European Regulatory Snapshot: Remuneration in the Financial Services Industry 2015

8 September 2015

Introduction

The past year has seen the issue of financial sector pay continue to generate headlines. With the EU having put in place a complex web of overlapping law, regulation and guidance during 2013 and 2014, national regulators are faced with the task of interpreting these requirements and imposing them on a sometimes sceptical (if not openly hostile) financial services industry.[1] This client memorandum aims to assist in navigating the European labyrinth by providing a snapshot of the four main European Directives that regulate remuneration:

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

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

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

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[1] This memorandum updates our memoranda of 2013 and 2014 summarising these developments as of that time. Those memoranda can be found here and here.

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

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

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

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

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

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

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

Pan-European law and regulation on remuneration

Banks and other financial institutions (CRD IV)

CRD IV sets out requirements in relation to the remuneration policies and practices of banks and other financial institutions. Among others, CRD IV prescribes a cap on bonuses, which has proved particularly contentious, causing banks across the EU to redesign their remuneration packages. In March 2015, the European Banking Authority (EBA) published a consultation paper[9] with a draft of its keenly awaited guidelines on sound remuneration policies under CRD IV (EBA Guidelines). The EBA Guidelines provide detailed guidance on the application of the bonus cap and other key aspects of the CRD IV remuneration provisions to ensure consistent, efficient and effective supervisory practices as well as a level playing field for banks in the EU. These Guidelines will be "Level 3" measures under the Lamfalussy approach used for EU financial services legislation. This means that EU Member State regulators will be required to adhere to this guidance in their implementation of CRD IV remuneration rules, or else explain to EBA the reasons for their non-compliance.[10]

A public consultation on the EBA Guidelines closed in June 2015, and EBA is expected to publish the final guidelines later this year. Once adopted, the EBA Guidelines will again require banks to revisit their remuneration arrangements and, if necessary, amend them with effect from the performance year 2016 under the current proposals.

Who *Entities:* all credit institutions and investment firms in the EU (jointly referred to as "institutions") as well as their non-EU subsidiaries and branches; in addition, EU subsidiaries and branches of financial institutions headquartered outside the EU.[11]

Individuals: institutions should apply sound remuneration policies to all staff; however, specific requirements for variable pay apply only to material risk takers (MRTs), *i.e.*, those employees whose professional activities have a material impact on the risk profile of the relevant institution. Non-exhaustive qualitative and quantitative criteria for MRTs are set out in a Delegated Regulation adopted by the European Commission, which is directly applicable in all EU Member States:[12]

- Employees who meet any of 15 standard qualitative criteria relating to their role and decision-making power are deemed to be MRTs, including, among others, members of the management body, senior management, heads of material business units and staff taking credit risk and market risk exposures above certain limits specified in the Delegated Regulation.

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[9] EBA Consultation Paper of 4 March 2015 (EBA/CP/2015/03) – Draft Guidelines on sound remuneration policies under Article 74(3) and 75(2) of Directive 2013/36/EU and disclosures under Article 450 of Regulation (EU) No 575/2013. The text of the Consultation Paper can be found **here**.

[10] Article 16(3), Regulation (EU) No 1093/2010 of the European Parliament and of the Council of 24 November 2010 establishing a European Supervisory Authority (European Banking Authority), amending Decision No 716/2009/EC and repealing Commission Decision 2009/78/EC.

[11] Paragraph 63, EBA Guidelines provides guidance on the application of CRD IV to subsidiaries that are not themselves subject to CRD IV, but to remuneration requirements set out in other sectoral legislation, *e.g.*, AIFMD and UCITS V. In respect of the bonus cap, EBA takes the view that this will apply to employees of such subsidiaries whose professional activities have a material impact on the group's risk profile on a consolidated basis, even though AIFMD and UCITS V themselves prescribe no bonus cap.

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

- In addition, employees are presumed to be MRTs if they meet any of the following quantitative criteria for the preceding financial year:[13] (i) their total pay is €500,000 or more; or (ii) they are part of the 0.3% of staff with the highest pay in the institution; or (iii) their total pay is equal to or greater than the lowest total pay of a member of senior management or of certain other MRTs in the institution.

