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Client Alert Commentary

Latham & Watkins Benefits, Compensation & Employment Practice Number 1597 | October 24, 2013

Autumn 2013 UK Remuneration Update

Updates for UK listed and regulated companies on incoming "say on pay" rules, the UK challenge to the EU "bonus cap" and new guidance on AIFMD remuneration rules.

This Client Alert summarises three key developments regarding the regulation of pay in the UK. New "say on pay" rules came into effect on 1 October which will require UK listed companies to extensively revise their annual director remuneration reports. The UK government has launched a legal challenged to incoming EU bonus cap, and the Financial Conduct Authority has issued new consultation papers providing insight into how they propose to apply the bonus cap and the new AIFMD remuneration rules. These developments will be highly relevant for UK listed and regulated companies.

New "say on pay" rules for listed companies

On 1 October 2013, new UK "say-on-pay" rules that provide for greater scrutiny of and control over directors' remuneration came into force. The rules change the previous position under which UK listed companies were only required to subject their directors' remuneration report to an annual advisory shareholder vote.

The new rules apply to UK-incorporated companies on the "Official List" maintained by the Financial Conduct Authority (the FCA). This includes UK-incorporated companies listed on a recognised European market, NYSE or NASDAQ, but not non-UK incorporated companies listed on the London Stock Exchange.

The new rules require affected companies' annual remuneration reports to comprise three separate parts:

- A statement from the remuneration committee chairman
- A forward-looking remuneration policy report that will be subject to a binding shareholder vote every three years
- A retrospective remuneration implementation report that will be subject to an annual advisory shareholder vote and must include a single figure for how much each director was paid in the previous year

Companies with 30 September 2013 year-ends will be affected first by the new rules and must comply when preparing their upcoming year-end reports. Their 2014 annual meetings must also include the binding vote on the policy report and the advisory vote on the implementation report. The report covers remuneration for both executive and non-executive directors.

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What information should the new remuneration reports contain?

- The forward-looking remuneration policy must include all of the following information:
  - A table describing each component of the directors' remuneration package
  - An explanation as to whether the directors' remuneration is different to that of other employees and if so, why
  - Whether and how employees' opinions of the proposed remuneration were obtained and how the pay and employment conditions of company employees were taken into account when setting the director remuneration policy
  - Whether any element of the remuneration is subject to a claw-back
  - Descriptions of any director severance packages, including an explanation of how each element will be determined when determining the final package, whether there is a distinction between good and bad leavers and how performance will be accounted for.

  Once a remuneration policy is approved the Company can only make payments within the limits allowed.

- The retrospective **implementation report** for the relevant financial year being reported will be similar to the previous remuneration report, although must comply with much more proscriptive formatting requirements and must also include the following information
  - A single total figure for remuneration for each director
  - Details about the performance conditions for annual bonuses, options and LTIPs and how the company performed against those targets
  - Details of how any severance packages have complied with the remuneration policy
  - A chart comparing total shareholder return with CEO remuneration over the last 5-10 years
  - Details of shareholder voting on company policy and implementation reports at the previous annual meeting (including the percentage of abstentions, reasons for significant dissent and any actions taken by the remuneration committee in response)

Bonus Cap: UK legal challenge and FCA guidance on applying the cap

UK Government challenge

As reported in our previous Client Alert, "*Special Report on the Regulation of Pay in Europe*" the European Capital Requirements Directive IV (CRD IV) was approved by the European Parliament in April 2013 and European member states are expected to comply with it from 1 January 2014. CRD IV amends the EU's rules on capital requirements for banks and investment firms and includes new rules relating to the remuneration of certain staff. These remuneration rules largely restate the previous rules on remuneration which came into effect in January 2011 through the FCA's Remuneration Code, although with one or two notable exceptions.

The most controversial of the new changes is the introduction under CRD IV of a new 1:1 bonus cap – *i.e..* affected firms will not be entitled to pay bonuses to certain regulated staff which exceed 100 per cent of their fixed remuneration (or 200 per cent if shareholder consent is obtained). This “bonus cap” has been heavily criticised in the UK where it is expected to have the biggest impact, given the size of the UK financial services market. In August 2013, the FCA published a consultation paper on the implementation of the CRD IV in the UK which was notably silent as to how the bonus cap would be implemented. This led to further speculation as to whether the bonus cap would in fact be introduced in the UK at all.

