CLIFFORD
CHANCE

CLIFFORD CHANCE LLP
10 UPPER BANK STREET
LONDON
E14 5JJ
TEL +44 20 7006 1000
FAX +44 20 7006 5555
DX 149120 CANARY WHARF 3
www.cliffordchance.com

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Ref: EBA/CP/2015/03
Direct Dial: +44 207006 8936
E-mail:alistair.woodland@cliffordchance.com

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European Banking Authority
One Canada Square (Floor 46)
Canary Wharf
London E14 5AA

Dear Sirs,

Clifford Chance Response to the EBA Consultation Paper 2015/03 ("*Draft Guidelines on sound remuneration policies under Article 74(3) and 75(2) of Directive 2013/36/EU and disclosures under Article 450 of Regulation (EU) No. 575/2013*") (the "CP")

Introduction

Clifford Chance welcomes the opportunity to comment on the CP. We comment below on questions 1, 4-6, 8-9 and 11-12.

Definitions

Question 1: ***Are the definitions provided sufficiently clear; are additional definitions needed?***

See the comment at question 8 below on the definition of long term incentive plan.

Remuneration policies and group context

Question 4: ***Are the guidelines regarding remuneration policies and group context appropriate and sufficiently clear?***

Paragraph 39 of the CP states that "*all significant institutions at individual, parent company and group level must establish a remuneration committee*". Many global financial institutions rely on a single parent company remuneration committee to oversee and implement remuneration decisions. The advantages of this approach are that it:-

a. enables the firm to implement and oversee a group-wide remuneration policy;

b. enables the firm to take into account group-wide issues when determining bonus pools, which are typically set at the level of the ultimate parent company;

c. ensures a consistency of approach throughout the group in relation the identification of material risk takers, the operation of ex-ante adjustments and the operation of malus.

It would not be desirable, in our view, for each significant entity within a group to have its own remuneration committee. On the contrary, adopting multiple remuneration committees would:-

a. materially increase the administrative burden for institutions;

b. risk creating a disjointed approach to remuneration practices and make it harder to establish consistent, group-wide practices;

c. diminish the accountability of members of the remuneration committees, who would have a narrower scope to consider group wide issues.

The requirement to ensure that the Chair of the remuneration committee and the "majority of members" are independent, would be difficult in practice to fulfill (since firms do not typically recruit "independent" non-executive directors for each of their subsidiaries).

We would welcome clarification that firms will continue to be permitted to rely on the decisions of a single remuneration committee at the level of the consolidating institution, to oversee and implement the remuneration policy throughout the relevant consolidation group. This would be consistent with the draft guidance at paragraph 104 of the CP ("*The consolidating institution should ensure the overall consistency of the group remuneration policies including the identification processes.....*". It is difficult to see how "*consistency*" of this sort could be achieved through the adoption of multiple (and independent) remuneration committees at the level of each subsidiary.

Proportionality

Question 5: ***All respondents are welcome to provide their comments on the chapter on proportionality, with particular reference to the change of the approach on 'neutralisations' that was required following the interpretation of the wording of the CRD. In particular institutions that used 'neutralisations' under the previous guidelines for the whole institution or identified staff receiving only a low amount of variable remuneration are asked to provide an estimate of the implementation costs in absolute and relative terms and to point to impediments resulting from their nature, including their legal form, if they were required to apply, for the variable remuneration of identified staff: a) deferral arrangements, b) the pay out in instruments and, c) malus (with respect to the deferred variable remuneration). In addition those institutions are welcome to explain the anticipated changes to the remuneration policy which will need to be made to comply with all requirements. Wherever possible the estimated impact and costs should be quantified, supported by a short explanation of the methodology applied for their estimation and provided separately for the three listed aspects.***

The CEBS Guidelines on Remuneration Policies and Practices under CRD III, published in December 2010, acknowledged that the pay out process rules could be "neutralised" on proportionality grounds. The European Parliament, in the knowledge that this approach had been taken under CRD III, adopted CRD IV without any change to the proportionality wording. This strongly suggests that there was no intent to alter the approach adopted in the CEBS Guidelines.

