MAYER • BROWN

Legal Update
July 2013

Bonus Cap for Bankers in the EEA

In February 2013 the European Parliament reached provisional agreement with the Council of the EU on the Fourth Capital Requirements Directive (CRD IV), insisting on the inclusion of controversial proposals to cap bankers' bonuses as a condition of their agreement. Despite the UK's objections, the CRD IV text has now been adopted and published in the Official Journal of the EU. The legislative package will come into force on 1 January 2014 but, as explained below, it appears that the effect of the bonus cap will not be felt until the 2015 bonus round.

This update considers the current position on the bonus cap, and other changes contained in the remuneration provisions of CRD IV.

These provisions will apply to banks (and some investment firms) and have the same territorial effect as CRD III. In particular, they will apply to the EEA subsidiaries (but not branches) of banks headquartered in the United States.

Summary of changes

CRD IV makes the following main changes to the CRD III remuneration provisions:

- **Bonus Cap** The ratio of variable to fixed remuneration was previously left to the banks to set. It will now be subject to a cap, so that variable remuneration cannot exceed fixed remuneration, or, with the approval of shareholders, two times the fixed remuneration. This major and controversial change is considered in more detail below.
- **Identified Staff** The category of staff to which the provisions will apply (identified staff) will ostensibly remain the same. However the European Banking Authority (EBA) is required to develop a draft regulatory technical standard with respect to "qualitative and appropriate quantitative criteria to identify categories of staff whose professional activities have a material impact on the institution's risk profile" and are accordingly subject to the provisions. Previously, as noted above, it was down to the banks to identify these staff. The EBA has published a consultation paper on the draft standard, which for some banks may increase the number of staff subject to the provisions considerably. This is also considered in more detail below.
- **Guaranteed bonuses** CRD III included the principle that "guaranteed variable remuneration is exceptional and occurs only when hiring new staff and is limited to the first year of employment". This is now further restricted by requiring the institution to have a sound and strong capital base, and a new principle is included: "guaranteed variable remuneration is not consistent with sound risk management or the pay-for-performance principle and shall not be a part of prospective remuneration plans". It will be interesting to see how these new provisions are implemented in the UK, where the Parliamentary Commission on Banking Standards has called for a reform in the area of "buy-out awards": the Commission was concerned that if malus or clawback provisions threaten an employee's deferred bonuses, the employee could avoid them by moving to a new employer, with buy-out awards replacing the existing awards.
- **Malus and clawback** There is now a specific requirement that up to 100% of total variable remuneration be subject to malus or clawback arrangements, which shall, in particular, cover situations where the staff member participated in or was responsible for conduct which resulted in significant losses to the institution, or failed to meet appropriate standards of fitness and propriety.
- **Disclosure** The information to be disclosed in relation to remuneration will increase, in particular the ratios set between fixed and variable remuneration, and the number of individuals receiving at least €1 million in remuneration per year must be disclosed.

Background – CRD III and the negotiation of CRD IV

The Third Capital Requirements Directive (CRD III)[1] introduced remuneration provisions applying to banks and certain investment firms[2] operating in the EEA[3] in an attempt to reduce risk in the financial system. In particular these provisions imposed requirements to defer the payment of a proportion of "variable remuneration" (largely, bonuses) over a period of three to five years, and to pay a proportion of variable remuneration in the form of shares, equivalent interests and other instruments which "reflect the credit quality of the institution as a going concern". Also, institutions were required to "set the appropriate ratios between the fixed and the variable component of the total remuneration".

These provisions applied to "senior management, risk takers, staff engaged in control functions 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 [institution's] risk profile", and it was left to the institution to identify the appropriate people.

The provisions were to be complied with in a way and to the extent that it was appropriate to the institutions' "size, internal organisation and the nature, the scope and the complexity of their activities".

