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Proposed Changes to the FSA's Remuneration Code

Introduction

On 29 July 2010, the UK's Financial Services Authority (the "**FSA**") published a consultation paper which sets out proposals to make significant amendments to its existing Remuneration Code (the "**Code**")[1]. If implemented in the proposed form, these revisions will have a significant impact on how remuneration policies and practices at UK financial institutions (and some foreign financial institutions operating in the UK) are operated. In particular, the revisions will mean that the Code will now be significantly expanded in its scope of application and will introduce relatively prescriptive rules on bonus deferrals, proportions of bonuses that must be paid in shares and guaranteed bonuses.

This briefing looks at the background and reasons for the proposed changes and summarises some of the most significant proposals. It also contrasts the approach of US regulators in addressing incentive compensation structures at financial institutions under the recently enacted Dodd-Frank Wall Street Reform and Consumer Protection Act (the "**Reform Act**").

Why are these changes being implemented?

Following the deterioration of the global financial crisis in the last quarter of 2008 and the first quarter of 2009, regulators worldwide began examining the role remuneration practices such as bonuses played in causing the crisis. The FSA published a consultation paper in March 2009 on introducing a Remuneration Code that would apply to large banks, building societies and broker dealers.[2] The consultation paper was followed by a policy statement in August 2009[3] in which the FSA set out its proposals for amendments to the FSA Handbook so as to incorporate the Code. The Code came into force on 1 January 2010 and applies to large banks, building societies and broker dealers. It contains a number of high-level principles on remuneration and draws upon the Financial Stability Forum's "Principles for Sound Compensation Practices" of 2 April 2009[4] , which were endorsed by the G20 leaders at their London summit of April 2009.

On 13 July 2009, the European Commission adopted a proposal to amend the Capital Requirements Directive[5]. This proposal – known as "**CRD3**" – contains a set of high-level requirements relating to remuneration, similar to the ones contained in the FSA's Code, that would apply to all firms subject to the Capital Requirements Directive and not just to large

1 The Code is set out in Chapter 19 of the SYSC sourcebook of the FSA Handbook.
2 FSA Consultation Paper: Reforming remuneration practices in financial services (CP 09/10).
3 FSA Policy Statement: Reforming remuneration practices in financial services (PS 09/15).
4 The Financial Stability Forum was succeeded by the Financial Stability Board in April 2009.
5 The Capital Requirements Directive consists of two directives: (i) the Recast Banking Consolidation Directive (Directive 2006/48/EC); and (i) the Recast Capital Adequacy Directive (Directive 2006/49/EC).

banks, building societies and broker dealers as is the case with the current version of the Code. CRD3 permits firms to apply its requirements "in a way that is appropriate to their size, internal organisation and the nature, scope and complexity of their activities". On 30 June 2010, the European Parliament agreed a number of amendments to the CRD3 proposal with the European Council. These amendments to the text of CRD3 incorporated a number of prescriptive rules and limits on bonuses into CRD3, such as:

i. capping of up-front cash bonuses at 30% of the total bonus and 20% for particularly large bonuses;

ii. 40% to 60% of a bonus to be deferred;

iii. 50% of a bonus to be paid in the form of shares or contingent capital; and

iv. bonuses to be proportional to salary.

As a result of these amendments to CRD3, as well as several other factors, the FSA now proposes to make further changes to the Code to bring it in line with the latest version of CRD3 and to widen its application to all firms that fall within the scope of the Capital Requirements Directive.

It should be noted that the Financial Services Act 2010 (the "**FS Act 2010**") requires the FSA to ensure that the Code is consistent with the Financial Stability Board's Implementation Standards for the Principles for Sound Compensation Practices. The FSA considers that various changes are needed to the Code to ensure such consistency. The FS Act 2010 also gives the FSA the power to render void provisions of any remuneration agreements which breach certain provisions of the Code and further changes are needed to implement this.

When will the changes come into force?

The consultation period will close on 8 October 2010. In November 2010 the FSA will publish the final form Policy Statement and the revised FSA Handbook rules will come into effect on 1 January 2011 applying to remuneration in respect of 2010 performance.

How do the FSA's proposals differ from CRD3?

Unlike CRD3, the FSA's proposals do not envisage a requirement to establish limits on bonuses relative to salary levels, although firms would be required to have an appropriate balance between the fixed and variable elements of total remuneration. Furthermore, there is no requirement that upfront cash bonuses be capped at 30% of the total bonus (20% for particularly large bonuses).

To which institutions will the revised Code apply?

