

# Financial Services Remuneration in the UK

January 31, 2011

## INTRODUCTION

Last month, the FSA published its final version of its Remuneration Code (the **Code**). The Code now incorporates requirements contained in the latest version of the Capital Requirements Directive (**CRD3**) – European legislation which, amongst other things, deals with remuneration in the financial services industry. This alert gives an overview of the Code, focusing on:

- its scope;
- the deadlines for compliance;
- the constraints on variable remuneration;
- the proportional application of the Code through the division of businesses covered by the Code into four tiers, each with different compliance requirements; and
- voiding provisions — i.e. provisions which render certain contractual terms on variable remuneration void if they breach Code requirements.

This bulletin also summarises the related and new obligations on disclosure of remuneration, which were published by the FSA at the same time as the Code. Like the Code, these disclosure obligations also implement requirements contained within CRD3.

## THE SCOPE OF THE CODE

The three key questions on scope are:

- which businesses are within scope (by reference to what they do and where they are located);
- which staff are covered; and
- the meaning of variable remuneration.

### Which businesses

The Code applies in some form to all banks, building societies and investment firms which are within the scope of the Capital Adequacy Directive. There are more than 2,500 of these, which include asset managers, hedge fund managers, UCITS investment firms, stockbrokers and some firms that engage in corporate finance, venture capital and the provision of financial advice.

### **UK operations of groups headquartered elsewhere**

UK operations of groups headquartered elsewhere which carry out relevant activities, whether subsidiaries with overseas parent companies or branches, will be subject to the Code. The sole exception to this is that the Code will not apply to UK branches of firms whose home state is within the EEA. The basis for this is that the home state of such entities will be required to apply equivalent provisions under the latest version of CRD3.

### **Overseas branches and group members**

UK headquartered groups are required to apply the Code globally to all their entities carrying out relevant activities. Therefore, where a UK-headquartered firm is caught by the Code, it will also apply to its overseas branches and (on a consolidated basis) to non-UK group members if they form part of the UK firm's consolidation group (or an EEA subgroup). A UK firm's overseas operations will therefore fall within the scope of the Code.

The table below is illustrative of the scope of the Code, based on 3 banks, the London headquartered Bishops Square Bank, the New York headquartered Times Square Bank and the Paris headquartered Saint Honoré Bank, each of which has branches in London, New York and Paris.

### **Does the Code apply?**

	Bishops Square Bank	Saint Honoré Bank	Times Square Bank
London Branch	ü	X	ü
Paris Branch	ü	X	X
New York Branch	ü	X	X

### **Which staff**

The Code applies to all “Code Staff”. It has wide scope and covers:

- senior management – which is defined as any *"individual employed by the firm to whom the governing body (or a member of the governing body) of the firm has given responsibility for management and supervision, and who reports directly to the governing body, a member of the governing body, the chief executive, or the head of a significant business group"*;
- risk takers – where examples of high-level risk takers provided by the Code include heads of significant business lines and heads of support and control functions who have a material impact on the firm’s risk profile. The Code includes a non-exhaustive table of examples of the key positions that it would expect to be within a firm's definition of risk takers;
- staff engaged in control functions such as compliance and risk; and
- any employee receiving total remuneration that takes them into the same remuneration bracket as senior management and risk takers, whose professional activities have a material impact on the firm's risk profile. This is effectively a catch-all category.

In practical terms, despite the broad definition of Code Staff, it will generally be clear which staff are Code Staff – not least because they will be highly remunerated and receive a significant proportion of their remuneration by way of bonus payments.

### **De minimis threshold**

Even for Code Staff, generally, the restrictions on variable remuneration will only apply if either or both of the following conditions are satisfied: (i) the individual's variable remuneration is 33% or more of their total remuneration; and (ii) the individual's total remuneration is £500,000 or more. This is referred to as the de minimis threshold.

Despite this, firms should be live to the possibility of remunerating staff who fall below the de minimis threshold in accordance with the Code requirements where such people have a material impact on the firm's risk profile because of their particular job function or responsibilities. This is because the overriding objective of the Code is to ensure remuneration policies, procedures and practices do not undermine effective risk management – failing to comply with guidelines in respect of individuals not expressly covered by the Code could be evidence of a more general failure to comply with this overriding objective.

