

Recent European Compensation Developments: Financial Institutions and Beyond

April 23, 2013

Almost half a decade after the onset of the financial crisis, populist sentiment and the resulting political environment continue to fuel stricter regulation of executive and director compensation, with the latest wave in Europe including substantive restrictions on compensation in the financial services industry and “say-on-pay” initiatives (*i.e.*, initiatives providing for shareholder approval of compensation). This memorandum describes these recent European compensation developments, namely:

- The so-called “banker bonus cap” – substantive limits on the amount of variable compensation that can be paid to certain employees at financial institutions; and
- Say-on-pay developments in the E.U. and Switzerland.

Banker bonus cap. Last week, the European Parliament approved restrictions on bonus payments by financial institutions as part of Capital Requirements Directive (CRD) IV, which greatly amends the E.U.’s rules on capital requirements for credit institutions (including banks) and investment firms.¹ This memorandum describes these limits and related restrictions for financial institutions in the E.U. Notably, the bonus cap is not only an issue for E.U. employees, but will also apply to certain U.S. employees of financial institutions that are in the E.U. and to E.U.-based employees of financial institutions, regardless of where the institutions are headquartered. And, while the bonus cap has received the most press, there are several other items of interest, including certain pension deferral requirements and the collection of information relating to employees receiving €1,000,000 or more per fiscal year.

Say-on-pay. This memorandum also describes the recent groundswell of say-on-pay initiatives that has swept across Europe – ranging from the E.U. as a whole to individual countries inside and outside of the union. For example, the U.K. is expected to implement binding say-on-pay and limitations on “loss of office” payments by October 2013.² Germany, Spain and Switzerland have also made progress with their own say-on-pay and compensation measures.

Details of the foregoing proposals and the timing of their implementation remain in the works, since they must make their way through their respective legislative processes.

¹ CRD IV is a directive and is required to be incorporated into the national laws of the E.U.’s member states. Thus, the rules on financial institution remuneration, among other items, will remain the responsibility of the member states’ national competent authorities. The procedural force of the CRD IV rules is in contrast with other aspects of the new rules that are part of the Capital Requirements Regulation (CRR), which sets forth prudential requirements for capital, liquidity and credit risk. As a regulation, the CRR applies directly in every member state. It is a “single rule book” applicable to all investment firms and credit institutions across the E.U.

Here are a number of useful links relating to CRD IV: [text](#) of the directive; [press release](#); [background note](#) published by the Director for the Media; and CRD IV / CRR [frequently asked questions](#).

² For our prior discussion on the subject of binding say-on-pay in the U.K., please see [here](#) (blog post regarding the U.K. government’s consultation paper on say-on-pay), [here](#) (memorandum regarding the U.K. government’s package of proposals) and [here](#) (blog post regarding the U.K. government’s consultation paper on company remuneration reports).

E.U. bonus cap for financial institutions

Background and effective date

On April 16, 2013, the European Parliament approved various elements of CRD IV, including restrictions on bonus payments by credit institutions and investment firms, despite marked disagreement by the U.K. government and by the financial services sector in the City of London. The next step in the legislative process is approval by the Council of Ministers, which is slated to occur without further discussion. Subject to this process and publication of the rules in the Official Journal by June 30, 2013, it is expected that the bonus cap, together with the other elements of CRD IV, will become effective on January 1, 2014 and will restrict bonuses paid in 2015 for performance in 2014. If, for some reason, the rules are not published by June 30, 2013, then they will apply starting July 1, 2014. These provisions will apply whether or not the financial institution's equity securities are publicly traded.

CRD IV follows CRD III, which was introduced post-financial crisis with the intent to implement the internationally agreed upon [Financial Stability Board Principles for Sound Compensation Practices](#) and the [Commission Recommendation](#) of April 30, 2009 on remuneration policies in the financial services sector. CRD III's compensation provisions focused on the structure of remuneration for material risk-takers at financial institutions. These included, in particular:

- At least 50% of any variable pay should consist of equity-linked instruments; and
- At least 40-60% of variable pay should be deferred over a period of not less than three to five years.

