

10/19***

Financial Services Authority

Revising the Remuneration Code

July 2010

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The Financial Services Authority invites comments on this Consultation Paper. Comments should reach us by 8 October 2010.

Comments may be sent by electronic submission using the form on the FSA's website at (www.fsa.gov.uk/Pages/Library/Policy/CP/2010/cp10_19_response.shtml).

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It is the FSA's policy to make all responses to formal consultation available for public inspection unless the respondent requests otherwise. A standard confidentiality statement in an e-mail message will not be regarded as a request for non-disclosure.

A confidential response may be requested from us under the Freedom of Information Act 2000. We may consult you if we receive such a request. Any decision we make not to disclose the response is reviewable by the Information Commissioner and the Information Tribunal.

Copies of this Consultation Paper are available to download from our website – www.fsa.gov.uk. Alternatively, paper copies can be obtained by calling the FSA order line: 0845 608 2372.

List of acronyms used in this Consultation Paper

AIFMD	Alternative Investment Fund Managers Directive
AIFM	Alternative Investment Fund Managers
ARROW	Advanced Risk-Responsive Operating FrameWork
BCBS	Basel Committee on Banking Supervision
BCD	Banking Consolidation Directive
BIPRU	Prudential sourcebook for Banks, Building Societies and Investment Firms
BTS	Binding Technical Standards
CAD	Capital Adequacy Directive
CBA	Cost Benefit Analysis
CEBS	Committee of European Banking Supervisors
CEO	Chief Executive Officer
CESR	Committee of European Securities Regulators
CP	Consultation Paper
CRD3	The latest amendments to the Capital Requirements Directive
EEA	European Economic Area
EMEA	Europe, Middle East and Africa
EU	European Union
FAQ	Frequently Asked Questions
FS	Feedback Statement
FSB	Financial Stability Board

FSMA	The Financial Services and Markets Act 2000
GABRIEL	GATHERing Better Regulatory Information ELelectronically
HR	Human Resources
ICAAP	Internal Capital Adequacy Assessment Process
IOSCO	International Organisation of Securities Commissions
LTIP	Long Term Incentive Plan
MFA	Market Failure Analysis
MiFID	Markets in Financial Instruments Directive
PERG	The Perimeter Guidance Manual
PS	Policy Statement
RemCo	Remuneration Committee
RPS	Remuneration Policy Statement
SIF	Significant Influence Function
SREP	Supervisory Review and Evaluation Process
SYSC	Senior Management Arrangement, Systems and Controls (sourcebook)
UCITS	Undertakings for Collective Investment in Transferable Securities

1 Overview

Purpose

- 1.1 This Consultation Paper (CP) proposes, and formally consults on, changes to our Remuneration Code (the Code), as set out in the FSA Handbook (see SYSC¹ 19). Chapter 2 sets out the reasons why these changes are required. These include the passing of the Financial Services Act 2010 in April 2010, and the amendments to the Capital Requirements Directive (CRD3) which come into force on 1 January 2011. As its name implies, CRD3 is principally concerned with revisions to capital requirements, but it also contains important provisions relating to remuneration practices.²
- 1.2 We also report on the implementation of the Code so far, and on the progress made in achieving international alignment of remuneration principles in the G20 countries and the EU. These reports are set out in Annexes 3 and 4.
- 1.3 As Chapter 2 explains, agreement on the CRD3 text was only reached in early July, which has given us a tight timetable to consult and prepare a Policy Statement (PS) before the rules have to be in force at the beginning of 2011. The Financial Services and Markets Act 2000 (FSMA) requires us to undertake and publish a Cost Benefit Analysis (CBA) of the CP's proposals. We estimate this process (which involves surveying a sample of firms) will take about six weeks.
- 1.4 As a result of the timing constraint, we have decided to publish the CP before the CBA is completed to give firms information about the prospective changes to the Code, and allow as much time as we can for the consultation. The CBA results, which will form Annex 1 of this CP, will be published separately in early September and will be fed into the PS. We may then need to revise discretionary aspects of the Code in September if the CBA results indicate this is appropriate. The full timetable is set out in paragraph 1.19.
- 1.5 The CRD3 text contains several ambiguities that may be resolved during the review which takes place in September and October this year by the Commission's jurist/linguists process. In addition, a number of key issues have been remitted to the

1 SYSC: Senior Management Arrangement, Systems and Controls (sourcebook).

2 The FSA published a CP on 23 July 2010 in order to consult on the capital proposals in CRD3 (CP 10/17: Strengthening Capital Standards 3 – feedback to CP09/29), final rules for CRD2 and further consultation – www.fsa.gov.uk/pages/Library/Policy/CP/2010/10_17.shtml.

Committee of European Banking Supervisors (CEBS). CEBS plans to publish guidelines for consultation on these issues, as well as on other key issues of interpretation, such as applying provisions in the text on proportionality, in October. As a result the CP can only offer a provisional interpretation on a number of aspects of the CRD3 text.³ We may clarify further in our PS, which we intend to issue in November.

- 1.6 We also propose a set of transitional provisions for the Handbook which will help implement the CRD3 rules proportionately.
- 1.7 We are grateful to the banks, building societies and their trade associations, that have given us feedback on implementing the Code so far, and also to other industry professionals including consulting firms and commentators, for their ideas and views. Our analysis has benefited greatly, and been influenced by, the work that we have done with supervisory colleagues from other financial centres, conducted within working groups of the Financial Stability Board (FSB) and CEBS.

Background

- 1.8 Our first CP on remuneration was issued in March 2009.⁴ After consultation, this was followed by a PS⁵ in August 2009, which reflected feedback from the consultation and an assessment of progress in international alignment. The PS incorporated the Code into the Handbook for a group of the largest banks, building societies and broker dealers, with effect from 1 January 2010. The PS made it clear that we expected the firms in scope to materially comply with the Code by that date.
- 1.9 We wrote to all the firms within the scope of the Code on 1 September 2009 asking them to supply us with a Remuneration Policy Statement (RPS), to help us understand their remuneration policies and compliance with the Code. We asked them to provide answers to a set of questions, and to complete tables with information on remuneration profiles and structures.
- 1.10 We responded to numerous questions from firms about the RPS process during September and issued a set of FAQs to all the firms in scope in October. We used that communication to clarify that we expected the payment of any remuneration made after the Code came into force on 1 January 2010 to comply with the Code. Firms were asked not to communicate the results of their 2009 remuneration reviews or distribute them to staff without our sign-off.
- 1.11 The 2009 reviews focused on remuneration structures such as deferral, but we consider issues such as governance and risk adjustment of bonus pools to be equally important. We have made it clear to the current firms in scope that these are areas we will focus on during 2010/11.

3 We do not intend to be super-equivalent to CRD3 unless required to do so by domestic legislation (e.g. to fulfil our duty to have rules consistent with the Financial Service Act). We intend to mirror the CRD3 text from the Directive although there are some provisions carried over from the 2009 Code.

4 www.fsa.gov.uk/pages/Library/Policy/CP/2009/09_10.shtml

5 www.fsa.gov.uk/pages/Library/Policy/Policy/2009/09_15.shtml

Summary of our proposals

- 1.12 We are consulting on a number of changes to the Remuneration Code, as set out in Appendix 1. Chapter 2 explains that the changes will:
- incorporate requirements relating to remuneration in the Financial Services Act, which received Royal Assent on 8 April 2010. The Act requires us to ensure that the Code is consistent with the Implementation Standards set by the FSB.⁶ Although the Code is substantially consistent with the FSB standards, we need to make some changes to reflect this requirement. The Act also enables us to render void provisions of remuneration agreements that breach specified provisions of the Code, and changes are required to give effect to this;
 - incorporate the remuneration provisions of CRD3. Again, the Code is substantially consistent with CRD3, but we need to make some changes. We will amend the wording of the Code to ensure it is fully aligned with the Directive, even where there is no change to the substance of the provision;
 - adjust the Code to reflect experience gained in implementing the Code since its inception on 1 January 2010; and
 - incorporate a recommendation of *The Walker Review*⁷ of corporate governance in UK banks and other financial institutions, published in November 2009.
- 1.13 Significant changes that we propose to make to the Code are set out in Chapters 3 and 4. These include:
- Scope of the Code: as required by CRD3, this will include all banks, building societies and Capital Adequacy Directive (CAD) investment firms. CAD investment firms includes a large number of asset managers (including most hedge fund managers and all UCITS investment firms), plus some firms which engage in corporate finance, venture capital, the provision of financial advice, brokers, several multilateral trading facilities and others. In all, over 2,500 FSA-authorized firms will be within the Code's scope.
 - Recasting of certain existing evidential provisions and guidance into rules, to reflect the binding nature of the CRD3 provisions once they come into force.
 - A commitment to adopt a proportional approach in applying the rules, reflecting CRD3, which says that 'institutions shall comply with [...] principles in a way and to the extent that is appropriate to their size, internal organisation and the nature, the scope and the complexity of their activities'.
 - New rules that require firms to ensure that total variable remuneration does not limit their ability to strengthen their capital base, and that total variable remuneration must generally be significantly reduced in circumstances where the firm produces subdued or negative financial performance.

⁶ Chapter 2 sets out details of the work of the Financial Stability Board on remuneration.

⁷ <http://webarchive.nationalarchives.gov.uk/>

- A new rule to act on the voiding provisions of the Financial Services Act 2010. This rule defines instances where breaches of the Code may render a contract void, and require recovery of payments to be made.
- New rules on remuneration structures, covering the deferral of variable remuneration, ‘ex-post’ performance adjustment,⁸ and guaranteed minimum bonuses.
- Changes in the group of employees to which the Principles of the Code apply.

Summary of our reports

- 1.14 This paper includes two reports. Annex 3 reports on the implementation of the Code since it came into effect on 1 January 2010. From November 2009 to April 2010 we examined the remuneration policies of the firms in scope. It ensured that the remuneration of firms that distributed awards after 1 January 2010 were compliant.
- 1.15 It will take time to thoroughly assess the impact of the Code in reducing excessive risk and in contributing to effective risk management. However we believe that the implementation of the Code has already led to improvements in remuneration practices in the London market.
- 1.16 Annex 4 reports on progress in achieving international alignment. Drawing on a review of the implementation of the FSB’s Principles and Standards,⁹ it notes that national supervisors have done much to implement remuneration principles. Although international alignment has increased, it remains inconsistent. A difference has appeared between countries that are implementing the FSB’s standards by enforceable rules or regulations, and those who are incorporating it into supervisory processes via guidance. Further work is underway to increase the consistency of approach across the G20 countries.
- 1.17 The UK has adopted enforceable rules, via the Remuneration Code, as have many other EU countries. CRD3 will require the authorities to adopt enforceable rules across the EU.

Structure of the paper

- 1.18 The rest of the CP is set out as follows:
- Chapter 2 explains why we are revising the Code, describing the developments that have taken place since our PS introduced the Code in August 2009.
 - Chapter 3 explains the proposed revisions, and gives some guidance on how we plan to implement them.

⁸ See Glossary

⁹ www.financialstabilityboard.org/publications/r_090925c.pdf

- Chapter 4 focuses on implementation. We plan to assess how the firms currently in scope are complying by using a two stage approach. Firstly, we discuss the question of proportionality and indicate how we plan to apply it. We then discuss our views on risk adjustment.
- Chapter 5 sets out next steps and provides early guidance on what firms should do to prepare for the introduction of CRD3.
- Annex 1 will provide a CBA. This will be published in the first week of September 2010.
- Annex 2 analyses how our proposals are compatible with our statutory objectives and the principles of good regulation.
- Annex 3 reports on the implementation of the Code since it was incorporated into the Handbook on 1 January 2010.
- Annex 4 reviews the current state of international alignment in remuneration principles since the publication of our PS in August 2009.
- Annex 5 provides our proposals on proportionality.
- Annex 6 lists the consultation questions.
- Appendix 1 contains the draft text that is proposed to be used to incorporate the revised draft Code into the Handbook.

Next steps

1.19 The timetable for applying the revised Code is as follows:

- 29 July 2010: publish CP;
- first week of September 2010: publish Annex 1 of the CP, reporting on our CBA of the proposals;
- 8 October 2010: consultation period closes;
- November 2010: publish PS;
- 1 January 2011: Handbook rules come into effect for remuneration in respect of 2010 performance.

Who should read this paper and to whom do our proposals apply?

1.20 This CP should be read in particular by all FSA authorised banks, building societies and CAD investment firms. This audience corresponds to firms subject to the Markets in Financial Instruments Directive (MiFID), although exempt CAD firms

are not caught.¹⁰ The CP will also be of interest for other FSA-authorised firms, as the scope of the Code will probably extend in future to other firms via other Directives. Shareholders, creditors and other stakeholders of firms covered may also find this paper of value.

- 1.21 This paper may also be of interest to trade associations and consumer groups.

10 See PERG 13 for guidance on the scope of a CAD investment firm.

2 Why we are revising the Code

- 2.1 In PS09/15 (published in August 2009), we agreed to review our Code, and amend it as necessary to take account of new developments. These include:
- the coming into force (on 8 June 2010) of the provisions relating to remuneration within the Financial Services Act 2010;
 - the need to take into account recent international work on remuneration principles under the auspices of the FSB and at the EU level, most notably the amendments to the CRD3;
 - Sir David Walker’s review of corporate governance in UK banks and other financial institutions, published in November 2009;
 - lessons learned from our experience in implementing the Code so far, as set out in Annex 3; and
 - the need to review whether to extend the Code to other financial institutions.
- 2.2 We conducted a Market Failure Analysis (MFA) in last year’s Consultation Paper (CP09/10) when we applied the Code to large banks, building societies and broker-dealers. We also considered potential remuneration risks at financial institutions in other sectors in our December Feedback Statement (FS). Although there may have been instances of market failure, we did not deem them to be of sufficient magnitude to warrant action ahead of EU legislative changes.
- 2.3 All substantive changes to the Code proposed in this CP are the result of legislative requirements, which are discussed in more detail below. We believe that the MFA has not changed fundamentally for the large banks, building societies and broker-dealers in scope. Our position on extending the scope to other firms also remains unchanged.

The UK Financial Services Act 2010

- 2.4 The Financial Services Act 2010 was enacted on 8 April 2010. Sections 4 to 6 of the Act contain a number of provisions concerning remuneration. The Treasury can now require regulated firms to disclose remuneration-related matters. We have also been granted new powers and duties, which came into force on the same date.
- 2.5 Sections 4 to 6 reinforce the key principles of our Code, notably the need to align remuneration practices with effective risk management, and generally do not require us to make changes to the Code. However, there are two provisions within the Act relating to remuneration, which require us to consult on changes to the Code.
- 2.6 Firstly, we have been given express powers to prohibit employees (or groups of employees) from being remunerated in a specific way. Remuneration contracts that breach prohibitions on forms of remuneration under the Code can be rendered void, and the Act enables us to provide for recovery of any payments made, or other property transferred.
- 2.7 This CP will consult on how we might apply this voiding power under the Code (Chapter 3). It is likely that we will limit its application to instances where breaches of the Code can be most clearly identified and measured.
- 2.8 Secondly, under section 6 of the Act, our rules must ensure that the remuneration policies of firms subject to our Code are consistent with the FSB's implementation standards. As noted below, the Code is already largely consistent with these standards, but some changes will be needed (and we must also take into account other international standards).
- 2.9 Under the Act, the Treasury has powers enabling it to implement the remuneration disclosure provisions of CRD3. There is also potential for disclosure provisions to be implemented under the FSA's powers. We are currently considering the appropriate approach to implementing these requirements.

The FSB's principles and standards

- 2.10 The FSB published a set of high level principles in April 2009, which were endorsed by the G20 summit meeting in London (for further details see Annex 4). These were followed by more detailed implementation standards in September, which were approved at the G20 meeting in Pittsburgh. The implementation standards were designed to prioritise and give more detail on areas that should be addressed by firms and supervisors so the principles could be effectively globally implemented.
- 2.11 We were closely involved in discussions which led to the FSB's documents, and our existing Code is largely consistent with the FSB's principles and standards. There are, however, differences between the Code and the implementation standards, which mainly reflect how international thinking has evolved on remuneration principles between the publication of the Code in March 2009 and the standards in September 2009.

- 2.12 We therefore propose a number of changes to the Code to increase alignment with the FSB's implementation standards; details are set out in the following chapter.

The amendments to the Capital Requirements Directive (CRD3)

- 2.13 On 7 July 2010, the European Parliament approved the text of the new EU Directive to amend CRD3. The EU is expected to publish the final text in its Official Journal towards the end of 2010.
- 2.14 Among other things, CRD3 will require firms' remuneration policies and practices to take into account several principles covering the structure, amount and timing of bonus payments. Depending on the interpretation of CRD3, these principles could go beyond the FSB's standards concerning limits on the cash proportion of bonuses and the composition of payments.¹¹
- 2.15 Our current Code is generally consistent with the CRD3 text, although in some instances elements of guidance will need to be converted into rules to satisfy our obligations to implement CRD3. This will also, in most cases, satisfy our duty to have rules consistent with FSB Standards.
- 2.16 There is however a major difference in the scope of application. The current Code (and the FSB Standards) applies to a limited number of large firms. CRD3 applies to all banks and building societies and investment firms to which the Market in Financial Instruments Directive (MiFID) rules apply,¹² which is a much larger group. In Handbook terms, CRD3 remuneration requirements apply to firms to which the Prudential Sourcebook for Banks, Building Societies and Investment firms (BIPRU)¹³ applies. We estimate that over 2,500 firms will be subject to CRD3's remuneration requirements.
- 2.17 CRD3 requires us to consider the size, nature and complexity of the institutions within its scope. This proportionality clause is of great importance and will be discussed in further detail in Chapter 4.
- 2.18 We are aware of, and are contributing to, further work that is being carried out by the Committee of European Banking Supervisors (CEBS) to provide guidance on implementing the text of CRD3. We intend to take account of this guidance when it is published in line with our duty to comply or explain with CEBS guidelines under CRD3.

The Walker Review recommendations on remuneration

- 2.19 In 2009, Sir David Walker conducted a review of corporate governance in UK banks and other financial institutions (*The Walker Review*) and published his final recommendations on 26 November 2009. We believe that our Code is currently

11 See Chapter 3 – Proportion in Shares – for our proposals

12 Excluding exempt CAD firms (see PERG 13).

13 CRD3 does not apply to third country firms, but Member States have obligations not to provide more favourable treatment.

well aligned with *The Walker Review* recommendations. The one area where we propose to change the Code is in relation to long term incentive plans, which we discuss in Chapter 3.

- 2.20 *The Walker Review* makes 11 recommendations on remuneration. We believe our Code is largely aligned with these recommendations, notably: roles and responsibilities of remuneration committees, skills and experience of members, responsibility for approving and reviewing remuneration policy; risk management input into the remuneration process; and incentive structures for ‘high end’¹⁴ employees.
- 2.21 *The Walker Review* states that: ‘Executive board members and ‘high end’ employees should be expected to maintain a shareholding or retain a portion of vested awards in an amount in line with their total compensation on a historic or expected basis, to be built up over a period at the discretion of the remuneration committee’. We believe that this recommendation is largely met through the deferral and vesting conditions stipulated under our Code. We are also proposing a rule requiring firms to have in place appropriate retention policies in place for share-based awards in line with CRD3 and the FSB (see chapter 3).

Experience gained from the 2009 remuneration reviews

- 2.22 Annex 3 reports on our implementation of the Remuneration Code in respect of firms’ 2009 remuneration arrangements. We gained valuable experience from applying the Code and have received feedback from firms which we have considered as far as possible in our proposed revisions. We summarise the key points below:
- a) For the 2009 reviews, provisions relating to the remuneration structures of ‘Principle 8’¹⁵ (P8) employees were expressed as guidance and there was a lack of clarity around implementation. For 2010, we propose to convert the provisions for P8 employees into rules. This will also make the Code consistent with CRD3.
 - b) There were difficulties in firms consistently interpreting the definition of P8 employees as set out in the Code. As a result we clarified this in the ‘supervisory framework’ issued to firms in December 2009. We are proposing additional clarification of the P8 definition in this CP.¹⁶
 - c) We encountered a number of time pressures during last year’s assessment of firms’ remuneration arrangements. To improve the process this year, we have decided to separate the assessment process into two stages, with a review of remuneration policies occurring for most firms in Q4 2010, and sign-off of the remuneration data at an appropriate time ahead of firms announcing their awards.

14 Where ‘high end’ relates to individuals who as executive board members or other employees perform a significant influence function for the entity or whose activities have, or could have, a material impact on the risk profile of the entity. This definition is consistent with the classification of employees to whom certain parts of the Code applied last year.

15 P8 is defined in the Glossary (Annex 7)

16 We are now calling this group ‘Code Staff’ – see Glossary.

Extending the Code to other parts of the financial sector

- 2.23 Last year we explored whether, and if so how, the Code should be extended to other parts of the financial sector. The results were published in an FS in December 2009 (FS 09/5).¹⁷ We concluded that remuneration risks could be found in other parts of the financial sector, particularly in larger and more complex firms, but they were not of such seriousness as to warrant action by the UK ahead of international agreement. In practice, this meant we would wait for the forthcoming EU Directives to be implemented so we could move in tandem with other EU member states.

