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Alert Memo

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The Revised FSA Remuneration Code

On December 17, 2010, the UK Financial Services Authority ("**FSA**") published a Policy Statement outlining amendments to the Remuneration Code (the "**Revised Code**")[1] to take account of the revised Capital Requirements Directive ("**CRD III**")[2] rules on financial institutions' remuneration structures, performance measurement and governance. The Revised Code requires that firms "establish, implement and maintain remuneration policies, procedures and practices that are consistent with and promote effective risk management." Although the Revised Code is of course only applicable to institutions under the FSA's jurisdiction, it may serve as a model for the enforcement of CRD III in other EU Member States as well.

The Revised Code will come into force on January 1, 2011 and will replace the existing Code, which governs the remuneration of employees at a limited number of large UK banks. Firms that are not subject to the existing Code may justify not complying with certain of the Revised Code requirements relating to remuneration structures until July 1, 2011. For firms already subject to the existing Code, it may be possible to justify non-compliance with the requirement to pay 50% of variable remuneration in shares or other non-cash instruments until July 1, 2011.

Also on December 17, 2010, the FSA published a Policy Statement[3] outlining amendments to "BIPRU", the Prudential Sourcebook for Banks, Building Societies and Investment Firms (the "**Disclosure Rules**") to implement the CRD III requirements on disclosure of remuneration policies and practices.

Key aspects of the Revised Code and the Disclosure Rules are summarized below.

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1 http://tinyurl.com/FSA-Remuneration-Code

2 http://tinyurl.com/CRD3-Text. Also see our Alert Memo: http://tinyurl.com/CGSHAlert-CRD3

3 http://tinyurl.com/FSA-Disclosure-Rules

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I. INTRODUCTION

Although CRD III implements internationally agreed principles set out in the FSB Principles for Sound Compensation Practice,[4] CRD III is considerably more prescriptive than remuneration policy requirements applicable outside the EU. In particular, the United States has adopted a more flexible principles-based approach. The FSA acknowledges that UK (and presumably other EU) firms may suffer a competitive disadvantage as a result of these discrepancies. However, the FSA's ability to provide relief from the more onerous provisions of CRD III was limited to taking a flexible approach to the principle of proportionality.

The Revised Code takes account of the Committee of European Banking Supervisors ("**CEBS**") Guidelines on Remuneration Policies and Practices, published on December 10, 2010 (the "**CEBS Guidelines**").[5] CEBS published a consultation paper on those Guidelines on October 8, 2010.[6]

Building on the CEBS Guidelines' confirmation that certain CRD III requirements could be modified or even "neutralized" where requiring strict compliance would be disproportionate, the Revised Code divides firms into four "tiers," each subject to decreasing "minimum expectations of compliance." Tier four firms, including asset managers and most other members of alternative investment fund groups, will be eligible to disapply a number of the most onerous CRD III requirements.

On the other hand, for firms not eligible to disapply those requirements, the FSA followed the CEBS Guidelines in applying the CRD III requirement that a substantial portion of covered individuals' variable remuneration be deferred for at least three to five years, not to variable remuneration as a whole, but separately to each of equity-linked and cash variable remuneration.

II. PROPORTIONALITY

When establishing and applying remuneration policies for Code Staff (as defined below), a firm must comply with the Revised Code in a way and to the extent that is appropriate to its size, internal organization and the nature, scope and complexity of its activities (the "proportionality rule").

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4 The FSB April Principles are available at http://tinyurl.com/FSBStandards-April and the FSB Implementation Standards are available at http://tinyurl.com/FSBStandards-International. See our Alert Memo at http://tinyurl.com/CGSHAlert-FSB.

5 http://tinyurl.com/CEBS-Remuneration-Guidelines

6 See our Alert Memo: http://tinyurl.com/CGSHAlert-CEBS

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The Revised Code includes an appendix containing guidance on the application of the proportionality rule. The Revised Code sets out four "tiers" of firm, each with differing minimum expectations of compliance:

- Proportionality tiers one and two contain credit institutions and broker dealers that engage in significant proprietary trading/investment banking activities:

  - The top tier catches the very largest banks and building societies: banks and building societies with capital resources exceeding £1bn; "full-scope BIPRU investment firms"[7] with capital resources exceeding £750m; and "third country BIPRU firms"[8] (that are not "limited licence"[9] or" limited activity"[10] firms) with total branch assets exceeding £25bn.
  - The second tier catches slightly smaller banks and building societies, including banks and building societies with capital resources between £50m and £1bn; full-scope BIPRU investment firms with capital resources between £100m and £750m; and third-country BIPRU firms (that are not limited licence or limited activity firms) with total branch assets between £2bn and £25bn.

- Proportionality tier three consists of primarily small banks and building societies and investment firms (both domestic and third country) which may occasionally take over-night/short-term risk with their balance sheet.

- Proportionality tier four catches the vast majority of investment firms that "generate income from agency business without putting their balance sheets at risk": *i.e.*, firms that are classified as either limited licence or limited activity firms.

