

# 11KBW

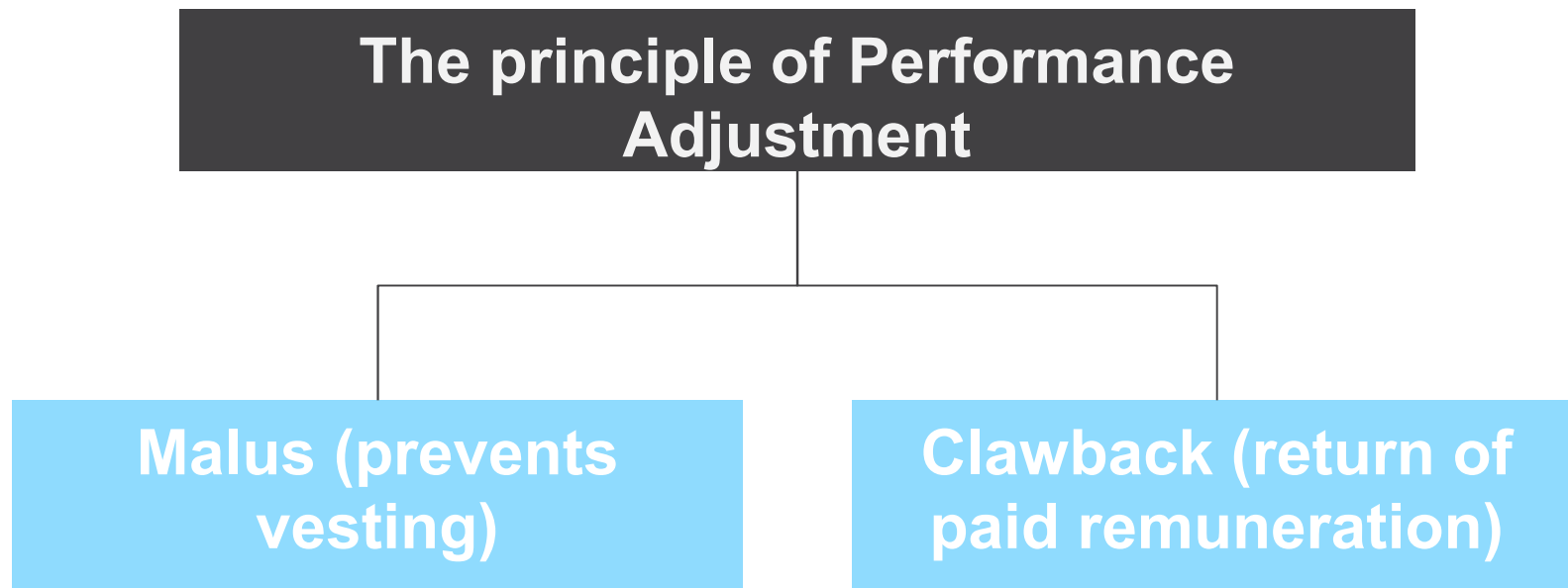
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## Current Employment Issues in Financial Services and the Senior Managers Regime

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## The Remuneration Codes: Malus, Clawback and the Common Law



## Malus

“an arrangement that permits the institution to reduce the value of all or part of deferred remuneration based on ex post risk adjustments before it has vested”