International developments

- 2.24 Two other EU Directives are likely to come into effect in 2012 or 2013 which will deal with remuneration issues: The Alternative Investment Fund Managers Directive (AIFMD) will extend the scope to fund managers and the Solvency II Directive will cover insurance companies. Consequently, some firms within the scope of CRD3 will potentially also be subject to AIFMD, and this question of overlap will need to be addressed as the AIFMD details are finalised. Key details, such as applying proportionality clauses, have yet to be agreed for both Directives. Overlap with Solvency II may also occur where groups contain firms subject to different directives. More information on AIFMD and Solvency II can be found in Annex 4.
- 2.25 The FSB has recommended that its standards should be applied to ‘all significant financial institutions’, but has left national authorities to determine which institutions fall into that category. Some countries have already included major insurance companies and asset managers in their implementation of FSB standards. However it is likely that a substantial number of FSB member states in the EU will wait until the introduction of the EU Directives.

Competition between firms in and out of scope

- 2.26 The firms currently within scope of the Code have expressed concerns about losing their staff to competitors outside the scope of the Code. For example, those firms with investment banking business are concerned that they are at a competitive disadvantage relative to hedge fund managers.¹⁸ Smaller firms, both retail and wholesale, have complained they will be disadvantaged against competitors that are currently out of scope.
- 2.27 The introduction of CRD3, and extending scope to all banks, building societies and certain investment firms including asset managers, will reduce these competitive concerns. Applying remuneration rules to the Alternative Investment Fund Managers – via AIFMD – and the insurance companies – via Solvency II – will be a further

¹⁷ www.fsa.gov.uk/pubs/discussion/fs09_05.pdf

¹⁸ Although the two types of firms may compete for persons (e.g. traders) with similar capabilities, it does not imply that the one firm is at a competitive disadvantage relative to the other.

significant step. The policies we adopt on proportionality will need to have due regard to competitive concerns.

- 2.28 The European Directives will, we hope, ensure consistency in applying remuneration principles within the EU. As noted elsewhere in this CP, there is a wider question of differences in regulatory approach at the global level creating an uneven playing field, and a risk of geographic arbitrage in favour of jurisdictions that are perceived to be more lenient.
- 2.29 We recognise 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.

3 The proposed revisions to the Code

Introduction

- 3.1 This chapter sets out the proposed changes to the Code and should be read in conjunction with the proposed Handbook text as set out in Appendix 1. This chapter has two main parts.
- 3.2 Firstly, we revisit the purpose and general requirements of the Code, and outline our proposals for the application of the revised Code to: firms, staff and groups.
- 3.3 Secondly, we set out the proposed new rules, with guidance where appropriate, highlighting any necessary changes to the current Code. The new rules can be grouped as follows:
 - risk management and governance (Principles 1 – 5);
 - new CRD rules on capital, government intervention, pensions, hedging and avoidance (Principles 6, 7, 9, 10 and 11);
 - risk adjustment – the associated guidance can be found in Chapter 4 (Principle 8);
 - remuneration structures, such as deferral and guarantees, with additional guidance (Principle 12); and
 - effect of breaches of the Remuneration Principles.
- 3.4 The Handbook text, as set out in Appendix 1, is structured as follows:
 - application provisions including timing, interpretation and notifications;
 - the general rule and guidance;
 - remuneration principles; and
 - annex on voiding powers.

Scope of the Code

Application to firms

3.5 The implementation of CRD3 on 1 January 2011 requires us to change the scope of the Code to incorporate:

- all banks and building societies covered by the definition of credit institutions in Article 4 (1) Banking Consolidation Directive (BCD); and
- all firms within the scope of investment firms to which the CRD3 requirements apply, as set out in the Capital Adequacy Directive (CAD).¹⁹

In view of this requirement, we propose to replace the current SYSC 19 text with the CRD3 text, as shown in Appendix 1. This also includes some provisions carried over from the current Code, additional FSB requirements and provisions relating to the voiding powers.

3.6 CRD3 will significantly increase the scope of firms subject to the Code from the current set²⁰ to over 2,500 firms. This population will incorporate the following types of firm:

- all banks and building societies;
- all CAD investment firms (as previously explained in paragraph 2.16); and
- UK branches of firms whose home state is outside the EEA.

3.7 UK branches of firms whose home state is within the EEA are not required to apply the Code, as their home state will be required to apply equivalent provisions under CRD3.²¹

Application to individuals

3.8 To ensure alignment with the structure of CRD3 text, we need to define a group of employees to whom all the Principles of our Code will apply. We will refer to these individuals as ‘Code Staff’.

3.9 In respect of non-Code Staff, we propose to issue guidance explaining that firms should also give consideration to the Remuneration principles on a firm-wide basis under the general rule (subject to proportionality – discussed later in Chapter 4).

19 Paragraph 3.5 covers all BIPRU firms.

20 The scope of the firms subject to the Remuneration Code is currently defined by three Handbook rules. This means that the Code currently applies to banks and building societies with total capital resources of £1bn, and BIPRU 730k investment firms (as defined in the FSA Handbook) with total capital resources of £750m. In relation to an overseas firm, the Code only applies in relation to activities carried on from an establishment in the UK. The Code does not apply to a firm that is a branch of an incoming EEA firm. Such branches will be subject to the requirements that their home country establishes to implement CRD3. Incoming services are also subject to home state regulation.

21 We expect CRD3 and the CEBS guidelines to align remuneration rules within the EU.

3.10 In order to identify Code Staff, we have referred to the relevant section of CRD3 text on remuneration policies²² which states:

“When establishing and applying the total remuneration policies, inclusive of salaries and discretionary pension benefits, for categories of staff, including senior management, risk takers, control functions and any employee 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 their risk profile...”

3.11 We propose to apply this CRD3 text as a rule (19.2.1 R) that applies the remuneration principles to any staff which have a material impact on a firm’s risk profile. This group will comprise Code Staff.

3.12 Building on our experience of implementing a similar definition for ‘P8 employees’ for the 2009 remuneration reviews, we propose guidance that we would expect Code Staff to include the following:

- a) a person who performs a significant influence function for a firm (a SIF²³);
- b) a Senior Manager;²⁴
- c) all staff, whose total remuneration takes them into the same bracket as senior management and risk takers, whose professional activities could have a material impact on a firm’s risk profile.

3.13 For reasons described below, this group may not match perfectly with the ‘P8 employees’ of the 2009 remuneration review. In the 2009 review, the remuneration structure provisions under Principle 8 only applied to ‘P8 employees’, while the other principles were applied more broadly. We propose that for all payments made on or after 1 January 2011, all principles of the Code will apply to Code Staff, and the term ‘P8 employees’ will no longer be used.

3.14 To ensure a more consistent interpretation between firms of individuals who could have a material risk impact on the firm, the following table provides a non-exhaustive list of examples of key positions that we believe should be subject to the Code:

22 References to CRD3 are to the text agreed by Coreper (the Permanent Representatives Committee of the Council of the European Union) on 30 June 2010. <http://register.consilium.europa.eu/pdf/en/10/st11/st11527.en10.pdf>. See Annex 1, section 11, point 23.

23 Significant Influence Function as defined in the Handbook Glossary

24 As defined in the Glossary to this CP

Table 3.1 – Examples of Code Staff (non-exhaustive)

High-level category	Suggested business lines (This list is not exhaustive)	
Heads, including regional heads, and any individuals or groups within their control who have a material impact on the firm's risk profile.	Fixed Income Foreign Exchange Commodities Securitisation Sales Areas Investment Banking (incl. Mergers & Acquisitions advisory)	Commercial Banking Equities Structured Finance Lending Quality Trading Areas
Heads of support and control functions and other individuals within their control who have a material impact on the firm's risk profile.	Credit/Market/Operational Risk Legal Treasury Controls Human Resources	Compliance Internal Audit Investment Research Information Technology

- 3.15 We recognise that firms have different organisational structures and use different terminology to express seniority. However, when interpreting this guidance, we will expect all firms to consider how best to overlay the examples provided above to their own organisational structures. In addition to the individuals shown in the table, firms may choose to devise their own additional metrics, e.g. based on trading limits, to identify their Code Staff.
- 3.16 We would expect all individuals who have held either a significant influence function, a senior management position or performed a role as a head of a significant business line or support and control function for all or part of the given year to be identified as Code Staff in that year.
- 3.17 As mentioned above, firms in scope may find that their number of Code Staff does not match the number of 'P8 employees' of last year's review.²⁵ This is due to last year's P8 parameters being a practical, temporary measure focusing on consistency between firms. This year, our rules for Code Staff have been guided by CRD3 with the intention of tying the definition more closely to effective risk management, by focusing on individuals who have a material impact on the firm's risk profile. We believe that this definition will result in a more appropriate application of the Code's general requirement.
- 3.18 We expect firms to compile a list of Code Staff ahead of the bonus allocation period so firms can notify staff who will be potentially subject to the Code's rules, including the voiding provisions. In the event that a Code Staff's bonus is not paid, the individual would still be considered Code Staff and their remuneration would have to comply with relevant provisions of the Code.
- 3.19 We also propose that, as a minimum, firms provide an annual attestation via GABRIEL²⁶ regulatory returns that all Code Staff have been identified and listed. At the same time, we retain the right to challenge a firm's list of Code Staff if, in our view, the list is inconsistent with the rules described above.

²⁵ See Annex 3

²⁶ See Glossary

3.20 Further work to develop the reporting requirements will be necessary, and we will consult on this later this year.

Q1: Do you agree with our proposed approach to the definition of Code Staff?

Interpretation of references to remuneration (Secondees)

- 3.21 We are proposing a new rule (SYSC 19.2.5R) to clarify to whom the references to remuneration apply.
- 3.22 Secondees were not mentioned explicitly in the current Code, although the definition of employee in the Handbook has always been wider than an employment law interpretation and extends to secondees. We have sought to clarify this following discussions with some of our stakeholders. The proposed guidance (SYSC 19.2.6G) states that remuneration awarded by a bank headquartered outside the UK (not subject to the Code) to an individual on secondment to a major bank within the UK, would be subject to our Code.
- 3.23 Firms should take this guidance into account when reviewing their 2010 remuneration arrangements. Firms should also consider whether there are other people whom we might consider to be employees or staff, such as special advisers.

Application to Groups

- 3.24 We propose to adopt the following approach to the territorial scope of the Code:
- UK groups should apply the Code globally to all their regulated and unregulated entities; and
 - UK subsidiaries of third country groups must apply the Code in relation to all entities within the subgroup, including the entities based outside the UK (e.g. for several firms this will consist of their EEA or EMEA²⁷ operations).
- 3.25 SYSC 12.1.3R states that firms must ensure that their risk management process and internal control mechanisms at the level of any UK consolidation group or non-EEA sub-group of which it is a member comply with the obligations set out in the Code on a consolidated or sub-consolidated basis.
- 3.26 As mentioned above, the Code will apply in relation to any entity that is part of a UK group/subgroup that is located outside the UK, including in a non-EEA jurisdiction. We expect in-scope firms to refrain from:
- setting up special group structures or offshore entities, or
 - allowing or assisting staff to become employed by such structure or entities in order to circumvent the application of the Code. A firm that is found to engage in such practices may be found to be non-compliant with the general rule.

27 Europe, Middle East and Africa.

- 3.27 As firms develop remuneration policies and practices for subsidiaries, they should consider the nature, scale, scope and complexity of the subsidiary's activities along with the level and types of employees working there. If the subsidiary poses a higher risk to the regulated entity, more robust remuneration policies and practices should be required for that entity.
- 3.28 For firms which engage in more than one type of financial activity, including financial conglomerates, consideration should be given to the different sectoral requirements on remuneration. For example, where a group contains both an insurance firm which is covered by the relevant insurance Directive and an investment firm covered by CRD3, remuneration policies should take account of each type of market activity including any relevant sectoral standards.

Q2: Do you agree with our approach to applying the Code to firms, individuals and groups, as outlined above?

The general requirement

Remuneration policies must be consistent with and promote effective risk management

- 3.29 The general requirement (SYSC19.2.1R²⁸) that remuneration policies must be consistent with and promote effective risk management underlies our work on remuneration and remains the central tenet of the revised Code. We will measure all firms' remuneration proposals against this rule and we would expect firms themselves to use this rule as the first point of consideration. We expect this rule to apply in relation to all staff within a firm.

Equality and diversity

- 3.30 As a public authority, we are obliged under equality legislation²⁹ to consider the potentially discriminatory impact of our regulatory proposals (the 'basic duty') and to demonstrate due regard in seeking opportunities to promote equality & diversity (the 'general duty'). The Code (19.2.2G (2)) already reminds firms of their need to comply with equality legislation and requires policies and processes which support equality and diversity – for example, the requirement that remuneration decisions should be properly documented. Although we found that most firms that we surveyed monitor staff diversity as standard, we may request evidence from firms on this subject, in line with our general duty.
- 3.31 We have judged that the requirements outlined in this CP are non-discriminatory, however we acknowledge that remuneration structures constantly change (due to the combined impact of the Code, taxation and other external reasons). Therefore we

²⁸ See Appendix 1

²⁹ Currently contained in section 71 of the Race Relations Act 1976, section 49A of the Disability Discrimination Act 1995 and section 76A of the Sex Discrimination Act 1975. The equivalent duty public sector duty under s149 of the Equality Act 2010 will supersede the current duties when brought into force.

will monitor whether the proposed changes have a disproportionate impact on specific groups defined through equality legislation.

- 3.32 Principle 2 of our current Code states that procedures for setting remuneration within a firm should be clear and documented. Although this is not within the CRD3 text, we propose retaining this as guidance in the revised Code (SYSC 19.2.4G), with no change of substance. We will expect all firms to demonstrate that robust processes are in place for recording remuneration decisions.

Q3: Do you have any comments on how the proposals contained in this CP affect equality and diversity issues?

Conduct risk and remuneration

- 3.33 We will expect firms to avoid remuneration structures which could create incentives for employees to take excessive risks in order to maximise bonuses, thereby jeopardising the prudential standing of the firm.

Remuneration Principles

- 3.34 With regard to the factors mentioned in Chapter 2 and the changing scope of our remuneration rules, we believe it is necessary to revise and update the Principles of our Code. Our proposed new Principles are outlined below.

Principle 1 – Risk management and risk tolerance

- 3.35 We are proposing a new rule (SYSC 19.3.7R) ensuring that a firm's remuneration policy does not encourage risk taking that exceeds a firm's tolerated level of risk. This is not a significant change in substance to our existing rule and means our Code is aligned with CRD3 and FSB text.

Principle 2 – Supporting business strategy, objectives, values and long-term interests of the firm

- 3.36 We propose that a new rule (SYSC 19.3.8R) is included within the Code to ensure a firm's remuneration policy is in line with its business strategy and long term corporate values. This is consistent with the current Code, which states that the assessment of an employee's remuneration should be based on longer-term performance, and it is aligned with CRD3 text.

Principle 3 – Avoiding conflicts of interest

- 3.37 Conflicts of interest are addressed as guidance under Principle 2 of our current Code. We found that most firms have policies in place to avoid such conflicts and propose that this guidance is converted into a rule (SYSC 19.3.9R) to be aligned with CRD3. We will expect to see evidence of procedures that contain measures to avoid conflicts of interest, including those related to customers' interests, in a firm's remuneration policy.

Principle 4 – Governance

- 3.38 Principle 1 of our current Code states that firms' Remuneration Committees (RemCos) should exercise independent judgement and have the skills and experience to do so. RemCos should also be able to demonstrate their decisions are consistent with a reasonable assessment of the firm's situation; and be responsible for approving and periodically reviewing the firm's remuneration policy.
- 3.39 These governance provisions are largely aligned with CRD3 and FSB, however we propose certain changes to reflect the CRD3 text (see SYSC 19.3.12R in Appendix 1). Although the substance of the current provisions is retained, there are several specific additional requirements proposed, which are summarised below.
- RemCos should be responsible for the preparation of decisions regarding remuneration, including those with implications for risk management.
 - The implementation of a firm's overall remuneration policy and framework should be subject to annual independent internal review.
 - Firms significant in size must establish a RemCo.
 - The RemCo chair and members must be non-executive directors.
- 3.40 The latter two proposals in particular, are generally acknowledged to be good industry practice for corporate governance and consistent with promoting the independence of the RemCo and its oversight role. We observed that many of the firms in scope for the 2009 reviews already had such governance structures in place. Firms should note that the rules do not preclude executive directors from attending meetings and contributing to the RemCo decision-making process where appropriate. We also deem the input of Human Resources (HR) and Risk to be particularly important.
- 3.41 We recognise that establishing a separate independent RemCo may not be appropriate for smaller firms. This is in accordance with SYSC 19.3.12R (1), which states that only firms "significant in [...] size, internal organisation and [...] nature [...] must establish a remuneration committee". Further guidance on proportionality is provided in Chapter 4.
- 3.42 Furthermore, it may not always be necessary for a firm with an overseas parent to establish a RemCo solely for the UK entity. We will however want to ensure that the UK governing body sufficiently oversees the remuneration policies of the UK entities and has the capability to act in an independent manner.

Principle 5 – Risk and compliance function input

- 3.43 Principle 3 of our current Code states that remuneration for employees in risk and compliance functions should be determined independently and should be based on achieving the objectives of those functions.
- 3.44 We propose to make this provision a rule (SYSC 19.3.14R) and amend its wording to align with the CRD3 text. There is no change of substance and the proposed amendments will not affect our approach to implementation; our focus will continue to be on risk and compliance. However firms should note that the HR and Legal

functions should also be included within the definition of “control functions”. The findings from our 2009 reviews suggest that this is an area where firms were already well aligned with our requirements.

- 3.45 We also propose to retain, as an Evidential Provision, our expectation that firms’ risk and compliance functions have appropriate input into setting remuneration policy and individual remuneration decisions where appropriate. We consider this an important indication that firms have remuneration procedures that support effective risk management. Firms should be able to demonstrate that control function input is sought and taken into account as appropriate. This provision links in with several other areas of our Code, including governance, risk adjustment of bonus pools and performance measurement.

Principle 6 – Remuneration and capital

- 3.46 CRD3 requires that a firm’s total variable remuneration should not limit its ability to strengthen its capital base. We propose including this as a rule (SYSC 19.3.18R) in our Code for all firms.
- 3.47 We plan to assess compliance by the largest firms against this requirement by conducting an annual exercise to review the extent to which remuneration payouts are consistent with their capital plans. The aim will be to link this into other existing supervisory work on capital. It is our intention to perform this assessment on a forward-looking basis.

Principle 7 – Exceptional government intervention

- 3.48 CRD3 places a number of requirements around executive directors of firms in receipt of state aid. We will incorporate these as a rule, but we would normally expect appropriate variable remuneration to be capable of being justified for directors who join a stricken company after the crisis occurred (SYSC 19.3.21G).

Principle 8 – Profit based measurement and risk adjustment

- 3.49 In order for remuneration policies to support effective risk management, firms need to ensure that their techniques for assessing variable remuneration take sufficient account of current and future risks. This is an area of focus for us in the coming review process. Last year we paid close attention to how firms adjust for risks after the pay-out of bonuses (so-called “ex-post risk adjustment”). This year we intend to focus on the techniques used by firms to take account of risks when calculating their bonus pools prior to pay-out (“ex-ante risk adjustment”). This is clearly relevant for all firms, especially those that pay substantial bonuses.
- 3.50 We are therefore proposing new rules (SYSC 19.3.22R) on risk adjustment to state that firms must take into account current and future risks when determining variable remuneration. This is in line with CRD3. Further details are set out in Chapter 4.
- 3.51 Firms that operate Long Term Incentive Plans (LTIPs) should ensure that future risks are taken into account in the performance measures (SYSC 19.3.24G(1)).

Principle 9 – Enhanced discretionary pension benefits

- 3.52 SYSC 19.3.29R(1) states that a firm’s pension policy must be in line with the business strategy, objectives, values and long-term interests of the firm.
- 3.53 CRD3 introduces new requirements on enhanced discretionary pensions. Such pensions are enhanced pension benefits granted on a discretionary basis by a firm to an employee as part of that employee’s variable remuneration package, but excluding accrued benefits granted to an employee under the terms of their company pension scheme. The new rule is not intended to apply to an employee’s standard pension plan entitlements or the firm’s financial contribution schedule to meet its contractual pension obligations. The intended focus is to capture any non-standard one off payments on an individual basis that are deemed to be of a variable nature.
- 3.54 CRD3 also states that such discretionary pension benefits should be held for five years in the form of shares or share-like instruments (SYSC 19.3.29R (2) and (3)). We expect SYSC 19.3.29R (2) and (3) may only apply in limited circumstances and to the most senior management if it is to be applied proportionately to meet the aims of the Directive. We are taking further advice on the application of these pension provisions.

