European Regulatory Snapshot: Remuneration in the Financial Services Industry

August 8, 2013

Introduction

The move toward stricter regulation of remuneration in the financial services industry in the European Union has resulted in a confusing web of overlapping European Directives and local EU Member State law and regulation, each of which seeks to place limits on remuneration. This client memorandum aims to assist in navigating the new European labyrinth by providing a snapshot of the three main European Directives that regulate remuneration:

- Capital Requirements Directive IV[1] (CRD IV);
- Alternative Investment Fund Managers Directive[2] (AIFMD); and
- fifth Undertakings for Collective Investment in Transferable Securities Directive[3] (UCITS V).

In addition, this memorandum discusses the European Securities Market Authority's (ESMA) recent Markets in Financial Instruments Directive[4] (MiFID) Guidelines on remuneration policies and practices.[5] The memorandum then considers the additional requirements on remuneration that the UK is planning to impose in relation to the financial services industry.[6]

Pan-European law and regulation on remuneration

Banks and other financial institutions (CRD IV)

CRD IV, which was published in the Official Journal of the European Union on June 27, 2013, includes restrictions on bonus payments by credit institutions and investment firms.

Who *Entities:* all credit institutions (including banks) and investment firms in the EU and the non-EU subsidiaries of such entities; in addition, EU subsidiaries of financial institutions headquartered outside the EU.

[1] Directive 2013/36/EU of the European Parliament and of the Council of 26 June 2013 on access to the activity of credit institutions and the prudential supervision of credit institutions and investment firms, amending Directive 2002/87/EC and repealing Directives 2006/48/EC and 2006/49/EC. The text of the Directive can be found here.

[2] Directive 2011/61/EU of the European Parliament and of the Council of 8 June 2011 on Alternative Investment Fund Managers and amending Directives 2003/41/EC and 2009/65/EC and Regulations (EC) No 1060/2009 and (EU) No 1095/2010. The text of the Directive can be found here.

[3] Amendments adopted by the European Parliament on 3 July 2013 on the proposal for a directive of the European Parliament and of the Council amending Directive 2009/65/EC on the coordination of laws, regulations and administrative provisions relating to undertakings for collective investment in transferable securities (UCITS) as regards depositary functions, remuneration policies and sanctions. The text of the amendment can be found here.

[4] Directive 2004/39/EC of the European Parliament and of the Council of 21 April 2004 on markets in financial instruments amending Council Directives 85/611/EEC and 93/6/EEC and Directive 2000/12/EC of the European Parliament and of the Council and repealing Council Directive 93/22/EEC. The text of the Directive can be found here.

[5] Final Report: Guidelines on remuneration policies and practices (MiFID), ESMA/2013/606, June 11, 2013. The text of the report can be found here.

[6] For a more detailed analysis of the CRD IV requirements in relation to remuneration and an overview of the EU, German, Spanish, Swiss and UK plans in relation to say-on-pay, please refer to our April 23, 2013 memorandum **Recent European Compensation Developments: Financial Institutions and Beyond**.

Individuals: employees whose professional activities have a material impact on the risk profile of the relevant financial institution, including senior management, risk takers, employees engaged in control functions and employees whose total pay puts them into the same bracket as senior risk management and risk takers.

What *Variable pay:* "variable pay" is capped at 100% of total fixed pay or, with shareholder approval,[7] 200% of total fixed pay. Variable pay includes payments or benefits that depend on performance and, in exceptional circumstances, other contractual elements that do not "*form part of a routine employment package*" (examples of routine elements of compensation noted in the Directive include healthcare, child care facilities or proportionate regular pension contributions).[8] EU Member States have the discretion to adopt stricter standards (*e.g*., lower bonus caps).

Skin in the game: at least 50% of any variable pay must consist of shares or equivalent ownership interests (or share-linked or equivalent non-cash instruments, for non-listed institutions).

Deferred payment: at least 40% of any variable pay must be deferred over a period of at least three to five years.

Clawback arrangements: up to 100% of variable pay will be subject to clawback or malus arrangements. Financial institutions will be required to set specific criteria for such arrangements.

When EU Member States have until December 31, 2013 to implement CRD IV into local law that should be applicable from December 31, 2013. The ratio of variable to fixed pay will apply to "*services provided or performance from the year 2014 onwards, whether due on the basis of contact concluded before or after 31 December 2013.*"[9]

Investment funds (AIFMD)

On February 11, 2013, ESMA adopted the Guidelines on sound remuneration policies under the AIFMD,[10] which together with the AIFMD set out the framework for the remuneration of identified staff at managers of alternative investment funds. The AIFMD regulates alternative investment fund managers (AIFMs) other than UCITS funds and includes restrictions on variable compensation of certain identified staff of EU-authorised AIFMs. The definition of "identified staff" in this context is similar, though not identical, to the definition used for CRD IV. It is worth noting that there is no cap on variable pay under the AIFMD, nor are there any malus or clawback requirements. Following the European Parliament's recent rejection of bonus caps in relation to identified staff at UCITS V managers (see below), it is now unlikely that a bonus cap along the lines of the one introduced under CRD IV will be adopted in the foreseeable future in relation to AIFMs.

