

Financial Services and Markets

Pay regulation for financial services firms

Last Thursday the FSA published proposals for revising its Remuneration Code. Until now, only 27 of the largest banks, building societies and investment banks have been subject to the Code. From 1 January 2011, the Code will impose pay regulation on 2,500 firms. It will make some types of incentives void, even where staff are contractually entitled to receive them. All FSA regulated firms should now identify whether the Code will apply to them and if so what effect it will have on their bonus and other pay arrangements. Affected firms may need to change their remuneration arrangements in order to comply.

FSA CP10/19: Revising the Remuneration Code

The Consultation Paper sets out the FSA's revised Remuneration Code, which will replace Chapter 19 of the Senior Management Arrangements, Systems and Controls Sourcebook (**SYSC**). The Code:

- implements amendments to the Capital Requirements Directive recently approved by the European Parliament (**CRD3**); and
- includes rules, made under the powers given to the FSA by the Financial Services Act 2010, which void certain remuneration arrangements and oblige firms to recover payments made under them.

You can find a copy of the Consultation Paper here: http://www.fsa.gov.uk/pages/Library/Policy/CP/2010/10_19.shtml. The consultation period ends on 8 October 2010.

Who is caught?

Firms

The Code will apply to BIPRU firms. This includes any firm, other than an insurer, which the FSA requires to produce an ICAAP. All banks and building societies are covered, as well as most brokers, quoted investment managers and hedge fund managers. Most private equity firms and some UCITS firms will be exempt because they will not be subject to CRD3. Non-MiFID and exempt CAD firms will be exempt.

Application to groups

Affected firms in a UK group will be required to apply the Code to the entire group. For instance, a UK bank must apply the Code to all group entities whether within or outside the UK and even if some of them are unregulated or would fall outside of scope if they were not owned by a bank. If a UK subsidiary of a non-EEA group falls within scope, it must apply the Code to itself and its subsidiaries.

Does the Code apply to all staff pay?

The Code will apply to the remuneration arrangements for **Remuneration Code staff**. This means staff whose activities have a material impact on the firm's risk profile. It includes any of the following staff: senior management, risk takers, any other employees in the same remuneration bracket and "control functions" (not defined). "Staff" includes employees, secondees, members of LLPs and some consultants.

The FSA's definition of **remuneration** for these purposes is likely to be the subject of considerable debate. It includes any remuneration "paid, provided or awarded by any person to the extent that it is paid, provided or awarded in connection with employment by a firm" (SYSC 19.2.5R). This is clearly much wider than salary, bonus and incentive scheme entitlements. It will apply, for instance, to most drawings and profit distributions by LLP members and it could catch a variety of other employment related benefits.

What is required?

Principles/rules

The Code sets out twelve remuneration principles, together with detailed rules and guidance on compliance with these.

Proportionality

CRD3 recognises that it may not be proportionate for investment managers and brokers to comply with all the remuneration principles. It requires firms to comply in a way and to the extent that is appropriate to their size, internal organisation and the nature, the scope and complexity of their activities. The FSA's consultation paper sets out the FSA's proposed approach to implementing this proportionality principle, which we summarise below. The Committee of European Banking Supervisors (**CEBS**) is due to issue guidance on proportionality in October. The Code is likely to be amended if CEBS take a different approach to the FSA.

Annex 5 of the FSA's consultation paper summarises its proposed approach to proportionality. It divides the rules into three tables:

- the first sets out rules with which all firms must comply in full;
- the second sets out rules which firms may apply proportionately in line with their nature, internal organisation etc; and
- the third sets out rules where firms may apply a "comply or explain" approach.

The FSA will consult later in the year on exactly how the "comply or explain" process will work. Firms which do not fully comply with the Code on the basis of the proportionality approach will need to be able to justify this to the FSA, which will expect all firms to have conducted a self assessment as to whether the Code should apply to them in full.

We summarise below a number of the key requirements for firms such as brokers and investment managers from the first and third tables. Other rules apply – please see the Consultation Paper for details.