To ensure a complete and harmonised identification of MRTs across the EU, the EBA Guidelines set out how institutions should apply the qualitative and quantitative criteria within their self-assessment identification process.[14]

Proportionality: institutions should comply with the CRD IV remuneration provisions in a manner and to the extent that is appropriate to their size, internal organisation and the nature, scope and complexity of their activities.[15] In the EBA Guidelines, EBA takes the view that this "proportionality principle" cannot justify any disapplication of the bonus cap or other specific requirements with numerical criteria, *e.g.*, the below mentioned minimum thresholds for payment in instruments ("skin in the game"), deferred payment and clawback arrangements. Thus, the proportionality principle should only lead to *more strict* criteria, in particular for significant institutions and their senior management.[16] EBA's interpretation represents a departure from the prior guidelines issued in 2010 by its predecessor body, the Committee of European Banking Supervisors (CEBS),[17] and during the public consultation, several respondents have voiced concerns over the impact that this may have, particularly for smaller and non-complex institutions.[18]

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Bonus cap: "variable pay" is capped at 100% of total fixed pay or, with shareholder approval,[19] 200% of total fixed pay. EU Member States have the discretion to adopt stricter standards, *e.g.*, lower bonus caps.

Fixed vs. variable pay: crucial to the application of the bonus cap is the distinction between "fixed" and "variable" pay on which CRD IV only provides limited guidance.[20] As reported in our memorandum of December 2014,[21] following its investigation into the use of so-called "role-based allowances" (RBAs) that are intended by banks to be treated as fixed pay, EBA published an opinion and a report in October 2014, which set out the conditions that must be complied with if RBAs are to qualify as fixed pay. Taking into account this opinion and report, the EBA Guidelines set out general criteria for fixed pay and further provides that pay should be classified as variable if a "clear" allocation to fixed pay is not possible based

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

[14] Paragraphs 83–107, EBA Guidelines.

[15] Recital 66 and Articles 74(2) and 92(2), CRD IV.

[16] Paragraphs 72 and 73, EBA Guidelines.

[17] CEBS Guidelines on remuneration policies and practices of 10 December 2010 (CEBS Guidelines). The text of the CEBS Guidelines, which will be repealed with the coming into force of the final EBA Guidelines, can be found **here**.

[18] Responses to the consultation are available at EBA's website **here**.

[19] Approval by either 66% of shareholders provided that at least half of the shares are represented or, failing that quorum requirement, 75% of the shares represented. Paragraph 36, EBA Guidelines provides guidance on the specific procedure to be adopted at such shareholder meeting. Particularly interesting is paragraph 36(b), which requires that an institution exercising voting rights as a shareholder of its subsidiary should vote either upon specific instruction of its own shareholders or subject to a group remuneration policy adopted by the shareholders of the consolidating institution. This would seem to require approval of the shareholders of the ultimate parent of a non-EU headquartered entity despite the fact that Article 94(1)(g), CRD IV, only refers to approval of the shareholders of the immediate parent.

[20] *See*, in particular, recital 64, CRD IV.

[21] The memorandum can be found **here**.

on these criteria.[22] The EBA Guidelines also provide specific guidance on the proper treatment of, among others, allowances, retention bonuses and discretionary pension benefits.[23]

Non-executive directors: the EBA Guidelines provide that members of the institution's supervisory function should be compensated only with fixed pay. Where variable pay is exceptionally awarded, the bonus and risk alignment should be strictly tailored to their authorities and responsibilities and the achievement of objectives linked to their functions.[24]

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

Skin in the game: at least 50% of any variable pay must consist of shares or equivalent ownership interests (or, for non-listed institutions, share-linked or equivalent non-cash instruments) or certain classes of Additional Tier 1, Tier 2 and other instruments that fulfil specific requirements as specified in a Delegated Regulation adopted by the European Commission.[26]

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

Clawback arrangements: up to 100% of variable pay shall be subject to clawback[27] or malus[28] arrangements. Institutions are required to set specific criteria for such arrangements, particularly in situations where the employee contributed to conduct which resulted in significant losses to the institution or failed to meet appropriate fit and proper standards.

