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Time for the United Kingdom to implement statutory clawback provision on directors' remunerations: Lessons and experiences from the United States and Netherlands

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Senior executives' remunerations of public companies have aroused much debate and attention in the media. In the aftermath of the Global Financial Crisis (GFC), excessive executive pay arrangements were blamed for contributing to excessive risk-taking which caused the financial meltdown. Since then, regulators and lawmakers around the world have introduced regulations to strengthen corporate governance of listed companies. A key aspect of such reform is by strengthening regulatory intervention over executives' remunerations and increasing the transparency of such information. This article is written against such background and examines the recent proposal by the UK BEIS to ask the FRC to amend the UK Corporate Governance Code (UKCGC) to strengthen clawback provisions for directors' remuneration in listed companies as part of its audit reform. The article examines the background and debates regarding the possible implementation of such a measure in the UK. Contrary to the BEIS' proposal, it argues that implementing it through the UKCGC is unlikely to enhance overall corporate governance and audit quality. It argues that the UK should follow the footsteps of its US and Dutch counterparts by enacting legislation to clawback directors' remunerations. It will also provide some recommendations as to the key factors that need to be considered in drafting such a statutory provision.

Introduction

Almost everything about senior executives' remunerations of public companies is a hot topic of debate in the media, including when a pay package of a CEO goes from reasonable to excessive. In the aftermath of the Global Financial Crisis (GFC), concerns were raised that executive pay arrangements have contributed to excessive risk-taking during the run up to the financial crisis. According to Bebchuk and Fried[1], modern remuneration schemes for senior executives such as bonus and equity compensation have had excessive focus on short-term results. Senior executives were able to pocket bonuses based on short-term results and were permitted to unload substantial parts of their equity incentives based on short-term share prices. These arrangements provided executives with incentives to seek short-term increases

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The author is grateful to the anonymous reviewer and Professor Andrew Johnston for providing precious comments on an earlier draft of this paper.
[1] L. Bebchuk and J. Fried, *Pay without Performance: The Unfulfilled Promise of Executive Compensation*, 2004, Harvard University Press.

in profits even when these came at the expense of piling up latent and excessive risks of an implosion later on.[2]

An empirical study conducted after the GFC illustrated that top executives of financial institutions regularly unloaded shares and options, and thus were able to cash out a lot of their equity before the share price of their company plummeted.[3] The top executives' payoffs were further increased by large bonus compensation during 2000-2007; while the earnings providing the basis for these bonuses evaporated in 2008, the companies' pay arrangements did not contain any clawback provisions that would have enabled recouping the bonuses that had already been paid. Altogether, while the long-term shareholder values in these companies were largely decimated, the executives' performance-based remuneration kept them in decidedly positive territory.[4]

Since the GFC, regulators and lawmakers in major financial markets have introduced a series of reform in order to enhance corporate governance by strengthening regulatory intervention over executives' remuneration and increasing the transparency of this information.

This article is therefore written against such background and examines the recent proposal by the UK Department for Business, Energy and Industrial Strategy (BEIS) to ask the Financial Reporting Council (FRC) to amend the UK Corporate Governance Code (UKCGC) to strengthen clawback provisions for directors' remuneration in listed companies as part of its reform to enhance overall corporate governance and audit quality, where companies are to adopt this on a comply or explain basis.[5] The paper is divided into the following sections. Section one will examine the theoretical foundation of corporate executives' remunerations and explain the rationale of modern remuneration schemes for senior executives. It will also identify the problems with the governance of these remunerations. Section two will examine legislation introduced by regulators and lawmakers in the United States (US) and Netherlands for the recovery of erroneously awarded remuneration from directors. Section three will briefly examine the development and use of

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[2]Ibid.

[3]L. Bebchuk, A. Cohen and H. Spamann, "The Wages of Failure: Executive Compensation at Bear Stearns and Lehman 2000-2008", 2010, *Yale Journal on Regulation*, Vol. 27, 257-282.

[4]Ibid., at p. 271

[5]UK BEIS, "Restoring trust in audit and corporate governance: proposals on reforms", 18 March 2021, available at: https://www.gov.uk/government/consultations/restoring-trust-in-audit-and-corporate-governance-proposals-on-reforms

director remuneration clawback provisions in the United Kingdom (UK) and discuss the reform proposed by the BEIS in its audit reform White Paper[6] to amend the UKCGC to strengthen clawback provisions in listed companies as part of its reform to enhance overall corporate governance and audit quality. Section four will provide a brief analysis and discussion as to why regulating director remuneration clawbacks through the UKCGC on a comply or explain basis is unlikely to enhance overall corporate governance and audit quality of Corporate UK. Section five will argue that it is time for the UK to learn from its US and Dutch counterparts by enacting legislation to clawback director remunerations that are erroneously awarded. It will provide some recommendations as to the key factors that need to be considered in drafting a statutory clawback provision. Section six concludes.

I). Theoretical foundation of corporate executives' remunerations and its governance issue

The agency theory is the main framework underpinning for why executives of the Berle and Means corporations are remunerated according to modern remuneration schemes such as bonuses and share options instead of a flat salary.[7] The model captures the economic interactions of an uninformed party, the principal (shareholder), who delegates tasks to an informed party, the agent (manager), whose private action can affect both parties' benefits and whose interest is not perfectly aligned with the uniformed party. In most developed financial markets, modern public companies are characterized by a dispersed ownership structure, whereby the shareholders delegate the business operation to professional managers. Yet unlike the input of physical capital that are easy to measure, the input of managerial effort is hardly measurable and cannot be directly traded.[8] A principal-agent problem, called moral hazard, arises when self-interested managers intend to secretly choose an effort level different from what would maximize the benefits of shareholders.[9] Since managers do not have a major ownership stake in the company, they therefore bear only a small fraction of the results from their self-interested decisions, leaving shareholders to bear the majority of the

[6]Ibid.
[7]Edward M. Iacobucci, "The Effects of Disclosure on Executive Compensation", 1998, *The University of Toronto Law Journal*, Vol. 48, No. 4, 489-520.
[8]George-Levi Gayle, Chen Li and Robert A. Miller, "How Well Does Agency Theory Explain Executive Compensation?", 2018, *Federal Reserve Bank of St. Louis Review*, Vol. 100, No. 3, 201-236.
[9]Ibid., at p. 2

consequences.[10] This principal-agent dilemma is therefore the cornerstone of executive remuneration problems.[11]

Since managers are the people that run the companies, they have an informational advantage over the shareholders. In theory, managers should act in the best interest of the shareholders by maximizing shareholders' wealth. However, due to this informational advantage managers may behave opportunistically and transfer some of those wealth into their own pockets at the expense of shareholders.[12]

The agency problems, information asymmetry and moral hazards can cause serious damage to companies. In order to resolve this principal-agent dilemma, the optimal contracting approach has been utilized as a corporate governance mechanism to justify for the modern remuneration schemes for senior executives. The optimal contracting approach considers performance-based remuneration as an instrument used by shareholders to mitigate the agency problem.[13] Hence performance-based remuneration such as bonuses are commonly seen as an efficient tool for avoiding agency problems by trying to align the interests of the shareholders and managers.[14] According to Jensen & Murphy, the agency theory predicts that such management remuneration scheme will create an incentive of management to act in the interests of shareholders and to maximize shareholders' wealth.[15]

However, performance based remuneration is only awarded if manager's behaviour affects the company in a positive way. Therefore, the performance of directors must be measurable in some degree and most of the time corporate performance is measured by meeting certain financial targets. Yet this creates the problem of incentivizing managers to focus on meeting short-term profits but not necessarily create long term interests for a company.[16] Consequently, executives are encouraged to take high and even excessive risks and this is precisely what caused the GFC in which a lot of banks and financial institutions

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[10]Ibid.

