FSA Remuneration Code of Practice

FSA publishes final Code of Practice on Policies Relating to Remuneration of Personnel at FSA Regulated Firms

On 12 August 2009, the UK Financial Services Authority ("FSA") published policy statement PS 09/15 — Reforming remuneration practices in financial services (the "PS"), which includes the final text of the UK's new remuneration code of practice (the "Code"). The Code requires certain large banks, building societies and broker-dealers in the UK to establish, implement and maintain remuneration policies that are consistent with and promote effective risk management. The amended final Code will now only apply to approximately 26 UK-based firms, although the FSA views the Code as good practice for all banks, building societies and broker-dealers in the UK. All firms in those categories should, therefore, use the Code as a basis against which to assess their own remuneration policies, ensuring that they are consistent with sound risk management practices. The FSA proposes to publish in October 2009 a document considering the possible extension of the Code’s scope to FSA-authorised firms outside the 26 firms currently covered. In the meantime, however, all FSA-authorised firms would be well advised to consider the relevance of the approach taken by the Code to their own business, as the FSA is incorporating remuneration risk into Arrow and other supervisory programmes, albeit using a risk-based and proportionate approach.

Background

The FSA's views on bonuses and remuneration were reiterated in the PS: "if remuneration consists predominantly of cash bonuses that are paid out immediately without any deferral or claw back mechanism, and are based on a formula that links bonuses to current year revenues rather than risk-adjusted profit, there are strong incentives for managers to shy away from conservative valuation policies, strong incentives to ignore concentration risks, strong incentives to rig the internal transfer pricing system in their favour and strong incentives to ignore risk factors, such as liquidity risk and concentration risk, that could place the institution under stress at some point in the future. These strong incentives could undermine effective risk management."

To avoid these negative outcomes and bolster effective risk management, the FSA circulated an initial draft Code on 26 February 2009 and then significantly revised it before publishing an amended draft on 18 March 2009 in consultation paper CP 09/10 — Reforming remuneration practices in financial services (the "CP") (see: http://www.fsa.gov.uk/pubs/cp/cp09_10.pdf). For further details of the previous draft of the Code and our commentary and analysis on it please refer to our previous client alert on this subject.

The Code

The principal changes to the Code (which will become Chapter 19 of the FSA's Systems and Controls Sourcebook ("SYSC") in the FSA Handbook) from the version consulted on in the CP and assessed in our previous client alert are:
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- The implementation date of the Code is now 1 January 2010 rather than 6 November 2009 (please see below for further details on the timetable).

- The scope of application has been narrowed down so that now only approximately 26 large banks, building societies and broker-dealers will be subject to the Code, rather than the 47 firms that the CP estimated would be required to comply with the Code. SYSC 19.1 states that the Code only applies to firms that meet one or more of the following conditions:
  a. the firm is a UK bank or building society that had capital resources exceeding £1 billion on its last accounting reference date
  b. the firm is a BIPRU 730k firm (i.e., an FSA authorised investment firm with the highest base capital requirement for regulatory capital) that had capital resources exceeding £750 million on its last accounting reference date; or
  c. the firm is:
     I. a full credit institution, a BIPRU 730k firm or a third country BIPRU 730k firm;
     II. the firm is part of a group; and
     III. on the firm's last accounting reference date total capital resources held within the group:
        A. by UK banks or building societies exceeded £1 billion; or
        B. by BIPRU 730k firms exceeded £750 million.

However, it should be noted that the Code expressly does not apply to UK branches of EEA firms.

- In addition, new principle 8 applies only to employees who perform significant influence functions (including directors, senior managers of significant business units and most proprietary traders) and any other employees whose activities could have a significant impact on the firm's risk profile.

- Principle 8 contains an important new paragraph of guidance indicating that guaranteed bonuses (and similar payments in addition to an employee’s salary) that run for a period of more than one year and that are not based on performance during the performance period under review are likely to be inconsistent with principle 8.

- Further new guidance to new principle 8 clarifies that the Code need not prevent a firm from paying a bonus to employees in a loss-making part of the business if the bonus is justified on other grounds, for example incentivising employees involved in new business ventures that could be loss-making in their early stages.

*An evidential provision is an FSA Handbook provision that has evidential value in showing that a binding rule (in this case, the Code’s general requirement in SYSC 19.2.1) has been breached or complied with. As the FSA notes in the PS, evidential provisions are not per se compulsory; it remains open for a firm to attempt to demonstrate that it complies with the general requirement, even if it does not or cannot comply with an evidential provision. The supporting non-binding guidance provides the FSA’s further thoughts as to how it believes firms should interpret each evidential provision.

**Timing**

The key steps for the implementation of the Code and its associated regulatory framework are:

- By the end of August 2009, the FSA will send letters to firms’ remuneration committees asking them to complete a remuneration policy statement and providing further details as to what they should include in the statement.

- Firms must return their remuneration policy statements to the FSA by the end of October 2009.
The FSA will hold meetings with remuneration committees and HR/risk function staff.

The Code will come into force for firms within its scope on 1 January 2010.

The transitional arrangements for firms required to amend employment contracts that may be amended by the firm end on 31 March 2010.

Transitional arrangements for firms required to amend or terminate other employment contracts will end on 31 December 2010.

Review and Follow-up

Firms to which the Code applies must provide the FSA with their remuneration policy statement (signed off by their remuneration committees) by the end of October. This will enable the FSA to check compliance with the Code. Non-compliant firms could face enforcement action or ultimately, be forced to hold additional capital should they pursue risky processes.

The FSA has said that it will keep the Code under close review to assess its effectiveness and will take account of future market developments and progress on international implementation. The FSA has also indicated that it plans, if it is appropriate, to amend the Code in line with an international approach, once one has been agreed. The FSA will publish a follow-up statement on the implementation and effectiveness of the Code during the third quarter of 2010.