

# Clients & Friends Memo

## Revising the Remuneration Code: Pan-European Requirements Applicable From 1 January 2011

5 January 2011

### A. Scope: Firms

On 17 December 2010, the Financial Services Authority (**FSA**) published final rules expanding on its Remuneration Code in order to implement amendments being brought in by the Capital Requirements Directive (**CRD 3**) and guidelines on remuneration from the Committee of European Banking Supervisors (**CEBS**). These new rules expand the scope of application of the FSA's existing Remuneration Code beyond the 26 larger banks covered by the original Code to include all banks, building societies and CAD investment firms (which will include asset managers, UCITS funds and most hedge fund managers).

The Code is global in its reach insofar as it applies to the non-UK activities of a UK-headquartered firm as well as branches of third country firms operating in the UK. Group companies that form part of a UK consolidation group or EEA sub-group will also be caught even if they are established abroad. The effect of this is to bring into scope relevant staff employed at foreign subsidiaries of UK firms.

### B. Scope: Staff

"Remuneration Code staff" (**Code Staff**) are staff whose professional activities have a material impact on the firm's risk profile and who fall into one of four categories: (i) senior management, (ii) risk takers, (iii) staff engaged in control functions, and (iv) any employee receiving total remuneration that takes them into the same remuneration bracket as senior management and risk takers.<sup>1</sup>

The FSA's new rules make it clear that:

- heads of significant business lines, support and control functions and other individuals who have a material impact on the firm's risk profile are Code Staff;

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<sup>1</sup> See new SYSC 19A.3.4R.

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- support and control functions include credit/market/operational risk, legal, treasury controls, human resources, compliance and internal audit; and
- any staff performing a significant influence function, which will of course include any partners in investment firms structured as partnerships (such as hedge funds), should be considered as Code Staff – the FSA has responded to industry concerns over this aspect of the Code's reach by pointing to the availability of "proportionality" (see E. below) when applying the Code which "means that these individuals, along with individual proprietors and other owner/managers, do not necessarily have to apply our rules on remuneration structures (although this depends on the characteristics of the firm of which they are partners, rather than on their status as partners)".<sup>2</sup>

### **C. Scope: Remuneration**

The FSA defines remuneration as being any aspect of compensation that can have a bearing on effective risk management. This takes the scope beyond salaries and bonuses to include signing-on and severance packages, pensions, options and long-term incentive plans.

### **D. Remuneration Principles**

The Code is based around a series of principles underpinned by Principle 1 which requires firms to put in place a remuneration policy that is consistent with and promotes sound and effective risk management and does not encourage risk-taking that exceeds the level of tolerated risk of the firm. Other Principles include the avoidance of conflicts of interest, ensuring that a firm's remuneration practices do not endanger its capital base, basing assessments of financial performance on profit and ensuring that employees undertake not to use personal hedging strategies to offset the risk-based approach to their compensation.

Principle 12 is the most contentious of the Principles as it sets out new requirements for remuneration structures (but see E. below on proportionality). Principle 12 requires that payments being made after 1 January 2011 abide by the following strictures and parameters to the extent the firm is unable to disapply the requirement or requirements on proportionality grounds:

- (i) Remuneration must be structured to be consistent with and promote effective risk management;
- (ii) Performance-related remuneration must take into account individual, business unit and firm-wide performance and include non-financial performance metrics as a significant element of the assessment. The assessment itself should be set in a multi-year framework;

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<sup>2</sup> FSA Policy Statement 10/20 at page 14.

- (iii) Guarantees should be exceptional, for new hires only and limited to a year;
- (iv) Firms must set “appropriate” ratios between the fixed and variable elements of total compensation;
- (v) Early termination payments should not reward failure;
- (vi) At least 50% of variable remuneration should consist of shares/ownership interests/share-linked instruments/equivalent non-cash instruments and this 50% minimum should be applied to both the deferred and non-deferred elements of variable remuneration. These instruments must be subject to an “appropriate” retention policy that functions to align incentives with the long-term interests of the firm;
- (vii) At least 40% of variable remuneration should be deferred over a minimum period of three to five years and deferred remuneration must vest no faster than on a pro-rata basis;
- (viii) For staff with a variable component of their remuneration that exceeds £500,000, 60% should be deferred;
- (ix) Variable remuneration should be paid or vest only if it is justified in light of the performance of the firm, business unit and employee concerned and the firm should adjust unvested elements of remuneration should subsequent circumstances warrant such a performance adjustment.

#### **E. Proportionality and the Four Tier Framework**

In order to be able to calibrate remuneration practices to individual firms’ risk profiles, the Code allows firms to comply “in a way and to the extent that is appropriate to [its] size, internal organisation and the nature, the scope and the complexity of its activities.”

The FSA has endeavoured to assist firms in this calibration exercise by dividing firms up into four tiers of risk and indicating which of the Code’s rules are likely to apply to each tier. Tier One covers the largest banks, building societies and investment firms, and subject to a very limited carve-out on Remuneration Committees, applies the entirety of the Code. Tiers Two and Three cover medium sized firms and allow for the disapplication of Remuneration Committee requirements (for Tier Three firms)<sup>3</sup> as well as certain of the remuneration structure requirements set out at D., above.

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<sup>3</sup> The FSA’s guidance on Remuneration Committees says that it is “desirable” that larger Tiers Three and Four firms establish Remuneration Committees, but that it may be more “appropriate” for the governing body of the firm to act as such.

Tier Four (all limited licence and limited activity firms including third country firms with equivalent permissions, which is likely to include most hedge and other unregulated funds) allows qualifying firms to disapply the largest number of Code requirements, including the remuneration structure requirements on ratios, retained shares and other instruments, deferred payments and *ex post facto* performance adjustments. In addition, guidance in the new Code makes it clear that individuals whose variable remuneration is no more than 33% of total remuneration and whose total remuneration is no more than £500,000 should not be subject to these remuneration structure requirements in any event.

#### **F. Contracts of Employment**

New Rule 19A.1.5 applies to employment agreements made on or before 29 July 2010 and requires firms to take reasonable steps to amend or terminate provisions in such agreements that conflict with the Remuneration Code. In addition, Section 6 of the Financial Services Act 2010 allows the FSA to make rules to void provisions in otherwise legitimate employment agreements to the extent they contravene Remuneration Code requirements. This means, in effect, that executed employment contracts are subordinate to regulatory requirements and firms should take advice on the renegotiation of those contracts that are no longer compliant.

#### **G. Timing**

Firms already covered by the original Code must comply in full with the new rules as of 1 January 2011. Firms newly subject to the Code must comply as soon as reasonably possible, and in any event by 1 July 2011 at the latest. The new remuneration requirements (see D., above) apply to any remuneration paid out on or after 1 January 2011. By this date, and depending on how they are able to apply proportionality, firms should have in place at least the following:

1. A list of Code Staff;
2. A remuneration policy; and
3. A rationale as to why Code provisions have been disapplied on proportionality grounds.

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Please feel free to contact any of the following attorneys if you have any questions about this memorandum.

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