

**MEMO# 24558**

September 24, 2010

## **FSA's Proposal to Revise the UK Remuneration Code**

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TO: INTERNATIONAL COMMITTEE No. 12-10 RE: FSA'S PROPOSAL TO REVISE THE UK REMUNERATION CODE

On July 29, 2010, the UK Financial Services Authority (FSA) published Consultation Paper 10/19: Revising the Remuneration Code ("Paper"). [\[1\]](#) The FSA is proposing significant revisions to the Remuneration Code of Practice ("Code") to incorporate recent amendments to the Capital Requirements Directive ("CRD3") and the UK Financial Services Act of 2010. A large number of asset managers will be impacted by the revisions. UK groups are expected to apply the revised Code globally to their regulated and unregulated entities and UK subsidiaries of third country groups also must apply the revised Code in relation to all entities within the subgroup, including those based outside the United Kingdom. The Institute plans to submit a comment letter.

In the United States, under the recently adopted Dodd-Frank Wall Street Reform and Consumer Protection Act (the "legislation"), the scope and nature of any limits on incentive-based executive compensation arrangements in financial institutions generally are not clear. [\[2\]](#) The legislation directs the following, not later than 9 months after enactment (April 21, 2011):

- (1) federal financial regulators must jointly draft regulations requiring federal financial institutions, including investment advisers, with more than \$1 billion in assets to disclose all incentive-based compensation arrangements to their federal regulator sufficient to determine whether the compensation structure provides covered executives with excessive compensation, fees or benefits or could lead to material financial loss to the financial institution; and
- (2) federal financial regulators must jointly prescribe regulations or guidance that prohibit any incentive-based payment arrangement, or any feature of such arrangement, that regulators determine encourages inappropriate risks by

federal financial institutions by providing a covered executive with excessive compensation, fees or benefits or could lead to material financial loss to the financial institution. [\[3\]](#)

## Scope of the Revised Code

The revised Code will apply to firms subject to CRD3, meaning all banks and building societies as well as most investment firms to which the Market in Financial Instruments Directive (“MiFID”) rules apply. Such investment firms include a large number of asset managers (including most hedge fund managers and UCITS investment firms), brokers and some firms which engage in corporate finance, venture capital and the provision of financial advice. As noted above, UK groups are expected to apply the revised Code to all entities within the subgroup, including outside the United Kingdom. The FSA estimates that the revised Code will apply to more than 2500 firms.

With regard to the application of the revised Code to specific employees of a covered firm, the FSA proposes to apply the revised Code to a broad range of employees under the term “Code Staff,” generally defined as any staff which have a material impact on a firm’s risk profile. Examples of such staff include a person who performs a significant influence function for a firm (including, for example, a director), a senior manager and staff whose total compensation places them in the same bracket as senior management and risk takers whose professional activities could have a material impact on a firm’s risk profile.

## Remuneration Principles

The FSA outlines several remuneration principles (with proposals for new or changed rules) [\[4\]](#) to ensure symmetry between pay and performance and to promote effective risk management, including:

1. Risk management and risk tolerance. A firm’s remuneration policy should discourage risk taking that exceeds a firm’s tolerated level of risk.
2. Supporting business strategy, objectives, values and long-term interests of the firm. A firm’s remuneration policy should be in line with its business strategy and long-term corporate values.
3. Avoid conflicts of interest. A firm’s remuneration policy should contain measures to avoid conflicts of interest, including those related to customers’ interests.
4. Governance. A firm’s remuneration committee should exercise independent judgment to make a reasonable assessment of the firm’s situation and be responsible for approving and periodically reviewing its remuneration policy.
5. Risk and compliance function input. Remuneration for employees in risk and compliance functions, in particular, should be determined independently and should be based on achieving the objectives of those functions.
6. Profit based measurement and risk adjustment. Firms need to ensure that their techniques for assessing variable remuneration take sufficient account of current and future risks.
7. Personal investment strategies. Firms are required to ask employees to undertake not to use personal hedging strategies, or to take out insurance contracts, that undermine risk alignment. This is needed to maintain the alignment between risk and reward, i.e., so employees do not avoid the downside risks relating to their activities.
8. Remuneration structures. A firm must ensure that the structure of an individual’s remuneration is consistent with and promotes effective risk management. This covers

a wide range of issues such as a balance between fixed and variable remuneration, deferral, performance adjustment, proportion of shares or share-linked instruments in variable remuneration, guarantees, and severance pay. For example, the FSA has included a proposal to require that at least 40% of variable remuneration be deferred with a specified vesting period and has also proposed that at least 50% of any variable remuneration be taken in shares or other equivalent non-cash instruments of the firm with a minimum retention period. In line with the FSA's approach to proportionality (discussed below), the FSA also proposed a "de minimus concession" that employees whose earning and bonuses are below particular amounts would not be required to meet the deferral requirements. [\[5\]](#) In addition, firms should retain the ability to make adjustments to an individual's unvested deferred amounts of variable remuneration to reflect actual outcomes as they materialize over time.