Who *Entities:* EU-authorised AIFMs (and, specifically, non-EU AIFMs who become EU-authorised in order to make use of the pan-European passport). The remuneration requirements do not apply to non-EU AIFMs that are not EU-authorised, although non-

[7] Approval by either 66% of shareholders owning half the shares represented or, failing that, 75% of all shares represented. Note that employees who are directly affected by the higher bonus cap must not be allowed to exercise, directly or indirectly, any voting rights that they may have as shareholders of the financial institution in connection with such vote.

[8] Recital 64, CRD IV.

[9] Article 162(3), CRD IV.

[10] Final Report: Guidelines on sound remuneration policies under the AIFMD, ESMA/2013/201, February 11, 2013. The text of the report can be found **here**.

EU AIFMs should bear in mind the applicable disclosure and transparency requirements described in our June 4, 2013 client memorandum.[11]

Individuals: "identified staff" at the relevant AIFM broadly includes senior management, risk takers, control functions (*e.g.*, compliance, internal audit) and others whose remuneration is in the same bracket as senior management and risk takers, and whose activities have a "*material impact on [the AIFM's] risk profile or the risk profiles of the [alternative investment funds (AIFs)] that [it] manage[s]*."[12]

What *Fixed pay:* the remuneration of identified staff must include a "fixed" component that "*should be sufficiently high to remunerate the professional services rendered, in line with the level of education, the degree of seniority, the level of expertise and skills required, . . . the relevant business sector and region.*"[13] There is no prescribed maximum or minimum percentage figure.

Variable pay: the non-fixed or variable component should be based on both the individual's performance and the AIF's and the AIFM's performance as a whole.

Skin in the game: at least 50% of variable remuneration must consist of units or shares in the AIF or in other non-cash instruments that convey equivalent ownership interests.

Deferred payment: at least 40% of the variable remuneration must be deferred over an appropriate period of time in view of the life cycle and redemption policy of the AIF, and in any event must be at least three to five years (unless the life cycle of the AIF is shorter).

When The deadline for implementation of the AIFMD into EU Member State law was July 22, 2013. The AIFMD provides for a transitional period of up to one year (*i.e.*, July 22, 2014) for those AIFMs performing activities under the AIFMD before July 22, 2013. For non-EU AIFMs, the regime will be applicable upon authorisation in an EU Member State.

Managers of UCITS funds (UCITS V Directive)

On July 3, 2013, the European Parliament approved an amendment to the proposed UCITS V directive and rejected a proposal to cap the variable component of a UCITS manager's identified staff's remuneration at 100% of the fixed component (which would have been similar in nature to the bonus cap with respect to certain employees of banks and investment firms under CRD IV).

Who *Entities:* managers of UCITS established in the EU.

Individuals: the definition of "identified staff" in this context is broader than for CRD IV or AIFMD and includes fund managers; persons who take investment decisions that affect the risk position of the fund; persons who exercise influence on staff, such as investment policy advisors and analysts, and senior management, risk takers and personnel in control functions.

What *Fixed pay:* the fixed and variable component of identified staff's remuneration must be "appropriately balanced" with the fixed component representing "*a sufficiently high proportion of the total remuneration to allow the operation of a fully flexible policy on variable remuneration components, including the possibility to pay no variable*

[11] **The Impact of the Alternative Investment Fund Managers Directive on Non-EU Managers of Non-EU Funds**.

[12] Paragraph 1, Annex II to AIFMD.

[13] Paragraph 94, ESMA AIFMD Guidelines.

remuneration component."[14] There is no prescribed maximum or minimum percentage figure.

Variable pay: the non-fixed or variable component should be based on both the individual's performance as well as the UCITS fund's and the UCITS manager's performance as a whole. Where the financial performance of the UCITS manager or the UCITS fund is "*subdued or negative*," the variable compensation "*shall generally be considerably contracted*."[15] It is currently uncertain exactly how this additional limitation is to be interpreted.

Skin in the game: at least 50% of variable remuneration must consist of units or shares in the UCITS fund or in other non-cash instruments that convey equivalent ownership interests.

Deferred payment: at least 25% of the variable remuneration must be deferred over an appropriate period of time in view of the life cycle and redemption policy of the UCITS fund, and in any event must be at least three to five years (unless the life cycle of the UCITS fund is shorter). Where the variable remuneration component is a "*particularly high amount*," at least 60% of the variable remuneration must be deferred. It is unclear what would constitute a "*particularly high amount*" for these purposes.[16]

When The final text of UCITS V is expected in the third quarter of 2013 and, as such, the restrictions on remuneration would likely be applicable from mid-2015.

Guidelines on remuneration policies and practices (MiFID)

On June 11, 2013, ESMA published the ESMA MiFID Guidelines with the aim of ensuring that firms' remuneration policies and practices are aligned with their conflict of interest and conduct of business obligations so that their clients' "*interests are not impaired by the remuneration policies and practices adopted by the firm in the short, medium and long term.*"[17] In addition, the ESMA MiFID Guidelines set out a number of examples of what ESMA considers to be good and bad practice in relation to firms' remuneration policies and practices.