CRD III did not prescribe any ratios between the fixed and variable components of total compensation.

Key features of the bonus cap

CRD IV begins where CRD III left off. The key features of CRD IV's bonus cap, which is intended to curb excessive risk-taking, are as follows:

- Bonus payments (referred to as "variable pay") will be capped at 100% of total fixed pay or, with shareholder approval, 200% of total fixed pay.
 - For this purpose, "variable pay" includes payments or benefits that depend on performance and, in exceptional circumstances, other contractual elements that do not "form part of a routine employment package[]", and "fixed pay" includes payments and benefits that do not involve the consideration of any performance criteria, as well as regular pension contributions.
 - Shareholder approval means approval by either 66% of shareholders owning half the shares represented or, failing that, 75% of all shares represented. Employees who are directly affected by the higher bonus cap must not be allowed to exercise, directly or indirectly, any voting rights that they may have as shareholders of the financial institution.³

³ CRD IV includes specific procedures that financial institutions must follow in order to obtain shareholder approval. Among other things, there is a requirement to provide shareholders with a detailed recommendation containing the reasons for and the scope of any approval sought, including the number of employees affected, their functions and the expected impact on the financial institution's capital base. A financial institution must promptly inform its regulator of, among other things, its recommendation to shareholders and their decision.

- The effective bonus cap may be increased by applying a notional discount rate to the value of up to 25% of total variable pay, if the pay takes the form of long-term deferred instruments (*i.e.*, instruments deferred for a period of at least five years).
 - The European Banking Authority (EBA)⁴ will prepare guidelines on the applicable discount rate for long-term deferred instruments by March 31, 2014, taking into account factors such as inflation and risk.
- At least 50% of any variable pay must consist of:
 - Shares or equivalent ownership interests (or share-linked or equivalent non-cash instruments, for non-listed institutions); and
 - Where possible, “Additional Tier 1 instruments” and “Tier 2 instruments”, or other instruments that can be fully converted to Common Equity Tier 1 instruments or written down.
- At least 40% of any variable pay must be deferred over a period of at least three to five years.
 - For “particularly high” variable pay, which is not defined but which presumably exceeds 100% of total fixed pay, the percentage that must be deferred is at least 60%.
 - 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 member of staff in question”, and vesting cannot occur faster than on a *pro rata* basis.
- Up to 100% of variable pay will be subject to malus or clawback arrangements. Financial institutions will be required to set specific criteria for such arrangements.
- E.U. member states have the discretion to adopt stricter standards (*e.g.*, lower bonus caps).

Scope of the bonus cap

Subject entities. The bonus cap will apply to all credit institutions (including banks) and investment firms in the E.U. and the non-E.U. subsidiaries of such entities, as well as to the E.U. subsidiaries of financial institutions headquartered outside the E.U. For example, if a financial institution is headquartered in London or Madrid or Paris, all of its subject employees (including subject employees located in New York or Hong Kong) will be affected, and, even if a financial institution is headquartered in New York or Hong Kong, its subject employees working for an E.U. subsidiary will be affected.

Subject employees. The bonus cap will not apply to all employees of a subject entity; rather, it will only affect employees whose professional activities have a material impact on the risk profile of the relevant financial institution. Examples of such employees include:

- Senior management;
- Risk-takers;
- Employees engaged in control functions; and

⁴ The EBA came into being as of January 1, 2011 and superseded the Committee of European Banking Supervisors. The EBA acts as a “hub and spoke network” of E.U. and national bodies and is intended to safeguard public values, such as the stability of the financial system, the transparency of markets and financial products and the protection of depositors and investors.

- Employees whose total pay takes them into the same bracket as senior risk management and risk-takers.

The EBA will prepare draft standards regarding the qualitative and quantitative criteria used to determine these categories of subject employees and will then submit these standards to the European Commission by March 31, 2014 for adoption in final form. Moreover, by June 30, 2016, the European Commission and the EBA will review and report on the bonus cap's impact on competitiveness and financial stability, and on the non-E.U. employees of E.U. financial institutions. In particular, the report will consider whether the bonus cap should continue to apply to such non-E.U. employees.

