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New Remuneration Code

For investment firms regulated under the Markets in Financial Instruments Directive

Inside

Introduction

Since the 2007/08 financial crisis, as a result of both UK government and European initiatives, the financial services industry has been the focus of wide-ranging reform. A key aim of this reform is to align remuneration principles in the various sectors within financial services with a view to ensuring that policies and practices promote, and are consistent with, effective risk management.

Various restrictions affecting the structure and timing of bonus payments have been imposed and, for banks, building societies and certain investment firms, restrictions have been placed on the quantum of variable pay under the EU Capital Requirements Directive (CRD) - the so-called "bonus cap".

For investment firms regulated under the Markets in Financial Instruments Directive (MiFiD), the latest reform is contained in the EU Investment Firm Regulation (IFR) and the Investment Firm Directive (IFD). In the UK, the remuneration requirements under the IFR and IFD will be implemented by a new instrument called the MIFIDPRU Remuneration Code (the New Code), which will be set out by the Financial Conduct Authority (FCA) in its Handbook.

The requirements of the New Code will apply to performance periods beginning from 1 January 2022. This Inbrief provides an overview of the New Code based on details contained in a policy statement issued by the FCA in July 2021.

What are the Remuneration Codes?

The Financial Services Authority issued the first Remuneration Code (Code) in August 2009 as part of its regulatory response to the banking crisis. It applied with effect from 1 January 2010 to the UK's largest banks, building societies and broker dealers (approximately 26 firms in total). The Code required those firms to ensure that their remuneration policies, practices and procedures were consistent with, and promoted, effective risk management.

The first Code was substantially revised, and the number of firms within its scope significantly extended, to take account of the requirements of the CRD III. It was subsequently revised to take account of CRD IV and more recently CRD V. Several other remuneration codes have also been issued, detailing the remuneration requirements for firms in different financial services sectors including investment firms regulated under MiFiD.

The New Code will be set out in SYSC 19G of the FCA's Handbook. It will replace the existing IFPRU Remuneration Code for IFPRU investment firms (SYSC 19A of the FCA Handbook) and the BIPRU Remuneration Code for BIPRU investment firms (SYSC 19C of the FCA Handbook) for performance periods beginning on or after 1 January 2022.

Many of the principles of the New Code will be familiar to firms already regulated under the IPRU or BIPRU Remuneration Codes, but there are some important differences and extensions which are explained below. Details of the New Code can currently be found in a FCA policy statement that was issued in July 2021.

The requirements of the MiFiD Incentives Code (SYSC 19F of the FCA Handbook) will continue to apply to those individuals who have a direct or indirect effect on investment services and/or ancillary services provided by a firm or in its corporate behaviour.

Which firms are caught by the New Code?

The New Code applies to all investment firms authorised under MiFID. It will be applied proportionately, with firms caught by the New Code divided into three categories with different minimum expectations:

- Small and non-interconnected (SNI) firms. The first category includes firms which meet certain size requirements, do not hold client money or assets, and are not permitted to deal on their own account. Such firms are in the lowest proportionality level and their remuneration policies and practices will be subject to "light touch" basic regulation. Broadly these firms will be required to implement a remuneration policy to ensure, among other things, that there is an appropriate balance between fixed and variable pay and that the levels of variable pay do not adversely affect the firm's capital base.
- Non-SNI firms. The second and third categories cover larger, more complex firms. Different levels of regulation will apply to non-SNI firms depending on their size:
  - Smaller non-SNI firms will be subject to the basic regulation applicable to SNI firms and further standard regulation. The latter includes a requirement to implement a malus and clawback policy for all "material risk takers" (see below) and to comply with various requirements when paying guaranteed bonuses, buy-out awards, retention awards and termination payments to a material risk taker.
  - Larger non-SNI firms will be subject to the most stringent regulation. This includes the basic and standard regulation to which a smaller non-SNI firm is subject, together with further extended regulation. The additional measures include the requirement to apply deferral, payment in instruments and

retention periods to the variable pay of material risk takers whose remuneration package is above a certain level.

