European Regulatory Snapshot: Remuneration in the Financial Services Industry 2014

5 September 2014

Introduction

The move toward stricter regulation of remuneration in the financial services industry in the European Union has continued over the course of the past year, rendering the web of overlapping European Directives and local EU Member State law and regulation, each of which seeks to place limits on remuneration, ever more confusing[1]. This client memorandum aims to assist in navigating the new European labyrinth by providing a snapshot of the four main European Directives that regulate remuneration:

- Capital Requirements Directive IV[2] (CRD IV);
- Alternative Investment Fund Managers Directive[3] (AIFMD);
- fifth Undertakings for Collective Investment in Transferable Securities Directive[4] (UCITS V); and
- Markets in Financial Instruments Directive (MiFID).

With respect to MiFID, this memorandum discusses the European Securities Market Authority's (ESMA) Markets in Financial Instruments Directive[5] (MiFID I) Guidelines on remuneration policies and practices[6] as well as the impact of the revised Markets in Financial Instruments Directive (MiFID II). MiFID II has been split into a Directive[7] and a Regulation[8].

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[1] This memorandum updates our memorandum of August 2013 summarising these developments as of that time. That memorandum can be found **here**.

[2] 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**.

[3] 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**.

[4] 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 UCITS V can be found **here**.

[5] 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**.

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

[7] Directive 2014/65/EU of the European Parliament and of the Council of 15 May 2014 on markets in financial instruments and amending Directive 2002/92/EC and Directive 2011/61/EU (recast). The text of the Directive can be found **here**.

[8] Regulation (EU) No 600/2014 of the European Parliament and of the Council of 15 May 2014 on markets in financial instruments and amending Regulation (EU) No 648/2012. The text of the Regulation can be found **here**.

The memorandum then considers the additional requirements on remuneration that the UK is planning to impose in relation to the financial services industry, including in relation to clawback.

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 27 June 2013, sets out detailed requirements in relation to the remuneration policies and practices of banks and other financial institutions. Among others, CRD IV prescribes a cap on bonuses, which has proved particularly contentious, causing banks to redesign their remuneration packages across Europe and the UK government to challenge the bonus cap before the Court of Justice of the EU (ECJ).[9]

Who *Entities:* all[10] credit institutions and investment firms in the EU (jointly referred to as "institutions") as well as their non-EU subsidiaries and branches; in addition, EU subsidiaries and branches of financial institutions headquartered outside the EU.

Individuals: employees whose professional activities have a material impact on the risk profile of the relevant institution. Non-exhaustive qualitative and quantitative criteria for "material risk takers" are set out in a delegated regulation adopted by the European Commission, which came into force on 26 June 2014 and is directly applicable in all EU Member States:[11]

- Employees who meet any of 15 standard qualitative criteria relating to their role and decision-making power are deemed to be material risk takers, including among others, members of the management body, senior management, heads of material business units and staff taking credit risk and market risk exposures above certain limits specified in the delegated regulation.
- In addition, employees are presumed to be material risk takers if they meet any of the following quantitative criteria for the preceding financial year:[12] (i) their total pay is €500,000 or more; or (ii) they are part of the 0.3% of staff with the highest pay in the institution; or (iii) their total pay is equal to or greater than the lowest total pay of a member of senior management or of certain other material risk takers in the institution.

What *Bonus cap:* "variable pay" is capped at 100% of total fixed pay or, with shareholder approval,[13] 200% of total fixed pay. Variable pay includes payments or benefits that depend on

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[9] *United Kingdom v Parliament and Council*, Case C-507/13. The UK government is seeking the annulment of several remuneration-related provisions in CRD IV and CRR, including, among others, the bonus cap. The ECJ has set a hearing date of 8 September 2014. Information about the case can be found **here**.

[10] Subject to the "proportionality principle" expressed in Article 92(2), CRD IV: the remuneration requirements shall apply in a manner and to the extent that is appropriate to the institution's size, internal organisation and the nature, scope and complexity of its activities.