Other noteworthy aspects of CRD IV

While the bonus cap has been the subject of much of the discussion of CRD IV's compensation-related provisions, other noteworthy aspects include the following:

- CRD IV aims to ensure that every financial institution has sound and fair remuneration policies, so that pay reflects effective risk management and performance, without encouraging unjustified risk-taking.
- Guaranteed pay "is not consistent with sound risk management or the pay-for-performance principle" and is generally prohibited as a prospective matter, except under exceptional circumstances, where the financial institution is hiring a new employee, where it has a sound and strong capital base and where the guarantee is limited to the first year of employment.
- A financial institution's pension policy is required to be in line with the business strategy, objectives, values and long-term interests of the institution. If an employee leaves before retirement, discretionary pension benefits must be held by the institution for a period of five years. If an employee reaches retirement, then such benefits must be paid subject to a five-year retention period.⁵
- Financial institutions that "are significant in terms of their size, internal organization and the nature, the scope and the complexity of their activities" are required to establish a remuneration committee.
 - The committee is required to be constituted in such a way as to enable it to exercise "competent and independent judgment on remuneration policies and practices and the incentives created for managing risk, capital and liquidity".
 - The chair and other members of the remuneration committee are required to be members of the management body who do *not* perform any executive function at the financial institution.⁶

⁵ As is the case whenever there is the possibility of extending the payment timetable of deferred compensation, an issue that will need to be considered for any employees subject to U.S. federal income taxation is Section 409A of the U.S. Internal Revenue Code, which generally requires that compensation that constitutes non-qualified deferred compensation be paid out only upon permissible payment dates or events.

⁶ A "management body" should be understood to have executive and supervisory functions. In member states where management bodies have a one-tier structure, the board usually performs management and supervisory tasks. In member states with a two-tier structure, the supervisory function of the board is performed by a separate supervisory board that has no executive functions, and the executive function is performed by a separate management board, which is responsible and accountable for the day-to-day management of the undertaking.

- If employee representation on the management body is provided for by national law, the remuneration committee is required to include one or more employee representatives.
- When making its decisions, the remuneration committee is required to take into account the “long-term interest of shareholders, investors and other stakeholders in the institution and the public interest”.
- Employees engaged in control functions are required to be independent from the business units that they oversee, to have appropriate authority and to be remunerated in accordance with the achievement of the objectives linked to their functions.
- If a financial institution fails to satisfy applicable capital buffer requirements and intends to distribute any of its profits for specified purposes, which include the payment of variable pay or discretionary pension benefits, it must disclose the amount of profits it intends to pay for that purpose.
- In the case of financial institutions that benefit from “exceptional government intervention”, there are additional principles, which include that no variable pay may be paid to members of the management body of the institution, unless justified.
- The European Securities and Markets Authority (ESMA)⁷ is charged with cooperating closely with the EBA to develop guidelines on remuneration policies for categories of employees involved in the provision of investment services.
- E.U. member state regulators are required to collect information on the number of individuals per financial institution being remunerated €1,000,000 or more per fiscal year, in pay brackets of €1,000,000, including their job responsibilities, the business area involved and the main elements of salary, bonus, long-term award and pension contribution. This information is to be forwarded to the EBA, which will publish it on an aggregate home member state basis.

E.U. say-on-pay⁸

On December 12, 2012, the European Commission **announced** its intent to propose an initiative to allow shareholders to approve the remuneration policy and any remuneration report of listed companies incorporated in any of the 27 member states of the European Union.⁹ On March 6, 2013, the European Commissioner for Internal Market and Services further **commented** on the proposal, indicating that the shareholder vote would be mandatory. However, details remain unclear, as draft legislation that would implement the proposal has yet to be published.

⁷ ESMA is an independent E.U. authority that is intended to contribute to safeguarding the stability of the E.U.’s financial system by ensuring the integrity, transparency, efficiency and orderly functioning of securities markets, as well as enhancing investor protection.

