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Dear Sirs

Consultation Paper 10/19 – Revising the Remuneration Code

The City of London Law Society (CLLS) represents approximately 13,000 City lawyers through individual and corporate membership including some of the largest international law firms in the world. These law firms advise a variety of clients from multinational companies and financial institutions to Government departments, often in relation to complex, multi jurisdictional legal issues.

The CLLS responds to a variety of consultations on issues of importance to its members through its 17 specialist committees. This response has been prepared by the CLLS Regulatory Law Committee (the "**Committee**"). Members of the Committee advise a wide range of firms in the financial markets including banks, brokers, investment advisers, investment managers, custodians, private equity and other specialist fund managers as well as market infrastructure providers such as the operators of trading, clearing and settlement systems.

The Committee welcomes the opportunity to respond to Consultation Paper 10/19 (the "**CP**") and appreciates the Financial Services Authority's (the "**FSA**") endeavour both to include a full consultation process within the tight timetable set by CRD3 and to clarify and provide for a proportionate application of CRD3. We are also grateful to the FSA for permitting us to submit this response after 8 October. In view of the great variety of type and size of firm to be covered by the new requirements we believe it is particularly important to focus on a flexible and proportionate application of the provisions. In view of the intervention into individual contractual rights, which includes in some cases rendering or purporting to render contractual provisions void, it is also important to have as much clarity as possible on the applicable requirements.

We are very concerned to ensure that the final rules can be understood by and be relevant and fair to the very wide range of firms to which they will apply. Many of these firms will have no direct supervisory relationship within which to raise the host of questions to which the rules give rise, and so the further guidance we request below on a number of provisions will be essential if such firms are to have any chance of understanding and applying the rules to their particular businesses. Limited licence and limited activity firms have not been considered in any detail at all by those who drafted CRD3. Rather the "proportionality" principle has been inserted to deal with them and it is critical that this principle is applied with sensitivity to businesses that are not banks or otherwise systemically relevant.

We set out below our responses to a number of specific consultation questions and comments on certain other areas where we consider that further attention to clarification and proportionate application is needed. We note that there may be changes arising out of the finalisation of the text of CRD3 and/or CEBS guidelines in October and as a result our current views may be modified and we may need to write again.

We appreciate that we have made a lengthy submission, but the issues are very important and many of our comments raise relatively technical matters which are important but which go to clarity of the text rather than anything more substantive.

1 **Q1: Do you agree with our proposed approach to the definition of Code Staff?**

1.1 **Meaning of "staff"/"employees"** Generally we agree with the alignment of the term "staff" in the Remuneration Code with the very wide definition of "employees" under the FSA Rules, which definition reaches far beyond those who are employees under a contract of service and includes secondees and others.

1.2 However, there are a number of specific difficulties with the application of the Code to individuals where the personnel concerned are simultaneously "owners" and "workers" and there is no divide between the two groups. We address these further below. Given the real difficulties in applying a concept of remuneration in the context of executives who are also owners (e.g. individual proprietors, directors who are also shareholders, partners or LLP members) some consideration should be given to whether it is necessarily appropriate for the FSA's wide definition of "employees" to be used automatically throughout the Code. Alternatively it may be possible to address some of the difficulties by guidance on the meaning of "remuneration" and/or proportionality disapplications.

1.3 In view of the breadth of the Glossary definition of "employees" we find it difficult to see how the undefined term "staff" could be any wider than the defined term "employees". We therefore think it is inappropriate for SYSC 19.3.6(3)(a) to state that a firm's staff "includes" its employees. If the FSA believes that the term staff could conceivably be wider than the Glossary definition of "employees" it should set out who else is covered and explain why the extension is appropriate.

1.4 As a technical matter we note that 19.2.5 and 19.2.6 both use the word "employment" as an italicised defined term. We believe it is intended that this term links with the FSA definition of "employee" and suggest this is clarified.

1.5 **Limitation to those with a material impact on risk profile** We note that the copy out of CRD3 in 19.3.4 inevitably brings with it the uncertainties and ambiguities of the Directive wording. For example CRD3 does not identify what is meant by senior management, risk takers or control functions and is not entirely clear as to what is governed by the final phrase "whose professional activities have a material impact on the firm's risk profile". Our understanding is that it is an overriding and governing factor which is to be applied to limit the staff covered by the detailed requirements so that, for instance, it would not apply to junior control staff and traders or to highly paid staff who do not have material impact on the firm's risk profile. We recommend that an express statement to this effect should be made.

1.6 It is helpful that the FSA has sought to provide guidance and clarification of aspects of 19.3.4 in 19.3.6(3) and (4). We would welcome further clarification on the following points:

(a) **LLP Members not necessarily all Code Staff** Depending on the size and nature of the firm certain significant influence and senior manager positions may not have a material impact on the firm's risk profile. In particular, many firms which are LLPs or partnerships register all members or partners as CF4 even though governance of the firm is entrusted to one or more committees which act in a manner similar to the board of directors of a company. Other members do not have the same level of impact on the firm's risk profile. Similarly the responsibilities of senior managers at lower levels than the governing body can vary widely. We suggest that in this context the Code should be concerned principally with those who fall into the "risk taker" and "control" functions and in fact have a material impact on the firm's risk profile. We note that 19.3.6(3)(b) only says that SIFs and senior managers "would be expected to be" Code staff. We suggest that this should be amended to say "would **normally** be expected to be" in order to allow for the possibility that in some cases this would not be the case

(b) **CF00 not normally Code Staff** The FSA's recent policy statement creates a new parent entity significant influence position (CF00). We have highlighted before the difficulties surrounding this concept. In the context of this consultation we wish only to note that:

(i) the treatment of this function should be aligned with the overall application of the Remuneration Code to the relevant group (which is itself an area of difficulty as discussed below). It would be disproportionate and impractical to seek to carve out and apply the Code to a single individual in a parent entity to which the Code does not otherwise apply;

(ii) the CF00 will not be an employee or member of staff of the authorised firm so that (subject to the general question of group application) if the UK applies the Code to such people it will be super-equivalent to the CRD and is likely to be out of line with their treatment by other EEA states;

(iii) the involvement of a CF00 with the authorised firm may be a very small part of his or her overall responsibilities, again making it disproportionate to seek to apply the Remuneration Code to him or her.

(c) **Need for clarity over "risk takers"** 19.3.6(3) indicates that the table in 19.3.6(4) provides examples of key positions which should be within a firm's definition of "risk takers".

As a drafting matter we note that (4) is divided into two parts, the second of which relates to control functions, rather than risk takers.

More substantively, while the examples in (4) are a helpful note of potentially significant business lines in a bank or broker dealer they appear to have been drafted in the context of the types of systemically important, principal trading, firm which are currently subject to the Remuneration Code and to have little relevance to the much wider universe of firms which are to be subject to the new Code.

We recommend that this is made clear and that some guidance is given on what, if any, relevance the term "risk taker" has for those limited licence and other firms which do not take balance sheet risk, either generally or in a particular area. This point is touched upon in paragraph 2.29 of the Consultation Paper but the conclusion is unclear and does not appear in the draft Rules. It appears to us that such firms do not have "risk takers" properly so described, although they are of course subject to legal and operational risks which need to be managed and controlled by senior management and control functions. The same consideration may apply to some of the functions referred to in the list of business lines (e.g. research).

