Client Advisory

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Remuneration in the Financial Services Industry: Implementation of Restrictions

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Further to our 28 September Client Advisory, Alternative Investment Firms Should Prepare for Restrictions on Remuneration, the Committee of European Banking Supervisors (CEBS) has announced that it will now publish final form Guidelines on Remuneration Policies and Practices on or around 11 – 12 December 2010, somewhat later than expected. The delay at the CEBS level has caused the UK Financial Services Authority (FSA) to announce the postponement of its own revised remuneration code (the Code), as in part implements the CEBS guidelines. Despite the delay, the FSA still intends to apply the Code to investment firms from 1 January 2011. This effectively compresses the implementation period for firms to no more than three weeks, including the Christmas/New Year break. To assist with this, the FSA hopes to be able to provide, on a slightly earlier basis, more information on the crucial question of proportionality.

To recap, in July 2010 the European Parliament approved the package of amendments to the EU's Capital Requirements Directive (CRD) known as 'CRD3'. CRD3 includes a variety of remuneration restrictions and extends them beyond the banking industry to some 2,500 UK firms presently subject to CRD. The restrictions are intended to align a firm's remuneration policies with its risk profile.

CEBS is empowered under CRD3 to issue guidelines on sound remuneration policies in the financial sector in order to facilitate compliance with the remuneration principles in the CRD. On 8 October 2010, CEBS published draft guidelines for consultation. The Guidelines address high-level remuneration policies and the day-to-day practices of remuneration decisions and procedures through which these policies are implemented.

CEBS has stated that "proportionality is key" in applying both the general as well as the specific requirements of CRD3. The CEBS approach, if retained, is likely to inform the FSA's own implementation of the Code, although confirmation of this will have to await publication of the Code in December.

CEBS's approach is to permit the disapplication (or "neutralisation"), where appropriate, of a number of key principles which would have caused problems for asset managers, and the ability for firms and regulators to apply the remaining principles proportionately. The principles subject to neutralisation include:

- the requirement to defer 40% (in some cases 60%) of variable remuneration (if the firm is a "non-complex institution");
- the requirement to pay at least 50% of variable remuneration in shares or equivalent non-cash instruments (if the firm is a non-complex institution whose securities are not traded on a regulated market and has no alternatives for equity-based variable remuneration available);

- the requirement to have in place clawback and malus arrangements; and
- the requirement for a firm to have a remuneration committee (although "alternative, independent oversight should be available").

A firm "should be able to explain" its decision to completely neutralise any given principle.

CEBS recognises that while most of the rules will apply on a firmwide basis, others (mainly in the area of risk alignment) will apply only to "Identified Staff" (essentially, those with a material impact on the firm's risk profile). In respect of the firmwide provisions, firms will be expected to apply proportionality on the basis of their size and internal organisation, and the nature, scope and complexity of their activities when looked at as a combination. Size alone, for example, would not be a relevant factor.

The Guidelines indicate that proportionality can also lead to the remuneration requirements being differentially applied to particular Identified Staff based on, for example, their degree of seniority and/or the size of the obligations into which they may enter on behalf of the firm.

CRD3 requires firms to disclose to the public "detailed information" regarding their remuneration policies and practices for Identified Staff. The Guidelines recognise that disclosure should be proportionate. Thus, small or non-complex firms will only be expected to provide "some qualitative information and very basic quantitative information". A further consultation on this topic is expected. For private, unlisted/non-publicly traded firms, a 'public' disclosure requirement is clearly inappropriate.

In other areas, CEBS takes a stricter approach:

- The Guidelines will limit Identified Staff to receiving no more than 30% of their bonus in cash up-front by requiring 50% of their variable remuneration to be in non-cash instruments in respect of both the deferred and the non-deferred portions.
- The Guidelines will also require firms to establish (and justify) a minimum retention period in respect of the 50% element of any up-front payment in the form of shares or other non-cash instruments. Regulators will determine whether the retention periods proposed by the institution are sufficient and appropriate.
- The Guidelines require firmwide application of the principles, including to subsidiaries outside the EEA.

Further clarification may be needed from CEBS on certain points:

- The Guidelines do not comment on what happens to deferred compensation owed to employees if their contract is terminated early. CEBS has said that it will be up to each firm to determine its own approach to the impact on leavers of any outstanding deferred bonus and to the early liquidation of any non-cash remuneration.
- Although firms would be obliged to set a maximum ratio between fixed and variable remuneration, the Guidelines do not specify what this maximum should be.
- The Guidelines do not say much on what instruments unlisted firms can use to comply with the requirement to award at least 50% of variable remuneration in shares or "equivalent ownership interests" except to note that "such non-cash equivalents are under full development in the industry." We believe this is alluding to phantom share and similar schemes.
- CEBS notes that "some of the remuneration requirements may not be applicable to staff at [individual sole traders] or partnerships". No further guidance is given. The Guidelines do state that dividends received by partners as owners of a firm "are not covered by these guidelines (unless they represent a vehicle or method for circumvention...)". This seems to be a potential get out for hedge fund and other managers established as limited liability or other partnerships.

The CRD3 remuneration rules overlap to some extent with the Alternative Investment Fund Managers Directive (AIFMD) provisionally agreed by the EU last month. However, the AIFMD is not expected to come into force until 2013.

Conclusion

All FSA regulated firms who are covered by CRD3 should consider:

- if they can avail themselves of the proportionality and neutralisation concepts in the Guidelines to disapply or limit the application of certain remuneration rules;
- if they have Identified Staff, and the implications of the Guidelines for those persons' contracts and remuneration packages;
- if the firm is an LLP or limited partnership, which instruments may be used to satisfy the requirement that 50% of any variable remuneration component of salaried staff will have to be made in shares or "equivalent ownership interests"; and
- the employment law and tax ramifications of the above.

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