FSA Remuneration Code Update

Final rules and application to hedge fund managers

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On 17th December 2010 the UK Financial Services Authority (FSA) published its delayed policy statement (PS) and final rules on revising its Remuneration Code. The FSA had previously announced that its revised Code would be published after the Committee of European Banking Supervisors (CEBS) published its finalised guidelines on remuneration policies and practices, which were published 10th December 2010.

The final Code is now such that:

- The FSA has introduced a 'tiered' proportionality test that takes into account a firm's size and activities in determining how the Code is to be applied to each firm;

- Most UK-based hedge fund managers, or UK affiliates of US-based hedge fund managers, will qualify for Tier 4 (the lowest tier), which means they will not have to comply with the provisions of the Code that require the deferral of bonuses to Code Staff, and the payment of 50% of variable remuneration in shares, non-cash instruments or other share equivalent instruments;

- The FSA has strengthened its position regarding guaranteed bonuses and will now require that the rules on guaranteed bonuses are applied to all employees and not just to Code Staff. Firms will only be able to award, pay or provide guaranteed bonuses in exceptional circumstances, and only then in the context of hiring new Code Staff and where they are limited to the first year of service; and

- Even Tier 4 firms remain subject to complying with the Code, maintaining appropriate records and providing explanations to the FSA that their policies are consistent with risk management and do not expose the firm to excessive risk.

Background

The FSA's consultation on the Code, published on 29th July 2010, set out the FSA's proposed revisions to the Code, which had previously only applied to large banking institutions in the UK. The proposed revisions included updated remuneration principles (Principles) with which many FSA-authorised firms, including most UK-based hedge fund managers (and UK affiliates of US hedge fund managers), would need to comply. The previous draft of the Code would have required that (i) at least 40% of a bonus paid to Code Staff would have to be deferred for at least three years (and at least 60% where a bonus is in excess of £500,000) and (ii) at least 50% of such bonus would have to be paid in shares, non-cash instruments or other share-equivalent instruments. One major open item, which remained a concern of many UK-based hedge fund managers was that until the final Code was published it was unclear how the Code might apply to the profit shares of partners/members of a manager structured as a limited liability partnership (LLP); the issue being that the Code might require the deferral of the distribution of such profit shares to the partners/members of an FSA authorised LLP, but the partners/members would be subject to tax on their profit shares as income of the year in which the profit share was granted, despite 40% to 60% of such income not being payable for up to three years.

Key changes

The principal differences between the draft Code and the finalised Code are that:

- The FSA has clarified that for Code Staff the requirement that at least 50% of any variable remuneration should be paid in shares, non-cash instruments or other share-equivalent instruments will now be applied equally to both the deferred and undeferred portions of variable remuneration.

- The FSA has strengthened its position regarding guaranteed bonuses and will now require that the rules on guaranteed bonuses are applied to all employees and not just to Code Staff. Firms will only be able to award, pay or provide guaranteed bonuses in exceptional circumstances, and only then in the context of hiring new Code Staff and where they are limited to the first year of service.

- The FSA has clarified the geographical application of the Code, based on CEBS' Guidelines. The Code rules on remuneration are to be applied to UK consolidation groups and all subsidiaries and branches within those groups, wherever located. Thus, if a UK-based hedge fund manager is a subsidiary of a US or non-EEA entity, the Code will only be applicable to the UK-based hedge fund manager and subsidiaries of the UK-based hedge fund manager. If a UK-based hedge fund manager is a subsidiary of an EEA entity it is likely that all subsidiaries of that EEA parent entity will have to apply the rules in the Code. If a UK-based hedge fund manager has non-EEA subsidiaries those non-EEA subsidiaries will not be within the scope of the Code.

- The FSA has, in line with CEBS' guidelines, enhanced the principle of proportionality and, instead of the originally proposed 'comply or explain' regime, has now introduced a ranking or 'tier' system so that different elements of the Code will be applicable depending on a firm's size and activities. The FSA has stated in the PS that it believes that this approach "takes account of firms' risk profiles to an extent that is practicable and enforceable". Firms are to conduct a self-assessment as to which tier the firm falls within. The principal metric by which the assessment is made is based on capital resource thresholds (i.e. regulatory capital requirements), although the activities that firms conduct will also be a factor. Firms in Tier 1 (including the largest banks) must apply the Code in the strictest manner, while those firms in Tier 4 (which includes all FSA limited licence and limited activity firms – including most UK-based hedge fund managers) may completely disapply some parts of the Code and choose to either comply with other Principles or explain their non-compliance. Firms should apply the requirements relevant to the tier in which they are classified in a manner that is proportionate to their own particular business – not all firms within a tier necessarily need to apply the Code in exactly the same manner.

Application of the code to UK-based hedge fund managers

UK-based hedge fund managers, as Tier 4 firms, must review their remuneration policies to ensure that they are consistent with the Code. However, such firms will be permitted to disapply the following Code requirements:

- To have a remuneration committee (although very large Tier 4 firms will have to assess whether, based on the principle of proportionality, they ought to have such a committee) (Principle 4);

- To set a maximum ratio between fixed and variable pay (Principle 12(d));

- To set the assessment of an individual's performance in a multi-year framework (in order to ensure that the assessment process is based on longer term performance) when calculating variable remuneration payments (Principle 12(b));

- To pay at least 50% of variable remuneration in shares, non-cash instruments or other share-equivalent instruments (Principle 12(f));

- To defer at least 40% (and, in some cases, at least 60%) of variable remuneration (Principle 12(g)); and

- To ensure that non-deferred variable remuneration paid in the form of equity (or equivalent) is subject to an "appropriate retention" period (Principle 12(h)), (together, the "Disapplied Principles").

