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FSA Consults on Amendments to the Remuneration Code and Extension of its Scope

The FSA has published a consultation paper proposing significant changes to its Remuneration Code, including a major increase in scope from the approximately 27 largest banks, building societies and broker-dealers operating in the UK that are currently covered to over 2,500 FSA-authorised banks, building societies, asset managers, UCITS investment firms and some firms engaged in corporate finance, venture capital, the provision of financial advice and stockbrokers. The asset managers within the scope of the proposed rules are those to which the Markets in Financial Instruments Directive rules apply, other than so-called exempt CAD firms which do not exercise investment discretion.

Introduction

On 29 July 2010, the UK Financial Services Authority published a consultation paper (CP10/19 - *Revising the Remuneration Code*), setting out proposed amendments to the FSA's existing code of practice on remuneration policies. The consultation paper can be found here. The revised Code will be effective from 1 January 2011.

The FSA Remuneration Code has been in force since 1 January 2010 for the largest banks, building societies and broker-dealers operating in the UK, but the FSA needs to make changes to reflect amendments to the EU Capital Requirements Directive (CRD III), and also the UK Financial Services Act 2010. For our previous alerts regarding the Remuneration Code and CRD III, see here and here.

Proposed Changes to the Remuneration Code

(a) Significant Extension of Scope

The proposed changes will significantly increase the scope of the Remuneration Code, with the Code now to apply to all UK-authorised banks and building societies, a large number of asset managers (including most hedge fund managers, and all UCITS investment firms), as well as some firms that engage in corporate finance, venture capital, the provision of financial advice and stockbrokers. The asset managers within the scope of the proposed rules are those to which the Markets in Financial Instruments Directive rules apply, other than so-called exempt CAD firms which do not exercise investment discretion. The FSA estimates that the revised Code will apply to over 2,500 FSA-authorised firms from 1 January 2011.

However, the FSA has made it clear that it intends to adopt a proportional approach to supervising firms and is, consistent with CRD III, proposing that firms comply "in a way and to the extent that is appropriate to their size, internal organisation and the nature, the scope and the complexity of their activities". It is, however, awaiting guidance to be issued by the Committee of European Banking Supervisors ("CEBS") before finalising its approach to the proportional application of the Remuneration Code.

In the meantime the FSA is proposing a sub-division of the Code into three groups of rules:

i. minimum requirements expected of all firms;

ii. rules which could be applied proportionally in line with a firm's nature, scale, scope and complexity; and

iii. rules which could be applied on a 'comply or explain' basis.

CP 10/19 contains more detail on how the FSA believes this sub-division could work but invites relevant trade bodies to assist with the process of determining the way in which the rules will apply to different kinds of firm. Greater clarity for firms newly within the scope of the Remuneration Code should emerge when the FSA publishes examples and guidance following its work with relevant trade bodies. At present the FSA's proposal is to include some of the more specific and, for asset managers, potentially problematic provisions from CRD III and the current Remuneration Code, such as the deferral requirements and restrictions on guaranteed bonuses (each described more fully below), in the 'comply or explain' category.

Other significant changes are:

(b) Staff Proposed to be Affected

Under the current Code, the main rules prescribing remuneration policies arise under Principle 8 of the Code and only apply to "persons who perform a significant influence function for a firm and employees whose activities have or could have a material impact on the firm's risk profile" (generally known as "Principle 8 employees"). Under the revised Code, it is proposed that the Principle 8 employee group will be replaced with a similar group referred to as "Code staff", which is expected to include senior management, persons who perform a significant influence function for the firm, and staff receiving total remuneration that takes them into the same remuneration bracket as senior management and risk takers, whose professional activities may have a material impact on the firm's risk profile. Firms will be expected to compile a list of all Code staff ahead of the bonus allocation period in respect of 2010.

The FSA is considering whether individual proprietors and the general partners of limited partnerships should be subject to the Code. However, the consultation paper notes that limited partners are considered to be subject to the Code, which could be seen as surprising in that they are not employees receiving remuneration and significant tax issues could arise where deferral is required.