### Clawback

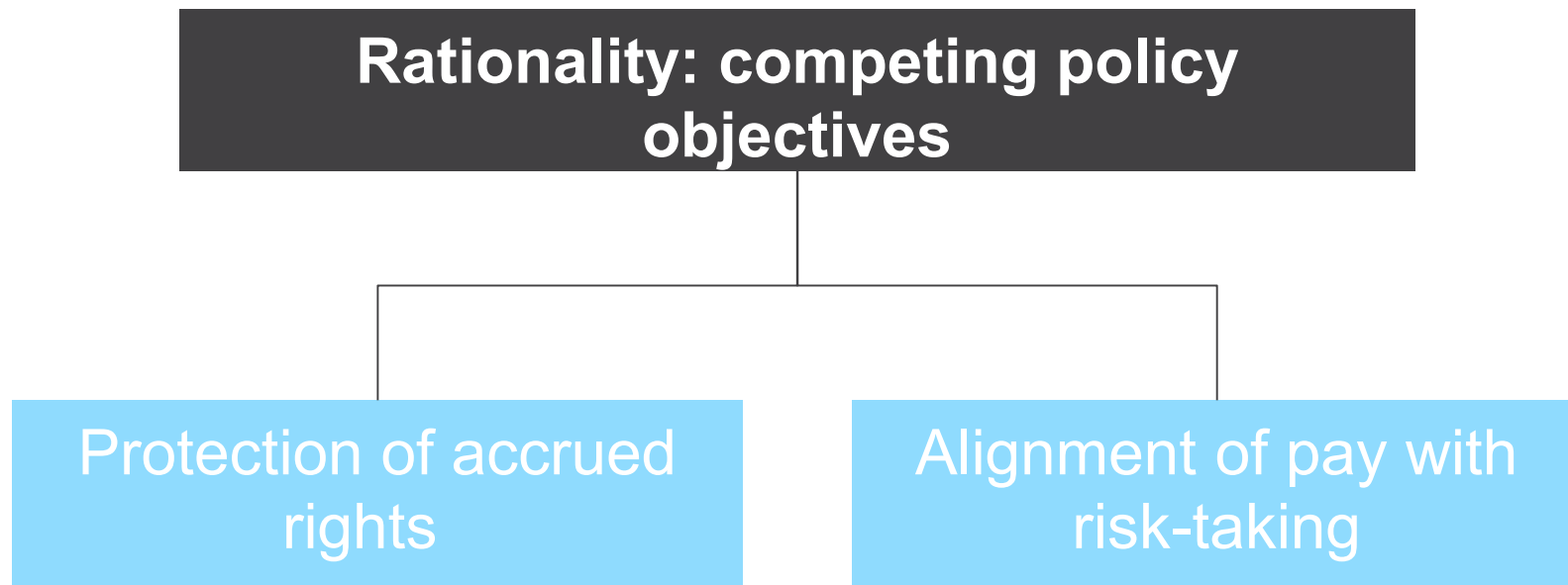
“an arrangement under which the staff member has to return ownership of an amount of variable remuneration paid in the past or which has already vested to the institution under certain conditions”

# The Remuneration Codes and Common Law **11KBW**

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## Principles overlaying Performance Adjustment

- Rationality
- Reasons
- Relevant and irrelevant considerations



### Protection of accrued rights:

“Options are granted in reward for past performance, and in anticipation of future loyalty, and, if you like, future performance, but ... after three years they ‘vest’. In such circumstances any committee of directors which is contemplating applying its discretion ... to the mature options of a participant needs to bear in mind that it is dealing with vested property rights” (Rix LJ in ***Mallone v BPB Industries Ltd*** [2002] ICR 1045)



### Alignment of pay with risk-taking

“The effective and meaningful use of *ex-post* risk adjustment, including malus, is absolutely necessary to align remuneration policy with risk-taking. *Ex-post* risk adjustment allows firms to adjust previously awarded remuneration to take account of subsequent performance and potential risk outcomes thus enabling them to recoup variable pay in the event of a downturn in performance or a risk management failure.” (PRA SS1/13 para 3, October 2013)

### **Firms' remuneration policies and employment contracts should clarify that variable remuneration awards (PRA CP 33/16 para 4.5, Sept 16):**

- Are conditional, discretionary and contingent upon a sustainable and risk-adjusted performance, and so subject to forfeiture at employer's discretion.
- Include a deferred portion that vests only if sustainable and justified by performance.
- Will be reduced or clawed back according to set criteria

## Reasons

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*Commerzbank v Keen* [2007] ICR 632: *obiter* remarks on reasons:

- “an employer ought to supply an employee with an explanation of the reasons for the exercise of a discretion in respect of additional pay” (Mummery LJ at [44])
- The T & C term will “generally require an employer to give his reasons for the exercise of his discretion to pay or withhold a bonus and to identify the decision-maker” (Moses LJ at [110]).