Principle 10 – Personal Investment Strategies

- 3.55 CRD3 introduces a new rule (SYSC 19.3.30R) requiring firms to ask employees to undertake not to use personal hedging strategies, or to take out insurance contracts, that undermine risk alignment.
- 3.56 A firm’s efforts to operate an appropriate remuneration structure that takes account of risk will, if sufficiently effective, occasionally result in a downward adjustment to the amount of remuneration paid to staff. This will be the case, for example, if performance adjustment measures such as ‘malus’³⁰ are implemented.
- 3.57 The purpose of such measures is to maintain the alignment between risk and reward; in other words, to ensure that employees do not avoid the downside risks relating to activities that they have undertaken. The effectiveness of such measures therefore will be significantly weakened if the employee is able to transfer the downside risks to another party through hedging certain types of insurance.
- 3.58 We would argue that the employee has, in effect, hedged away the risk of a downward adjustment in remuneration if:
- a) the employee enters into an arrangement with a third party; and
 - b) the arrangement requires the third party to make payments directly or indirectly to the employee that are linked to or commensurate with the amounts by which the employee’s remuneration has been reduced.
- 3.59 The effectiveness of risk alignment would also be undermined if the employee were to buy an insurance contract that promises to compensate the employee in the event of a downward adjustment in remuneration. As a general rule, however, this would

30 See Glossary

not prohibit insurance designed to cover personal payments such as healthcare and mortgage instalments.

- 3.60 We therefore propose that firms should ask employees not to use personal hedging strategies, or to take out insurance contracts, that undermine risk alignment. Firms should maintain effective arrangements to ensure that employees comply.

Principle 11 – Avoidance of the Code

- 3.61 We are proposing a new rule (SYSC 19.3.32R) stating that firms should not award remuneration through alternative vehicles and methods in an attempt to avoid the rules within our Code. This is consistent with our views on groups structures as expressed in paragraph 3.24 above, but is also intrinsically linked to the general rule, and hence is relevant to all firms.
- 3.62 One area we intend to scrutinise closely is the practice by certain firms of providing non-recourse loans to staff. It is intended that highly paid staff will receive a large proportion of remuneration in stock or equivalent instruments, subject to rules on deferral and retention. In our view, a firm that allows staff to pledge stock or instruments that are still subject to deferral or retention periods as collateral for a non-recourse loan (whether from the firm or another source) is unlikely to be in compliance with the proposed Principles 10 and 11.

Q4: Do you agree with our proposals for changes to the Remuneration Principles 1-11?

Principle 12 – Remuneration structures

Introduction

- 3.63 Principle 12 is concerned with the structure of remuneration awards and covers a range of issues such as deferral, performance adjustment and guarantees. It also proposes our approach to the ‘*de minimis concession*’. Our starting point is that we intend to retain the rule, as expressed in our Code for 2009, that a firm must ensure that the structure of an individual’s remuneration is consistent with and promotes effective risk management.
- 3.64 In last year’s implementation process, we found that the rules and guidance on remuneration structures presented the most challenges and so, following issuance of a supervisory framework to firms in December 2009, we are now proposing additional guidance on these key aspects.

Performance measurement

- 3.65 Principle 6 of the current Code states that non-financial performance metrics should form a significant part of the performance assessment process.
- 3.66 Principle 5 of the current Code states that performance assessment on a moving average of results can be a good way of measuring long term performance.

- 3.67 We are not proposing any changes to the substance of either of these principles. We are retaining them in the Handbook text as guidance (SYSC 19.3.35G).

Fixed/variable balance

- 3.68 Having a fully flexible policy on variable remuneration meets the FSB principle of symmetry between pay and performance. We therefore propose including a new rule (SYSC 19.3.42R), to ensure firms have an appropriate balance between the fixed and variable elements of total remuneration, to reinforce the existing guidance. The proposed new rule is not dissimilar to the existing guidance in the Code.
- 3.69 CRD3 requires CEBS to set out specific criteria to determine the appropriate ratios between the fixed and the variable component of total remuneration. We shall review our Handbook text on this point once these guidelines have been published.
- 3.70 There are also questions around disclosure of fixed/variable pay within the EU. We await the CEBS guidelines for further clarification on this.

Deferral

- 3.71 Our aim is to define an approach to deferral structures that is aligned with the FSB Standards and CRD3.
- 3.72 We propose:
- a) A rule (SYSC 19.3.46R (1)) stating that at least 40% of the variable remuneration component must be deferred with vesting over a period of at least three years for all 'Code Staff' and be correctly aligned with the nature of the business, its risk and the activities of the individual in question. Remuneration payable under deferral arrangements must vest no faster than on a pro-rata basis, with the first vesting no sooner than one year after the award.
 - b) A rule (SYSC 19.3.46R (3)) stating that at least 60% of all variable remuneration must be deferred when variable remuneration is a particularly high amount. We propose to interpret this as 60% deferral when total remuneration is in excess of £500,000 (as per last year's supervisory framework).
 - c) While any total remuneration component of £500,000 or more paid to Code Staff must be subject to 60% deferral, firms should also consider whether lesser amounts should be considered to be 'particularly high' taking account, for example, whether there are significant differences in the levels of variable remuneration paid to the Code Staff within a firm.
 - d) Guidance (SYSC 19.3.47R (2)) stating that we would expect a firm to have a firm-wide policy on deferment, subject to de minimis, which includes a rising proportion of deferment according to the amount of variable remuneration.
- 3.73 Rule (1) is in line with FSB Standards that state that a substantial portion of variable compensation, such as 40% to 60%, should be payable under deferral arrangements over a period of years.

- 3.74 Rule (3) is consistent with the FSB requirement of 60% deferral for the most senior management and highly paid staff.
- 3.75 We recognise that our proposed approach may not be aligned with some other international jurisdictions; and that some globally active UK firms feel that this leads to recruitment and retention issues. However, we are aware of our obligations to implement CRD3 and the need to adopt an approach that will be applied consistently by all firms in scope to ensure we can apply the voiding powers granted to us by the Financial Services Act 2010.
- 3.76 We propose that LTIP awards may be included in the calculation of the deferred proportion to meet the Code's requirements, but only if we are satisfied that upside incentives are adequately balanced by downside arrangements such as malus. The LTIP award should be valued at the time it is granted, using an appropriate valuation technique. For this approach to work, the LTIP award must be linked to a specific performance year, and the counting of that LTIP award towards deferral can only be in relation to that one year.
- 3.77 Firms that operate LTIPs should also consider *The Walker Review's* recommendation that half of the award should vest after not less than three years and the remainder after five years (SYSC 19.3.24(2)).

De minimis

- 3.78 Last year our supervisory framework specified that employees earning under £500,000 and whose bonus was less than 25% of total remuneration would be subject to our de minimis concession and would not be required to meet our deferral requirements.
- 3.79 As part of our approach to proportionality, we are now proposing (SYSC 19.3.6) 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, we would not generally consider it necessary to apply the rules relating to: deferral; performance adjustment; proportion of remuneration paid in shares; and guaranteed bonuses.
- 3.80 We do not anticipate that this proposed change will have a large impact on the Code Staff of the current firms in scope. However we are proposing the change as part of our intention to apply a proportionate approach to the firms that will come into scope for the first time from 1 January 2011. We will review this proposal following publication of the CEBS guidelines later in the year. Our approach to proportionality is discussed further in Chapter 4.

Proportion in shares

- 3.81 In order to further align the Code with CRD3 and the FSB Implementation Standards, we propose to add a new rule (SYSC 19.3.45R) requiring at least 50% of any variable remuneration component to be made in shares, share-linked instruments, or other equivalent non-cash instruments of the firm, and, where appropriate, other long dated financial instruments that adequately reflect credit quality (as a group referred to here as 'share-equivalent instruments'), subject to the legal structure of the firm.

- 3.82 We are aware that there are different interpretations of the CRD3 requirement. Firms should consider the most suitable arrangement in the context of their overall remuneration policy. The interpretation put forward in a press release on behalf of the European Parliament rapporteur was that the 50% requirement applies equally to both the deferred and the non-deferred portions of variable remuneration.
- 3.83 We have taken the view that the reference in CRD3 to the 50% requirement applies to variable remuneration as a whole. Firms can decide whether shares form part of the non-deferred payment, part of the deferred element, or a mixture of both. Our view is a provisional one and we will need to consider whether it is appropriate to maintain this view when we finalise the rules, in the light of the ongoing CEBS discussions. We and firms will also need to have regard to the final CEBS guidance on this.
- 3.84 These shares and share-equivalent instruments will need to be subject to deferral or a retention policy. For the portion of shares or share-equivalent instruments issued as upfront payment, firms will be required to implement appropriate policies stipulating minimum transfer retention periods. This is distinct from deferral, as retention periods may apply to awards paid upfront or deferred awards that have vested.
- 3.85 For example, our view would suggest that if the level of deferral is greater than or equal to 50% of variable remuneration, the firm can choose to issue the full deferred proportion as shares and this would meet the proposed share-based requirement. However, if the deferred shares amount to less than 50% of variable remuneration (e.g. 40% deferred), the remaining required portion (e.g. 10% upfront) should be allocated in shares or share-equivalent instruments and subject to a retention period.
- 3.86 The objective of linking remuneration to an instrument, such as shares, that intrinsically reflects firm performance, is an important concept. However, for firms that are unable to issue shares, for example mutuals (building societies), we recognise that this requirement is not easily applied and we are sensitive to the difficulties in implementing suitable alternatives to shares and share-linked instruments. We will also want to be satisfied that the instruments which firms intend to use to meet this requirement (which will typically form a component of Tier 1 capital) meet our capital requirements.
- 3.87 We will continue to encourage the use of shares as a method for deferral (subject to our new performance adjustment requirements set out below) for firms where this is practicable. However, in recognition of the challenges, although firms should commence the application process by 1 January 2011, we are proposing that firms may be able to justify not complying with these requirements by 1 January 2011, provided they take reasonable steps to comply as soon as reasonably possible and in event by 1 July 2011(see Chapter 4 on transitional arrangements). We will also be taking account of the CEBS guidelines on this matter.

Performance adjustment

- 3.88 Firms should retain the ability to make adjustments to an individual's unvested deferred amounts of variable remuneration, after the amount has been communicated to the employee, to reflect actual outcomes as they materialise over

time. We refer to this as ‘performance adjustment’, encompassing the key elements of ex-post risk adjustment.³¹

- 3.89 Performance adjustment of awards can be a valuable tool in encouraging a culture of longer-term focused, accountable behaviour within a firm. We consider it important that sufficient thought is put into the design and implementation of performance adjustment schemes to establish a credible, effective link between the future risk of activities undertaken and individual reward.
- 3.90 We distinguish between adjustments made to deferred variable remuneration that has not yet vested (known as ‘malus’) and that which has already vested but which the individual agrees to repay (known as ‘clawback’). Our focus in this section is on malus arrangements³², where, as a result of poor performance, a reduction is made to a deferred award prior to vesting (i.e. before ownership has transferred to the employee).

Proposed changes

- 3.91 Principle 8 in our current Code states that a significant proportion of the variable component of remuneration should be linked to the future performance of the firm, the employee’s division or business unit, or business undertaken by the employee
- 3.92 We propose to amend our current Code to include a rule (SYSC 19.3.27R) which stipulates that all deferred remuneration is subject to an appropriate form of performance adjustment. This is in line with CRD3.
- 3.93 As a consequence, firms should have a performance adjustment scheme which is documented and communicated to all Code Staff. Details of the scheme should be available for our review on request.
- 3.94 As noted, our proposed new rules will require all deferred compensation to be subject to an appropriate form of performance adjustment and firms’ policies and processes to be effective in identifying conditions under which malus should be considered. Our new Evidential Provision on performance adjustment requires that firms consider applying malus in the following situations, where:
- a) there is evidence of employee misbehaviour or material error;
 - b) the firm and/or the business unit subsequently suffers a material downturn in its financial performance;
 - c) the firm and/or the business unit in which the employee works suffers a material failure of risk management.
- 3.95 How firms choose to incorporate and implement these measures is a decision for firms, typically guided by their RemCos. Nonetheless, we believe that the three areas set out above provide the basis on which policies should be designed. This should help put into practice measures that allow malus to operate at the firm, business unit, and individual performance level and is in alignment with the FSB principles.

31 See Glossary

32 We recognise there are limits to the ways in which clawback can be operated as an effective performance adjustment technique.

- 3.96 On share and share-linked deferred awards, although the share price will provide a form of performance adjustment at the firm level, in many cases the link between individual performance and share price performance can be relatively weak (except in certain cases such as the CEO). It is therefore highly desirable for firms to have the ability to reduce the number of shares awarded based on business unit and/or individual performance (SYSC 19.3.49E). We view this as an important step towards establishing a more effective link to individual behaviour. This is also in line with current discussion on performance adjustment at CEBS level.

Guarantees

- 3.97 The current Code states that guaranteed minimum bonuses, “*which run for a period of more than one year.....*” are likely to be inconsistent with Remuneration Principle 8.” Furthermore, the FSB principles only allow one-year guaranteed bonuses for new hires in exceptional circumstances.
- 3.98 We are aware of firms’ concerns to ensure that a level playing field is maintained. We propose to introduce:
- A rule (SYSC 19.3.38R) stating that firms must not offer guaranteed bonuses of more than one year. Guarantees may only be given in exceptional circumstances to new hires for the first year of service only.
 - An evidential provision (SYSC 19.3.39E) that a signing on/buy out bonus should not exceed the terms offered by a previous employer under the deferred remuneration or incentive plan arrangements which it is seeking to buy out. The vesting schedule for the award from the new employer should match or exceed the vesting schedule of the previous arrangements. The award from the new employer should be subject to performance adjustment requirements.
 - Guidance (SYSC 19.3.41G) on retention bonuses (see paragraph 3.101).
 - Guidance (SYSC 19.3.47(3)) that all guaranteed bonuses should be subject to the same deferral criteria as other types of variable remuneration.
 - Guidance (SYSC 19.3.40G) to note that it is good practice to extend the above rule and Evidential Provision to all employees.

Arrangements for existing employees

- 3.99 Guaranteed bonuses awarded in the first year of employment cannot be extended beyond this period, even if the employee has moved into a new role with less certainty around the future potential performance of that unit. For some firms, each year, we may request the names of individuals who have been offered guaranteed bonuses, to check that the same people are not being offered guaranteed bonuses repeatedly (even in cases of an ‘internal promotion’).
- 3.100 We would expect retention bonuses to be permitted only in exceptional circumstances if the firm is undergoing a major restructuring and a case can be made for the retention of key staff on prudential grounds.

- 3.101 Firms should not award guarantees for the purpose of retention except in exceptional circumstances, for example where key staff must be retained during a merger process or when a firm is winding down. Supervisory assessment of an institution's risk profile will determine whether a retention award might be granted on a case-by-case basis in these situations.

Severance pay

Proposed changes

- 3.102 The current Code does not specifically refer to severance pay, which is an important component of a firm's overall strategic Human Resources and remuneration policy. We are proposing a new rule (SYSC 19.3.43R) and guidance (SYSC 19.3.44R) to ensure that payments related to the early termination of a contract reflect performance over time and do not reward failure. The proposed text will be aligned with CRD3.
- 3.103 We recognise that there will often be a sound rationale for granting severance pay, which is essentially intended to provide a financial safety net for staff in case of early termination of the employment contract for reasons other than cause. We believe that severance arrangements that generate large payouts to senior staff that do not relate to effective performance, or are given in situations where inappropriate risk taking has occurred, are incompatible with our Code.
- 3.104 Firms should set up a framework in which severance pay is determined and approved in line with their general governance structures for employment. Firms should be able to explain to us the criteria they use to determine severance pay. It is good practice to defer any outstanding bonus payments or LTIPs and for these to mirror the original deferral schemes.

Q5: Do you agree with the above proposals regarding remuneration structures (Principle 12)?

Effect of breaches on the Remuneration principles

- 3.105 Section 6 of the Financial Services Act 2010 has given us express powers to:
- prohibit a firm from remunerating its staff in a specified way;
 - render void any provision of an agreement that contravenes such a prohibition; and
 - provide for the recovery of payments made, or property transferred, in pursuance of a void provision.
- 3.106 We recognise that these powers are only likely to be effective where the effect of the prohibition can be clearly ascertained in advance. This would be the case, for example, with a contract that offers a multi-year guaranteed bonus, which would be in clear breach of Principle 12 (SYSC 19.3.51R) of the amended Code. Similarly, we recognise that these powers will only be effective in respect of staff for whom set rules have been defined.

- 3.107 We currently propose to exercise this power only in relation to Code Staff and only in relation to:
- deferral arrangements, as set out in SYSC 19.3.46R, and
 - guaranteed bonuses, as set out in SYSC 19.3.38R.
- 3.108 Where it has been established that our voiding powers apply in respect of a particular contract, the firm will be obliged to recover payments made or property transferred to the individual. Firms would be restricted from making further variable remuneration awards to the individual in respect of the same performance year unless they have legal advice that the award complies with the Code. A payment made in breach of this rule would be void and must be recovered (SYSC 19 Annex 1 5R and SYSC 19 Annex 1 7R). With respect to secondees, this obligation will apply to the entity or person making the payments to the secondee.

4 Implementation

Introduction

- 4.1 The first section of this chapter sets out the extent to which we can use the provisions in CRD3 to apply a differentiated approach to firms according to their nature, scale, scope, internal organisation and complexity. The second section sets out how we plan to implement the Code in respect of the 2010 bonus round for those firms currently in scope (including our plans for a programme of meetings during Q4 2010) and firms who will come into scope on 1 January 2011. The third section gives further information on how firms should take account of risk when assessing and calculating their bonus pools. The final section discusses the transitional arrangements we intend to apply.

Approach to proportionality

- 4.2 CRD3 gives regulatory authorities the flexibility to apply a proportionate approach to applying the remuneration provisions. As set out in Appendix 1 '[firms] shall comply with the following principles in a way and to the extent that is appropriate to their size, internal organisation and the nature, the scope and the complexity of their activities.'³³
- 4.3 Our approach to proportionality falls under the following broad pillars:
- application to firms;
 - application to staff; and
 - supervisory approach.
- 4.4 This consultation gives guidance on our approach to proportionality. Further work needs to be done to establish precisely how to apply a proportionate approach to all firms. A key unresolved question is how to agree clear distinctions between different proportionate approaches. We invite firms to provide further information and opinions on this through our consultation questions.

33 See <http://register.consilium.europa.eu/pdf/en/10/st11/st11527.en10.pdf>

- 4.5 Furthermore the Committee of European Banking Supervisors (CEBS) working group on remuneration is considering several issues concerning proportionality. Its report is expected to be published in October 2010. We are participating fully in their discussions and will take their recommendations into account in any subsequent proposals. We may be in a position to provide more detail on proportionality in our Policy Statement (PS) later this year. However we may need to consult further on proportionality guidelines once the CEBS process is complete.

Applying the Code to firms

- 4.6 Paragraphs 3.6 and 3.7 set out how the scope of the Code will be changed when CRD3 is implemented from 1 January 2011 and indicates the broad range of firms to be covered.
- 4.7 In our view it is clear that proportionality cannot be interpreted as a complete exemption from the Code for any firm within the scope of CRD3. All firms will be required to consider the application of the full Code to their firm in the form of a self-assessment. We will challenge the outcome of these assessments where appropriate.

While some of the Code's rules will apply to all firms in scope, we recognise that applying the full Code may be inappropriate and/or overly burdensome for others. These firms may be able to apply specific rules in a manner that takes account of their nature, scale, scope and complexity. They may also be able to apply rules on a comply or explain basis, since we will expect firms to justify why it would be disproportionate to apply the principles fully.³⁴

- 4.8 Annex 5 shows three tables which set out our proposals on:
- minimum requirements expected of all firms (Proportionality Table 1);
 - rules which could be applied proportionally in line with a firm's nature, scale, scope and complexity (Proportionality Table 2); and
 - rules which could be applied on a comply or explain basis (Proportionality Table 3).
- 4.9 We intend to conduct further analysis and engage with trade bodies and firms to identify the parameters that will determine our expectations for each rule. We will then provide examples and guidance to help firms conduct their own self-assessments against the Code. Examples of possible parameters include:
- firms' impact ratings as communicated as part of our 'ARROW' risk assessment process;
 - different types of legal status;
 - different types of business undertaken; and

34 A Comply or Explain basis means a firm could be released from the requirement to apply certain rules if they can satisfactorily justify their reasons for doing so.

- other financial metrics e.g. levels of capital (as currently used in the current Code for larger firms), assets, funds under management, liabilities.
- 4.10 We also intend to define criteria to identify firms that will be required to apply the rules within the Code. These firms will still be able to use the de minimis concession for individual Code staff (see below).

Applying the Code to staff

4.11 The Code applies to a defined group of employees, Code Staff,³⁵ as set out in paragraphs 3.8 to 3.14.

- In paragraph 3.79 we set out the proposed conditions where certain rules relating to remuneration structures need not apply. We will consider the position of individual proprietors and general partners. Limited partners, whose position is more akin to employees, will not be excluded.

Q6: Do you agree with our proposals, as set out in Annex 5, for applying proportionality at the rules level?

Q7: Which metrics and thresholds do you believe are appropriate to determine how different firms can apply the specific rules of proportionality?(Please refer to Annex 5)

Supervisory approach

4.12 From 1 January 2011, we propose to incorporate the review of firms' remuneration policies into our existing supervisory processes. We intend to use the ARROW impact framework³⁶ to implement the Code in a risk-based way.

4.13 We propose that all firms in scope will be required to submit a minimum level of data via an electronic return on the GABRIEL system³⁷ at their year end. This regulatory return will include a requirement to certify that the firm's remuneration policies are compliant with the Code. Where appropriate, we may ask firms to provide the necessary explanation under the comply or explain procedure. We will consult on these changes later this year.

