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CLIENT BRIEFING

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10 QUESTIONS ON THE NEW REMUNERATION CODE FOR INVESTMENT FIRMS

The Financial Conduct Authority (FCA) has published the final version of the single remuneration code for MIFID investment firms, referred to as the MIFIDPRU Remuneration Code (the Code).

1. WHAT IS THE BACKGROUND TO, AND OBJECTIVE OF, THE CODE?

Since the financial crisis, the financial services industry has been the focus of wide-ranging reform, including measures that are intended to ensure that remuneration policies and practices in regulated firms promote, and are consistent with, effective risk management. There are, as it stands, a series of Codes that set out the remuneration requirements for employees and directors of firms in various financial services sectors. The Code is the latest iteration and forms part of the UK's new Investment Firms Prudential Regime (IFPR).

The overall objectives of the Code are, to paraphrase the FCA, to:

- promote effective risk management in the long-term interests of investment firms and their customers;
- ensure alignment between risk and individual reward;
- support positive behaviours and healthy firm cultures; and
- discourage behaviours that can lead to misconduct and poor customer outcomes.

2. WHICH FIRMS ARE CAUGHT BY THE CODE?

The majority of investment firms regulated under MiFID (including asset managers, hedge funds, and investment advisers) will be subject to the Code. It will ultimately replace the existing IFPRU Remuneration Code (SYSC 19A) and the BIPRU Remuneration Code (SYSC 19C).

The extent to which the Code applies depends on how it is categorised under the IFPR. Investment firms will either be 'small and non-interconnected' (SNI) or not, based on certain financial thresholds. Transitional provisions apply where firms move between the different categories. See the Annex for further details.

For remuneration purposes, non-SNI firms are also sub-divided into 'small' and 'large' categories. A non-SNI firm will be 'large' if the value of its balance sheet assets and off-balance sheet items over four years is a rolling average of more than £300m (for firms without a trading book); or more than £100m but less than £300m if it has trading book business of over £150m and/or derivatives business of over £100m.

3. WHICH CODE REQUIREMENTS APPLY?

Firms will need to apply basic, standard or extended remuneration requirements, depending on their categorisation.

All investment firms, including SNIs, will be required to comply with a handful of basic remuneration requirements. This level of compliance is equivalent to the high level principles that currently apply to firms subject to the BIPRU Remuneration Code. It includes a requirement to have a remuneration policy that promotes sound and effective risk management, with a clear distinction between the criteria determining fixed and variable pay, and an 'appropriate balance' between those elements. The FCA has published a Remuneration Policy Statement to assist firms in documenting their policies and practices in this regard.

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Non-SNI firms will be subject to additional requirements (on top of the basic requirements) referred to as the standard remuneration requirements. These include the annual identification of material risk takers (MRTs) (see question 4) and the application of rules on ex ante and ex post risk adjustment. Non-SNIs also need to have in place in-year adjustments, malus and clawback arrangements, set minimum malus and clawback periods and determine triggers for malus and clawback (see question 5). They must set a ratio of fixed to variable remuneration for MRTs, though there is no maximum 'bonus cap'.

Large non-SNI firms will be subject to the full extended remuneration requirements. These include the requirement for a remuneration committee (RemCo) (of which at least 50% of the members must be non-executive members of the management body), the deferral of a proportion of variable remuneration and rules on the use of shares and non-cash instruments and retention policies. (A 'small' non-SNI with a RemCo won't need to comply with the composition requirement).

4. HOW ARE MRTS IDENTIFIED?

MRTs are identified on the basis of qualitative criteria. There is no requirement to identify MRTs based on remuneration alone. MRTs include staff who have a material impact on the risk profile, not only of the firm, but of the assets that the firm manages (which includes all aspects of the MiFID activities carried out by the firm). The FCA has produced a template to assist firms in identifying MRTs (see question 10).

Some of the Code requirements (e.g. relating to guaranteed bonuses, buy-out awards, retention awards, severance pay, discretionary pension benefits and the pay-out process rules) apply only to MRTs.