A firm is a larger non-SNI firm if the average value (calculated over the preceding four-year period) of its on and off-balance sheet gross assets are:

- more than £300 million; or
- more than £100 million and it either has:
  - a gross trading book business greater than £150 million; and/or
  - a gross derivatives business greater than £100 million.

These tests are applied to each firm rather than on a consolidated group basis. The FCA expects that around 100 firms will be larger non-SNI firms.

The FCA encourages SNI and smaller non-SNI firms to consider whether applying some or all of the standard and/or extended requirements might be helpful in ensuring effective risk management and providing appropriate incentives to staff. Similarly, where the requirements are limited to material risk takers (see below), non-SNI firms are encouraged to consider whether to apply them to staff members more widely.

Which individuals are subject to the New Code?

The basic remuneration requirements in the New Code apply to all firms and all their staff members, including employees, secondees from non-UK group companies who are working in the UK, consultants, partners and members.

However, the requirements relating to guaranteed bonuses, buy-out awards, retention awards, severance pay, discretionary pension benefits and the pay-out process rules (deferral, payment in instruments and retention) apply only to “material risk takers”.

Each year, non-SNI firms must identify those staff who are material risk takers. An individual is a material risk taker if their professional activities have a material impact on the firm’s risk profile or the assets it manages (takings into account prudential, operational, market, conduct and reputational risks). Unlike the position under the CRD, individuals need not be identified as a material risk taker solely because their remuneration exceeds a certain level.

The FCA expects firms to develop their own criteria to identify whether a staff member is a material risk taker based on the specific types of activity and risks relevant to the firm. In assessing whether a staff member is a material risk taker, the FCA has identified the following key factors:

- there is no sufficiently senior and experienced individual supervising the particular staff member on a day-to-day basis or to whom the particular staff member reports (the level of responsibility and authority held by the individual is decisive);
- the staff member is responsible for key strategic decisions; and
- the staff member is responsible for: significant revenue; material assets under management; or approving transactions.

In addition, the FCA has indicated that staff members should be treated as material risk takers if they:

- are members of the management body and/or senior management;
- have managerial responsibility over the firm’s control functions or a material business unit;
- have responsibility over the firm’s prevention of money laundering and terrorist financing policies;
- are responsible for managing information technology, information security or other outsourcing arrangements for critical or important functions;
- are responsible for managing a material risk or risk-management policies; and/or
- have authority to take decisions approving or vetoing the introduction of new products.

Material risk takers are exempt from the pay-out process rules and requirements relating to discretionary pension benefits if their variable pay for a performance year is:

- £167,000 or less; and
- 33% or less of the total of the individual’s remuneration for that performance year.

We refer to this below as the “De Minimis Concession”.

Remuneration policy

All firms must have a documented remuneration policy for all staff which is proportionate to the firm’s activities and structure. Non-SNI firms must ensure that their remuneration policy is reviewed annually.

A firm’s remuneration policies and practices must be consistent with and promote sound and effective risk management, including by containing measures to:

- avoid conflicts of interest;
- encourage responsible business conduct; and
- promote awareness or risk and prudent risk-taking.

In addition, the policies and practices must be in line with the firm’s business strategy and objectives and be gender neutral – that is, based on equal pay for women and men for work of equal value.

Remuneration structure

The main principles of the New Code relating to the structure of remuneration are set out below.

Ratio of fixed pay to variable pay

All firms must ensure there is an appropriate balance of fixed pay and variable pay to ensure that fixed pay is a sufficiently high proportion of total remuneration to allow for the possibility of paying no variable pay. All non-SNI firms must set a ratio between fixed pay and variable pay.

"Fixed pay" is defined as remuneration which primarily reflects relevant professional experience and organisational responsibility, as set out in the staff member's job description as part of the terms of employment. It should be permanent, pre-determined, non-discretionary, non-revocable and not dependent on performance. Salary and non-cash benefits in kind are fixed pay.