[11] Commission Delegated Regulation (EU) No 604/2014 of 4 March 2014 supplementing Directive 2013/36/EU of the European Parliament and of the Council with regard to regulatory technical standards with respect to qualitative and appropriate quantitative criteria to identify categories of staff whose professional activities have a material impact on an institution's risk profile. The text of the Delegated Regulation can be found **here**.

[12] Article 4(2)-(5), the Delegated Regulation provides for a limited possibility to rebut the presumption that staff members meeting one or more of the quantitative criteria, but not any of the qualitative criteria, are identified as material risk takers.

[13] Approval by either 66% of shareholders provided that at least half of the shares are represented or, failing that quorum requirement, 75% of the shares represented. The European Banking Authority has issued a Q&A on the specific procedure to be adopted at such shareholder meeting, as well as clarification that any voting rights of employees who are shareholders of the relevant institution and directly affected by the higher bonus cap should be ignored entirely. The text of the Q&A can be found

performance or, in exceptional circumstances, other contractual elements, but not those that "*form part of routine employment packages (such as healthcare, child care facilities or proportionate regular pension contributions)*".[14] EU Member States have the discretion to adopt stricter standards, *e.g.*, lower bonus caps.

The distinction between fixed and variable pay is by no means clear-cut, and will likely result in further guidance at the European level. In particular, the introduction by several banks of role-based allowances that are intended to be treated as fixed pay has been widely scrutinized. The European Banking Authority (EBA) is currently reviewing these practices, and the results will inform the update of the EBA guidelines on remuneration policies. A consultation on the revised guidelines is expected to be launched by the end of 2014.

Discount rate: for purposes of calculating the bonus cap, EU Member States may allow institutions to apply a discount rate to up to 25% of the variable pay, provided it is paid in instruments deferred for a minimum period of five years. The European Banking Authority (EBA) has published guidelines on the applicable notional discount rate for variable pay, which has the effect of increasing the bonus cap.[15]

Skin in the game: at least 50% of any variable pay must consist of shares or equivalent ownership interests (or, for non-listed institutions, share-linked or equivalent non-cash instruments) or certain classes of Additional Tier 1, Tier 2 and other instruments that fulfil specific requirements as specified in a delegated regulation adopted by the European Commission.[16]

Deferred payment: at least 40% of any variable pay must be deferred over a period of at least three to five years. In the case of variable pay of a particularly high amount, the minimum amount to be deferred is increased to 60%.

Clawback arrangements: up to 100% of variable pay shall be subject to clawback or malus arrangements. Institutions are required to set specific criteria for such arrangements, particularly in situations where the employee contributed to conduct which resulted in significant losses to the institution or failed to meet appropriate fit and proper standards.

Disclosure: another novelty, which has proved contentious, is the increased disclosure requirements relating to remuneration policies and practices, which are set out in the Capital Requirements Regulation[17] and, as such, directly applicable in all EU Member States. Among others, institutions must disclose the ratios between fixed and variable pay and the number of individuals being remunerated €1 million or more per financial year, broken down into pay bands of €500,000 for remuneration between €1 million and €5 million and into bands of €1 million for remuneration of €5 million and above. EU Member States may also require

[14] Recital 64, CRD IV.

[15] Guidelines on the applicable notional discount rate for variable remuneration of 27 March 2014 (EBA/GL/2014/01). The text of the Guidelines can be found **here**.

[16] Article 94(1)(l), CRD IV and Commission Delegated Regulation (EU) No 527/2014 of 12 March 2014 supplementing Directive (EU) No 2013/36/EU of the European Parliament and of the Council with regard to regulatory technical standards specifying the classes of instruments that adequately reflect the credit quality of an institution as a going concern and are appropriate to be used for the purposes of variable remuneration. The text of the Delegated Regulation can be found **here**.

[17] Regulation (EU) No 575/2013 of the European Parliament and of the Council of 26 June 2013 on prudential requirements for credit institutions and investment firms and amending Regulation (EU) No 648/2012 (CRR). The text of the Regulation can be found **here**.

disclosure of the total remuneration of each member of the institution's management body or senior management.[18] These disclosures must be published publicly by institutions at least on an annual basis, in conjunction with the publication of the financial statements.[19]

When EU Member States were required to implement CRD IV into national law with effect from 1 January 2014. The bonus cap applies to remuneration for "*services provided or performance from the year 2014 onwards, whether due on the basis of contracts concluded before or after 31 December 2013.*"[20] The cap will thus kick in for bonuses payable in 2015.

