct (including sexual harassment) and relying on protocols that more easily trigger disciplinary procedures and dismissals. Both reminding employees of the conduct standards and (universal and seniority-specific) procedures that apply to them and consistently and methodically implementing those procedures are important to culturally drive ethical behavior.

Incentivizing Good Behavior in Workplace Investigations

When responding to alleged or suspected employee misconduct, most large companies will have a prepared strategy that minimizes company exposure and incorporates internal investigations as an essential fact-finding element. Internal investigations provide companies (or their audit committees, special committees or boards) with a factual predicate upon which informed decision-making can occur. Internal reviews also enable companies to respond to external requests. The success of an internal investigation depends in substantive part on employee cooperation and may necessitate employee discipline or dismissal. In establishing internal investigation procedures, companies should consider the process for initiating internal investigations, maintain standards for ensuring that investigations are independent and credible, document information collection practices, and include policies requiring cooperation of employees and providing for employee discipline.

Companies benefit from setting the groundwork for internal investigations at the outset of employment, including by incorporating into employment agreements the company's expectations for cooperation during internal investigations, processes regarding the use of data, and provisions for clawbacks in instances of noncompliance or misconduct. Employee handbooks, company bylaws and policy documents often also contain provisions regarding company use of employee data, document collection, workplace searches, communication monitoring, privacy and confidentiality. In addition, many employee handbooks or codes of conduct contain provisions that protect employees from retaliation for participating in an investigation or raising concerns. Together, these documents can help facilitate efficient internal investigations before the investigations even begin by encouraging employee participation and cooperation.

The fact-gathering stage of an investigation often involves reviewing documents and conducting witness interviews. U.S. employment agreements and corporate policies typically obligate employees to cooperate with a company's investigations, and

[1] See our January 19, 2023, client alert "DOJ Doubles Down on Efforts To Incentivize Early Self-Reporting and Cooperation" for details.

employees may face disciplinary action, including potential termination, for failing to cooperate. Although employees in the U.S. are free to obtain independent legal advice regarding a potential interview, they are nonetheless obliged to cooperate with their employer and its counsel. Former employees are not likely to be bound by the same confidentiality obligations as company personnel and may refuse to cooperate with the investigation unless they are contractually compelled to do so. Accordingly, companies should establish processes for dealing with employees who leave while a review is ongoing so that the employee's departure does not adversely affect the retention of documents and data or key fact-gathering efforts such as interviewing witnesses.

The findings of an internal investigation will guide a company's strategy for remediation, which may include employee discipline. Company policies and procedures should prescribe avenues for such discipline following investigation findings. In light of recent DOJ guidance, companies should consider incorporating compensation-based deterrents into their disciplinary structures.

Conclusion

As both the U.K. Audit and Governance Paper and the recently announced DOJ corporate enforcement policy make clear, companies are expected to create structures that incentivize employees to behave ethically. Both the U.K. and U.S. government acknowledge the importance of financial and cultural tools in driving ethical behavior. Both jurisdictions emphasize the importance of a culture of ethical behavior — underscored by sufficient policies, adequate training and a "zero tolerance" tone from the top — the existence of which is likely to be viewed favorably in a governmental investigation. Equally as important as compliance-focused company culture and messaging is readiness to respond to alleged or suspected misconduct. Additionally, in both jurisdictions regulatory environments encourage companies to use clawbacks and malus to discipline misconduct. Where misconduct is suspected or alleged, companies with established frameworks that facilitate internal investigations from the outset of employment can mitigate the risks of external investigations by considering regulator priorities and taking a cooperative position.

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