The CRD III remuneration provisions were implemented in the UK by way of changes to the Remuneration Code, effective at 1 January 2011 (and it is anticipated that the relevant provisions of CRD IV will be implemented by further changes to the Code in the UK). The Remuneration Code is currently SYSC 19A in the handbooks of the Financial Conduct Authority and the Prudential Regulation Authority (successor bodies to the Financial Services Authority).

During the negotiations on CRD IV, the European Commission and the European Council were initially of the view that the remuneration regime in the financial services industry had been sufficiently strengthened by the provisions in CRD III but the European Parliament was less sanguine. It argued that excessive risk taking had exacerbated the financial crisis and a cap on bankers' bonuses would curb their risk appetite. The negotiations between the EU institutions responsible for adopting the legislation lasted over a year and at times appeared to have stalled as the Parliament made its proposed provisions on remuneration key to reaching a deal.

On 27 March 2013 a majority of the Council agreed to the Parliament's provisions in order to reach agreement on CRD IV despite the UK stating that it could not support the package if it included the provisions on remuneration. The UK argued that the provisions were not supported by any evidence or impact assessment, that they would merely encourage an increase in basic pay and pointed out that it is not possible to clawback remuneration in the form of basic pay, nor to reduce basic pay if a troubled bank needed to conserve capital. It said its preference was for greater use of bonuses deferred on a long-term basis and a strengthening of the clawback provisions. The UK expressed concerns that the Parliament's proposals would undermine the significant progress that has been made in requiring banks to align remuneration with risk, particularly following the UK's strict implementation of CRD III. Concerns were also raised that a cap on bankers' bonuses would make it hard for the EEA to remain competitive with the financial centres of New York, Singapore and Hong Kong, which have not taken such an approach.

Although some Member States expressed sympathy for the UK's position[4], they still favoured the package as a whole. As a result, on 20 June 2013 the UK found itself in an unprecedented position on a major financial services legislative proposal: CRD IV was adopted by a qualified majority of the Council, with the UK voting against it.

CRD IV recasts and amends the previous Capital Requirements Directive provisions, but a lot of the wording of the CRD III remuneration provisions is retained.

1 CRD III amended the Banking Consolidation Directive (2006/48/EC) and the Capital Adequacy Directive (2006/49/EC), which were together known as the Capital Requirements Directive.

2 The application to investment firms was substantially reduced by the proportionality principle: in implementing CRD III in the UK, the FSA adopted a tiering system, under which limited licence and limited activity MiFID firms were not required to comply with the more restrictive remuneration provisions of CRD III.

3 The European Economic Area (EEA) comprises the European Union (EU) and Norway, Iceland and Liechtenstein.

4 Data published by the EBA on 15 July 2013 revealed that banks in the UK employed 2,436 bankers earning more than €1m in total pay in 2011, as opposed to 736 in all the other EU Member States combined. The data also revealed that the highest earning bankers in the UK on average received bonuses of 3.5 times their fixed salary in 2011 (and almost 6.5 times in 2010). The figures demonstrate the impact that the remuneration provisions in CRD IV will have in the UK.

Implementation of the directive

CRD IV consists of a directive (2013/36/EU) (the "Directive") and a regulation (575/2013). The remuneration provisions are found within the Directive (mainly at Articles 92 to 96). The regulation is largely directly applicable across all of the EEA without the need for further action by the individual Member States, but the Directive contains relatively broad principles and provisions which must be implemented into the domestic legislative framework of each Member State.

Both the Prudential Regulation Authority (PRA) and the Financial Conduct Authority (FCA) will consult later this summer on the changes to the UK rules which will be needed to reflect CRD IV. Implementation must be completed by 31 December 2013 but, at this stage, it is not particularly clear how some of the provisions in the Directive will be implemented.

The provisions of CRD IV will apply from 1 January 2014. The bonus cap will apply to "remuneration awarded for services provided or performance from the year 2014 onwards whether due on the basis of contracts concluded before or after 31 December 2013" (Article 162(3) of the Directive).