- “Firms should ensure that the value of performance adjustments made to an individual’s variable remuneration, and the reasons for the adjustments, are clearly communicated to the affected individuals in writing” (PRA CP33/16 para 4.16 Sept 16)

## Relevant and irrelevant considerations

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Common law widened:

- *Braganza v BP Shipping Ltd* [2015] ICR 449

Cautionary note:

- *Paturel v DB Services (UK) Ltd* [2016] IRLR 286

## Recent developments in discretion

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*Hills v Niksun Inc* [2016] IRLR 715

- Burden of proof
- Sufficiency of evidence

## Recent developments in discretion

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Watson v Watchfinder [2017] Bus LR 1309

- *Braganza* requires proper process
- Identifying “target” of duty
- Substantive consideration and understanding

## Recent developments in discretion

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*IBM UK Ltd v Dalgleish* [2018] Pens LR 1

- The weight of reasonable expectations
- Reasonableness and rationality
- Burden of proof



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### **Relevant considerations: Malus (CRR Remuneration para 15.21, SYSC 19D.3.62R)**

- Is there reasonable evidence of employee misbehaviour of material error?
- Has the firm or business unit suffered a material downturn in financial performance?
- Has the firm or business unit suffered a material failure of risk management?

## Relevant considerations: Clawback

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PRA-authorized firms in proportionality levels 1 or 2

Vested remuneration to be recovered where

- There is reasonable evidence of employee misbehaviour or material error; or
- The firm or business unit suffers a material failure of risk management

## **Relevant considerations: Proximity (PRA CP33/16 Sept 16 para 4.8)**

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**Performance adjustment should not be limited to employees directly culpable of malfeasance:**

- Was employee aware of failure or misconduct, and failed to take adequate steps?
- Given seniority, was employee indirectly responsible or accountable?
- Given role in control functions, was employee responsible for failings in control functions?
- Was there a collective or pervasive failure by a group of employees?

## **Buy-outs and variable remuneration**

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Contracts concluded after 1 Jan 17 (PRA CRR  
Remuneration 15A):

- Former employer to provide employee with a remuneration statement
- Malus and clawback determinations made by the former employer
- New employer bound to apply (subject to limited right to apply for waiver)
- New right of action of employee against former employer

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## Regulatory References

## **(1) References: introduction**

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- Context: why are we talking about regulatory references?
- Historical position.
- The rules from 7 March 2017.
- Future proposals.

## (2) Refs: Context

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Today's talk:

- The Senior Managers and Certification Regimes: 7 March 2016 for banks.
  - FEMR (June 2015): the 'rolling bad apples'.
- Shift in responsibility for F+P assessments from the regulators to firms:
  - Certification: annual re-certification after 7 March 2017.
  - Senior managers: section 60A FSMA.
- Previous enforcement action by the FSA (final notices):
  - *Neale Andrew Morton* (24 June 2010);
  - *Nazia Bi* (14 October 2011);
  - *Case Funding Centre* (18 December 2009).

## (3) Refs: Historical Position

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- Position is the same for all firms.
- No (strict) obligation to request references.
- If requested to provide a reference (SUP 10A.15):
  - Must provide “all relevant information”, having regard to purpose of request, including F+P.
  - FCA guidance: “reference should be accurate and based on documented fact”, should take “reasonable care” in the preparation of the reference.
- Guidance: SUP10A.15 applies regardless of settlement agreements, and firms should “not enter into any such arrangements”



## (4) Refs: Historical Position

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- Ambitious CPs in October 2015: FCA CP15/31 and PRA CP36/15.
- Interim rules for 7 March 2016 to 6 March 2017:
  - FCA PS16/3:
    - historical requirements applied to ‘RAPs’.
    - FCA requirements for other firms kept the same.
  - PRA PS16/5:
    - New requirements to requests references before appointment.
    - If in same role before 7 March 2016, rules did not apply: see *Fitness and propriety transitional provisions*.

## (5) Refs: 7 March 2016

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FCA PS16/22 and PRA PS27/16 published on 28/9/2016.