Disclosure: another novelty, which has proved contentious, is the increased disclosure requirements relating to remuneration policies and practices, which are set out in the Capital Requirements Regulation[29] and, as such, are directly applicable in all EU Member States. The EBA Guidelines highlight the importance of transparency to facilitate market discipline and provide further guidance on the disclosure requirements.[30] Among others,

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[22] Paragraph 116, EBA Guidelines.

[23] Paragraphs 122–133, EBA Guidelines.

[24] Paragraphs 167–170, EBA Guidelines.

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

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

[27] Paragraph 6(s), EBA Guidelines defines "clawback" as *"an arrangement under which the staff member has to return ownership of an amount of variable remuneration paid in the past or which has already vested to the institution under certain conditions."*

[28] Paragraph 6(r), EBA Guidelines defines "malus" as *"an arrangement that permits the institution to prevent the vesting of all or part of deferred variable remuneration based on ex-post risk adjustments."*

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

[30] Paragraphs 283–310, EBA Guidelines.

institutions must disclose the ratios between fixed and variable pay and the number of individuals being remunerated €1 million or more per financial year, broken down into pay bands of €500,000 for remuneration between €1 million and €5 million and into bands of €1 million for remuneration of €5 million and above. EU Member States may also require disclosure of the total remuneration of each member of the institution's management body or senior management.[31] These disclosures must be published publicly by institutions at least on an annual basis, in conjunction with the publication of the financial statements.[32]

When EU Member States were required to implement CRD IV into national law with effect from 1 January 2014 and apply the bonus cap to remuneration for "*services provided or performance from the year 2014 onwards, whether due on the basis of contracts concluded before or after 31 December 2013*."[33] The EBA Guidelines are expected to be adopted by EBA later this year and are proposed to apply from 1 January 2016.[34]

Investment funds (AIFMD)

On 3 July 2013, ESMA adopted the Guidelines on sound remuneration policies under AIFMD,[35] which together with AIFMD set out the framework for the remuneration of identified staff at managers of alternative investment funds.[36] AIFMD regulates alternative investment fund managers (AIFMs) other than UCITS funds and includes restrictions on variable compensation of certain identified staff of EU-authorised AIFMs. The definition of "identified staff" in this context is similar, though not identical, to the definition used for CRD IV. It is worth noting that there is no cap on variable pay under AIFMD, nor are there any malus or clawback requirements. Following the European Parliament's recent rejection of bonus caps in relation to identified staff at UCITS V managers (see below), it is now unlikely that a bonus cap along the lines of the one introduced under CRD IV will be adopted in the foreseeable future in relation to AIFMs.

Who *Entities:* EU-authorised AIFMs (and, specifically, non-EU AIFMs who become EU-authorised in order to make use of the pan-European passport). The remuneration requirements do not apply to non-EU AIFMs that are not EU-authorised, although non-EU AIFMs should bear in mind the applicable disclosure and transparency requirements described in our 4 June 2013 client memorandum.[37]

Individuals: "identified staff" at the relevant AIFM broadly includes senior management, risk takers, control functions (*e.g.*, compliance, internal audit) and any employee whose remuneration is in the same bracket as senior management and risk takers, whose professional activities have a "*material impact on the risk profiles of the AIFMs or of [alternative investment funds (AIFs)] they manage*."[38]

What *Fixed pay:* the remuneration of identified staff must include a "fixed" component that "*should be sufficiently high to remunerate the professional services rendered, in line with the level*

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[31] Article 450(1), CRR.

[32] Article 433, CRR.

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

[34] Paragraph 324, EBA Guidelines.

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

[36] These Guidelines were proposed to be amended in July 2015 by ESMA's Consultation Paper on Guidelines for sound remuneration policies under the UCITS Directive and AIFMD. That paper proposed a revision by clarifying that in a group context, non-AIFM sectoral prudential supervisors of group entities may deem certain staff of an AIFM in that group to be "identified staff" for the purposes of their sectoral remuneration rules.

[37] That memorandum can be found here.

