CLEARY GOTTLIEB

Alert Memo

BRUSSELS AND LONDON AUGUST 17, 2010

www.clearygottlieb.com

New EU Regulation of Remuneration in Financial Institutions

In July 2010, the European Parliament approved[1] new requirements governing the remuneration of certain personnel of credit institutions and investment firms subject to the EU Capital Requirements Directive ("CRD").[2] The EU Council of Ministers did not adopt the new rules – known as "CRD III" – at its July meeting, however, and it is now expected to do so only in October 2010. CRD III's remuneration rules will apply from January 1, 2011, including retroactively in respect of compensation paid in 2011 for services rendered in 2010.

The new rules are complex, and subject institutions will have little time to prepare for them. The Committee of European Banking Supervisors ("CEBS") will publish implementing guidelines, but again these will likely not be available until late 2010. On July 29, however, the UK Financial Services Authority ("FSA") issued a consultation draft of implementing rules in advance of the publication of the CEBS guidelines.[3] The FSA's consultation draft sheds light on how some of the ambiguous provisions of CRD III are likely to be interpreted.[4]

1 European Parliament legislative resolution of July 7, 2010: http://tinyurl.com/Europarl-Renumeration

2 http://tinyurl.com/CRD2006-48-EC

3 FSA Consultation Paper: http://tinyurl.com/FSA-Remuneration

4 In Germany, a draft bill to implement CRD III is expected to be published after CRD III enters into effect. The German Act on Regulatory Requirements Relating to Remuneration Systems of Institutions and Insurance Enterprises (Gesetz über die aufsichtsrechtlchen Anforderungen an die Vergütungssysteme von Instituten und Versicherungsunternehmen; the "German Remuneration Act"), dated July 21, 2010, amended, *inter alia*, the Kreditwesengesetz (the "German Banking Act") and will require changes to the draft German Ordinance on Regulatory Requirements Relating to Remuneration Systems of Institutions (Verordnung über die aufsichtsrechtlichen Anforderungen an Vergütungssysteme von Instituten; the "Draft German Remuneration Ordinance"), dated May 27, 2010. The German Remuneration Act became effective on July 27, 2010, while the Draft German Remuneration Ordinance, to which the German Remuneration Act refers for most of its material provisions, is expected to become effective in about October 2010. The German Remuneration Act was intended to reflect the compensation-related provisions of CRD III, to the extent these seemed undisputed

© Cleary Gottlieb Steen & Hamilton LLP, 2010. All rights reserved.

This memorandum was prepared as a service to clients and other friends of Cleary Gottlieb to report on recent developments that may be of interest to them. The information in it is therefore general, and should not be considered or relied on as legal advice.

Although the new rules broadly follow the FSB Principles for Sound Compensation Practice,[5] they are in many respects considerably more prescriptive. Because they will apply to EU credit institutions and investment firms at group, parent company and subsidiary levels, they will catch non-EU subsidiaries of EU financial institutions, as well as EU subsidiaries (and possibly branches) of non-EU institutions. The new rules will apply to employees whose professional activities have a material impact on their employers' risk profile, including senior management, "risk takers," employees in "control functions" and employees in the same "remuneration bracket" as senior management and risk takers.

This Memorandum summarizes the main features of CRD III's new remuneration rules and highlights some of the issues they may raise in practice.

I. REMUNERATION POLICIES

CRD III's remuneration provisions require credit institutions and investment firms to establish remuneration policies aligned with effective risk management, to ensure that incentives are aligned with the long-term interests of the institution. Set out below are brief summaries of these rules.

A. SCOPE

CRD III's remuneration rules apply to both credit institutions and investment firms subject to the Markets in Financial Instruments Directive ("MiFID").[6] Managers of private equity, hedge, and other alternative investment firms will be subject to separate but likely similar rules under the proposed Alternative Investment Fund Managers Directive.[7] The Commission has also indicated, in its Green Paper on

---

when the German Remuneration Act was adopted. Due to last minute changes to CRD III, however, there are some discrepancies between the German financial institution compensation legislation and CRD III.

