

# Client Alert

A report  
for clients  
and friends  
of the Firm    May 2009

## UK FSA Proposes Remuneration Policy Reform for Financial Sector Firms; EU Commission Follows with Recommendations

The reform of remuneration practices in the financial sector is currently the subject of regulatory and political debate worldwide. Regulators in the major financial centres are reviewing remuneration practices in light of recent events. Unprecedented turmoil in global financial markets has led financial regulators to co-operate internationally as never before and, with the publication in March of its consultation paper entitled: "Reforming remuneration practices in financial services" (the "Paper"), the UK Financial Services Authority (the "FSA") appears to be leading the global regulatory charge alongside international industry groups such as the Financial Stability Forum and the Committee of European Banking Supervisors. The Paper contains the FSA's proposals relating to the implementation of its draft code of practice on remuneration (the "Code"), and it is proposed that the Code will initially apply to large banks, building societies and broker dealers.

On 29 April 2009 the European Commission adopted a Recommendation to EU Member States to adopt measures on remuneration of risk-taking staff in financial institutions. Under EU law a Recommendation unlike a Directive, is not legally binding.

### Background

The FSA began to consider the extent to which remuneration practices may have contributed to the financial crisis during Summer 2008. In October 2008 the FSA wrote to the CEOs of around 20 of the larger UK-based banks (including investment banks and retail banks), asking them to review their remuneration policies against a set of criteria of good and poor practice. The FSA obtained further information from all UK-based banks via a questionnaire and a series of bi-lateral meetings which were held between November 2008 and January 2009. The FSA does not consider remuneration practices at financial sector firms to be directly responsible for the recent financial crisis. However, the FSA does consider that remuneration practices may have been a significant contributory factor to the market turmoil, as they often awarded short-term revenue and profits targets and did not take account of the longer-term effects of unduly risky practices. Lord Turner, the Chairman of the FSA, stated in his report on the global banking crisis that "there is a strong *prima facie* case that inappropriate incentive structures played a role in encouraging behaviour which contributed to the financial crisis."

### The Proposed Code

On 26 February 2009, the FSA published the first draft of the Code alongside the publication by Her Majesty's Government of the details of the Asset Protection Scheme (APS). Since then the draft has been significantly revised and the current draft is appended to the Paper. The Code consists of one general requirement and ten specific principles relating to firms' remuneration policies and arrangements. The aim of the Code is to ensure that all firms have remuneration policies which are consistent with sound risk management, and which do not expose them to "excessive risk". Although the Code will likely not come into effect until November 2009, compliance with the Code already forms part of the eligibility requirements for participation in HM Treasury's asset protection scheme, and the FSA is encouraging all FSA-regulated firms to use the Code to benchmark their remuneration practices.

It is clear from the Paper that the FSA is aware that staff remuneration is a sensitive topic, and that it recognises that it should not introduce remuneration guidelines that are too stringent as this would adversely affect competition for staff and undermine the position of London as one of the leading financial centres of the world.

In contrast to EU policy, the FSA is not concerned with the absolute amount of remuneration awarded in any particular case; rather it intends to focus any new policies on the extent to which remuneration practices pose risks to a firm and are inconsistent with effective risk management. The FSA states that in many cases industry remuneration practices ran counter to effective risk management and effectively undermined systems that had been set up to control risk.

In deciding whether to implement its proposals on remuneration, the FSA confirms that it will take into account similar plans by regulators in the major financial centres.

### Application of the Code

The FSA originally proposed in February that the Code should apply to all FSA-regulated firms; however, this has since been scaled back to cover only banks, building societies and broker dealers as follows:

- a bank or building society if:
  - the total capital resources held by UK banks or buildings societies within the firm's group exceeds £1 billion; or
  - it is part of a financial group (UK or international) whose regulatory capital exceeds £20 billion.
- An investment firm of the BIPRU 730k type if it:
  - has capital resources exceeding £750 million; or
  - is part of a financial group (UK or international) whose regulatory capital exceeds £5 billion.

The FSA estimates that these criteria will extend the Code to approximately 24 UK banking entities, ten other banks in the UK which are part of larger banking groups, three building societies and 11 UK-authorized BIPRU firms with consolidated regulatory capital in excess of £750 million.

