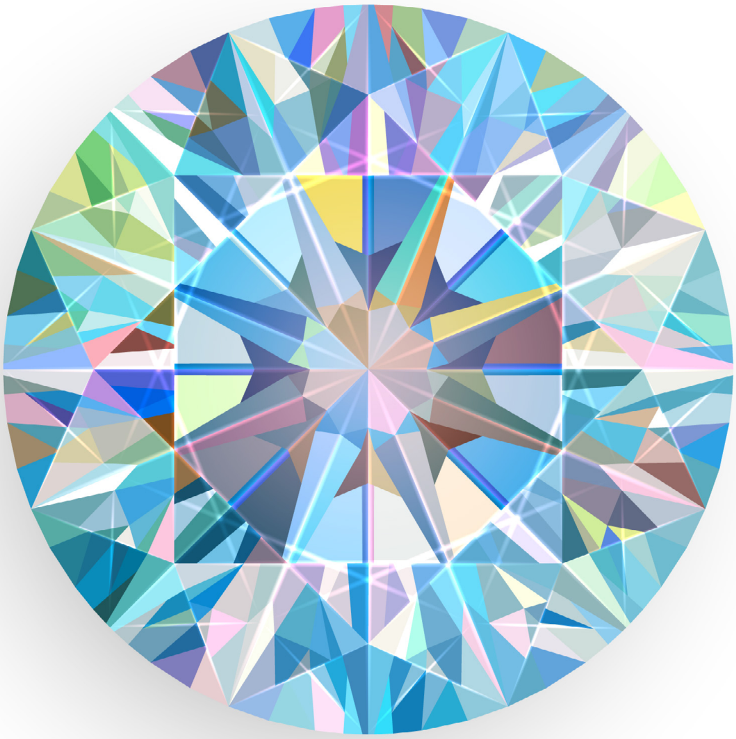


Financial Services Reward – April 2021

FCA publishes its draft remuneration rules under the new Investment Firm Prudential Regime (IFPR)

Introduction

Firms in scope:

- Any MiFID investment firm authorised and regulated by the FCA that is currently subject to any part of the Capital Requirements Directive (CRD) and the Capital Requirements Regulation (CRR), including BIPRU and IFPRU firms, specialist commodities dealers, oil and energy market participants.
- Collective Portfolio Management Investment Firms (CPMIs)
- Regulated and unregulated holding companies of groups that contain an investment firm authorised and regulated by the FCA and that is currently authorised under MiFID and/or a CPMI.

Timing: On 19 April 2021, the FCA published its second Consultation Paper setting out its proposals for the implementation of the Investment Firm Prudential Regime (IFPR), including new remuneration rules for UK investment firms. **Firms will have until the 28 May 2021 to respond to the FCA's proposals.** Following the consultation, the FCA will publish a Policy Statement and 'near final' rules. Final rules will be published once the Financial Services Bill has passed through Parliament and all the consultations are complete.

The IFPR requirements will come into effect for remuneration awarded in relation to **performance periods beginning on or after 1 January 2022**. Firms subject to IFPRU and BIPRU Remuneration Codes should continue to apply the current rules until 1 January 2022 or up to the start of their next performance period after that date, whichever is the later.

Overview: Having been heavily involved in the policy discussions which led to the creation of the EU's Investment Firm Directive ('IFD') and Investment Firm Regulation ('IFR'), the FCA is supportive of its aims. The regulator expects that the UK's 'version' of the regime, the IFPR, will achieve the same overall outcomes, albeit that the FCA has incorporated some changes to ensure that the IFPR is appropriate to the UK market.

Under the IFPR, the FCA will introduce a **new MIFIDPRU Remuneration Code (SYSC 19G)**. This will apply to all FCA investment firms and will replace the existing IFPRU and BIPRU Remuneration Codes (SYSC 19A and SYSC 19C) non-handbook guidance on these codes. SYSC 19F will remain unchanged and continue to apply for all sales staff and advisers. The FCA has also confirmed that, following the UK's exit from the EU, the final EBA guidelines on sound remuneration policies under the IFD will not apply to FCA investment firms.