5 http://tinyurl.com/FSBPrinciples

6 CRD III's remuneration provisions amend Annex V of Directive 2006/48/EC, which is primarily addressed to credit institutions, but these provisions are incorporated by reference into Directive 2006/49/EC, which applies to investment firms. Credit institutions are defined as "an undertaking whose business is to receive deposits or other repayable funds from the public and to grant credits for its own accounts." Investment firms subject to MiFID are "any legal person whose regular occupation or business is the provision of one or more investment services to third parties and/or the performance of one or more investment activities on a professional basis."

7 http://tinyurl.com/CGS-HAlertMay2010

corporate governance in financial institutions and remuneration policies,[8] that it proposes to apply similar remuneration provisions to the insurance sector and to UCITS.

CRD III's remuneration rules will apply to subject institutions at group, parent company and subsidiary levels, including those established in "offshore financial centres." The FSA proposes to apply the rules to any entity that is part of a United Kingdom group for the purposes of consolidated supervision, even if it is located outside the EU. . The FSA also intends to apply the rules to non-EU institutions' United Kingdom subsidiaries, but not to United Kingdom branches of EU firms, which will be subject to their own home state rules. Firms classifed as "exempt CAD firms" that only provide the MiFID services of investment advice and reception and transmission of orders will not be subject to the remuneration principles. However, the FSA proposes to issue guidance recommending that firms should give consideration to the remuneration principles on a firm-wide basis, including in respect of staff who are not specifically subject to these principles.

CRD III's rules will apply to employees "whose professional activities … have a material impact" on their companies' risk profile, including senior management, risk takers, those in "control functions" and any employee whose total remuneration places them in the same remuneration bracket as senior management and risk takers. The precise scope of the employees subject to the rules is not entirely clear; this issue will presumably be addressed in the CEBS guidelines and national implementing rules. The FSA has provided some guidance on the types of employees who will fall within the regime and produced a short and non-exhaustive table of staff to which the new rules should be applied. The FSA also reserves the right to review and challenge the list of staff to which a financial institution proposes to apply the rules.

B. SUBSTANTIVE RULES

CRD III's remuneration rules seek to encourage effective risk management and to avoid the pursuit of short-term gain at the expense of long-term results. To this end, the rules discourage up-front cash bonuses based on expected performance and instead attempt to strengthen the correlation between payment and actual results through staggered payments and potential clawbacks. They also include "anti-avoidance" provisions prohibiting covered employees from circumventing the rules through insurance or personal hedging strategies.

CRD III recognizes that credit institutions and investment firms vary, and the application of the rules will necessarily vary among these businesses. The preamble states that subject firms may apply the provisions in different ways, "according to their size, internal organization and the nature, scope and complexity of their activities," but it

[8] http://tinyurl.com/EC-GreenPaper, http://tinyurl.com/CGSH-RegReform

does not indicate how these factors will be taken into account in practice. The FSA has indicated that all firms will be subject to a minimum set of requirements, while other rules could be applied proportionally in line with an institution's "nature, scale, scope, internal organisation and complexity." The FSA identifies a third set of requirements that could apply to firms on a "comply or explain" basis, whereby subject institutions must justify to the FSA "why it would be disproportionate to apply the principles fully."[9]

CRD III's specific requirements include the following:

- Performance-related remuneration should be based on a combination of the performance of the individual concerned, the performance of his or her business unit and the overall results of the institution. Financial and non-financial criteria should be taken into account in assessing individual performance. The assessment of performance is to be set in a multi-year framework, and payment of performance-based remuneration should be spread over a period taking account of the institution's business cycle and risks. Total variable remuneration may not be such as to limit an institution's ability to strengthen its capital base.[10]