Under the FSA's proposals the scope of the Code would be substantially expanded. The current version of the Code applies to a relatively limited group of firms in the UK (essentially the largest banks, building societies and broker dealers). The FSA proposes that the application of the Code would be expanded to ensure it applies to all institutions falling within the scope of the Capital Requirements Directive, including all banks and building societies, asset managers, hedge fund managers, UCITS investment firms as well as some firms that engage in corporate finance, venture capital, the provision of financial advice and stockbrokers. This will see a substantial expansion of the application of the Code from a current group of 27 institutions to some 2,500 institutions. The Code will also apply to UK branches of firms whose home state is outside the European Economic Area[6].

UK groups would be required to apply the Code globally to all their regulated and unregulated entities and UK subsidiaries of third-country groups would have to apply the Code in relation to all entities within the sub-group, including entities based outside the UK falling within the sub-group. The FSA expects in-scope firms to refrain from setting up special group structures or offshore entities, or allowing or assisting staff to become employed by such structures or entities in order to circumvent the application of the Code.

The requirements of the Code will be applied by the FSA in a proportional manner, taking into account each firm's size, internal organisation and the nature, scope and complexity of its activities. The consultation paper proposes the following structure of application of the Code's provisions to reflect the proportional approach:

i. minimum requirements that all firms would be expected to comply with. These requirements are mainly the high-level principles that form part of the Code in its current version, including the requirement to ensure variable and fixed components of remuneration are appropriately balanced;

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" (which includes the requirements relating to bonus deferrals, guaranteed bonuses, severance pay, share-based awards, performance adjustment, discretionary pension benefits, and voiding and claw-back, as discussed below). A firm will have the option whether or not to implement such rules, but if it decides not to implement them, it must provide acceptable reasons for its decision.

Furthermore, a firm may be able to rely on the proportionality provisions in the Code and the FSA Handbook as a justification for not complying with the Code's requirements relating to remuneration structures by 1 January 2011, provided that it takes reasonable steps to comply as soon as is reasonably possible, and in any event by 1 July 2011.

To which staff will the revised Code apply?

The Code will be amended to define a group of employees to whom it will apply. Such staff will be known as "Code Staff". The FSA will essentially use the same definition for Code Staff as the one used in CRD3, which will cover those categories of staff whose professional activities have a material impact on the firm's risk profile, and will include senior management, risk-takers, control functions and any employees receiving total remuneration that takes them into the same remuneration bracket as senior management and risk-takers. It appears that remuneration awarded by a bank headquartered outside the UK (and therefore not normally subject to the Code) to individuals on secondment to a major bank within the UK would be subject to the Code. In relation to other staff who do not fall within the definition of Code Staff, the FSA proposes to issue guidance under which firms should give consideration to the remuneration principles on a firm-wide basis under the general rule, subject to a test of proportionality.

It is proposed that firms will be required to maintain their own records of Code Staff and take steps to ensure that Code Staff understand the implications of being categorised as such (including the potential for remuneration to be rendered void and recoverable by the firm if it does not comply with the Code).

[6] Although the Code will not apply to UK branches of firms whose home state is within the EEA, such firms will effectively be covered by its provisions as their EEA home state will be required to apply equivalent provisions under CRD3.

The key changes

The most significant changes which the FSA proposes to introduce as part of the amended Code are as follows:

i. *Bonus deferrals*

There will be a new rule requiring at least 40% of the variable remuneration of Code Staff to be deferred with vesting spread over a period of at least three years. Such deferred amounts must be correctly aligned with the nature of the firm's business, its risks and the activities of the individual in question. Such deferred variable remuneration must also not vest faster than on a *pro-rata* basis, with the first vesting occurring no earlier than one year after the date of grant of the award.

Where the variable remuneration is of a "particularly high amount" a minimum of 60% must be deferred. The FSA proposes that the threshold for variable remuneration to fall within this category should be set at £500,000, but also states that firms should consider whether lesser amounts should be considered "particularly high" taking into account, for example, whether there are significant differences in the levels of variable remuneration paid to Code Staff within a firm.

Firms would be expected to have a firm-wide policy on deferral of bonuses, which should include a rising proportion of deferment according to the level of variable remuneration.

ii. *Requirement to pay proportion in shares*

The Code would be amended to require that at least 50% of any variable remuneration should be paid in the form of shares, share-linked instruments or other equivalent non-cash instruments of the firm.

When the European Parliament announced the proposed changes to CRD3 it stated that this 50% requirement applied equally to the deferred and non-deferred portions of the variable remuneration, but it was not altogether clear exactly what this meant. The FSA has taken the view that the 50% requirement will apply to variable remuneration as a whole, so that the firm could choose to pay all of the 50% deferred portion in shares, all of the non-deferred portion in shares or some of each in shares. The FSA emphasises that this view is provisional and may change in due course.