Firm wide proportionality – application of the remuneration requirements to different firms

In line with the European approach, the FCA is proposing to allow for a proportionate implementation of the remuneration requirements depending on the size, scope and nature of activities of the firm. Under the IFPR, the FCA has proposed **two broad categories of investment firm**. Firms will either be classed as 'small and non-interconnected' (an **SNI firm**), based on tests relating to their size and activities or a **non- SNI firm** i.e. all firms not classed as an SNI firm. An explanation as to how SNI firm status will be determined can be found in the appendix.

SNI firms will only need to comply with the 'basic,' principles-based parts of the MIFIDPRU Remuneration Code. They will not be required to identify, or apply specific remuneration rules to, Material Risk Takers (MRTs). The largest non-SNI firms (which exceed certain balance sheet thresholds), will need to meet the full or 'extended' requirements of the Code, which include rules on deferral, pay-out of variable remuneration in retained instruments and discretionary pension benefits. Non-SNI firms that fall below the balance sheet thresholds will be subject to 'standard' remuneration requirements i.e. the MIFIDPRU Code, without the extended provisions above. The FCA has summarised the basic, standard and extended remuneration requirements as follows:

01. Basic remuneration requirements – these will apply to all FCA investment firms and in relation to all staff. SNI firms will only be required to apply the following requirements:

- **Remuneration policy design** – a remuneration policy must be in place for all staff which cover all components of remuneration covered in the proposed MIFIDPRU Remuneration Code, including ensuring it is gender neutral and has regard to environmental, social and governance (ESG) risk factors.
- **Governance and oversight** – there must be a periodic review of the remuneration policy, ensuring control functions are independent from the business units they oversee, and remunerated according to objectives linked to their functions. Remuneration of senior staff in risk and compliance should be directly overseen by the remuneration committee or management body.
- **Fixed to variable remuneration** – the remuneration policy must make a clear distinction between the criteria applied to determine fixed and variable remuneration and the fixed and variable components must be appropriately balanced. It may be appropriate for some categories of staff to receive only fixed remuneration but there is no requirement to set specific ratios.
- **Assessment of individual performance** – both financial and non-financial criteria must be taken into account when assessing individual performance.
- **Restrictions on variable remuneration** – variable remuneration must not affect the firm's ability to ensure a sound capital base. A firm which benefits from extraordinary public financial support must not pay any variable remuneration to members of the management body.

02. Standard remuneration requirements – these will apply to all non-SNI firms in addition to the basic requirements above. Of particular significance is the requirement for all non-SNI firms to identify their MRTs (discussed below). Unlike the basic remuneration requirements, which apply to all staff, the additional rules that make up the standard requirements apply only to MRTs. The standard remuneration requirements include:

- **Setting a ratio between variable and fixed remuneration** – firms should set their own internal ratios for MRTs as part of their remuneration policies. Different ratios can be set for different categories of staff and ratios may differ from one performance year to the next as a firm's risks, strategies and priorities shift.
- **Performance assessment** – performance-related variable remuneration of MRTs must be based on a combination of the performance of the individual, the relevant business unit and the overall firm and must be based on a multi-year period.
- **Ex-ante and ex-post risk adjustment** – firms must take into account all current and future risks when measuring performance to calculate and allocate bonus pools. Firms must also have mechanisms in place to allow for in-year adjustments and malus and clawback, including setting minimum malus and clawback periods and determining triggers.
- **Restrictions on non-performance related variable remuneration** – the FCA proposes certain restrictions relating to guaranteed variable remuneration, retention and 'buy-out' awards and severance pay.
- **Other requirements for firms** – firms must ensure that the control functions undertake an independent internal annual review of the remuneration policy; discretionary pension benefits must be in line with business strategy, objectives, values and long term interests of the firm; firms must take all reasonable steps to ensure their MRTs do not undermine the remuneration rules; and variable remuneration must not be paid through vehicles or methods that facilitate non-compliance with the remuneration rules.