Investment funds (AIFMD)

On 3 July 2013, ESMA adopted the Guidelines on sound remuneration policies under the AIFMD,[21] 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-EU AIFMs should bear in mind the applicable disclosure and transparency requirements described in our 4 June 2013 client memorandum.[22]

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]*."[23]

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.*"[24] There is no prescribed maximum or minimum percentage figure.

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[18] Article 450(1), CRR.

[19] Article 433, CRR.

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

[21] ESMA Guidelines on sound remuneration policies under the AIFMD, ESMA/2013/232, 3 July 2013. The text of the guidelines can be found **here**.

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

[23] Paragraph 1, Annex II to AIFMD.

[24] Paragraph 94, ESMA AIFMD Guidelines.

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 22 July 2013. The initial one-year transitional period for those AIFMs performing activities under the AIFMD before 22 July 2013 has now ended. For non-EU AIFMs, the regime will be applicable upon authorisation in an EU Member State.

Managers of UCITS funds (UCITS V Directive)

On 23 July 2014, the Council of the EU announced that it has adopted the text of the UCITS V Directive that the European Parliament had adopted on 15 April 2014. The publication of the Directive in the Official Journal of the EU (OJ) is expected to occur in Q4 2014. UCITS V objectives are to enhance the depositary's duties and liabilities; introduce common standards for sanctions arising from UCITS V; and create remuneration policies for investment and management companies.

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

Individuals: the definition of "identified staff" in this context is broader than that 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 (including employees whose total remuneration places them in the bracket of senior management), risk takers and personnel in control functions. ESMA is mandated to issue non-binding guidelines that are expected to provide further clarification on the categories of staff falling within the scope of the rules and the application of proportionality.

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 remuneration component.*"[25] 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 and vest only if sustainable and justified. Where the financial performance of the UCITS manager or the UCITS fund is "*subdued or negative*," the variable compensation "*shall generally be considerably contracted*."[26] 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. The

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

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

50% minimum will not apply if UCITS accounts for less than 50% of the total portfolio managed by the entity.[27]

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.[28]

When The Directive should be adopted and should be published in the OJ around Q4 2014. Member States will have 18 months to implement the Directive following its entry in the OJ.

Markets in Financial Instruments Directive

MiFID I was adopted in 2004 as a framework directive and supplemented by an implementing directive and regulation. MiFID I was implemented into Member State law in 2007. Following the European Commission's legislative proposals to amend MiFID I, the text of MiFID II (both the Directive and the Regulation) was published in the Official Journal of the EU on 12 June 2014. Whereas MiFID I and its implementing measures do not specifically mention remuneration issues, their importance has been highlighted by MiFID II, which will provide for explicit requirements in relation to remuneration policies and arrangements.

ESMA Guidelines on remuneration policies and practices (MiFID I): on 11 June 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.*"[29] 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,[30] 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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[27] Article 14b(1)(m) UCITS V Directive.

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

[29] Paragraph 13, ESMA Guidelines.

[30] 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.*"[31]

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.

ESMA consultation on remuneration and practices (MiFID II): a large number of elements of the MiFID II Directive need to be further specified in delegated acts to be adopted by the European Commission and technical standards. ESMA published a discussion paper on MiFID II technical standards and a consultation paper relating to its technical advice to the European Commission on 22 May 2014[32]. MiFID II introduces a new, explicit requirement on the management bodies of investment firms to "*define, approve and oversee […] a remuneration policy of persons involved in the provision of services to clients aimed at encouraging responsible business conduct, fair treatment of clients as well as avoiding conflicts of interest in the relationships with clients.*"[33] In its consultation paper, ESMA clarifies that the principles included in the 2013 ESMA guidelines on remuneration under MiFID I should form the basis of its advice on the implementing measures for MiFID II and sets out its technical advice for the implementation of MiFID II. It is worth noting that these standards will be in addition and without prejudice to the provisions on remuneration under CRD IV and AIFMD.