- **‘Full-scope’ regulatory reference firms:** PRA-regulated firms, except for ‘Small NDFs’.
  - i.e. banks, building societies, PRA-designated investment firms, Solvency II insurers, Large NDFs, Lloyds, UK SPVs, branches.
- **Other firms:** Small NDFs and FCA-only firms.
  - E.g. asset managers, independent financial advisers, consumer credit firms, insurance intermediaries, investment managers and stockbrokers.

## (6) Refs: 7 March 2016

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- Those ‘**other firms**’ are required to:
  - Provide a reference upon request in relation to SMFs, SIMFs, controlled functions, certification functions, KFJs, notified NEDs.
  - Include “all relevant information” going back 6 years in that reference, or any ‘serious matters’ within any time limit.
  - Not enter into agreements that conflict with its reference-giving obligations.
- Not required to:
  - Request references.
  - Use the template.
  - Update a reference.
  - State whether disciplinary action constituted a conduct rule breach

## (7) Refs: full-scope firms

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### Basic points:

- Duty to take reasonable steps to obtain a reference covering the past 6 years, before:
  - deciding whether a person is F+P;
  - issuing a certificate;
  - appointing a notified NED or KFH;
  - relevant period for SMFs (see next slide).
- Request references from employers, firms where a NED, SMF, SIMF, KFH, approved person or certificate holder.
- New requirements do not apply to pre-existing staff prior to 7 March 2017 (...there are now two sets of transitional provisions: pre-March 2016, & pre-March 2017).
- Associated record-keeping requirements.
- References, senior managers and listing rules: may not need to take up reference before applying for approval if a 'mandatory disclosure' would result.

## (8) Refs: full-scope firms

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### Requesting references:

- What must be requested in a reference:
  - If asking a full-scope firm: information in template (see next slide).
  - If not asking full-scope firm: all matters old firm reasonably considers relevant to assessment of F+P.
- Intra-group appointments: no reference required if adequate information-sharing arrangements.
- Promotions etc.: no need to acquire compliant references again, but otherwise references must be taken up.
- Overseas firms: only 'reasonable steps' required.

## (9) Refs: full-scope firms

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### The template:

- Find it at SYSC 22 Annex 1 in FCA Handbook.
- Requirement to disclose breaches of conduct rules where resulted in ‘disciplinary action’ (see template).
- Over-arching rule: provide “all information of which B is aware that B reasonably considers to be relevant to A’s assessment of whether P is fit and proper”.
- Information relating to matters which occurred:
  - In six years before request;
  - After request made, but before reference given;
  - At any time in the case of ‘serious matters’.

## (10) Refs: full-scope firms

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### Verification:

- New regulatory emphasis on ‘verification’ and fairness to employees.
- Guidance:
  - References should be “based on documented fact”.
  - References should not be based on unproven allegations or mere suspicions.
  - Fairness requires the employee be given an opportunity to comment on the information.
- Firms utilise ‘fitness and propriety’ panels for difficult cases.

## (11) Refs: updating

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### Updating references:

- Only applies to references given after 7 March 2017 by full-scope firms.
- An updated reference must be sent if firm becomes aware of issues that:
  - are “significant” re F+P; and
  - would require the reference to be drafted differently.
- Firm must make ‘reasonable enquiries’ as to new employer.
  - No obligation to ‘update’ a firm to which no reference was sent.
- The obligation applies for six years after the original reference was given (regardless of whether there is ‘serious matter’).
  - Look-back period: six years unless ‘serious matter’.



## (12) Refs: updating

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- A practical example for a reference given in 2020:
- In 2023, misconduct in 2018 is discovered.
  - In 2023, the 2018 misconduct is within the 6 year 'look-back' period: update if issues significant re F+P and the reference would be required to be drafted differently.
- In 2027 the same 2018 misconduct discovered.
  - No requirement to update: outside six year updating period starting in 2020.
- In 2023, misconduct in 2010 is discovered.
  - The 2010 misconduct is outside the 6-year 'look-back' period, but 2023 is within the 6-year updating period. Only update if:
    - (1) the misconduct was "serious"; and,
    - (2) issues are significant re F+P and must draft ref differently.