⁸ Say-on-pay is already binding in a number of European jurisdictions, including Denmark, the Netherlands, Norway and Sweden.

⁹ In addition, among other items, the European Commission indicated its desire to harmonize the disclosure requirements of individual director remuneration across the E.U.’s member states. It also expressed its view that employee share ownership schemes “could play an important role in increasing the proportion of long-term oriented shareholders” and announced its intent to “identify and investigate potential obstacles to trans-national employee share ownership schemes” with the goal of encouraging employee share ownership throughout Europe.

For our prior discussion on the European Commission Action Plan on Corporate Governance of Listed Companies, please see [here](#).

Meanwhile, individual E.U. member states, as well as Switzerland, are proceeding at different paces to implement their own say-on-pay proposals. We describe several of these proposals below.

Say-on-pay in European countries

U.K.

The U.K.'s annual *advisory* say-on-pay vote has been the harbinger of say-on-pay in other jurisdictions, including the United States. Now, a package of *binding* say-on-pay and related proposals is pending before the U.K. Parliament as part of the Enterprise and Regulatory Reform Bill 2012-13. The House of Commons recently returned the bill to the House of Lords, with amendments. Once both Houses reach agreement on the form of the bill, it will come into force as an Act of Parliament. The bill is expected to come into force on October 1, 2013, which would impact general meetings held in fiscal years beginning on or after that date. As part of this initiative, the U.K. government has made available a set of [frequently asked questions](#) and [draft regulations](#), summarized as follows.

Policy report

A binding shareholder vote would be held at least every three years on a company's compensation **policy report**, which is prospective in that it sets out the company's future policy regarding the compensation (including "loss of office" payments) of directors, including executive directors.

The policy report would cover the following elements:

- Tabular disclosure of the key elements of pay and supporting information (including how each supports the achievement of the company's strategy), the maximum potential value and performance metrics.
- Principles that the company would apply in establishing a compensation package for a new director, including the maximum level of salary which may be awarded.
- Information on the provisions in directors' employment contracts or terms of appointment that could give rise to or affect remuneration or loss of office payments.
- Scenario charts indicating what directors would get paid for performance that is above, on or below target (maximum, on-target and minimum scenarios).
- Principles on which loss of office payments would be made, including how they would be calculated, how the company would take into account the circumstances under which a director leaves and how performance would be taken into account.
- How employee pay and how, if at all, shareholder views have been taken into account when setting compensation policy.

Implementation report

A continued advisory shareholder vote would be held each year on a company's compensation **implementation report**, which is retrospective in that it sets out how the company's compensation policy was implemented in the past fiscal year, including actual payments to directors and details on the link between company performance and pay.

The implementation report would cover the following elements:

- A single total figure of remuneration for each director, presented in a specific tabular format disclosing salary, benefits, pension, bonus, long-term incentives and the total remuneration amount.
- Performance against metrics for long-term incentives.

- Total pension entitlements (for defined benefit plans).
- Variable pay awarded in the past fiscal year.
- Payments made in the relevant fiscal year to past directors.
- Loss of office payments made in the past fiscal year.
- Total shareholding of directors.
- A performance graph indicating the company's total shareholder return compared with that of a broad equity market index (the period covered is initially the five most recent fiscal years inclusive of the year in which the report is first produced; this period increases yearly to reach a maximum of the nine most recent fiscal years).
- Percentage increases from the past fiscal year of the CEO's pay and of the total aggregate pay of all the employees of the company, or a different group of employees chosen by the company with a statement indicating why that group was chosen.
- Percentage details and amounts of retained and distributed profits, tax paid and overall expenditure on pay, identifying within that amount the overall spend on pay for directors.
- Information about who has advised the remuneration committee.
- Percentage details of the votes for and against each of the policy report and the implementation report at the last general meeting at which such votes were proposed, as well as any reasons for significant dissent, where known, and actions taken by the directors in response.