4.14 Using ARROW impact scores to achieve a tiered approach, we envisage the following supervisory approach.

- a) 'High impact' groups, which contain at least one CRD3 firm, should submit a Remuneration Policy Statement (RPS) annually ahead of their year end/bonus season. These will be discussed at an annual meeting with the Remuneration Committee (RemCo) Chair and/or senior management. Some high impact firms will also be expected to supply details of their remuneration awards for

35 It should be noted that the general rule applies to all employees of a firm.

36 www.fsa.gov.uk/Pages/About/What/Approach/Assessment/index.shtml

37 See List of acronyms used in this Consultation Paper.

supervisory review in the weeks before their planned pay out date. Some high impact firms may also be required to conduct an annual capital exercise related to their intended pay-outs.

- b) ‘Medium high’ and ‘medium low’ impact CRD3 groups/firms will be required to prepare an RPS annually that supervisors will request as part of the standard supervisory processes, for example before an ARROW review.
- c) ‘Low impact’ firms will only be required to prepare an RPS if they are part of a thematic review. Otherwise, their GABRIEL regulatory returns will provide their minimum reporting requirements for these firms.

4.15 This approach is summarised in the table below:

Table 4.1 – Proposed supervisory approach

Group/ Firm Impact Category	Supervision Type	Required compliance checks		
		Regulatory Returns (GABRIEL)	Meeting with RemCo Chair or appropriate governing body	“Remuneration Policy Statement and associated spreadsheets”
H	“Close & Continuous (C&C)”	Yes	“Annual meeting as part of minimum C&C meetings requirements.”	“RPS submitted annually as part of minimum C&C data requirements.”
MH & ML	Full ARROW or ARROW Light	Yes	“Meeting may form part of ARROW/SREP risk assessment and/or if firm is selected for a thematic review of remuneration practices.”	“RPS may be requested as part of ARROW/SREP risk assessment and/or if firm is selected for a thematic review of remuneration practices.”
L	Small Firms	Yes	“Meeting may be required if firm is selected for a thematic review of remuneration practices.”	“RPS to be requested if firm is selected for a thematic review of remuneration practices.”

4.16 The level of detail within an RPS can be proportionate to a firm’s size and internal organisation, and the nature, scope and complexity of its activities. An RPS will need to be reviewed and, if necessary, updated annually. We will assist firms in preparing an RPS by providing a template.

Implementation in 2010

4.17 For the purposes of the 2010 bonus round, we intend to apply a dual approach to our assessment of the current scope and extended scope of firms as an interim measure for this year only. Our intended approach is set out below.

Firms currently in scope

- 4.18 For the 2009 remuneration round, we limited our scope to a group of large banks, building societies and broker-dealers. For the forthcoming remuneration round, we intend to divide our review of the remuneration arrangements for these firms into two parts.
- 4.19 The first part will address the issues of governance, controls, performance measurement and risk adjustment through a programme of meetings and discussions. This will take place for most firms in early Q4 2010.
- 4.20 In the second part, we will review these firms' plans for the 2010 remuneration awards against the Code's rules on remuneration structures, which will come into effect on 1 January 2011. This information will be requested in the weeks before each firm's proposed announcement of bonus awards. Further information and data requests will be communicated to those firms as appropriate in due course.

Firms in the extended scope

- 4.21 In respect of firms coming into the scope of our Code from 1 January 2011, we intend to take a proportionate approach, as set out above. It is not our intention to apply the same two-step process to the extended scope firms.
- 4.22 We expect all extended scope firms to begin planning for the implementation of suitable remuneration structures, policies and practices, as soon as possible. It will be desirable for these firms to have the appropriate governance arrangements and procedures, as set out in the Code, in place by 1 January 2011. We recognise, however, that other measures take time to implement. Therefore, we will not expect extended scope firms to have the prescribed remuneration structures (such as minimum levels of deferral and performance adjustment where appropriate) in place until later in 2011.

Risk adjustment

- 4.23 Last year our reviews mainly focused on how firms adjust for risk after the pay-out of bonuses ('ex-post risk adjustment'), e.g. through deferral mechanisms. We had insufficient time to consider fully how firms risk-adjust their bonus pools before pay-out ('ex-ante risk adjustment'). Our aim now is to address this.
- 4.24 As yet, there is no internationally agreed 'best practice' in this area. Our approach therefore focuses on transparency, accountability and methodology. We wrote to in-scope firms in June setting out our thoughts on this. Since then, we have received internal and external feedback, and CEBS has also published draft guidance on this topic. We have therefore extended our discussion to take account of additional points raised.

Our approach

- 4.25 Our starting point is that firms should earn a risk-adjusted return on their capital, and the process of assessing and setting remuneration, in particular variable remuneration, should take account of the risks incurred. Firms also need to consider all costs incurred, including the risk-adjusted cost of capital. Our experience from last year's round has pointed to a potential lack of transparency, and to some extent a lack of consistency, in the techniques applied by firms.
- 4.26 As set out in our Code and in the Financial Stability Board (FSB) principles, a firm's remuneration should be adjusted for all types of risk. As well as market, credit and interest rate risk, firms should not overlook funding, liquidity, reputational and operational risk. All other things being equal, we would not normally expect two employees who generate the same profit but take different amounts of risk on the firm's behalf, or who use different amounts of the firm's capital in the process, to be remunerated in the same way.
- 4.27 Firms should pay due regard to the impact of their remuneration arrangements on their capital base, including the potential need to build capital to support planned business growth.
- 4.28 We recognise that risk adjustment of variable remuneration will not, in and of itself, prevent excessive risk taking. Risk adjustment techniques to remuneration should be part of the firm's overall culture and management of risk at various levels of the business.

What we would like to see

- 4.29 In view of the differences in firms' business models, as well as the proportionality principle, we do not propose to be prescriptive on the exact risk adjustment techniques that firms should use. Firms should choose the techniques and measures most appropriate to their circumstances. Nonetheless, we believe there are certain elements and principles of risk adjustment that all firms should at least consider.

Culture and governance

- 4.30 A firm's entire risk adjustment process should be driven primarily by a culture that champions and encourages strong risk management practices within a robust policy framework. This culture should be driven from the very top levels of management. It should support effective controls and governance and an open attitude towards the regulator.
- 4.31 An independent and knowledgeable RemCo should offer the appropriate checks and balances to prevent inappropriate manipulation of risk adjustment metrics. The RemCo should consult closely and frequently with the firm's risk management, including those relating to operational, market and credit risk, as well as liquidity management. Any material changes in remuneration risk adjustment metrics should be understood, approved and documented by the RemCo.

Assessing bonus pools

- 4.32 When assessing financial performance, bonus pool calculations should be based principally on profit measures. We believe that measures based primarily on revenue or turnover are unlikely to pay sufficient regard to the quality of business undertaken or services provided.
- 4.33 The profit measures used should take account of specific features of each firm's business model. For example, where a major banking group offers intra-group funding or collateral borrowing, these should be costed at arm's length to produce a more realistic profit measure.
- 4.34 Firms should consider the manner in which they recognise potential future revenues in the profit measures used for current-year bonus pool assessment.
- 4.35 As a general rule, a firm's total variable remuneration should be reduced in any year where the firm's performance is weak or the firm is loss-making. In such circumstances, the firm should also consider activating existing performance adjustment measures, such as malus.
- 4.36 We accept that firms will tend to apply a combination of top-down and bottom-up approaches to calculate their bonus pools, with the degree of emphasis varying between firms. Each firm should ensure that a robust challenge framework is in place to provide the necessary checks and balances between the two approaches. It will be useful for us to see detailed records (e.g. minutes of meetings) to provide comfort that such a framework is in place (see also "*Qualitative measures*" below).

Capital and liquidity

- 4.37 Firms should be able to demonstrate that their assessment process considers their current and future capital needs, including the potential need to build capital to support business growth. Firms should ensure their remuneration policies do not limit their ability to strengthen their capital base if and when this becomes necessary.
- 4.38 Firms should take account of the need to achieve an appropriate risk-adjusted rate of return on capital. In effect, this would ensure that capital has been appropriately compensated for the risks that the bank has taken. Failure to do so could undermine a firm's ability to raise capital.
- 4.39 Similarly, as part of the assessment process, firms should consider the cost and quantity of liquidity risk incurred.

Transparency and accountability

- 4.40 Firms should aim for a high level of transparency and accountability in the risk adjustment process. We recognise that there is a broad spectrum of approaches here, often comprising quantitative measures (numerical or formulaic adjustments) and qualitative measures (e.g. market competitiveness, strategic aims).

- 4.41 Firms should be prepared to disclose and discuss the quantitative and qualitative measures they have applied, and demonstrate clearly how they have reached the final assessment of quantum of their bonus pools.

Quantitative measures

- 4.42 Firms may use several different quantitative measures to inform their risk adjustment process. Frequently used measures include return on capital and return on risk-weighted assets, while measures based on economic capital and economic profit are increasingly common.
- 4.43 Quantitative measures may have some advantages in terms of transparency if they use a pre-agreed formula. However, our experience in assessing these measures so far suggests that the formulae may themselves rely on judgmental inputs, the derivation of which may lack transparency. Principle 4 of the current Code states that:
- SYSC³⁸ 19.3.8G (5) ‘The FSA expects a firm to be able to provide it with information relating to the workings of the calculations.’
- 4.44 Firms should be prepared to disclose and discuss in detail all the adjustments made under a formulaic approach, in particular any judgmental elements incorporated into the formula. Firms should also be prepared to allow us to test their formulaic measures on a selective basis.

Qualitative measures

- 4.45 We recognise that a formulaic approach may not capture all the risks firms are exposed to. Qualitative measures are also required, e.g. to address certain types of conduct, reputational, operational risk and strategic achievements amongst others.
- 4.46 Qualitative considerations may be applied at various levels, from the firm-wide level to individual employees. Examples for each level may include:
- firm-wide: competitiveness of pay-levels versus peers
 - business unit: strategic aims to build franchise, compliance track record
 - individual: adherence to risk limits, ‘key man’ risk
- 4.47 The process of making such adjustments may be less transparent than those of a formulaic quantitative nature. This is why we believe firms should maintain detailed records of how they have agreed qualitative adjustments. This may include minutes of all relevant meetings, in particular Remco meetings. Evidence of the discussion processes leading up to such adjustments will provide greater transparency.
- 4.48 Firms should be prepared to provide further details if the final outcome after applying qualitative measures is significantly different from the initial outcome using quantitative measures.

Q8: Do you agree with our proposed approach to risk adjustment?

Transitional arrangements

- 4.49 The amended Code will take effect as of 1 January 2011, in line with the intended implementation date for CRD3. SYSC 19.1.3R sets out, in terms of timing, the awards that will be subject to the amended Code:
- remuneration awarded on or after 1 January 2011,
 - remuneration due on the basis of contracts concluded before 1 January 2011 which is awarded or paid after 1 January 2011, and
 - remuneration awarded, but not yet paid, before 1 January 2011 for services provided in 2010.
- 4.50 In our view, the above rule does not require firms to breach contract or employment law. Where obligations arising from an agreement made on or before the date of publication of this CP are inconsistent with the Code, we expect firms to take reasonable steps to amend or terminate the relevant provision of the agreement, to enable them to comply with the Code as soon as possible. Until that can be achieved, we expect firms to adopt effective arrangements to manage the risks raised by that provision.

Extended scope firms

- 4.51 We recognise that not all firms are at the same point of readiness to implement the Code. Firms that were not in scope for 2010 may require additional time to comply in full with the Code. There are uncertainties about how to implement the proportionality provisions of CRD3 which will not be resolved until the CEBS working group issues its guidelines. These may not be finalised until late 2010 at the earliest.

Proportionality

- 4.52 The greatest challenge is likely to be creating and implementing remuneration structures that comply with Principle 12 of the amended Code. Our expectations concerning remuneration structures will therefore take account of proportionality. A firm may be able to rely on the provisions in SYSC 4.1.2R and SYSC 19.3.3R to justify not complying with the Code's requirements relating to remuneration structures by 1 January 2011, provided that it takes reasonable steps to comply as soon as is reasonably possible, and in any event by 1 July 2011.
- 4.53 For the major firms that were in scope for 2010, the changes are likely to be less demanding, and therefore we do not believe that proportionality will apply as broadly as described above. However there is one potential exception, as described below.

50% variable remuneration in shares or other instruments

- 4.54 One new rule that may be particularly challenging, especially for non-listed firms, is the requirement to pay at least 50% of variable remuneration in shares or other non-cash instruments. While listed firms that have shares in issuance will be in a

better position to fulfil this requirement, non-listed firms will need time to consider the structure of instruments that they wish to use. Implementation of this rule is being considered as part of CEBS consultation.

4.55 We propose that, based on the proportionality provisions, a firm that was in scope for 2010 may be able to justify not complying with the requirement to pay 50% of variable remuneration in the form of shares or other non-cash instruments by 1 January 2011, provided that it takes reasonable steps to comply as soon as is reasonably possible, and in any event by 1 July 2011. We intend this to be considered primarily for non-listed firms, including any that were in scope for 2009.

4.56 We plan to issue further guidance on this point to all firms (including those that were not in scope for 2010) once CEBS has published its own guidance on the subject.

Q9: Do you agree with our proposed transitional arrangements for implementation of the amended Code?

5 Next steps

Trade associations

- 5.1 We will ask all trade associations representing firms within the scope of CRD3 to inform firms about the proposed new rules. We also encourage the associations to prepare a collective response to the Consultation Paper (CP) on their member's behalf, as is common practice.

Firms

- 5.2 Firms must ascertain whether they are covered by the scope of CRD3 as soon as possible. A summary of its scope is given in paragraph 1.20, and further information can be found in a Chapter 2 of CP09/29 'Strengthening Capital Standards 3'.³⁹
- 5.3 We ask all firms covered by CRD3 to read the proposals in this CP and to give us feedback by 8 October. As discussed in paragraph 1.4, we will publish a Cost Benefit Analysis (CBA) of our proposals as Annex 1 of this paper in September 2010. Therefore, firms will have the opportunity to give feedback on the entire CP including Annex 1.
- 5.4 Firms may of course give us feedback individually. However, as noted above, we are encouraging trade associations to produce a collective response on behalf of their members.
- 5.5 We appreciate that final rules will not be available until our Policy Statement (PS) is published in early November. However, given the tight timetable for implementation, we strongly recommend firms begin to consider how the proposed new rules will affect their remuneration policies, procedures and practices.

39 www.fsa.gov.uk/pubs/cp/cp09_29.pdf

FSA

- 5.6 As set out in Chapter 1, the timetable for applying the revised Code is as follows:
- 29 July 2010: CP published;
 - Early September 2010: CBA published;
 - 8 October 2010: consultation period closes;
 - Mid November 2010: PS and final rules published; and
 - 1 January 2011: Handbook rules come into effect.
- 5.7 A series of presentations and seminars for firms will take place after the PS and final rules are published.
- 5.8 For firms currently in the scope of the Code, requests for Remuneration Policy Statements (RPS) will be sent in the coming months. The format will differ from last year, but the information required will cover similar ground. We would encourage firms to begin preparations now. Meetings will be held with these firms in Q4 to discuss their RPS.
- 5.9 As with last year's awards, we will require firms currently in scope to obtain our approval of their 2010 remuneration awards before they announce or distribute them. We will agree a timetable with each firm to review their plans for remuneration awards.

Cost benefit analysis

This annex will be published separately as soon as a cost benefit analysis of the proposals has been completed. We aim to be in a position to do so by early September. Please see paragraph 1.4 of the main document.

Compatibility statement

1. This annex sets out our view on how the proposals and draft rules in this CP are compatible with our general duties under section 2 of FSMA and our regulatory objectives set out in sections 3 to 6 of FSMA. We also outline how our proposals are consistent with our principles of good regulation.

Compatibility with our statutory objectives

2. Our duty is, as far as is reasonably possible, to act in a way which is compatible with our regulatory objectives and which we consider most appropriate for the purpose of meeting those objectives. The following objectives are particularly relevant to our proposals.

Market confidence and financial stability

3. We believe that our proposals will contribute to greater market confidence by further aligning compensation practices with sound risk management. The proposals are aimed at curbing incentives that contribute to excessive risk-taking in the financial services industry, which can lead to failure of firms, systemic problems and a loss in confidence in the financial system.

Consumer protection

4. Although we are principally concerned with the risks posed by remuneration practices to financial stability and prudential soundness, we note that inappropriate remuneration practices can also pose conduct risks for the fair treatment of customers. We believe the proposals set out in this Consultation Paper also contribute to mitigating these risks.

Compatibility with the Principles of Good Regulation

5. Section 2(3) of FSMA requires that, in carrying out our general functions, we must have regard to a number of matters we refer to as ‘principles of good regulation’. Of these, the following are relevant to our proposals.

The need to use our resources in the most efficient and economic way

6. Extending the scope of our Code to a wider group of financial institutions means that we will need to dedicate additional resources to the supervision of firms’ remuneration practices. However, our approach to implementation has been designed to ensure the efficient use of resources. We have used ‘copy-out’ to the extent we are implementing changes to align with CRD3 and will take into account the work of other regulators and international fora. Costs should also be minimised by our intention to integrate the remuneration process into existing supervisory arrangements as soon as possible. The experience we gained from implementing the Code last year will help us in minimising the cost of applying these proposals.

The responsibilities of those who manage the affairs of authorised persons

7. Our proposals would result in placing greater responsibilities on firms’ senior management, in particular remuneration committees (or governing bodies where appropriate), to establish, implement and maintain remuneration practices that are consistent with effective risk management. They are consistent with the requirement to hold senior management responsible for risk management and controls within firms. The proposals also continue to put emphasis on firms to ensure that remuneration policies and frameworks have adequate (independent) oversight and any conflicts of interest are managed effectively.

The principle that a burden or restriction which is imposed should be proportionate to the benefits

8. At this stage, we believe that the costs associated with our proposals will be proportionate to the benefits delivered. In particular, as discussed in Chapter 4, we intend to adopt a proportionate approach in implementing the proposed rules. Further detail on anticipated incremental costs to firms will be provided in a cost benefit analysis, to be published later this year.

The international character of financial services and markets and the desirability of maintaining the competitive position of the UK

9. We have tried, as far as possible, to achieve alignment with internationally agreed standards to minimise adverse effect on the competitiveness of the UK as a financial centre. In drafting the proposed rules we have taken account of developments in the EU, in particular the amendments to the Capital Requirements Directive (CRD3). Our intention is to adopt a predominantly ‘copy-out’ approach to implementing the

remuneration provisions of CRD3 into Handbook rules. We will also continue our work in CEBS to achieve effective and harmonised implementation. A further discussion of international work can be found in annex 4.

The need to minimise adverse effects on competition and the desirability of facilitating competition between those who are subject to any form of regulation

10. We believe that the extension of our Code to a wider population of firms, the inclusion of UK branches of non EEA firms within the scope of our Code, and the EU-wide application of the CRD3 proposals will minimise the adverse effects on competition of our proposals. Further detail on the impact on competition will be provided in a cost-benefit analysis, to be published later this year. Please also see our discussion of competition in Chapter 2.

Report on the implementation of the Code

1. This annex describes our experience in implementing the Code for the major firms in respect of their 2009 remuneration. As mentioned in Chapter 1 of this CP, CRD3 will broaden the scope of the Code, which will result in additional considerations and issues for the 2010 remuneration round. These potential differences should be considered when reading this annex.

I. Overview

2. We successfully implemented the Code and the Financial Stability Board's (FSB) Principles and Standards, which improved remuneration practices for 2009 in the London market, bringing them more in line with effective risk management. The task for 2010 is to ensure these improvements are sustained, while seeking to ensure consistency between remuneration policies as implemented in the UK and other major financial centres, as far as is possible under CRD3.
3. The Code came into force for the principal banks and investment banks in the UK market⁴⁰ on 1 January 2010 and was applied to remuneration awards made after that date in relation to 2009 performance.
4. The focus of the 2009 review was primarily on remuneration structures (deferral, vesting and performance adjustment). Issues such as governance, the role of risk functions in remuneration processes and risk adjustment of bonus pools were also an important part of the assessment process.

Outcomes

5. It will take time to assess the full impact of the Code in contributing to effective risk management, as several other factors have influenced remuneration policies over the past year, including political and media pressure, and recognition by firms of the need for change. Unexpectedly strong conditions in the financial markets in 2009 also had an impact on the levels of variable remuneration that year.

40 This group constitutes banks, building societies and investment banks with total regulatory capital exceeding £1bn or BIPRU 730k firms with total regulatory capital exceeding £750m.

6. However, we can confidently say that successfully implementing the Code within the 2009 firm population has resulted in more demanding standards in a number of areas, and has shifted the composition of remuneration structures to forms more consistent with effective risk management. In particular, variable remuneration to key employees (referred to as ‘P8’ employees for the 2009 round)⁴¹ was subject to more demanding requirements under the standards established in the Code for:
- **Deferral** – All bonuses awarded to P8 employees met (or exceeded) the standards set out in the Code that:
 - a) limited the amount of variable remuneration that could be paid to employees immediately in cash; and
 - b) required the remaining portion of the variable remuneration award to be deferred for a minimum of three years.⁴²
 - **Performance adjustment** – All deferred bonus awards made by firms in scope contained performance adjustment and malus provisions in line with the Code.

