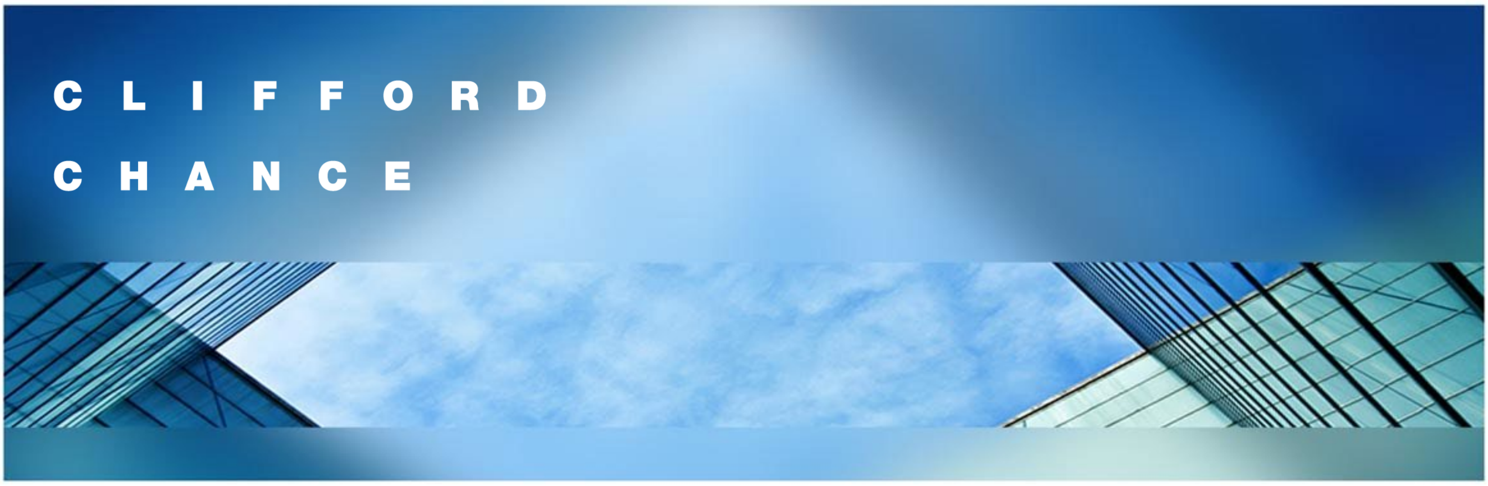

UK'S PRUDENTIAL REGIME FOR MIFID INVESTMENT FIRMS: FCA PUBLISHES CONSULTATION ON NEW REMUNERATION CODE

The FCA has published a second consultation paper on its new investment firm prudential regime. As anticipated, a single remuneration code is being proposed for FCA investment firms authorised under the Markets in Financial Instruments Directive ('MIFID') (to be known as **'the MIFIDPRU Remuneration Code'**).

This will become new SYSC 19G in the Handbook and will replace the BIPRU and IFPRU Remuneration Codes. It will apply to performance periods beginning on or after 1 January 2022.

Impacted firms will want to consider whether to respond to the consultation paper, closing on 28 May 2021. A copy of the consultation paper can be found here.

The MIFIDPRU Remuneration Code will still broadly follow the EU's IFD and IFR remuneration rules, however the proposals do diverge in some respects. Although the concepts will be familiar to firms, there are some technical changes to those set out in the FCA's discussion paper (published in August 2020), as we've flagged below.

Key issues

- The FCA has published its new proposed MIFIDPRU Remuneration Code, to replace BIPRU and IFPRU Remuneration Codes
- Consultation closes on the 28 May 2021
- Impacted firms will need to apply basic, standard or extended remuneration requirements depending on their classification
- The new MIFIDPRU Remuneration Code will apply to performance periods beginning on or after 1 January 2022

Clifford Chance Comment

Although the new MIFIDPRU Remuneration Code is currently at the consultation stage, firms may still want to think about getting ahead and early planning. The level of preparation needed will largely depend on the size and complexity of your firm and what level of regulation you are currently used to. For investment firms unfamiliar with remuneration regulation, the impact of the MIFIDPRU Remuneration Code will be similar to that faced by smaller banks that were previously exempted from the remuneration rules under the Capital Requirements Directive and Capital Requirements Regulation ('CRD/CRR') but brought into scope by the CRD5 changes earlier this year.

