CLIFFORD CHANCE

UK investment firm prudential regime (IFPR): A new remuneration code for investment firms

The EU Investment Firm Regulation and Directive prudential regime (IFR/IFD) will apply to all investment firms authorised in the EU from June 2021. It includes a new and potentially onerous remuneration regime modelled closely on that contained in CRD4 that will apply to many EU investment firms.

Although the UK is no longer a member of the EU and not obliged to implement the IFR/IFD, legislation will be passed to enable the introduction of a new UK investment firm prudential regime (IFPR). The legislation will delegate powers to the PRA and the FCA to introduce the IFPR. The Government and the UK regulators propose that the IFPR achieves "similar intended outcomes as those in IFR/IFD" and intend that the IFPR should come into effect in the summer of 2021.

The FCA has published a discussion paper (DP) setting out the technical details of the IFR/IFD and its initial views on the UK's IFPR. The FCA is actively seeking feedback from investment firms so that it can develop its approach before consulting on any necessary rules.

In respect of remuneration, the FCA DP indicates that the IF Remuneration Code will reflect the IFD remuneration principles (which in turn draw heavily on the equivalent provisions of CRD4). In this Briefing we set out the key concepts and requirements under these principles, as well as looking at the proposed proportionality regime from which some firms and/or individuals will benefit.

Which investment firms are affected?

Certain large investment firms (including those with consolidated assets of EUR30bn or more) will remain subject to the Capital Requirements Regulation and Directive (CRR/CRD) remuneration rules as they apply in the UK after the end of the Brexit transition period (currently SYSC 19D). The FCA will consult on changes to SYSC 19D to implement changes required under CRD5 very shortly.

All other investment firms authorised under the Markets in Financial Instruments Directive (MiFID) will be subject to the IFR/IFD and will not be subject to the CRR/CRD regime (except to the extent that they are included in

Key issues:

- The FCA proposes a new Investment Firm Remuneration Code, reflecting the IFD remuneration principles.
- The FCA has published a discussion paper, inviting responses by 25 September 2020. It will then consult on a draft IF Remuneration Code, to come into effect in June 2021 and apply to remuneration for the following performance year.
- Many firms would be subject to more onerous rules on remuneration governance and on the structure of "variable" remuneration than is currently the case.
- Some firms and individuals will benefit from exemptions on grounds of proportionality, but these are likely to be much more limited than under the current Remuneration Codes.

Key terms:

- **CRR/CRD**: the EU Capital Requirements Regulation and Directive (including **CRD4** and **CRD5**).
- **IFPR**: the proposed UK investment firm prudential regime (to include a new **IF Remuneration Code**).
- **IFR/IFD**: the EU Investment Firm Regulation and Directive.
- **MiFID**: the EU Markets in Financial Instruments Directive.

a group subject to consolidated supervision under that regime). These investment firms are divided into two main categories: larger or interconnected firms (non-SNIs) and smaller and non-interconnected firms (SNIs). SNI investment firms are not subject to the remuneration requirements under IFR/IFD, except to the extent that they are included in a group subject to consolidated supervision under the new regime.

The FCA has indicated that the IFPR will take the same approach. For UK non-SNI investment firms, the FCA proposes to introduce a new IF Remuneration Code, replacing the Codes currently applicable to IFPRU and BIPRU firms (SYSC 19A and SYSC 19C respectively).

In the UK, the biggest impact of the IF Remuneration Code is likely to be on those non-SNI investment firms that are currently able to disapply the more onerous structural renumeration requirements of the BIPRU Remuneration Code (SYSC 19C) and 'exempt CAD' firms that find themselves classified as non-SNI firms under the IFPR regime and therefore subject to a remuneration regime for the first time.

To reiterate, the IF Remuneration Code would apply to relevant UK investment firms. EU investment firms will be subject to IFR/IFD as implemented in the relevant jurisdiction. For further information on IFR/IFD and the relevant remuneration provisions, please see our previous briefings here and here.

Key concepts for non-SNI firms: which staff and which remuneration?

Material Risk Takers: The IFD remuneration requirements apply to all staff whose professional activities have a material impact on the investment firm's risk or of the assets it manages. This group is known as Material Risk Takers, or MRTs.

The European Banking Authority (EBA) is currently consulting on regulatory technical standards specifying the criteria that should be taken into account when identifying MRTs. The FCA will in turn issue rules on the identification of MRTs that are based on the EBA's technical standards, subject to any (as yet unspecified) adjustments that might be appropriate to the UK market.