[11]Mark Anson et al., "Aligning the Interests of Agents and Owners: An Empirical Examination of Executive Compensation", 2004, *Ivey Business Journal*, May/June 2004, available at : https://iveybusinessjournal.com/publication/aligning-the-interests-of-agents-and-owners-an-empirical-examination-of-executive-compensation/

[12]H. Hansmann and R. Kraakman. "Agency problems and Legal Strategies", in *The anatomy of corporate law: a comparative and functional approach*, Oxford University Press, 2004, 21-31.

[13]P.K. Maskara, E.Z. Zekeriya and B. Claassen, "Biggest corporate failures, the underlying agency problem, and the corporate governance measures", 2012, *Journal of Management*.

[14]Ibid

[15]M.C. Jensen & K.J. Murphy, "Performance pay and top-management incentives", 1990, *The Journal of Political Economy*, Vol. 2, 225-264.

[16]HayGroup, "Is bonus banking the answer to banking bonuses?", London: HayGroup 2009.

either collapsed or were at the brink of collapse.[17] What is even more dangerous is that, executives may be motivated to falsify or inflate financial data to make the company appears to be more profitable than it really is in order to boost executives' bonuses. The collapse of Enron during the early 2000s exposed how its former CEO and CFO fabricated the company's financial earnings in order to reward themselves.[18]

The above analysis illustrates the controversies and governance problems surrounding the issue of modern executive remuneration schemes and its interplay with corporate control markets. For the reasons above, regulators and lawmakers around the world have developed various mechanisms that seek to mitigate the negative side-effects of these remuneration schemes such as bonuses. One of these mechanisms is a clawback provision. We shall now turn to discuss how the US and Netherlands have enacted legislations on this matter.

II). Legislation introduced in the US and Netherlands for director remuneration clawbacks

a). The United States

In the US, director remuneration clawback provisions can be found in the Sarbanes-Oxley Act (SOX), the Dodd Frank Act and the Emergency Economic Stabilization Act (EESA). SOX was introduced in 2002 to enhance overall audit integrity of Corporate America as a result of the collapse of Enron and WorldCom, caused by executives' fraudulent behaviours. With that in mind, the US Congress inserted section 304 into SOX which provides that if any CEO and CFO remuneration is linked to earnings that have to be restated and if the misstatement was material and a result from misconduct, this remuneration can be subjected to a clawback.[19] Remuneration can be recouped over a period of twelve months following the first improper filing. Moreover, case law suggests that liability under section 304 does not necessarily require personal misconduct by the CEO or CFO anymore.[20] The court observed that clawback under the provision is merited to prevent corporate officers from

[17]Above n. 3, at p. 272.
[18]David Teather, "Enron paid out $681m to top executives", *The Guardian*, 18 June 2002.
[19]Corporate Board Member Magazine, "Sarbanes-Oxley Section 304: A Sharper Tool in the Enforcement Toolbox", Q2, 2010.
[20]*SEC v. Jenkins* 718 F. Supp. 2d 1070 (D. Ariz. 2010); *SEC v. Jensen* 835 F.3d 1100 (9th Cir. 2016).

profiting from the proceeds of misconduct, whether it is their own misconduct or the misconduct of the companies they are paid to run.[21]

One of the most recent high-profile sanctions imposed by the SEC was on former Hertz CEO and Chairman, Mark Frissora, for aiding and abetting the company in its filing of inaccurate financial statements and disclosures.[22] The SEC charged Frissora with aiding and abetting Hertz's reporting and records violations and with violating SOX 304 by failing to reimburse Hertz for the requisite amount of incentive-based compensation he received.[23] Without admitting or denying the allegations, Frissora eventually consented to a judgment permanently enjoining him from aiding and abetting any future violations of the applicable federal securities laws, requiring him to reimburse Hertz for close to US$2 million in bonus and other incentive-based compensation and requiring him to pay a US$200,000 civil penalty.[24]

In the aftermath of the GFC, there was a common need to improve the mandatory clawback provision in the US, leading to the Congress passing the Dodd-Frank Act in July 2010.[25] Section 954 of the Dodd-Frank Act provides for the recovery of erroneously awarded compensation from directors. At the time of writing, section 954 is still not mandatory and in October 2021, the SEC re-opened the period to solicit input from the public on the compensation clawback rules it proposed in 2015 to implement section 954 of the Dodd-Frank Act.[26] As currently drafted the clawback rule will apply to all public companies. In contrast to SOX 304, section 954 of the Dodd-Frank Act shall broaden and refine the circumstances in which clawback of excess performance-based compensation will apply. It applies to any current and former executive officer of the company and not only to CEO and CFO. The section does not require misconduct to trigger the clawback. It applies to excess incentive-based compensation awarded during the 3-year period preceding the date of the accounting restatement.[27]

[21] Ibid., *SEC v. Jensen*, at 1116.

[22] SEC Press Release, "SEC Charges Hertz's Former CEO With Aiding and Abetting Company's Financial Reporting and Disclosure Violations", 2020-183, 13 August 2020.

[23] Ibid.

[24] Ibid.

[25] DODD-FRANK WALL STREET REFORM AND CONSUMER PROTECTION ACT, PUBLIC LAW 111-203-July 21, 2010.

[26] Sidley, Corporate Governance Update – SEC Seeks Additional Feedback on Proposed Compensation Clawback Rules", 21 October 2021.

[27] Harvard Law School Forum on Corporate Governance, "The SEC Proposed Clawback Rule", 28 October 2015.

The third statutory clawback provision is only applicable to financial institutions that fall under the scope of the Troubled Asset Relief Program (TARP), which became law in 2008. Under the TARP, eligible financial institutions can receive support from the US government. The government can purchase assets and equity of these institutions in order to salvage them from collapse and bring more financial stability.[28] A TARP recipient is required to comply with section 11(b)(3)(b) of the EESA of 2008, which is part of the TARP. The EESA provision was later amended by the American Recovery and Reinvestment Act (ARRA) of 2009.[29] Under the Act a TARP recipient must establish executive payment standards, containing a clawback provision. Any bonus payment to a senior executive officer (SEO) or to one of the twenty most highly awarded employees within the TARP period can be subjected to a clawback.[30] The trigger for a clawback is that if compensation was made on an inaccurate financial statement or any other inaccurate performance metric criteria. The question whether a statement is inaccurate depends on all the relevant facts and circumstances of each case, but if an employee is engaged in purposely providing inaccurate information, this is considered to be of material inaccuracy.[31]

All three mandatory clawback provisions seem to have made profound changes of executive remuneration schemes on Corporate America. Despite section 954 of the Dodd-Frank Act not officially implemented by the SEC yet, clawbacks have become a widely recognized corporate governance mechanism in the United States. According to statistics provided by Equilar, a highly reputable company that specializes in the research of corporate leadership data, publicly disclosed clawback provisions adopted by Fortune 100 companies increased from 17.6% in 2006 to over 89% in 2013.[32] One main reason for the increasing number of companies that implemented clawback provisions is the proposed implementation

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[28]US Department of the Treasury, "About TARP", available at, https://home.treasury.gov/data/troubled-assets-relief-program/about-tarp

[29]US Congress, "H.R.1 – American Recovery and Reinvestment Act of 2009", 111th Congress (2009-2010).