Timings are tight. Although the delay in bringing in the MIFIDPRU Remuneration Code until January 2022 is helpful, there is still much to think about now. For example, pay structures and policies will need to be thoroughly reviewed and firms will want to prepare for a different Material Risk Taker ('MRT') population, changes to MRT identification and for new individuals within the organisation being impacted. Firms will also need to prepare for the proposed requirement for remuneration committees (of which at least 50% of the members must be non-executive members of the management body) to be established at individual entity (as opposed to at group) level, including deciding whether or not to apply for a waiver for any entities.

The new MIFIDPRU Remuneration Code will differ in some ways from the EU's Investment Firms Directive and Investment Firms Regulation ('IFD/IFR') regime; the FCA has made it clear that it is introducing a post-Brexit regime with changes that are 'appropriate for the specifics of the UK market'. Careful analysis will be needed by groups, including looking at applicable group consolidation rules and any jurisdictional overlap. The regulatory landscape will inevitably now become more complex as the UK and EU rules diverge from 2022 onwards.

AT A GLANCE: APPLICATION OF REMUNERATION REQUIREMENTS

Application

- Aside from the larger, systematically important firms that are subject to CRR/CRD, the majority of MIFID investment firms will now be subject to the MIFIDPRU Remuneration Code.
- The extent to which the MIFIDPRU Remuneration Code applies to a firm will depend on how the firm is classified under the new regime. Investment firms are divided into two categories:
  - Larger or interconnected firms ('non-SNIs') and
  - Smaller and non-interconnected firms ('SNIs').

  SNIs, as smaller institutions, will be subject to the MIFIDPRU Remuneration Code, but only be required to apply the most basic of requirements. Non-SNIs will have more onerous requirements, which will vary depending on whether certain thresholds are met, as set out in our table below.

- A Non-SNI firm will be subject to all of the requirements of the MIFIDPRU Remuneration Code where the value of its assets (on and off balance sheet) over 4 years is a rolling average of:
  - more than £300m; or
  - more than £100m but less than £300m and if it has trading book business of over £150m and/or derivatives business of over £100m.

  A Non-SNI firm below these thresholds will not be subject to the rules on RemCos, deferrals, use of shares and non-cash instruments and retention policies, as we've set out in our table.

SNIs	**"Basic Remuneration requirements"** including: • Remuneration policy required to promote sound and effective risk management • Policies and practices must be gender neutral. As with CRD firms, this means that they must be 'based on equal pay for male and female workers for equal work or work of equal value' • Policy must have a clear distinction between the criteria that determines fixed and variable pay, with an 'appropriate balance' between those elements • Remuneration must not affect the firm's ability to ensure a sound capital base • Remuneration reporting structure proposed. Detailed rules on the disclosure of remuneration information to follow in the FCA's third consultation paper
Non-SNIs not classified as Largest non-SNIs	**"Standard Remuneration requirements"** including all 'basic' requirements and: • Requirement to identify MRTs annually • Restrictions on guarantees, retention awards, buyouts and severance pay • Ex-ante and ex post risk adjustments apply (including malus and clawback) • Appropriate ratio required between fixed and variable (although no bonus cap)
Largest non-SNIs	**"Extended remuneration requirements"** including all 'standard' requirements and:

Value of a firm's on and off balance sheet assets over a 4 year period is a rolling average of more than £300m (or a rolling average of more than £100m with a trading book business of over £150m, and/or derivatives business of over £100m).	• Deferral of at least 40% or 60% of MRT variable pay for at least 3 years (vesting no faster than pro rata) • At least 50% of MRT variable pay in shares or non-cash instruments (including non-cash instruments that reflect the instruments of managed portfolios). Certain 'alternative' arrangements will require FCA approval, for example instruments that may be used by LLPs and partnerships, which is a new requirement • No dividend or interest payments may be made on deferred shares or instruments for MRTs • MRT share awards subject to 'appropriate' retention policy (no minimum imposed) • Discretionary pension benefits subject to a payment in shares requirement and holding periods • Remuneration committee ('RemCo') required at individual entity level (requirement can be modified by groups where setting up a RemCo at entity level would be 'unduly burdensome')

Material Risk Takers

- The FCA has published requirements to apply in identifying MRTs as part of the consultation. In a different approach to CRR/CRD firms, MRTs will only be identified on the basis of qualitative criteria, and there is no requirement to identify MRTs based on remuneration alone.
- The approach to de minimis MRTs has changed since the discussion paper and this will be a step that is welcomed by firms. The de minimis MRT carve out (applied to the requirements on discretionary pension benefits, payment in shares or instruments and deferrals) will apply to individuals whose total annual variable remuneration is £167,000 or less (an increase from the EUR 50,000 as proposed in the discussion paper) and is not more than 1/3 of total annual remuneration (previously 1/4 in the discussion paper).

Application to Groups

- Under the new regime, the FCA may grant permission for investment firm groups to apply a group capital test. In such cases no prudential consolidation at group level is required. Where this applies, these groups may apply the basic, standard or extended remuneration rules on an individual entity basis. Where the prudential consolidation rules do apply, FCA investment firm groups must apply the new requirements at both an individual entity and consolidated group level. Where different rules apply to group entities, the strictest of the rules should apply to any MRTs (subject to the exception for third countries, as set out below) who have either a material impact on another member of the group (that is subject to the stricter requirements), or on the risk profile of the group as a whole.

- The FCA has taken into account feedback on the application of the rules to entities in third countries in FCA investment firm groups subject to prudential consolidation. In an effort to reduce the compliance burden and address contradictory outcomes, the new rules will only apply to MRTs of group entities in third countries who oversee or are responsible for business activities in the UK. This will be a welcome development and addresses many of the concerns raised as part of the discussion paper feedback.
- Groups with entities that contain PRA designated investment firms (but not credit institutions) must satisfy the requirements of both the Dual-regulated firms Remuneration Code (SYSC 19D) and the new MIFIDPRU Remuneration Code, using a similar approach to MRTs as FCA investment firm groups described above.

Partnerships, co-investments and carried interest

- The FCA acknowledges that LLPs and partnerships require further guidance on determining what constitutes fixed or variable pay, as this may not always be clear cut. The MIFIDPRU Remuneration Code includes guidance to help in determining what types of payments should be treated as remuneration and which types should be treated as return on equity, and therefore outside the rules. Broadly, residual profits are not considered to be remuneration, whereas monthly drawings and discretionary payments are considered to be remuneration.
- New provisions and further clarification are also included for firms operating co-investment and carried interest arrangements. Consistent with current practice:
    - returns made by staff on co-investments do not constitute remuneration (with a clarification that the investment is made from an individual's own funds and not a loan from the firm); and
    - carried interest, where these are payments that are a share in the profits of a fund and not related to a co-investment arrangement, will be considered to be remuneration.

NON REMUNERATION-RELATED PROVISIONS

- Although the MiFIDPRU Remuneration Code takes up a significant part of the consultation paper, the paper also addresses other prudential and governance-related aspects of the regime which were not addressed by the FCA's first consultation paper (published in December). These include: governance-related matters, the fixed overheads-based capital requirement (FOR); liquid assets requirements; the prudential treatment of asset management-related activities (including the K-AUM requirement and its interaction with K-COH charges) and related regulatory processes. A third consultation paper, addressing the remaining issues is expected for early Q3 2021.

C L I F F O R D
C H A N C E

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