Scope of measures

The remuneration provisions in CRD IV apply to deposit-taking banks (credit institutions) and some MiFID investment firms[5]. The application to banks will generally be the same as for CRD III. The criteria for investment firms appear to exclude more firms than CRD III, although in practice the effect of this is likely to be limited, as the impact of the CRD III remuneration provisions on investment firms was reduced through the application of the proportionality principle, as it is likely to be for CRD IV[6].

The remuneration provisions apply at group, parent company and subsidiary level and apply to offshore financial centres (Article 92(1) of the Directive). This means that the provisions apply to:

- all relevant institutions within the EEA;
- non-EEA branches and subsidiaries of institutions which have their head office in the EEA; and
- EEA subsidiaries (but not branches) of institutions which have their head office outside the EEA.

This provision was also in CRD III and so the territorial scope of the remuneration provisions is unchanged. Thus they apply to an EEA consolidation group, as well as individual subsidiaries of the group. This includes branches and offshore subsidiaries of an EEA parent institution. In the case of EEA subsidiaries of a wider non-EEA group, the remuneration provisions apply at the EEA-based level.

The principle of proportionality, however, will impact on the application of the provisions to individual entities and across a group. The principle is a basic requirement of EU law and is enshrined in the EU Treaties. In essence, it requires that the means used to achieve a given aim must not exceed what is necessary and appropriate to achieve that aim. Article 92(2) of the Directive expressly requires regulators to ensure that institutions comply with the remuneration provisions of the Directive "in a manner and to the extent that is appropriate to their size, internal organisation and the nature, scope and complexity of their activities" (as for CRD III). The EBA ought to adhere to the principle of proportionality when drafting regulatory technical standards and any guidance, as should national regulators when implementing and enforcing the legislation.

Bonus Cap

CRD IV draws a distinction between fixed remuneration, which includes "payments, proportionate regular pension contributions, or benefits (where such benefits are without consideration of any performance criteria)", and variable remuneration, which includes "additional payments, or benefits depending on performance or, in exceptional circumstances, other contractual elements but not those which form part of routine employment packages (such as healthcare, child care facilities or proportionate regular pension contributions)". In both cases monetary and non-monetary benefits should be included.

The basis of the bonus cap (which is not a phrase used in the Directive) is that the variable remuneration cannot exceed 100% of the fixed remuneration for any one individual (although this can be increased to 200% with the approval of shareholders meeting specified

5 Investment firms to which the Markets in Financial Instruments Directive applies.

6 Recital 66 of the Directive provides that "The provisions of this Directive on remuneration should reflect differences between different types of institutions in a proportionate manner, taking into account their size, internal organisation and the nature, scope and complexity of their activities. In particular it would not be proportionate to require certain types of investment firms to comply with all of those principles".

criteria). For many banks, the face value of variable remuneration can be a much larger multiple of salary for many of their higher paid employees, so this could entail a big change to the structure of their remuneration.

We assume that the cap will need to be applied on an annual basis, but the Directive does not expressly specify this. It does say that the bonus cap will apply to "remuneration awarded for services provided or performance from the year 2014 onwards, whether due on the basis of contracts concluded before or after 31 December 2013" (Article 162(3)). It would appear therefore that the 2015 bonus round would be the first to be caught (those bonuses being awarded in relation to services and/or performance in 2014), but the position is less clear in relation to the grant of a long term incentive plan (LTIP) award in 2014, which has a performance condition measured over the years 2014 to 2018, say. Similarly, the position is not clear in relation to such an award granted in, say, 2012, with a performance/vesting period covering 2014. We would assume that such awards would not be caught, but this remains to be seen. LTIP awards would normally be made as part of the bonus process, so it would seem to be both logical and practical to treat an LTIP award granted in February 2014, at the same time as decisions on 2013 bonuses are made, as being for the employee's services and performance in 2013, despite the forward looking performance condition and vesting period.

