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The annual bonus round

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In anticipation of the new year's annual bonus round, there has been a flurry of regulatory requirements that will have to be taken into account this time around:

Clawback or malus? The PRA opines

The PRA has issued a supervisory statement (SS2/13) on the application of the pre-vesting malus provisions to variable remuneration. It clarifies how the PRA expects firms to comply with the ex-post risk adjustment requirements of the Remuneration Code. A clear distinction is drawn between the terms 'clawback' and 'malus', which are often used interchangeably.

'Malus' is defined in the CEBS Guidelines on Remuneration Policies and Practices ('CEBS Guidelines') as 'an arrangement that permits the institution to prevent vesting of all or part of the amount of a deferred remuneration award in relation to risk outcomes or performance' i.e. it is applied before vesting.

By contrast, 'Clawback' is a contractual agreement 'whereby the staff member agrees to return ownership of an amount of remuneration to the institution under certain circumstances. This can be applied to both upfront and deferred variable remuneration' i.e. post vesting and/or payment

Firm contracts and policies

The PRA requires firm remuneration policies and employment contracts to show that:

- variable remuneration awards are conditional, discretionary and contingent upon a sustainable and risk-adjusted performance in excess of that required to fulfil the employee's job description as part of the terms of employment. They must be capable of forfeiture or reduction at the employer's discretion.
- variable remuneration awards should be paid, or vest only if this is sustainable according to the financial situation of the firm and justified by the performance of the firm, the business unit and the individual concerned.
- variable remuneration awards should be reduced according to specific criteria set by the firm . As a minimum, these should cover each of the scenarios outlined in SYSC 19A.3.52(E).

The PRA also requires that the use of ex-post risk adjustment should not be limited to employees directly culpable of malfeasance.

Where there is evidence of material failure or misconduct, the PRA expects firms to consider applying ex-post risk adjustment to employees who:

- could have been reasonably expected to be aware of the failure or misconduct at the time but failed to take adequate steps to promptly identify, assess, report, escalate or address it; or
- by virtue of their role or seniority, could be deemed indirectly responsible or accountable for the failure or misconduct, including senior staff in charge of setting the firm's culture and strategy.

Firms are expected to have in place firm-wide policies (and group-wide policies, where appropriate) on post-risk adjustment and to develop procedures for deciding cases that could result in the use of ex-post risk adjustment as part of, or alongside, their existing internal disciplinary procedures. Firms should therefore now be incorporating these requirements into their internal policies before the next annual bonus round.

FCA consults on its implementation ofCRD IV

The FCA has published a Consultation Paper (CP13/12) on its implementation of Capital Requirements Directive ('CRD') IV and in particular, the controversial CRD IV bonus cap provisions.

These specify that the basic ratio between the variable and fixed components of total remuneration that can be paid to a staff member subject to the remuneration provisions should be capped at 1:1. The FCA proposes to copy out this requirement directly into its Remuneration Code.

No implementation of CRD IV's discretionary requirements

Where CRD IV allows Member State regulators their own discretion to impose stricter requirements to either lower the upper limit set for bonuses and/or lower the maximum percentage of total variable remuneration to be discounted and/or place restrictions or prohibit certain types of deferred instruments the FCA proposes not to apply these discretions.

Proportionality

CRD IV requires the principle of proportionality *'The provisions of this Directive on remuneration should reflect differences between different types of institutions in a proportionate manner, taking into account their size, internal organisation and the nature, scope and complexity of their activities. In particular it would not be proportionate to require certain types of investment firms to comply with all of those principles.'*

The FCA proposes to apply this principle of proportionality through its existing levels of general guidance on proportionality of the CRD III provisions of the Remuneration Code. The existing levels will apply the principle as follows:

- Level 1 (firms with assets exceeding 50bn) and Level 2 (firms with assets between 15bn and 50bn) 'full scope investment firms'. These firms are expected to apply the limits on bonuses. There are no firms prudentially supervised by the FCA in these levels ie this only applies to dual regulated firms.
- Level 3 investment firms (that could be 'full scope', 'limited licence' or 'limited activity' depending on their permissions). All investment firms subject to CRD IV that are prudentially regulated by the FCA are in level 3. Within the current CRD investment firm population, for each 'activity' type of investment firm in level 3 there is a concentration of a small number of large investment firms and a significant number of small and medium sized investment firms.

Groups

There are no plans to change the existing guidance where a firm is part of a group. Where a group of firms has individual firms that would otherwise fall into different lower proportionality levels, each firm is put into the highest proportionality level of a firm in that group. For example, where a group has an investment firm in level 3 and another firm in level 1, then all its firms are to be treated as if they were in level 1. However it will still be available for a level 3 firm to apply for a change in the proportionality level and the FCA could issue individual guidance to 're-tier' the level 3 firm after considering the particular circumstances.

The FCA's consultation will remain open until 10 November, following which, the FCA expects publish finalised rules in January 2014.

CRD IV and firms remaining on CRD III

The FCA has sent a letter to BIPRU investment firms explaining that they will need to determine whether they will be subject to CRD III or CRD IV rules from 1 January 2014. Some firms may be able to remain subject to the existing (and less stringent) capital and reporting requirements under CRD III, (and remain subject to the BIPRU sourcebook rather than the new Prudential sourcebook for Investment Firms (IFPRU)) once CRD IV is officially implemented.

Whether or not a firm qualifies to remain on the less stringent CRD III rules depends on which investment services and activities it carries out. Such a firm must not carry out the following MiFID investment services and activities:

- dealing on own account;
- underwriting of financial instruments and/or placing of financial instruments on a firm commitment basis;
- operation of Multilateral Trading Facilities;
- MiFID ancillary services of safekeeping and administration of financial instruments for the account of clients, including custodianship and related services such as cash/collateral management; or be permitted to hold money or securities belonging to their client; or
- holding money or securities belonging to their client.

Firms that do not intend to carry on the activity of placing of financial instruments without a firm commitment basis from January 2014, and wish to stay on the existing CRD III rules, must inform the FCA by 20 November 2013 and will also need to apply for a variation of permission for a requirement to be placed on its permissions not to carry on this activity. Firms which intend to place financial instruments without a firm commitment basis from 1 January 2014 do not need to respond to the letter.

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