1.7 **Position of those with limited involvement in relevant activities** The drafting of the CRD3 tends to assume that staff will fall fairly clearly within or outside the Code staff categorisation. The FSA has recognised that this is not necessarily the case but further guidance is highly desirable. In practice some staff may spend most of their time on activities which are not senior management, serious risk taking or significant control relating to the firm but nevertheless have some involvement in those activities. We assume that in these circumstances it would be necessary for the firm to exercise judgement as to whether they have a material impact on the firm's risk profile but it would be helpful if the FSA could:

(a) give an indication of whether it is appropriate, for example, to apply a “wholly or mainly” type of test to determine whether an individual is Code Staff at all; and/or

(b) confirm that if Code staff spend only part of their time as "employees" of the firm, and the rest of the time employed in the activities of members of the group to which the Code does not apply (assuming that it does not apply to all group members) then it is only the part of their remuneration which relates to their work for the relevant firm which is to be subject to the Code. It needs to be recognised that this may be not be significant - many groups have employees in positions in UK firms for reasons of group corporate governance and matrix management rather than because they have a major involvement in that firm.

1.8 **Position of those who spend only part of year as Code Staff** The guidance given by the FSA in 19.3.6(3)(e) in relation to those who are Code staff for only part of a year addresses a similar issue but seems unnecessarily draconian in providing that someone who fell within the relevant category for even a very small part of the year should be subject to the Code in relation to the whole performance year. Such a classification could put the firm in breach of contract for the earlier period where the relevant person was not originally Code staff. Subject to the need to avoid breach of contract or employment law (as recognised by Recital 7 to CRD3), either a "wholly or mainly" test or division of the performance year into two parts would seem more likely to be proportionate. The general anti avoidance provision should prevent misuse of a more flexible approach such as this.

1.9 **Excessive extension of Code** There are two further points which interrelate with the definition of Code Staff where it appears that the FSA is potentially extending the scope of the Code considerably beyond the requirements of CRD3:

1.10 The first is that it is not clear to us that it is appropriate, as seems to be proposed in 19.1.2, for the application of 4.1.1(2) relating to the detailed Remuneration Code to be identical to the application of the higher level requirements of 4.1.1(1). In the light of the origin and very detailed requirements of the Code it may be inappropriate, and will certainly be very difficult, for the Code to apply, as is suggested by the repetition of the normal Part 2 of SYSC1 Annex 1 application provisions, to the “carrying on of unregulated activities in a prudential context”. If that extension is to apply some clarification is needed of whether remuneration is always, or generally, regarded as being in a “prudential context” as defined in the Glossary. How the Remuneration Code is to apply to groups is also a major issue, as discussed further below, the understanding of which is not particularly helped by the Annex 1 reference to taking group activities into account.

1.11 The Code is so detailed in nature that it is extremely hard to apply it at the high level which is normally appropriate when considering unregulated activities and group members to which the provisions do not directly apply. We suggest that it is the high level requirement in 19.2.1, and the specific dangers outlined in 19.1.7(2) which should have application beyond regulated activities, rather than the whole of the Code and that this should be made clear.

1.12 The second is that while CRD3 clearly and sensibly requires that firms should have remuneration policies applying to all staff, not just to Code staff, which are consistent with and promote sound and effective risk management as set out in 19.2.1, CRD3 does not apply the detailed principles beyond the identified Code staff.

1.13 It appears to us to be super-equivalent to the Directive and disproportionate for the FSA to give the guidance in 19.2.3G to the effect that in complying with this general requirement the FSA expects firms to apply on a firm-wide basis not only the principles relating to governance and conflicts of interest but also those relating to risk adjustment, guaranteed variable remuneration and deferral. While some firms will wish to have uniform policies across the board this does not seem an appropriate area for across the board guidance.

1.14 We appreciate that elsewhere in the Code the FSA has sought to apply proportionality to each of these provisions but we suggest that it is disproportionate at the outset to expect all firms to apply these provisions to non-Code staff (particularly bearing in mind that Code staff can include all those paid at a level equivalent to senior management and risk takers who have a material impact on the firm's risk profile).

2 Q2: Do you agree with our approach to applying the Code to firms, individuals and groups?

Application to firms

2.1 We agree that relevant firms for the purposes of the Code are credit institutions under the Banking Consolidation Directive, investment firms subject to the Capital Adequacy Directive and the UK branches of equivalent third country firms, i.e. BIPRU firms and activities carried out from the UK establishments of third country BIPRU firms. We note that this may distort international competition and make third country firms less willing to carry on activities from their UK establishments but that the FSA is obliged to implement CRD3, which may have that effect. We recommend that the FSA is very cautious about any extension of the Code beyond the requirements of CRD3. We also think it should have regard to how CRD3 is implemented in respect of non credit institutions in other Member States with significant financial centres.

2.2 We note that the defined term "firm", meaning authorised firm, is used throughout the Code to indicate those subject to the relevant requirements. We consider this is correct but if and to the extent that at any point the FSA considers that the term "firm" stretches wider, to apply also to unauthorised members of the relevant firm's group we recommend that the FSA makes this clear specifically in the relevant rules or section. We comment further below on the treatment of groups.

Application to individuals

2.3 Our comments on the Code's application to individuals are set out our answer to Q1.

Application to groups

2.4 The extent and way in which the remuneration provisions apply to groups containing an FSA authorised firm is one of the more difficult areas of CRD3 and we regret to say that it is not fully clarified in the CP.

2.5 Paragraph 23(v) of Annex V to the amended BCD provides that the principles should be applied at “group, parent company and subsidiary levels, including those established in offshore financial centres". This is duly reflected in SYSC19.3.1, with an alteration to refer to the inclusion of subsidiaries established outside the EEA, rather than referring to offshore financial centres. However this arguably begs the question whether the provisions are meant to be applied to the whole group to which the firm belongs, which could be broader even than normal consolidated prudential requirements under BIPRU. At a number of points in the Rules and Guidance the FSA, by using the term “group" without more elucidation, generates the risk of such an application.

2.6 Some of the provisions of the Remuneration Code are of a systems and controls nature which it is reasonably easy to apply across the whole of the relevant consolidation group. The more detailed provisions are not well adapted for that purpose.

2.7 A better reading of paragraph 23(v) is the narrower one of simply applying the provisions to payments or other remuneration given to staff of the authorised firm, even if they were technically employed by or received remuneration from another group entity (effectively an anti-avoidance provision). This would make it easier to interpret the provisions relating to identification of Code Staff and relevant risks.

2.8 Our understanding is that it is the intention of the FSA to take a middle course in interpretation and (a) apply the general high level provisions to those entities which are members of the UK consolidation group, or non-EEA sub-group, as is provided in SYSC 12.1.13 and is in line with the normal application of consolidated prudential requirements, but not to any wider group; and (b) apply the detailed provisions of the Code to Code Staff of the authorised firm, using the wider definition of employees and the group provisions as an anti-avoidance measure rather than to require Code Staff to be identified across the whole group.