[30]Jones Day, "TARP Compensation Guidance and Other Executive Compensation Proposals", Commentaries, June 2009, available at, https://www.jonesday.com/en/insights/2009/06/tarp-compensation-guidance-and-other-executive-compensation-proposals

[31]Shearman & Sterling LLP, "Executive Compensation Restrictions on TARP Recipients Under the Economic Stimulus Bill", February 2009, available at, https://www.shearman.com/~/media/Files/NewsInsights/Publications/2009/02/Executive-Compensation-Restrictions-on-TARP-Reci__/Files/View-Full-Text/FileAttachment/ECEB_021809.pdf

[32]Center on Executive Compensation, "Nearly 90% of Fortune 100 companies Now Disclose Clawback Policies, According to Equilar Survey", 25 October 2013, available at, https://execcomp.org/News/NewsStories/nearly-90-pct-of-fortune-100-companies-now-disclose-clawback-policies-according-to-equilar-survey

of Section 954 of the Dodd-Frank act by the SEC. But Equilar's Clawback Policy Report 2013 illustrated that even before the introduction of section 954, some Fortune 100 companies already fulfilled the requirements of the Dodd-Frank Act.[33] This means that these companies had more extensive clawback provisions than the SOX required of them. However, this is not strange because from the beginning of the financial crisis, shareholders were increasingly demanding stronger corporate governance mechanisms of companies in order to restrain excessive risk taking and create financial stability.[34]

b). The Netherlands

The Dutch financial market first adopted the Corporate Governance Code in 2003 and was updated in 2008 and 2016. Under the prior Dutch Corporate Governance Code (DCGC) 2008, Provision II.2.10 provided for a test of reasonableness in order to adjust bonus payments. Provision II.2.11 provided for the clawback of incentive-based remuneration. The provision stated that the Supervisory Board has the authority to claw back variable remuneration awarded to members of the Management Board if this remuneration is based on wrongful information. However, like its UK counterpart, the DCGC is adopted on a comply or explain basis and not directly enforceable. According to a study conducted in 2009, although the overall compliance with the DCGC was high, 26 of the top 100 companies in the Netherlands did not implement a clawback provision.[35]

The Dutch Banking Code which came into effect on 1 January 2010 also provided for a clawback provision. All banks with a banking licence as stated in the Dutch Financial Services Act fall under the scope of the Banking Code.[36] Section 6.4.5 of the Banking Code states that the Supervisory Board has the authority to clawback the variable part of the remuneration if awarding was based on wrongful information. However, like the DCGC, the Banking Code is also a piece of soft law and is not directly enforceable.

[33]Ibid.
[34]Ibid.
[35]W. van der Stede, "Designing effective reward systems", 2009, *Finance and Management*, 170, 6-9.
[36]De Brauw Blackstone Westbroek, "Remuneration and legal position of directors of Dutch listed companies and financial institutions", *De Brauw Blackstone Westbroek*, January 2011.

In the aftermath of the GFC, the Dutch government at the time considered the comply or explain nature of the DCGC and the Banking Code to be insufficient in regulating bonuses clawback. Moreover, contracts that already existed between companies and directors before the introduction of both Codes could not be amended. These concerns eventually led the government to introduce a clawback bill in the Dutch Parliament.[37]

In September 2010 the Parliament approved the *Bill for Revision and Claw Back of Executive Bonuses and Profit-sharing* (clawback bill) in order to amend the Dutch Civil Code and the Dutch Financial Supervision Act. The clawback bill introduced a legal mechanism for the Supervisory Board to: (i). adjust bonus payments of executives based on grounds of reasonableness and fairness or to (ii). recoup them if they are paid out based on wrongful information. Simultaneously, during the passage of the bill, Dutch bank SNS Reaal was bailed out by the government in early 2013 and came under state ownership. At the time, Dutch media estimated the financial consequences of the bail out for taxpayers were almost €27,000 per capita. It was therefore argued that it would be unfair if executives who were responsible of the bank failure could get away with lucrative bonuses.[38] For this reason, the enactment of a mandatory clawback provision was seen as an important and timely regulatory intervention.[39]

Article 2: 135(8) of the Dutch Civil Code[40] eventually became effective since 1 January 2014, allowing public companies the power to seek recovery of the erroneously awarded bonuses from directors. The Dutch provision is not prescriptive of the potential triggers of the clawback and does not narrowly confine the clawback to situations where there are financial misstatements. The clawback is possible in situations where incorrect information about the realization of the underlying goals or about the circumstances on which the entitlement to the bonus was made dependant. This could be a realisation on the part of the Dutch legislature that remuneration incentives may be determined not only in the light of financial performance metrics but also in the light of non-financial performance metrics like risk management and other circumstances significant to the company as well.[41]

[37]Reuters, "Dutch government to introduce bonus clawback bill", 10 September 2010.
[38]Thomas Escritt and Anthony Deutsch, "Dutch nationalize SNS Reaal bank group in $14 billion rescue", *Reuters*, 1 February 2013.
[39]Ibid.
[40]Title 2.4 Open Corporations (public limited companies), Dutch Civil Code.
[41]Allen & Overy, "Legislation on claw back of bonuses", Sept/Oct 2013.

Having examined how the US and Dutch governments have implemented statutory clawback provisions on executive remunerations, the article shall now turn focus to the development and use of director remuneration clawback provisions in the UK and discuss the reform proposed by the BEIS in its audit reform White Paper to regulate on the matter.

III). Development and use of clawback provisions in the UK and proposed reform

In the aftermath of the financial crisis, the then Financial Services Authority (FSA)[42] first introduced a clawback provision in 2009 in the Remuneration Code which was later updated in December 2010. And came into effect on 1 January 2011.[43] Under Policy Statement 10/20 (PS 10/20), the FSA amended the remuneration structure in the UK, by implementing the EU Capital Requirements Directive 3, which is applicable to all EU financial institutions falling under the scope of the Markets in Financial Instruments Directive (MiFID).[44] The FSA Remuneration Code is rule-based and the provisions are mandatory for financial institutions that fall under its scope. The original Remuneration Code which was introduced in January 2010 only applied to the largest banks, building societies and broker dealers. Only 26 institutions in the UK fell within its scope. The revised Code for 2011 has had an impact on all banks, building societies, asset managers, hedge fund managers, firms that engage in corporate finance and the provision of financial advice and stockbrokers. Over 2,500 financial services institutions were reported to have fall within the scope of the revised Remuneration Code of 2011.[45]

Under Principle 1 of the now FCA Remuneration Code, a regulated institution must ensure that its remuneration policy is consistent with and promotes sound and effective risk management and does not encourage risk-taking that exceeds the level of tolerated risk.[46] Principle 8 of the Remuneration Code contains the ex-post risk adjustment and a clawback provision for remunerations.[47] Under Principle 8, an institution is required to have