- Subject institutions must set establish appropriate ratios between fixed and variable remuneration of covered employees, with the fixed

[9] The Draft German Remuneration Ordinance sets out (i) general requirements applicable to all institutions, as well as (ii) additional requirements applicable only to "important" institutions (*bedeutende Institute*). Under the Draft German Remuneration Ordinance, an institution is "important" if its average balance sheet total during the preceding three fiscal years amounted to at least €10bn. The main additional requirements applicable to important institutions include (i) the adequacy of the ratio between fixed remuneration elements and variable remuneration elements (this ratio is "adequate" if there is no "significant dependency" of the relevant individual on variable remuneration elements, but at the same time the amount of the variable remuneration elements is significant enough to create effective behavioral incentives) and (ii) the following main requirements for the determination of variable remuneration elements: (a) taking into account the overall performance (positive or negative, as the case may be) of the relevant institution, as well as the contributions of the relevant business unit and the relevant individual to such performance; (b) retention of at least 40% of the relevant individual's bonus payments for at least three years; and (c) making at least 50% of such retained bonus payments dependent on the sustainable development of the relevant institution's "value." In addition, any formulae for the calculation of variable remuneration elements must be designed in a way that any negative contributions of the relevant manager or employee, or of their respective business units, to the institution's performance, as well as any overall negative performance of the institution, must result in a reduction of the variable remuneration elements (including any retained amounts).

[10] Ironically, however, CRD III provides for clawbacks of share and share-linked compensation (see below), which could risk weakening an institution's capital base.

component being sufficiently high to allow for a fully flexible policy, including the possibility to pay no variable remuneration. These ratios will need to take into account specific criteria to be set out in guidelines issued by the CEBS.

- Performance measures used to determine variable remuneration must take into account all types of current and future risks and the cost of capital and liquidity required. The FSA has indicated that in its view the financial criteria used to determine variable remuneration should include "profit measures," not simply revenue or turnover.

- At least 50% of any variable remuneration must consist of an appropriate balance of shares or share equivalents and other instruments that adequately reflect the credit quality of the institution and are subject to an appropriate retention policy. The CEBS will issue guidelines addressing the eligibility of different types of instruments for this purpose, though Member State authorities can restrict or ban the use of certain instruments. The FSA acknowledges that compliance with this rule will be challenging, particularly for non-listed subject institutions, and proposes that subject institutions be allowed to justify non-compliance until July 2011.

- At least 40% of variable remuneration (60% if the amount is "particularly high") must be deferred. The apppopriate deferral period will depend on the business cycle, nature of business, and risks of the relevant institution and the activities of the relevant employee, but may not be less than three to five years. Deferred remuneration should vest no faster than *pro rata*. The FSA has proposed £500,000 as the amount of variable remuneration triggering the 60% deferral requirement. The FSA further notes that share-linked variable remuneration may be treated as up-front remuneration, deferred remuneration or a combination.

- Variable remuneration, including deferred amounts, may be paid or vest only if it is sustainable according to the institution's financial situation and justified according to the performance of the institution, the business unit and the individual concerned. Subject to general principles of national contract and labor law, total variable remuneration should generally be considerably contracted where subdued or negative financial performance of the firm occurs, taking into account current compensation and reductions in payouts of amounts previously earned, including through *malus* or clawback arrangements. The FSA proposes that remuneration not yet vested should be adjusted in response to employee misbehavior or material error, a material downturn in the financial

situation of a subject institution or its business, or a material failure of risk management.

- Institutions that have benefited from State Aid are subject to additional (though rather general) restrictions. In such institutions, priority should be given to strengthening the firm's capital base and providing for recovery of taxpayer assistance. The required measures may include limiting directors' remuneration. Directors should receive variable remuneration only if it is "justified." The FSA suggests that variable remuneration could be justified for directors who joined an institution after the occurrence of the crisis giving rise to the need for State Aid.