2.9 If this interpretation is adopted we believe that the scope of application, which in context restricts the meaning of group, parent undertaking and subsidiary undertaking to members of the UK consolidation group/non EEA sub-group, also needs to be made clear in SYSC 19.3.1 and wherever else there is a reference to “group”. We have noted above the potential for confusion in the reference to taking account of group activities in SYSC19.1.2(1)(c) and recommend that, if the provision remains, it is made entirely clear that in this context taking account of group activities does not require the application of the Code to those activities.

2.10 It would also be necessary to make it clear throughout the whole of SYSC that:

(a) references to “firm” and “group” are only to members of the UK consolidation group/non-EEA sub group. Alternatively the term “firm” should, as normal, refer to the authorised firm and only in certain places would reference be needed to the relevant consolidation group or other members of that consolidation group;

(b) Code staff should be assessed by reference to their impact on the risk profile of the relevant consolidation group (if that is what is intended) or of the authorised firm (if, as we believe, that is what is intended). They should not be assessed by their impact on other individual members of the consolidation group unless it would also have a material impact on the relevant group/authorised firm

At present the references to “firm” and “group” and how far it is necessary to assess the presence of Code Staff in entities other than the authorised firm (except where they are acting as employees, in the wide sense, of the authorised firm) are not clear.

2.11 The different wage markets and employment law and regulatory requirements in different jurisdictions can make it difficult to have identical remuneration arrangements across the whole of a global group. SYSC19.1.1 makes it clear that as far as a third country BIPRU firm is concerned the provisions apply only to activities carried on from a UK establishment. While this may reduce the willingness of such firms and their employees to be based in the UK the proposed application is clear.

2.12 The jurisdictional impact of SYSC 19.1.2, particularly in the context of multinational groups is less clear. It states that the Code will apply to the firm's UK activities, its passported activities from an EEA branch and to the activities of a UK domestic firm worldwide in a prudential context. The latter phrase is uncertain in its impact and guidance is desirable on whether remuneration is always to be regarded as involving a "prudential context" for the purposes of worldwide application to a UK domestic firm and, if not, where the boundary lies. This issue has a particular relevance to the competitiveness of UK firms outside Europe. Why would a firm choose a UK headquarters if, say, its Asian offices have to comply with the Code? Some of our members have already seen evidence of this effect.

2.13 It is our understanding that this jurisdictional limit to the application of the Code also applies to any group members who are brought within the Code because they are members of the UK consolidation group or non-EEA sub-group but it would be helpful if this was confirmed.

2.14 If the FSA does decide that, subject to the jurisdictional limits, it is necessary to apply the remuneration provisions to all members of the UK consolidation group, or non-EEA sub-group we should note that, quite apart from the competitive impact on groups headed by a UK firm, there are considerable potential difficulties, given that employment and company law and regulation as well as financial markets regulation all vary from jurisdiction to jurisdiction. There is therefore a risk that certain of the more detailed provisions of the Code may not be capable of application by all members of the group or may be difficult to make consistent with applicable local requirements. As relevant provisions are finalised inconsistencies may arise even in relation to different EEA countries and the different financial sector industries within the EEA. We recommend that this fact is recognised in proportionality provisions in the Code so that:

(a) where the UK firm is also a member of a group which is lead regulated by another EEA authority the FSA should state that it will normally regard a remuneration policy which satisfies the requirements of that other regulator as also satisfying the requirements of the Code, even if implementation by the other EEA regulator has not been identical to the Code provisions; and

(b) where members of the group are subject to other legislation or regulation affecting remuneration or the application of the principles firms may take account of that legislation or regulation in formulating their group remuneration policies even if in some cases this may lead to the adjustment of certain of the more detailed principles.

2.15 A further question relates to the treatment of authorised firms within a single group, and of staff carrying out different businesses within the same firm. Different risk profiles may well apply to different firms and business units. It would seem reasonable for firms to adjust their remuneration policies accordingly so that, for instance, a small low risk limited licence firm should not be required to adopt full scale high risk banking/proprietary trading remuneration policies for its staff even if a parent or another group member is such a bank/proprietary trader and therefore has more complex remuneration policies.

3 Q3: Do you have any comments on how the proposals contained in the CP affect equality and diversity issues?

No comment. We do not see that the proposals need have any impact on equality and diversity issues.

4 Q4: Do you agree with our proposals for changes to the Remuneration Principles 1-11?

4.1 We have no comments on Principles 1-3 (risk management, business strategy and conflicts), 6 (capital) or 7 (exceptional government intervention) or 11 (avoidance).

Principle 4 (governance)

4.2 Our comments relate principally to proportionality as noted in our answers to Q6 below. However it would be helpful if guidance in the text of the rules reflected the comment made in CP paragraph 3.42 to the effect that a firm with an overseas parent need not necessarily have a separate Remuneration Committee, provided the UK governing body sufficiently oversees the remuneration policies of the UK entities and has the capability to act independently. It should also be borne in mind that in some cases the UK governing body would be made up entirely of those whose pay is being determined, whereas the remuneration committee of the parent can take a more independent view.

Principle 5 – Control functions

4.3 Using this Principle to combine the previous Principles 2 (procedures and risk and compliance function input) and 3 (remuneration of employees in risk and compliance functions) may have introduced some confusion. In particular the second half of the guidance in 19.3.17 seems to relate to governance and conflicts of interest relating to the payment of non-control staff rather than to the conflicts/risks involved in business units having undue influence over the payment of control staff.

4.4 Despite the use of the "appropriate authority" link to the CRD3 provisions to justify the retention of the evidential provision in 19.3.15 we wonder whether it might be desirable to put some of these provisions, or some of the guidance, elsewhere in the Code (e.g. under governance or conflicts). If this is not done we suggest that at least there is a rearrangement of the guidance to separate out the different issues.

4.5 More substantively we suggest that guidance is added indicating that requirement for control function staff to be remunerated "in accordance with the achievement of the objectives linked to their functions, independent of the performance of the business area they control" does not prevent some of their remuneration reflecting the performance of the firm, for example by participating in appropriately structured Long Term Incentive Plans or other schemes or, indeed, by being partners or members of a partnership or LLP.

4.6 It would also be helpful to make it clear that the fact that the governing body will itself include people from other business areas is not a breach of the Principle - otherwise the guidance in 19.3.17(1) might be read as contradicting the rule in 19.3.16.

Principle 8 – Profit based measurement and risk adjustment

4.7 We recognise that the CRD3 requirement that account is taken of "all types of current and potential risk" is somewhat aspirational and that, as noted in the CP, not only has international best practice not yet been established but also there must be an substantial element of proportionality in the application of this Principle. Small banks and investment firms and limited licence and limited activity firms should not be expected to address risk adjustment with the same degree of detail, process nor even transparency as the largest and most systemically important institutions. They are likely to rely more heavily on qualitative assessment, possibly in some cases coupled with one or more very simple quantitative measures. We believe it is important that guidance recognises all these facts.