03. Extended remuneration requirements – these will apply to the largest non-SNI firms in addition to the basic and standard remuneration requirements (highlighted above). A firm will be considered as one of the largest non-SNI firms, and therefore in scope of all the remuneration rules, if:

- the value of its on-and off-balance sheet assets over the preceding 4-year period is a rolling average of more than £300m
- or the value of its on-and off-balance sheet assets over the preceding 4-year period is a rolling average of more than £100m (but less than £300m), and it has trading book business of over £150m, and/or derivatives business of over £100m

The extended remuneration requirements include:

- **Pay-out of variable remuneration** – at least 50% of variable remuneration must be paid out in shares, instruments or using alternative arrangements (approved by the FCA), and subject to an appropriate retention policy. The FCA permits firms to use a broad range of instruments for deferral, including shares (or equivalent ownership interests), share-linked instruments (or equivalent non-cash instruments), additional Tier 1 instruments, Tier 2 or other instruments which can be fully converted to Common Equity Tier 1 instruments, and non-cash instruments which reflect the instruments of the portfolios managed.
- **Retention periods** – firms must ensure that all shares and instruments issued for variable remuneration are subject to an appropriate retention period post-vesting. The FCA has not prescribed a minimum timeframe but when setting an appropriate retention period expects firms to consider at least the length of the deferral period, the business cycle, the types of risk relevant to the role of the MRT and how long it could take for the risks underlying the performance to crystallise. As a general guide, the FCA advises that the greater the impact of the MRT on the risk profile of the firm and/or the funds managed, the longer the retention period should be.
- **Deferral and vesting** – At least 40% of variable remuneration should be deferred for at least 3 years, or 60% where the variable remuneration is a ‘particularly high amount’, and always where it is £500,000 or more. The deferred awards must not vest faster than on a pro-rata basis. MRTs whose roles and responsibilities mean they have a considerable impact on the risk profile of the firm or the funds it manages (for example members of the management body or senior management), should be subject to a deferral period longer than the 3-year minimum. The FCA consider it good practice for the deferred portion of variable remuneration to contain a higher proportion of shares/instruments than the non-deferred (upfront) portion.
- **Restriction on the payment of interest and dividends** – the FCA proposes that investment firms must not pay to MRTs dividends or interest on variable remuneration in respect of the period it is deferred, either during or after the deferral period ends.
- **Discretionary pension benefits** – where an MRT leaves the firm before retirement, the firm must hold the pension benefits in the form of shares, instruments or within any alternative arrangements for 5 years. However, where an MRT retires, the firm must pay out the pension benefit in shares /other instruments or alternative arrangements and the MRT is required to retain the pension benefits for 5 years.
- **Remuneration Committee** – the FCA proposes that non-SNI firms subject to the extended remuneration requirements must establish a Remuneration Committee. The Chair, and at least 50% of the committee members must be non-executive members of the management body (where the legal structure of the firm permits).

Application of the remuneration requirements in certain circumstances

Subsidiaries established in third countries

- The FCA is proposing to apply the remuneration rules only to the material risk takers (MRTs) of group entities in third countries who oversee or are responsible for business activities that take place in the UK. As such, the UK remuneration requirements will not be applied to entities in third countries for individuals who are not identified as MRTs for the group.

FCA investment firm groups

- Where prudential consolidation applies the relevant remuneration rules (basic, standard or extended) apply at both the individual entity and consolidated level. Where there is no prudential consolidation, each FCA investment firm in the group would need to apply the basic, standard or extended remuneration rules on an individual entity basis.
- Where entities within a consolidation group are subject to different rules, the way they apply will differ depending on the different rules that apply (e.g. some firms may be subject to the standard, others the extended requirements or different remuneration rules such as the AIFM Remuneration Code). In this instance **firms should apply the stricter requirements** (i.e. longer deferral periods) for any MRT who has a material impact on the risk profile of another entity in the group (or of the assets it manages) that is subject to the stricter requirements, or on the risk profile of the group as a whole. For individuals who are MRTs in respect of only one entity, the requirements applicable to the individual entity should be applied.