Helpfully, firms in proportionality tiers three and four may disapply a broad range of requirements, including the requirement to have a remuneration committee;

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7 An investment firm that is subject to the EU directive on markets in financial instruments ("**MiFID**") with its head office in the United Kingdom (or which would be subject to MiFID if its head office were in an EEA State) but excluding banks, building societies and certain other types of institutions.

8 An overseas firm that is not an EEA firm, has its head office outside of the EEA and would be a BIPRU firm if it had been a UK domestic firm, it had carried on all its business in the United Kingdom and had obtained whatever authorisations for doing so are required under the Financial Services and Markets Act 2000.

9 An investment firm that is not authorized to deal on its own account or provide the services of underwriting or placing financial instruments on a firm commitment basis.

10 An investment firm that deals on its own account only: (i) for the purpose of fulfilling or executing a client order; or (ii) for the purpose of gaining entrance to a clearing and settlement system or a recognised investment exchange or designated investment exchange when acting in an agency capacity or executing a client order; or (b) it satisfies the following conditions: (i) it does not hold client money or securities in relation to investment services that it provides and is not authorised to do so; (ii) the only investment service it undertakes is dealing on own account; (iii) it has no external customers in relation to investment services it provides; and (iv) the execution and settlement of its transactions in relation to investment services it provides takes place under the responsibility of a clearing institution and are guaranteed by that clearing institution, in each case.

deferral of variable remuneration; the requirement to provide at least 50% of variable remuneration in the form of shares or share-like instruments; and performance adjustment. Firms in tier four may also disapply the "leverage" requirement, which requires firms to set appropriate ratios between the fixed and variable components of total remuneration and include these in their remuneration policies.

The FSA emphasizes that the tiers are only a starting point for the application of the Revised Code and that each firm must develop its own approach to compliance reflecting the risks faced by the firm and providing "adequate and effective incentives."

III. REVISED CODE PROVISIONS

A. Scope - Firms

The Revised Code will apply to firms within the scope of the EU directive on capital adequacy of investment firms and credit institutions ("**CAD**"), which include banks, building societies and investment firms. Firms that are exempt from CAD, such as many small corporate finance firms and fund advisors, will not be subject to the Revised Code. To ensure a level playing field, the Revised Code will also apply to UK branches of firms whose home state is outside the European Economic Area ("**EEA**"). UK branches of EEA firms will instead be subject to the equivalent rules in the firm's home Member State.

The Revised Code's application to a group headquartered in the UK will be determined by the scope of that group's consolidated supervision by the FSA. The Revised Code will apply on a consolidated basis at the level of any UK consolidation group or EEA sub-group, meaning that certain overseas group members (both within and outside the EEA) within that consolidation group must comply with the Revised Code. However, the FSA stresses that it believes the scope of Code Staff may result in only "a reduced and more senior group of employees" being subject to the most onerous Code requirements (see "Scope – Individuals", below).

B. Scope - Individuals

Although some of its rules must be applied on a firm-wide basis, the Revised Code obligations apply in particular to "Code Staff," who include the following:

- Individuals who have been formally approved by the FSA as Approved Persons of the firm who perform a significant influence function ("**SIF**") (*i.e.*, Controlled Functions 1 - 29);
- Any other "senior managers"[11];

[11] An 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" whose professional activities have a material impact on the firm's risk profile; and
- Any employees whose total remuneration takes them into the same bracket as senior management and "risk takers" and whose professional activities have a material impact on the firm's risk profile.

The Revised Code contains a non-exhaustive list of examples of such risk takers, who include:

- Heads of significant business lines (including regional heads) and any individuals or groups within their control who have a material impact on the firm's risk profile; and
- Heads of support and control functions and other individuals within their control who have a material impact on the firm's risk profile, including heads of credit, market and operational risk, legal, treasury controls, human resources, compliance and internal audit.

The FSA does not require firms to apply the rules relating to guaranteed variable remuneration, retained shares or other instruments, deferral or performance adjustment to a particular individual if: (a) his or her total remuneration is no more than £500,000; and (b) his or her variable remuneration is no more than 33% of his or her total remuneration.

Risk takers and those performing a SIF who are employed by a UK firm, but located outside the UK, may be caught by the Revised Code if the individual is "in a position to have a material impact" on the risk profile of the UK firm. Although all such persons should in principle be Code Staff, the FSA may consider exemptions "where the individual has global responsibilities, and where the UK entities form only a part of those responsibilities."

C. Variable Remuneration Composition

Remuneration Deferral: A firm must not award, pay or provide variable remuneration unless at least 40% (60% where the variable remuneration is at least £500,000) is deferred for not less than three to five years. The FSA expects this rule to be applied on a firm-wide basis. This requirement may be disapplied by firms in tier three and four.

Equity-based remuneration: The Revised Code requires at least 50% of any variable remuneration to consist of an appropriate balance of shares or equivalent ownership instruments. Following the CEBS guidelines, the Revised Code applies this requirement separately to both deferred and non-deferred remuneration components. This requirement may be disapplied by firms in tier three and four.