4.8 As it stands, although it is generally useful to be aware of the FSA's views on matters such as this, we do not find the guidance in 19.3.23 or 19.3.24 to be particularly clear or easy to follow.

We question whether some of the guidance has been drafted by reference to firms subject to the current Remuneration Code and misleadingly tends to imply that firms will all have, or should strive to have, the type of systems and structures appropriate for the largest banks and proprietary traders (c.f. 19.3.23 "should ask the risk management function to validate and assess risk adjustment techniques….be able to provide … details of all adjustments made under a formulaic approach …consult closely and frequently with the firm's risk management functions in particular those relating to operational, market, credit and liquidity risk").

4.9 The comments on LTIPs in 19.3.24, while indicating some possible areas of concern over risk adjustment in some current plans, do not give much indication of approaches which the FSA would regard as good practice. No explanation is given for the statement in 19.3.24 that awards cannot count towards calculation of the deferred part of variable remuneration unless upside incentives are balanced by down side adjustments, despite the requirement that awards should not vest in less than 3 and 5 years, which would prima facie appear to involve deferral. Performance adjustment in LTIPs seems to us to be a matter of compliance with 19.3.48R, not of whether they amount to deferral at all under 19.3.46. It would also be helpful in this context if the FSA could give some guidance on what it would regard as an appropriate balance of downside adjustment against upside incentives. Would, for instance, a typical free share award with performance conditions satisfy this requirement? And if awards are to be valued at the time of grant for the purposes of calculation of remuneration and percentages can the FSA confirm that they should not be valued or considered under the Remuneration Code at the time of vesting or payment?

4.10 We note that Rule 19.3.25 has been retained from the FSA's previous Remuneration Code and is not required under CRD3. While in general we agree that risk and capital adjusted profits are a more appropriate measure than simple turnover or revenue, there are some business models and sizes of firm where it is not unreasonable to operate on a cash received (e.g. from earned management fees which are not at risk of clawback) or simpler performance measure provided that appropriate steps are in place, as indicated in the guidance in 19.3.26(2) to ensure that quality and appropriateness of service are also taken into account. Profits are in some ways more capable of manipulation when used as a performance criterion than actual cash receipts. Any measure that is chosen is likely to require some form of adjustment to minimise the risk of misuse. We suggest that the requirement to base performance criteria principally on profits should therefore not be an absolute rule and may be more appropriately phrased as guidance.

Principle 9: pension policy

4.11 Clearly there are many contractual and labour relations difficulties in adjusting pension policies and to the extent this principle applies to a firm in a way which could require adjustment to existing policies a significant amount of time is likely to be needed to achieve that.

4.12 It is helpful that the FSA has given a definition of "discretionary pension benefits" which clarifies the focus on the grant of enhanced pension benefits as part of the variable remuneration package. We also note from paragraph 3.53 of the CP that but further clarification is desirable on matters such as:

(a) whether the term can apply to the normal exercise of discretions under the relevant pension policy or scheme. A right may not strictly have "accrued" and may even technically be discretionary but nevertheless be part of the normal company pension scheme;

(b) what the position is when an employee gives up part of his fixed remuneration in order to gain enhanced pension benefits;

(c) what the timing is for the application of the rule. Are discretionary pension benefits, like other benefits, identified as remuneration just in the year of grant? So do the provisions of 19.3.29 (2) and (3) effectively apply only in respect of such benefits granted in the year of/before the employee leaves? Or are these additional restrictions meant to apply even if the grant of enhanced benefits occurred many years before?

4.13 Points (a) and (b) above would, we believe, be covered by the addition of guidance on the lines of the last two sentences in paragraph 3.53 of the GP (that the new rule is not intended to apply to standard pension plan entitlements or the firm's financial contribution schedules to meet its obligations but only to capture non-standard one-off payments on an individual basis that are deemed to be of a variable nature). That would clarify the intended meaning of the definition.

<u>Principle 10 - Personal investment strategies</u>

4.14 It is clearly possible for the firm to require employees to give an undertaking not to use personal hedging strategies of the kind mentioned and from time to time seek confirmation from the employees that they have complied with the undertaking and to discipline them if a breach is discovered. It is not, however, clear to us what, if any, further arrangements the FSA may wish the firm to put in place under SYSC19.3.30. Further guidance on that question would be of assistance since this is clearly a matter of individual behaviour and it is likely to be very hard for firms to ensure compliance or even to discover breaches. CRD3 requires only the undertaking from staff, not some further detailed arrangements seeking to ensure compliance.

4.15 Although we believe that the guidance in 19.3.31 is intended to convey a similar message to paragraph 3.59 of the CP, we recommend that a statement should be added on the lines of the last sentence in paragraph 3.59 of the CP that the rule would not generally prohibit insurance covering personal payments such as healthcare and mortgage instalments. Other examples of personal commitments, such as school fees insurance, might helpfully be added.

5 Q5: Do you agree with our general approach to remuneration structures as set out in Principle 12?

5.1 A number of aspects of Principle 12 potentially create significant difficulties. We appreciate that a substantial number of these are generated by the terms of CRD3 but urge the FSA to apply the principle of proportionality, and the general overriding nature of the requirement for remuneration structures to be consistent with and promote effective risk management as far as possible. This is necessary to minimise the practical problems of application across such a wide range of firms, and, indeed, the significant risks of loss of key staff to firms and jurisdictions which are not subject to the Code. Here as elsewhere the FSA should be particularly careful not to “gold plate” the requirements by going beyond CRD3.

Absence of a clear meaning for remuneration and variable remuneration (particularly in relation to partnerships and LLPs)

5.2 There is a basic problem in discussing remuneration principles and structures and in particular the application of Principle 12 which is generated by the lack of a definition of variable remuneration (and indeed remuneration). This is most easily identified by considering an LLP or other tax transparent partnership structure, which are extremely common for service providing firms. Its members or partners will be taxed on all profits as generated and will normally therefore also distribute those profits.

5.3 There will be no distinction between the return they receive as investors in/providers of capital to the LLP and the return they receive for their work. Moreover, the whole amount received will vary by reference to the profits ultimately achieved in the relevant tax year. Even if some regular drawings are made throughout the year these will only be an advance on future profits, not fixed in the same way as a salary is. The FSA's capital rules require any drawings made in excess of profits to be deducted directly from Eligible Capital.

5.4 In the normal course therefore a partner or LLP member's entire "remuneration" is variable. Moreover some of it is commonly a return on investment/in respect of ownership, not in any normal sense remuneration for work done. Applying remuneration structures which require a calculation of percentages of fixed and/or variable remuneration, or even an assessment of what element is remuneration, does not reflect reality.

5.5 This situation contrasts with a limited company in which directors and employees are also shareholders. They will take any dividends on their shares in the same way as other investors without recharacterising them as remuneration (although the shares themselves may originally have been a form of remuneration).

5.6 It is of course easier to roll up profits and defer payments in a company than in a partnership or LLP, because they are not taxed in the hands of the shareholder until distribution, It is important to seek to reach a result which does not penalise partners and LLP members for the business structure they are using by treating by treating their return on equity/investment (including the investment which originally arose out of their past work) as if it was all simple remuneration.