There is a de minimis MRT carve out (applied to the requirements on discretionary pension benefits, payment in shares or instruments and deferrals) for individuals whose total annual variable remuneration is £167,000 or less and is not more than 1/3 of total annual remuneration. The carve out is only relevant where the extended remuneration requirements apply.

WHAT EXACTLY IS GOING TO CHANGE?

Exempt CAD firms that find themselves categorised as SNIs under the IFPR may be subject to remuneration rules for the first time.

The Code will introduce a limited number of new provisions for BIPRU and IFPRU firms that are categorised as non-SNIs and that have previously been able to disapply the more onerous requirements of the existing regime on proportionality grounds. For example, if they have not already done so, non-SNIs will need to identify their MRT population and consider whether any changes need to be made to their pay structures.

Existing BIPRU and IFPRU firms that disapply the current pay-out process rules will need to apply clawback provisions and set maximum ratios between fixed and variable remuneration.

Just over 100 out of around 3,600 UK investment firms are likely to fall within the scope of the extended remuneration requirements. They will need to prepare for the requirement to establish a RemCo at individual entity level (unless they apply to the FCA for a waiver or meet the requirements to rely on a RemCo at group level).

These firms will also be required to apply the full pay-out process rules. At least 50% of an MRT's variable remuneration would need to be paid out in shares, share-linked or other instruments. According to the FCA, a number of these firms already apply the rules to their MRTs, or even to wider categories of staff. The FCA considers that a majority of investment firms that will be subject to the extended remuneration requirements are already in scope of at least one of the existing remuneration codes, though it is aware that it may not be straightforward for many privately owned firms to meet this requirement. It is, however, possible to apply for a modification to permit alternative arrangements.

5. WHAT ARE THE FCA'S EXPECTATIONS AROUND EX-POST RISK ADJUSTMENT?

The FCA has set out its expectations in Finalised Guidance FG21/5: General guidance on the application of ex-post risk adjustment to variable remuneration. Previously this applied to firms in scope of the Dual-regulated firms Remuneration Code (SYSC 19D), but will now also apply to all firms in scope of the IFPR.

The FCA expects all firms subject to ex-post risk adjustment to have a firm-wide policy on the application of ex-post risk adjustment (and group-wide policy, where appropriate) for staff subject to the relevant provisions of the Code. All

unvested variable remuneration is, in principle, capable of forfeiture or recovery through ex-post risk adjustment. Deferred remuneration for the purposes of adjustment includes Long-Term Incentive Plans.

When setting minimum clawback periods where no deferral is used, the FCA reminds firms to carefully consider all types of risks, including conduct risks, and how long they may take to crystallise. The minimum deferral period for firms subject to the extended remuneration requirements is 3 years, and the FCA generally considers this to be an appropriate starting point for all FCA investment firms when considering minimum clawback periods.

6. HOW DOES THE CODE APPLY TO CARRIED INTEREST?

The Code applies to carried interest arrangements and carried interest must be valued at the time of its award. The requirements on pay-out, deferral, retention and ex-post risk adjustment do not apply where:

- the value of the carried interest is determined by the performance of the fund in which the carried interest is held;
- the period between award and payment of the carried interest is at least 4 years; and there are provisions for the forfeiture or cancellation of carried interest in certain situations.

The FCA did not accept amendments proposed by industry groups which would have meant that carried interest arrangements would be deemed to meet the clawback rules without further adjustment. The result is that the Code carried interest rules are more onerous than those applied to full-scope AIFMs under the UK AIFMD regime.

7. HOW DOES THE CODE APPLY TO INVESTMENT FIRM GROUPS?

The FCA may grant permission for investment firm groups to apply a group capital test, in which case, no prudential consolidation at group level is required. These groups can apply the basic, standard or extended remuneration rules on an individual entity basis. Where the prudential consolidation rules do apply, FCA investment firm groups must apply the basic and standard requirements at both an individual entity and consolidated group level.

The extended remuneration requirements do not apply on a consolidated basis. This means that an entity within an investment firm consolidated group is subject to the extended remuneration requirements (pay-out in instruments, deferral, retention and pay-out of discretionary pension benefits) only if it exceeds the thresholds itself, and not solely because another entity in the group exceeds the thresholds.