## (13) Refs: common law

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- No duty to provide a reference.
- If one is provided, it should be true, accurate and fair.
- Potential tortious liability:
  - Negligence: *Spring v Guardian Assurance* [1995] 2 AC 296.
  - Breach of statutory duty: s.138D FSMA.
  - Defamation: qualified privilege unless malice shown (*Spring*). Also, deceit.
  - Discrimination/victimisation (including for failure to provide a reference) *Coote* [1988] IRLR 656; *Rhys-Harper* [2003] IRLR 484
  - Data Protection Act 1998 claims.

## (14) Refs: common law

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### Spring v Guardian Assurance [1995] 2 AC 296

- Reference: serious case of mis-selling; S could not be regarded as honest
- Lautro rules required “full and frank disclosure of all relevant matters believed to be true”
- Trial judge found G was motivated by leaping to a conclusion of dishonesty, careless of the true facts

## (15) Refs: common law

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### **Spring v Guardian Assurance** [1995] 2 AC 296

- HL found that claim for economic loss could be made for negligent misstatement
- The ‘employer’ had voluntarily assumed responsibility for the reference
- Reference had been “the kiss of death” to career in insurance
- Fall out of Spring: the limited reference

## (16) Refs: common law

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### **Bartholomew v LB of Hackney [1999] IRLR 246 (CA)**

- Whilst each statement in the reference was factually correct, that is not an end to the enquiry: it is necessary to consider whether the reference may in the round give an unfair or potentially unfair impression to the reader; the reference must not mislead, including by omission
- A reference need not in every case be full and comprehensive

## (17) Refs: common law

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### **Kidd v Axa Equity & Law Life Assurance Society plc [2000] IRLR 301**

Must not give misleading information:

- unfairly selective provision of information
- inclusion of facts/opinions so as to give rise to a false or misleading inference.

“I concluded that” the reference need not in every case be full and comprehensive

3 stages for claimant to prove [prior to causation]

- The information provided in the reference was misleading.
- The provision of that misleading information was likely to have a material effect on the mind of a reasonable recipient, to the detriment of the claimant.
- The company was negligent in providing that information.

## (18) Refs: common law

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### **Cox v Sun Alliance [2001] IRLR 448**

Need to make reasonable enquiries into the factual statements in the reference (like in a *Burchell* case):

- Reasonable investigation
- Reasonable grounds for believing statements to be true

## **(19) Refs: common law**

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### **Abdel-Khalek v Ali [2016] IRLR 358**

Causation: emphasis on any misstatement being the cause of the withdrawal of the job offer.

False statements in the reference did not in fact render the overall impression misleading.

### **Jackson v Liverpool [2011] IRLR 1009**

No negligence.

Former employer referred to newly discovered issues.

But made clear that they were uninvestigated concerns.



## Some practical situations

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**(a) Emp'er: we just dismissed an employee w/o investigation.**

Do we investigate or not?

**(b) Emp'ee: I've been told an updated ref will be sent.**

When / how tell current employer?

What representations should be made?

Should any allegations be admitted?

## Some practical situations

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**(c) Emp'ee: I just lost a job because a reference.**

Should I sue?

**(d) Emp'er: I've discovered historic misconduct.**

Should I investigate?

How should the individual be permitted to comment?

CONDUCT AND PAY  
IN THE FINANCIAL  
SERVICES INDUSTRY  
THE REGULATION OF INDIVIDUALS

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1. Introduction – *Thomas Ogg and Richard Leiper*
2. The Conduct Regime – *Thomas Ogg*
3. Fitness and Propriety – *Richard Leiper*
4. The Approved Persons Regime – *Thomas Ogg*
5. The Certification Regime – *Richard Leiper*
6. The Senior Managers Regime – *Jonathan Swift QC*
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10. Sanctions – *Leo Davidson*
11. Enforcement Procedure – *Leo Davidson*
12. Bonuses: The General Law – *Daniel Stilitz QC*
13. The Remuneration Codes – *Patrick Halliday*
14. Malus and Clawback: Further Discussion – *Richard Leiper*

**Any Questions?**

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