5.7 Even in relation to directors and employees of a normal company there can be questions over what exactly fixed remuneration is, whether it can encompass fixed payments for specific tasks/achievements or whether that all counts as variable and, indeed, whether notionally "discretionary" payments to which an employee has through practice become entitled to as a matter of employment law count as fixed remuneration.

Performance measurement

5.8 The FSA has noted that the more complex forms of multi-year assessment and risk adjustment may not be appropriate for smaller firms. It is important to note more generally that highly formalised systems of performance measurement and records also tend to be more appropriate for larger institutions. As a matter of supervisory practice the FSA should not expect to see the same degree of formality in performance assessments at smaller firms, where individuals, and their contribution and adherence to firm values, tend to be known better.

Guaranteed variable remuneration

5.9 There seems to be a degree of confusion in the rules and guidance between "signing on bonuses", commonly a fixed amount paid to incoming staff who are much in demand, and "guaranteed bonuses", where the employer guarantees that bonuses/remuneration which would normally vary by reference to performance over a forthcoming period will reach a particular level over/throughout that period. It would be helpful if the FSA could clarify its view on both and in particular whether it regards both as covered by the rule in 19.3.38, since the terms of CRD3 appear to relate to the latter only.

5.10 The rule in 19.3.38, taken from CRD3, expressly states that guaranteed variable remuneration can be granted on an exceptional basis in the context of hiring new Code staff provided it is limited to the first year of service. We note that the effect of such a rule is potentially to encourage poaching and short term moves by employees, the exact contrary of the long term approach the provisions were intended to encourage, but that the FSA has no discretion to change that rule.

5.11 It appears to us to be doubtful whether the FSA is able to limit the rule in the manner proposed in 19.3.39, even if it wishes to do so in order to mitigate the potential ill effects of the rule. We do not see how, logically, it amounts to a breach of the rule in 19.3.38 (which relates to the circumstances in which guaranteed variable remuneration can be paid) if a firm in those circumstances pays guaranteed remuneration which is in excess of that paid by the previous employer. Nor is it clear to us how guaranteed variable remuneration (which is ex hypothesis fixed) can be subject to performance adjustment without ceasing to be guaranteed.

5.12 It may be that paying more generous remuneration, or remuneration which is not deferred, retained or subject to adjustment in the same way as it would have been if received from the previous employer is in breach of other rules (e.g. the overall rule relating to sound and effective risk management). It will be a question of fact in each case whether that is so. However it does not seem to us that such more generous payments (in amount or terms of payment) would contravene the prohibition in 19.3.38 on paying guaranteed variable remuneration unless the circumstances of payment fell outside that rule. To suggest that it would do so goes significantly beyond the provisions of CRD3.

5.13 If the provisions in 19.3.39 remain, considerable difficulties could arise in trying to relate the guaranteed remuneration from a new employer directly to the package given by the old employer. If, for instance, an employee has deferred cash and his new employer does not operate a deferred cash scheme, would the default position be that the deferred cash must be converted into deferred equity or could the cash be paid up straight away?

Ratios between fixed and variable remuneration

5.14 We have noted above that there can be difficulties in determining what counts as fixed and as variable remuneration, and, indeed, what amounts to remuneration at all (especially in the owner managed situation where some rewards relate to ownership or sale of the business). This is particularly the case for partnerships and LLPs. Moreover in some situations, such as a start up, where it is undesirable and risky to burden the business with high fixed costs even with a normal corporate structure there may be an agreement that there should be very low, or no, fixed remuneration unless and until profits are made. The FSA has recognised in 19.3.28G that variable remuneration may be justified in some such situations, even if losses are being made. Could it also recognise in guidance to this section that the ratio between fixed and variable remuneration (to the extent it is imposed at all) may also vary in such situations, provided that it remains a genuine option for the firm to pay no variable remuneration?

5.15 We note that the policy of requiring there to be a set ratio has been set in CRD3 (and will be elaborated in CEBS guidance) despite the fact that it is arguable that increasing the level of fixed salaries to meet such a ratio will itself make executives less, rather than more, risk sensitive. Accordingly all that the FSA can do is to make the requirement apply in a proportionate manner in accordance with the Remuneration Code general requirement and not allow it to be used to force high fixed costs on firms.

5.16 Even where it is clear that a particular payment or benefit should be regarded as variable there will be difficulties of valuation for the purposes of calculating percentages. It is common, for instance, for performance adjustment to be carried out not by granting a certain benefit and then having it removed, nor by granting notional benefits which vest over time, but by granting "blossoming" interests which at the outset have little or no value but which as certain performance targets are met acquire additional rights, for instance to share in a percentage of profits once a hurdle or target is met. Ratchet mechanisms can fulfil similar performance adjustment purposes. How should such rights be dealt with in calculating the ratio between fixed and variable remuneration?

Early termination payments

5.17 In view of the guidance and transitional provisions in 19.1.4 and 19.1.5 could the FSA please clarify whether 19.3.43 and 19.3.44 are intended to encourage firms to break (or at least seek to terminate, as to which see below on transitional provisions) existing employment contracts providing for, or which have the effect of requiring, certain payments on termination? Most such payments relate to damages for the breach of notice provisions by the firm rather than being specifically described as termination payments or severance pay under the contract. Those notice periods tend to be fixed at the outset of a contract, rather than reflecting performance over time, but payments under them are as a matter of law calculated by reference to the loss/damage suffered from breach of the notice provision. Accordingly they do take into account the loss of variable remuneration as well as the loss of fixed remuneration.

5.18 Is the FSA able to give guidance on the type of situation, or length of notice, which it would consider likely, and unlikely, to comply with the Remuneration Code general requirement? Does it expect firms to seek to draft contracts (to the extent the law of contract and employment permit) so that the normal rules for calculation of damages for breach of a notice provision in the contract do not apply if Code staff are dismissed without due notice being given? That would be a very major exercise, potentially affecting all Code staff contracts. Would the FSA expect it also to extend to renegotiating or terminating all such existing contracts? Doing so could in itself open firms up to substantial constructive dismissal claims.

5.19 We welcome the FSA's indication that a proportionate approach will apply these provisions only to the highest paid staff in the largest high impact firms.

Non-cash proportion

5.20 As the FSA is aware there are a number of practical difficulties with the application of this rule. In the listed company and mutual arena it may offend against shareholder/member rights and/or dilute their interests unduly over the long term in a way which is contrary to institutional investor guidelines. Consideration might be given to providing that the requirement to pay a particular proportion in shares or other non-cash instruments should be disapplied if and to the extent that shareholders/members prohibit the grant of the relevant interests.

5.21 Where the firm is not listed and actively traded then, in addition to the dilution concerns which shareholders other than the working executives have, there is the inherent difficulty that interests in it have no external market as the basis of valuation or means of realising value. Mutual organisations where the customers are also the owners, would need to create new types of "equivalent" instrument. So would partnerships and LLPs if anything more complex than a change of profit sharing ratios was envisaged. Creating "equivalence", or even determining the meaning of that term in this context, is not straightforward.