Effective date

As noted above, the new regime is expected to come into force on October 1, 2013. Assuming that it does, for any annual shareholders meetings held in the first fiscal year beginning on or after October 1, 2013, companies will be required to produce a director remuneration report in the new format, with a separate policy part and implementation part. At these shareholders meetings, many of which will occur in the spring of 2014, both parts will be put to shareholders for approval.

All companies will be required to successfully seek approval for their remuneration policies by no later than the start of the second fiscal year to begin after October 1, 2013; thus, for calendar year-end companies, this will mean January 1, 2015. After this date, all remuneration and loss of office payments to directors will be required to comply with the company's approved remuneration policy, or else be separately approved by shareholders. Before this date, any such payments that do not comply with the approved remuneration policy will not be unlawful.

The forward-looking and binding remuneration policy will be required to be put to shareholders at least once every three years, and the backward-looking and advisory implementation report will be voted on once a year. The binding remuneration policy vote will need to be held more frequently than every three years if:

- The company wishes to change its remuneration policy, in which case the company would be required to obtain shareholder approval; or
- If the advisory vote on the implementation report is not passed in a fiscal year where there was no vote on the policy report, in which case the company would be required to hold a binding vote on the policy report in the following fiscal year.

If a company were to fail its binding remuneration policy vote, it would need to continue using its existing policy until a revised policy were approved by shareholders and/or seek shareholder approval for any specific remuneration or loss of office payments inconsistent with the policy. The company would have the choice of convening an extraordinary general meeting to put forward a revised policy or waiting until

the next annual general meeting to do so. If a company were to fail its very first binding vote, it would be required to call a general meeting and put a remuneration policy (which could, but need not, be an amended version of the last policy) to shareholders for approval.

The restrictions on loss of office payments will apply from the start of the second fiscal year to begin on or after October 1, 2013 (*i.e.*, January 1, 2015 for calendar year-end companies). There are limited exceptions for judicially compelled payments and payments mandated by other legal requirements.

Further details

- The proposals will apply only to U.K.-incorporated companies (*i.e.*, companies with a registered office in England, Wales, Scotland or Northern Ireland) with shares listed on the U.K. FSA's official list, shares officially listed in the European Economic Area or shares admitted to dealing on the New York Stock Exchange or Nasdaq. (At present, there are approximately 900 such companies.)
 - The proposals would *not* apply to companies incorporated outside the U.K., such as those incorporated in Jersey or Guernsey, even if they have shares listed in the U.K.; nor will the proposals apply to companies listed on AIM, the London Stock Exchange's international market for smaller growing companies.
- The requisite voting threshold will be a simple majority. For this purpose, abstentions and withheld votes will not count.
- Once the policy report is approved by a majority of shareholders, companies will be required to act within its parameters and will be prohibited from paying any remuneration or making any loss of office payments outside of its scope without separate shareholder approval.
 - *Impact on existing contracts:* Payments that are contractually required to be made under agreements entered into, and obligations arising, before the legislation was published on June 27, 2012 and which have not been amended or renewed since then will *not* be subject to these restrictions. However, any payments made under agreements entered into, amended or renewed after that date will be subject to the new rules.
 - *Impact on new hires:* A company's shareholder-approved policy will apply to payments made to new hires, including any compensation that is paid in the nature of a "make whole" or "buy-out" of compensation forfeited by the incoming hire's previous employer. Thus, the policy will need to address the company's approach to the remuneration of new hires.
 - *Impact on newly quoted companies:* Newly quoted companies will need to put a remuneration policy to a shareholder vote at the meeting occurring in the first fiscal year to begin on or after the day on which the company becomes a quoted company. The restrictions on remuneration and loss of office payments will apply to newly quoted companies from the first day of their second fiscal year as a quoted company.
 - *Impact on M&A transactions:*
 - Any *remuneration payments* will need to be consistent with the approved remuneration policy of whichever company is making the payment. Where a company is acquired by another company, the acquiror's remuneration policy becomes the relevant policy. Where a newly quoted company is formed, please see above regarding the impact on newly quoted companies.
 - Any *loss of office payments* will need to be consistent with the approved remuneration policy of whichever quoted company the director is departing

from, regardless of the actual payor of the payment. If, at the point that the director departs, the company is no longer a quoted company, these restrictions will not apply.