In reviewing governance, we have generally seen stronger and more independent Remuneration Committees (RemCos) and greater recognition of the need to consider risk when setting remuneration policies and signing off bonus policies. There is still room for improvement within firms concerning risk adjustment, so this area has been recognised as a priority for 2010.

II. Background

7. We started to consider the extent to which inappropriate remuneration policies might have contributed to the market crisis during the summer of 2008, and published a Dear CEO letter in October of that year. The letter asked CEOs to review their policies ahead of the 2008 reviews, and set out what we considered to be examples of good and poor practice in remuneration policies. During the winter we conducted further research on remuneration policies in major firms in the London market and began work on the Code of Practice.
8. We issued a Consultation Paper (CP) on 18 March 2009,⁴³ which proposed introducing the Code into the Handbook for a group of large investment banks, retail banks, building societies and broker-dealers. This was followed by a Policy Statement (PS) in August, which reflected feedback from the consultation and a further assessment of progress in international alignment. The main changes in the PS were to:
- a) reduce the number of firms in scope; and
 - b) consolidate the Code’s Principles on remuneration structures into one (Principle 8).

41 See Glossary.

42 96% of the bonuses awarded met the standards for deferral. The remaining 4% were awarded (under the terms of the Transitional Provisions) under contractual arrangements that will end by 31 December 2010.

43 www.fsa.gov.uk/pubs/cp/cp09_10.pdf

The PS made it clear that we expected firms to comply with most aspects of the Code by 1 January 2010.

9. The review of awards for the 2009 performance year focused on remuneration structures such as deferral. However, we also reviewed issues such as governance and the principles of risk adjustment of bonus pools. We made it clear to firms that these are areas we intend to focus on during 2010.

III. Policy issues

10. We addressed several policy issues as part of the implementation process.

Scope of the Code

11. **Firms to which the Code applied.** We decided to limit the initial application of the Code to the major firms described above.⁴⁴ This captured the vast majority of firms measured in terms of assets, deposits and trading activities.
12. **Geographic scope of the Code.** We applied the Code globally for the UK headquartered firms in scope. For UK subsidiaries of firms headquartered elsewhere that met the scope criteria, we applied the Code to the UK subsidiary. Where qualifying UK subsidiaries operated in the UK alongside other subsidiaries and branches of the same third country bank, the rules allowed for the Code to be applied to other subsidiaries and to the branch or branches. Although UK branches of European Economic Area (EEA) banks were not covered by the Code's scope, the UK government sought and received assurances from these institutions that they would apply the Code voluntarily to UK branch employees. Therefore, all major banks and investment banks active in the UK were subject to the Code for their UK operations, and the Code applied to UK-headquartered firms globally.
13. This approach minimised competitive distortions within the London market and ensured that the Code's risk mitigation benefits were applied to UK banks globally. We intend to follow the same approach for 2011.
14. **Persons to whom the Code applied (P8 employees).** Initially we determined that the detailed restrictions on remuneration structures, with respect to deferral and vesting, would apply to persons with a 'significant influence function' (according to the FSA Handbook) and those whose business activities 'have or could have a material impact on the risk profile of the firm'. These 'P8 employees' were subject to requirements governing what proportion of a bonus that should be deferred; the period over which the deferred elements should vest; the extent to which they should be subject to performance adjustment; and restrictions on multi-year guaranteed bonuses.
15. The Remuneration Policy Statements (RPS) we received from firms in November 2009 indicated a very wide range of interpretations of the term 'whose business

⁴⁴ The firms were defined by reference to minimum levels of regulatory capital. The Code did not apply to asset managers, insurance companies or other non-bank financial firms in 2009. However, when assessing the firms in scope, the FSA took the remuneration structures of other group entities, such as insurance and asset management subsidiaries into account, if they could transmit risks to the firm to which the Code applied.

activities have or could have a material impact on the risk of the firm'. Given the lack of time available to reach convergence on the definition, we decided to presume any person (in addition to those already identified) with more than £1m total remuneration to be a P8 employee. While this was to some extent a practical temporary measure, we felt that it ensured the Code was uniformly applied and greatly facilitated the timely review and approval of 2009 remuneration awards.

16. We acknowledged that this presumption would need to be revisited in 2010 in light of international experience. In drawing up our rules for Code Staff for the coming round (see Chapter 3), we have not only been guided by CRD3 but have also sought to tie the process more closely to effective risk management, focusing on individuals who have a material impact on the firm's risk profile.
17. **Implementation timing.** We made it clear in PS 09/15 that the Code would apply from 1 January 2010, i.e. that the Code would apply to remuneration awards made after that date, including awards made in 2010 concerning performance in 2009. We asked firms to submit detailed reports to demonstrate that remuneration for P8 employees complied with the Code. We prohibited firms from making any variable remuneration awards to P8 employees until we had verified that those firms complied with the Code.
18. We acknowledged that we were implementing the FSB Principles and Standards on remuneration ahead of other countries. However, we believe it was important to assure immediately that remuneration policies were consistent with and promoted effective risk management at the group of firms to which the Code applied.

Link between remuneration and capital

19. The FSB's Standards and CRD3 require a firm to avoid remuneration payouts (or dividend distributions) that could undermine the requirement to maintain or strengthen that firm's capital base.
20. We agreed that the major firms in scope should assess the impact of potential regulatory changes on their base case capital projections up to 2012, and review them against their estimated 'glide path' for capital management, taking account of planned management actions to conserve capital. If a firm faced clear capital constraints, we planned to discuss further potential actions, such as limitations on bonus pools and the distribution of dividends in cash.
21. Our interventions ensured that in some critical cases the amount and/or form of firms' payouts were adjusted to be more consistent with their 'glide paths' for capital management.
22. We will continue to monitor banks' capital planning closely as part of our ongoing close and continuous supervisory programme, and we may conduct a similar exercise with the largest firms later in 2011.

IV. Key findings from implementing the Code

23. All firms in scope that have paid bonuses since 1 January 2010 have adhered to the general rule and implemented remuneration arrangements in line with the Code. This section illustrates some key findings at an aggregate level.

Scope of analysis

24. The analysis in this section focuses mainly on the following groups:
- major wholesale/investment banks – includes UK based staff of seven major international banking groups; and
 - major UK banking groups – includes six major UK banks. In most cases, these figures cover staff in global operations, including investment banking.

Impact of Principle 8 guidance

25. We reviewed deferral arrangements for over 4,300 P8 employees. Over 3,900 P8s were employed by the 13 firms in our two main peer groups.
26. Of the latter total, almost 2,800 were ‘presumed P8s’ (those with total remuneration in excess of £1m) in our two main peer groups (see Chart 1). These individuals accounted for over 70% of the total P8s identified in these peer groups.

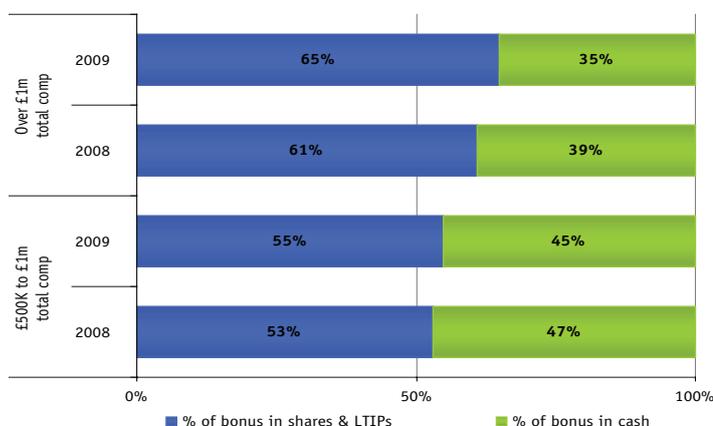
Chart 1: Break-down of P8 types



Bonus composition

27. Comparing bonus compositions for 2008 to 2009, the majority of firms increased the proportions delivered in shares and Long Term Incentive Plans (LTIPs) and decreased the proportions given as cash. The combined weighted average for both peer groups shows the proportion of bonuses delivered in shares increasing slightly between 2008 and 2009 for employees earning in excess of £500,000 total remuneration.
28. Chart 2 includes both the up-front payments and the deferred elements of awards to employees with over £500,000 total remuneration.

Chart 2: Both peer groups combined – Weighted average proportion of bonuses delivered in cash vs. shares and LTIPs



Deferral

29. In December 2009, we clarified the deferral parameters that we expected firms to adhere to. The most significant of these was that all employees with total remuneration greater than £1m should have at least 60% of their bonus deferred.
30. All firms in scope that have paid bonuses since the introduction of the Code (and particularly within the two main peer groups) agreed to implement the 40% and 60% bonus deferral rates (as recommended by the FSB) as a general remuneration policy for their P8 employees.
31. While all major firms already included an element of deferral in their remuneration structures, most increased deferral rates for P8 employees to meet our expectations. A minority relaxed their deferral arrangements to align with our minimum expectations, either as part of pre-arranged changes to their deferral schemes or to be in line with their competitors' remuneration practices.
32. At a more detailed level, our review found that 96% of P8s in the two main peer groups met (or exceeded) the 40% and 60% expected deferral rates. The remaining 4% of P8s had legally binding contracts/guarantees that did not meet our deferral criteria. To resolve this, we asked firms to renegotiate contracts or terminate them within the timescales provided by the Code's Transitional Provisions, where possible.

Vesting

33. Guidance under Principle 8 of the current Code and in the FSB Principles states that deferred awards should have a minimum vesting period of three years, vesting no faster than on a pro rata basis, and beginning not sooner than 12 months from the date of the award.
34. All firms in scope applied these criteria as a minimum, although there were a small number of variances for the 2009 reviews. We have made it clear to these firms that their vesting policies must be compliant for the 2010 remuneration awards.

Performance adjustment

35. The initial information firms supplied showed that most had some form of policy on performance adjustment⁴⁵ in relation to deferred awards, although these tended to be limited to incidences of misconduct by an individual. This did not fully meet our expectations for performance adjustment criteria, which ideally should cover situations where the firm (or a smaller unit within the firm) faces significant deterioration in its financial performance, or situations where losses arise as a result of significant failures of risk management.
36. To cover this short-fall, we set an expectation that at least 75% of deferred remuneration for P8 employees should be subject to performance adjustment. We accepted that this expectation would be met if variable remuneration was deferred in shares.
37. Most banks in our two main peer groups delivered deferred awards as greater than 75% in equity, thereby meeting our expectations. We ensured that the remainder had suitable performance adjustment arrangements in place.
38. Some of the banks and building societies in our scope were not able to award bonuses in shares. For these firms we sought to ensure that appropriate cash deferral schemes and malus⁴⁶ arrangements were in place to comply with our expectations.

Guarantees

39. The Code states that guaranteed minimum bonuses that run for over one year are likely to be inconsistent with Principle 8. The FSB Principles only allow one-year guaranteed bonuses for new hires in exceptional circumstances.
40. A number of employees at the firms in scope had been granted guarantees for a period that overlapped with the implementation of the Code. Firms were asked to renegotiate these contracts where possible, and to impose additional risk monitoring on those employees in cases where the contracts were not capable of renegotiation.
41. Several firms suggested we should review our policy on guaranteed bonuses to avoid an adverse effect on employee mobility or staff retention. We have also been made

45 See Glossary.

46 See Glossary

aware of examples of firms outside the scope of the Code poaching staff from competitors outside the current scope by offering large ‘sign-on’ bonuses, including multi-year guarantees. It is our expectation that CRD3 will help to create a more level playing field in this respect.

Changes in the proportion of total compensation to net revenue

42. Across both peer groups, we observed that variable remuneration as a percentage of total remuneration was much higher in 2009 than 2008 and about the same, if not slightly less, when comparing 2009 to 2007. This was largely explained by market trends over those periods.
43. We also asked firms to disclose remuneration ratios comparing total remuneration and variable remuneration to net revenue. We found, however, that these figures were affected by market volatility, and that it was potentially misleading to draw conclusions based on this data alone.

Leverage

44. Principle 8 of the Code states it is good practice for the fixed component of an employees’ remuneration to be a sufficient proportion of their total remuneration to allow a firm to operate a fully flexible bonus policy. The Code does not set guidelines regarding leverage ratios (i.e. fixed pay compared to bonus).
45. We found that some firms, particularly investment banks, had very high average leverage ratios, especially for those earning over £1m. The table below displays the average salary and bonus proportions in major investment banks and highlights the increase in fixed pay in 2009 (given that bonus levels increased between 2008 and 2009).
46. This area is currently under close scrutiny at EU level, and therefore we will wait for an agreed outcome before recommending any measures in this regard.

Table 1: Weighted average leverage in major wholesale/investment banks

Total comp bands	2008		2009	
	% base salary	% bonus	% base salary	% bonus
£500K to £1mn	19%	81%	24%	76%
>£1m	9%	91%	11%	89%

Findings from our wider review of firms’ remuneration policies

47. We also reviewed firms’ remuneration policies by examining their governance arrangements and analysing their risk adjustment practices. Most firms had satisfactory governance arrangements in place, which included an independent Remuneration Committee, comprising non-executive directors who meet regularly to consider their firm’s remuneration practices. We found that the Risk Functions generally had good input into firms’ remuneration decisions.

48. Our discussions with all firms within our scope indicated there is room for improvement in how firms calculate bonus pools and adjust them for current and future risks (Principle 4 of the current Code). We are working closely with supervisors in other jurisdictions to see how standards of risk adjustment can be improved.

International alignment – a progress report

Introduction

1. This annex outlines the progress made in achieving international alignment of remuneration principles over the past twelve months. The following sections set out the main developments at Financial Stability Board (FSB), Basel Committee, and EU level.

Key work streams

2. The FSB's Implementation Standards were agreed in September 2009 and endorsed at the Pittsburgh G20 Summit, representing a notable advance in international alignment. However, over time, differences in implementation have emerged. Some G20 members are implementing the Standards via guidance and reviews within existing supervisory approaches, while others, including EU countries, are implementing via legislation or enforceable rules.
3. At EU level, amendments to the Capital Requirements Directive (CRD3) that include provisions on remuneration were approved by the Council in October 2009 and the European Parliament's ECON Committee proposed its own amendments in June 2010. Agreement on a common text was reached between the Commission, Council and European Parliament in early July 2010, and we are using this text as our basis for this CP. We are aware that the text will be scrutinised by legal and linguistic experts before an official version is finalised. Timing is the key issue here, as the final updated Directive may not be available until late autumn, thus posing potential challenges for timely implementation.
4. The FSB has asked the Basel Committee to prepare guidelines on methodologies for risk and performance adjustment of remuneration schemes. A task force is working on this project, and will produce a report for consultation by the end of October 2010.
5. A task force of the Committee of European Banking Supervisors (CEBS) is working on guidance to implement CRD3. Among other things, it is focusing on how to apply a proportionate approach to the smaller firms within the CRD3 scope. We expect this text will be published for consultation in October 2010.

6. We actively participate in all task forces and working groups that are involved in achieving international alignment.

UK approach

7. Our priorities are to:
 - ensure our rules are consistent with the FSB Implementation Standards (as required by the Financial Services Act 2010) and with other provisions of the Act;
 - ensure our rules are consistent with the remuneration clauses in CRD3, and take account of guidance from CEBS when issued;
 - take the necessary steps to implement the CRD3 by 1 January 2011;
 - ensure that, in doing so, we deliver outcomes that are consistent with the ultimate objective of remuneration principles, as expressed in the Code's general rule; and
 - seek to minimise any competitive distortions in the UK market that may arise from differences in implementation between jurisdictions, including the US and EU.

Financial Stability Board

8. At the global level, the FSB produced its 'Principles for Sound Compensation Practices' in April 2009, which was endorsed at the G20 London summit. These high level principles were followed up by more detailed 'Implementation Standards' produced in September 2009 and endorsed at the Pittsburgh G20 summit.
9. The UK government encouraged UK-based firms to sign up to the implementation of the FSB Principles and Standards at meetings in autumn 2009. Parliament has also included the requirement in the Financial Services Act 2010⁴⁷ that our rules must be consistent with FSB standards.
10. At the G20's request, the FSB has just completed a progress report on implementing the standards. The report indicates that countries have adopted one of two approaches. Many EU countries, including the UK and Switzerland, have adopted enforceable regulation. Other countries, such as the US, Japan, and Canada, have adopted an approach based on guidance and implementation via supervisory programmes.
11. The difficulty with the latter approach is that, although it may give supervisors greater flexibility, it will be harder to deliver transparency or consistency on a global basis. Furthermore, although all countries have signed up to the FSB standards, some do not wish to adopt the FSB's quantitative approach to remuneration structures, such as specific figures for the proportions of variable remuneration to be deferred.

47 The Implementation Standards are already closely aligned in substance with the FSA Code, and we made some adjustments to the implementation of our Code in December to increase alignment further.

12. The FSB's thematic review does not express a view on which of the two approaches is preferable, but it notes that more work is needed to increase international alignment.
13. The thematic review includes a recommendation that FSB members should work to ensure that 'all significant financial institutions in their jurisdiction' – as identified by the national authorities – follow sound remuneration principles. To date, a small number of national authorities propose to apply FSB standards to significant non-bank firms. While they are encouraging others to follow suit, it is unclear how many will do so. At this point, it appears that the US will not extend its guidance to non-banks in the near future, and it seems likely that other EU states may wait for the Alternative Investment Fund Managers Directive (AIFMD) and the Solvency II Directive in 2012/13 (see below) to be introduced.
14. The FSB will conduct a follow up review on remuneration in Q2 2011, by which time more information should be available to make firmer judgements on implementation. We have emphasised that the review should focus on outcomes, rather than processes.

Basel Committee on Banking Supervision: Standards Implementation Group task force

15. At the FSB's request, a remuneration task force has been set up under the auspices of the Basel Committee on Banking Supervision (BCBS). In January 2010, the Committee published an 'Assessment Methodology' for supervisors, to help them to assess remuneration practices and conduct supervisory reviews. This document contains much valuable analysis and advice for supervisors but does not specify which of the various options should be followed.
16. The Basel task force on remuneration has been asked to develop further guidance on methodologies for aligning remuneration policies with risk and performance outcomes. A report on this is due to be published in October 2010. It remains to be seen whether this can lead to closer alignment of supervisory practices across the major jurisdictions.

CRD 3

17. The European Commission produced proposals to incorporate remuneration rules into the Capital Requirements Directive in May 2009. The proposals were discussed in Council working groups during the summer, and updated in October to increase alignment with the FSB's Principles and Standards. The text was approved by the Council in November as its 'general approach' to negotiations with the European Parliament.
18. In June and July 2010, the Council and European Parliament respectively approved the new amendments to the text. This is now due to be scrutinised by legal and linguistic experts (the 'jurist linguists' process) before an official version is finalised.

Further amendments may be called for as a result of that process, although these should not affect the legislators' intentions. The EU Council of Ministers is expected to publish the final text in the Official Journal in late autumn 2010.

19. CRD3 contains crucial text on proportionality with regards to remuneration policies and practices – saying that firms may apply the provisions in different ways according to their size and the complexity of their activities. It notes that it may not be appropriate for some investment firms to comply with all specific provisions on remuneration.
20. A CEBS group is currently working on guidelines for implementing the CRD3 remuneration provisions. It is in close contact with the Basel Committee task force, and will ensure its guidance on risk is consistent with that of Basel. There are key questions of detail still to be resolved, particularly on how to apply the proportionality clauses in practice. The group is aiming to issue the guidelines for consultation in the autumn, with final texts in December 2010. It is possible that, under the new European supervisory arrangements being put in place, some of the guidelines might be converted at a later stage into Binding Technical Standards (BTS).

Committee of European Banking Supervisors

21. CEBS published a set of High-level Principles for Remuneration Policies on 20 April 2009. In drafting these, CEBS cooperated closely with other bodies working on remuneration, in particular the FSB, BCBS and Committee of European Securities Regulators (CESR). Financial institutions were expected to apply and implement the principles by the end of Q3 2009 (including a transitional period). CEBS has recently undertaken an extensive implementation study on the national implementation of the principles by EU regulators and firms. CEBS will publish a report in 2010 presenting the main findings of the implementation review. The current UK Code is largely consistent with the CEBS principles.
22. The task force that prepared the High level Principles is now fully engaged in preparing guidelines to implement CRD3 by EU supervisory authorities. This task is important as CRD3 rules are high-level and many important details have yet to be decided. One of the most important is the question of 'proportionality' – how the rules should be applied across the broad range of firms covered by CRD3.

AIFMD, Solvency II Directive and Undertakings for Collective Investment in Transferable Securities (UCITS)

23. Both AIFMD (covering asset managers and hedge funds) and Solvency II (for insurers) include clauses on remuneration. The texts are at a higher level than CRD3 and they do not currently include specific numbers on the proportions of variable remuneration to be deferred. Negotiations are continuing on both, and the current expectation is that these Directives may come into force towards the end of 2012 or

early 2013. This would mean that the provisions on remuneration may not apply before the 2013 remuneration reviews for firms captured by these Directives. However, some investment firms may be subject first to CRD3's remuneration requirements before they come under the remit of AIFMD.

24. UCITS does not currently include any remuneration proposals.

Other

25. The International Organisation of Securities Commissions (IOSCO) is continuing its work on remuneration and published its 'Principles for Periodic Disclosure by Listed Entities'⁴⁸ in February 2010.