- Pension policy should be in line with the business strategy, objectives, values and long-term interests of the subject institution. Payments related to an early contract termination should reflect performance and should in any case not be designed to reward failure. If an employee leaves the institution before retirement, discretionary pension benefits should be held by the institution for a period of five years in the form of instruments linked to long-term performance, such as shares and share-linked instruments. For retiring employees, discretionary pension benefits should be paid in the form of such instruments and subject to a retention period of five years.

- Institutions that are "significant" in terms of size, structure, and activity should establish remuneration committees. The remuneration committee's structure must encourage independent and competent judgment on remuneration policies and practices and the incentives created for managing risk, capital and liquidity. Membership will be limited to management body members who do not perform any executive functions.

Information on remuneration policies should be made available to all stakeholders (shareholders, employees and the public in general) in order to provide the market with comprehensive information regarding the risk profile of certain institutions. This information must cover aggregate quantatitive information on remuneration by business area and showing, amongst other things, the split between fixed and variable remuneration and the number of beneficiaries.

C. TIMING

As noted, CRD III's remuneration provisions will apply as from January 1, 2011, including to remuneration paid in 2011 for services provided in 2010. Recital 14 provides that the provisions on remuneration should be "without prejudice to … general principles of national contract and labor law." The FSA accordingly takes the view that subject institutions are not required to breach existing contracts or employment law to

comply with these provisions.

The Commission will review CRD III's remuneration principles by December 2012, paying particular attention to their efficiency, implementation, and enforcement. The Commission will also consider international developments, including further proposals by the Financial Stability Board. Attention will also be given to the implementation of the principles in other jurisdictions and the connection between management of risk and the structure of variable remuneration.

II. ISSUES

As noted, CRD III's remuneration rules will apply from January 1, 2011. The CEBS guidelines will likely not be available until October 2010 or later. The short period available to analyze and apply these rules and guidelines will likely prove challenging for national authorities and for financial institutions alike. The new rules are complex and (in some cases) ambiguous, and their application is likely to raise significant issues for covered institutions. These issues include the following:

- Because the new EU rules are more prescriptive than required by international standards, subject institutions may be placed at a competitive disadvantage to their international peers. The FSA recognizes that the "proposed approach may not be aligned with some other international jurisdictions; and that some globally active UK firms feel that this leads to recruitment and retention issues." CRD III imposes even tighter restrictions on remuneration paid by institutions benefiting from State Aid. As a result, firms recovering from financial difficulties suffered in the economic crisis may be subject to a competitive disadvantage not only compared to non-EU firms, but also compared to EU firms that did not require State Aid.

- The rules have a retroactive component, in that they will apply to remuneration paid as from January 2011, including under contracts concluded before that date and to remuneration paid after that date in respect of services performed in 2010. Recital 14 notes that the remuneration rules are subject to national contract and labor law, but the application of the new rules to existing agreements and plans is likely to give rise to many interpretative issues.

- The specific requirements on variable remuneration are complex. The requirements that at least 50% of variable remuneration consist of shares, share equivalents and other appropriate instruments; that at least 40% be deferred; and that all variable remuneration be "considerably contracted" in the event of subdued or negative performance, will be difficult to apply, especially in combination. For example, one acceptable payment

device could be a capital instrument that is converted into equity should financial difficulties arise.

- The rules will apply at group, parent company and subsidiary levels, including to entities established in "offshore financial centres." Depending on how national authorities interpret these rules, there is a potential for multinational financial institutions to be subject to duplicative and possibly conflicting requirements. As noted, the FSA proposes to regulate the remuneration policies of non-UK subsidiaries of multinational groups subject to consolidated supervision in the UK, and to UK subsidiaries of non-UK financial institutions (but not UK branches of financial instittions established in other EU Member States).

- Some of the new rules, such as rules on deferral and clawback of variable remuneration, may raise difficult tax and accounting issues, especially in the case of institutions operating in multiple jurisdictions.

