

FSA Remuneration Code – Next Steps

Introduction

The FSA Remuneration Code (“**the Code**”) was published on Friday 17 December 2010. It is intended to be a significant document, making noteworthy changes to bonus practice in the City and encouraging prudent behaviour by regulated entities. This alert focuses on the remuneration principles in the Code, and identifies how the final Code differs from the draft Code and identifies steps which firms should be taking as a matter of urgency and those which can wait until early 2011. We have also set out the further guidance on the proportionality principles which are likely to be key for many firms. We will be hosting a breakfast briefing on the Code on 26 January 2011. If you would like to attend and have not received an invitation, please contact Nicholas Robertson (whose contact details are set out at the end of this Update).

Background

As is well known, the Code aims to regulate firms’ remuneration structures in relation to Code Staff. These changes follow from but build on the Capital Requirements Directive, also known as CRD 3. The overall Code contains 12 principles, including the need for bonuses to be structured in the correct way, with a significant proportion of any bonus being deferred and a significant proportion being paid in shares or similar instruments. These are designed to prevent short-term behaviours unduly influenced by the prospect of receiving a bonus at the end of the year. In a number of places, the draft Code indicated that firms could adopt a proportionate approach to implementation.

The Code, which has now been published in its final form, is accompanied by a very useful document providing a summary of the feedback received by the FSA on the earlier draft Code and, helpfully, the FSA’s responses to the points made. These in turn form useful guidance as to how the FSA interprets its own Code.

Changes to draft Code

The FSA has identified a number of changes in the final Code from the draft Code. The key changes are:

1. At least 50% of variable remuneration is to consist of shares (or share-linked instruments or equivalent non-cash instruments). Crucially, the FSA has accepted that 50% of deferred remuneration and 50% of non-deferred needs to be paid in shares or equivalent instruments. This gives less scope for flexibility to firms wishing to make larger upfront immediate bonus payments but this is subject to the proportionality provisions;
2. Variable remuneration paid in shares should be subject to an appropriate retention period; and
3. Guaranteed bonuses are now generally prohibited for all staff and not just Code Staff.

Proportionality Principle

In relation to many of the principles, including the remuneration principles in the Code, a proportionate approach may permit employers to act contrary to the above changes but this will need to be a carefully considered decision rather than a knee jerk reaction.

Helpfully, in the final Code, the FSA has gone further in identifying the proportionate approach which they have in mind.

First of all, firms will be divided into four tiers, with tier one being subject to the most stringent controls, and tier four the least stringent. Tier four, for example, covers firms which generate income from agency business without putting their balance sheets at risk. Tier four firms are likely to be able to disapply significantly more of the Code on the grounds that it is not proportionate to require them to comply. Thus tier one firms are required to comply with all aspects of the Code, but may be able to avoid the need to set up a separate Remuneration Committee if there is an

overseas parent sufficiently overseeing the remuneration policies of the UK entity. For tier four firms, the provisions requiring 50% of variable remuneration to be paid in shares or equivalent instruments can be disapplied, as can the rules requiring deferral of part of variable remuneration for a minimum period, and the need to have provisions requiring after the award adjustments for subsequent risk events. In all cases, firms must be able to explain their thinking to the FSA when challenged.

Next steps

Clearly, firms need to move speedily to take a final account of the Code and determine how to apply it to their businesses. However, there is a transitional provision. For firms who were not previously caught by the old Code during 2010, provisions do apply from 1 January 2011 but there is some leeway, in relation to the remuneration provisions, up to 1 July 2011, providing firms are taking reasonable steps to comply as soon as practicable.

We consider, to the extent that firms which are being caught by the Code for the first time have not yet finalised their thinking on the Code (which would be understandable given the uncertainties which have remained up to this point), that such firms ought to take the following steps:

- Identify which tier the firm falls into.
- Draw up a list of Code Staff. At this stage, there may still be some rough edges particularly with individuals who are abroad but who exercise a significant influence function within the UK. Similarly, the extent to which an individual has potentially a material impact on the risk profile of the firm may require further consideration.
- Individuals should be told as soon as possible that they are either Code Staff or potentially Code Staff (with clarification to follow in early January 2011). They should also be told what this means.
- Bonus plans need to be reviewed to take into account the provisions relating to deferral, payments in shares etc. Each firm must then determine whether it considers it is proportionate to apply the rules on payment and shares, deferral etc., in the context of its own business.

- Employees' contracts should be amended at the earliest opportunity to include a clause permitting any subsequent changes to any variable remuneration provisions which are necessary to comply with the Code or subsequent regulation. Where firms do not currently have the ability to introduce such a clause unilaterally, consent will need to be obtained or, ultimately, this will need to be tied into a future pay rise etc, prior to 1 July 2011.
- Amendments to bonus schemes will need to be made. Again, it may be prudent to include a clause in any bonus schemes which are being promulgated to take effect from 1 January 2011, to permit any necessary changes to be made for Code Staff to enable the provisions of the Code to apply. Where bonus schemes are international in nature, this might require a separate scheme for Code Staff or it may require a set of provisions in the body of the main scheme which will apply solely to Code Staff.

Conclusion

The Code is likely to change City bonus practice significantly. In the short-term, it is likely to generate a significant amount of work for firms and their advisers equally. Given the political importance being attached by the Government to this year's bonus round, it is also clear that firms need to be seen to be doing what they can to be Code compliant.

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