The FSA Produces Final(ly) Remuneration Code Rules

On 17 December 2010, the Financial Services Authority ("FSA") published its final Remuneration Code rules (the "Code"). The Code comes into force on 1 January 2011.

Unlike the current Remuneration Code, which applies to fewer than 30 firms, the Code will apply much more widely (the FSA's estimate is that in excess of 2500 firms will be affected). This is because the Code implements revisions to the Capital Requirements Directive regarding remuneration (usually referred to as "CRD3"), and CRD3 applies not only to banks and the largest broker-dealers, but also to investment firms more generally. Those alternative fund managers that are subject to the Markets in Financial Instruments Directive ("MiFID"), for instance, will be subject to the Code.

Given this, it is far from satisfactory that the FSA's final version of the Code should appear a fortnight before the Code takes effect, though in the FSA's defence they have been waiting for the final version of the guidance from the Committee of European Banking Supervisors ("CEBS") on CRD3, which did not appear until December 10. In addition, the Code does contain limited transitional provisions for firms newly affected by remuneration requirements, which mean that parts of the Code relating to remuneration structures do not need to be complied with until July 1, 2011.

The Code, which forms chapter 19A of the FSA's Senior Management Arrangements, Systems and Controls Handbook ("SYSC") consists of a general requirement — 'a firm must establish, implement and maintain remuneration policies and practices that are consistent with and promote sound and effective risk management' — and twelve "remuneration principles". The definition of "remuneration" is wide, and includes any form of remuneration, including salaries, discretionary pension benefits and benefits of any kind. In addition, firms must maintain records of "Remuneration Code staff" — senior staff whose professional activities have a material impact on the firm's risk profile. Firms are required to apply the Code in full with respect to Remuneration Code staff, though the FSA proposes that firms should give consideration to applying the remuneration principles on a firm-wide basis.

The remuneration principles are as follows:

- Risk management and risk tolerance.
- Supporting business strategy, objectives, values and long term interests of the firm.
- Avoiding conflicts of interest.
- Governance.
- Control functions.
- Remuneration and capital.
- Exceptional government intervention.
- Profit-based measurement and risk adjustment.
- Pension policy.

- Personal investment strategies.
- Avoidance of the Code.
- Remuneration structures.

The Code introduces the concept of four ‘tiers’ of firm:

- **Tier 1:** UK banks and building societies with capital resources exceeding £1 billion, and full scope BIPRU 730k firms with capital resources exceeding £750 million; third country BIPRU firms that are not limited licence firms or limited activity firms with total assets of the firm covering activities of the UK branch that exceed £25 billion;
- **Tier 2:** UK banks and building societies with capital resources between £50 million and £1 billion, and full scope BIPRU 730k firms with capital resources between £100 million and £750 million; third country BIPRU firms that are not limited licence firms or limited activity firms with total assets of the firm covering activities of the UK branch between £2 billion and £25 billion;
- **Tier 3:** all UK banks, building societies, full scope BIPRU 730k firms, and third country BIPRU firms that are not limited licence firms or limited activity firms which do not fall within Tiers 1 or 2; and
- **Tier 4:** BIPRU limited licence or limited activity firms.

Firms in Tier 1 (the largest, most complex firms) need to apply the Code most strictly; firms in Tier 4 have the ability to disapply completely certain parts of the Code, and may choose to comply or explain their non-compliance with other parts. This reflects the fact that the CRD3 remuneration principles are required to be applied by firms “in a way and to the extent that is appropriate to their size, internal organisation, and the nature, the scope and complexity of their activities”.

The good news for alternative investment managers is that the vast majority will fall within Tier 4, and as such they will be able to disapply a number of provisions where appropriate to do so. In particular, certain requirements in the “Remuneration Structures” principle that had caused alternative investment managers concern can be disapplied completely, such as:

- the requirement to set ratios between fixed and variable remuneration;
- the requirement to pay at least 50% of variable remuneration in shares or equity-like instruments (which in any event would be problematic for those firms established as LLPs); and
- the requirement to defer at least 40% of variable remuneration (which increases to at least 60% if the variable remuneration is “of a particularly high amount”) over three to five years.

This is a much better outcome than at one time seemed likely.

The Code will apply in respect of remuneration made or awarded on or after 1 January 2011 (including payments made in respect of bonuses for services provided in 2010. Firms will therefore need in short order to evaluate the extent to which the Code applies to them and their staff.

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