[42]The Financial Services Authority was eventually replaced by the Financial Conduct Authority (FCA) in 2013.
[43]FSA, "Revising the Remuneration Code – Policy Statement 10/20", December 2010.
[44]Directive 2004/39/EC. The MiFID was in force from January 2007 to January 2018. Since then it was replaced by the MiFID II.
[45]Pinsent Masons, "The FSA's Remuneration Code", 11 October 2010.
[46]FCA, "SYSC 19C.3 Remuneration Principles", Principle 1.
[47]Ibid., Principle 8.

appropriate adjustment mechanism that fits best to its characteristics.[48] Accordingly, the financial institution has to implement mechanisms that make it possible to adjust unvested variable remuneration, especially in case of misconduct of an employee, financial downturn of the firm or material failure in risk management.[49]

Apart from the FCA Remuneration Code, the Prudential Regulation Authority (PRA)[50] has also issued Supervisory Statement (SS) to all financial institutions which fall within the scope of the Remuneration Part of the PRA Rulebook. The purpose of this SS is to set out the PRA's expectations on how these institutions should comply with the requirements of the Remuneration Part, enabling them to make judgments which advance the objectives of the PRA.[51] Under SS2/17, the PRA states that regulated institutions should comply with the rules on performance adjustment in remuneration.[52] Performance adjustment refers to the downward adjustment of variable remuneration, which includes the use of clawback.[53] The PRA argues that the effective and meaningful use of performance adjustment is necessary to align risk and remuneration policy. Performance adjustment allows firms to adjust remuneration to take account of risks that have subsequently crystallised.[54] The SS then goes on and state that regulated institutions' remuneration policies and employment contracts should also clarify that variable remuneration awards should be reduced or clawed back according to specific criteria set by the firm which should, as a minimum, cover each of the relevant scenarios outlined.[55]

However, both the FCA Remuneration Code and the SS of the PRA only apply to financial institutions. For all other UK-listed companies, clawbacks of director remunerations are regulated through the United Kingdom Corporate Governance Code (UKCGC). The UKCGC came into application after 1992 in response to the Cadbury's Report[56], which set new baseline standards to improve independence, integrity and challenge

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[48]Ibid., SYSC 19C.3.23(2).
[49]Ibid.
[50]The PRA was formed together with the FCA by the UK government in 2013 to replace the FSA. The PRA is responsible for the prudential regulation and supervision of banks, building societies, credit unions, insurers and major investment firms. It sets standards and supervises financial institutions at the level of the individual firm. The PRA's functions fall within the jurisdiction of the Bank of England and are exercised through the Prudential Regulation Committee.
[51]Bank of England Prudential Regulation Authority, "Supervisory Statement (SS2/17) Remuneration", December 2021.
[52]Ibid., at para. 4.1
[53]Ibid., at para. 4.2
[54]Ibid., at para. 4.3
[55]Ibid., at para. 4.5(iii).
[56]Adrian Cadbury, "Report of the Committee on The Financial Aspects of Corporate Governance",

in boardrooms. The Cadbury recommendations were implemented through changes to the UK Listing Rules in 1992 and were subsequently incorporated, along with Greenbury's 1995 recommendations on executive remuneration, into a Combined Code on Corporate Governance published in 1998. The Code has been through several revisions since then and has since 2009 been known as the UKCGC.[57] Its provisions must be followed on "comply or explain" basis by all UK Premium-listed companies under the London Stock Exchange (LSE) Listing Rules.[58] Director and executive remuneration clawbacks are recommended under Paragraph 37 the UKCGC.[59] Yet the CG Code leaves it to individual companies to decide what appropriate triggers should be for operating clawbacks. Hence the adoption of a clawback provision is not mandatory.

The UK was one of the hardest hit economies during the GFC with major banks receiving government money to be salvaged from collapse. This led to public outrage about bonus payments in the financial sector. Since the GFC, a number of banks have exercised their clawback mechanisms against senior executives. In 2012, HSBC clawed back £2 million in bonuses from 13 directors as a consequence of misstatements with regard to the sale of payment protection insurance.[60] Likewise, in 2013 the Royal Bank of Scotland (RBS) announced that it would abolish 2012 bonus payments and claw back bonuses from 21 employees for the engagement in the Libor scandal.[61] RBS claw backed £4 million from its former CEO of markets and international banking.[62]

Yet other than financial institutions, clawbacks are not prevalent in other public companies. Although one research shows that almost 90% of FTSE 100 companies have adopted a clawback provision.[63] This is similar to the figure for Fortune 100 companies in the US with over 89% having clawback provisions. But given that director remuneration clawbacks are only recommended under the UKCGC, they are neither legally nor practically straightforward provisions, particularly when it comes to their enforcement. A clawback is only triggered in exceptional circumstances and in most cases an employer will only be entitled to claw back sums if there is a clearly documented contractual right for it to do so,

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1 December 1992.

[57]The latest version of the UKCGC was revised in 2018.

[58]FRC, "The UK Corporate Governance Code 2018"

[59]See Paragraph 37 of the UK Corporate Governance Code 2018 for details.

[60]Jill Treanor, "HSBC poised to claw back bonuses after fine for misselling", *The Guardian*, 26 February 2012.

[61]Mark Kleinman, "RBS Eyes £100 million Bonus Clawback Over Libor Fine", Sky News, 1 February 2013.

[62]Martin Flanagan, "RBS Libor: Shamed bank to pay fine with bonuses", *The Scotsman*, 7 February 2013.

[63]Deloitte, "2018 guide to directors' remuneration in FTSE 100 companies", October 2018.

which the employee has expressly agreed to prior to the payment/award which is allegedly subject to claw back being made. If there is no contractual right to claw-back a payment, a decision by an employer to do so may risk claims for breach of contract and/or unauthorised deductions from wages. As a result, there have been calls that more need to be done to regulate on the matter and this is where the article will now turn to for discussion.

a). Proposed reform by the BEIS to enhance audit quality of public companies

Since the Cadbury Report in 1992, UK corporate governance has gradually evolved, usually following reviews and reports established to tackle a particular failing. This evolutionary approach to reform, although frequently reactive in nature, has served to refresh the UK's corporate governance framework and helped to keep it at the leading edge of international standards.[64] According to the UK Parliament report on corporate governance, *The evolution of corporate governance,* published in April 2017, the UK's strong corporate governance regime is a considerable asset which enhances the reputation of the UK as a place to do business.[65] However, it simultaneously states that despite a high international reputation in this field, there should be no complacency, nor any sense that improvements cannot be made.[66] Accordingly, the challenge is for business and government to keep improving standards, without the impetus of high profile corporate scandals, in order to minimize the risks of future failings and to reflect both changes to the business environment and the rising expectations of society and stakeholders. The report claims that the government must help ensure that the UK stays ahead of the game in the light of changing business trends and practices.[67]

Yet since 2018, after a succession of corporate collapses from Carillion to Thomas Cook, the UK is facing a battle to restore trust in business. As a result of these scandals, the effectiveness of the UK audit regime has been seriously questioned. A 2018 UK Parliament joint committee report of the Carillion inquiry[68] slammed the company as "a story of

[64] UK Parliament, "The evolution of corporate governance", 4 April 2017, available at: https://publications.parliament.uk/pa/cm201617/cmselect/cmbeis/702/70205.htm
[65] Ibid.
[66] Ibid.
[67] Ibid.
[68] House of Commons, *Business, Energy and Industrial Strategy and Work and Pensions Committee – Carillion*, 16 May 2018.