## Proportionality

As permitted under CRD3, the FSA has proposed a proportional approach to ensure that firms comply with the Code "in a way and to the extent that is appropriate to their size, internal organization and the nature, the scope and the complexity of their activities." The FSA recognizes that, while some of the Code's essential rules will apply to all firms, applying the full revised Code may be inappropriate and/or overly burdensome in some cases. With respect to asset managers, generally, the FSA stated:

We recognize that the definition of risk will vary according to the type of firm. For example, for an asset management or investment firm, investment risk is invariably assumed on an agency rather than a principal basis, as investment decisions made by staff are carried out on behalf of clients in line with the mandates they have agreed between them. These risks are not taken onto a firm's balance sheet as they would be for credit institutions. We believe the key risks affecting the success or failure of an asset management firm are typically operational or legal risks arising from asset management activities. Of course, a key control of legal risk will relate to a firm's ability to ensure that investment managers act in line with the mandates they have agreed with their customers.

Nevertheless, it is unclear how this observation by the FSA should be incorporated into a proportionate approach tailored to an asset manager.

Annex 5 of the Paper sets forth the FSA's proposed approach to proportionality through the following three tables:

- Proportionality Table 1: Code rules and remuneration principles, to be applied to all firms.
- Proportionality Table 2: Code rules and remuneration principles which apply in line with the nature, internal organization, scale, scope and complexity of a firm.
- Proportionality Table 3: Code rules and remuneration principles which firms may apply on a "comply or explain" basis, based on their nature, internal organization, scale, scope and complexity.

The FSA is seeking input on the proportionate approach. The FSA is also waiting for guidance from the Committee of European Banking Supervisors ("CEBS") before finalizing its approach.

# FSA's New Voiding Powers

As a result of the UK Financial Services Act of 2010, the FSA will have express power to prevent firms from breaching the remuneration principles. For instance, the FSA has the authority to prohibit a firm from remunerating its staff in a specified way or it may render void any provision of any agreement that contravenes such a prohibition.

## Effective Date and Implementation

The FSA's consultation period ends on October 8, 2010. Final wording for the revised Code is not expected until November 2010 with the revised Code effective January 1, 2011 for remuneration awarded or paid on or after that date. In recognition that the time table may be challenging, particularly for companies not within the scope of the current Code or certain other companies, the FSA has included transitional provisions whereby such companies may rely on the proportionality principles in the Code to justify less than full compliance by January 1, 2011; however, firms must comply as soon as possible or no later than July 1, 2011.

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### endnotes

[1] Consultation Paper 10/19: Revising the Remuneration Code (July 7, 2010) available at [http://www.fsa.gov.uk/pubs/cp/cp10\\_19.pdf](http://www.fsa.gov.uk/pubs/cp/cp10_19.pdf)

[2] In June, US federal banking regulators issued final guidance on sound incentive compensation policies. The guidance is designed to help ensure that incentive compensation policies at banking organizations do not encourage imprudent risk-taking and are consistent with the safety and soundness of the organization. Final Guidance on Sound Incentive Compensation Policies, Office of the Comptroller of the Currency, Board of Governors of the Federal Reserve System, Federal Deposit Insurance Corporation, Office of Thrift Supervision, 75 FR 36395 (June 25, 2010), available at <http://edocket.access.gpo.gov/2010/pdf/2010-15435.pdf>.

[3] In addition, federal regulators must ensure that any standards for compensation are comparable to standards established under the Federal Deposit Insurance Act for insured depository institutions. Dodd-Frank Wall Street Reform and Consumer Protection Act, Pub.L. 111-203, Section 956. The enrolled bill (passed by both the Senate and the House of Representatives) is available at [http://frwebgate.access.gpo.gov/cgi-bin/getdoc.cgi?dbname=111\\_cong\\_bills&docid=f:h4173enr.txt.pdf](http://frwebgate.access.gpo.gov/cgi-bin/getdoc.cgi?dbname=111_cong_bills&docid=f:h4173enr.txt.pdf) and the conference report is available at [http://frwebgate.access.gpo.gov/cgi-bin/getdoc.cgi?dbname=111\\_cong\\_reports&docid=f:hr517.111.pdf](http://frwebgate.access.gpo.gov/cgi-bin/getdoc.cgi?dbname=111_cong_reports&docid=f:hr517.111.pdf).

[4] Section 3 of the Paper describes the proposed Code revisions and principles and Appendix 1 contains draft Remuneration Code rules.

[5] The FSA is proposing that for Code Staff whose bonus is less than 33% of total remuneration and whose total remuneration is less than or equal to £500,000, it would not

generally consider it necessary to apply rules relating to deferral , performance adjustment, proportion of remuneration paid in shares, and guaranteed bonuses.

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