Groups with credit institutions or PRA-designated investment firms

- For groups with credit institutions of PRA-designated investment firms, firms will be expected to comply with the requirements of the Dual-Regulated firms Remuneration Code (SYSC 19D). For groups containing both a PRA-designated investment firm and an FCA investment firm, but no credit institution, the group must satisfy the consolidated requirements of both SYSC 19D and SYSC 19G.

Application to collective portfolio management investment firms (CPMIs)

- The new MIFIDPRU Remuneration Code should apply to the MiFID business of CPMIs, which was previously exempt from the CRD remuneration regime. This means that CPMIs will need to apply both the MIFIDPRU and the AIFM or UCITS V Remuneration Codes, they are currently subject to. Where an MRT of a CPMI has responsibilities only for MiFID or only for non-MiFID business, the firm should apply the relevant remuneration code. Where an MRT has responsibilities for both MiFID and non-MiFID business, the FCA proposes that the firm must apply the stricter of the remuneration requirements (for example any longer deferral periods) to the individual MRT.

Exemptions for certain individuals

In non-SNI firms which are subject to the extended requirements, MRTs who earn below a certain remuneration threshold will be able to disapply the rules relating to deferral, payment in instruments/ shares and holding and retention periods for discretionary pension benefits (when an MRT leaves the firm). An individual MRT would need to meet both of the following criteria in order to qualify for the exemption:

- the individual's variable remuneration is £167,000 or less; **and**
- the individual's variable remuneration makes up one-third or less of their total remuneration

Individuals who do not meet these exemption criteria must still be identified as MRTs

The FCA has indicated that it will consider further data and evidence on the appropriateness of these thresholds before finalising its rules and that this threshold may be subject to change over time to reflect future developments, including EU market access.

Material Risk Taker identification

The FCA expects all non-SNIs to identify MRTs on an **annual basis**. The FCA makes clear that it expects firms to consider all types of risks including prudential, operational, market, conduct and reputational risks.

The FCA considers that individuals should be identified as MRTs where they:

- are a member of the management body (in its management or supervisory function) or of senior management
- have managerial responsibilities for the activities of a control function or for the prevention of money laundering and terrorist financing
- have managerial responsibility for a business unit that is carrying on at certain regulated activities including managing or dealing in investments
- work for a firm with permission to carry on any of the regulated activities mentioned in the above point, and are responsible for managing information technology, information security or the outsourcing arrangements of critical or important functions
- are responsible for managing a material risk or risk management policies
- have authority to take decisions approving or vetoing the introduction of new products

These categories of staff are intended to be used as a starting point with firms expected to develop their own additional criteria to identify further individuals based on the specific types of activities and risks relevant to the FCA investment firm. To assist with this, the FCA has provided some guidance on the types of factors that firms may find useful, as well as examples of other roles that could be included as MRTs. This includes heads of key areas (e.g. equities, fixed income, alternatives, private equity), heads of investment research, individuals responsible for a high proportion of revenue, senior advisors where they can exert key strategic influence, chief market strategists, where media profile is linked to reputational risk and risk to market integrity, heads of a trading or broking desk and all individuals with responsibility for information technology, information security and outsourcing where there is not a single person with responsibility for all three areas.

The FCA is not proposing to require firms to identify individuals solely based on their level of remuneration awarded. This is a notable divergence from the European Banking Authority's (EBA) Regulatory Technical Standards for the identification of MRTs under IFD, where firms are expected to apply quantitative criteria when identifying their MRTs.

Co-investment and carried interest arrangements

The FCA would not generally consider returns made by staff on co-investment arrangement to constitute remuneration, however, carried interest would usually be considered to be remuneration for the purposes of the rules.

Remuneration in partnerships

The FCA has proposed to assist partnerships in determining which types of payments to partners should be treated as remuneration for the purposes of the MIFIDPRU Remuneration Code, and which as a return on equity (not in scope of the rules). The guidance suggests that firms should consider how a partner currently receives their profit share and the rationale for the payment. Alternatively, or in combination with the above approach, a firm could use a benchmarking approach. The FCA expect a reasonable portion of a partner's profit share to be considered as remuneration.