III. CONCLUSION

While CRD III and similar rules adopted in the UK, Germany and elsewhere seek to implement the FSB standards, they have failed to achieve convergence among international standards. The differences will create challenges in particular for multinational institutions, whose employees may be subject to differing rules. For example:

- Countries such as the United States, Japan and Canada have adopted a supervisory approach to compensation, rather than imposing detailed requirements as in CRD III.

- Although CRD III recognizes that the application of the new rules needs to take account of the size and internal organization of subject institutions and the nature, scope and complexity of their activities, the United States and others appear to allow for more flexibility. For instance, while CRD III requires establishment of a maximum percentage of compensation that may be variable, no such limitation exists in the United States.

- While CRD III seems to interpret the FSB implementation standards as requiring that 50% of all variable compensation be in stock or similar non-cash instruments, an equally valid reading of the implementation

standards is that 50% of only deferred variable compensation be stock based.[11]

- The United States has not extended its compensation rules to non-banks, such as investment firms subject to MiFID, which will be subject to CRD III, and managers of hedge funds, private equity funds and other alternative investment vehicles, which will be subject to CRD III-like rules under the proposed EU alternative investment fund managers directive.

- The United States has focused on incentive compensation of groups of employees who may give rise to material risks to subject firms (*e.g.,* loan originators), a category of employees that was on the front line of sub-prime mortgage origination in the United States. The category is absent from the CRD III and FSA rules.

* * *

If you have any questions, please feel free to contact any of your regular contacts at the firm or any of our partners and counsel listed under the 'Practices' section of our website at http://www.clearygottlieb.com.

CLEARY GOTTLIEB STEEN & HAMILTON LLP

[11] The difference between these two readings was significant enough that the FSA noted that: "Our view is a provisional one and we will need to consider whether it is appropriate to maintain this view when we finalise the rules, in the light of the ongoing CEBS discussions. We and firms will also need to have regard to the final CEBS guidance on this."

CLEARY GOTTLIEB

Office Locations

BRUSSELS
Rue de la Loi 57
1040 Brussels, Belgium
32 2 287 2000
32 2 231 1661 Fax

NEW YORK
One Liberty Plaza
New York, NY 10006-1470
1 212 225 2000
1 212 225 3999 Fax

WASHINGTON
2000 Pennsylvania Avenue, NW
Washington, DC 20006-1801
1 202 974 1500
1 202 974 1999 Fax

PARIS
12, rue de Tilsitt
75008 Paris, France
33 1 40 74 68 00
33 1 40 74 68 88 Fax

LONDON
City Place House
55 Basinghall Street
London EC2V 5EH, England
44 20 7614 2200
44 20 7600 1698 Fax

MOSCOW
Cleary Gottlieb Steen & Hamilton LLP
CGS&H Limited Liability Company
Paveletskaya Square 2/3
Moscow, Russia 115054
7 495 660 8500
7 495 660 8505 Fax

FRANKFURT
Main Tower
Neue Mainzer Strasse 52
60311 Frankfurt am Main, Germany
49 69 97103 0
49 69 97103 199 Fax

COLOGNE
Theodor-Heuss-Ring 9
50668 Cologne, Germany
49 221 80040 0
49 221 80040 199 Fax

ROME
Piazza di Spagna 15
00187 Rome, Italy
39 06 69 52 21
39 06 69 20 06 65 Fax

MILAN
Via San Paolo 7
20121 Milan, Italy
39 02 72 60 81
39 02 86 98 44 40 Fax

HONG KONG
Institution of China Tower
One Garden Road
Hong Kong
852 2521 4122
852 2845 9026 Fax

BEIJING
Twin Towers – West
12 B Jianguomen Wai Da Jie
Chaoyang District
Beijing 100022, China
86 10 5920 1000
86 10 5879 3902 Fax