"Variable pay" is defined as remuneration which is based on performance or, in exceptional circumstances, other conditions. It reflects the long-term performance of the staff member as well as performance exceeding that required to fulfil their job description. Variable pay includes not only annual discretionary and guaranteed bonuses but also long-term cash and equity incentive plans.

The FCA has provided guidance on how the remuneration received by partners and members should be classified – that is, whether it is fixed or variable.

Discretionary variable pay

All firms should ensure that the size of their annual bonus pool does not affect the firm's ability to maintain a sound capital base. When assessing an individual's performance, firms should consider both financial and non-financial metrics, such as compliance with effective risk-management policies and regulatory requirements. Non-financial metrics should form a "significant" part of the performance assessment process.

For non-SNI firms, the amount of the discretionary variable pay pool should be based on profit, adjusted for current and future risks, and firms should consider the cost and quantity of the capital and liquidity required. Such firms must ensure that performance-related bonuses are assessed in a multi-year framework, considering the performance of the individual, the relevant business unit, and the overall results of the firm.

Larger non-SNI firms must ensure that the variable pay of those material risk takers who do not satisfy the De Minimis Concession is subject to the pay-out process rules.

In relation to deferral, at least 40% of variable pay awarded to the material risk taker should be deferred over a period of at least three years, depending on the seniority and remuneration of the individual. In setting the deferral period, firms should consider the business cycle, the nature of the business and its risks, and the activities of the relevant individual. Where the variable pay is of a particularly high amount, and in any case where it is £500,000 or more, at least 60% must be deferred.

The FCA has indicated that for material risk takers who have a significant effect on the firm's risk profile (for example, members of the management body), it may be appropriate to impose a longer deferral period.

The awards must not vest faster than pro rata and only after the first year.

Generally, at least 50% of the variable pay of material risk takers should be paid on a net-of-tax basis in the form of shares, equivalent ownership interests, or share-linked instruments or equivalent non-cash instruments. It is not necessary to apply this to both the upfront and deferred components of variable pay. So, for example, in a case where a material risk taker is subject to deferral at 60%, this requirement would be satisfied if the deferred component was wholly paid in non-cash instruments.

Any shares, ownership instruments or other non-cash instruments should also be subject to a retention policy to ensure that the incentives are aligned with the longer-term interests of the firm. The FCA has not specified the length of the retention period but advises firms to consider: their business cycle; the type of risks relevant to the staff member's role; and how long it could take for the risks underlying the staff member's performance to crystallise. In short, the greater the effect of the material risk taker on the risk profile of the firm and the assets managed, the longer the retention period should be.

Dividends and interest may accrue to the material risk taker during the deferral period (provided that the interest rate or level of dividends is not higher than the amount which would have been paid to an ordinary holder of the instrument). However, firms are not permitted to pay these amounts until vesting.

Guaranteed variable pay

All non-SNI firms must not award or pay guaranteed variable pay to any material risk taker, or provide it as an incentive, unless:

- it occurs in the context of hiring a new material risk taker;
- it is limited to the first year of service; and
- the firm has a strong and sound capital base.

The FCA expects non-SNI firms to award guaranteed remuneration "only rarely and not as common practice".

Buy-out awards

A buy-out award is an award which buys out a staff member's rights which will be reduced or forfeited on them leaving their former firm.

When making such awards, all non-SNI firms should ensure that the duration of the retention, deferral, vesting and performance adjustment provisions are no shorter than the duration applied to, and remaining on, the awards which the material risk taker will forfeit. The buy-out award should also align with the long-term interests of the firm.

Retention awards

Retention awards are bonuses (and so variable pay) which are dependent on the individual remaining in a role until a defined event or for a set length of time. A retention bonus may be appropriate, for example, in the case of a restructure, a specific project or a winding down.

Retention bonuses must only be paid to material risk takers after a defined event or at a specified point in time and may be dependent on the individual meeting certain performance criteria. Like guaranteed variable pay, retention bonuses should only be made to material risk takers rarely and not as common practice.