### **What is variable remuneration**

Variable remuneration is not just limited to bonus payments. Rather, the term encompasses any element of pay that is not fixed, including commission payments. In particular, the Code expressly states that long-term incentive plans should be treated as pools of variable remuneration. Similarly, although standard pension payments (such as benefits that accrue under the employee's company pension plan or the firm's contractual pension obligations), would not constitute variable remuneration, non-standard, enhanced, pension benefits granted on a discretionary basis, especially if granted as part of a variable remuneration package, would constitute variable remuneration.

## **DEADLINES FOR COMPLIANCE**

The Code came into effect on 1 January 2011.

The limited number of firms that were already subject to the previous version of the Code (mostly large banks and building societies) are expected to have complied with the Code from 1 January 2011. The one exception to full compliance for such firms is for non-listed firms and building societies, where there is some scope to delay compliance with the requirement for at least 50% of variable remuneration to be paid in an appropriate non-cash form. However, firms are nonetheless expected to take steps to ensure compliance with this requirement as soon as reasonably possible, and in any event by 1 July 2011.

Businesses that will become subject to the Code for the first time are required to start planning for the implementation of suitable remuneration structures, policies and practices as soon as possible. Indeed, the FSA considers it "*desirable*" for all such firms to have appropriate governance arrangements and procedures in place immediately. However, the Code accepts that firms will not be in breach of the Code, provided they take reasonable steps to comply with it as soon as is reasonably possible, and in any event by 1 July 2011. Importantly, this means that firms should actively be taking steps now to ensure that their remuneration structures are fully compliant with the requirements of the Code by the 1 July 2011 deadline.

## **THE CONSTRAINTS ON VARIABLE REMUNERATION**

Subject to proportionality (see below), the key requirements on variable remuneration contained within the Code are as follows:

- For Code Staff who satisfy the de minimis thresholds:
  - **Deferral:** At least 40% of variable remuneration must be deferred over at least three years, with vesting to be no faster than on a pro-rata basis (and the first vesting no earlier than one year after the award). This deferred amount rises to 60% where variable remuneration exceeds £500,000.
  - **Proportion in shares:** At least 50% of any variable remuneration components must be made in shares, share-linked instruments or other equivalent non-cash instruments of the firm, subject to a minimum retention policy. This applies to both the deferred and upfront portions of any award.
  - **Performance adjustment:** Firms should retain the ability to make adjustments to an individual's deferred amounts of variable remuneration, after the amount has been communicated to an individual, to reflect actual outcomes as they materialise over time.
- For all staff (including Code Staff):
  - **Guaranteed bonuses:** These must be limited to new hires, only be offered in exceptional circumstances and subject to performance adjustment. They must also be limited to the first year of service. Additionally, a firm must take reasonable steps to ensure that the bonus offered is not more generous than what the individual received from or was offered by their previous firm (for example by not overpaying when "buying out" someone for the benefits lost by moving jobs).
  - **Retention payments:** These should only be paid in exceptional circumstances where the firm is undergoing a major restructuring and the firm can justify the awards on prudential grounds.
  - **Severance payments:** These should reflect performance over time and failure must not be rewarded.

## PROPORTIONALITY AND THE FOUR TIER SYSTEM

CRD3 allows regulators to apply a proportionate approach to firms by reference to their size, internal organisation and the nature, scope and complexity of their activities. The Code has addressed this by dividing firms covered by the Code into four tiers with different minimum requirements for each tier. They are divided as follows.

### Tier 1

FSA-regulated firms that were covered by the previous version of the Code, which are:

- banks and building societies with capital resources of more than £1 billion; or
- BIPRU €730k firms that are full scope BIPRU investment firms with capital resources of more than £750 million; or
- third-country BIPRU firms (that is branches of firms established outside the EEA) with total assets (for the UK branch) of more than £25 billion.

They are broadly expected to comply with the Code in full although one exception is that some Tier 1 firms with an overseas parent will not need to establish a remuneration committee for UK staff, provided that adequate procedures are in place to ensure compliance with the Code for UK staff.

## **Tier 2**

FSA-regulated firms such as credit institutions and broker dealers that engage in significant proprietary trading/investment banking activities. Specifically, Tier 2 consists of:

- banks and building societies with capital resources of between £50 million and £1 billion; or
- BIPRU €730k firms that are full scope BIPRU investment firms with capital resources of between £100 million and £750 million; or
- third-country BIPRU firms with total assets (for the UK branch) of more than £2 billion.