Key rules to be applied by all firms (from Annex 5 table 1)

Remuneration policy and practice <i>(General requirement, Principle 4: Governance)</i>	Establish, implement and maintain written remuneration policies, updated at least annually and approved by the firm's governing body, as well as procedures and practices, that are consistent with and promote sound and effective risk management. <i>(SYSC 19.2.1R)</i>
Training	Train all Remuneration Code staff on the implications of their status, including where applicable the potential for non-compliant remuneration arrangements to be rendered void. <i>(SYSC 19.3.5R)</i>
Profits <i>(Principle 8: Profit-based measurement)</i>	Assessments of financial performance used to calculate variable remuneration components must be based principally on profits. <i>(SYSC 19.3.25R)</i>
Fixed/variable pay <i>(Principle 12: Remuneration Structures)</i>	Set appropriate ratios between the fixed and variable components of remuneration, and allow for the possibility to pay no variable remuneration. <i>(SYSC 19.3.42R)</i>
Annual report	Annually report the identities of all Remuneration Code staff to the FSA.

Key "comply or explain" rules (from Annex 5 table 3)

Guaranteed incentives <i>(Principle 12: Remuneration Structures)</i>	No guaranteed variable remuneration unless it: <ul style="list-style-type: none"> (a) is exceptional; (b) occurs in the context of hiring a new employee; and (c) is limited to the first year of that new employee's service. <i>(SYSC 19.3.38R)</i>
Share based awards <i>(Principle 12: Remuneration Structures)</i>	Ensure that at least 50% of any variable remuneration consists of an appropriate balance of: <ul style="list-style-type: none"> (a) shares in the firm or share linked instruments, or equivalent non-cash instruments for a non-listed firm; and (b) where appropriate, hybrid capital reflecting the credit quality of the firm. <i>(SYSC 19.3.45R)</i>
Deferral <i>(Principle 12: Remuneration Structures)</i>	At least 40% (or, for high earners, 60%) of the variable proportion of remuneration must be deferred over at least 3-5 years. <i>(SYSC 19.3.46R)</i>
Performance adjustment <i>(Principle 12: Remuneration Structures)</i>	Variable remuneration must be paid or vest only if it is sustainable according to the financial situation of the firm as a whole. <i>(SYSC 19.3.48R)</i>

Staff earning below the de minimis threshold

The FSA does not expect firms to apply the detailed rules on variable remuneration to staff who both:
(a) earn no more than £500,000 per year (total); and
(b) for whom variable remuneration is no more than one-third of total remuneration.

Power to void contracts

The power to void contracts set out in the Financial Services Act 2010 is a significant extension of the FSA's powers. The FSA proposes to exercise this power by making the rules in SYSC 19.3.51R and SYSC 19 Annex 1. The effect of these rules is that contractual provisions (e.g. in an employment contract) **will be void** if:

- the employee is a member of Remuneration Code staff; and
- the employee either earns more than £500,000 per annum or variable remuneration forms more than one third of his total remuneration; and
- the contractual provisions breach the restrictions on guaranteed variable remuneration or the requirements for deferral.

Firms will be obliged to recover any payments made under contractual provisions which are rendered void under these provisions.

The Code includes transitional provisions, which would allow firms' contractual obligations to stand (as a matter of contract law) if those obligations were assumed before the new rules are made. We note that the rules will be made by some time before 1 January 2011 (the date on which they come into force). The FSA's clear expectation is that firms will take steps to amend or terminate non-compliant provisions as soon as possible. It is unclear how the proportionality provisions and transitional guidance tie in with these voiding and recovery provisions.

When must firms comply?

The rules will come into force on 1 January 2011. The draft rules include transitional guidance for firms not currently subject to the Code to comply from 1 July 2011, provided they take reasonable steps to comply as soon as reasonably possible before this date. The FSA indicates all firms should ensure their remuneration policy is in place by 1 January 2011 (even if they do not comply with the detailed rules on variable remuneration before 1 July 2011).

What should firms do now?

All firms should:

- identify whether they will be subject to the Code;
- identify whether changes are required to their remuneration structures in order to comply with the Code;
- raise any particular issues with their trade associations and/or the FSA; and
- identify whether to bring forward to 2010 any proposed bonus or other remuneration that would otherwise be paid in 2011.

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