Who *Entities:* same as under MiFID I (see above).

Individuals: all relevant persons who can have a material impact, directly or indirectly, on investment and ancillary services provided by the firm, regardless of whether the clients are retail or professional, to the extent that the remuneration of such persons and related incentives – including non-financial remuneration such as in-kind benefits and career progression – may create a conflict of interest that encourages them to act against the interests of the clients.[34]

What *Remuneration design policy:* investment firms should define their remuneration policies under appropriate internal procedures taking into account the interests of clients, with a view to ensuring that clients are treated fairly and their interests are not impaired by the remuneration practices adopted by the firm in the short, medium or long term. In particular, remuneration policies and practices should be designed in such a way so as not to create incentives that may lead relevant persons to favour their own interests or the firm's interests to the potential detriment of clients.[35]

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[31] Paragraph 14, ESMA Guidelines.

[32] ESMA Consultation Paper MiFID II/MiFIR, 22 May 2014 (ESMA/2014/549). The text of the Consultation Paper can be found **here**.

[33] Article 9(3), MiFID II Directive.

[34] Article 2, Draft Technical Advice, Section 2.11 Consultation Paper.

[35] Article 3, Draft Technical Advice, Section 2.11 Consultation Paper.

Governance: the design of the firm's remuneration policy should be approved by the management body of the firm after taking advice from the compliance function. The day-to-day implementation of the remuneration policy and the monitoring of compliance risk related to the policy should be the responsibility of the senior management of the firm.[36]

Variable pay: remuneration and similar incentives may be partly based on commercial criteria, but should be principally based on criteria reflecting compliance with the applicable regulations, the fair treatment of clients and the quality of services provided to clients, so that an appropriate balance between fixed and variable components of remuneration is maintained at all times, and provided that in any event the remuneration structure does not favour the interests of the firm or its staff against the interests of any clients.[37]

When ESMA is required to provide its technical advice to the European Commission by the end of 2014. Delegated acts under MiFID II are required to be transposed by member states by June 2016, and MiFID II will become applicable for the most part from December 2016.

Individual European member state regulations on remuneration

The UK – Additional requirements

On 30 July 2014, the UK's twin regulators, the Prudential Regulation Authority (PRA) and the Financial Conduct Authority (FCA) published a consultation paper[38] in response to the remuneration aspects of the 19 June 2013 UK Parliamentary Commission on Banking Standards (PCBS) Report on the reform of the UK banking industry. The UK government had already published its response[39] on 18 July 2013.

In July 2014, the PRA also published a policy statement[40] in relation to clawbacks, amending the current Remuneration Code with effect from 1 January 2015.

Clawback (from 1 January 2015)

Who *Entities:* all PRA-regulated banks, building societies, investment firms and the UK operations of the non-EEA equivalent thereof.

Individuals: Remuneration Code staff, which includes senior management, risk takers, staff engaged in control functions and any employees receiving total remuneration that takes them into the same remuneration bracket as senior management and risk takers, whose professional activities have a material impact on the firm's risk profile.

What *Clawback arrangements:* any variable remuneration awarded on or after 1 January 2015 is subject to clawback[41]. Firms must make all reasonable efforts to recover an appropriate amount corresponding to some or all vested variable remuneration where either of the following circumstances arises during the period in which clawback applies: (a) there is reasonable

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[36] Articles 4 & 5, Draft Technical Advice, Section 2.11 Consultation Paper.

[37] Article 6, Draft Technical Advice, Section 2.11 Consultation Paper.

[38] Strengthening the alignment of risk and reward: new remuneration rules, Prudential Regulation Authority and Financial Conduct Authority, CP15/14/FCA CP14/14 (July 2014).

[39] 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**.

[40] Clawback, PRA Policy Statement (PS 7/14) (July 2014).