Performance adjustment

Performance adjustment refers to the downward adjustment of variable pay paid to material risk takers. There are two mechanisms for implementing performance adjustment:

- a **malus** arrangement, under which unvested, deferred variable pay is reduced; or
- a **clawback** arrangement, under which the staff member is required to repay amounts they have received.

All non-SNI firms are required to apply performance adjustment to variable pay paid to material risk takers as a minimum where the material risk taker:

- participated in or was responsible for conduct which resulted in significant losses to the firm; and/or
- failed to meet appropriate standards of fitness and priority.

Smaller non-SNI firms are not required to defer variable pay. If such a firm does not defer variable pay, it will not be able to apply a malus arrangement. However, it will then be required to apply clawback arrangement to all variable remuneration.

Where financial performance is subdued or negative, firms must ensure that variable pay is "considerably contracted", including reducing pay-outs of amounts previously earned.

Firms must ensure that any variable pay awarded to material risk takers (including both the non-deferred and deferred element) is only paid or vested if it is sustainable according to the financial situation of the firm, and justified by the performance of the firm, business unit and individual.

Under the New Code, firms should apply malus to deferred variable pay when:

- there is reasonable evidence of the material risk taker's misbehaviour or material error;
- the firm and/or relevant business unit suffers a material downturn in its financial performance; and/or
- the firm and/or relevant business unit suffers a material failure of risk management.

Clawback should be applied in cases of fraud or other conduct with intent or severe negligence which led to significant losses, and the clawback period should allow sufficient time for any potential risks to crystallise. For smaller non-SNI firms who do not operate deferral, the FCA has indicated that the clawback period should be at least three years from the date of award.

Carried interest and co-investment plans

Carried interest (valued at the time of its award) counts as variable pay under the New Code. However, the pay-out process rules and performance adjustment requirements do not apply to carried interest payments where:

- the value of the carried interest is determined by the performance of the fund in which the carried interest is held;
- the period between award and payment of the carried interest is at least four years; and
- there are performance-adjustment provisions for, as a minimum, those situations where the individual participated in or was responsible for conduct which resulted in significant losses to the firm, or where the individual failed to meet appropriate standards of fitness and propriety.

The returns on co-investment plans generally do not count as variable pay unless the investment was made using a loan provided by the firm, and either the loan was not provided on commercial terms or is not repaid in full by the date on which the returns on investments are paid.

Pension policy

All non-SNI firms must ensure that their pension policy is in line with their business strategy, objectives, values and long-term interests.

Larger non-SNI firms must also ensure that pension contributions for material risk takers which are discretionary (i.e. in the nature of a bonus) should be held for five years in the form of shares/equivalent ownership interests and should be subject to performance adjustment.

Termination payments

All non-SNI firms must ensure that their remuneration policy sets out the maximum level of termination payments or the criteria for determining the amount. Termination payments are variable pay and should generally be included in the fixed to variable pay ratio for the performance year in which the payment is made, unless the firm is obliged to pay the payment as a result of a legal obligation which arose after the date on which the firm adopted its remuneration policy.

In addition, all non-SNI firms must ensure that payments on termination of a material risk taker's employment do not reward failure or misconduct, but rather that they reflect the performance achieved over time.

Non-compliance with the New Code

All non-SNI firms should take reasonable steps to ensure that their material risk takers do not undermine the requirements of the New Code, for example by engaging in hedging or remuneration-related insurance strategies. Firms must ensure that they do not pay variable pay via vehicles or methods that facilitate non-compliance.

Sanctions available to the FCA for breach of the New Code include: private warnings (which may include restricting how a firm structures its variable pay in the future); fines; public censure; and ultimately, variation or cancellation of a firm's authorisation.

How can we help?

Firms should start preparing for the New Code, including by ascertaining their proportionality category, identifying their material risk takers and reviewing their remuneration policies.

We have a specialist team of employment, reward and financial services lawyers able to review and advise on your remuneration plans, policies and practices and contracts for individual staff members. We can ensure they are compliant with the New Code and advise where necessary on how they should be amended.

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