(c) Proposed Limits on Bonuses

- At least 40% of any Code staff's variable remuneration must be deferred for at least three years. It is currently proposed that this would increase to 60% where either total remuneration or total variable remuneration (CP 10/19 is ambiguous on this point) exceeds £500,000.
- At least 50% of any Code staff's variable remuneration (deferred or non-deferred) must be delivered in shares or share-linked instruments and (where appropriate) capital instruments which reflect the credit quality of the firm. The equity instruments must be subject to a minimum retention policy. The FSA concedes that its interpretation of CRD III on this point is different from an interpretation advanced in a press release on behalf of the European Parliament rapporteur to the effect that the 50% requirement should apply separately to the deferred and non-deferred portions of variable remuneration. Accordingly the FSA says that its view on this point may change following its consideration of the awaited final CEBS guidance referred to above.
- Guaranteed bonuses can only be offered in exceptional circumstances to new hires for the first year of service. The payments should not be more generous in either amount or term than the variable remuneration awarded or offered by the previous employer and should be subject to performance adjustment.
- Retention guarantees should only be offered in exceptional circumstances.

- Total variable remuneration must not limit the firm's ability to strengthen its capital base, and must be significantly reduced if the firm's financial performance is subdued or negative.
- The current *de minimis* level which exempts from deferral requirements staff whose bonus forms less than 25% of their total remuneration, and whose total remuneration is less than or equal to £500,000 will be extended to Code staff whose variable pay is up to 33% of total remuneration. It is proposed that such staff would not be subject to rules relating to deferral, performance adjustment, proportion of remuneration paid in shares, and guaranteed bonuses.

(d) Proposals on Severance Pay

It is proposed that severance payments will now be brought within the Code to ensure that they reflect performance over time and are not a reward for failure. Likewise the FSA proposes limits on enhanced discretionary pension contributions (*i.e.* one-off payments, not standard pension plan contributions), which must take the form of shares or share-linked instruments and be held for at least five years. The FSA has indicated that they expect both of these provisions to be relevant only to the most highly remunerated Code staff in large firms.

(e) New Voiding Power

It is expected that breaches of the revised Code will render contractual provisions void and/or require recovery of payments made. The FSA propose only to apply this to provisions that clearly breach the rules on bonus deferral and guaranteed bonuses.

Timing

The consultation period ends on 8 October 2010, and the FSA is encouraging comments to be submitted through trade associations. In addition, the final wording of CRD III is expected to be released in October 2010, as are the guidelines being worked on by the CEBS. The CEBS guidelines are particularly relevant as they will include guidance on proportionality, the appropriate ratios of fixed versus variable remuneration and public disclosure, which will be of key importance especially to firms which will be coming within the scope of the Code for the first time. Final wording for the Code is therefore not expected until November 2010, with the Code coming into force with effect from 1 January 2011 for remuneration awarded or paid on or after that date.

This is a very tight timescale and is going to be of particular concern to companies not within the scope of the current Code. Because of this, the FSA has introduced transitional provisions for these firms stating that they can rely on the proportionality principles in the Code to justify less than full compliance by 1 January 2011. However, firms must take reasonable steps to comply as soon as possible and in any event by 1 July 2011. This also applies to firms currently within the scope of the Code if they are not able to comply with the requirement to pay 50% of variable remuneration in shares or equivalent instruments by 1 January 2011, although the likelihood is that only non-listed companies will be able to make use of this.

Comment

The proposed extension of the scope of the Remuneration Code will mean that a large number of firms will need to consider compliance for the first time. While the CEBS guidance on proportionality may mean that the FSA can take a light touch approach in certain cases, it is clear that all firms within the revised scope of the Code will have additional obligations. Firms coming into the scope of the revised Remuneration Code should consider whether their remuneration policies and practices need to be adjusted as soon as possible to be in a position to comply with the FSA's tight timescales. Depending on the size and type of firm, significant new FSA reporting obligations could arise in relation to remuneration. Also, new public disclosure obligations could arise following the issue of the CEBS guidance.

The new Code will apply to remuneration awarded on or after 1 January 2011, and to payments made after 1 January 2011 that relate to contracts concluded or services provided in 2010 or earlier. Firms that have entered into binding remuneration commitments may wish to consider paying them out before 31 December 2010 if compliance with the revised Code appears problematic.

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