[38] Paragraph 1, Annex II to AIFMD.

of education, the degree of seniority, the level of expertise and skills required, [. . .] the relevant business sector and region."[39] There is no prescribed maximum or minimum percentage figure.

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

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

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

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

Investment Funds (UCITS V)

On 23 July 2014, the Council of the EU announced that it had adopted the text of UCITS V that the European Parliament had adopted on 15 April 2014. UCITS V objectives are to enhance the depositary's duties and liabilities; introduce common standards for sanctions arising from UCITS V; and require the creation of remuneration policies for investment and management companies with honoured principles for such policies.

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

Individuals: the definition of "identified staff" in this context is broader than that for CRD IV or AIFMD and includes fund managers; persons who take investment decisions that affect the risk position of the fund; persons who exercise influence on staff, such as investment policy advisors and analysts, and senior management (including employees whose total remuneration places them in the bracket of senior management), risk takers and personnel in control functions. ESMA is mandated to issue non-binding guidelines that are expected to provide further clarification on the categories of staff falling within the scope of the rules and the application of proportionality.

What *Fixed pay:* the fixed and variable component of identified staff's remuneration must be "appropriately balanced" with the fixed component representing "*a sufficiently high proportion of the total remuneration to allow the operation of a fully flexible policy on variable remuneration components, including the possibility to pay no variable remuneration component.*"[40] There is no prescribed maximum or minimum percentage figure.

Variable pay: the non-fixed or variable component should be based on both the individual's performance as well as the UCITS fund's and the UCITS manager's performance as a whole and vest only if sustainable and justified. Where the financial performance of the UCITS manager or the UCITS fund is "*subdued or negative*," the variable compensation "*shall generally be considerably contracted.*"[41] It is currently uncertain exactly how this additional limitation is to be interpreted.

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

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[39] Paragraph 94, ESMA AIFMD Guidelines.

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

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

interests. The 50% minimum will not apply if UCITS accounts for less than 50% of the total portfolio managed by the entity.[42]

Deferred payment: at least 25% of the variable remuneration must be deferred over an appropriate period of time in view of the life cycle and redemption policy of the UCITS fund, and in any event must be at least three to five years (unless the life cycle of the UCITS fund is shorter). Where the variable remuneration component is a "*particularly high amount*," at least 60% of the variable remuneration must be deferred. It is unclear what would constitute a "*particularly high amount*" for these purposes.[43]

When Member states must transpose the Directive into their national law by 18 March 2016.

ESMA Guidelines on sound remuneration policies under UCITS V

On 23 July 2015, ESMA published a consultation paper[44] setting out its proposed guidelines addressed to national regulators concerning the application of the remuneration principles set out in UCITS V. The proposed guidelines are closely aligned with the AIFMD guidelines referred to above, but differ in some respects to take account of the nature of UCITS funds. The proposed guidelines include the following elements:

- **Proportionality** – an approach on proportionality in line with the AIFMD guidelines referred to above;
- **UCITS management companies that are part of a group** – clarification that, in a group context, non-UCITS sectoral prudential supervisors (*e.g.*, CRD IV prudential supervisors) may deem certain staff of the management company which is part of that group to be "identified staff" for the purposes of their sectoral remuneration rules;
- **A common definition of "performance fees"**;
- **Application of different sectoral rules** – proposals on how different sectoral rules (*e.g.*, CRD IV and AIFMD remuneration rules) should apply where a management company's employees perform services subject to different sectoral remuneration principles;
- **Application of remuneration rules to delegates** – proposals to prevent management companies circumventing the remuneration rules through delegation to external service providers, including a requirement for such management companies to ensure that the delegated industries are subject to equivalent regulatory requirements on remuneration and appropriate contractual requirements are put in place. The consultation also proposes a system of equivalence between the AIFMD, CRD IV and UCITS V remuneration rules;
- **Payment in instruments** – proposes guidance (including a worked example) on how firms should comply with the rules on payment of variable remuneration in instruments under UCITS V.

ESMA anticipates finalising these guidelines and publishing a final report in early 2016, ahead of the transposition deadline of UCITS V on 18 March 2016.