Disclosure, reporting and record keeping

The FCA are proposing to introduce a new MIFIDPRU Remuneration Report and will retire the existing Remuneration Benchmarking Information Report and High Earners Report. Reporting requirements will be proportionate depending on whether a firm is subject to basic, standard or extended remuneration requirements as follows:

- SNI firms will be required to report only basic information about the total number of staff they have, and how much total fixed and variable remuneration was awarded in the relevant reporting year.
- Non SNI firms will be required to split this information between MRTs and non-MRTs, and also to provide information on the ex-post risk adjustments made to variable remuneration.
- Non-SNI firms subject to extended remuneration requirements will be required to provide the above data as well as information on the remuneration awarded to their highest three earners.

At this stage, the FCA will not require investment firms to report on diversity-related pay gaps, for example on gender and/or ethnicity, but will consider the potential use of reporting on diversity-related data as part of its broader work on diversity and inclusion later this year. The new remuneration report will need to be submitted annually within 4 months of a firm's accounting reference date.

The FCA intends to review and amend the current Remuneration Policy Statement ('RPS') templates to align with the final MIFIDPRU Remuneration Code.

Alignment and divergence with EU regulation

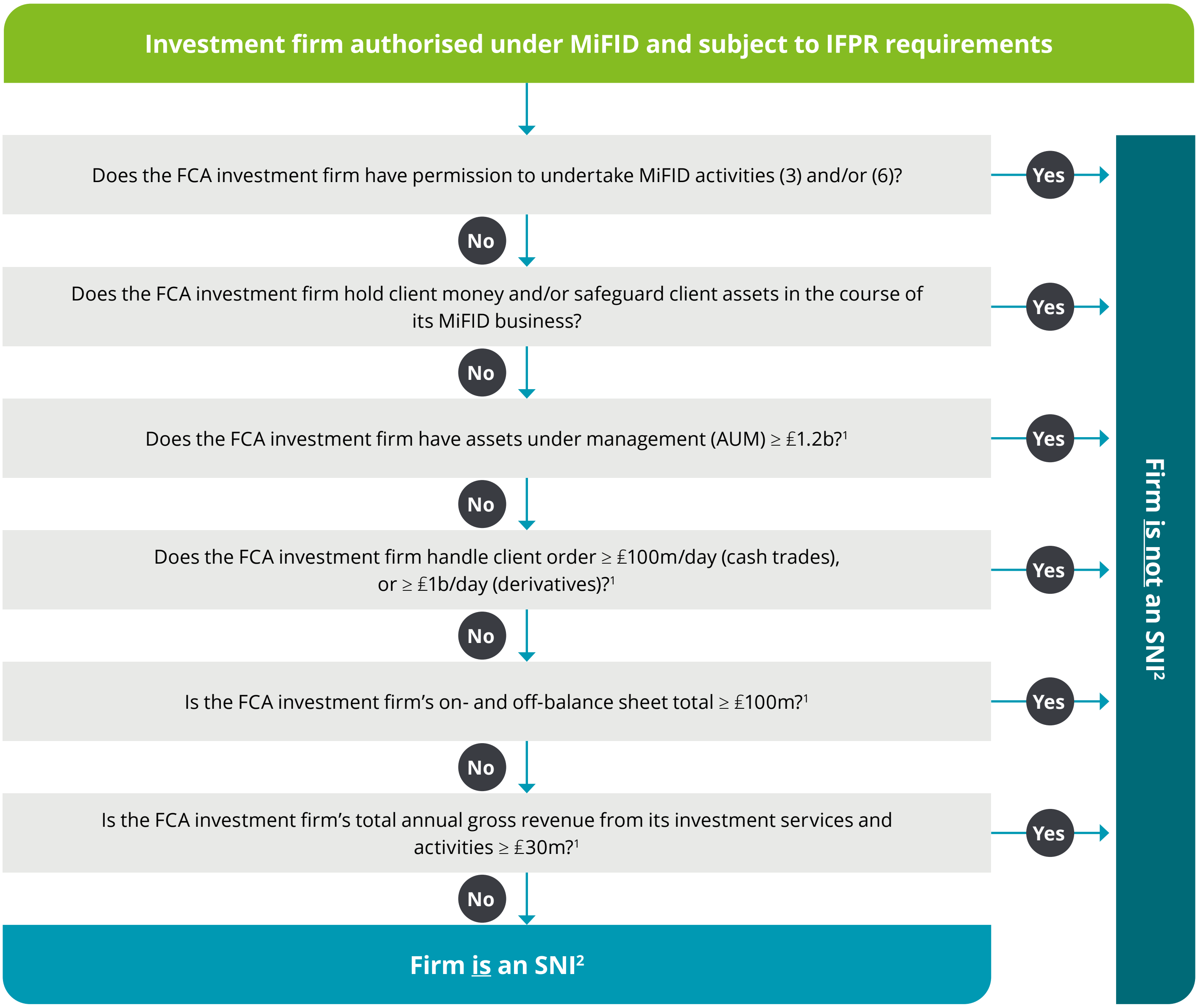
- The FCA has clarified that FCA investment firms will not be required to apply the EBA guidelines on sound remuneration policies under the IFD.
- The FCA has proposed in its consultation paper that firms will not be permitted to pay to their MRTs dividends or interest on variable remuneration in respect of the period it is deferred, during the deferral period or after the deferral period ends. Whilst this approach aligns with the EBA guidelines under IFD, interest and dividends payments on deferred awards will still be permissible for MRTs identified under the AIFMD and UCITS V pay regimes.
- While the FCA proposals are largely aligned to the remuneration requirements under the IFD, there are a few key areas where there is divergence from the EBA's prescribed rules for EU firms. The principle areas of alignment and divergence are outlined below:
  - **MRT identification:** removal of the quantitative tests to identify categories of staff whose professional activities have a material impact on the investment firm's risk profile.