[41] SYSC 19A.1.3R(3), PRA Handbook.

evidence of employee misbehaviour or material error; or (b) the firm or the relevant business unit suffers a material failure of risk management. The firm must take into account all relevant factors (including, where the circumstances described in (b) arise, the proximity of the employee to the failure of risk-management in question and the employee's level of responsibility) in deciding whether and to what extent it is reasonable to seek recovery of any or all of their vested variable remuneration[42].

When The PRA's "clawback" regulations will come into force on 1 January 2015 and apply in respect of remunerations awarded on or after 1 January 2015. Variable remuneration is subject to clawback for a period of at least seven years from the date on which it is awarded[43].

PRA/FCA consultation

Who *Entities:* all regulated banks, building societies, investment firms and the UK operations of the non-EEA equivalent thereof.

Individuals: Remuneration Code staff, which includes senior management, risk takers, staff engaged in control functions and any employees receiving total remuneration that takes them into the same remuneration bracket as senior management and risk takers, whose professional activities have a material impact on the firm's risk profile.

What *Deferral:* the PRA/FCA are proposing larger deferral periods to "align the risk horizons of key individuals further with the longer-term safety and soundness of the firms for which they work". The PRA/FCA are therefore proposing the following two-level minimum deferral and vesting periods. For Senior Managers: (a) deferral for no less than seven years; (b) first vesting of deferred remuneration no earlier than the third anniversary of award; and (c) vesting no faster than pro rata between years three and seven. For all other material risk takers: (a) deferral for no less than five years; (b) first vesting of deferred remuneration no earlier than the first anniversary of award; and (c) vesting no faster than pro rata.

Clawback: the FCA is consulting as to whether it should adopt clawback rules in line with the PRA's clawback rules (see above). The PRA/FCA are further consulting on extending the seven-year clawback period by a further three years for senior managers if there are outstanding investigations underway at the end of the seven years.

Bailed-out banks: bank management should be incentivised to avoid bank failures. The PRA/FCA are therefore proposing to make explicit in the remuneration rules a presumption against payment or vesting of all discretionary payments, including payment for loss of office and discretionary pension benefits where the bank requires taxpayer support.

Buy-outs: in response to the practice of buy-outs (whereby a firm cancels the unvested bonus awards of staff who are leaving one firm to join a competitor and the competitor "buys out" the forfeited award), the PRA/FCA, recognising the complexities involved, have outlined four broad potential approaches: (a) banning buy-outs; (b) requiring firms to continue to honour unvested awards even if a staff member leaves to join a competitor; (c) applying malus to bought-out awards (in practice, malus would either effectively become a regulatory disciplinary procedure if the regulator exercises discretion to recover buy-outs where the previous employers could have applied malus, or, if buy-outs are to be held on trust on behalf of the former employer, the buy-outs might be reduced, although, again, the regulator would be involved in deciding on the

[42] SYSC 19A.3.5.1R(2), PRA Handbook.

[43] SYSC 19A.3.51R(3), PRA Handbook.

applicability of malus); and (d) relying on clawback of both deferred and undeferred variable remuneration awards by banks and other financial institutions.

Risk adjustment: the PRA is proposing a rule requiring all UK-regulated firms, when determining the size of their annual bonus pools, to calculate profit for this purpose by deducting a “prudential valuation adjustment” figure from the fair value accounting profit.

Disclosure: in light of the new statutory regime for unquoted companies that significantly enhances remuneration reporting requirements at the board level, the PRA/FCA have decided against introducing further disclosure requirements at this juncture.

Remuneration of non-executive directors: the PRA/FCA have backed the PCBS recommendation that non-executive directors should not receive variable remuneration, proposing that this should be made explicit in the Remuneration Code.

Sales-based incentives for retail staff: recognising that it introduced guidance in January 2013 to help firms manage the risks associated with sales-based incentive structures, the FCA does not intend to immediately address this issue further, although it does intend to revisit financial incentive schemes for sales staff as it implements MiFID II.

When The consultation period ends on 31 October 2014. The PRA/FCA expect to publish separate policy statements (including final rules and related guidance thereafter). The new remuneration requirements are expected to come into force for awards made for performance periods starting on or after 1 January 2015.

If you have any questions regarding the matters covered in this publication, please contact any of the lawyers listed below or your regular Davis Polk contact.

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