

UK Financial Regulator Revises the Remuneration Code

By Christopher Fisher, Nicholas Robertson and Bernadette Daley (Mayer Brown LLP)

The Financial Services Authority (the FSA), the regulator responsible for the financial services industry in the UK, has published a consultation paper setting out its proposed changes to the Remuneration Code (the Code). We previously reported on the introduction of the Code in August 2009. The Code was introduced in response to concern that remuneration practices may have been a contributory factor to the global market crisis. The Code currently applies only to 26 of the largest banks, building societies and broker dealing groups in the UK but is now being significantly extended in scope and revised to take account of recent international and EU work on remuneration principles.

The Code is being revised to take account of:

- the coming into force on June 8, 2010 of provisions relating to remuneration within the Financial Services Act 2010;
- the need to take account of recent international work on remuneration principles, most notably the amendments to the Capital Requirements Directive (CRD 3), which come into force on January 1, 2011;
- Sir David Walker's review of corporate governance in UK banks, published in November 2009; and
- lessons learned from the FSA's experience in implementing the Code so far.

Christopher Fisher is a Partner resident in the firm's London office. Mr. Fisher advises on a broad range of contentious and non-contentious matters. His advisory experience includes recruitment and termination of executives; team moves; restructuring programmes, including collective and individual consultation; business transfers and outsourcing; and the implications of the Business Transfer Regulations. (cfisher@mayerbrown.com) Nicholas Robertson is a Partner in the employment practice of the London Office. His experience includes a full range of employment matters for employers, both on a collective basis and in relation to individual employees. He has extensive experience advising on the recruitment and termination of executives and advising on policy issues. (nrobertson@ayerbrown.com) Bernadette Daley is a Partner resident in the firm's London office. Ms. Daley advises employers on all aspects of employment law, including complex employment litigation and large-scale redundancy and restructuring programmes. She has significant experience advising on cross-border employment law issues, particularly multi-jurisdictional outsourcing and business transfers as well as advising on day-to-day employment issues including dismissals, grievances, sickness absence, performance management, bullying and harassment. (bdaley@mayerbrown.com)

While the consultation paper provides details of the proposals and how these will be implemented, it does not yet provide the full picture. The FSA acknowledge that the timetable moving forwards is tight. The consultation period closes on October 8, 2010, and there are still a number of areas which require clarification over the next few months. The Policy Statement is due to be published in November 2010, effective from January 1, 2011.

Currently the Code applies to 26 of the largest banks, building societies and broker dealer groups in the UK. As a result of CRD3, the FSA is required to substantially increase the scope of the Code to over 2,500 FSA authorized firms.

Which Firms Are to Be Covered?

This is the most significant change. Currently the Code applies to 26 of the largest banks, building societies and broker dealer groups in the UK. As a result of CRD3, the FSA is required to substantially increase the scope of the Code to over 2,500 FSA authorized firms. All banks and building societies, a large number of asset managers, most hedge fund managers and all UCITS investment firms will be in scope, plus some firms which engage in corporate finance, venture capital, the provision of financial advice, brokers, several multilateral trading facilities and others.

The FSA has committed to adopt a proportional approach in applying the rules, reflecting the extent to which the application of the rules is appropriate to a firm's size, internal organization and the nature, scope and complexity of its activities.

Territorial Scope

The following is proposed:

- UK groups should apply the Code globally to their regulated and unregulated entities.
- UK subsidiaries of non-European Economic Area (EEA) parents must apply the Code in relation to all entities within the relevant sub-group, including entities based outside the UK.
- UK subsidiaries of EEA parents, that are regulated entities in the UK, must apply the Code. However,

these entities are likely to be subject to a dual regime as their parent company's home state will need to implement the provisions of CRD3.

- UK branches of firms whose home state is outside the EEA will continue to be caught by the Code.
- UK branches of firms whose home state is within the EEA are not required to apply the Code as their home state will be required to apply equivalent provisions under the CRD3.

Remuneration Principles

The general requirement that remuneration policies must be consistent with and promote effective risk management remains the central tenet of the Code. The FSA has, however, revised and updated the principles of the Code. We set out a summary of the key proposals below:

Fixed/Variable Balance

The FSA wants to ensure that firms have an appropriate balance between fixed and variable elements of total remuneration. The FSA are waiting for the Committee of European Banking Supervisors (CEBS) to set out its specific criteria in its guidelines, which are due in October 2010, before determining ratios.

Deferral

In relation to large bonuses, which will be those in excess of £500,000, at least 60% should be deferred, rather than 40% which was previously set out in the Code. Firms should also consider whether smaller amounts should be considered to be 'particularly high' and therefore should be subject to the 60% deferral.

Proportion in Shares

A new rule is proposed requiring at least 50% of any variable remuneration to be made in shares, shares linked in instruments, or other equivalent non-cash instruments, subject to the legal structure of the firm. The FSA's view is that firms can decide whether this 50% forms part of the non-deferred payment, or the deferred element, or a mixture of both. The FSA does recognize that for firms that are unable to issue shares, such as building societies, this requirement will not be as easily applied and the FSA is sensitive to the difficulties in implementing suitable alternatives to shares and share linked instruments.