Given that this requirement could pose challenges for non-listed firms, the FSA proposes a transitional provision whereby a firm to whom the existing Code applied for 2010 may be able to justify not complying with the requirement to pay 50% of variable remuneration in the form of shares or other non-cash instruments by 1 January 2011, provided that it takes reasonable steps to comply as soon as is reasonably possible, and in any event by 1 July 2011. This provision would primarily cover non-listed firms, including any to whom the existing Code applied for 2009. The FSA will provide further guidance on this area once the Committee of European Banking Supervisors ("**CEBS**") publishes its guidance on the subject.

iii. *Performance adjustment*

The Code would be amended to include a new rule requiring that all deferred remuneration should be subject to an appropriate form of "performance adjustment" i.e., the firm will have the ability to make amendments to the amount of an employee's unvested deferred amounts between the date on which it has first been communicated to the employee and the vesting date to reflect actual performance outcomes.

iv. *Restrictions on guaranteed bonuses*

The Code's existing provisions on guaranteed bonuses are to be strengthened so that there would be an explicit rule stating that firms must not offer guaranteed bonuses unless they are "exceptional", occur in the context of hiring Code Staff and are limited to the first year of service only.

Any signing-on or buy-out bonuses offered to new hires should not exceed the terms offered by the previous employer and the vesting schedule for such bonuses should mirror (or exceed) the vesting terms set by that previous employer.

All guaranteed bonuses would be subject to the same deferral requirements as other variable remuneration. Retention bonuses should only be used in exceptional circumstances where the firm is undergoing a major restructuring and a case can be made for using such bonuses on prudential grounds.

v. De minimis exception

For Code Staff whose bonuses are less than 33% of their total remuneration and whose total remuneration is less than or equal to £500,000 the requirements in relation to deferral, performance adjustment, proportion of remuneration paid in shares and guaranteed bonuses would not apply.

vi. Severance pay

The current version of the Code does not specifically address severance pay. The FSA proposes to insert a requirement into the Code to the effect that payments relating to the early termination of an employment contract must reflect performance achieved over time and do not reward failure. Firms should review existing contractual payments provisions to ensure that these are consistent with the proposal on severance pay.

vii. Voiding provisions

Section 6 of the FS Act 2010 gives the FSA certain powers to restrain remuneration practices which are in breach of certain provisions of the Code. Specifically, it can prohibit a firm from remunerating its staff in a specified way, render void a provision in an agreement which contravenes such a prohibition and require recovery of payments or property provided to an employee pursuant to a void provision.

The FSA proposes that the Code would be amended to clarify that this power would only be used in relation to Code Staff and, in addition, only in relation to the requirement to defer a minimum proportion (i.e., 40% or 60%) of variable remuneration and the restrictions on guaranteed bonuses.

It remains to be seen how this power of the FSA, to render certain arrangements void or require repayment of certain payments or benefits, will interact with existing provisions of UK employment law and general contract law. In addition it is far from clear how these voiding provisions would work where, for example, the relevant employee is based abroad and may have protections under the employment law of that country (in relation to which presumably the FSA's voiding powers would be ineffective).

viii. Enhanced discretionary pension benefit

The Code would be modified to reflect the requirements under CRD3 on enhanced discretionary pensions. These are enhanced pension benefits paid on a non-standard, one-off discretionary basis as part of an individual's remuneration package (it is not intended to apply to an employee's standard pension arrangements or the firm's employer pension contribution obligations). The Code will require that, where an employee leaves the firm before retirement, any such discretionary pension benefits must be held by the firm in the form of shares or share-like instruments. It is likely that such provisions will only apply to the most senior management.

ix. Capital and liquidity

Firms will have to ensure that their remuneration policies do not limit their ability to strengthen their capital base if and when this becomes necessary. They should also ensure that they take into account the implications on liquidity of their remuneration policies. It should be noted that the Basel Committee on Banking Supervision and the European Commission, in their proposals to reform the regulatory capital regime applicable to banks[7], contemplate the introduction of a "capital conservation buffer" which would be an amount of Tier 1 capital held above the regulatory minimum. Institutions would be free to build the buffer either by reducing discretionary distributions of earnings (i.e., reducing dividends, share buy-backs or staff bonus payments) or by raising capital in the capital markets. Where an institution's capital falls within a buffer range established by regulators, it would be restricted in the discretionary distributions that it could make, unless it were able to raise capital privately in order to take its capital above the buffer range.

Potential for retrospective application

The amended Code will take effect as of 1 January 2011. The following will be subject to the amended Code:

i. remuneration awarded on or after 1 January 2011;

ii. remuneration due on the basis of contracts concluded before 1 January 2011 which is awarded or paid after 1 January 2011; and

iii. remuneration awarded, but not yet paid, before 1 January 2011 for services provided in 2010.

