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

The FCA has published its single remuneration code for 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 FCA Handbook and will replace the BIPRU and IFPRU Remuneration Codes. The new rules will apply to performance periods beginning **on or after 1 January 2022**.

A copy of the FCA's policy statement (PS 21/9) including the new rules can be found here.

The MIFIDPRU Remuneration Code will broadly follow the EU's Investment Firms Directive and Investment Firms Regulation ('IFD and IFR') remuneration rules, however they do diverge in some respects. There are some minor and technical changes (as well as some helpful clarifications) to the requirements set out in the FCA's consultation paper (published in April 2021), as we've underlined below.

Key issues

- The FCA has published its new MIFIDPRU Remuneration Code, to replace BIPRU and IFPRU Remuneration Codes
- 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: What do you need to do now?

Timings are tight and there is much to think about and plan for now.

- 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 exempt 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.
- As a first step, firms will need to assess their classification to determine which requirements will apply to them.
- Remuneration policies and practices will need to be thoroughly reviewed and updated where required.

- Larger or interconnected firms ('non-SNIs') will also want to assess which individuals will be identified as Material Risk Takers ('MRTs'), review pay structures for those MRTs and consider what changes need to be made to those structures going forward.
- Non-SNIs that are subject to the extended remuneration requirements will also need to prepare for the requirement to establish a remuneration committee ('RemCo') (of which at least 50% of the members must be non-executive members of the management body). These firms will need to establish a RemCo at individual entity level unless they decide to apply to the FCA for a waiver or meet the requirements to rely on a RemCo at group level (see further below).
- Careful analysis will be needed by groups, including looking at applicable group consolidation rules and any jurisdictional overlap. The FCA has included further guidance on what to do where rules overlap at the domestic level. The cross-jurisdictional 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 be subject to the MIFIDPRU Remuneration Code for performance periods starting on or after 1 January 2022.
- 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:
  - 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 balance sheet assets and off-balance sheet items 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' • Remuneration 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 requirements 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) • Requirement to carry out an annual review of remuneration policies and practices • Appropriate ratio required between fixed and variable pay (although no bonus cap)
Largest non-SNIs Value of a firm's balance sheet assets and off-balance sheet items 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)	"**Extended remuneration requirements**" including all 'standard' requirements and: • 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 • Dividend or interest payments may be made on deferred shares or instruments for MRTs, but only delivered at vesting and not during the vesting period • MRT share awards subject to 'appropriate' retention policy (no minimum imposed) • Discretionary pension benefits subject to a payment in shares requirement and holding periods

	• Requirement to set up a RemCo. Where the firm is part of a group that is consolidated for IFPR purposes, the RemCo may be at group level (see below). Where firms are subject to the group capital test the RemCo must be at entity level, however this requirement can also be modified where setting up a RemCo at entity level would be 'unduly burdensome'

Material Risk Takers

- 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 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 and is not more than 1/3 of total annual remuneration. For clarity, the FCA has reminded firms that it is the amount of the actual variable remuneration awarded that is decisive and that the de minimis carve out is only relevant where the extended remuneration requirements apply.

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 basic and standard requirements at both an individual entity and consolidated group level. The FCA has clarified that the extended remuneration requirements do not however apply on a consolidated basis. This means that an entity within an investment firm consolidated group is subject to the extended remuneration requirements (pay-out in instruments, deferral, retention and pay-out of discretionary pension benefits) only if it exceeds the thresholds itself, and not solely because another entity in the group exceeds the thresholds. 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. Illustrative examples and guidance have been added to help firms with this determination process.
- In an effort to reduce the compliance burden and address contradictory outcomes, the MIFIDPRU Remuneration Code provisions will only apply to MRTs of group entities in third countries who oversee or are responsible for business activities in the UK.

- Groups with entities that include PRA designated investment firms (but not credit institutions) must satisfy the requirements of both the Dual-regulated firms Remuneration Code (SYSC 19D) and the MIFIDPRU Remuneration Code, using a similar approach to MRTs as FCA investment firm groups described above.

Malus and Clawback

- Non-SNIs will need to apply malus and clawback to variable remuneration going forward. Firms should ensure that the clawback period spans at least the combined length of any deferral period and retention period. Where clawback applies to awards where there is no deferral, a minimum of 3 years from grant is deemed appropriate.

Interest and Dividends

- The FCA has listened to feedback and changed the proposals on dividend and interest payments. MRTs may now accrue interest and dividends during the deferral period, but firms will not be permitted to pay them to MRTs until the point of vesting.
- The interest rate or level of dividends paid may not be higher than that which would have been paid to an ordinary holder of the instrument. Firms need not include the dividends and interest when calculating the pay ratio.

RemCo requirements

The FCA has responded to feedback from the consultation paper and has amended its final rules. In brief terms:

- A non-SNI firm may rely on a group-level RemCo where it is part of an FCA investment firm group to which prudential consolidation applies and where the UK parent entity has a RemCo that meets the composition requirements, has the necessary powers and has members with the appropriate knowledge and skills in relation to that entity. Where these criteria are met, a firm may rely on the group level RemCo without needing to apply for modification.

Non-SNI firms in groups subject to the group capital test may apply also for a modification from the FCA, where setting up a RemCo would be 'unduly burdensome'.

Guarantees, severance pay, retention awards and buy-outs

The MIFIDPRU Remuneration Code includes rules and guidance on the use of guaranteed variable remuneration, retention awards, buy-out awards and severance pay for MRTs. In particular:

- For non-SNI firms, all variable remuneration rules should apply to severance pay and these amounts must, save in limited circumstances, also be included in the variable component of the ratio calculation.
- Retention awards must only be paid to MRTs after a defined event or at a specified point in time.
- Where a non-SNI firm buys out the unvested deferred awards of a new employee, it must ensure that the award is aligned with the long-term interests of the firm and that it is subject to 'no shorter' retention, deferral, vesting and ex-post risk adjustment terms than those applied under the previous employer's award.

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. Carried interest must be valued at the time of grant. A new rule has been added to the MiFIDPRU Remuneration Code clarifying that certain requirements (pay-out in instruments, deferral, retention and ex-post risk adjustment) do not apply to carried interest where the value is determined by reference to the performance of the fund in which it is held, the period between award and payment of the carried interest is at least 4 years and there are provisions for the forfeiture or cancellation of carried interest in circumstances that include individual conduct resulting in significant losses to the firm and failing to meet standards of fitness and propriety.

Variable to fixed ratio

Non-SNIs must have an 'appropriate' ratio in place between their fixed and variable elements, however unlike CRD/CRR firms there will be no hard cap. Given the diversity of investment firm business and their activities, the FCA has stopped short of stating what it may consider appropriate in its PS 21/9. Firms are however reminded that 'all potential scenarios' must be considered when setting ratios and that the maximum ratio should reflect the highest amount of variable remuneration that can be awarded to MRTs. The issue is expected to be covered further in the upcoming FCA consultation on remuneration disclosure.

Annual review

Non-SNI firms will now be required to subject their remuneration policies and practices to an annual independent review by their internal control functions. Additional guidance has been included in the MIFIDPRU Remuneration Code on what the review should include and who can carry it out including where the review may be outsourced in whole or in part.

NON REMUNERATION-RELATED PROVISIONS

- Although the MiFIDPRU Remuneration Code takes up a significant part of PS 21/9, the policy statement also addresses other prudential and governance-related aspects of the regime. 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 Q4 2021.

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