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[42] Article 14b(1)(m) UCITS V.

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

[44] Consultation Paper – Guidelines on sound remuneration policies under the UCITS Directive and AIFMD. In addition to setting out ESMA's proposals for the guidelines on remuneration policies required by UCITS V, the consultation paper also proposes a targeted revision of the guidelines on sound remuneration policies under AIFMD referred to above. The text of the Consultation Paper can be found here.

Markets in Financial Instruments Directive

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

ESMA Guidelines on remuneration policies and practices (MiFID I)

On 11 June 2013, ESMA published the ESMA MiFID Guidelines with the aim of ensuring that firms' remuneration policies and practices are aligned with their conflict of interest and conduct of business obligations so that their clients' "*interests are not impaired by the remuneration policies and practices adopted by the firm in the short, medium and long term.*"[45] In addition, the ESMA MiFID Guidelines set out a number of examples of what ESMA considers to be good and bad practice in relation to firms' remuneration policies and practices.

Who *Entities:* MiFID investment firms,[46] including credit institutions (when providing investment services), UCITS managers and external AIFMs when providing the investment services of individual portfolio management or non-core services. These Guidelines are in addition to those placed on entities under CRD IV, the AIFMD and UCITS V. EU Member State competent authorities are also expected to comply with the ESMA MiFID Guidelines by incorporating them into their supervisory practices.

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

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

Variable pay: when determining variable remuneration, firms should design remuneration policies and practices in such a manner as to not "*create incentives that may lead relevant persons to favour their own interest, or the firm's interests [. . .], to the potential detriment of clients.*"[47]

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

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

[45] Annex 1, Paragraph 13, Final Report: ESMA Guidelines on remuneration policies and practices (MiFID).

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

[47] Annex 1, Paragraph 14, Final Report: ESMA Guidelines on remuneration policies and practices (MiFID).

ESMA consultation on remuneration and practices (MiFID II)

A large number of elements of the MiFID II Directive need to be further specified in delegated acts to be adopted by the European Commission and technical standards. ESMA published a discussion paper on MiFID II technical standards and a consultation paper relating to its technical advice to the European Commission on 22 May 2014[48]. MiFID II introduces a new, explicit requirement on the management bodies of investment firms to "*define, approve and oversee [. . .] a remuneration policy of persons involved in the provision of services to clients aimed at encouraging responsible business conduct, fair treatment of clients as well as avoiding conflicts of interest in the relationships with clients.*"[49] In its consultation paper, ESMA clarifies that the principles included in the 2013 ESMA guidelines on remuneration under MiFID I should form the basis of its advice on the implementing measures for MiFID II and sets out its technical advice for the implementation of MiFID II. It is worth noting that these standards will be in addition and without prejudice to the provisions on remuneration under CRD IV and AIFMD.

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

Individuals: all relevant persons who can have a material impact, directly or indirectly, on investment and ancillary services provided by the firm, regardless of whether the clients are retail or professional, to the extent that the remuneration of such persons and related incentives — including non-financial remuneration such as in-kind benefits and career progression — may create a conflict of interest that encourages them to act against the interests of the clients.[50]

What *Remuneration design policy:* investment firms should define their remuneration policies under appropriate internal procedures taking into account the interests of clients, with a view to ensuring that clients are treated fairly and their interests are not impaired by the remuneration practices adopted by the firm in the short, medium or long term. In particular, remuneration policies and practices should be designed in such a way so as not to create incentives that may lead relevant persons to favour their own interests or the firm's interests to the potential detriment of clients.[51]

Governance: the design of the firm's remuneration policy should be approved by the management body of the firm after taking advice from the compliance function. The day-to-day implementation of the remuneration policy and the monitoring of compliance risk related to the policy should be the responsibility of the senior management of the firm.[52]

Variable pay: remuneration and similar incentives may be partly based on commercial criteria, but should be principally based on criteria reflecting compliance with the applicable regulations, the fair treatment of clients and the quality of services provided to clients, so that an appropriate balance between fixed and variable components of remuneration is maintained at all times, and provided that in any event the remuneration structure does not favour the interests of the firm or its staff against the interests of any clients.[53]

When ESMA was required to provide its technical advice to the European Commission by the end of 2014. Delegated acts under MiFID II are required to be transposed by EU Member

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

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

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

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

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

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

States by June 2016, and MiFID II will become applicable for the most part from 3 January 2017.