5.22 The provisions appear effectively to require the firm to treat itself as if it was about to become a liquid traded company or sell equity interests in its business and/or as if it was about to issue traded loan instruments or credit default swaps referenced to the firm's credit quality and then to issue and value instruments of some kind on that basis. Even undertaking a valuation exercise of this kind can be a very expensive and difficult exercise. Many firms cannot reasonably be expected to undertake such an exercise. Formulae such as those used in some circumstances (e.g. HMRC normally valuing management companies by reference to a multiple of fees under management) may reach disproportionate results (and impose additional tax on executives) when there is in fact no expectation or ability to dispose of the firm or the instrument concerned.

5.23 A key question if the issue of non-cash instruments is to be mandatory is how executives are to realise value from those interests in the medium to long term. Generally the business can only be sold as a whole and there is no real market for shares or other instruments. Normally there are restrictions on transfer and/or pre-emption provisions. Creating interests from which executives could actually realise value at the end of a formally mandated deferral period may be impractical unless it is structured as a buy-in by the company or by a third party funded by the company. Yet constructing a mechanism for such a buy in would impose ongoing liabilities on the company which could in themselves run contrary to the Remuneration Code general requirement and would certainly impose burdens on the unlisted company which would not be suffered by a listed company.

5.24 In each case these difficulties are even more complex and acute in the case of a partnership or LLP which does not have shares and is not, without significant and onerous restructuring, even in a position to issue relevant non-cash instruments.

5.25 Where the Code staff and the shareholders/members/partners are, in whole or in part, the same people, issuing new equity or quasi-equity interests to Code staff dilutes their existing interests. Is account to be taken of that reduction in value of their existing interests in calculating the value of non cash instruments issued to satisfy the 50% requirement?

5.26 As noted above in relation to deferral it is also necessary to address how "blossoming" rights and ratchet mechanisms should be treated for the purposes of calculating ratios.

5.27 Guidance is also needed on:

(a) the circumstances in which it is appropriate to issue other types of capital instrument under 19.3.45;

(b) how the retention period under 19.3.45 (2) is meant to interact with the deferral period under 19.3.46 referred to in 19.3.45.

(i) Should the periods be concurrent or consecutive when the shares or other instruments form part of the deferred element of variable remuneration?

(ii) The FSA's comments in CP 3.84 are not entirely clear on this question. In the first and second sentences it is said that the instruments will need to be subject to deferral or a retention period and that for those shares issued upfront a minimum retention period will be required. However in the last sentence it is said that retention periods may apply to awards paid upfront or deferred awards that have vested. It is our understanding that it is the first and second sentences which apply so that further retention periods are not required where the issue or vesting is itself deferred. Once this question is clarified, we suggest it should be incorporated in the rules as guidance.

(iii) It would also be helpful to have commentary on how far, if at all, it should be assumed that the retention period(s) should be of a similar length to the deferral periods in circumstances when shares are not part of the deferred element of remuneration.

5.28 We note that the FSA has in its CP (paragraph 3.82-5) indicated that its interpretation of the requirement for 50% of variable remuneration to be paid in shares or other non-cash instruments is that this applies to variable remuneration as a whole so that firms may choose whether shares form part of the deferred element, non-deferred element or a mixture of both and effectively satisfy the whole of the deferred element in shares.

5.29 We agree with that interpretation and trust that the FSA is able to persuade CEBS that it is the correct approach. Meanwhile it is not clear to us that the rules as drafted set out the FSA's interpretation accurately. In particular 19.3.45(3) as it stands, without further comment or guidance of the kind given in the CP, could be read to support the view of the Parliamentary rapporteur as referred to in CP3.82 which is expressly rejected by the FSA's subsequent explanation of its own provisional view.

5.30 We note that the provisions in 19.3.45 relate to interests in the firm itself. Consideration should be given to guidance on their operation in a group context.

5.31 There are also a number of fund management firms which operate arrangements by which executives are required or enabled to invest in the funds to whose management they contribute. These structures generally need to be agreed with investors and can operate to align interests of investors and the staff of limited licence firms and manage the legal and operational risks for the firm of misalignment generating inappropriate staff behaviour. It currently seems likely that the Alternative Investment Fund Managers Directive will recognise and may enforce some arrangements of this kind. It is important both in the implementation of CRD3 and in the finalisation of the AIFMD that there should be both consistency of approach and sufficient flexibility and proportionality to allow for different structures and satisfying investor requirements.

5.32 Those firms whose investors/fund structures mandate executive investment (whether by means of carry, co-invest, golden shares or otherwise) in funds under management in a way which is consistent with the overall risk management objective should not also be subject to provisions requiring remuneration to be in the form of interests in the firm.

5.33 However, other limited licence firms, for instance those which manage assets for a wide range of clients under discretionary mandates, or whose investors object to co-investment, will not be able to establish such structures. Consideration should be given across the board to how appropriate, if at all, it is to apply the provisions relating to non-cash remuneration to any limited licence or limited activity firm in view of the fact that they do not take their own positions and are not therefore at risk by reason of those positions. In our view it will very rarely be appropriate and we would have major concerns if the FSA were to disagree.

Deferral

5.34 There are a number of aspects of the deferral provisions which need to be very precisely clarified in view of the proposed application of voiding provisions to this rule. These include:

(a) whether:

(i) the total length of the deferral period should be set to end at some point between 3-5 years (or such later time as the firm considers appropriate) dependent on the matters set out in 19.3.46(4) with vesting taking place pro rata over the chosen period; or

(ii) full deferral is required for at least 3 years with pro rata vesting only starting after that and continuing for the next 2 or more years.

We believe the former is the correct interpretation but clarification is desirable.

(b) what amounts to a firm being significant in size etc. We think that guidance should be given that this should be equated with the firms which the FSA originally made subject to its Remuneration Code.

(c) what amounts to a "particularly high amount" other than variable remuneration of £500,000 or more. Given the systemic risk origins of the remuneration code and CRD3 and other provisions which require performance and risk adjustment it seems counter intuitive that the guidance in 19.3.47 could:

(i) operate in favour of lessening the degree of such adjustment between members of a particular firm;

(ii) require more calibration and deferral in smaller firms where few if any staff are paid more than £500,000 than in larger firms.

(iii) create problems as a firm grows and is successful so that differences arise, or are removed, between the remuneration of Code Staff leaving some subject to different deferral arrangements.

5.35 We query whether the guidance in 19.3.47(1) relating to risk adjustment and performance criteria might more appropriately be located as guidance to 19.3.48 and also whether it will necessarily be proportionate for all firms which pay deferred compensation to have a formal scheme with detailed risk and performance adjustment measures rather than in some cases retaining general discretion not to pay or vest under 19.3.48. The latter query also applies to 19.3.50(2)

5.36 19.3.47(2) refers to firms to having firm-wide and group-wide policies on deferral. We assume this is not intended to impose deferral obligations in relation to all staff in all group members but only in relation to Code staff in either the FSA authorised firm or, if the application of the Code is so extended, in the UK consolidation group or non-EEA sub group. This should however be clarified. It is an example of references to the "firm" and the "group" which seem to us potentially to extend the application of the Code inappropriately and far beyond the required impact of the CRD3.