Fixed and variable remuneration: Many of the remuneration principles rely on a distinction between "fixed" and "variable" remuneration. Broadly, fixed remuneration is any permanent, non-discretionary payment or benefit to which an individual is entitled (such as salary), whereas any other remuneration (such as performance bonuses or discretionary pension benefits) is "variable". However, this is not always a straightforward distinction in practice, and will likely pose particular difficulties for LLPs and partnerships, whose members typically receive profit share.

Key requirements of the IFD remuneration principles

Most of the IFD remuneration principles will be familiar to those with experience of the equivalent CRR/CRD requirements. We set out below the most material provisions, in our experience.

Ratio of fixed to variable remuneration: Unlike under CRD4, no mandatory 'bonus cap' will be imposed under the IFD remuneration principles. However, the investment firm's remuneration policy must set appropriate ratios between the fixed and the variable component of total remuneration. The FCA DP acknowledges that different ratios may be appropriate for different categories of staff and, therefore, the FCA does not intend to issue further guidance on what is an "appropriate ratio".

Guaranteed Bonuses: Investment firms must not award guaranteed bonuses other than for new staff in their first year, subject to the investment firm having a strong capital base. The FCA has indicated that it is likely to address sign-on bonuses and buy-out awards in the IF Remuneration Code with clarification of its expectations of firms in accompanying guidance.

Deferral: At least 40% of a variable remuneration award has to be deferred over a three to five year period (vesting pro rata). In the case of variable remuneration of a particularly high amount, at least 60% of the amount should be deferred. In the DP, the FCA suggests setting a threshold of £500,000 as a "particularly high amount" (which is the same approach as under the equivalent CRR/CRD requirement).

Payment in shares or equivalent interests: At least 50% of any variable remuneration must be paid in shares or similar instruments. This is expected to apply equally to the deferred and non-deferred portions of variable remuneration. The FCA acknowledges in the DP that some non-SNI firms may not issue any such instruments that could be used in variable remuneration and suggests that alternative arrangements could be permitted for such firms.

Ex-post risk adjustment (malus and clawback): Variable remuneration must be subject to "malus" (pre-vesting reduction) or "clawback" (repayment by the individual to the firm) in situations where the individual in question participated in or was responsible for conduct which resulted in significant losses for the investment firm; and/or is no longer considered fit and proper. The FCA intends to consult on guidance around its expectations on malus and clawback.

Discretionary pension benefits: If an individual leaves an investment firm before retirement, discretionary pension benefits should be held by the investment firm for five years in the form of instruments. If an employee reaches retirement, discretionary pension benefits must be paid in the form of instruments subject to a five year retention period.

Termination payments: Firms must not reward failure or misconduct. The DP indicates that the FCA is likely to include provisions on early termination payments in the new IF Remuneration Code and provide clarification of its expectations in guidance.

Remuneration committee: The IFD requires firms to establish a gender-balanced remuneration committee, which must be comprised of individuals who do not perform an executive role in the investment firm.

The FCA has said that it will not prescribe equal representation on the remuneration committee but expects firms to promote a culture of inclusion and ensure appropriate representation.

Proportionality

As under the existing Remuneration Codes, firms may be able to disapply certain requirements on grounds of proportionality, either on a firm-wide basis or in respect of particular individuals. However, the firms and individuals benefiting from such exemptions are likely to be significantly reduced under the IF Remuneration Code.

Proportionality: firm disapplication: The rules on:

- remuneration committees,
- payment in shares or equivalent interests,
- deferral, and

- discretionary pension benefits,

can potentially be disapplied by some firms. Under the IFD, these rules can be disapplied if the value of the investment firm's on- and off-balance sheet assets is on average €100 million or less over the four-year period immediately preceding the given financial year.

The FCA considers that for the purposes of the IF Remuneration Code it might be appropriate to increase this asset threshold to €300 million for certain non-SNI firms. While this will be welcome for some non-SNI firms, it is important to note that the other provisions of the IF Remuneration Code would still apply. This includes the requirement for ex-post risk adjustment, so a firm that elects not to apply deferral would need to ensure that variable remuneration payments are subject to clawback.

All other non-SNI firms above the €300/ €100 million threshold will in principle have to meet all of the remuneration requirements in the IF Remuneration Code, subject to a new general proportionality rule. It is unclear how this would work in practice, but it would not be as wide as the current proportionality provisions that apply (for example) to BIPRU firms.

