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FINANCIAL MARKETS UPDATE

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The New FSA Code on Remuneration Comes into Effect in the UK

On 1 January 2011, the Financial Services Authority ("FSA") Remuneration Code (the "Code") came into force. The Code sets out rules and associated guidance regarding remuneration within a wide variety of organisations. In July 2010, the European Union agreed amendments to the Capital Requirements Directive 2006/48-9/EC ("CRD 3"). CRD 3 requires Member States to introduce stricter controls on remuneration for specified employees and "risk takers" within specified credit institutions and investment firms from 1 January 2011.

As a result of CRD 3, the provisions set out in the Financial Services Act 2010 (FS Act) and the Principles for Sound Compensation Practices (as published by the Financial Stability Board), the FSA have revised and expanded the previous Remuneration Code and have published this revised Code which came into force on 1 January 2011.

According to the FSA, the Code now applies to over 2,500 FSA-authorised firms. It covers 12 core principles including governance, performance management and composition of remuneration committees. In publishing the Code, the FSA have recognised that remuneration policies, practices and procedures were a contributory factor in the recent financial crisis, but were not the dominant factor.

Which Institutions are Covered by the Code?

The Code, as required by CRD 3, will apply to all banks, building societies and firms which are subject to the provisions of the Capital Adequacy Directive ("CAD"). This includes most hedge fund managers, all UCITS firms, plus some firms which engage in corporate finance, venture capital, the provision of financial advice, brokers, several multilateral trading facilities and others.

The Code also applies to the UK branches of firms whose home states are outside the EEA. Interestingly, the Code will not apply to UK branches of firms whose home states are within an EU Member State, as the firm's own home state should have implemented the provisions of CRD 3 accordingly.

Which Individuals are Covered?

Technically, all employees of a firm which is subject to the Code are covered, as the firm is required to ensure that its remuneration policies and procedures provide for effective risk management. However, the Code will primarily affect two categories of employee:

1. Code Staff (a concept introduced by the Code for the first time)
2. Employees engaged in control functions.

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Code Staff are those employees who perform a significant influence function for the firm. This includes senior managers, all staff whose total remuneration takes them into the same bracket as senior management and risk takers whose professional activities have a material impact on the firm's risk profile.

The Code contains a non-exhaustive list of the key positions which it considers to fall within the definition of 'risk takers'. Examples include: Heads of business lines including commodities, equities, structured finance and fixed income. The FSA also expects firms to compile a list of Code Staff ahead of the bonus allocation period, so that firms can notify staff who may be potentially subject to the Code's rules.

It is important to note that where a member of staff is classified as Code Staff for part of a performance year, the firm should treat that member of staff as Code Staff for the entirety of that year.

Individuals who earn less then £500,000 ***and*** who receive variable remuneration which is not more than 33% of their total remuneration are generally considered by the FSA to fall outside the Code Staff definition for certain purposes such as deferral and performance adjustment, guaranteed bonuses and the 50% rule regarding variable remuneration. This is called the *de minimis* threshold. Accordingly, if a member of Code Staff ***either*** receives variable remuneration amounting to more than 33% of their total remuneration ***or*** their total remuneration is more than £500,000, they will not satisfy the *de minimis* threshold and will be caught by the full Code Staff requirements.

The FSA have indicated that staff who fall below the *de minimis* threshold may still be categorised as Code Staff. As the Committee of European Banking Supervisors ("CEBS") guidelines state, firms should be aware of cases where staff do not receive a high level of remuneration, but still have a material impact on the firm's risk profile on account of their particular job function or responsibilities. CEBS cautions firms against categorically dismissing low earners as non risk takers.

Consultants and other individuals who provide services to a firm may also be classified as Code Staff despite not being direct employees. It is for this reason that firms should consider whether any consultants or special advisers should be identified as Code Staff, for example, because their remuneration is equivalent to the levels of remuneration paid to senior management, or because their roles could materially impact the firm's risk profile.

What are the Remuneration Requirements?

Many of the evidential provisions and guidance under the previous remuneration code have been replaced by new rules in the Code. Therefore firms need to ensure that they review the Code thoroughly, including those firms which were already subject to the Code.

The requirements and principles set out in the Code build on those contained in the previous code. The central tenet of the Code remains the general requirement that firms' remuneration policies must be consistent with and promote effective risk management and not expose them to excessive risk.

Firms need to establish whether, for each member of Code Staff, there is a suitable balance between the employee's fixed pay and variable compensation. Firms should set a maximum ratio of variable to fixed pay for different categories of Code Staff.

Subject to proportionality for Code Staff whose remuneration exceeds the *de minimis* threshold, firms need to take steps to ensure that:

- At least 40% of variable remuneration paid to Code Staff is deferred over at least three to five years, with awards vesting no faster than on a pro-rata basis (and the first vesting no earlier than one year after the award). Where the amount of variable remuneration is particularly high (generally £500,000), at least 60% should be deferred.

- At least 50% of variable remuneration (whether paid upfront or deferred) is paid in a non-cash form, specifically in an appropriate balance of non-cash instruments, that is:

    - Share (or equivalent ownership interests, for non-corporate firms), share-linked instruments or equivalent non-cash instruments (that is, rights that will deliver value at some point in the future, based on the value at that time of a specified ownership interest, such as phantom share options or share appreciation rights); and

    - (at least for some firms) bonds which are convertible into equity if regulatory capital needs to be increased.

- Measures are in place that allow the firm to adjust awarded but unvested variable remuneration, in particular where there is evidence of employee misbehaviour or material error, or the firm suffers a material financial downturn or there is a material failure in risk management.

- Guaranteed bonuses are only paid in exceptional circumstances in the context of hiring new staff and are limited to an employee's first year of employment.

Firms should also evaluate their current remuneration structures to assess whether there is anything that could encourage Code Staff to take risks in order to maximise the amount of variable compensation being paid to them.

Application

Any new contractual term that contravenes the prohibition on guaranteed bonuses or the rules on deferral will be void and the firm must take reasonable steps to recover any payment made under it ('voiding and recovery'). Whilst this rule is extremely onerous, it only applies to contracts of employment concluded after the new Code came into effect, or to contracts of employment subsequently amended so as to contravene the Code. In addition, the FSA is adopting what it calls a "proportionate approach" to the implementation of the Code in relation to voiding and recovery, according to the size and nature of the firm - with less onerous standards applying to the lower tier firms and the strictest standards applying to those firms which were already subject to the previous Code. For the lower tier firm at least, the rules on voiding and recovery will not apply until January 2012.

All other provisions of the Code apply to remuneration awarded or paid after 1 January 2011, even if it is due under a contract of employment entered into before that date. Therefore the FSA is expecting firms to review all contracts of employment for Code Staff and take reasonable steps to amend them to ensure they comply with the Code. In making such contractual amendments, firms need to be aware that without an express power to amend or without employee consent, this could give rise to significant breach of contract claims. We are yet to see any litigation in this regard but when it comes (which it will), it will be interesting to see how the Courts balance the public policy requirements of the Code against individual contractual rights.

If you would like to discuss any aspect of this alert or require further information on the matters referred to, please contact any member of the UK employment team:

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