Performance Adjustment

The Code will be amended to state that all deferred variable remuneration which has not yet vested should be subject to an appropriate form of performance adjustment. The FSA suggests that performance adjustment should be applied in the following situations, namely, where:

- there is evidence of employee misbehavior or material error;
- the firm and/or the business unit subsequently suffers a material downturn in its financial performance; and

- the firm and/or the business unit in which the employee works suffers a material failure of risk management.

Guarantees

The FSA has confirmed a continuing ban on guaranteed bonuses other than, in exceptional circumstances, to new hires for the first year of service only, which should also be subject to deferral. Sign on/ buy-out bonuses should not exceed the terms offered by the previous employer (being bought out) and should be subject to performance adjustment requirements. Retention bonuses will only be permitted in exceptional circumstances. The FSA has proposed that it will be good practice to extend the guarantee rules to all employees.

In relation to large bonuses, which will be those in excess of £500,000, at least 60% should be deferred, rather than 40%, which was previously set out in the Code.

Severance Pay

The FSA is proposing a new rule in relation to severance pay to ensure that payments related to the early termination of a contract reflect performance and do not reward failure.

The Financial Services Act 2010 has given the FSA the power to be able to prohibit a firm from remunerating its staff in a certain way. The FSA can render void a provision of an agreement that contravenes the Code and recover payments. The FSA have proposed that this power will only be used in relation to deferral arrangements and guaranteed bonuses.

Which Staff Are Covered?

The revised Code will apply to any staff that have a material impact on the firm's risk profile, the "Code Staff." The individuals covered may be slightly different to the staff, known as "P8 staff," to which the Code previously applied. There are three categories of individuals who the FSA would expect to see on a firm's list of Code Staff:

- (a) a person who performs a significant influence function for the firm;
- (b) a senior manager;
- (c) all staff whose total remuneration takes them into the same bracket as senior management and risk takers.

In addition to heads of the business, the FSA has confirmed that, subject to the nature of their duties, the potential list of Code Staff would also normally include

Remuneration Code, continued on page 16

Remuneration Code *(from page 15)*

heads of support and control functions, such as human resources, legal, compliance and information technology. The FSA is considering the position of individual proprietors and general partners. However, it has confirmed that limited partners whose position is more akin to employees will not be excluded from the scope of Code Staff.

It is for the relevant firms to determine a defensible list of Code Staff for the FSA, ahead of bonus allocations. The staff on the list will need to be notified that they are subject to the Code. In relation to non-Code staff, the FSA proposes that firms should consider the Code principles on a firm-wide basis under a general rule, subject to proportionality.

There is a proposed de minimis exemption for Code Staff whose bonus is less than 33% of total remuneration and whose total remuneration is less than or equal to £500,000. For such persons the FSA would not generally consider it necessary to apply the rules relating to deferral, performance adjustment, proportion of remuneration paid in shares and guaranteed bonuses. This proposal will be reviewed following the publication of the CEBS Guidelines later this year.

Proportionality

The FSA has confirmed that it will apply the Code in a proportional way, in accordance with the flexibility given by CRD3. This will not mean that there is a complete exemption from the Code for any firm, but it is recognized that applying the full Code may be inappropriate and/or overly burdensome for some. The FSA have proposed an approach which provides that: there are minimum require-

ments which all firms are expected to comply with;

- there are rules which could be applied proportionally in line with a firm's nature, scale, scope and complexity; and
- there are rules that could be applied on a "comply or explain" basis.

The FSA has confirmed a continuing ban on guaranteed bonuses other than, in exceptional circumstances, to new hires for the first year of service only, which should also be subject to deferral.

The FSA Consultation Paper provides tables setting out where each of the proposals falls within the proportionality principles, but there will need to be further clarification on this issue. In addition, the CEBS is considering several issues relating to proportionality and a report is expected in October 2010.

Implementation

Firms in extended scope: The FSA expects the extended scope firms to begin planning for the implementation of suitable remuneration structures, policies and practices as soon as possible. Whilst they state that it is desirable that such arrangements are in place by January 1, 2011, the FSA will not expect such firms to have achieved this until later in 2011.

Firms currently in scope: The review of remuneration

arrangements will be divided into two parts. The first part will take place in the last quarter of 2010 through meetings and discussions and will address the issues of governance, controls, performance measurement and risk adjustment. The second part will review the proposed plans for 2010 awards against the rules that will come in on January 1, 2011. The FSA will request such information in the weeks before each firm's proposed announcements of bonus awards. □

Subscribe Today to

EuroWatch®

☐ \$960 one year/US delivery ☐ \$1010 one year/non-US delivery
(One year consists of 22 issues)

Mail your order to:

WorldTrade Executive, PO Box 761, Concord, MA 01742 USA

or place your order by fax at: (978) 287-0302 or phone: (978) 287-0301

Credit Card # _____

☐ VISA ☐ Mastercard ☐ American Express

Expiration Date: _____

Signature _____

Name _____

Title _____

Company Name _____

Address _____

City _____

State/Country _____ Zip _____

Telephone _____

Fax _____