  - **Individual proportionality:** The UK has applied a slightly different individual proportionality threshold that permits firms to exempt individual MRTs from the rules on deferral and payment in instruments. Individuals awarded total variable remuneration of £167,000 or less and variable remuneration is less than 1/3 of their total annual remuneration, then the pay-out process rules will not apply. For EU investment firms subject to the IFD, firms will be able to dis-apply the rules on deferral and payment in instruments for MRTs who are awarded variable remuneration of no more than EUR 50,000 and where variable remuneration is no more than 25% of total remuneration.
  - **Retention period:** Unlike under IFD, where the retention period is set at a minimum of 1 year, the FCA does not specify what would constitutes an "appropriate retention period" for firms to apply but does provide some guidance for firms to consider when setting the retention period.
  - **Deferral:** The IFD remuneration rules state that firms must defer between 40% to 60% of MRTs' variable remuneration for a minimum of three to five years, with individuals earning a particularly high amount of variable remuneration required to defer at least 60%. For members of the management body, firms are required to apply a five year deferral period. The FCA also proposes that firms should defer 40% to 60% of the variable remuneration of MRTs for at least three years, but there is no requirement for senior management to defer for five years, although a period of more than three years is required. The FCA also clarifies that where the variable remuneration is of a 'particularly high amount', and always where it is £500,000 or more, the higher deferral level of at least 60% will apply.
  - Note that for UK firms with EU based investment firm entities, the expectation from the EBA is that the EU based entities will need to comply with the EBA Guidelines on sound remuneration policies under the IFD. This may create some practical challenges for firms when setting their remuneration policies across their UK and EU regulated entities. In particular, firms will need to consider their approach to deferral, setting an 'appropriate retention period' for UK MRTs and identifying MRTs under slightly different criteria.

APPENDIX – Determining if a firm is SNI or non-SNI

To qualify as an SNI, an FCA investment firm:

- must not carry out activities that have the greatest potential to cause harm to its customers or to the markets in which it operates, and
- must not carry out any activities on such a scale that would cause significant harm to customers or to the markets in which it operates

In particular, the FCA provides a guide (as illustrated in the diagram below) so that an individual FCA investment firm can determine if it is an SNI or a non-SNI firm.



[1] These metrics are assessed on a combined/group basis.
[2] Small and non-interconnected FCA investment firm.