The Disapplied Principles are the most onerous in the Code and UK-based hedge fund managers will not be required to comply with them provided they explain in their remuneration policy that, as a Tier 4 firm, these Disapplied Principles need not be complied with. However, the remaining elements of the Code must still be complied with, including requirements that:

- A firm's remuneration policy is consistent with and promotes effective risk management and does not expose the firm to excessive risk (Principles 1 and 12(a));

- 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 2);

- A firm must maintain a list of all Code Staff and take reasonable steps to ensure that such Code Staff understand the implications of their status as such (Code general principle);

- A firm's remuneration policy should avoid conflicts of interest and ensure that individuals engaged in "control functions" 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 (Principles 1 and 5);

- A firm must ensure that total variable remuneration does not limit the firm's ability to strengthen its capital base (Principle 6);

- Bonus pools should be based principally on profits and be adjusted for risk and the cost of capital (Principle 8);

- A firm should ensure that its pension policy is in line with its business strategy, objectives, values and long-term interests (Principle 9);

- A firm should ensure that its employees do not undertake personal hedging strategies or remuneration- or liability-related contracts of insurance to undermine the risk alignment effects embedded in their remuneration arrangements (Principle 10);

- A firm should not pay remuneration through vehicles or be using methods designed to avoid the Code (Principle 11);

- 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;

- A firm must not award, pay or provide guaranteed variable remuneration unless it is exceptional, occurs in the context of hiring new Code Staff and is limited to the first year of service (Principle 12(c)); and

- 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 (Principle 12(e)), (together, the "Applicable Principles").

Remuneration disclosure

In parallel with the PS and the revised Code, on 17th December 2010 the FSA also published a policy statement on firms' remuneration disclosure requirements. The FSA's four tier proportionality framework will also apply to disclosure of remuneration, and requires that firms in Tier 1 will need to make full disclosure to the FSA, while firms in lower tiers will be subject to less onerous requirements.

However, all firms, irrespective of the tier into which they are classified, will be required to disclose to the FSA details of their remuneration policies on at least an annual basis (more frequently for Tier 1, less frequently for firms in lower tiers). The first disclosure to the FSA must be made by 31st December 2011 at the latest. The FSA may, if the FSA considers an aspect of a firm's remuneration policy to be inappropriate, require that the firm amends its policies to comply with the relevant Principle(s) of the Code.

Recommended actions for UK-based hedge fund managers

UK-based hedge fund managers should (acting through their compliance officers, chief financial officers and such other senior persons as the firm considers to be appropriate) take (and document the analysis and processes connected with (retaining such documents with compliance files)) the following steps:

1. Identify which tier the firm will be in. If the firm is a (i) limited licence firm (i.e. it does not have FSA permission to deal on its own account (i.e. dealing in investments as principal) or underwrite investments) or (ii) limited activity firm (i.e. it is a firm that only deals as principal for the purpose of executing a client order, or for the purpose of gaining entrance to a clearing and settlement system) it will be a Tier 4 firm.
2. Analyse group structure and identify all EEA regulated entities and their branches and subsidiaries. For each EEA entity, confirm the relevant remuneration rules that will apply (the rules relating to the highest Tier will apply to all firms within an EEA consolidation group).
3. Establish which Principles the firm is able to disapply in full. As we explain above, Tier 4 firms do not need to comply with the Disapplied Principles. As part of a firm's assessment of remuneration policies and procedures these specific Principles should be noted as being Principles that the firm is permitted to disapply in full.
4. Establish rules/thresholds for identifying Code Staff. Such persons should include those persons (i) performing a significant influence function (directors, non-executive directors, the chief executive, partners, the person responsible for compliance oversight, and the firm's money laundering reporting officer), (ii) senior managers, (iii) all staff, whose total remuneration takes them into the same bracket as senior management, (iv) risk takers, whose professional activities could have a material impact on a firm's risk profile (for example, portfolio managers), as well as (v) secondees who fulfil such a role at the firm to which they are seconded.
5. Create a list of the firm's Code Staff. This list should be updated, as appropriate, when new directors, partners or employees join or when existing staff leave the firm.
6. Notify Code Staff that they are within the scope of the Code and that their remuneration could potentially be affected by the Principles of the Code.
7. Establish a written remuneration policy consistent with the Applicable Principles setting out the processes by which the remuneration of Code Staff is determined and paid.
8. Audit bonus letters and deferred compensation schemes to check ability to comply with the Applicable Principles.
9. Consider whether any amendments need to be made to employment contracts/compensation schemes/LLP agreements/side letters.
10. Review existing guarantee arrangements/ processes for monitoring the ongoing use of guarantee arrangements.
11. Consider bonus award process and remuneration policy.

Timing

The Code came into force on 1st January 2011. However, for UK-based hedge fund mangers and other firms to which the Code has not previously been applicable, there exists a transitional period of six months so that such firms must be fully compliant with the Code by 1st July 2011. The first remuneration disclosure must be made to the FSA by 31st December 2011. **THFJ**

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