Proportionality: individual disapplication: The IFD rules on payment in shares, deferral and discretionary pension benefits can be disapplied if the individual's annual variable remuneration does not exceed €50,000 and does not represent more than 25% of the individual's total annual remuneration.

The FCA acknowledges that the scope for disapplication of the 'pay-out and deferral rules' based on an individual's remuneration is much narrower under IFD than under the IFPRU/BIPRU Remuneration Codes, which permit firms to disapply the rules on guaranteed bonuses, pay outs, deferral and performance adjustment for an individual if their variable remuneration is no more than 33% of total remuneration which is no more than £500,000.

The FCA is therefore seeking feedback from firms about the likely number and type of individuals that would be affected, although it gives no indication of whether it is countenancing increasing the threshold for disapplication of these rules.

Disclosure and reporting obligations

Investment firms will have to disclose detailed information on their remuneration policies and practices, including information related to gender neutrality and the gender pay gap. In addition, they will have to report to the relevant regulator information on the number of staff per investment firm that receive remuneration of €1 million or more in a financial year.

Timeframe

The FCA has invited responses to the discussion paper by 25 September 2020. It will then consult on a draft IF Remuneration Code and assorted guidance. It is expected that the IF Remuneration Code would come into effect in the summer of 2021.

The FCA Discussion Paper: A new UK prudential regime for MiFID investment firms (DP 20/02) can be found here.

EBA Consultation on Draft Regulatory Technical Standards on criteria to identify investment firm MRTs can be found here.

Action points:

Firms potentially subject to the new IF Remuneration Code should consider the following action points:

- Consider responding to the DP to draw the FCA's attention to areas of concern;
- Identify the regulated entities subject to IFPR and their classification as SNI or non-SNI (and for non-SNI firms, whether they would fall under the proposed €300 million asset threshold);
- Identify the group structure of those firms and the group members potentially within the scope of consolidated supervision (and whether the firm may qualify for a waiver);
- Consider how the applicable pay-out rules could be satisfied; and
- Determine whether a remuneration committee is required and/or whether changes would be required to existing remuneration committee arrangements.

IFPR Remuneration regime: application overview

Class of investment firm	Impact of new remuneration rules
Smaller and non-interconnected firms (SNI firms) Likely to encompass some smaller private equity and other advisory firms, portfolio managers and distributors.	SNI firms will not be subject to the new IF Remuneration Code on a solo basis. In practice these will include many CAD exempt firms that are not subject to the current CRD or (in the UK) BIPRU remuneration regimes. SNI firms (and all other investment firms) will, however, remain subject to MiFID2 remuneration requirements. These provide that firms must not remunerate or assess the performance of their own staff in a way that conflicts with their duty to act in the best interests of their client, or provides an incentive for recommending or selling a particular financial instrument when another product may better meet the client's needs.
Non-SNI investment firms: average balance sheet assets €300m+ Likely to encompass larger introducing brokers, portfolio managers and other investment firms exceeding (on a group basis) one or more of the thresholds set by reference to: • assets under management (including ongoing non-discretionary advisory arrangements) • client orders handled (or received and transmitted) • on- and off-balance sheet assets • annual gross turnover and any investment firm that holds client money or client assets, executes transactions or takes positions or counterparty risk.	Firms will be required to comply with the full IF Remuneration Code requirements, including the requirement to: • set appropriate ratios between the variable and the fixed component of the total remuneration of their material risk takers, • issue at least 50% of variable pay in non-cash instruments, • provide for deferral of a proportion of variable pay (at least 40%) for 3 to 5 years, • subject variable pay to malus and clawback, • publicly disclose certain aspects of their remuneration system and of the awards made, and • establish a remuneration committee.
Smaller Non SNI investment firms: average balance sheet assets less than €300m	Firms will be required to comply with the full IF Remuneration Code, save for the requirements relating to payment in shares or equivalent interests, deferral, discretionary pension benefits and remuneration committees.
Large investment firms Investment firms which deal on own account and underwrite or place financial instruments on a firm commitment basis and whose total assets are at least €30bn (individually or on a group basis) or meet other threshold size requirements (or are part of a consolidated group under CRR/CRD and elect to be treated in this way).	Subject to remuneration rules in SYSC 19D (as amended to give effect to CRD5), including bonus cap, malus and clawback provisions, deferral of variable pay and non-cash rules.

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