On 25 September 2013, the UK government launched a legal challenge to the implementation of the bonus cap with the European Court of Justice (ECJ). Although full details of the content of the challenge are not yet available, the UK government has announced that its main concern is that the bonus cap is unfit for the purpose and will simply lead to a higher proportion of bankers’ pay being paid as fixed salary, rather than leading to more responsible remuneration practices. The government has criticised the CRD IV for rushing the cap into force with insufficient evidence as to its potential impact. The government also challenged the legal basis of the cap in particular, arguing the cap: unlawfully delegates to the European Banking Authority policy matters which are outside that body’s remit; unlawfully seeks to impose legislation which affect the rights and interests of employed persons; and unlawfully applies to individuals outside the EU.

The UK government’s challenge will be widely supported (and closely watched) by the UK financial services industry. Unfortunately, the ECJ likely will not reach a decision prior to 1 January 2014 when firms will become subject to CRD IV or before the 2015 bonus season when the first bonuses subject to the cap are likely to become payable. Thus, even if the UK government is ultimately successful in its challenge, the bonus cap is likely to apply to bonuses awarded in 2015 for work carried out in 2014. This means that, affected firms should continue to prepare for the cap’s implementation but consider building as much flexibility as possible into their 2014 bonus plans to allow for a scenario in which the cap is overturned before bonuses become payable. In the meantime, the new FCA consultation paper provides helpful guidance as to which firms will be required to implement the bonus cap.

FCA “Proportionate” approach to implementing the bonus cap

On 10 October 2013 the FCA published a new consultation paper confirming that in light of its obligations under European law, it will implement the new bonus cap rules by incorporating them into the FCA handbook, notwithstanding the UK government’s legal challenge. However, the FCA also announced their proposed approach to applying the bonus cap on a “proportionate” basis confirming that some investment firms will be excluded from application of the cap on the basis of their size, internal organization and the nature, scope and complexity of their activities.

The consultation paper suggests that both:

- Banks and firms currently categorised in proportionality Level 1 (*i.e.,* firms with assets exceeding £50 billion) or Level 2 (*i.e.*, firms with assets valued between £15 and 50 billion) will be expected to apply the bonus cap.
- There will be a presumption that Level 3 firms will not have to apply the bonus cap.

The senior management of Level 3 firms will be expected to demonstrate, if requested by the FCA, why it believes disapplying the rules based on the level of risk within the firm’s operations would be proportionate. The FCA will have a power to impose the bonus cap on particular Level 3 firms where it believes that it is appropriate in light of the firm’s risk profile. This determination would be made on an individual firm by firm basis. Many investment firms who have been dealing with the uncertainty as to whether the cap would apply or not will welcome this news.

The FCA consultation closes on 10 November 2013 and final guidance should be issued shortly afterwards. In the meantime, however, most Level 3 firms will now be able to plan their 2014/2015 remuneration policy on the basis that the bonus cap is unlikely to apply to them.

AIFMD: New FCA guidance on the implementation of the AIFMD Remuneration rules

The UK Financial Conduct Authority (the FCA) has published some draft guidance in relation to the way affected firms should apply the new AIFM Remuneration Code. The draft guidance clarifies how the rules will interact with established practices in many private equity and asset manager firms — such as carried interest arrangements — and indicates how the FCA will take a "proportionate" approach to applying the AIFM Remuneration Code.

Background

On 22 July 2013 the European Alternative Investment Fund Managers Directive (AIFMD) came into effect in the UK. Broadly, the AIFM imposes new regulations on alternative investment firms (AIFs) and alternative investment fund managers (AIFMs) including rules relating to the remuneration of staff. These remuneration rules are set out in Annex II of the AIFMD and in the UK the rules have been incorporated into a new AIFM Remuneration Code in the FCA handbook at SYSC 19B.