recklessness, hubris, and greed and its business model was a relentless dash for cash".[69] The report accused Carillion's directors of prioritizing their own financial rewards over the interests of shareholders, employees and pensioners. The Thomas Cook scandal also illustrated how the company used dubious accounting method to make its profits appear larger for their executives to earn bonus payments. It was discovered that Thomas Cook's Group accounts for the year-end of 30 September 2018, contains a 194-page set of accounts, which presents positive earnings several pages before the losses are made clear. Only on page 118 that one sees the profit and loss, and not until page 122 that one sees the weak balance sheet.[70] Thomas Cook was warned over its accounting method in 2018 by its auditor, Ernst & Young (EY), that made its profits appear larger and could be used to boost executives' bonuses.[71] It was revealed that the company reported pre-tax "underlying profits" of £250 million in its 2018 financial statement, a figure which was reached after it wrote off £150 million in costs as "exceptional" and "one off". Meanwhile its reported operating profit was just £97 million.[72]

Amidst these corporate scandals, the government commissioned a series of independent reviews to explore how corporate financial reporting can be enhanced. Ultimately, the BEIS published a White Paper in March 2021[73] with the key objective to restore public trust in the way that the UK's largest companies are run and scrutinized.[74] The proposals set out how companies should report on their governance and finances and how reports should be audited.

On the matter of directors' remuneration arrangements, the audit reform White Paper stated that the ability to recover remunerations already paid to directors or to withhold pending awards are important mechanisms in directors' remuneration arrangements which can be exercised by remuneration committees and, where relevant, administrators or liquidators in the event of insolvency.[75] Yet the White Paper admitted that outside of the

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[69]Rob Davies, "Recklessness, hubris and greed – Carillion slammed by MPs", The Guardian, 16 May 2018.
[70]Accounting Web, "Thomas Cook management under fire for litany of accounting failures", 24 September 2019, available at, https://www.accountingweb.co.uk/business/finance-strategy/thomas-cook-management-under-fire-for-litany-of-accounting-failures
[71]Joseph Curtis, "Thomas Cook's auditor warned the travel company in 2018 to stop using accounting method that exaggerated its profits by 150 million and boosted executives' pay and bonuses", *Daily Mail*, 24 September 2019.
[72]Ibid.
[73]Above n. 5
[74]Above n. 5, at p. 14.
[75]Ibid., at para. 5.2.1, p. 91.

financial services sector there are no mandatory requirements for companies to include clawback provisions in directors' remuneration arrangements.[76]

The BEIS Committee has taken a close interest in the adequacy of powers to clawback cash or shares paid to directors where a company has failed or underperformed. Following its report into the collapse of Thomas Cook, it recommended the need for provisions on clawback to be strengthened and for the scope of application to be extended.[77] The White Paper recognized that a practical challenge can be the enforceability of clawback provisions even if they exist. If they are drawn too broadly, they become difficult to enforce. But if drawn too narrowly, they can exclude clawback where it would seem self-evident that action should be taken.[78]

The White Paper proposed to strengthen clawback arrangements to provide better reassurance against rewards for failure. It shall do this by initially asking the regulator to consult on changes to the UKCGC to include provisions which recommend that certain minimum clawback conditions or "trigger points" are included in directors' remuneration arrangements and that these have a minimum period of application of at least two years after an award is made.[79] Following a review, the Government will consider whether there is a need to further extend this to all listed companies, potentially through the Listing Rules.[80] The White Paper proposed the following as minimum conditions within which clawback provisions can be triggered:[81] (i). material misstatement of results or an error in performance calculations; (ii). material failure of risk management and internal controls; (iii). misconduct; (iv). conduct leading to financial loss; (v). reputational damage; and (vi). unreasonable failure to protect the interests of employees and customers.

However, contrary to the proposal under the audit reform White Paper, it is argued here that it is not sufficient for the UK to continuously rely on the UKCGC to regulate on director remuneration clawbacks. As mentioned, the UKCGC is not mandatory and adopted by public companies on a comply or explain basis. Hence it is questionable as to the effect this would have in regulating corporate governance. It is therefore strongly recommended here that the regulator and lawmakers should implement a statutory clawback provision for

[76]Ibid.
[77]UK Parliament, "BEIS Committee 2019 Report into the Collapse of Thomas Cook", November 2019.
[78]Above n. 5, at para. 5.2.3, p. 91.
[79]Ibid., at para. 5.2.4, p. 91.
[80]Ibid., at pp. 91-92.
[81]Ibid., at para. 5.2.5, p. 92.

directors' remunerations, similar to what its US and Dutch counterparts have done. The next section will provide a brief analysis and discussion as to why regulating director remuneration clawbacks through the UKCGC on a comply or explain basis is unlikely to enhance overall corporate governance and audit quality of Corporate UK.

IV). Why the comply or explain approach of the UKCGC is unlikely to be effective in regulating remuneration clawbacks and enhance audit quality of UK-listed companies?

It seems what is clear from the proposal under the BEIS audit reform White Paper is that revising the provision under the UKCGC is the preferred choice of the government to enhance the mechanism of clawing back directors' remunerations. The author of this paper is of the view that simply revising the UKCGC by inserting the conditions within which clawback provisions can be triggered is no longer sufficient because the UKCGC carries less weight and is more difficult to enforce.

It is argued here that the UK should follow the footsteps of its US and Dutch counterparts and implement a statutory provision to clawback directors' remunerations under certain circumstances. The Enron and WorldCom scandals in the US show that senior executives were motivated to fabricate financial data to boost their bonuses and other financial rewards. This prompted the US Congress to enact SOX 304 which provides that if any CEO and CFO remuneration is linked to earnings that have to be restated and if the misstatement was material and a result from misconduct, this remuneration can be subjected to a clawback.

The Netherlands, like the UK, also relied on soft laws such as the DCGC and the Banking Code to regulate executive remuneration clawbacks. But the near collapse of many of its financial institutions during GFC caused by senior executives making high-risk short-term decisions to boost their financial rewards, exposed the inadequacy of using the comply or explain approach to regulate on the matter. This eventually prompted the Dutch government to amend the Dutch Civil Code and the Dutch Financial Supervision Act by inserting Article 2: 135(8) into the Dutch Civil Code, allowing public companies the power to seek recovery of the erroneously awarded bonuses from directors.

Certainly, there are concerns as to whether the US and Dutch approach can be transplanted to the UK given differences in corporate governance philosophy and legal tradition. Despite the UK and US both having common law legal system, they have adopted

different philosophy to corporate governance. The former has relied on voluntary approach to regulation while the latter has enacted mandatory features. The Netherlands being a civil law jurisdiction which traditionally relies on codification of laws is also very different to the common law system where laws have traditionally developed through precedents.

However, differences between civil and common law legal systems have experienced erosion in recent years since both systems continue to regulate and codify.[82] Also, lessons and experiences from the past show that voluntary best practices in the UK have not been effective in regulating directors' remuneration arrangements. The Greenbury Report published in 1995[83] proposed a new code of voluntary best practices for executive pay for UK listed companies. These practices included the disclosure of remunerations and a voluntary say-on-pay by shareholders.[84] These recommendations were subsequently incorporated into the Combined Code on Corporate Governance (now UKCGC).