Sustainability/performance adjustment of variable remuneration, including deferred remuneration

5.37 We note and generally agree with the FSA's approach in 19.3.48-49 of focussing on what the CRD3 calls "malus" or reduction of unvested deferred remuneration, rather than clawback of amounts actually paid, as the main technique of ex post risk adjustment. The clawback of sums already paid, for which the voiding provisions are required, will clearly have major practical difficulties.

5.38 In some asset management cases, where the firm’s money is not at risk and provided that the payment remains sustainable for the firm, it may be appropriate for firms to look to the performance of the fund(s) or other clients whose assets are under management and on which the executive works for the relevant adjustment criteria, even if the firm as a whole or other assets managed have a reduced performance. Would the FSA consider this an acceptable interpretation of “business unit” in this context even if the firm is not formally divided into different business units? If so could guidance be given to that effect? Although the performance is not directly that of part of the firm but of its clients it will affect the firm both in terms of fees and in terms of reputation and ability to raise further funds for management.

5.39 A related question is whether it is always necessary/appropriate to make reductions in the event of a downturn in performance, again subject to the proviso that the firm and its sustainability should not be damaged by payment/vesting, since a downturn may be caused by economic events outside the control of the Code Staff or firm and the staff concerned may be responsible for minimising the effect on the firm or the relevant business area or indeed for maintaining profitability in at least one part of the firm.

5.40 The guidance in 19.3.50(1) relating to incentivising new ventures which may be lossmaking does not clearly link up with the rule and evidential provisions in 19.3.48 and 19.3.49. Is the FSA intending to make it clear that this is an example of a situation where it is acceptable to pay, and not subsequently adjust downwards, variable remuneration even though the venture is loss making and might not be sustainable in the long term, provided that the executives/firm/business unit perform in accordance with its reasonably assessed targets?

5.41 As noted above we query whether it is appropriate or proportionate for all firms, particularly any smaller firms, to which 19.3.48 applies to have detailed adjustment schemes of the kind envisaged by 19.3.50, although some adjustment power will frequently be advisable.

6 Q6: Do you agree with our proposals, as set out in Annex 5, for applying proportionality at the rules level?

6.1 In this context we note in particular the general requirement in CRD3 that firms are to comply with the remuneration principles "in a way and to the extent that is appropriate to their size, internal organisation and the nature, the scope and the complexity of their activities." Further light is thrown on this provision, and the possibility that certain of the principles will not extend to some firms, in the recitals and we also note that:

(a) Recital 4 to CRD3 states that "The principles recognise that credit institutions and investment firms may apply the provisions in different ways according to their size, internal organisation and the nature, the scope and the complexity of their activities. In particular, it may not be proportionate for investment firms referred to in Articles 20(2) and 20(3) of Directive [i.e. limited licence and limited activity firms] to comply with all the principles."; and

(b) Recital 5b relating to deferral of a proportion of remuneration and payment of part in a non-cash/share linked form recognises that the types of instrument which can be issued will depend on the legal form of the firm and also states that "In this context, the principle of proportionality is of great importance since it may not always be appropriate to apply these requirements in the context of small credit institutions and investment firms."

6.2 As general points:

(a) We believe that the CP and draft rules do not yet fully take account of these CRD3 provisions. While the proportionality proposals made by the FSA are helpful we do not believe they extend as far as is needed in some areas. We trust that the FSA will encourage CEBS also to take full account of these recitals and the general need for proportionality in any guidance it issues. We note that the UK is probably relatively unusual in Europe for having a very substantial number of independent investment firms (asset managers, brokers and others) which are not also banks or part of banking or insurance groups. Proportionate application to such firms is therefore particularly important in the UK.

(b) It will be necessary to incorporate the proportionality guidance fully into the body of the Rules. We agree it is important to have a general provision, such as that in 19.3.3 (and for consistency we suggest the proportionality wording in 19.2.2(3) is also amended to track Recital 4 CRD3) in order to enable the tailoring of the Code to be proportionate to each firm. In addition we believe that the views that the FSA has reached on aspects of the Code which it will not be proportionate to apply to certain types of firm should be set out expressly in guidance to the Rules.

(c) This can be done on a rule by rule basis but the table format used in Annex 5 is also a helpful approach, once it is clearly linked in to the text of the Rules and Guidance.

(d) A number of our comments relating to proportionality appear in our answer to Q5 and elsewhere in our response.

Proportionality in application to staff

6.3 We note from CP 4.11 that the FSA is considering the position of individual proprietors and general partners but states that "Limited partners, whose position is more akin to employees, will not be excluded". It is not clear to us from that whether the FSA is considering complete exclusion of individuals who practice on their own account or as partners in a general partnership and, if so, whether the justification for doing so is the unlimited liability they carry for the activities of the firm. We can see that there is a case for such an approach.

6.4 We believe that more consideration needs to be given to the position of “owner managers” and owner managed businesses generally. We note that increasingly the standard model for a service providing firm in the UK, including financial services firms, is a limited liability partnership (LLP) whose members (or partners) have limited liability. It is less common for a limited partnership to be used, if only because once its limited partners become involved in management they become general partners.

6.5 An LLP is a tax transparent vehicle which, subject to certain provisions relating to its statutory incorporation, operates in much the same way as a partnership, in accordance with its LLP Agreement. There is a great deal of flexibility in setting the terms and governance of the LLP under that LLP Agreement, just as there is for any partnership, for instance there may be executive committee(s) of members or a managing member managing the firm or management may be done directly by all members, but a key feature is that, as in a normal partnership, the partners share in the profits and are taxed on those profits whether or not distributed to them. Members, like partners, combine ownership with actively working in the business and therefore are both owners and managers. If it had been a company they would be both shareholders and directors/employees (although members of an LLP are of course not employees). In some cases there will also be other members investing alongside the working partners, sometimes even a corporate member which is its parent undertaking (and may in turn be a subsidiary of an overseas partnership/LLP/LLC in which some or all of the LLP members are also partners - this is a common US fund manager group model). Executive members, like other members, receive their returns as a profit share which does not normally distinguish between the element which relates to their ownership and the element which relates to their working. If the business is sold they may receive capital profits from payments buying out their interests as members or the LLP may sell the business so that its profits on sale are allocated to members. However it more complex transactions are often done under which the purchaser is admitted as a member, makes contributions to the LLP which are reallocated between members and agreements are reached for ongoing profit sharing which would also reflect the purchase of the business (so that executive members took part of the disposal proceeds on an ongoing basis by reference to the continued success of the business, and in some cases their agreement to remain involved in it). The LLP may also have employees in addition to its members.

6.6 The older form of owner managed business, which is also very common, is the private or unlisted company model. In this case most or all of the shareholders of the company (or its holding company) will be directors or employees of the company, which may again also have other employees. The executives who are also shareholders will receive both a salary and benefits as directors/employees and dividends as shareholders. If the business is sold again either there would be an asset sale out of the company or they would sell their shares for a capital profit. Commonly the purchase terms would provide for some deferred payments relating to performance which might again be linked to their continuing involvement in the business or giving of restrictive covenants.