Individual European Member State regulations on remuneration

The UK – Implementing EU law and additional standards

Despite the opposition of the UK Government to elements of the CRD IV and AIFMD regimes, the UK's twin regulators, the Prudential Regulation Authority (PRA) and the Financial Conduct Authority (FCA) have been faced with the task of implementing the remuneration requirements of CRD IV and AIFMD for UK banks, investment firms and fund managers. They have done this through the introduction of a number of Remuneration Codes applicable to such firms, which set out some of the detail of the restrictions in the EU legislation.

In addition, however, the PRA and FCA have also been tasked with responding to domestic political pressure on bankers' pay and conduct. In June 2013, the UK Parliamentary Commission on Banking Standards (PCBS) published its report on the reform of the UK banking industry,[54] including proposals for extensive clawback provisions in respect of senior managers. The UK Government published its response to the PCBS proposals on 18 July 2013.[55]

From July 2014 onwards, the PRA and FCA have published a number of consultations and policy statements which set the framework for the new regime for clawback and other restrictions which augment the EU requirements described elsewhere in this memorandum. These rules were finalised, after a delay, in June 2015, putting in place the following regime for financial services remuneration in the UK.

Remuneration Codes

There are now five separate remuneration regimes in force in the UK: the Remuneration part of the PRA Rulebook[56] and four separate Remuneration Codes in the Systems and Controls Sourcebook (SYSC) of the FCA Handbook.[57] The FCA Codes are:

- SYSC 19A for "IFPRU" firms (generally more complex FCA solo-regulated investment firms subject to CRD IV);
- SYSC 19B for "AIFMs" (Alternative Investment Fund Managers solo-regulated by the FCA);
- SYSC 19C for "BIPRU" firms (smaller and/or less complex FCA solo-regulated investment firms); and
- A new SYSC 19D, which applies to dual-regulated firms, *i.e.*, banks, building societies and PRA-designated investment firms. This new set of rules is this focus of the remainder of this section.

Features of the new regime

Clawback

The PRA introduced new rules which took effect on 1 January 2015 requiring all PRA regulated firms to apply clawback in instances of misconduct or failures of risk management up to seven years

[54] Parliamentary Commission on Banking Standards – Fifth Report – Changing banking for good. The text of the Report can be found here.

[55] The Government's response to the Parliamentary Commission on Banking Standards. The text of the Government's Response can be found here.

[56] The PRA Rulebook is available at the PRA's website here.

[57] The FCA Handbook is available at the FCA's website here.

following the date of the award. In 2014, the FCA consulted whether it should adopt clawback rules in line with the PRA's clawback rules. In their finalised rules, the regulators have adopted the following:

- Any variable remuneration awarded to Remuneration Code staff in PRA-authorised firms on or after 1 January 2015 is subject to clawback. Firms must make all reasonable efforts to recover an appropriate amount corresponding to some or all vested variable remuneration where either of the following circumstances arises during the period in which clawback applies: (a) there is reasonable evidence of employee misbehaviour or material error; or (b) the firm or the relevant business unit suffers a material failure of risk management. The firm must take into account all relevant factors (including, where the circumstances described in (b) arise, the proximity of the employee to the failure of risk-management in question and the employee's level of responsibility) in deciding whether and to what extent it is reasonable to seek recovery of any or all of their vested variable remuneration.
- For PRA-designated senior managers, the clawback period will be extended by up to three years where there is an internal or regulatory investigation at the end of the normal seven-year clawback period. This new clawback requirement applies to variable remuneration awarded for performance periods beginning on or after 1 January 2016.
- The FCA has decided to align its clawback regime with that of the PRA, meaning all MRTs will be subject to a seven-year clawback period as described above. The FCA's "clawback" regulations will come into force on 1 January 2016 and apply in respect of remuneration awarded on or after 1 January 2016.