Yet the best practice approach to executive remuneration did not yield the desired results. Remuneration disclosures were often vague, lacking the detailed information necessary to make an informed assessment, including clarity about the relationship between rewards and performance.[85] Only a small number of companies chose to give their shareholders a vote on remuneration reports, despite shareholder concerns relating to executive remuneration.[86] This eventually prompted the government to take action and introduced the Directors' Remuneration Report Regulations 2002[87], elevating executive remuneration provisions to statutory level. Likewise, as mentioned the UK in recent years have also seen a series of corporate collapses caused by financial misstatements due to the use of dubious accounting methods by directors to boost their bonus payments. Since the proposed BEIS audit reform is the largest overhaul of the UK audit and corporate governance for generations[88], it therefore provides the right opportunity for the UK to consider whether

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[82]Ruth V. Aguilera, Michael Goyer and Luiz Ricardo Kabbach de Castro, "Regulation and Comparative Corporate Governance", *The Oxford Handbook of Corporate Governance*, 2013, Oxford University Press.
[83]Directors' Remuneration: Report of a Study Group chaired by Sir Richard Greenbury", 1995.
[84]Ibid., paras 5.28-5.32
[85]M. Petrin, "Executive Compensation in the United Kingdom – Past, Present and Future", 2014, Paper presented in the 2014 OECD European Symposium on Business Ethics and Governance.
[86]Department of Trade and Industry (DTI), "Directors' Remuneration: A Consultative Document", 1999, at Chapter 2.
[87]The 2002 Regulations was issued by the DTI, the precursor of the Department for Business Innovation & Skills (BIS).
[88]Above n. 5

the continuous reliance on soft law to regulate clawback of directors' remunerations is still ideal in an increasingly complex financial market.

Scholars have argued that the aim of comply or explain under the UKCGC is to empower investors to make an informed evaluation as to whether non-compliance is justified, given the company's circumstances.[89] Although it has been found that non-compliance could have negative implications on companies such as higher cost of capital[90], yet it is argued that comply or explain approach may be seen as being workable in the context of corporate governance because the ones regulated are relatively high profile and their actions are monitored by self-interested investors.[91] Arguably, comply or explain does not actually exist for some investors because investors are not concerned about what their companies are actually doing providing that they are performing well.[92] Yet a company that performs well financially on face value can be deceptive. As mentioned, both Enron and WorldCom appeared highly profitable before they eventually collapsed during the early 2000s. Similarly, Thomas Cook also made its profits looked bigger before it collapsed in 2019. These incidents illustrate how easy it could be for senior executives to use dubious or fraudulent accounting methods for their own personal gains.

Furthermore, the concern is that while non-compliance of the UKCGC is a breach of the Listing Rules, which can lead to sanctions such as public censure, there have been no occasions on which the FSA or FCA has initiated action against a company for non-compliance.[93] Although a study conducted by Grant Thornton shows that compliance with UKCGC remains high[94], with 73% of companies claiming full compliance and 95% report that they were either complying with all, or all but one or two of its provisions.[95] Yet according to an empirical study conducted by analysing annual reports of 245 UK non-financial companies belonging to the FTSE 350 index[96], it found that some companies merely follow the letter of the UKCGC without making a serious commitment to corporate

[89]Andrew Keay, "Comply or explain in corporate governance codes: in need of greater regulatory oversight?", *Legal Studies*, 2014, Vol. 34, No. 2, 279-304.
[90]R. Hooghiemstra and H. van Ees, Uniformity as response to soft law: evidence from compliance and non-compliance with the Dutch corporate governance code", *Regulation and* Governance, 2011, Vol. 5, 480.
[91]Above n. 79, at p. 283.
[92]Ibid., at p. 287.
[93]Ibid., at p. 285.
[94]Grant Thornton, "Corporate Governance Review 2019", November 2019.
[95]Ibid.
[96]S. Arcot, V. Bruno and A. Faure-Grimaud, "Corporate Governance in the UK: Is the comply or explain approach working?", *International Review of Law and Economics*, 2010, Vol. 30, No. 2, 193-201.

governance. They depart from best practice and provide an explanation which is totally uninformative.[97] Comply or explain offers flexibility for companies but that does not present us with evidence that there is complying or explaining going on, in accordance with the idea behind the principle. A study of German companies concluded that it is doubtful on whether comply or explain is effective.[98] De Jong et al. also report that the Dutch self-regulation initiative had no effect on corporate governance practices nor on their relationship with value.[99]

Moreover, a major argument against regulating director remuneration arrangements such as clawbacks through the UKCGC is that it would only apply to Premium-listed companies and would do nothing to improve the audit quality and remuneration arrangements of smaller listed companies such as those on the AIM. However, reports published by the FRC itself in 2015[100] and 2018[101] have shown that audit quality of smaller listed and AIM companies is a cause for concern. In its 2015 report, the FRC focused on listed companies with a market capitalization between £20 million and 100 million and quoted companies on the AIM with a market capitalization of greater than £5 million. Accordingly, it found that these companies have a higher incidence of poorer quality annual reports than their larger counterparts.[102] Likewise, in its 2018 report which surveyed 22 listed companies outside the FTSE 350 and 18 AIM quoted companies, FRC expressed disappointment that few companies provided sensitivity analyses or quantified ranges of possible outcomes when describing sources of estimation uncertainty.[103] Also, the review of cash flow statements identified apparent errors such as the misclassification of cash flows between operating, investing or financing activities.[104]

For smaller listed and AIM quoted companies, financial reporting is not always seen as a top priority. While some of these companies may be planning for a period of growth and therefore require high quality financial reporting and information for investment purposes,

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[97]Ibid.
[98]C Andres and E Thiessen 'Setting a fox to keep the geese – Does the comply-or-explain principle work?', *Journal of Corporate Finance*, 2008, Vol. 14, 289.
[99]A. DeJong et al., "The Role of Self-Regulation in Corporate Governance: Evidence and Implications from the Netherlands", *Journal of Corporate Finance*, 2005, 473-503.
[100]FRC, "Improving the Quality of Reporting by Smaller Listed and AIM Quoted Companies – Discussion paper on the FRC's findings and proposals", June 2015.
[101]FRC, "Corporate Reporting Thematic Review – Reporting by Smaller Listed and AIM Quoted Companies", November 2018
[102]Above n. 89, at p. 6.
[103]Above n. 90, at p. 7.
[104]Ibid.

others may have listed as a one-time financing exercise with no need for further investment. The effect of this diversity has contributed to varying standards of financial reporting quality in this segment of the market. But if the overall objective of BEIS is to enhance the overall audit integrity of UK-listed companies by imposing higher responsibilities on directors to report accurately on their companies' financial statements through its reform agenda, then it certainly does not make sense that so many smaller listed and AIM quoted companies are left out of being regulated through the UKCGC. As Sarah Wilson, chief executive of investor group Minerva put it, shareholders wanted stronger rather than less robust standards given they bear the risk of total loss of capital.[105] She argues that the UK by falling back on the UKCGC with this reform will again lead to a scenario which "the good follow and the bad neglect".[106]

V). Statutory clawback provision and factors to be considered in drafting

As discussed above, clawbacks on directors' remunerations in the UK have its origin in the banking and financial services sector. In the aftermath of the GFC, the FCA Remuneration Code which incorporated the EU Capital Requirements Directive 3, mandatorily provided a clawback of executive remunerations for the banking and financial services sector. Due to the vital role that banks play in our economy, the government provides a safety net to banking customers to ensure the smooth functioning of this part of the economy.[107] It therefore makes sense that when banks were on the brink of collapse during the GFC, government intervened financially to rescue them.[108] But given that banks received state funding for a financial bail-out, it would seem unjust that their senior executives get away with high bonuses while taxpayers had to pay for their mistakes in taking excessive risks. For this reason, it was therefore logical to mandate remuneration clawbacks from these directors.