Another area of uncertainty is the valuation of LTIP awards for these purposes. For accounting purposes, the market value of a share-based LTIP award at the date of grant can be substantially less than the value of the maximum number of shares subject to that award, depending on the vesting conditions applicable to the award. There is currently little guidance on the valuation of awards in the context of CRD III, presumably on the basis that such issues were left to the discretion of the institution. The Remuneration Code, in the context of including LTIP awards in the deferred portion of variable remuneration, states that "the valuation of the award should be based on its value when the award is granted, and determined using an appropriate technique". In the particular case of determining whether a particular staff member is exempt from the voiding provisions in Annex 1 to the Code because his remuneration is below certain limits, it is stated that "where remuneration is, when awarded, subject to any condition, restriction or other similar provision which causes the amount of the remuneration to be less than it otherwise would be, that condition restriction or provision is to be ignored in arriving at its value". Given the increased importance of valuation in determining compliance with the provisions, together with the general tendency of the European authorities to be more prescriptive on issues such as this, we would not be surprised if this were now to be the subject of more detailed guidance.

An important provision of the Directive is that Member States may allow a discount to be applied to the value of variable remuneration paid in the form of instruments deferred for at least five years. Such discounted remuneration may form up to a maximum of 25% of the total variable remuneration. It appears that the permitted discount is to be set by individual Member States, but the EBA is mandated to prepare and publish, by 31 March 2014, guidelines on the applicable discount rate "taking into account all relevant factors including inflation rate and risk, which includes length of deferral". These guidelines "shall specifically consider how to incentivise the use of instruments which are deferred for a period of not less than five years". We understand a consultation draft of this guidance is due to be published in the fourth quarter of 2013, likely to be in October. Depending on the levels of discount suggested, this could be a powerful tool to encourage the use of long-term deferred instruments in bonus and incentive planning, and it may allow banks to preserve some aspects of current remuneration structures, with large values being paid in deferred variable remuneration.

Member States may allow banks to increase the cap to up to 200% of fixed remuneration, but this is subject to shareholder approval. The procedural provisions relating to this approval (see Article 92(1)(g)(ii) of the Directive) are relatively detailed, and the majority required is 66%, provided that at least 50% of shares are represented at the meeting, or 75% if not. It is not clear, in the case of a bank which is an EEA subsidiary of a parent outside the EEA whether it is the approval of the parent that is required, or the parent's shareholders. Staff who are directly concerned by the higher maximum level of cap shall not be allowed to vote, directly or indirectly, on the proposal. It is not clear whether it will be sufficient not to count any votes cast by such staff, or they will need to be prevented in some way from voting.

CRD IV requires a review of the impact of the bonus cap on staff working in subsidiaries outside the EEA of EEA parent institutions by 30 June 2016. The review will also consider the impact of the bonus cap on competitiveness and financial stability.

Identified Staff

There has been concern that the criteria in CRD III for identifying the staff to whom the remuneration provisions apply (usually referred to as "Code Staff" in the context of the UK Remuneration Code) have in many cases not been applied correctly, and there were wide differences in application of those criteria. Accordingly, the EBA is now required to develop a draft regulatory technical standard (RTS) containing qualitative and quantitative criteria to be applied by institutions in identifying staff caught by the provisions. They are required to deliver this draft to the European Commission by 31 March 2014 but it may then be some months before it is adopted[7] (so that it is highly unlikely to apply for the 2014 bonus round).

The EBA has published a consultation paper on this, including an initial version of the text of the draft RTS. The deadline for comments on the consultation is 21 August 2013.