Tier 2 firms are expected to comply with the Code in a similar fashion to Tier 1 firms, except Tier 2 firms such as building societies and unlisted firms, will not have to comply with the requirement to deliver at least 50% of variable remuneration in an appropriate non-cash form where they can show that this is inappropriate.

## **Tier 3**

FSA-regulated firms, such as small banks and building societies or firms that may occasionally take overnight/short-term risk with their balance sheets. Specifically they are:

- banks, building societies and full scope BIPRU investment firms not within tiers one and two; or
- third-country BIPRU firms not within tiers one, two and four.

Tier 3 firms will generally **not** be required to:

- have a remuneration committee (although this will be "desirable" for larger Tier 3 firms);
- deliver at least 50% of variable remuneration in an appropriate non-cash form;
- defer a proportion of Code Staff variable remuneration (although such firms will be encouraged to use firm-wide deferral to align remuneration with effective risk management); or
- reduce deferred variable remuneration to reflect performance.

For other rules, the FSA will apply a discretionary approach that is likely to result in less-onerous requirements for Tier 3 firms than Tier 1 and 2 firms.

## **Tier 4**

FSA-regulated limited licence and limited activity firms (and third-country BIPRU firms with equivalent permissions). For example, firms that generate income from agency business without putting their balance sheets at risk would fall within Tier 4.

Tier 4 firms are expected to comply with the Code in a similar fashion to Tier 3 firms, except that Tier 4 firms will also generally:

- not be required to specify appropriate limits for the proportion of variable remuneration; and
- be able to take into account their specific activities when applying rules on profit-based measurement and risk adjustment of variable remuneration, and multi-year performance periods for the assessment of variable remuneration.

## **Other noteworthy features of the Tier system**

The following should be borne in mind.

- Firms within a group in which several firms are subject to the Code, will generally all fall within the highest proportionality tier to which any group member belongs.

- The Tier system will be applied flexibly. In particular, firms close to the boundary between two proportionality tiers may find themselves being judged as if they are in a higher tier having regard to that firms' specific risk characteristics.
- Firms can make submissions to the FSA that they should be treated as being in a lower proportionality tier than the general guidance would suggest and the FSA may authorise such treatment. Again this will depend on a firm's specific risk characteristics. Similarly, the FSA may determine that a firm should be moved into a higher proportionality tier than the general guidance would suggest, based on a firms' individual risk characteristics.

## **VOIDING PROVISIONS AND RECOVERING BONUSES**

The Code contains provisions rendering void certain contractual provisions insofar as they are in breach of the Code. Moreover, a firm will be obliged to recover payments in breach of such provisions. Specifically, any contractual provision for Code Staff (whose remuneration exceeds the de minimis threshold) will be void if it is breach of requirements in respect of:

- guaranteed bonuses;
- the deferral of a bonus; or
- prohibitions on payments made to replace any payments or property recovered from Code Staff as a result of the voiding provisions.

In addition, a firm that makes a voidable payment to an individual, will then be restricted from paying further variable remuneration to that person in respect of the same performance year, unless it has a legal opinion stating that the new award complies with Code.

A firm must notify the FSA of any breach of a rule which leads to a contractual provision being rendered void.



The voiding provisions therefore mean it is necessary for agreements between firms and their staff to have provisions in place giving the firm the right to recover payments made to staff in breach of the Code. The need for such provisions is all the more so given that the Code requires firms to have the right to make changes to bonus payments awarded or even paid to staff (for example where performance adjustments are needed). This requirement may be difficult to reconcile with local laws prohibiting recovery of such amounts (for example where there is a need to apply an adjustment to an employee employed by an overseas branch of a UK firm). In the UK, while we appreciate the practical difficulties, we would strongly recommend amending policies and contracts of employment (especially for new hires) to enable compliance with this. A sample starting point for a clause for the UK could read as follows:

*The Company is entitled to:*

*(a) withhold;*

*(b) defer;*

*(c) reduce the amount of;*

*(d) require repayment by the Employee of;*

*(e) change the date of payment or vesting of;*

*(f) change the proportion of any payment payable by way of cash, shares (or equivalent ownership interests), share-linked instruments or equivalent non-cash instruments in respect of; or*