[105]Daniel Thomas et al., "Scaled back UK audit reforms attract investor anger", *Financial Times*, 17 November 2021.
[106]Ibid.
[107]Sheila C. Dow, "Why the Banking System Should be Regulated", *The Economic Journal*, 1996, Vol. 106, No. 436, 698-707.
[108]Joseph E. Stiglitz, "The Role of the State in Financial Markets", *The World Bank Economic Review*, 1993, Volume 7, Issue 1, 19-52.

However, corporate collapses in other sectors can be just as severe to the economy as the collapse of a large bank or financial institution. According to the UK Parliament joint committee report of the Carillion inquiry[109], the collapse of the company left a pension liability of around £2.6 billion. The 27,000 members of its defined benefit pension schemes would be paid reduce pensions by the Pension Protection Fund.[110] As Carillion was a major strategic supplier to the UK public sector, its works spanned from building roads and hospitals to providing school meals and defence accommodation. Since its collapse, the government had committed £150 million of taxpayers' money to keep essential services running.[111]

Therefore, it is no longer sufficient just to have mandatory clawback provision of directors' remunerations specific for one or two sectors of the economy. Both the Carillion and Thomas Cook scandals illustrate that the risks of executives manipulating financial data to enrich themselves are just as high as the banking and financial services sector. Some may argue that shareholder activism can be powerful monitor of compliance in terms of directors' remunerations, but it often generates headlines with little achieved in practice.[112] For instance, at Supermarket chain Morrisons only 30% of shareholders' vote went in favour of its boardroom pay in June 2021. Despite that, its CEO and his two most senior managers still received £9 million in pay and bonuses after the remuneration committee used its discretion and adjusted its calculations to ignore Covid-19 costs of £290 million.[113]

As mentioned, if there is no contractual right to claw-back a payment from directors as recommended under the UKCGC, a decision by a company to do so may risk claims for breach of contract and/or unauthorised deductions from wages. The absence of a statutory provision mandating the clawback means that shareholders may have to embark on costly legal proceedings to recover the amounts erroneously awarded. However, clawback litigation may be protracted and costly for shareholders.[114] Hence a robust framework for the regulation of clawbacks in a manner applying to all public companies will enhance transparency and accountability, contributing positively to the audit integrity of Corporate

[109]Above n. 64
[110]Ibid.
[111]Ibid., at p. 3.
[112]Phillip Inman, "Investors turn ire on firms whose executives are to set cash in", *The Guardian*, 26 June 2021.
[113]Ibid.
[114]Jesse Fried and Nitzan Shilon, "Excess-Pay Clawbacks", *Journal of Corporation Law*, 2011, Vol. 36, 722-751.

UK. The article will now offer some recommendations as to the key factors that need to be considered in drafting a statutory clawback provision.

a). Triggering conditions for clawback

To avoid legislative rigidity, in drafting a clawback provision the UK should draw reference from Article 2: 135(8) of the Dutch Civil Code as discussed above. The Dutch provision is drafted in a manner which is not prescriptive of the potential triggering conditions of the clawback. If implemented, companies must be able to recover incentive-based remuneration such as bonuses to the extent that the awarding or payment of such remuneration has been made on the basis of "incorrect information" about the realization of the underlying goals.

Financial misstatements, whether fraudulently or negligently prepared are without doubt grounds for clawing back the remunerations. But focusing solely on financial performances or metrics could restrict the operation of clawbacks because companies may use a wide variety of metrics, events or circumstances, including non-financial data to determine performance-based remuneration. The UK enacted the the Companies Act 2006 (Strategic Report and Directors' Report) Regulations in 2013 which places greater emphasis on the non-financial aspects of a company's annual report. Under section 414A of the 2013 Regulations, directors of a public company must prepare a Strategic Report for each financial year.[115] Section 414C(7) of the 2013 Regulations provides that the Strategic Report must, to the extent necessary for an understanding of the development, performance or position of the company's business, include:[116] (a) the main trends and factors likely to affect the future development, performance and position of the company's business, and (b) information about environmental matters, company's employees, and social, community and human rights issues.

The Strategic Report must be approved by the board of directors and signed on behalf of the board by a director or the secretary of the company.[117] If a Strategic Report is

[115]See section 414A of the Companies Act 2006 (Strategic Report and Directors' Report) Regulations 2013, available at: https://www.legislation.gov.uk/ukdsi/2013/9780111540169#:~:text=New%20section%20414A%20requires%20companies,each%20sex%20within%20the%20company.
[116]Ibid., see section 414C(7) for details.
[117]Ibid., see section 414D for details.

approved that does not comply with the requirements of the legislation, every director of the company commits an offence and can be held legally liable.[118]

In addition, the UK is to become the first G20 country to make it mandatory for its largest businesses to disclose their climate-related risks and opportunities in line with Taskforce on Climate-related Financial Disclosure (TCFD) recommendations.[119] From April 2022, over 1,300 of the largest UK-registered companies and financial institutions will have to disclose climate-related financial information on a mandatory basis. This will include many of the UK's largest public companies as well as private companies with over 500 employees and £500 million in turnover.[120]

Therefore, given legislative requirements on companies and directors to accurately report on financial and non-financial aspects of companies, the reach of the statutory clawback provision on directors' remunerations must be broad enough to cover financial performance metrics, non-financial performance metrics, as well as other circumstances in order to be effective. The term "data" and "corporate reporting" must cover financial as well as non-financial information.

b). Who should be subject to clawbacks?

As discussed above, SOX 304 in the US provides that if any CEO and CFO remuneration is linked to earnings that have to be restated and if the misstatement was material and a result from misconduct, this remuneration can be subjected to a clawback. However, this excludes many officers who play an influential role in the management of companies from being subjected to clawback and would restrict the effectiveness of the clawback provision in practice.

In recognizing such drawback, section 954 of the Dodd-Frank Act as is currently drafted, shall broaden and refine the circumstances in which clawback of excess performance-based compensation will apply. It applies to any current and former executive officers of the company. Furthermore, in contrast to SOX 304, where remuneration can be

[118] Ibid., see section 414D(3) for details.
[119] TCFD, "Final Report – Recommendations of the Task Force on Climate-related Financial Disclosures", June 2017.
[120] UK government press release, "UK to enshrine mandatory climate disclosures for largest companies in law", 29 October 2021.

recouped over a period of twelve months following the first improper filing, section 954 of the Dodd-Frank Act will broaden and refine the circumstances in which clawback of excess performance-based compensation will apply. It will apply to excess incentive-based compensation awarded during the 3-year period preceding the date of the accounting restatement.[121]

The view of the author is that in drafting a statutory clawback provision for the UK, regulators and lawmakers ought to adopt a pragmatic approach as to who can be subjected to clawbacks. It concurs with the approach adopted by the Dodd-Frank Act that any current and former executive officers of the company should be subjected provided they participated in the misstatement and misconduct. However, the provision needs to be cautious whether lower-level employees should also be subject to clawbacks. In the RBS Libor scandal as discussed above[122], all current and former employees who received incentive-based remunerations relating to the incident were subject to clawback. But such a broad extension of subjects can lead to controversies. Many employees are not at the level to make corporate decisions that have any impact, and if they are at risk of losing their bonuses without even being responsible for the act or omissions that lead to conditions triggering the clawback, it may seem unfair to them.

