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IFR/IFD: NEW EU REMUNERATION REQUIREMENTS FOR INVESTMENT FIRMS

The EU has adopted a new harmonised prudential regime that will apply to all investment firms authorised in the EU from June 2021. The new Investment Firm Regulation and Directive (IFR/IFD) include a new and potentially onerous remuneration regime that will apply to many EU investment firms, including new rules for fixed and variable remuneration, new disclosure and reporting obligations and requirements for some firms to establish a remuneration committee. Firms need to act now to prepare for the application of the new regime.

Key issues

- The new EU Investment Firm Regulation and Directive were published in the Official Journal on 5 December 2019.
- In addition to imposing new prudential requirements, the directive will impose new remuneration requirements from 26 June 2021.
- Existing investment firms will be reclassified under three broad categories.
- Class 1 firms (systemically important and larger investment firms) will remain subject to the CRD remuneration regime.
- Class 2 firms (other larger and interconnected firms) will be subject to the new IFD remuneration regime, on a solo basis.
- Class 3 firms (smaller, non-interconnected firms) will not be subject to the new IFD remuneration regime, on a solo basis.

For details on the other prudential requirements under IFR/IFD, including a flow chart explaining how investment firms are classified under the new regime, please see the briefing on our website here.

The new IFD/IFR regime will apply from 26 June 2021. It is expected that the new remuneration requirements will not apply retrospectively and that the new rules will apply to the remuneration year commencing January 2022. Many firms will therefore need to begin considering now what they need to do to ensure that they can comply with the remuneration requirements.

Brexit

The UK will not be required to apply the new rules unless, in June 2021, the UK is still in the EU or still in the transition period under the proposed withdrawal agreement with the EU. However, the UK authorities might choose to implement all or part of IFR/IFD to address deficiencies in the 'onshored' EU regime that will form part of UK law or to facilitate a finding by the European Commission that the UK regime governing investment firms is equivalent to the EU regime for the purposes of the cross-border access requirements in the Markets in Financial Instruments Regulation (although gaining equivalence could be challenging even if the UK concludes a withdrawal agreement and then a long-term trade agreement with the EU). The FCA is expected to consult in the next few months on the introduction of a new regime for investment firms aligned to IFR/IFD.

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Which investment firms are affected?

The IFR/IFD regime introduces a new classification system for investment firms. Some systemically important and larger firms will remain subject to the remuneration regime under the Capital Requirements Regulation and Directive (CRR/CRD – these firms are often referred to Class 1 investment firms).

All other investment firms authorised under the Markets in Financial Instruments Directive (MiFID) will be subject to the prudential regime in IFR/IFD and will not be subject to the CRR/CRD regime (except to the extent that they are included in a group subject to consolidated supervision under that regime). These investment firms are divided into two main categories: larger or interconnected firms (Class 2 investment firms) and smaller and non-interconnected firms (Class 3 investment firms).

The remuneration rules will generally apply to Class 2 investment firms on an individual and consolidated basis. However, in some cases the national regulator may waive the application of the rules on an consolidated basis if there is no significant risk to the clients or market that would otherwise require the firm to be supervised on a consolidated basis.

Class 3 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.

At present, some UK investment firms are subject to the BIPRU prudential supervision regime including the BIPRU Remuneration Code which imposes a number of remuneration requirements that are similar to those of the IFD/IFR remuneration regime. For BIPRU investment firms, the IFR/IFD remuneration rules, even if they are implemented in the UK, may only require moderate revision to existing arrangements. In contrast, other UK Class 2 investment firms may need to make significant revisions to the way in which some staff are remunerated.

In the UK, the biggest impact of the IFD Remuneration Rules would likely to be on those Class 2 investment firms which 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 Class 2 under the IFD regime.

The classification of any individual firm will have to be carried out on a case-by-case basis which is beyond the scope of this briefing. However, the table below provides a high-level overview of the impact of the IFD remuneration provisions for each class of firm.

What are the key remuneration requirements for variable remuneration?