48 www.iosco.org/library/pubdocs/pdf/IOSCOPD317.pdf

Proposed approach to Proportionality

1. The following tables illustrate how a proportionate approach could be taken in applying the rules of the Code to firms and Code Staff. CRD3 does not allow for any firms to be completely exempt from the Code, therefore we have proposed: a minimum set of rules that must be applied by all firms (see Table 1); other rules that could be applied in line with a firm's nature, internal organisation, scale, scope and complexity etc (see Table 2); and rules which some firms may apply on a 'comply or explain' basis (see Table 3). A proportionate approach can be applied to all guidance set out in the Code.

Proportionality Table 1: Remuneration Code rules to be applied by all firms:

Principle	Code rules
General Requirement	A firm must establish, implement and maintain remuneration policies, procedures and practices that are consistent with and promote sound and effective risk management.
Remuneration Code Staff	A firm must <ol style="list-style-type: none"> (1) maintain a record of its Remuneration Code Staff in accordance with the general record-keeping requirements (SYSC 9); and (2) must take reasonable steps to ensure that its Remuneration Code Staff understand the implications of their status as such, including the potential for remuneration which does not comply with certain requirements of the Remuneration Code to be rendered void and recoverable by the firm.
Principle 1: Risk management & risk tolerance	A firm must ensure that its remuneration policy is consistent with and promotes sound and effective risk management and does not encourage risk-taking that exceeds the level of tolerated risk of the firm.
Principle 2: Supporting business strategy	A firm must ensure that its remuneration policy is in line with the business strategy, objectives, values and long-term interests of the firm.
Principle 3: Conflicts of interest	A firm must ensure that its remuneration policy includes measures to avoid conflicts of interest.

Principle 4: Governance (see also Table 2)	A <i>firm</i> must ensure that its <i>governing body</i> in its <i>supervisory function</i> adopts and periodically reviews the general principles of the <i>remuneration</i> policy and is responsible for its implementation.
Principle 6: Remuneration and capital	A <i>firm</i> must ensure that total variable remuneration does not limit the <i>firm's</i> ability to strengthen its capital base.
Principle 8: Profit-based measurement and risk adjustment (also see Table 2)	Assessments of financial performance used to calculate variable remuneration components or pools of variable remuneration components must be based principally on profits.
	A <i>firm</i> must ensure that its total variable <i>remuneration</i> is generally considerably contracted where subdued or negative financial performance of the <i>firm</i> occurs, taking into account both current <i>remuneration</i> and reductions in payouts of amounts previously earned.
Principle 11: Facilitating avoidance	A <i>firm</i> must ensure variable remuneration is not paid through vehicles or methods that facilitate the avoidance of the <i>Remuneration Code</i> .
Principle 12: Remuneration Structures (see Tables 2 & 3)	<p><i>General</i> – A <i>firm</i> must ensure that the structure of an <i>employee's remuneration</i> is consistent with and promotes effective risk management.</p> <p><i>Leverage</i> – A <i>firm</i> must set appropriate ratios between the fixed and variable components of total <i>remuneration</i> and ensure that:</p> <ol style="list-style-type: none"> (1) fixed and variable components of total <i>remuneration</i> are appropriately balanced; (2) the fixed component represents a sufficiently high proportion of the total <i>remuneration</i> to allow the operation of a fully flexible policy on variable <i>remuneration</i> components, including the possibility to pay no variable <i>remuneration</i> component.

* All text is subject to change.

Proportionality Table 2 – Remuneration Code rules which some firms will apply in line with their nature, internal organisation, scale, scope and complexity:

Principle	Code Rules	Approach
Principle 4: Governance (also see Table 1)	A firm must ensure that the implementation of the remuneration policy is, at least annually, subject to central and independent internal review for compliance with policies and procedures for remuneration adopted by the governing body in its supervisory function.	Policies must be reviewed annually, but there is scope to relax the requirement for independent reviews.
	(1) A firm that is significant in terms of its size, internal organisation and the nature, the scope and the complexity of its activities must establish a remuneration committee. Plus (2) to (5) inclusive of SYSC.19.3.12.R.	Some firms may not be expected to have a remuneration committee.
Principle 5: Control functions	A firm must ensure that employees engaged in control functions: (1) are independent from the business units they oversee; (2) have appropriate authority; and (3) are remunerated: (a) adequately to attract qualified and experienced staff; and (b) in accordance with the achievement of the objectives linked to their functions, independent of the performance of the business areas they control.	Applies to firms which are organised with separate control functions. Smaller firms will be expected to consider how best to apply this rule, even if compliance is outsourced.
	A firm must ensure that the remuneration of the senior officers in risk management and compliance functions is directly overseen by its governing body or remuneration committee, as appropriate.	See above.
Principle 8: Risk adjustment (also see Table 1)	(1) A firm must ensure that any measurement of performance used to calculate variable remuneration components or pools of variable remuneration components: (a) includes an adjustment for all types of current and potential risks and takes into account the cost and quantity of the capital and the liquidity required; and (b) takes into account the need for consistency with the timing and likelihood of the firm receiving potential future revenues incorporated into current earnings. (2) A firm must ensure that the allocation of variable remuneration components within the firm also takes into account all types of current and potential risks.	Firms with low leverage remuneration structures may be able to adopt a less strenuous approach to risk adjustment.

Principle 12: Remuneration Structures (see Tables 1 & 3)	<i>Performance Assessment</i> – A firm must ensure that where remuneration is performance-related: (1) the total amount of remuneration is based on a combination of the assessment of the performance of: (a) the individual; (b) the business unit concerned; and (c) the overall results of the firm; (2) when assessing individual performance, financial as well as non-financial criteria are taken into account.	Firms that do not have organisational structures which include business units and/or do not report financially at a business unit level will not be expected to apply (b).
	<i>Performance Assessment</i> – A firm must ensure that the assessment of performance is set in a multi-year framework in order to ensure that the assessment process is based on longer term performance and that the actual payment of performance-based components of remuneration is spread over a period which takes account of the underlying business cycle of the firm and its business risks.	It may be too onerous for some firms to set up monitoring systems to gauge longer-term performance.

* All text is subject to change.

Proportionality Table 3 – Remuneration Code rules where some firms may apply a ‘Comply or Explain’ approach, based on their nature, internal organisation, scale, scope and complexity:

Principle	Code Rules	Approach
Principle 7: Exceptional government intervention	A firm that benefits from exceptional government intervention must ensure that: (1) variable <i>remuneration</i> is strictly limited as a percentage of net revenues when it is inconsistent with the maintenance of a sound capital base and timely exit from government support; (2) it restructures <i>remuneration</i> in a manner aligned with sound risk management and long-term growth, including when appropriate establishing limits to the <i>remuneration of directors</i> ; and (3) no variable <i>remuneration</i> is paid to its <i>directors</i> unless this is justified.	Only applies to firms that have received exceptional government intervention.
Principle 9: Pension policy	A firm must ensure that: (1) its pension policy is in line with its business strategy, objectives, values and long-term interests; (2) when an <i>employee</i> leaves the <i>firm</i> before retirement, any <i>discretionary pension benefits</i> are held by the <i>firm</i> for a period of five years in the form of instruments referred to in SYSC 19.3.45R(1); and (3) In the case of an <i>employee</i> reaching retirement, <i>discretionary pension benefits</i> are paid to the <i>employee</i> in the form of instruments referred to in SYSC 19.3.45R(1) and subject to a five-year retention period.	Likely only to be relevant to the most highly remunerated Code Staff in large firms which may need a specific policy.
Principle 10: Personal Investment Strategies	(1) A firm must ensure its employees undertake not to use personal hedging strategies or remuneration- and liability-related insurance to undermine the risk alignment effects embedded in their remuneration arrangements. (2) A firm must maintain effective arrangements designed to ensure employees comply with their undertaking.	Only applies to firms and Code Staff which apply share-based awards and/or deferral (see below).

Principle 12: Remuneration Structures (see Tables 1 & 2)	<i>Guarantees</i> – A firm must not award, pay or provide guaranteed variable remuneration unless it: (1) is exceptional; (2) occurs in the context of hiring a new employee; and (3) is limited to the first year of that new employee’s service.	Applies to Code Staff within all firms in scope. De minimis concession can be applied to individual Code Staff, as long as the guaranteed amount does not push the individual above the specified leverage and total remuneration thresholds.
	<i>Severance</i> – A firm must ensure that payments related to the early termination of a contract reflect performance achieved over time and are designed in a way that does not reward failure.	Likely only to be relevant to the most highly remunerated Code Staff in large firms which may need a specific policy.
	<i>Share-based awards</i> – A firm must ensure that a substantial portion, which is at least 50%, of any variable remuneration consists of an appropriate balance of: (a) shares or equivalent ownership interests, subject to the legal structure of the firm concerned, or share-linked instruments or equivalent non-cash instruments in the case of a non-listed firm; and (b) where appropriate, hybrid capital, where applicable that adequately reflects the credit quality of the firm on an ongoing basis.	Proportionality applies for firms based on nature, scale, scope & complexity etc. De minimis concession can be applied to individual Code Staff.
	<i>Deferral</i> – (1) A firm must not award, pay or provide a variable remuneration component unless a substantial portion of it, which is at least 40%, is deferred over a period which is not less than three years. Plus (2) to (6) inclusive of SYSC.19.3.46.R.	Proportionality applies for firms based on nature, scale, scope and complexity etc. De minimis concession can be applied to individual Code Staff.
	<i>Performance Adjustment</i> – A firm must ensure that any variable remuneration, including a deferred portion, is paid or vests only if it is sustainable according to the financial situation of the firm as a whole, and justified according to the performance of the firm, the business unit and the individual concerned.	We expect the main impact of this to be on firms that apply deferral.
Effect of breaches of the Remuneration Principles	(1) The detailed provisions on voiding and recovery in SYSC 19 Annex 1 apply in relation to the prohibitions on persons being remunerated in the ways specified in: (a) SYSC 19.3.38R (guaranteed variable remuneration), disregarding paragraph (1) of that rule; and (b) SYSC 19.3.46R (non-deferred variable remuneration). Plus (2) to (4) inclusive of SYSC.19.3.51.R	Proportionality applies for firms based on nature, scale, scope & complexity etc. De minimis concession can be applied to individual Code Staff.

* All text is subject to change.

List of questions in this Consultation Paper

- Q1: Do you agree with our proposed approach to the definition of Code Staff? (pg 21)
- Q2: Do you agree with our approach to applying the Code to firms, individuals and groups, as outlined above?(pg 22)
- Q3: Do you have any comments on how the proposals contained in this CP affect equality and diversity issues? (pg 23)
- Q4: Do you agree with our proposals for changes to the Remuneration Principles 1-11? (pg 27)
- Q5: Do you agree with our general approach to remuneration structures as set out in Principle 12? (pg 33)
- Q6: Do you agree with our proposals, as set out in Annex 5, for applying proportionality at the rules level? (pg 37)
- Q7: Which metrics and thresholds do you believe are appropriate to determine how different firms can apply the specific rules of proportionality? (Please refer to Annex 5) (pg 37)
- Q8: Do you agree with our proposed approach to risk adjustment? (Pg 42)
- Q9: Do you agree with our proposed transitional arrangements for implementation of the amended Code? (pg 44)

Glossary

The Code	FSA's Remuneration Code. The current Code was published as part of Policy Statement 09/15 in August 2009. We are now consulting on amendments to that Code.
Code Staff	All staff who have a material impact on the firm's risk profile, including a person who performs a significant influence function for a firm, a Senior Manager (as defined below) and risk takers.
Comply or explain	Where a provision of CRD3 is a 'comply or explain' provision, firms have the option as to whether or not to implement. Firms that decide not to implement must provide acceptable reasons for the decision.
Clawback	A performance adjustment practice that enables firms to demand payback of all or part of an individual's bonus that has already vested with the individual, to take account of developments after vesting. (See also 'Ex-post risk adjustment' and 'Malus'.)
Deferral	Delayed payment of variable remuneration. CRD3 and the Code call for a substantial portion of bonus to be deferred and to be paid in separate portions over a number of years, rather than up-front in one lump sum.
De minimis	A concession that allows Code staff, whose remuneration is below certain agreed thresholds, to be excluded from rules on deferral, performance adjustment, proportion of remuneration paid in shares and guaranteed bonuses.
Ex-ante risk adjustment (risk adjustment)	When calculating annual bonus pools prior to pay-out, firms are expected to make adjustments to take account of the risks (actual and potential) and costs incurred in generating income. This is known as ex-ante risk adjustment.

Ex-post risk adjustment (performance adjustment)	After bonuses have been announced and paid, firms are expected to make further adjustments to take account of subsequent crystallised risks and developments of an adverse nature. Such adjustment would be made to the deferred unvested portion of the bonus. This is known as ex-post risk adjustment. Malus and clawback are two techniques of ex-post risk adjustment.
Malus	A performance adjustment practice that allows firms to adjust the as-yet unvested portion of an individual's bonus to take account of developments after communication of the bonus. (See also 'Ex-post risk adjustment' and 'Clawback'.)
P8 Employee	Principle 8 Employee – an individual whose remuneration was subject to Principle 8 of the current Code (deferrals, performance adjustment, etc) in the review of 2009 remuneration.
Senior Manager	An individual employed by the firm to whom the governing body (or a member of the governing body) of the firm has given responsibility for management and supervision, and who reports directly to the governing body, a member of the governing body, the chief executive, or the head of a significant business group.
Solvency II	A fundamental review of the capital adequacy regime for the European insurance industry. It aims to establish a revised set of EU-wide capital requirements and risk management standards that will replace the current Solvency requirements.
Third country	A country that is not a member of the European Economic Area.
Vesting	The point at which an individual's remuneration (whether in cash, shares or other instruments) becomes that individual's legal property. Deferred portions of the bonus may not yet be the legal property of the individual, and will not have vested.

Draft Remuneration Code rules

**SENIOR MANAGEMENT ARRANGEMENTS, SYSTEMS AND CONTROLS
(REMUNERATION CODE) (NO 2) INSTRUMENT 2010**

Powers exercised

- A. The Financial Services Authority makes this instrument in the exercise of the following powers and related provisions in the Financial Services and Markets Act 2000 (“the Act”):
- (1) section 138 (General rule-making power);
 - (2) section 139A (General rules about remuneration);
 - (3) section 149 (Evidential provisions);
 - (4) section 156 (General supplementary powers); and
 - (5) section 157(1) (Guidance).
- B. The rule-making powers listed above are specified for the purpose of section 153(2) (Rule-making instruments) of the Act.

Commencement

- C. This instrument comes into force on [1 January 2011].

Amendments to the Handbook

- D. The modules of the FSA Handbook of rules and guidance listed in column (1) below are amended in accordance with the Annexes to this instrument listed in column (2).

(1)	(2)
Glossary of definitions	Annex A
Senior Management Arrangements, Systems and Controls sourcebook (SYSC)	Annex B
General Prudential sourcebook (GENPRU)	Annex C
Supervision manual (SUP)	Annex D

Citation

- E. This instrument may be cited as the Senior Management Arrangements, Systems and Controls (Remuneration Code) (No 2) Instrument 2010.

By order of the Board
[10 November 2010]

Annex A

Amendments to the Glossary of definitions

In this Annex, underlining indicates new text and striking through indicates deleted text, unless otherwise stated.

Insert the following new definitions in the appropriate alphabetical position. The text is not underlined.

discretionary pension benefit (in SYSC 19) enhanced pension benefits granted on a discretionary basis by a *firm* to an *employee* as part of that *employee's* variable *remuneration* package, but excluding accrued benefits granted to an *employee* under the terms of his company pension scheme.

[**Note:** article 4(49) of the *Banking Consolidation Directive*]

FSB Compensation Standards (in accordance with the definition of “the Implementation Standards” in section 139A(12) of the *Act*) the Implementation Standards for Principles for Sound Compensation Practices issued by the Financial Stability Board on 25 September 2009.

Remuneration Code staff (for a *BIPRU firm* and a *third country BIPRU firm*) has the meaning given in SYSC 19.3.4R.

Amend the following definitions as shown.

parent undertaking (1) (in accordance with section 420 of the *Act* (Parent and subsidiary undertaking) and section 1162 of the Companies Act 2006 (Parent and subsidiary undertakings)):

...

(c) (for the purposes of ... SYSC 12 (Group risk systems and controls requirement) and SYSC 19 (Remuneration Code) and in relation to whether an *undertaking* is a parent *undertaking*) an *undertaking* which has the following relationship to another *undertaking* (“S”): ...

remuneration any form of remuneration, including salaries, *discretionary pension benefits* and benefits of any kind.

[**Note:** paragraph 23 of Annex V to the *Banking Consolidation Directive*]

~~*remuneration committee*~~ a committee or other body responsible for a *firm's* remuneration policy.

~~*remuneration policy*~~ the policy, procedures and practices established, implemented

~~and maintained in accordance with the *Remuneration Code* general requirement.~~

~~third country BIPRU
730k firm~~

~~an overseas firm that:~~

~~(a) — is not an *EEA firm*;~~

~~(b) — has its head office outside the *EEA*; and~~

~~(c) — would be a *BIPRU 730k firm* if it had been a *UK domestic firm*, had carried on all its business in the *United Kingdom* and had obtained whatever authorisations for doing so as are required under the *Act*.~~

Annex B

Amendments to the Senior Management Arrangements, Systems and Controls sourcebook (SYSC)

In this Annex, underlining indicates new text and striking through indicates deleted text, unless otherwise stated.

1 Annex 1

Detailed application of SYSC

...

Part 3	Tables summarising the application of the common platform requirements to different types of firm	
3.1	G	The <i>common platform requirements</i> apply in the following two ways (subject to the provisions in Part 2 of this Annex).
3.2	G	For a <i>common platform firm</i> , they apply in accordance with Column A in the table below.
3.3	G	For all other <i>firms</i> apart from <i>insurers, managing agents</i> and the <i>Society</i> , they apply in accordance with Column B in the table below. For these <i>firms</i> , where a <i>rule</i> is shown modified in Column B as 'Guidance', it should be read as <i>guidance</i> (as if "should" appeared in that rule instead of "must") and should be applied in a proportionate manner, taking into account the nature, scale and complexity of the firm's business.

Provision	COLUMN A	COLUMN B
SYSC 4	Application to a common platform firm	Application to all other firms apart from insurers, managing agents and the Society
SYSC 4.1.1R	Rule but SYSC 4.1.1R(2) applies only to a BIPRU firm	Rule but SYSC 4.1.1R(2) applies only to a <i>third country BIPRU firm</i>

...

- 4.1.1 R (1) A *firm* must have robust governance arrangements, which include a clear organisational structure with well defined, transparent and consistent lines of responsibility, effective processes to identify, manage, monitor and report the risks it is or might be exposed to, and internal control mechanisms, including sound administrative and accounting procedures and effective control and safeguard

arrangements for information processing systems.

- (2) A BIPRU firm and a third country BIPRU firm must comply with the Remuneration Code.

[Note: article 22(1) of the *Banking Consolidation Directive*, article 13(5) second paragraph of *MiFID*]

- 4.1.2 R For a *common platform firm*, the arrangements, processes and mechanisms referred to in SYSC 4.1.1R must be comprehensive and proportionate to the nature, scale and complexity of the *common platform firm's* activities and must take into account the specific technical criteria described in SYSC 4.1.7R, SYSC 5.1.7R and, SYSC 7 and (for a BIPRU firm and a third country BIPRU firm) SYSC 19.

...

Remuneration policies

- 4.1.12 G ~~Certain banks, building societies and BIPRU 730k firms will need to comply with the Remuneration Code requirement to establish, implement and maintain an effective remuneration policy that is consistent with effective risk management. See SYSC 19.1 for details of the application of the Remuneration Code.~~[deleted]

...

- 6.1.4-A G In setting the method of determining the remuneration of relevant persons involved in the compliance function, ~~certain banks, building societies and BIPRU 730k firms~~ will also need to comply with the *Remuneration Code*. See SYSC 19.1 for details of the application of the ~~Remuneration Code~~.

...

- 7.1.7B G In setting the method of determining the remuneration of relevant persons involved in the compliance function, ~~certain banks, building societies and BIPRU 730k firms~~ will also need to comply with the *Remuneration Code*. See SYSC 19.1 for details of the application of the ~~Remuneration Code~~.

...

- 12.1.13 R If this rule applies under SYSC 12.1.14R to a firm, the firm must:
- (1) comply with SYSC 12.1.8R(2) in relation to any *UK consolidation group* or *non-EEA sub-group* of which it is a member, as well as in relation to its *group*; and
 - (2) ensure that the risk management processes and internal control mechanisms at the level of any *UK consolidation group* or *non-EEA sub-group* of which it is a member comply with the obligations set out in the following provisions on a consolidated (or sub-

consolidated) basis:

...

(da) the Remuneration Code;

...

SYSC Chapter 19 is deleted in its entirety and replaced by the following text. The deleted text is not shown struck through and the new text is not underlined.

19 Remuneration Code

19.1 General application and purpose

Who? What? Where?