Who *Entities:* MiFID investment firms,[18] including credit institutions (when providing investment services), UCITS managers and external AIFMs when providing the investment services of individual portfolio management or non-core services. These Guidelines are in addition to those placed on entities under CRD IV, the AIFMD and UCITS V. EU Member State competent authorities are also expected to comply with the ESMA MiFID Guidelines by incorporating them into their supervisory practices.

Individuals: staff who can have a material impact on the service provided and/or corporate behavior of the firm, including client-facing front-line staff, sales force staff and other staff indirectly involved in providing investment services and whose remuneration may create inappropriate incentives to act against the best interests of their clients.

What *Fixed pay*: the ratio between the fixed and variable components should be appropriate to encourage staff to act in the best interests of their clients (*e.g.*, a high variable component based on quantitative criteria could result in a focus on short-term gains over the client's best interests).

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[14] Article 14b(1)(j), Draft UCITS V Directive.

[15] Article 14b(1)(o), Draft UCITS V Directive.

[16] Article 14b(1)(n), Draft UCITS V Directive.

[17] Paragraph 13, ESMA Guidelines.

[18] As defined in Article 4(1)(1), MiFID.

Variable pay: when determining variable remuneration, firms should design remuneration policies and practices in such a manner as to not "*create incentives that may lead relevant persons to favour their own interest, or the firm's interests . . ., to the potential detriment of clients.*"[19]

Deferred payment: although no specific deferred payment framework is set out in the ESMA MiFID Guidelines, ESMA notes that aligning variable remuneration with the investment term of a product would be an example of good practice.

When Competent authorities must notify ESMA whether they comply or intend to comply with the ESMA MiFID Guidelines, stating their reasons for non-compliance where they do not comply or do not intend to comply, within two months of the date of publication of the translated versions by ESMA (the reporting requirement date). The ESMA MiFID Guidelines apply from 60 calendar days after the reporting requirement date.

Individual European Member State regulations on remuneration

The UK – Additional requirements

On July 18, 2013, the UK government published its response[20] to the June 19, 2013 UK Parliamentary Commission on Banking Standards Report on reform of the UK banking industry, which, in part, addressed the issue of remuneration. In its response, the UK government proposed that a number of the recommendations made in the Report be adopted on top of incoming EU-driven restrictions on remuneration and invited the UK Prudential Regulation Authority to consider a number of these recommendations. The UK government has proposed that the reforms be implemented through existing powers granted to the regulators – *e.g.*, under the Financial Services and Markets Act 2000 under which the Remuneration Code is currently issued – rather than via new legislation. Whilst the final position remains to be seen, at present the proposals under consideration are as set out below.

Who *Entities:* all banks and bank holding companies operating in the UK. It remains unclear whether the proposed regime would apply to other bank-like institutions.

Individuals: all Senior Persons (a proposed new category of individual that would replace the Significant Influence Function element on the current Approved Persons regime – *i.e.*, directors, partners and others exercising significant influence) and Licensed Staff (a proposed new broader category of individual that would replace the current Approved Persons regime) receiving variable remuneration.

What *Variable pay:* limits on the use and scale of sales-based incentives at both an individual and a business unit level with the regulator having the ability to limit or even prohibit such incentives. The new Remuneration Code should prohibit variable, performance-related remuneration for non-executive directors of banks.

Skin in the game: flexibility in the choice of instruments is recognised as vital, but greater use of non-equity instruments such as bail-in bonds[21] in deferred compensation structures should be considered by banks. Regulators should scrutinise these decisions.

Deferred payment: a significant proportion of variable remuneration should be in deferred form and, where necessary, deferred for up to 10 years.

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[19] Paragraph 14, ESMA Guidelines.

[20] The Government's response to the Parliamentary Commission on Banking Standards, HM Treasury and Department for Business, Innovation & Skills, CM 8661 (July 2013). The text of the report can be found **here**.

[21] Bail-in bonds are a type of debt that can either be written down or converted into equity by a regulator at certain trigger points, *e.g.*, if the financial institution issuing it is on the point of non-viability.

Clawback arrangements: the Government noted that it "*expects a proactive approach to the application of [the current performance adjustment (malus) policies that firms are obliged to have in place under the Remuneration Code] where there is evidence of misconduct.*"[22]

Change of employment: the Prudential Regulation Authority will be invited to consult on whether new rules are needed for "*a discretionary power to recover from a new employer the amount of deferred remuneration that would have been deducted from an employee guilty of misconduct, but could not be recovered because that individual switched employer and forfeited previously deferred remuneration*"[23] but was then "bought-out" by the new employer.

When The Government, the Bank of England and both the Prudential Regulation Authority and the Financial Conduct Authority are expected to set out their timetables for implementing these reforms in autumn 2013.

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[22] Paragraph 2.44, UK Government Response.

[23] Paragraph 2.52, UK Government Response.