Recital 66 of CRD IV states that: "*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 provisions*". The ECJ has recognised that, whilst recitals do not take precedence over the operative provisions of a directive, they help to establish the purpose of a provision. This wording suggest, in our view, that certain firms should be able to disapply some of the remuneration provisions entirely (i.e. that they should not be compelled to comply with "all of those provisions".

Further, Article 92(2) of the CRD IV states that '*competent authorities shall ensure that...institutions should comply with the... principles in a manner and to the extent that is appropriate to their size, internal organisation and the nature, scope and complexity of their activities*' (our emphasis). The term "*to the extent that*" clearly suggests that certain principles could be disapplied completely for certain institutions.

We do not consider that a distinction can justifiably be drawn between "*specific requirements with numerical criteria*" and the other "*non-numerical*" requirements, since no distinction is made between these types of criteria in either Recital 66 or Article 92(2). This is clearly the understanding of national regulators, many of which have issued guidance on the circumstances in which it may be appropriate for an institution not to apply certain remuneration principles on grounds of proportionality.

The interpretation proposed by the EBA is not consistent with that taken by ESMA in the AIFMD Remuneration Guidelines of July 2013. In relation to the equivalent AIFMD proportionality wording, ESMA has taken the view (consistent with the CEBS Guidelines) that the rules containing "*numerical requirements*" could be neutralised for certain firms and in certain circumstances on proportionality grounds. In their feedback statement, ESMA stated " *ESMA did not consider it necessary to add an explicit statement on the application of proportionality to all the principles under Annex II of the AIFMD since the application of proportionality is already determined in the text of the Level 1 provisions (i.e. Annex II of the Directive)* "

The identification process

Question 6: ***Are the guidelines on the identification of staff appropriate and sufficiently clear?***

Under paragraph 83 of the CP institutions are required to conduct an annual self-assessment in order to identify all staff whose professional activities have or may have a material impact on the institution's risk profile ("Material Risk Takers"). In our experience this is consistent with the current practice of most institutions. We also consider it to be a logical approach for

institutions that operate an annual remuneration cycle given that the consequence of being a Material Risk Taker is to impose specific requirements on the structure of any variable remuneration award.

However, paragraph 88 of the CP states that the self-assessment should be kept updated at all times during the year. We would suggest that it is sufficient for firms that operate an annual remuneration cycle to complete the self-assessment process annually, provided that firms also consider before making any off-cycle awards of variable remuneration whether the employee in question should be considered a Material Risk Taker.

Paragraph 98 of the CP states that the remuneration committee should be actively involved in the self-assessment process and where there is no remuneration committee the self-assessment should be conducted by non-executive, independent members of the management body. On a related issue, paragraph 92(a) provides that the decision that an individual has no material impact on the institution's risk profile (and can therefore be excluded from the Material Risk Taker population notwithstanding their total compensation) should be taken by the management body and reviewed by the supervisory function.

These requirements seem to us unnecessarily prescriptive. Paragraph 99 of the CP already provides that internal control and business support functions must be involved in the self-assessment process and paragraph 88 requires the whole self-assessment process to be properly documented. Therefore we do not see any need to be so prescriptive as to which management bodies and/or individual members of management should be involved.

Categories of remuneration

Question 8: ***Are the requirements regarding categories of remuneration appropriate and sufficiently clear?***

In relation to paragraph 117 of the CP:-

a. Paragraph 117(d) provides that remuneration can only be considered "fixed" where it is "*permanent i.e. maintained over a period tied to the specific role and organisational responsibilities*". Similarly, paragraph 117(e) provides that fixed remuneration must be "*non-revocable*" and paragraph 117(f) that payments of fixed remuneration "*cannot be reduced, suspended or cancelled by the institution*".