*(g) take any other action in respect of,*

*all or any part of any bonus awarded, paid or payable (as the case may be) to the Employee (whether directly or indirectly) [including any bonus pursuant to the [INSERT NAME OF ANY RELEVANT BONUS SCHEME]], if the Company determines in its absolute discretion that such action is appropriate in order to comply with the FSA Remuneration Code or any applicable laws or the rules, codes or guidelines of any statutory or regulatory body relating to the remuneration of employees (in each case as amended from time to time) or to comply with any policy or procedure implemented by the Company [or any Group Company] from time to time relating to the remuneration of employees. If the Company requires repayment of any amount paid to the Employee (whether directly or indirectly) pursuant to this clause, any such amount, on the request of the Company, must be repaid by the Employee to the Company forthwith and will be recoverable by the Company as a debt (without prejudice to the rights of the Company to any other remedy) and the Employee further agrees that at any time during the continuance of his or her employment and on termination of his or her employment, the Company shall be entitled to deduct from any sums due to the Employee (including salary, pay in lieu of notice, holiday pay or sick pay) any amount up to the total amount of any repayment required by the Company pursuant to this clause.*

## **NEW DISCLOSURE OBLIGATIONS**

There are no specific notification or disclosure requirements in the Code, although the FSA is proposing that firms provide, at a minimum, an annual attestation that all Code Staff have been identified and listed, via their regulatory returns. In this regard, later this year the FSA will issue a form for data and other information to be supplied by firms as well as questionnaires or templates for such disclosures.

However, last month, alongside the Code, the FSA also published new rules implementing CRD3's requirements on the disclosure of remuneration. Broadly, the new rules require firms to make disclosures relating to Code Staff in relation to its remuneration policy, procedures and practices. Specifically, the disclosures required include:

- information concerning the decision-making process used for determining the remuneration policy, including if applicable, information about the composition and the mandate of a remuneration committee, the external consultant whose services have been used for the determination of the remuneration policy and the role of the relevant stakeholders;

- information on the link between pay and performance;
- the most important design characteristics of the remuneration system, including information on the criteria used for performance measurement and risk adjustment, deferral policy and vesting criteria;
- information on the performance criteria on which the entitlement to shares, options or variable components of remuneration is based;
- the main parameters and rationale for any variable component scheme and any other non-cash benefits;
- aggregate quantitative information on remuneration, broken down by business area;
- aggregate quantitative information on remuneration, broken down by senior management and members of staff whose actions have a material impact on the risk profile of the firm, indicating the following:
- the amounts of remuneration for the financial year, split into fixed and variable remuneration, and the number of beneficiaries;
  - the amounts and forms of variable remuneration, split into cash, shares, share-linked instruments and other types;
  - the amounts of outstanding deferred remuneration, split into vested and unvested portions;
  - the amounts of deferred remuneration awarded during the financial year, paid out and reduced through performance adjustments;
  - new sign-on and severance payments made during the financial year, and the number of beneficiaries of those payments;
  - the amounts of severance payments awarded during the financial year, number of beneficiaries and highest such award to a single person.

Like the Code, the FSA is intending to apply the new disclosure requirements in a proportionate way, categorising firms between Tier 1 and Tier 4. In particular, the FSA expressly acknowledges that *"disclosure will be required in a manner that is appropriate to their size, internal organisation and the nature, scope and complexity of their activities"*. Although there will be no complete exemption from the disclosure requirements, and so all firms will be required to disclose at least some information, the expectation is that firms in lower tiers will be subject to less onerous disclosure requirements.

Under the new FSA rules, firms will be required to disclose information on their remuneration policies and pay-outs at least on an annual basis. The first disclosure under the new regime will need to be "*as soon as practicable*" after 1 January 2011, but the FSA is expected to impose an ultimate deadline of 31 December 2011.

## SUMMARY

The new rules on remuneration and disclosure do not come as a great surprise in the light of previous publications and consultation papers from both European and national governments and regulatory bodies.

However, now the details have been published and deadlines for compliance set, it is imperative that those in the financial services industry with UK operations, whether in the UK or elsewhere, start taking steps straightaway to ensure their remuneration policies, practices and procedures are compliant with the new regulatory regime.

### [Related Professionals](#)

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