The author argues that executives who received bonuses because of financial misstatements and other triggering conditions must be subject to clawbacks. However, the provision with regards to normal employees ought to be much stricter. For normal employees, the remunerations should only be recovered in cases where the employees in concerned materially participated in the act or omission that caused the restatement or incidents. As to how this legislative intent can be achieved is something that the regulator and lawmakers should consult with stakeholders when drafting the provision.

c). Who can enforce the provision?

It is important that the statutory provision is clear as to who has the power to enforce a clawback. Public regulator must certainly be conferred with adequate power to enforce the clawback provision. Public enforcement of corporate and securities laws is perceived as

[121]Above n. 23.
[122]Above n. 57.

imperative to the well-being of a financial market.[123] This is necessary to give investors confidence that those who do not play by the rules will not benefit from such conduct. Further, strong financial markets demand robust "law in action" in the form of effective supervision and enforcement. This means, the more confidence that investors have on the enforcement mechanism the more likely they are willing to actively engage and participate in the market.[124]

As mentioned above, the difficulties of private enforcement on clawback provisions by shareholders in the UK make public enforcement even more crucial. This is because the UK financial regulatory regime adopts a more ex-ante and hands on, paternalistic approach to preventing litigation from occurring in the first place by imposing more stringent regulatory requirements and full vetting of all issuers' public disclosures, as opposed to ex-post sanctions adopted in markets such as the US.[125] Hence there is a greater expectation from the investment community that the regulator will intervene timely to rectify market misconducts.

In the US, SOX confers full power on the SEC under section 304 to recover any remunerations from CEOs and CFOs erroneously awarded as a result of financial misstatements. According to the UK BEIS audit reform White Paper[126], the proposed Audit, Reporting and Governance Authority (ARGA) that is intended to replace the FRC as the audit regulator in 2023 will be conferred with stronger powers and this is consistent with the government's vision of a stronger regulator.[127] It is believed that the proposed new power to direct changes will strengthen the regulator's ability to rectify cases of non-compliance with accounting and other reporting requirements.[128] Should the statutory clawback provision on directors' remunerations is to be introduced, then the proposed ARGA must be conferred with the power to enforce the provision due to its role and function in ensuring audit integrity. Furthermore, it is also important for public regulator to ensure high-level of compliance by ensuring companies and individual directors meet their obligations should a statutory clawback provision be drafted. The Australian Securities and Investment

[123]John K.S. Ho, "Bringing responsible ownership to the financial market of Hong Kong: how effective could it be?", *Journal of Corporate Law Studies*, 2016, Vol. 16, No. 2, 437-469, at p. 464.
[124]Niamh Moloney, *How to Protect Investors: Lessons from the EC and UK*, 2010, Cambridge University Press, p. 426.
[125]John Armour et al., "Private Enforcement of Corporate Law: An Empirical Comparison of the United Kingdom and the United States", *Journal of Empirical Legal Studies,* 2009, Vol. 6, No. 4, 687-722, at p. 692.
[126]Above n. 5
[127]Ibid., section 4.2, at p. 77.
[128]Ibid., para. 4.2.2, at p. 77.

Commission (ASIC) corporate compliance program offers lessons.[129] The ASIC encourages high level of compliance by being upfront about its educative and enforcement strategies by helping companies and directors comply with their obligations. It helps companies and directors to understand their rights and responsibilities under the Corporations Act by making it simpler to comply. It also provides support to those who want to comply and ensure there are real and tangible risks for those that don't comply.[130] If a company or director still fails to comply with the requirements of the law, ASIC can obtain an order from the court or even take criminal action against the director. This is something which BEIS can adopt in the UK.

Apart from public regulator, companies themselves must also have the statutory power to recover remunerations from directors. The clawback provision under Article 2: 135(8) of the Dutch Civil Code[131] allows the claim to be filed in the name of the company by the Supervisory Board, the non-executive directors or by a special representative who is appointed by the General Meeting. Though UK public companies with unitary board structures do not have a Supervisory Board as they do in the Netherlands and other Continental European countries, the UKCGC provides that at least half of the board should be non-executive directors who are independent.[132] Moreover, the remuneration committee of the board should also be made up of independent non-executive directors.[133] Accordingly, it is the remuneration committee that determines the policy for executive directors and senior management remunerations.[134] Therefore, like its Dutch counterpart, should a statutory clawback provision on directors' remunerations be drafted in the UK, then similar powers must also be conferred on non-executive directors to enforce the provision in the name of the company.

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[130] Ibid.
[131] Dutch Civil Code, Title 2.4 Open Corporations (public limited companies).
[132] FRC, "The UK Corporate Governance Code", July 2018, at para. 11.
[133] Ibid., para. 32.
[134] Ibid., para. 33.

VI). Conclusions

Reliable corporate reporting is vital to well-functioning financial markets, business investment and growth. Over the last three decades, the UK has largely relied on updating the CG Code to enhance overall corporate governance but the recent collapse of Carillion and Thomas Cook caused by directors misrepresenting the financial statements of their businesses have seriously questioned the effectiveness of the comply or explain approach.

According to a study conducted by KPMG in 2017, less than 1 in 10 executive directors in the FTSE 350 received no annual bonus and around a third of executive directors in the FTSE 350 received annual bonuses of over 80% of the maximum opportunity.[135] However, as discussed extensively, instead of reducing agency costs, such incentive-based remunerations can be counter-productive and potentially increase the likelihood of executives taking short-term excessive risks in order to enrich themselves. These actions could seriously undermine the audit integrity of companies. Lessons and experiences from the US and Netherlands show that regulatory intervention backed by robust enforcement and sanctions are needed to deter senior executives from taking such actions.

As the economy recovers from the pandemic, auditors have warned of a "post-Covid organizational culture crisis" at UK companies and called on regulator to impose stricter rules on directors to avoid a repeat of recent corporate scandals.[136] Given that this proposed reform by the BEIS is the largest overhaul of the UK audit and corporate governance for generations, then the time is ripe for the UK to consider whether the continuous reliance on soft law to regulate on clawback of directors' remunerations is still ideal in an increasingly complex financial market. The recommendations suggested towards the end of this article will hopefully offer some insights for the regulator and lawmakers as to what factors they should consider in drafting a proposed statutory provision for the clawback of directors' remunerations.

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[135] KPMG, "Guide to Directors' Remuneration 2017", December 2017, available at, https://assets.kpmg/content/dam/kpmg/uk/pdf/2018/01/2017-kpmg-guide-to-directors-remuneration.pdf

[136] Michael O'Dwyer, "Auditors warn of organizational culture crisis at UK companies", *Financial Times*, 28 February 2022.