In summary, under the consultation draft, staff shall be identified as material risk takers if they meet one or more of the following criteria:

- Internal criteria (developed by the institution): these criteria shall be based on internal risk assessment processes and aim at reflecting the specific institution's risk profile.
- Standard qualitative criteria: related to the role and decision-making power of staff members (e.g. staff is a member of a management body, is a senior manager, has the authority to commit significantly to credit risk exposures, etc.)
- Standard quantitative criteria: related to the level of variable or total gross remuneration in absolute or in relative terms. In this respect, staff should be identified as material risk takers if:
  - (i) their total remuneration exceeds, in absolute terms, €500,000 per year; or
  - (ii) they are included in the 0.3% of staff with the highest remuneration in the institution, or
  - (iii) their remuneration bracket, in one of the last two financial years, is equal or greater than the lowest total remuneration of senior management and other risk takers, or
  - (iv) their variable remuneration could, in accordance with the institution's remuneration policy, exceed €75,000 and 75% of the fixed component of remuneration (if this text remains as "could exceed", this may be a very wide criterion for some institutions).

If a staff member is only identified by reason of criteria in (iii) and/or (iv), he could be excluded if he does not have a material impact on the institution's risk profile.

Payment of variable remuneration in instruments

As in CRD III, there is a requirement for at least 50% of any variable remuneration to be paid in certain instruments. These instruments will consist of "a balance" of:

- "shares or other ownership interest, subject to the legal structure of the institution concerned or share-linked instruments or equivalent non-cash instruments in the case of a non-listed institution";
- where possible other Additional Tier 1 instruments or Tier 2 instruments or "other instruments which can be fully converted to Common Equity Tier 1 instruments or written down" that "in each case adequately reflect the credit quality of the institution as a going concern and are appropriate to be used for the purposes of variable remuneration".

The wording of the second bullet has expanded somewhat as compared to CRD III, and the EBA is required to prepare a draft RTS on the classes of instrument which satisfy the conditions of this bullet. We understand a consultation paper on this is likely to be published in August 2013.

7 After the draft is submitted to the Commission, the Commission has 3 months to decide whether or not to endorse it. If the Commission amends the draft, the EBA has another 6 weeks to decide whether to adopt the amendments. Once this process is completed and the Commission has adopted the draft, it submits it to the European Parliament and Council who may have up to 3 months to exercise their right of scrutiny. (This period can, at the discretion of the Parliament and of the Council, be extended by another 3 months.) These periods are shortened to a month if the Commission adopts EBA's draft without amendment. The legislation will be published in the Official Journal of the European Union immediately after the receipt of a notice of 'non-objection' from the European Parliament and Council and is likely to enter into force on the twentieth day thereafter.

Parliamentary Commission on Banking Standards

The UK's Parliamentary Commission on Banking Standards published its lengthy report "Changing Banking Standards for Good" in June 2013. Perhaps unsurprisingly, given the UK's opposition to the bonus cap, the Commission is not convinced that "a crude bonus cap", with its tendency to raise fixed pay and reduce the opportunity for deferral and clawback, is the right way to control remuneration (see paragraphs 845 to 851 of volume II). Their preference is for substantial amounts of variable remuneration to be paid in the form of instruments such as "bail-in bonds" (which would tend to become worthless if the bank fell into difficulties) deferred for long periods, up to ten years.

The Commission is recommending that its proposals are incorporated into a new Remuneration Code – it remains to be seen the extent to which the EBA's forthcoming guidelines on the discount rate on variable remuneration paid in the form of deferred instruments will allow both the Commission's proposals and the CRD IV requirements to be satisfied by a revised Remuneration Code but it is worth noting that EBA guidelines are not binding and the UK has already created a precedent of non-compliance with EU guidelines.

The UK Government, in its response to this report, outlines the concerns it raised in relation to the bonus cap, and states "the Government insisted that the European Rules should further encourage banks to pay bonuses in long-term deferred remuneration and strengthen clawback provisions. EU rules in this area now enable firms to pay 25 per cent of total variable remuneration in long-term instruments, by discounting their value for the purpose of the bonus cap."

Action to be taken now?

