

Financial Services and Markets

Pay regulation for financial services firms – an update

Last Friday, the Committee of European Banking Supervisors (CEBS) published for consultation its draft guidelines on remuneration policies and practices for those financial institutions which will become subject to the remuneration provisions of the Capital Requirements Directive from 1 January 2011 (a package of measures known as CRD3). The CEBS guidelines will influence the UK Financial Services Authority in relation to its draft revised Remuneration Code. The CEBS consultation period closes on 8 November.

The draft guidelines are broadly good news for firms such as investment managers, agency brokers, platform providers and market infrastructure providers, who are likely to seek to take a "proportionate" approach to compliance. They will be less welcome to deposit-taking banks and investment banks to the extent that those institutions find it harder to justify proportionality carve-outs and are required to apply detailed requirements on which CEBS has given further guidelines.

Interaction with the FSA's revised Remuneration Code

CRD3 requires CEBS to publish guidelines on sound remuneration policies, in order to promote "supervisory convergence" between the FSA and other EU regulators. The guidelines are directed towards both affected firms and their supervisors. Whilst the guidelines do not have the force of law, they will in practice strongly influence the FSA in relation to its draft Remuneration Code. The FSA's consultation paper on its Remuneration Code reflects the UK obligation to implement CRD3 and it was expressly subject to the final form of the CEBS guidelines.

For the benefit of those of you who have some familiarity with the draft FSA Remuneration Code, we have used the FSA's jargon in this note. The terminology used by CEBS differs.

Proportionality

The draft guidelines are helpful in relation to the application of the proportionality principle in CRD3. They recognise that the effect is that not all institutions are obliged to give effect to the requirements in the same way.

Whilst the requirement for sound remuneration policies and practices will apply across the board, CEBS expressly recognises that the application of the proportionality principle may lead to "the complete neutralisation" of some requirements for some firms. In other words, the guidelines give the FSA sufficient latitude to press ahead with its proposed "comply or explain" approach in relation to deferral, share-based remuneration and performance adjustment requirements. CEBS contemplates that firms will be obliged to justify their non-compliance with the principles on a line-by-line basis.

CEBS sets out in Annex 2 to its paper a table of which principles are capable of "neutralisation". This table is broadly consistent with, but not identical to, the FSA's "Proportionality Tables" 1 and 3 in its consultation paper. In particular, CEBS contemplates that restrictions on guaranteed variable remuneration should apply to all staff at all firms.

CEBS suggests that each firm must take the proportionality criteria – size, internal organisation, nature, scope and complexity of activities – in the round. CEBS notes that "the size of an institution alone is not a relevant criterion for the application of the proportionality principle".

The guidelines for supervisors are also welcome, in that they encourage supervisors to examine the linkage between the firm's remuneration policy and the firm's risk appetite, risk tolerance, business strategy and long-term interests.

Affected staff

CEBS and the FSA have both recognised that some of the remuneration principles apply more broadly than to senior management and risk takers (for example those relating to remuneration governance structures and the incentivisation of control staff, including risk management and compliance professionals).

Other principles will apply only to certain staff. The CEBS guidelines on affected staff appear to be consistent with the FSA's concept of "Remuneration Code staff". CEBS emphasises that it will be for each firm to determine who are its Remuneration Code staff and to justify its conclusions to supervisors. CEBS cautions against any assumption that low earners cannot affect the firm's risk profile. Rather, the assessment must be based on "job function and responsibilities".

CEBS goes along with the FSA in noting that the proportionality principle can affect the application of the requirements to a particular member of Remuneration Code staff. The detailed requirements may be flexed to take account of: (a) an individual's seniority, (b) their authority to commit the firm to risks; (c) the fact that they may be only one of many members of a committee which collectively has a material impact on risk; and (d) the business model of the business line of the individual concerned (though the significance of this last factor is unclear).

Partners of firms structured as partnerships

CEBS recognises that some of the remuneration principles may not apply to partners, where they receive "dividends" in their capacity as owners of the firm, unless they represent a method for avoidance of the requirements. It is not clear: (a) to what extent partner receipts will be treated as dividends - there may be a stronger case where partners receive no other meaningful incentive; (b) whether some payments to partners are considered to have a different character (for example monthly drawings); or (c) to what extent this guidance will extend to owner-managers where the firm takes a different legal structure.

Where proportionality does not apply

To the extent that a firm cannot justify non-compliance with requirements relating to deferral, share-based remuneration and performance adjustment requirements, the guidelines will be less welcome. CEBS suggests that:

- to the extent that the non-deferred portion of variable pay takes the form of securities, it must be subject to a minimum retention period;
- that minimum retention period applies even in respect of those shares where vesting has already been deferred in accordance with the requirements; and
- there must be a cap (the level of which is not specified) on variable remuneration as a multiple of base salary.

Transparency

CEBS goes further than the FSA in giving guidance on public disclosure about their remuneration policies and practices. This is expected to form part of a firm's Pillar 3 disclosures as it comes from an amendment to the Pillar 3 provisions in the Capital Requirement Directive. Small or non-complex institutions will only be required to provide some qualitative information (i.e. a narrative) and "very basic quantitative information where appropriate", and subject to materiality (or with other Pillar 3 requirements). It remains to be seen how the FSA will implement this in practice. Its first consultation paper did not address the topic in any detail but a further CP on this topic is expected imminently.

Links

The CEBS draft guidelines can be found here:

www.c-ebs.org/Publications/Consultation-Papers/All-consultations/CP41-CP50/CP42.aspx

Our briefing note on the FSA's consultation paper 10/19 "Revising the Remuneration Code" is available here:

http://www.traverssmith.com/assets/pdf/Legal_Briefings/pay_regulation_for_financial_services_firms.pdf.

Key dates

The timetable is extremely tight:

2010

Mid-October: FSA expected to publish CP on transparency requirements.

8 November: the CEBS consultation period closes.

Mid-November: FSA expected to publish feedback on CP10/19, policy statement and near-final rules.

Late November: FSA expected to make its final rules (giving them force of law).

Late November: CEBS expected to publish its final guidelines.

2011

1 January: Remuneration Code in force (subject to very limited transitional provisions).

For further information in connection with these issues please contact one of the following partners in our Financial Services and Markets department or your usual contact at Travers Smith:

Travers Smith LLP
10 Snow Hill
London EC1A 2AL
T +44 (0)20 7295 3000
F +44 (0)20 7295 3500



Margaret Chamberlain
margaret.chamberlain@traverssmith.com
+44 (0)20 7295 3233



Jane Tuckley
jane.tuckley@traverssmith.com
+44 (0)20 7295 3238



Tim Lewis
tim.lewis@traverssmith.com
+44 (0)20 7295 3321

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