The IFD requires variable remuneration (which includes discretionary pensions benefits, early termination payments and buy-out payments) to comply with the principles set out below.

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.

Ratio of fixed to variable remuneration: The IFD does not impose a mandatory 'bonus cap' (although Member States are free to set a cap if they so wish). However, IFD requires that the investment firm's remuneration policy sets appropriate ratios between the fixed and the variable component of total remuneration with the ability to pay no variable remuneration in appropriate cases.

Pay-out (payment in shares and equivalent interests): At least 50% of any variable remuneration has to be paid in one or more of the following instruments:

- shares or equivalent ownership interests;
- share-linked instruments or equivalent non-cash instruments;
- additional Tier 1 instruments and Tier 2 instruments (i.e., certain long-term subordinated debt instruments used for regulatory capital purposes);
- other instruments which can be fully converted to Common Equity Tier 1 instruments;
- non-cash instruments which reflect the instruments of portfolios managed.

Investment firms are expected to apply an appropriate retention policy to any such instruments.

Member States or their competent authorities may place restrictions on the types and designs of these instruments or ban certain instruments as appropriate.

Deferral: At least 40% of the variable remuneration has to be deferred over a three to five year period. Deferred remuneration must vest on a pro-rata basis. In the case of a variable remuneration of a particularly high amount, at least 60% of the amount should be deferred. The IFD does not define what are 'particularly high amounts'; however it seems likely that the FCA will adopt the £500,000 threshold it applies in the context of the BIPRU remuneration code.

Proportionality: The IFD rules on pay-out and deferral can be disapplied if:

- the value of the investment firm's on- and off-balance sheet assets is on average equal to or less than EUR 100 million over the four-year period immediately preceding the given financial year; and
- the individual's annual variable remuneration does not exceed EUR 50,000 and does not represent more than one fourth of the individual's total annual remuneration. What is unclear at this stage is whether the EUR 100 million threshold is calculated on a solo or consolidated firm basis. The latter approach would significantly reduce the scope for disapplication of these rules.

Although many aspects of the BIPRU Remuneration Code are similar to the IFD remuneration regime a key difference is that the scope for disapplication is much narrower under IFD. The Code permits 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.

Discretionary pension benefits: If the employee leaves the 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: These must not reward failure or misconduct.

What other requirements apply to remuneration?

The IFD also imposes other requirements on remuneration of relevant staff.

Control function staff: These staff must be remunerated in accordance with the achievement of the objectives linked to their functions, regardless of the performance of the business areas they control. The remuneration committee must directly oversee the remuneration of senior officers in the risk management and compliance functions.

Long-term assessment of performance: Investment firms must assess performance over a multi-year period taking into account their business cycle and business risks.

Remuneration committee: Investment firms with on- and off-balance sheet assets of over €100 million must establish a gender-balanced remuneration committee. The remuneration committee can be established at group level and must be comprised of individuals who do not perform an executive role in the investment firm.

Which staff?

The IFD remuneration requirements apply to all staff whose professional activities have a material impact on the investment firm's risk profile; senior management, risk takers, control functions; and employees receiving overall remuneration equal to at least the lowest remuneration of any risk taker or member of senior management (MRTs).

However, investment firms below the €100m balance sheet asset threshold referred to above can disapply the rules on deferral and pay-out where an individual who would otherwise be in scope has annual variable remuneration of no more than €50,000 which does not represent more than 25% of their total annual remuneration.

The European Banking Authority will produce regulatory technical standards specifying the criteria that should be taken into account when identifying staff whose professional activities have a material impact on the investment firm's risk profile. It will have regard to guidelines under the Alternative Investment Fund Managers Directive, the UCITS Directive and MiFID to minimize the risk of divergence across sectors.

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 are receive remuneration of €1 million or more in a financial year, in pay brackets of €1 million, including information on their job responsibilities, the business area involved and the main elements of salary, bonus, long-term award and pension contribution.