The AIFM Remuneration Code imposes a number of rules which are intended to ensure that affected AIFMs implement a remuneration policy which is consistent with and promotes effective risk management. The rules apply to all payments and benefits paid by the AIFM or AIF (including payments by way of carried interest and payments by shares, units or similar instruments) in which the payment is in return for professional services rendered by the AIFM's "Remuneration Code Staff". The "Remuneration Code Staff" affected by the rules are those staff whose professional activities have a material impact on the risk profiles of the AIFM (or AIFs under management) including all senior managers, risk takers, control function staff and any employees receiving remuneration in the same bracket as senior managers and risk takers.

What are the AIFM Remuneration Code Rules?

The AIFM Remuneration Code includes the following key rules:

- **Performance Related Remuneration:** If pay is performance linked, assessment of performance must: (i) include risk adjustment mechanisms; (ii) take into account non-financial and financial criteria; (iii) be set in a multi-year framework appropriate to the life-cycle of the AIF; and (iv) be based on a combination of individual performance, performance of the relevant business unit and performance of the AIFM as a whole.
- **Guaranteed Bonuses:** Awarding guaranteed bonuses is restricted other than in exceptional circumstances in the context of recruitment where payment is restricted to the first year of employment.
- **Severance Pay:** Making severance payments which reward failure is restricted
- **Fixed/Variable Ratio:** The proportion of fixed to variable remuneration must be appropriately balanced and the fixed portion should be sufficient to allow for the proper operation of variable remuneration (including allowing for no variable remuneration to be paid at all).

- **Proportion to be Paid in Shares/Units:** 50 per cent of variable remuneration should be paid in units or shares "mainly" of the relevant AIF being managed. An appropriate retention policy should also apply to these instruments.[1] There appears to be some flexibility in terms of allowing staff to hold instruments in AIFs which they do not directly manage.
- **Deferral:** At least 40 per cent (and in some cases 60 per cent) of variable remuneration must be deferred over at least three years (and in some cases five years).
- **Reduction/Clawback Rules:** Variable remuneration should be reduced or clawed back where the AIFM or AIF performs badly.
- **Payment/Vesting of Deferred Amounts:** Deferred amounts must be subject to payment and vesting provisions, depending on the financial situation and performance of the relevant individual, business unit and AIF.

For a more detailed overview of the remuneration rules, please refer to our "*Special Report on the Regulation of Pay in Europe*" *published 17 July 2013*.

New Draft FCA Guidance

On 3 July 2013 the European Securities and Markets Authority (ESMA) published its final guidelines on the remuneration rules contained in Annex II of the AIFMD. On 6 September 2013 the FCA published draft guidance echoing and extending the ESMA guidelines. This guidance is now subject to consultation and should be confirmed in finalised guidance in the coming months.

Proportionality

The AIFM Remuneration Code allows affected AIFMs to implement the rules proportionately, *i.e.* "*in a way and to the extent that is appropriate to its size, internal organisation and the nature, scope and complexity of its activities".* The new FCA draft guidance provides more colour on what "proportionality" will mean in practice.

In particular there will be a presumption that if the firm falls beneath the proportionality threshold, it will be able to disapply the rules relating to (i) a portion of pay being paid in retained units, shares or other instruments; (ii) deferral; and (iii) adjustment/claw-back (which the FCA refers to collectively as the Payout Process Rules). According to the draft guidance there will be a presumption that firms can disapply the Payout Process Rules if both:

- AIFMs which manage at least one leveraged AIF have net assets under management valued lower than a prescribed threshold to be set between £500 million and £1.5 billion.
- AIFMs which manage portfolios of AIFs that are unleveraged and have no redemption rights exercisable during the period of 5 years following the date of initial investment, have assets under management valued lower than a prescribed threshold to be set between £4-6 billion.

The FCA intends to clarify the exact thresholds in its final guidance once it has received responses to this draft guidance consultation paper. The presumption that the Payout Process Rules can be disapplied following this “threshold” test may be rebutted on the basis of certain other “proportionality” indicators. For example:

- The number of partners, members, employees or consultants working for the AIFM — the higher the number, the more likely that the Payment Process Rules will apply.
- Whether the AIFM is listed on a regulated market — if it is listed, it’s more likely that the Payout Process Rules will apply.
- Ownership structure — if a large portion of the firm’s equity is owned by senior management, the Payout Process Rules are less likely to apply.
- The nature, scope and complexity of the activities carried out by the AIFM — the more complex and high-risk the activities, the more likely that the Payout Process Rules will apply.