The FSA considers that the application of the amended Code to remuneration awarded prior to 1 January 2011 or in relation to contracts concluded prior to that date will not require firms to breach contract or employment law. Firms are expected to take reasonable steps to amend or terminate employment contracts concluded prior to the publication of the consultation paper where such contracts conflict with the proposed requirements of the amended Code.

Next steps

Firms must ascertain whether they are covered by the scope of CRD3 as soon as possible. The FSA's final rules will be published in its Policy Statement due in November 2010. Firms currently falling within the scope of the Code will be sent requests for Remuneration Policy Statements in the coming months.

The FSA will consider the final text of CRD3 as well as the work of CEBS on providing guidance on the application of the remuneration provisions in CRD3 before finalising its proposals.

US Legislation

On 21 July 2010, President Obama signed the Reform Act, which represents the most significant reform of the US financial services industry in the last 75 years. Included in the broad range of issues addressed by the Reform Act is Section 956, which is aimed at incentive compensation arrangements at certain financial institutions.

In contrast to the formula-based approach in the UK under the proposed amendments to the Code and CRD3, Section 956 of the Reform Act is principles-based and does not seek to establish limits on the amount of remuneration that may be paid to

[7] Strengthening the resilience of the banking sector (Basel Committee on Banking Supervision) and Public consultation regarding further possible changes to the Capital Requirements Directive ("**CRD IV**") (European Commission).

employees or the form that the payment must take[8]. As is the case with most of the provisions of the Reform Act, rulemaking will be needed to implement the legislation and shape the true scope of what will be required.

Federal regulators are required to issue regulations to implement this legislation no later than 21 April 2011. The legislation applies to depository institutions and their holding companies, registered broker-dealers, insured credit unions and investment advisers and any other financial institution that federal regulators regulate ("covered financial institutions"). Covered financial institutions with less than $1 billion in assets are exempt from the legislation.

Covered financial institutions are required to disclose to the appropriate regulator the structures of their incentive compensation arrangements to determine whether the compensation structures (i) provide executive officers, employees, directors or principal shareholders with "excessive compensation", fees or benefits; or (ii) could lead to a material financial loss to the institution. The legislation does not, however, require a covered financial institution to report the actual compensation paid to any employee. Regulators are required to issue rules prohibiting payments under any incentive compensation arrangement that either provides excessive compensation, fees or benefits or could lead to a material loss to the institution. The legislation appears to apply to all covered financial institutions, including those that are not incorporated in the US.

The legislation does not expressly define what constitutes "excessive compensation" and regulators are required to adopt a standard that is comparable to the compensation soundness principles that apply to insured depository institutions under existing legislation applicable to these institutions. These existing standards do not provide for any caps and rules on the amount of remuneration that may be paid or the form of payment, but rather apply a principles-based "unreasonable" or "disproportionate to the services performed" standard.

Conclusion

It is important for businesses in the financial sector to consider whether they fall within the scope of the amended Code. Although businesses that are currently in scope may already have begun evaluating the impact of the FSA's proposals, those businesses without any experience of prescriptive regulation of remuneration should study the FSA's proposals closely and consider the implications they have for their remuneration practices. In particular, non-listed entities or entities without any share capital (such as partnerships) need to consider the impact of the provisions requiring payment of 50% of variable remuneration in the form of shares or similar capital instruments.

Otherwise, firms should also consider:

i. who within the firm will fall within the definition of Code Staff and what other staff should nonetheless be covered by the new remuneration principles;

ii. what amendments will be needed to record-keeping systems to keep track of staff who fall within the definition of Code Staff;

8 The American Recovery and Reinvestment Act of 2009 places restrictions on the amount and form of compensation that may be paid to executives by entities receiving governmental financial assistance under the Troubled Assets Relief Program ("TARP"). These restrictions generally continue to apply for as long as an entity continues to have an outstanding obligation to repay the governmental financial assistance. Many of the larger financial institutions that received assistance under TARP have satisfied their obligations and these restrictions generally no longer apply to those institutions.

iii. what employee communications may be needed to help employees understand the implications of being classified as Code Staff;

iv. undertaking an audit of existing remuneration arrangements with a view to assessing what structural changes will be required;

v. how any new remuneration structures that are required could be implemented in as tax-efficient manner as possible, for example bonus deferrals or payments in shares;

vi. how provisions of existing employment contracts that will not comply with the revised Code can be amended without incurring substantial risks of employment claims; and

vii. reviewing provisions of standard-form employment contracts to include provisions to reflect the Code proposals for new joiners.

This publication is intended only as a general discussion of these issues. It should not be regarded as legal advice. We would be pleased to provide additional details or advice about specific situations if desired.

If you wish to receive more information on the topics covered in this publication, you may contact your regular Shearman & Sterling contact person or any of the following:

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