- 19.1.1 R (1) The *Remuneration Code* applies to a *BIPRU firm* and a *third country BIPRU firm*.
- (2) In relation to a *third country BIPRU firm*, the *Remuneration Code* applies only in relation to activities carried on from an establishment in the *United Kingdom*.
- (3) Otherwise, the *Remuneration Code* applies to a *firm* within (1) in the same way as *SYSC 4.1.1R* (General Requirements).
- 19.1.2 G Part 2 of *SYSC 1 Annex 1* provides for the application of *SYSC 4.1.1R* (General Requirements). In particular, and subject to the provisions on group risk systems and controls requirements in *SYSC 12*, this means that:
- (1) in relation to what the *Remuneration Code* applies to, it:
- (a) applies in relation to *regulated activities*, activities that constitute *dealing in investment as principal* (disregarding the exclusion in article 15 of the *Regulated Activities Order* (Absence of holding out etc), *ancillary activities* and (in relation to *MiFID business*) *ancillary services*;
- (b) applies with respect to the carrying on of *unregulated activities* in a *prudential context*; and
- (c) takes into account activities of other *group members*; and
- (2) in relation to where the *Remuneration Code* applies, it applies in relation to:
- (a) a *firm's UK activities*;

- (b) a *firm's passported activities* carried on from a *branch* in another *EEA State*; and
- (c) a *UK domestic firm's* activities wherever they are carried on, in a *prudential context*.

When?

19.1.3 R A *firm* must apply the *remuneration* requirements in SYSC 19.3 in relation to:

- (1) *remuneration* awarded, whether pursuant to a contract or otherwise, on or after 1 January 2011;
- (2) *remuneration* due on the basis of contracts concluded before 1 January 2011 which is awarded or paid on or after 1 January 2011; and
- (3) *remuneration* awarded, but not yet paid, before 1 January 2011, for services provided in 2010.

[**Note:** article 3(1) of the Third Capital Requirements Directive (Directive 2010/x/EU)]

19.1.4 G Subject to the requirements of SYSC 19.1.5R, in the *FSA's* view SYSC 19.1.3R does not require a *firm* to breach requirements of applicable contract or employment law.

[**Note:** recital 7 of the Third Capital Requirements Directive (Directive 2010/x/EU)]

- 19.1.5 R
- (1) This *rule* applies to a *firm* that is unable to comply with the *Remuneration Code* because of an obligation it owes to a *Remuneration Code staff member* under a provision of an agreement made on or before 29 July 2010 (the “provision”).
 - (2) A *firm* must take reasonable steps to amend or terminate the provision referred to in (1) in a way that enables it to comply with the *Remuneration Code* at the earliest opportunity.
 - (3) Until a *firm* has complied with (2) it must adopt specific and effective arrangements, processes and mechanisms to manage the risks raised by that provision.

Purpose

19.1.6 G (1) The aim of the *Remuneration Code* is to ensure that *firms* have risk-focused *remuneration policies*, which are consistent with and promote effective risk management and do not expose them to excessive risk. It expands upon the general organisational

requirements in SYSC 4.

- (2) The *Remuneration Code* fulfils the FSA's duty under section 139A of the *Act* (General rules about remuneration) to have *rules* requiring certain *firms* to have and act in accordance with a *remuneration* policy which is consistent with the effective management of risks and with the *FSB Compensation Standards*.

Notifications to the FSA

- 19.1.7 G (1) The *Remuneration Code* does not contain specific notification requirements. However, general circumstances in which the FSA expects to be notified by *firms* of matters relating to their compliance with requirements under the *regulatory system* are set out in SUP 15.3 (General notification requirements).
- (2) In particular, in relation to *remuneration* matters such circumstances should take into account *unregulated activities* as well as *regulated activities* and the activities of other members of a *group* and would include:
- (a) significant breaches of the *Remuneration Code*, including any breach of a *rule* to which the detailed provisions on voiding and recovery in SYSC 19 Annex 1 apply;
 - (b) any proposed *remuneration* policies, procedures or practices which could:
 - (i) have a significant adverse impact on the *firm's* reputation; or
 - (ii) affect the *firm's* ability to continue to provide adequate services to its *customers* and which could result in serious detriment to a *customer* of the *firm*; or
 - (iii) result in serious financial consequences to the *financial system* or to other *firms*; and
 - (c) any proposed changes to *remuneration* policies, practices or procedures which could have a significant impact on the *firm's* risk profile or resources;
 - (d) fraud, errors and other irregularities described in SUP 15.3.17R which may suggest weaknesses in, or be motivated by, the *firm's* *remuneration* policies, procedures or practices.
- (3) Such notifications should be made immediately the *firm* becomes aware, or has information which reasonably suggests such circumstances have occurred, may have occurred or may occur in the foreseeable future.

Individual guidance

- 19.1.8 G The *FSA's* policy on individual *guidance* is set out in *SUP 9*. *Firms* should in particular note the policy on what the *FSA* considers to be a reasonable request for *guidance* (see *SUP 9.2.5G*). For example, where a *firm* is seeking *guidance* on a proposed *remuneration* structure the *FSA* will expect the *firm* to provide a detailed analysis of how the structure complies with the *Remuneration Code*, including the general requirement for *remuneration* policies, procedures and practices to be consistent with and promote sound and effective risk management.

19.2 General requirement

Remuneration policies must promote effective risk management

- 19.2.1 R A *firm* must establish, implement and maintain *remuneration* policies, procedures and practices that are consistent with and promote sound and effective risk management.

[**Note:** Article 22(1) of the *Banking Consolidation Directive*]

- 19.2.2 G
- (1) If a *firm's remuneration policy* is not aligned with effective risk management it is likely that *employees* will have incentives to act in ways that might undermine effective risk management.
 - (2) The *Remuneration Code* covers all aspects of *remuneration* that could have a bearing on effective risk management including wages, bonus, long term-incentive plans, options, hiring bonuses, severance packages and pension arrangements. In applying the *Remuneration Code*, a *firm* should have regard to applicable good practice on *remuneration* and corporate governance, such as guidelines on executive contracts and severance produced by the Association of British Insurers (ABI) and the National Association of Pension Funds (NAPF). In considering the risks arising from its *remuneration* policies, a *firm* will also need to take into account its statutory duties in relation to equal pay and non-discrimination.
 - (3) As with other aspects of a *firm's* systems and controls, in accordance with *SYSC 4.1.2R remuneration* policies, procedures and practices must be comprehensive and proportionate to the nature, scale and complexity of the *common platform firm's* activities. What a *firm* must do in order to comply with the *Remuneration Code* will therefore vary. For example, while the *Remuneration Code* refers to a *firm's remuneration* committee and risk management function, it may be appropriate for the *governing body* of a smaller *firm* to act as the *remuneration* committee, and for the *firm* not to have a separate risk management function.
 - (4) The principles in the *Remuneration Code* will be used by the *FSA* to

assess the quality of a *firm's remuneration policies* and whether they encourage excessive risk-taking by a *firm's employees*.

- (5) The *FSA* may also ask *remuneration* committees to provide the *FSA* with evidence of how well the *firm's remuneration policies* meet the *Remuneration Code's* principles, together with plans for improvement where there is a shortfall. The *FSA* will also expect relevant *firms* to use the principles in assessing their exposure to risks arising from their *remuneration policies* as part of the *internal capital adequacy assessment process (ICAAP)*.
- (6) The *Remuneration Code* is principally concerned with the risks created by the way *remuneration* arrangements are structured, not with the absolute amount of *remuneration*, which is generally a matter for *firms' remuneration* committees.

- 19.2.3 G Although specific *remuneration* requirements in this chapter may apply only in relation to certain categories of *employee*, in complying with the *Remuneration Code general requirement* the *FSA* would expect *firms* to apply at least the principles relating to governance, conflicts of interest, risk adjustment, guaranteed variable *remuneration* and deferral on a *firm-wide* basis.

Record-keeping

- 19.2.4 G In line with the record-keeping requirements in *SYSC 9*, a *firm* should ensure that its *remuneration* policies, practices and procedures are clear and documented. Such policies, practices and procedures would include performance appraisal processes and decisions.

Interpretation of references to remuneration

- 19.2.5 R (1) In this chapter references to *remuneration* include *remuneration* paid, provided or awarded by any *person* to the extent that it is paid, provided or awarded in connection with *employment* by a *firm*.
- (2) Paragraph (1) is without prejudice to the meaning of *remuneration* elsewhere in the *Handbook*.
- 19.2.6 G *Remuneration* includes, for example, payments made by a seconding organisation which is not subject to the *Remuneration Code* to a secondee in respect of their *employment* by a *firm* which is subject to the *Remuneration Code*.

19.3 Remuneration principles for banks, building societies and investment firms

Application: groups

- 19.3.1 R A *firm* must apply the requirements of this section at *group*, *parent undertaking* and *subsidiary undertaking* levels, including those *subsidiaries*

established in a country or territory which is not an *EEA State*.

[**Note:** Paragraph 22(ie)¹ of Annex V to the *Banking Consolidation Directive*]

- 19.3.2 G In the *FSA's* view, the requirement to apply this section at *group, parent undertaking* and *subsidiary undertaking* levels is in line with the requirements in article 73(3) of the *Banking Consolidation Directive* concerning the application of systems and controls requirements to *groups* (as implemented in *SYSC 12.1.13R*). In particular, the risk management processes and internal control mechanisms at the level of any *UK consolidation group* or *non-EEA sub-group* of which a *firm* is a member will need to comply with the obligations set out in this section on a consolidated (or sub-consolidated) basis.

Application: categories of staff and proportionality

- 19.3.3 R (1) This section applies in relation to *Remuneration Code staff*, except as set out in (3).
- (2) When establishing and applying the total *remuneration* policies for *Remuneration Code staff*, a *firm* must comply with this section in a way and to the extent that is appropriate to its size, internal organisation and the nature, scope and complexity of its activities.
- (3) This *rule* does not apply to the requirement for significant *firms* to have a remuneration committee (*SYSC 19.3.12R*).

[**Note:** Paragraph 23 of Annex V to the *Banking Consolidation Directive*]

- 19.3.4 R *Remuneration Code staff* comprises categories of staff, including senior management, risk takers, control functions and any *employee* 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.

[**Note:** paragraph 23 of Annex V to the *Banking Consolidation Directive*]

- 19.3.5 R A *firm* must:
- (1) maintain a record of its *Remuneration Code staff* in accordance with the general record-keeping requirements (*SYSC 9*); and
- (2) take reasonable steps to ensure that its *Remuneration Code staff* understand the implications of their status as such, including the potential for *remuneration* which does not comply with certain requirements of the *Remuneration Code* to be rendered void and

¹ References to paragraphs of Annex V to the Banking Consolidation Directive are to the numbering used in the [text agreed by Coreper \(the Permanent Representatives Committee of the Council of the European Union\) on 30 June 2010](#) and will be updated in the final instrument to reflect the final text published in the Official Journal of the European Union.

recoverable by the *firm*.

- 19.3.6 G (1) Taking account of the *remuneration* principles proportionality rule (SYSC 19.3.3R), the *FSA* would not generally consider it necessary for a *firm* to apply the *rules* referred to in (2) where in relation to an individual:
- (a) variable *remuneration* is no more than 33% of total *remuneration*; and
 - (b) total *remuneration* is no more than £500,000.
- (2) The *rules* referred to in (1) are those relating to:
- (a) guaranteed variable *remuneration* (SYSC 19.3.38R).
 - (b) retained *shares* or other instruments (SYSC 19.3.45R);
 - (c) deferral (SYSC 19.3.46R); and
 - (d) performance adjustment (SYSC 19.3.48R).
- (3) In the *FSA*'s view:
- (a) a *firm*'s staff includes its *employees*;
 - (b) a *person* who performs a *significant influence function* for, or is a *senior manager* of, a *firm* would be expected to be part of the *firm*'s *Remuneration Code staff*;
 - (c) the table in (4) provides a non-exhaustive list of examples of key positions that should be within a *firm*'s definition of staff who are 'risk takers' and *firms* should consider who the examples would apply in relation to their own organisational structure;
 - (d) *firms* may find it useful to set their own metrics to identify their 'risk takers' based, for example, on trading limits; and
 - (e) a *firm* should treat a *person* as being *Remuneration Code staff* in relation to *remuneration* in respect of a given performance year if they were *Remuneration Code staff* for any part of that year.

(4) High-level category	Suggested business lines
Heads of significant business lines (including regional heads) and any individuals or groups within their control who have a material impact on the <i>firm</i> 's risk profile	Fixed income Foreign exchange Commodities

	Securitisation Sales areas Investment banking (including mergers and acquisitions advisory) Commercial banking Equities Structured finance Lending quality Trading areas Research
Heads of support and control functions and other individuals within their control who have a material impact on the <i>firm's</i> risk profile	Credit / market / operational risk Legal Treasury controls Human resources Compliance Internal audit

Remuneration Principle 1: Risk management and risk tolerance

- 19.3.7 R A *firm* must ensure that its *remuneration* policy is consistent with and promotes sound and effective risk management and does not encourage risk-taking that exceeds the level of tolerated risk of the *firm*.

[**Note:** Paragraph 23(a) of Annex V to the *Banking Consolidation Directive*]

Remuneration Principle 2: Supporting business strategy, objectives, values and long-term interests of the *firm*

- 19.3.8 R A *firm* must ensure that its *remuneration* policy is in line with the business strategy, objectives, values and long-term interests of the *firm*.

[**Note:** Paragraph 23(b) of Annex V to the *Banking Consolidation Directive*]

Remuneration Principle 3: Avoiding conflicts of interest

- 19.3.9 R A *firm* must ensure that its *remuneration* policy includes measures to avoid conflicts of interest.

[**Note:** Paragraph 23(b) of Annex V to the *Banking Consolidation Directive*]

Remuneration Principle 4: Governance

- 19.3.10 R A *firm* must ensure that its *governing body* in its *supervisory function* adopts and periodically reviews the general principles of the *remuneration* policy and is responsible for its implementation.

[**Note:** Paragraph 23(c) of Annex V to the *Banking Consolidation Directive* and Standard 1 of the *FSB Compensation Standards*]

- 19.3.11 R A *firm* must ensure that the implementation of the *remuneration* policy is, at least annually, subject to central and independent internal review for compliance with policies and procedures for *remuneration* adopted by the *governing body* in its *supervisory function*.

[**Note:** Paragraph 23(d) of Annex V to the *Banking Consolidation Directive* and Standard 1 of the *FSB Compensation Standards*]

- 19.3.12 R
- (1) A *firm* that is significant in terms of its size, internal organisation and the nature, scope and complexity of its activities must establish a *remuneration* committee.
 - (2) The *remuneration* committee must be constituted in a way that enables it to exercise competent and independent judgment on *remuneration* policies and practices and the incentives created for managing risk, capital and liquidity.
 - (3) The *remuneration* committee must be responsible for the preparation of decisions regarding *remuneration*, including those which have implications for the risk and risk management of the *firm* and which are to be taken by the *governing body* in its *supervisory function*.
 - (4) The chairman and the members of the *remuneration* committee must be *non-executive directors* of the *firm*.
 - (5) When preparing such decisions, the *remuneration* committee must take into account the long-term interests of shareholders, investors and other stakeholders in the *firm*.

[**Note:** Paragraph 22a of Annex V of the *Banking Consolidation Directive* and Standard 1 of the *FSB Compensation Standards*]

- 19.3.13 G
- (1) A *firm* should be able to demonstrate that its decisions are consistent with an assessment of its financial condition and future prospects. In particular, practices by which *remuneration* is paid for potential future revenues whose timing and likelihood remain uncertain should be evaluated carefully and the *governing body* and/or *remuneration* committee should work closely with the *firm's* risk function in evaluating the incentives created by its *remuneration* system.

- (2) The *governing body* and any *remuneration* committee are responsible for ensuring that the *firm's remuneration* policy complies with the *Remuneration Code* and where relevant should take into account relevant guidance, such as that issued by the Basel Committee on Banking Supervision, the International Association of Insurance Supervisors (IAIS) and the International Organization of Securities Commissions (IOSCO).
- (3) The periodic review of the implementation of the *remuneration* policy should assess compliance with the *Remuneration Code*.
- (4) Guidance on what the *supervisory function* might involve is set out in SYSC 4.3.3G.

Remuneration Principle 5: Control functions

19.3.14 R A *firm* must ensure that *employees* engaged in control functions:

- (1) are independent from the business units they oversee;
- (2) have appropriate authority; and
- (3) are *remunerated*:
 - (a) adequately to attract qualified and experienced staff; and
 - (b) in accordance with the achievement of the objectives linked to their functions, independent of the performance of the business areas they control.

[Note: Paragraph 23(da) of Annex V to the *Banking Consolidation Directive* and Standard 2 of the *FSB Compensation Standards*]

19.3.15 E (1) A *firm's* risk management and compliance functions should have appropriate input into setting the *remuneration policy* for other business areas. The procedures for setting *remuneration* should allow risk and compliance functions to have significant input into the setting of individual *remuneration* awards where those functions have concerns about the behaviour of the individuals concerned or the riskiness of the business undertaken.

(2) Contravention of (1) may be relied on as tending to establish contravention of the *rule* on *employees* engaged in control functions having appropriate authority (SYSC 19.3.14R(2)).

19.3.16 R A *firm* must ensure that the *remuneration* of the senior officers in risk management and compliance functions is directly overseen by its *governing body* or *remuneration* committee, as appropriate.

[Note: Paragraph 23(db) of Annex V to the *Banking Consolidation Directive*]

- 19.3.17 G (1) This Remuneration Principle is designed to manage the conflicts of interest which might arise if other business areas had undue influence over the *remuneration of employees* within control functions. Conflicts of interest can easily arise when *employees* are involved in the determination of *remuneration* for their own business area. Where these could arise they need to be managed by having in place independent roles for control functions (including, notably, risk management and compliance) and human resources. It is good practice to seek input from a *firm's* human resources function when setting *remuneration* for other business areas.
- (2) The need to avoid undue influence is particularly important where *employees* from the control functions are embedded in other business areas. This Remuneration Principle does not prevent the views of other business areas being sought as an appropriate part of the assessment process.
- (3) The *FSA* would generally expect the ratio of the potential variable component of *remuneration* to the fixed component of *remuneration* to be significantly lower for *employees* in risk management and compliance functions than for *employees* in other business areas whose potential bonus is a significant proportion of their *remuneration*. *Firms* should nevertheless ensure that the total *remuneration* package offered to those *employees* is sufficient to attract and retain staff with the skills, knowledge and expertise to discharge those functions. The requirement that the method of determining the *remuneration of relevant persons* involved in the compliance function must not compromise their objectivity or be likely to do so also applies (see *SYSC* 6.1.4R(4)).

Remuneration Principle 6: Remuneration and capital

- 19.3.18 R A *firm* must ensure that total variable *remuneration* does not limit the *firm's* ability to strengthen its capital base.
- [**Note:** Paragraph 23(eb) of Annex V to the *Banking Consolidation Directive* and Standard 3 of the *FSB Compensation Standards*]

- 19.3.19 G This Remuneration Principle underlines the link between a *firm's* variable *remuneration* costs and the need to manage its capital base, including forward-looking capital planning measures. Where a *firm* needs to strengthen its capital base, its variable *remuneration* arrangements should be sufficiently flexible to allow it to direct the necessary resources towards capital building.

Remuneration Principle 7: Exceptional government intervention

- 19.3.20 R A *firm* that benefits from exceptional government intervention must ensure that:

- (1) variable *remuneration* is strictly limited as a percentage of net revenues when it is inconsistent with the maintenance of a sound capital base and timely exit from government support;
- (2) it restructures *remuneration* in a manner aligned with sound risk management and long-term growth, including when appropriate establishing limits to the *remuneration of directors*; and
- (3) no variable *remuneration* is paid to its *directors* unless this is justified.

[**Note:** Paragraph 23(ed) of Annex V to the *Banking Consolidation Directive* and Standard 10 of the *FSB Compensation Standards*]

- 19.3.21 G The *FSA* would normally expect it to be appropriate for the ban on paying variable *remuneration* to *directors* of a *firm* that benefits from exceptional government intervention to apply only in relation to *directors* who were in office at the time that the intervention was required.

Remuneration Principle 8: Profit-based measurement and risk adjustment

- 19.3.22 R (1) A *firm* must ensure that any measurement of performance used to calculate variable *remuneration* components or pools of variable *remuneration* components:
- (a) includes adjustments for all types of current and potential risks and takes into account the cost and quantity of the capital and the liquidity required; and
 - (b) takes into account the need for consistency with the timing and likelihood of the firm receiving potential revenues incorporated into current earnings.
- (2) A *firm* must ensure that the allocation of variable *remuneration* components within the *firm* also takes into account all types of current and potential risks.

[**Note:** Paragraph 23(h) of Annex V to the *Banking Consolidation Directive* and Standard 4 of the *FSB Compensation Standards*]

- 19.3.23 G (1) This Remuneration Principle stresses the importance of risk adjustment in measuring performance, and the importance within that process of applying judgment and common sense. A *firm* should ask the risk management function to validate and assess risk-adjustment techniques, and to attend a meeting of the *governing body* or *remuneration* committee for this purpose.
- (2) A number of risk-adjustment techniques and measures are available, and a *firm* should choose those most appropriate to its circumstances. Common measures include those based on economic profit or economic capital. Whichever technique is chosen, the full range of

potential risks should be covered. The *FSA* expects a *firm* to be able to provide it with details of all adjustments that the *firm* has made under a formulaic approach.

