Client Advisory

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Alternative Investment Firms Should Prepare for Restrictions on Remuneration

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Persuaded by the argument that the size and design of compensation and incentivisation packages in the financial sector contributed to the 2007–09 financial crisis, governments and regulators have spent much of 2010 working on a number of initiatives which they hope will address perceived problems.

Recent developments make it clear that the new rules will target not just the major financial institutions, which were at the heart of the financial crisis, but the alternative investment sector as well, including private equity firms, hedge fund managers and proprietary traders. As such, it is advisable that alternative investment firms begin to think about and prepare for life under the new regime in the few months which remain before it becomes law for them.

UK developments

In the UK, the opening salvo was fired on New Year's Day 2010, with the introduction by the Financial Services Authority (FSA) of a remuneration code covering banks and other major financial institutions. This was followed in April by the Financial Services Act 2010, which directs the FSA to regulate financial sector remuneration. In this context, the FSA has been given the power to ban particular remuneration practices and render void any contractual provision (e.g. in an employment contract) which contravenes such a ban.

In July, the FSA published a draft revised remuneration code which would apply to all banks and building societies, all Capital Adequacy Directive (CAD) investment firms and UK branches of firms whose home state is outside the EEA—in all, more than 2,500 firms, including most private equity houses and hedge fund managers. The revised code is intended to implement, among other things, the package of reforms to the EU's Capital Requirements Directive (CRD) known as CRD3, part of which relates to compensation arrangements.

Although the draft code is still at the consultation stage, given the political exigencies, it is not expected to change much before it comes into force on 1 January 2011. Clients should take note of the following code provisions, which may necessitate deliberation and/or action on their part:

(a) **Application to individuals**. All of the principles in the code would apply to "Code Staff", which includes senior management and anyone whose professional activities could have a "material impact" on a firm's risk profile. Secondees are also included. Firms will need to identify and list Code Staff. The FSA has the right to review and challenge the lists.

(b) **Governance**. Firms of a "significant size" must establish remuneration committees whose chairman and members are non-executive directors (NEDs). No specific parameters have thus far been set out to define the phrase "significant in size"; instead, the FSA's approach will be one of "proportionality".

(c) **Capital base**. A new principle will require firms to ensure that their total variable remuneration does not limit their ability to strengthen their capital base.

(d) **Deferred compensation**. At least 40% of a bonus must be deferred over a period of at least three years for Code Staff. For staff earning more than £500,000, the deferral rule rises to at least 60% of bonus. The code treats bonuses and long-term incentive plans (LTIPs) slightly differently. Firms that operate LTIPs should structure them so that 50% of the award should vest after not less than three years and the remainder after five years. Deferred compensation must vest no faster than on a pro rata basis, with the first vesting no sooner than one year after the award. For example, if a bonus is deferred over three years, that would imply that no more than of 33% of the bonus may vest every 12 months.

(e) **Proportion in shares**. At least 50% of any variable remuneration component will have to be made in shares, share-linked instruments or other equivalent non-cash instruments of the firm. Such shares and instruments will also need to be subject to a deferral or retention policy.

(f) **Guarantees**. Firms must not offer guaranteed bonuses of more than one year (other than in exceptional circumstances to new hires for the first year of service).

(g) **Severance pay**. Payments related to the early termination of a contract should reflect performance over time and must not reward failure.

(h) **Pensions**. A firm's pension policy must be in line with the business strategy, objectives, values and long-term interests of the firm. Discretionary pension benefits should be held for five years in the form of shares or share-like instruments.

(i) **Voiding provisions**. A proposed new rule sets out situations where breaches of the code may render a remuneration contract void or require recovery of payments made.

(j) **Partnerships/LLPs**. No mention is made as to how the Code should be applied to owner manager entities such as partnerships and limited liability partnerships, which are a popular vehicle for hedge fund managers. Here bonuses for partners do not arise as they get profit shares (even if bonus pool-type language is sometimes used for convenience), and any deferral of entitlements would result in a mismatch for tax purposes as current year profits are subject to current year taxation whether paid out or not. Firms which are not already structured as an LLP may wish to consider reorganising themselves and/or establishing an LLP alongside a corporate vehicle, which may be attractive in any case to enable owners to reduce tax on "excess profits" not needed for current year personal spending and/or to build up reserves at lower corporation tax levels.

The FSA says that it is committed to applying a "proportional approach" that would allow many smaller firms to adapt the rules to their circumstances, but it remains to be seen how this will evolve.

EU developments

At the EU level, in addition to the CRD3 reforms, the hotly debated Directive on Alternative Investment Fund Managers (AIFM Directive) has been wending its way through the EU legislative process and a further compromise text has just been published. This also contains a regulatory framework for remuneration. Some of the remuneration rules and principles in the AIFM Directive are similar in content to the FSA's revised remuneration code, but the detailed secondary regulations implementing the Directive will not be drafted by the European Commission until after the Directive itself has been finalized and approved. It is to be hoped that the AIFM Directive provisions will either be dropped on the grounds that they are duplicative of CRD3 or amended to ensure that they are not contradictory for firms covered by both.

Conclusion

All FSA regulated firms should:

- Identify whether they are covered by FSA's proposed extension of its Remuneration Code
- If covered, identify Code Staff
- Review overall remuneration structures to ensure compliance with the spirit and letter of the proposals and in particular the requirement that firms align remuneration practices with effective risk management
- Consider whether a remuneration committee is required/changes are needed to any existing committee and in particular the need to have it staffed by NEDs
- Review existing bonus arrangements and consider whether these comply with the new rules/amend as necessary
- Consider whether any existing contractual arrangements potentially breach the proposed rules and determine whether these need to be re-negotiated (e.g. guaranteed bonus arrangements)
- Consider how any existing employee share/share option/other schemes and pension schemes may be impacted
- If the FSA regulated firm is an LLP, consider whether compliance with the requirement that 50% of any variable remuneration component will have to be made in shares, share-linked instruments or other equivalent non-cash instruments of the firm applies/how to comply
- Consider the employment law and tax ramifications of all of the above
- Consider their corporate structure and maximisation of hybrid corporate and LLP entities and whether the deferred remuneration rules can be used to justify any necessary restructuring

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