Where different rules apply to group entities, the firms must apply the strictest to any MRTs (subject to an exception for third countries) who have either a material impact on another member of the group (that is subject to the stricter requirements), or on the risk profile of the group as a whole.

The Code provisions will only apply to MRTs of group entities in third countries who oversee or are responsible for business activities in the UK.

Groups with entities that include PRA designated investment firms (but not credit institutions) must satisfy the requirements of both the Dual-regulated firms Remuneration Code (SYSC 19D) and the Code.

8. HOW DOES THE CODE APPLY TO COLLECTIVE PORTFOLIO MANAGEMENT INVESTMENT (CPMI) FIRMS?.

CPMIs will need to apply the remuneration codes applicable to the types of business they conduct. In practice, this means CPMIs could potentially be required to apply two or three different remuneration codes. If a firm is subject to the Code and the AIFM Remuneration Code, for example, it must comply with the most onerous of them on a provision by provision basis.

9. FROM WHEN DOES THE CODE APPLY?

The Code will apply to performance periods beginning on or after 1 January 2022.

Firms currently subject to the existing BIPRU and/or IFPRU Remuneration Codes should continue to apply those rules in respect of remuneration awarded or paid out in 2022 which relates to performance or services provided during a period which started before 1 January 2022.

10. WHERE CAN I FIND MORE INFORMATION?

The remuneration provisions are addressed in Chapters 7 to 10 of the FCA's Policy Statement (PS21/9).

The Investment Firms Prudential Regime Instrument 2021 (FCA 2021/38) contains the text of the new Prudential sourcebook for MiFID Investment Firms (MIFIDPRU) and the Code, set out in the Senior Management Arrangements, Systems and Controls (SYSC) sourcebook at new SYSC 19G.

The Investment Firms Prudential Regime (Consequential Amendments to other Prudential Sourcebooks) Instrument 2021 (FCA 2021/39) contains consequential changes to parts of the FCA Handbook, including the revocation of the BIPRU and most of the IFPRU Codes.

See also Finalised Guidance: General guidance on the application of ex-post risk adjustment to variable remuneration (FG21/5), which sets out the FCA's expectations of the way in which firms should comply with requirements in SYSC 19D and SYSC 19G on ex-post risk adjustment, including malus and clawback.

Templates for firms' Remuneration Policy Statements have also been published, to assist firms to document their remuneration policies and practices, and for MRTS, which is intended for use by firms to record their assessment of which staff are identified as MRTs.

Annex

The Code categorises firms as Basic, Standard or Extended based on their IFPR firm categorisation (SNI, non-SNI, large non-SNI). The level of remuneration requirements will be dependent on the Code categorisation of the firm.

Firms that do not currently provide or carry on MiFID investment services or activities in the UK will not be affected by the IFPR. The exempt CAD category disappears under the IFPR; depending on their business model, these firms need to consider whether they should become an investment firm or avoid the IFPR altogether by using an exemption.

Firms subject to the IFPR will fall into one of two categories: small and non-interconnected (SNI) firms; or non-SNI firms.

SNI firms

SNI firms are firms that do not have permission to deal on own account and that satisfy all of the following conditions:

- average assets under management (AUM) < £1.2 billion;
- average client orders handled (COH):
- cash trades < £100 million per day;
- derivative trades < £1 billion per day;
- average assets safeguarded and administered = zero;
- average client money held = zero;
- average daily trading flow = zero;
- on- and off-balance sheet total < £100 million;
- average total annual gross revenue from investment services and/or activities < £30 million;
- not a clearing member or an indirect clearing member firm; and
- not appointed to act as a depositary.

Non-SNI firms

Non-SNI firms are firms that exceed any one of the above thresholds.

Note: AUM is defined for these purposes as discretionary portfolio management; and non-discretionary arrangements constituting investment advice of an ongoing nature. Average AUM is calculated by taking the total AUM as measured on the last business day of each of the previous 15 months; excluding the three most recent monthly values; and calculating the arithmetic mean of the remaining 12 monthly values.

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