b. Effectively, this seems to require that for remuneration to be considered fixed it must be granted indefinitely for as long as an individual holds a particular role. It is unclear to us why this should be the case. For example, an individual's role may be unchanged, but its value to the business may materially change due to changes in the business environment or the commercial focus of the institution. In such circumstances, we do not see what policy objective is served by preventing the institution from amending the fixed remuneration that was previously considered appropriate to the role, subject to local employment law.

c. Similarly, we do not see what policy objective is served by preventing fixed remuneration from being subject to forfeiture where, for example, there has been a material failure of risk management. Where forfeiture of remuneration would be

permitted under national employment law, it seems strange to us that the EBA should require remuneration to be paid in all circumstances, even where it was awarded on the basis of information and assumptions that turned out to be incorrect.

d. Paragraph 117(e) also states that the amount of fixed remuneration should only be changed "*via collective bargaining or following renegotiation in line with national criteria on wage setting*". This will not be appropriate in all countries. For example, in the UK no such national criteria exist. It would also be extremely unusual in financial services for remuneration to be set via collective bargaining. We see no good reason why fixed remuneration should not be subject to amendment by agreement with the relevant employee, in accordance with national employment law.

e. We therefore consider that it should be legitimate for fixed remuneration to be awarded:-

   i. for a particular period or varied or cancelled by the institution, provided that award of remuneration and decisions that remuneration should be varied or cancelled do not depend on performance;

   ii. subject to deferral and awarded in non-cash instruments such as shares; and

   iii. on the basis that it can be amended by agreement with the relevant employee, in accordance with national employment law.

In relation to paragraph 120 of the CP on long term incentive plans (LTIPs):-

a. The definition of LTIP is unclear and does not reflect the way in which LTIPs usually work in our experience. The definition and the wording of paragraph 120 seem to assume that an LTIP is awarded in two tranches; part on an unconditional basis upfront and part at a future date subject to conditions. However, in the UK at least, LTIPs are "awarded" when they are granted. The payment or vesting of an LTIP may depend on conditions being satisfied in the future but, regardless of whether payment or vesting occurs, the LTIP is "awarded" at grant. (This is consistent with the definition of "award" used in the guidelines which equates "award" with "grant");

b. Paragraph 120(a) states that the part of an LTIP which is "awarded" at a later stage should only be taken into account for the purposes of the fixed to variable remuneration ratio at the point it is "awarded" in the future. If this is the EBA's intention, it would make it very difficult for firms to operate within the confines of the ratio because the value of the LTIP when it pays out in the future is, by nature, unpredictable. The value of an LTIP will typically be linked not only to a firm's share price (and so subject to the mercy of market fluctuations) but also to the satisfaction of performance conditions. When an LTIP is granted, a firm will not be able to predict with any accuracy the future value that the LTIP may deliver. Requiring firms to value at least part of an LTIP on pay out could mean a firm inadvertently exceeding the ratio and potentially being forced to increase fixed remuneration in order to be able to deliver on the LTIP within the terms of the ratio. We assume that this could not be the EBA's intention;

c. We consider that the better approach would be for LTIPs to be taken into account for the ratio purposes at the point they are granted, as has been the case to date. This would require an amendment to the definition of LTIP and changes to paragraph 120.

In relation to paragraph 121 of the CP on the subject of awards under "carried interest" schemes:-

a. Paragraph 121(a) states that payments which do not represent a pro rata return on an investment made by staff should be considered as variable remuneration. We would welcome confirmation that it is the award made under the relevant remuneration scheme that should be treated as variable remuneration, as opposed to the resulting payment that may be made a number of years later. This would be consistent with the treatment of deferred bonuses awarded in shares, where the variable remuneration is calculated based on the value of the shares when the award is made, not the value of the shares following the relevant deferral and retention periods. Please see our comments above in relation to LTIPs where the same point arises.

b. Paragraph 121 of the CP adopts the ESMA Guidelines on sound remuneration practices under the AIFMD (the "**ESMA Guidelines**"). Paragraph 159 of the ESMA Guidelines provides that the "pay-out process rules" (i.e. the AIFMD requirements in respect of payment in appropriate instruments, deferral and pre-vesting performance adjustment) may be deemed to be met where the remuneration scheme fulfils certain requirements in respect of return of capital to investors and clawback.