In reviewing these “proportionality” indicators, firms are encouraged to compare themselves with peers and competitors in the UK market where appropriate.

How will carried interest arrangement be considered?

The draft FCA guidance also suggested that where performance fee structures, such as carried interest arrangements, meet the objectives of aligning employee interests with the investors and avoiding incentives for inappropriate risk-taking, the Payout Process Rules may be disapplied on the grounds of proportionality.

This guidance will be welcome news to many AIFMS with carried interest arrangements in place, in particular private equity firms. If those carried interest arrangements are sufficiently robust, the firm should not be required to comply with the Payout Process Rules. This approach is sensible given that the very nature of carried interest — with payment linked to the performance of the underlying fund and deferred over a long performance period — essentially mirrors the risk-management objectives of the Payout Process Rules.

Remuneration Committee

Only firms which are “significant” AIFMs should be required to establish a remuneration committee — for this test, the FCA draft guidance suggests that on each of the proportionality tests mentioned above, the firm should appear “significant”. A firm which exceeds the size threshold and/or is listed is likely to require a remuneration committee.

Application of AIFM Remuneration Code rules to particular employees

The FCA’s draft guidance also suggests that it may be “proportionate” to disapply certain AIFM Remuneration Code rules to certain employees. In particular:

- It will usually be proportionate to disapply the Payout Process Rules for staff who are not involved in the management of AIFs. Where an employee’s duties involve a mixture of AIFM and non-AIFM business, the firm can apply the AIFM Remuneration Code only to that portion of his remuneration which relate to his AIFM duties.
- If an employee’s variable remuneration does not exceed 33 per cent of their total remuneration and their total remuneration is no more than £500,000, there is a presumption that it will not be necessary to apply the Payout Process Rules or the restriction on granting guaranteed bonuses. This presumption is consistent with the FCA’s approach to implementing the FCA Remuneration Code which applies to banks and certain regulated investment firms.

How will the AIFM Remuneration Code apply to partners?

The draft FCA guidance also clarifies that to the extent that an AIFM is set up as a partnership or LLP and a partner is classified as Remuneration Code Staff, the partner's profit share payments should be analysed to determine which elements fall within the scope of the AIFM Remuneration Code. For example:-

- A profit share amount payable only to senior founding partners, is likely to be considered a return on investment which is outside the scope of the AIFM Remuneration Rules.
- A discretionary profit share distributed to all partners is likely to be "variable" remuneration (to which the AIFM Remuneration Code will apply).
- Drawings taken in advance are likely to comprise "fixed" remuneration (to which the AIFM Remuneration Code will not apply).

The draft FCA guidance also considers how to resolve the risk of a "dry-tax charge" when applying the deferral rules to partners. Under UK partnership tax rules, partners are taxed on their profit shares in the year that they arise, even if those profits are not distributed to, or received by, the relevant partners. Therefore, when remuneration is "deferred" under the AIFM Remuneration Code, tax will become due on the deferred portion, even though the partner has not received that amount to meet the tax charge. Further guidance on how to deal with this point is due to be published later in the year. In the meantime, the FCA have recommended that deferral is made on a "net of tax" basis. In other words, the amount deferred is reduced to reflect the net amount, after deduction of tax which allows the tax charge to be deducted and remitted to HMRC.

Timing

The draft FCA guidance explains when the new AIFM Remuneration Code will apply to affected firms. Once a firm becomes authorised as a full-scope AIFM it will become subject to the AIFM Remuneration Code with respect to awards for variable remuneration for performance periods following that in which the firm became authorised. This means that the AIFM Remuneration Code will not apply to remuneration earned, allocated or otherwise awarded in performance periods prior to the firm becoming authorised — including any remuneration which has not vested at the time the firm becomes authorised. This guidance should provide more certainty for AIFMs planning their compliance obligations.

The FCA should publish final guidance, incorporating responses to this draft guidance, in the coming months which will provide further certainty for affected firms as to their required level of compliance with the AIFM Remuneration Code.

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Endnotes

[1] Note this will not apply if less than 50 per cent of the total portfolio managed by the AIFM comprises AIFs.