D. Additional rules on Remuneration Practices

Performance Adjustment: A firm must ensure that any variable remuneration, including the deferred portion, is paid only if it is sustainable according to the financial situation of the firm as a whole and is justified according to the performance of the firm, the business unit and the individual concerned. This requirement may be disapplied by firms in tier three and four.

Guaranteed variable remuneration: A firm must not provide guaranteed variable remuneration unless it is (a) exceptional, (b) occurs in the context of hiring new Code Staff; and (c) is limited to the first year of service. In such circumstances, the firm must take reasonable steps to ensure the amount and terms (including any deferral or retention periods) of guaranteed remuneration are not more generous than the individual's previous employer and such remuneration is subject to appropriate performance adjustment requirements. Guaranteed variable remuneration should be subject to the same deferral criteria as other forms of variable remuneration awarded by the firm. The FSA expects this rule to be applied on a firm-wide basis.

Ratios between fixed and variable components of total remuneration: A firm must set appropriate ratios between the fixed and variable components of total remuneration and ensure that these are appropriately balanced and allow the operation of a fully flexible policy on variable remuneration components, including the possibility to pay no variable remuneration. This requirement may be disapplied by firms in tier four only.

D. Risk Adjustment

A firm must ensure that any performance measurement used to calculate variable remuneration include adjustments for current and future risks and take into account the cost and quantity of the capital and the liquidity required. In addition, the firm must "take into account the need for consistency with the timing and likelihood of the firm receiving potential future revenues incorporated into current earnings."

IV. DISCLOSURE

On December 17, 2010, the FSA also published the Disclosure Rules to implement the CRD III requirements on disclosure of remuneration policies and practices. The Disclosure Rules take into account the CEBS Guidelines and the Revised Code, in particular, and adopt the proportionality rule and the associated four-tier approach.

Unlike the Revised Code, the Disclosure Rules do not apply to third-country BIPRU firms. The FSA is considering consulting on extending the Disclosure Rules to the UK branches of such firms and may do so in early spring 2011. In this international

context, the FSA notes that many non-EU jurisdictions are awaiting the outcome of the Basel Committee on Banking Supervision's ("**BCBS**") consultation on remuneration disclosure, but it does not expect the BCBS's final proposals to differ significantly from CRD III. Thus, in contrast to the rules on remuneration structures, performance measurement and governance, it is less likely that significant differences will develop between the EU and non-EU approaches on remuneration disclosure.

Like the Revised Code, the Disclosure Rules will come into force on January 1, 2011, although firms within its scope need only make their first disclosure by December 31, 2011. Thereafter, disclosures must be made at least annually in relation to those categories of a firm's staff whose professional activities have a "material impact on its risk profile" and, in the case of proportionality tier one firms, its "senior personnel"[12].

The Disclosure Rules and the related Policy Statement set out the detailed information to be disclosed, depending on the relevant proportionality tier. Requirements applicable to all proportionality tiers include:

- Information concerning the decision-making process used for determining the remuneration policy;
- Information on the link between pay and performance; and
- Aggregate quantitative information on remuneration, including by business area.

For firms in proportionality tier one, the aggregate quantitative information must include details of the amounts of certain types of remuneration (including, fixed, variable, different types of variable, deferred and sign-on and severance payments).

In line with the CEBS Guidelines, firms may make the required disclosures in the form they find most appropriate, "providing this is easily accessible to users, and provides appropriate cross-references to other relevant information and disclosures in the Pillar 3 context."

V. CONCLUSION

In implementing the FSB Principles for Sound Compensation Practice, CRD III unfortunately failed to achieve convergence with other jurisdictions. In contrast with the EU's detailed and rule-based approach, the United States, Japan and Canada have adopted a more flexible supervisory approach to compensation. Moreover, unlike the United States, the requirements will bind not only banks, but also a broad range of investment firms. Accordingly, financial institutions operating both within and without the EU will potentially be subject to overlapping regulatory requirements, certain of

[12] Those persons who effectively direct the business of the firm, which could include the members of a firm's governing body and other persons who effectively direct the business of the firm. Note that the definition of Code Staff is not used in the Disclosure Rules.

which will be applied extra-territorially, and some of which impose detailed and prescriptive requirements on financial institutions.

Although CRD III will have a substantial impact on a wide range of credit institutions and investment firms, the FSA has made every effort to assist firms other than large credit institutions in creating bespoke remuneration policies, appropriate to their size and the nature of their business, within the boundaries set by the CEBS Guidelines. As a result, in the UK, CRD III's greatest impact will be limited to the largest of firms, falling within tiers one and two. It is to be hoped that regulators in other EU Member States will similarly permit a flexible application of the proportionality principle built into CRD III and recognized by the CEBS Guidelines to mitigate the most onerous aspects of CRD III.

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If you have any questions, please feel free to contact any of your regular contacts at the firm or any of our partners and counsel listed under the 'Practices' section of our website at http://www.clearygottlieb.com.

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