- (3) The *FSA* expects that a *firm* will apply qualitative judgments and common sense in the final decision about the performance-related components of variable *remuneration* pools.
- (4) A *firm's governing body* (or *remuneration committee* where appropriate) should take the lead in determining the measures to be used. It should offer the appropriate checks and balances to prevent inappropriate manipulation of the measures used. It should consult closely and frequently with the *firm's* risk management functions, in particular those relating to operational, market, credit and liquidity risk.

- 19.3.24 G (1) Long-term incentive plans should be treated as pools of variable *remuneration*. Many common measures of performance for long-term incentive plans, such as earnings per *share* (EPS), are not adjusted for longer-term risk factors. Total shareholder return (TSR), another common measure, includes in its measurement dividend distributions, which can also be based on unadjusted earnings data. If incentive plans mature within a two to four year period and are based on EPS or TSR, strategies can be devised to boost EPS or TSR during the life of the plan, to the detriment of the true longer-term health of a *firm*. For example, increasing leverage is a technique which can be used to boost EPS and TSR. *Firms* should take account of these factors when developing risk-adjustment methods.
- (2) *Firms* that have long-term incentive plans should structure them with vesting subject to appropriate performance conditions, and half of the award vesting after not less than three years and the remainder after not less than five years.
- (3) Long-term incentive plan awards may be included in the calculation of the deferred portion of *variable remuneration* only if upside incentives are adequately balanced by downside adjustments. The valuation of the award should be based on its value when the award is granted, and determined using an appropriate technique.
- 19.3.25 R Assessments of financial performance used to calculate variable *remuneration* components or pools of variable *remuneration* components must be based principally on profits.
- 19.3.26 G (1) Performance measures based primarily on revenues or turnover are unlikely to pay sufficient regard to the quality of business undertaken or services provided. Profits are a better measure provided they are adjusted for risk, including future risks not adequately captured by accounting profits.

- (2) Management accounts should provide profit data at such levels within the *firm's* structure as to enable a *firm* to see as accurate a picture of contributions of relevant staff to a *firm's* performance as is reasonably practicable. If revenue or turnover is used as a component in performance assessment, processes should be in place to ensure that the quality of business undertaken or services provided and their appropriateness for *clients* are taken into account.

19.3.27 R A *firm* must ensure that its total variable *remuneration* is generally considerably contracted where subdued or negative financial performance of the *firm* occurs, taking into account both current *remuneration* and reductions in payouts of amounts previously earned.

[**Note:** Paragraph 23(ia) of Annex V to the *Banking Consolidation Directive* and Standard 5 of the *FSB Compensation Standards*]

19.3.28 G Where a *firm* makes a loss the *FSA* would generally expect no variable *remuneration* to be awarded. Variable *remuneration* may nevertheless be justified, for example, to incentivise *employees* involved in new business ventures which could be loss-making in their early stages.

Remuneration Principle 9: Pension policy

19.3.29 R A *firm* must ensure that:

- (1) its pension policy is in line with its business strategy, objectives, values and long-term interests;
- (2) when an *employee* leaves the *firm* before retirement, any *discretionary pension benefits* are held by the *firm* for a period of five years in the form of instruments referred to in SYSC 19.3.45R(1); and
- (3) in the case of an *employee* reaching retirement, *discretionary pension benefits* are paid to the *employee* in the form of instruments referred to in SYSC 19.3.45R(1) and subject to a five-year retention period.

[**Note:** Paragraph 23(ib) of Annex V to the *Banking Consolidation Directive*]

Remuneration Principle 10: Personal investment strategies

19.3.30 R (1) A *firm* must ensure its *employees* undertake not to use personal hedging strategies or *remuneration-* or liability-related *contracts of insurance* to undermine the risk alignment effects embedded in their *remuneration* arrangements.

(2) A *firm* must maintain effective arrangements designed to ensure *employees* comply with their undertaking.

[**Note:** Paragraph 23(ic) of Annex V to the *Banking Consolidation Directive*]

and Standard 14 of the *FSB Compensation Standards*]

- 19.3.31 G In the *FSA's* view circumstances in which a *person* will be using a personal hedging strategy include entering into an arrangement with a third party under which the third party will make payments, directly or indirectly, to that *person* that are linked to or commensurate with the amounts by which the *person's remuneration* is subject to reductions.

Remuneration Principle 11: Avoidance of the Remuneration Code

- 19.3.32 R A *firm* must ensure variable *remuneration* is not paid through vehicles or methods that facilitate the avoidance of the *Remuneration Code*.

[**Note:** Paragraph 23(id) of Annex V to the *Banking Consolidation Directive*]

Remuneration Principle 12: Remuneration structures

- 19.3.33 R A *firm* must ensure that the structure of an *employee's remuneration* is consistent with and promotes effective risk management.

- 19.3.34 R A *firm* must ensure that where *remuneration* is performance-related:

- (1) the total amount of *remuneration* is based on a combination of the assessment of the performance of:
 - (a) the individual;
 - (b) the business unit concerned; and
 - (c) the overall results of the *firm*; and
- (2) when assessing individual performance, financial as well as non-financial criteria are taken into account.

[**Note:** Paragraph 23(e) of Annex V to the *Banking Consolidation Directive* and Standard 6 of the *FSB Compensation Standards*]

- 19.3.35 G Non-financial performance metrics should form a significant part of the performance assessment process and should include adherence to effective risk management and compliance with the *regulatory system* and with relevant overseas regulatory requirements. Poor performance in non-financial metrics such as poor risk management or other behaviours contrary to *firm* values can pose significant risks for a *firm* and should, as appropriate, override metrics of financial performance. The performance assessment process and the importance of non-financial assessment factors in the process should be clearly explained to relevant *employees* and implemented. A 'balanced scorecard' can be a good way to do this.

- 19.3.36 R A *firm* must ensure that the assessment of performance is set in a multi-year framework in order to ensure that the assessment process is based on longer term performance and that the actual payment of performance-based

components of *remuneration* is spread over a period which takes account of the underlying business cycle of the *firm* and its business risks.

[**Note:** Paragraph 23(ea) of Annex V to the *Banking Consolidation Directive*]

19.3.37 G The requirement for assessment of performance to be in a multi-year framework reflects the fact that profits from a *firm's* activities can be volatile and subject to cycles. The financial performance of *firms* and individual *employees* can be exaggerated as a result. Performance assessment on a moving average of results can be a good way of meeting this requirement. However, other techniques such as good quality risk adjustment and deferment of a sufficiently large proportion of *remuneration* may also be useful.

19.3.38 R A *firm* must not award, pay or provide guaranteed variable *remuneration* unless it:

- (1) is exceptional;
- (2) occurs in the context of hiring new *Remuneration Code staff*; and
- (3) is limited to the first year of service.

[**Note:** Paragraph 23(ec) of Annex V to the *Banking Consolidation Directive* and Standard 11 of the *FSB Compensation Standards*]

19.3.39 E (1) A *firm* should not award, pay or provide guaranteed variable *remuneration* in the context of hiring new *Remuneration Code staff* ('S') unless:

- (a) it has taken reasonable steps to ensure the *remuneration* is not more generous in either its amount or terms (including any deferral or retention periods) than the variable *remuneration* awarded or offered by S's previous employer; and

- (b) it is subject to appropriate performance adjustment requirements.

(2) Contravention of (1) may be relied on as tending to establish contravention of the *rule* on guaranteed variable *remuneration* (SYSC 19.3.38R).

19.3.40 G Guaranteed variable *remuneration* should be subject to the same deferral criteria as other forms of variable *remuneration* awarded by the *firm*.

19.3.41 G In the *FSA's* view, variable *remuneration* can be awarded to *Remuneration Code staff* in the form of retention awards where it is compatible with the *Remuneration Code general requirement* to do so. The *FSA* considers this is only likely to be the case where a *firm* is undergoing a major restructuring and a good case can be made for retention of particular key staff members

on prudential grounds. Proposals to give retention awards should form part of any notice of the restructuring proposals required in accordance with *Principle 11* and the general notification requirements in *SUP 15.3*.

- 19.3.42 R A *firm* must set appropriate ratios between the fixed and variable components of total *remuneration* and ensure that:
- (1) fixed and variable components of total *remuneration* are appropriately balanced; and
 - (2) the fixed component represents 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.

[**Note:** Paragraph 23(f) of Annex V to the *Banking Consolidation Directive*]

- 19.3.43 R A *firm* must ensure that payments related to the early termination of a contract reflect performance achieved over time and are designed in a way that does not reward failure.

[**Note:** Paragraph 23(g) of Annex V to the *Banking Consolidation Directive* and Standard 12 of the *FSB Compensation Standards*]

- 19.3.44 G *Firms* should review existing contractual payments related to termination of employment with a view to ensuring that these are payable only where there is a clear basis for concluding that they are consistent with the *Remuneration Code general requirement*.

[**Note:** Standard 12 of the *FSB Compensation Standards*]

- 19.3.45 R
- (1) A *firm* must ensure that a substantial portion, which is at least 50%, of any variable *remuneration* consists of an appropriate balance of:
 - (a) *shares* or equivalent ownership interests, subject to the legal structure of the *firm* concerned, or *share*-linked instruments or equivalent non-cash instruments in the case of a non-listed *firm*; and
 - (b) where appropriate, *capital instruments* which are eligible for inclusion at stage B1 of the calculation in the *capital resources table*, where applicable that adequately reflects the credit quality of the *firm* on an ongoing concern basis.
 - (2) The instruments in (1) must be subject to an appropriate retention policy designed to align incentives with the longer-term interests of the *firm*.
 - (3) This *rule* applies to both the portion of the variable *remuneration* component deferred in accordance with *SYSC 19.3.46R* and the portion not deferred.

[**Note:** Paragraph 23(ha) of Annex V to the *Banking Consolidation Directive* and Standard 8 of the *FSB Compensation Standards*]

- 19.3.46 R
- (1) A *firm* must not award, pay or provide a variable *remuneration* component unless a substantial portion of it, which is at least 40%, is deferred over a period which is not less than three to five years.
 - (2) *Remuneration* under (1) must vest no faster than on a pro-rata basis.
 - (3) In the case of a variable *remuneration* component of a particularly high amount or payable to a *director* of a *firm* that is significant in terms of its size, internal organisation and the nature, scope and complexity of its activities, at least 60% of the amount must be deferred.
 - (4) The length of the deferral period must be established in accordance with the business cycle, the nature of the business, its risks and the activities of the *employee* in question.

[**Note:** Paragraph 23(i) of Annex V to the *Banking Consolidation Directive* and Standard 6 of the *FSB Compensation Standards*]

- (5) £500,000 is a particularly high amount for the purpose of (3).
 - (6) Paragraph (5) is without prejudice to the possibility of lower sums being considered a particularly high amount.
- 19.3.47 G
- (1) Deferred *remuneration* paid in *shares* or *share*-linked instruments should be made under a scheme which meets appropriate criteria, including risk adjustment of the performance measure used to determine the initial allocation of shares. Deferred *remuneration* paid in cash should also be subject to performance criteria.
 - (2) The *FSA* would generally expect a *firm* to have a *firm*-wide policy (and *group*-wide policy, where appropriate) on deferral. The proportion deferred should generally rise with the ratio of variable *remuneration* to fixed *remuneration* and with the amount of variable *remuneration*. While any variable *remuneration* component of £500,000 or more paid to *Remuneration Code staff* must be subject to 60% deferral, *firms* should also consider whether lesser amounts should be considered to be 'particularly high' taking account, for example, of whether there are significant differences within *Remuneration Code staff* in the levels of variable *remuneration* paid.
- 19.3.48 R
- A *firm* must ensure that any variable *remuneration*, including a deferred portion, is paid or vests only if it is sustainable according to the financial situation of the *firm* as a whole, and justified according to the performance of the *firm*, the business unit and the individual concerned.

[**Note:** Paragraph 23(ia) of Annex V to the *Banking Consolidation Directive* and Standards 6 and 9 of the *FSB Compensation Standards*]

- 19.3.49 E (1) A *firm* should reduce unvested deferred variable *remuneration* when, as a minimum:
- (a) there is reasonable evidence of *employee* misbehaviour or material error;
 - (b) the *firm* or the relevant business unit suffers a material downturn in its financial performance;
 - (c) the *firm* or the relevant business unit suffers a material failure of risk management.
- (2) For performance adjustment purposes, awards of deferred variable *remuneration* made in *shares* or other non-cash instruments should provide the ability for the *firm* to reduce the number of *shares* or other non-cash instruments.
- (3) Contravention of (1) or (2) may be relied on as tending to establish contravention of the *rule* on performance adjustment (SYSC 19.3.48R).

- 19.3.50 G (1) Variable *remuneration* may be justified, for example, to incentivise *employees* involved in new business ventures which could be loss-making in their early stages.
- (2) The *governing body* (or, where appropriate, the *remuneration* committee) should approve performance adjustment policies, including the triggers under which adjustment would take place. The *FSA* may ask *firms* to provide a copy of their policies and expects *firms* to make adequate records of material decisions to operate the adjustments.

Effect of breaches of the Remuneration Principles

- 19.3.51 R (1) The detailed provisions on voiding and recovery in SYSC 19 Annex 1 apply in relation to the prohibitions on *Remuneration Code staff* being *remunerated* in the ways specified in:
- (a) SYSC 19.3.38R (guaranteed variable *remuneration*);
 - (b) SYSC 19.3.46R (non-deferred variable *remuneration*); and
 - (c) SYSC 19 Annex 1 7R (replacing payments recovered or property transferred).
- (2) This *rule* does not apply in relation to the prohibition on *Remuneration Code staff* being *remunerated* in the way specified in SYSC 19.3.38R (guaranteed variable *remuneration*) if both the conditions in paragraphs (2) and (3) of that *rule* are met.
- (3) This *rule* does not apply in relation to *Remuneration Code staff*

whose:

- (a) Variable *remuneration* is no more than 33% of total *remuneration*; and
 - (b) total *remuneration* is no more than £500,000.
- (4) In relation to (3):
- (a) references to *remuneration* are to *remuneration* awarded or paid in respect of the relevant performance year;
 - (b) the amount of any *remuneration* is:
 - (i) if it is money, its amount when awarded;
 - (ii) otherwise, the greater of: its value to the recipient when awarded; its market value when awarded; and the cost of providing it;
 - (c) where *remuneration* is, when awarded, subject to any condition, restriction or other similar provision which causes the amount of the *remuneration* to be less than it otherwise would be, that condition, restriction or provision is to be ignored in arriving at its value; and
 - (d) it is to be assumed that the member of *Remuneration Code staff* remains so for the duration of the relevant performance year.

- 19.3.52 G Section 139A(9) of the *Act* enables the *FSA* to make *rules* that render void any provision of an agreement that contravenes specified prohibitions in the *Remuneration Code*, and that provide for the recovery of any payment made, or other property transferred, in pursuance of such a provision. *SYSC 19.3.51R* (together with *SYSC 19 Annex 1*) is such a *rule* and renders void provisions of an agreement that contravene the specified prohibitions on guaranteed variable *remuneration*, non-deferred variable *remuneration* and replacing payments recovered or property transferred. This is an exception to the general position set out in section 151(2) of the *Act* that a contravention of a *rule* does not make any transaction void or unenforceable.

SYSC 19 Annex 1

Detailed provisions on voiding and recovery

Rendering contravening provisions of agreements void

- 1 R Any provision of an agreement that contravenes a prohibition on *persons* being *remunerated* in a way specified in a *rule* to which this annex applies (a “contravening provision”) is void.

- 2 R A contravening provision that, at the time a *rule* to which this annex applies was made, is contained in an agreement made before that time is not rendered void by 1R unless it is subsequently amended so as to contravene such a *rule*.
- 3 G The effect of 2R, in accordance with section 139A(11) of the *Act*, is to prevent contravening provisions being rendered void retrospectively. Contravening provisions may however be rendered void if they are contained in an agreement made after the *rule* containing the prohibition is made by the *FSA* but before the *rule* comes into effect.
- 4 R For the purposes of this chapter it is immaterial whether the law which (apart from this annex) governs a contravening provision is the law of the *United Kingdom*, or of a part of the *United Kingdom*.

Recovery of payments made or property transferred pursuant to a void contravening provision

- 5 R In relation to any payment made or other property transferred in pursuance of a contravening provision, a *firm* must take reasonable steps to:
- (1) recover any such payment made or other property transferred by the *firm*; and
 - (2) ensure any other *person* (“P”) recovers any such payment made or other property transferred by that *person*.
- 6 G The *rule* in 5R(2) would, for example, apply in the context of a secondment. Where a *group* member seconded an individual to a *firm* and continues to be responsible for the individual’s *remuneration* in respect of services provided to the *firm*, the *firm* would need to take reasonable steps to ensure the *group* member recovers from the secondee any *remuneration* paid in pursuance of a contravening provision.

Replacing payments recovered or property transferred

- 7 R (1) A *firm* must not award, pay or provide variable *remuneration* to a *person* whose *remuneration* has caused the *firm* to breach a contravening provision (the “contravening *remuneration*”) unless the *firm* has obtained a legal opinion stating that the award, payment or provision of the *remuneration* complies with the *Remuneration Code*.
- (2) This *rule* applies only to variable *remuneration* relating to a performance year to which the contravening *remuneration* related.
- (3) The legal opinion in (1) must be properly reasoned and be provided by an appropriately qualified independent individual.

Notification to the FSA

- 8 G The *FSA* considers any breach of a *rule* to which this annex applies to be a significant breach which should be notified to the *FSA* in accordance with *SUP 15.3.11R* (Breaches of rules and other requirements in or under the Act). Such a notification should include information on the steps which a *firm* or other *person* has taken or intends to take to recover payments or property in accordance with 5R.

Amend the following as shown:

TP 3 Remuneration code

- 1 R ~~TP 3 applies to a *firm* that is unable to comply with the *Remuneration Code general requirement* because of an obligation it owes to an *employee* (the “obligation”) under an agreement entered into on or before 18 March 2009 (the “agreement”). [deleted]~~
- 2 R ~~A *firm*’s compliance with the obligation shall not cause it to be in breach of the *Remuneration Code general requirement* provided that the *firm* complies with 3R. [deleted]~~
- 3 R (1) ~~Where a *firm* is entitled to amend the agreement in a way that enables it to comply with the *Remuneration Code general requirement* it must do so at the earliest opportunity and no later than 31 March 2010. [deleted]~~
- (2) ~~Otherwise, a *firm* must:-~~
- (a) ~~take reasonable steps to amend the obligation or terminate the agreement at the earliest opportunity;~~
- (b) ~~amend the obligation or terminate the agreement no later than 31 December 2010; and~~
- (c) ~~adopt specific and effective arrangements, processes and mechanisms to manage the risks raised by the obligation. [deleted]~~
- 4 G ~~By 1 January 2010, a *firm* should have at least initiated a review of the extent to which the measurement of performance for any existing long term incentive plans takes account of future risks. The *FSA* may discuss the timing of that review and any remedial action with the *firm*. [deleted]~~

- 5 G (1) The FSA recognises that firms may require additional time to comply in full with the requirements of the Remuneration Code where they were not subject to the version of the Remuneration Code that applied before 1 January 2011. The FSA considers that a firm may be able to rely on the proportionality provisions in SYSC 4.1.2R and SYSC 19.3.3R to justify not complying with the requirements of the Remuneration Code relating to remuneration structures by 1 January 2011 provided it takes reasonable steps to comply as soon as reasonably possible and in any event by 1 July 2011.
- (2) On a similar basis and on the same timescales set out in (1), a firm which was subject to the previous version of the Remuneration Code may be able to justify not complying with the requirement to pay 50% of variable remuneration in shares or other non-cash instruments (SYSC 19.3.45R).

Sch 4 Powers exercised

The following powers and related provisions in the <i>Act</i> have been exercised by the <i>FSA</i> to make <i>rules</i> in <i>SYSC</i> :

Section 138 (General rule-making power)

<u>Section 139A (General rules about remuneration)</u>

...

Annex C

Amendments to the General Prudential sourcebook (GENPRU)

In this Annex, underlining indicates new text and striking through indicates deleted text.

1.2.31 R ...

- (4) Business risk means any risk to a *firm* arising from changes in its business, including the risk that the *firm* may not be able to carry out its business plan and its desired strategy. It also includes risks arising from a *firm's remuneration policy* (see also the *Remuneration Code* which applies to ~~certain banks, building societies and BIPRU 730k~~ BIPRU firms and the detailed application of which is set out in SYSC 19.1).

...

Annex D

Amendments to the Supervision manual (SUP)

In this Annex, striking through indicates deleted text.

13A Annex 1 Application of the Handbook to Incoming EEA Firms

...		
(1) Module of Handbook	(2) Potential application to an incoming EEA firm with respect to activities carried on from an establishment of the firm (or its appointed representative) in the United Kingdom	(3) Potential application to an incoming EEA firm with respect to activities carried on other than from an establishment of the firm (or its appointed representative) in the United Kingdom
...
<i>SYSC</i>	... <i>SYSC 18 applies.</i> <i>SYSC 19 does not apply to an incoming EEA firm when acting as such.</i>	... <i>SYSC 19 does not apply.</i>
...

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