- Effective October 1, 2013, following the departure of a director, the company will be required to publish a statement disclosing the loss of office payments that he or she has received or may receive in future. The statement will need to be published as soon as reasonably practicable.
- If a company makes a payment that is inconsistent with its approved remuneration policy and has not been separately approved by shareholders, then an action can be brought either by the other directors or by shareholders, acting on behalf of the company, to recover the payment. If the company or the shareholders are not able to recover the payment, then the directors who authorized the payment may be held liable for the losses incurred as a result, unless a director can prove in court that he or she acted honestly and reasonably.

Germany

On March 12, 2013, the German government **announced** proposals to regulate executive compensation by shareholder vote and increase transparency regarding executive compensation. Details of the proposals are currently unclear, as no draft legislation has been published, although most commentators expect that the proposals will involve a *binding* shareholder vote that applies only to German companies. According to German lawmakers, the proposals could be enacted as early as the summer of 2013.

Spain

Also on March 12, 2013, the Spanish government **announced** proposals to introduce a *binding* shareholder vote on executive remuneration in the financial services sector and to allow shareholders of financial institutions to impose limits on total remuneration.¹⁰ Although details of the proposals are currently unclear, it is expected that the proposals would apply only to Spanish financial institutions.

Switzerland

On March 3, 2013, Swiss voters approved a constitutional amendment known as the “Minder Initiative”, which introduced a series of measures relating to *binding* say-on-pay and executive compensation, notwithstanding efforts by the Swiss parliament to propose an alternative legislative approach that would have adopted many of the Minder Initiative’s key aspects, but without its punitive rigor. The Minder Initiative measures will come into force no later than March 3, 2014, once implementing provisions have been enacted either by the Swiss Parliament or by the Swiss Federal Council. These measures will apply to Swiss companies, whether listed on a Swiss or overseas stock exchange, and will not apply to non-Swiss companies, even if they are listed in Switzerland.

Say-on-pay

Under the measures, shareholders will have a *binding* annual vote on the total compensation paid to the board of directors, members of management and any advisory board (together, “senior management”).

Other restrictions and requirements

In broad terms, companies will be prohibited from making payments of sign-on bonuses, severance payments (and other forms of exit payments) and success fees for M&A transactions to senior management. Companies will also be required, in their articles of association, to set out certain

¹⁰ Spain had earlier limited the salaries of senior executives to €500,000 at any bank that received governmental assistance.

restrictions affecting senior management regarding credit facilities, loans, pension benefits, bonus schemes and other compensation plans.

In addition, pension funds will be required to cast their votes in the interest of beneficiaries and to disclose how they voted.

These Swiss measures provide for significant *criminal* sanctions for violations, including fines of up to six times annual compensation and imprisonment for up to three years.

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.

London

| | | |
|-----------------|------------------|--|
| Simon Witty | +44 20 7418 1015 | simon.witty@davispolk.com |
| Simon Evers | +44 20 7418 1306 | simon.evers@davispolk.com |
| Matthew Hart | +44 20 7418 1313 | matthew.hart@davispolk.com |
| Alexander Mehra | +44 20 7418 1334 | alexander.mehra@davispolk.com |

Executive Compensation

| | | |
|----------------------|--------------|--|
| Edmond T. FitzGerald | 212 450 4644 | edmond.fitzgerald@davispolk.com |
| Kyoko Takahashi Lin | 212 450 4706 | kyoko.lin@davispolk.com |
| Cynthia Akard | 650 752 2045 | cynthia.akard@davispolk.com |

Financial Institutions

| | | |
|---------------------|--------------|--|
| Luigi L. De Ghenghi | 212 450 4296 | luigi.deghenghi@davispolk.com |
| Andrew S. Fei | 212 450 4063 | andrew.fei@davispolk.com |

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