Problem areas

The new regime will raise many practical issues, including the following:

- ***Remuneration structures:*** The remuneration structures of some investment firms, such as private equity houses, do not readily lend themselves to the variable remuneration rules (for example, where staff receive partnership drawings or benefit from 'carry' arrangements).
- ***Group application:*** Until national regulators clarify whether they will permit an investment firm to waive the application of consolidated requirements, firms will have to proceed on the assumption that the remuneration rules apply to their group on a consolidated basis.
- ***Territorial application:*** Firms subject to consolidated requirements will be required to ensure that subsidiaries in non-EEA countries comply with

the rules unless the investment firm can demonstrate to the regulator that the application of the rules would be unlawful in that country.

Action points

Firms potentially subject to the new regime should consider the following action points:

- Identify the regulated entities subject to IFR/IFD and their classification under IFR/IFD;
- 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);
- Establish rules/thresholds for identifying MRTs, identify which members of staff are MRTs and notify MRTs that they are within the scope of the regime;
- Consider how the pay-out rules can be satisfied and what shares or equivalent ownership interests can be used to satisfy those requirements;
- Assess whether the rules on deferral and pay-out can be disapplied;
- Review bonus letters and deferred compensation schemes to determine how to comply with the pay-out and deferral rules, the rules on claw-back and forfeiture and the position regarding severance;
- Consider whether any amendments need to be made to employment or other contracts or compensation schemes;
- Review existing guaranteed bonus arrangements and the process for monitoring the ongoing use of guarantee arrangements;
- Determine whether a remuneration committee is required or whether changes are required to existing remuneration committee arrangements;
- Consider the bonus award process, remuneration policy and the role of the remuneration committee, the setting of a fixed to variable ratio and the operation of malus and clawback arrangements.

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IFD/IFR: application overview

Class of investment firm	Impact of new remuneration rules
Class 3 investment firms Likely to encompass some private equity and other advisory firms, portfolio managers and distributors	Class 3 firms will not be subject to the new IFD remuneration requirements 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. Class 3 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.
Class 2 investment firms 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: • set appropriate ratios between the variable and the fixed component of the total remuneration of their material risk takers: • implement policies with strict criteria for setting an "appropriate" ratio of fixed to variable remuneration; • issue at least 50% of variable pay in non-cash instruments, provided for deferral of a proportion of variable pay for 3 to 5 years, malus and clawback; • publicly disclose certain aspects of their remuneration system and of the awards made; and • establish a remuneration committee.
Class 1, 1a and 1b 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 CRD4 (as amended by CRD5), including bonus cap, malus and clawback provisions, deferral of variable pay and non-cash rules.

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CONTACTS

Alistair Woodland
Partner
London

T +44 20 7006 8936
E alistair.woodland
@cliffordchance.com

Chris Bates
Partner
London

T +44 20 7006 1041
E chris.bates
@cliffordchance.com

Juan Calvente
Counsel
Madrid

T +34 91 590 7546
E juan.calvente
@cliffordchance.com

Simonetta Candela
Partner
Milan

T +39 02 8063 4245
E simonetta.candela
@cliffordchance.com

Mike Crossan
Partner
London

T +44 207 006 8286
E michael.crossan
@cliffordchance.com

Laura Douglas
Senior Associate
Knowledge Lawyer
London

T 44 207 006 3907
E laura.douglas
@cliffordchance.com

Ines Keitel
Head of the German
Employment Group
Frankfurt

T +496971991250
E ines.keitel
@cliffordchance.com

Anne Lemercier
Partner
Paris

T +33 1 4405 5214
E anne.lemercier
@cliffordchance.com

Owen Lysak
Partner
London

T +44 20 7006 2904
E owen.lysak
@cliffordchance.com

Chinwe Odimba-Chapman
Partner
London

T +44 207 006 2406
E chinwe.odimba-chapman
@cliffordchance.com

Tania Stevenson
Knowledge Director
London

T +44 20 7006 8928
E tania.stevenson
@cliffordchance.com

Floris van de Bult
Partner
London

T +31 207119158
E floris.vandebult
@cliffordchance.com

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