One widely anticipated response to the introduction of the bonus cap is the increase of fixed remuneration, in an attempt to avoid an overall reduction in remuneration for staff. Also, banks may consider amendments to the structure of their variable remuneration to take advantage of the discount to be applied when valuing remuneration paid in instruments subject to long-term deferral.

However, it will be difficult for banks to finalise their approach in the absence of the applicable implementing legislation adopted by the Member States, the RTSs on identified staff and classes of instrument approved for deferral purposes, and associated guidance. We understand that revised Guidelines on Remuneration Policies and Practices may not be published by the EBA until the end of 2014.

Generally, given the current uncertainty as to the application of the provisions, and in particular the requirement for provisions to apply to remuneration for services provided or performance from the year 2014 onwards "whether due on the basis of contracts concluded before or after 31 December 2013", it would make sense for any arrangements entered into pending finalisation of the provisions to expressly state that they are subject to any applicable legislation or rules.

Banks will also need to consider their positions in relation to obtaining shareholder approval for the increase of the bonus cap from 100% to 200% of fixed remuneration. Timings and details for this should become clearer when the local implementing legislation is finalised.

If you have any questions or require specific advice on any matter discussed in this update, please contact:

Andrew Stanger
Partner, London
+44 20 3130 3934
astanger@mayerbrown.com

Alex Carr
Of Counsel, London
+44 20 3130 3398
acarr@mayerbrown.com

About Mayer Brown

Mayer Brown is a global legal services organisation advising clients across the Americas, Asia and Europe. Our presence in the world's leading markets enables us to offer clients access to local market knowledge combined with global reach.

We are noted for our commitment to client service and our ability to assist clients with their most complex and demanding legal and business challenges worldwide. We serve many of the world's largest companies, including a significant proportion of the Fortune 100, FTSE 100, DAX and Hang Seng Index companies and more than half of the world's largest banks. We provide legal services in areas such as banking and finance; corporate and securities; litigation and dispute resolution; antitrust and competition; US Supreme Court and appellate matters; employment and benefits; environmental; financial services regulatory & enforcement; government and global trade; intellectual property; real estate; tax; restructuring, bankruptcy and insolvency; and wealth management.

OFFICE LOCATIONS

AMERICAS
- Charlotte
- Chicago
- Houston
- Los Angeles
- New York
- Palo Alto
- Washington DC

ASIA
- Bangkok
- Beijing
- Guangzhou
- Hanoi
- Ho Chi Minh City
- Hong Kong
- Shanghai
- Singapore

EUROPE
- Brussels
- Düsseldorf
- Frankfurt
- London
- Paris

TAUIL & CHEQUER ADVOGADOS
in association with Mayer Brown LLP
- São Paulo
- Rio de Janeiro

Please visit www.mayerbrown.com for comprehensive contact information for all Mayer Brown offices.

Mayer Brown is a global legal services provider comprising legal practices that are separate entities (the "Mayer Brown Practices"). The Mayer Brown Practices are: Mayer Brown LLP and Mayer Brown Europe–Brussels LLP, both limited liability partnerships established in Illinois USA; Mayer Brown International LLP, a limited liability partnership incorporated in England and Wales (authorised and regulated by the Solicitors Regulation Authority and registered in England and Wales number OC 303359); Mayer Brown, a SELAS established in France; Mayer Brown JSM, a Hong Kong partnership and its associated entities in Asia; and Tauil & Chequer Advogados, a Brazilian law partnership with which Mayer Brown is associated. "Mayer Brown" and the Mayer Brown logo are the trademarks of the Mayer Brown Practices in their respective jurisdictions.

This publication provides information and comments on legal issues and developments of interest to our clients and friends. The foregoing is not a comprehensive treatment of the subject matter covered and is not intended to provide legal advice. Readers should seek legal advice before taking any action with respect to the matters discussed herein.

© 2013. The Mayer Brown Practices. All rights reserved.

0672cor
July 2013