FSA To Strengthen Remuneration Code, Possibly Affecting 2,500 Firms

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The UK Financial Services Authority recently published a consultation paper describing how it intends to update its Remuneration Code (the "Code") to (i) implement the remuneration requirements of the Financial Services Act 2010 and (ii) incorporate the remuneration provisions of the latest amendments to the EU Capital Requirements Directive ("CRD3"). The requirement that remuneration policies must be consistent with and promote effective risk management remains the central tenet of the revised Code. Incorporation of CRD3 requirements, which come into force on 1 January 2011, will bring over 2,500 firms within scope of the Code. On 8 October 2010 the Committee of European Banking Supervisors (CEBS), which exists to ensure consistent implementation of EU law, published for consultation draft guidelines on the interpretation of the remuneration provisions of CRD3. FSA is obliged to take the guidance into account in their implementation of CRD3. The guidance will have a direct impact on both the delivery of 2010 remuneration for the largest UK banks, building societies and broker dealers, and the manner in which FSA revises the Code for investment firms.

The FSA first introduced the Code in January 2010, choosing to apply it merely to the largest banks, building societies and broker-dealers, fewer than 50 businesses. Going forward, the requirement to conform the Code’s scope to CRD3 means all banks, building societies and MiFID investment firms will be covered. The investment firm category includes broker dealers and asset managers, together with some firms that engage in corporate finance and financial advice. The relatively few private equity managers who fall within MiFID will be in scope. The Code also will apply to UK branches of firms whose home state is outside the European Economic Area, but not to UK branches of firms whose home state is within the EEA, as their home state will be required to apply equivalent provisions under CRD3. FSA proposes that UK groups should apply the Code globally to all their entities. CEBS confirms the extension of the provisions to the worldwide operations of European banks.

Significantly, CRD3 gives the regulators flexibility to take a proportionate approach to applying the remuneration provisions; in practice enabling them to shape the more detailed requirements so as to achieve their purpose across a range of different types of institutions. In a speech on 23 September 2010, senior FSA official Dan Waters focused on how FSA proposes to apply the CRD3 requirements to asset managers proportionately (see below under "Proportionality"). Asset managers will note the explicit comments by CEBS that proportionate implementation of the remuneration principles is especially justified for MiFID investment firms.

The new Code is more prescriptive than its predecessor, with over 30 new rules organised under 12 principles. FSA expects all extended scope firms to begin planning for the implementation of suitable remuneration structures, policies and practices as soon as possible.

In particular, the Code will be strengthened as follows:

- **Application** – to fit with CRD3, FSA must define a group of employees to which the Code applies. FSA proposes to include the following:
- a person who performs a significant influence function
- a senior manager (including those in support functions)
- all high-earning staff whose professional activities could have a material impact on a firm's risk profile.

The CEBS guidelines for Code staff are consistent with FSA's definition.

Whether members of a UK LLP would be covered is not addressed specifically by the consultation paper, which states "[FSA] will consider the position of individual proprietors and general partners." It is widely considered that pay regulation is inappropriate for owner-managers. Many smaller firms which are typically owner-managed will note the acknowledgement by CEBS that drawings paid to partners as owners of an institution are not covered. FSA may still try to apply the Code to members of partnerships, but such acknowledgement increases the likelihood that partners may escape some of the requirements even where they are defined as Code staff, based on individual roles and responsibilities.

- **Deferral** – at least 40 percent of a bonus must be deferred over at least three years, rising to 60 percent where the bonus exceeds £500,000. FSA is concerned that this requirement does not reflect the specificities of different types of funds; for example, those where the investment period is greater or less than three years.
- **Proportion in shares** – at least 50 percent 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. FSA recognises the asset management sector is dominated by owner-managed LLPs, and this will be challenging for non-listed firms who may need more time to comply.
- **Guarantees** – guaranteed bonuses of more than one year may not be offered. Guaranteed bonuses for new hires may only be offered in exceptional circumstances for the first year of service.
- **Strengthening of capital base** – firms must ensure that their total variable remuneration: (a) does not limit the ability to strengthen their capital base, and (b) must be reduced when the firm produces a subdued or negative performance.
- **Voiding provisions** – a new rule will be introduced which defines instances where breaches of the Code may render a contract void and/or require recovery of payments made.
- **Severance payments** – these should reflect performance over time, and failure must not be rewarded.
- **Pensions** – CRD3 requires that enhanced discretionary pension benefits should be held for five years in shares or share-like instruments. The focus is on deterring nonstandard one-off payments.

Regarding the few private equity and venture capital managers in scope, a threshold issue will be whether either carried interest or co-investment constitute "remuneration" in the first place, as opposed to returns on investment.

Proportionality

While CRD3 allows regulators to apply a proportionate approach to firms according to their size, internal organisation and the nature, scope and complexity of their activities, it does not allow for any firms captured by CRD3 to be exempt from the Code. Mr. Waters confirmed that while FSA will apply the Code's central tenet to all asset managers, it does not propose a rigid approach to those elements of the CRD3 requirements that are relevant in the design of remuneration structures for asset managers. FSA has proposed three sets of tables describing how proportionality is to be applied in specified circumstances, distinguishing between: a minimum set of rules to be applied by all firms; other rules that may be applied in line with a firm's nature, internal organisation, scale, scope and complexity; and rules which some firms may apply on a "comply or explain" basis. For example, FSA proposes that for staff earning under £500,000 whose bonus is less than 33% of their remuneration, they would not generally apply the rules relating to: deferral; performance adjustment; proportion of remuneration paid in shares; and guaranteed bonuses.

Timetable

FSA expects all extended scope firms to have the appropriate governance arrangements and procedures in place by 1 January 2011 and the prescribed remuneration structures by 1 July 2011. FSA originally had planned to publish a final version of the Code in mid-November. However, that deadline has been pushed back to mid-December to allow for CEBS to publish its final guidelines first and for FSA to take them into account. This will not leave firms much time to implement the new Code, but there are useful transitional provisions.

AIFMD

AIFMD, the text of which was agreed recently, covers managers of alternative investment funds including those not caught by CRD3 and contains provisions on remuneration in line with those of CRD3. AIFMD also allows for a proportionate approach. The current expectation is that AIFMD may come into force early to mid 2013, meaning that any AIFMD remuneration provisions would not apply before the 2013 remuneration reviews for AIFMD firms. Some firms captured by CRD3 will potentially also be subject to AIFMD, and this question of overlap will need to be addressed by UK and EU regulators during the forthcoming "Level II" implementation phase of AIFMD.

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