c. However, paragraph 159 of the ESMA Guidelines does not refer to the mandatory ratio of fixed to variable remuneration, because this is included only in CRD IV and not in the AIFMD. We would therefore welcome clarification that a remuneration scheme that meets the requirements of paragraph 159 of the ESMA Guidelines would be deemed to satisfy all of the pay-out process requirements of CRD IV, including that awards under such a scheme need not be taken into account for the purposes of calculating the ratio between fixed and variable remuneration.

d. We also note that the guidance given at paragraph 159 of the ESMA Guidelines is relevant to many institutions that are subject to the AIFMD (such as private equity fund managers) but will be less relevant to institutions that are subject to CRD IV. Institutions such as asset managers would not typically be required to return capital to investors before payments can be made under the relevant incentive scheme.

Question 9: ***Are the requirements regarding allowances appropriate and sufficiently clear?***

In relation to paragraph 124 of the CP:-

a. Paragraphs 124(a) and (b) provide that for an allowance to be considered fixed remuneration it should be tied to a role or organisational responsibility, should not depend on any other factors than fulfilling the role or organisational responsibility and should be awarded for so long as the individual holds that role or organisational responsibility. Our comments in respect of paragraph 117 in response to question 8 are also applicable to these requirements of paragraph 124.

b. Paragraph 124(c) provides that any other staff member fulfilling the same role or having the same organisational responsibility and who is in a comparable situation should be entitled to a comparable allowance. We note that two individuals may have the same corporate title but in fact have materially different roles and responsibilities. Therefore we would welcome clarification that institutions will not be fettered in their ability to award different allowances to different staff members, provided that such allowances are not awarded by reference to individual performance.

Exceptional remuneration elements and prohibition

Question 11: ***Are the provisions regarding severance payments appropriate and sufficiently clear?***

Under paragraph 140 of the CP an institution's remuneration policy must include the maximum amounts that can be awarded as severance pay to categories of identified staff. We do not see how it will be possible for institutions to do so in any meaningful way. One of the situations in which the EBA accepts that severance payments can be made is in settlement of an actual or potential labour dispute (paragraph 146(c)). However, the amount of the settlement payment that may be appropriate will depend on the merits of the potential dispute and the compensation that could be awarded by the competent court. Therefore we do not see how institutions can set a maximum amount as it is impossible to predict the claims that an individual may seek to raise.

Paragraph 143 of the CP sets certain circumstances in which severance pay should not be awarded. However, we would note that even in these circumstances the member of staff could still potentially bring a claim against the institution arising out of the termination of their employment. For example, an individual who resigns to take up a position with a different legal entity could still bring a claim for breach of contract under English law. Therefore we would welcome clarification that paragraph 143 is subject to the circumstances in which a severance payment is permitted under paragraph 146.

Paragraphs 152 and 153 of the CP set out circumstances in which a severance payment should and should not be considered variable remuneration for the purposes of calculating the ratio between fixed and variable remuneration. It is unclear to see why a severance payment should ever be considered variable remuneration. A severance payment is not remuneration at all. CRD IV already includes provisions that would prevent institutions labelling a payment as a severance payment in order to avoid the requirements in respect of the payment of variable remuneration. We consider that it would be better to rely on these "anti-avoidance" provisions rather than to suggest that a genuine severance payment could potentially be considered variable remuneration.

Question 12: ***Are the provisions on personal hedging and circumvention appropriate and sufficiently clear?***

Paragraph 155 of the CP provides that institutions must "ensure" that staff cannot transfer downside risk of variable remuneration. It is difficult to see how institutions can be expected to enforce this requirement in practice. If an employee enters into a hedging arrangement with a third party that is external to the institution and does not notify the institution that this has happened, the institution will not even know about the arrangement. Even with spot-

check inspections of internal custodian accounts and/or a requirement that external custodian accounts must be notified to the institution, ensuring absolute compliance would not be possible.

Yours faithfully

Clifford Chance LLP