Deferral

The deferral requirements apply to all regulated banks, building societies, investment firms and the UK operations of the non-EEA equivalent thereof. The requirements cover Remuneration Code staff, which includes senior management, MRTs, staff engaged in control functions and any employees receiving total remuneration that takes them into the same remuneration bracket as senior management and MRTs.

In 2014, the PRA and FCA proposed larger deferral periods to *"align the risk horizons of key individuals further with the longer-term safety and soundness of the firms for which they work."*[58] The finalised rules extend the deferral periods in the rules:

- for senior managers, to no less than seven years, with first vesting of deferred remuneration no earlier than the third anniversary of award; and vesting must be no faster than pro rata between years three and seven;
- for PRA-designated risk managers, to no less than five years, with vesting no faster than pro rata; and
- for all other PRA MRTs, and all FCA non-senior manager MRTs, to no less than the CRD IV mandated period of three to five years, with vesting no faster than pro rata.

Bailed-out banks

In the view of the regulators, bank management should be incentivised to avoid bank failures. The final PRA/FCA rules make explicit in the remuneration rules a presumption against payment or vesting of all discretionary payments, including payment for loss of office and discretionary pension benefits where the bank requires taxpayer support.

[58] Section 2.5, Consultation Paper – PRA CP15/14/FCA CP14/14 – Strengthening the alignment of risk and reward: new remuneration rules. The text of the Consultation Paper can be found here.

Buy-outs

In response to the practice of buy-outs (whereby a firm cancels the unvested bonus awards of staff who are leaving one firm to join a competitor and the competitor "buys out" the forfeited award), the PRA and FCA, recognising the complexities involved, consulted on a number of potential approaches in 2014, including the banning of buy-outs altogether.

In their June 2015 final statement of policy, the PRA and FCA did not come to a final decision. The regulators promised to consider further detailed proposals for applying malus to buy-out awards. Such awards would be held in a form that permits them to be subject to malus by the previous employer, *e.g.*, through a requirement for some form of escrow account. The regulators do not mention whether in practice, malus would effectively become a regulatory disciplinary procedure if the regulator exercises discretion to recover buy-out awards where the previous employers could have applied malus, or, if buy-out awards are to be held in escrow on behalf of the former employer, the buy-out awards might be reduced, although, again, the regulator would be involved in deciding on the applicability of malus. In the short term, however, the regulators have called for clawback arrangements to be robust in order to minimise the impact of buy-out arrangements.

Risk adjustment

The final rules provide further guidance on calculating profit for the purposes of awarding remuneration based on prudent valuation principles. The new PRA rules require all UK PRA-regulated firms, when determining the size of their annual bonus pools, to calculate profit for this purpose by deducting a "prudential valuation adjustment" (PVA) figure from the fair value accounting profit. For UK subsidiaries of international firms where there is a global bonus pool rather than a separate UK bonus pool, the firm must provide evidence that the change in the PVA for the UK subsidiary has been applied to the profits of the UK regulated entity that feeds into the global pool.

Remuneration of non-executive directors

In line with last year's consultation, the new PRA/FCA rules ban non-executive directors (NED) from receiving variable remuneration in respect of activity carried out in their role as NEDs.

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

Will Pearce	**+44 20 7418 1448**	**will.pearce@davispolk.com**
Michael Sholem	**+44 20 7418 1027**	**michael.sholem@davispolk.com**
Simon Witty	**+44 20 7418 1015**	**simon.witty@davispolk.com**
Anne Cathrine Ingerslev	**+44 20 7418 1029**	**annecathrine.ingerslev@davispolk.com**
Jeffrey P. Crandall	**212 450 4880**	**jeffrey.crandall@davispolk.com**
Edmond T. FitzGerald	**212 450 4644**	**edmond.fitzgerald@davispolk.com**
Kyoko Takahashi Lin	**212 450 4706**	**kyoko.lin@davispolk.com**
Jean M. McLoughlin	**212 450 4416**	**jean.mcloughlin@davispolk.com**
Cynthia Akard	**650 752 2045**	**cynthia.akard@davispolk.com**

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