### Enforcement of the Code

The FSA proposes that the Code be incorporated into the FSA Handbook so that it can be directly enforced by the FSA. It is proposed that the Code comprise one general requirement that “a firm must establish, implement and maintain remuneration policies, procedures, and practices that

are consistent with and promote effective risk management” and, in order to help firms understand what that requirement means in practice, ten principles. The ten principles are, broadly:

1. A remuneration committee should be appointed to approve and periodically review remuneration policy. The remuneration committee should be constituted in a way that enables it to exercise independent judgment and should be able to demonstrate that its decisions are consistent with a reasonable assessment of the firm's financial situation and future prospects.
2. A firm's risk management and compliance functions should have significant input in determining remuneration for other business areas and procedures for setting remuneration should be clear and well documented.
3. To avoid any potential conflict of interest, remuneration for those employees in risk management and compliance functions should be determined independently of other business areas.
4. Assessments of financial performance used to calculate bonus pools should be based principally on profits and should include an adjustment for current and future risk.
5. The assessment process for the performance-related portion of an employee's remuneration should ensure that assessment is based on longer-term performance.
6. Non-financial performance metrics, including adherence to effective risk management and compliance with the regulatory system and any relevant overseas regulatory requirements, should form a significant part of the performance-related assessment process.
7. The measurement of performance for long-term incentive plans, including those based on the performance of the shares, should be risk-adjusted.
8. The fixed component of remuneration should be a sufficient proportion of the total remuneration to allow a firm to operate a fully flexible bonus policy.
9. The majority of any significant bonus should be deferred with a minimum vesting period if, when compared to the fixed component of an employee's remuneration, the bonus is a significant proportion of that fixed component. The aim behind this principle is to align the interests of those receiving significant amounts of bonus with the longer-term interests of the firm.

10. Any deferred element of the variable component of remuneration should be linked to the future performance of the firm as well as the employee's division or business unit.

The FSA acknowledges in the Paper that not every principle would apply in the same way to every firm (the examples it gave were small firms not having a remuneration committee and building societies not having shareholders).

### **Possibility of extending the application of the Code**

The application of the Code may be extended to cover all FSA-regulated firms and the FSA has invited informal feedback on this possibility. If the Code were to apply to all FSA-regulated firms, the principal additional groups would include BIPRU 730k firms not already covered by the scope of the draft reforms (firms with a regulatory capital requirement below the threshold of £750 million), asset managers (including hedge fund and private equity managers), insurers, managing agents and Lloyd's brokers, mortgage and other home insurance providers, credit unions and retail investment intermediaries.

Although these reforms are only at the consultation stage and have not yet been incorporated into the FSA Handbook, we would advise firms to consider how these proposals will affect their current remuneration practices and determine exactly how their remuneration practices will need to be modified in order to comply with the FSA's proposed reforms. Common proposals appear to include increasing the shareholding requirements for executive directors, allocating a higher proportion of remuneration to come from deferred payments made in shares (which can be clawed-back if long-term performance targets are not met) and for higher-ranking executives to receive a greater proportion of their pay in equity.

The consultation period on the proposals to implement the Code for larger banks, building societies and broker dealers ends on 18 May 2009 and feedback on the possibility of extending the Code to other FSA-regulated firms can be made until 18 June 2009. It is intended that the new rules would be published in July 2009 so that the Code can come into effect early November 2009, in time for firms' 2009 remuneration reviews.

### **The EU Recommendation**

The EU Recommendation invites Member States to ensure that financial institutions have remuneration policies for risk-taking staff that are consistent with and promote sound and effective risk-management. The Recommendation sets out guidelines on the structure of pay, the process of design and

implementation of remuneration policies, and on the role of regulators in the review of such policies. On the same day the EU Commission also adopted a Recommendation on the pay of directors of companies listed on an EU-regulated market. After one year, the Commission will examine both Recommendations in the light of experience acquired and of the outcome of its monitoring and will submit an evaluation report on Member States' application of both Recommendations.

We will monitor the progress of the FSA's proposals and the EU Recommendations.

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