6.7 There are a number of particular points relating to owner managed businesses, LLPs, partnerships and unlisted companies (and indeed other business models although these are the most common) which affect the proportionate application of the Code:

(a) In small or even medium sized owner managed businesses it is arguable that, apart from limited liability, the owner managers have no significant differences from individual proprietors or partners in partnerships. In fact partners in a large general partnership may in terms of working practices and behaviour have more in common with employees than LLP members or shareholder directors in a small or medium sized owner managed business do. The term “staff” is not really appropriate for many owner-managers.

(b) The whole of an LLP member's (or a partner in a partnership’s) profit share is effectively variable simply because it is wholly dependent on profits. He may have a fixed drawing rate but that is only an advance on future profits and is generally set low out of prudence. It is accordingly not proportionate to apply requirements for there to be any particular ratio between fixed and variable remuneration. This is the case both in relation to the 19.3.42 rule requiring ratios to be set and in relation to the de minimis level.

(c) More generally in owner managed businesses, whether or not LLPs, the focus on the long term health of the business and desire to avoid burdening it with high fixed costs tends to mean that the owner-managers are willing to allocate themselves low salaries by comparison with the profits they hope to share. The same can apply to other employees in the case of start ups and other ventures where success is uncertain but they have high hopes for the future of the business. Requirements for particular ratios between fixed and variable remuneration may therefore be disproportionate in all these cases.

(d) Such part of an LLP member's profit allocation as is attributable to his membership/ownership of an interest in the LLP should not be regarded as remuneration at all, just as dividends on shares held by a director/employee are not regarded as remuneration. It will, however, often be difficult to determine how much of the profit allocation is attributable to that equity interest in the LLP since LLP agreements do not need to distinguish this and would not normally do so.

(e) Such part of the payments following sale of a business to its LLP members or directors and employees who were also shareholders as relate to payment for their past ownership and ongoing restrictive covenants etc, in whatever form paid are not and should not be regarded by the FSA as remuneration at all. To do so would be counter to the commercial reality.

(f) Absent a third party sale there is rarely a realistic method of either determining or realising the value of parts of an LLP or unlisted company.

(g) An unlisted company can grant share options and issue shares but there is most unlikely to be a market for them, so unless other members or the company itself is willing to purchase the shares the recipients can have no assurance of when, if ever, any value can be realised for those shares. This is the case even if notionally the shares are freely transferable. In practice there are normally tight restrictions on transfer or other dealings with shares so that ownership does not move outside the permitted group of executives and close relatives. It is not a matter, as in a traded company, of holding shares whose value will move by reference to performance of the company and can reasonably readily be realised. It is a commitment of indeterminate length. Moreover issuing more shares dilutes the interests of existing shareholders, who will be the same people in a classic owner managed company. It would be disproportionate therefore to apply the requirement for 50% of variable remuneration to be in shares or other share linked instruments to unlisted/untraded companies in the same way as to listed/traded companies.

(h) In the case of an LLP in addition to all the same issues of proportionality as apply to unlisted companies it would be very complex to restructure the LLP to create new types of quasi-share or equity or credit linked instrument of some kind and once such instruments were created they would be subject to an intensified form of the same difficulties outlined above in relation to unlisted companies.

(i) Arguably the 50% non-cash rule should not be applied at all except for the very largest and most systemically risky owner managed businesses - which should in turn be large enough to justify the costs of creating appropriate instruments and/or to have some form of internal traded market in them or other means of realising value at a later date.

(j) If a particular LLP is subject to the deferral requirements (on which see our further comments on proportionality) then we suggest it should be made clear that the deferral can be made net of any distributions required to meet taxation. Any other result would be unnecessarily penal and could cause real difficulties.

Code staff and de minimis application

6.8 We agree that it is sensible to have a monetary threshold for the application of a number of the more detailed structural provisions since the burden of making such arrangements for staff under these thresholds would be disproportionate. For the reasons given above:

(a) We believe that in the case of LLPs and partnerships there should be no specified ratio between fixed and variable remuneration, since it will normally all be variable, but only the cap of £500,000.

(b) We suggest that in a number of other situations firms should be allowed to agree to reduce the burden of fixed costs and have only a fixed cap with no limit on the proportion which might be variable. The relevant cap could in this case either be the same or possibly a lower amount such as £335,000 (£500K less 33%).

6.9 We agree that it will be helpful to use a de minimis rule to disapply the rules referred to in 19.3.6(2), which will also ensure that Code Staff below the threshold are not at risk of having contractual provisions made void.

6.10 There are other aspects of the rules where it may be disproportionately burdensome to apply the rules below a de minimis threshold. We suggest that as well as disapplying the items listed in 19.3.6 (2) (and presumably in each case related guidance and explanatory provisions) to those below the de minimis threshold consideration could also be given to disapplying Principle 8 profit based measurement and risk adjustment under 19.3.22 and 19.3.25 and related guidance, Principle 9 pensions policy under 19.3.29, Principle 10 personal investment strategies and, under Principle 12, 19.3.43 relating to early termination.

Proportionality in application to firms

6.11 For convenience our comments on proportionality are given by reference to the Annex 5 table. References to application to all firms are only to application to the Code Staff of FSA authorised firms which are subject to the Code.

6.12 As general comments:

(a) We agree that proportionality cannot be interpreted as a complete exemption from the Code, except possibly for certain types of individual proprietor and owner managers where there is little real distinction between their economic lives as individuals and as a firm. In that case, as noted above, it is more a matter of identifying that they cannot really be described as "staff" at all and then giving consideration to how the definition of Code Staff should be adapted than applying proportionality. In such cases the issue is identifying and managing risk, not remuneration as such.

(b) Although it is helpful for the FSA to give specific examples of situations where particular rules, or parts of rules will not apply by reason of the nature, scale, scope and complexity of the firm we are not sure that there is a clear dividing line between the rules identified in Table 2 for proportionate application and those identified in Table 3 for "comply or explain". It seems to us that "comply or explain" is another manifestation of proportionate application.

(c) As noted above all guidance available on proportionality needs to be brought into the text of rules and guidance.

Proportionality Table 1

6.13 We agree that the general requirement and principles 1 and 2 (which might be seen as reformulations of aspects of the general requirement) should apply to all firms and that each firm must maintain a record of its Code Staff.

6.14 Although firms should also inform staff that they have been identified as Code Staff, we query whether it is always essential for all firms to give detailed explanations to staff about the implications of their Code status, particularly when the firm in question has a relatively simple remuneration structure or is not subject to the more detailed provisions of the Code.

6.15 If a firm fully avoids or manages conflicts in other ways we query whether it is always essential for it also to be subject to Principle 3, requiring it to ensure that its remuneration policy includes measures to avoid conflicts (as opposed to not having any measures which create or aggravate conflicts). For instance if a firm had a simple fixed remuneration package without bonuses would it be essential to create bonuses or other aspects of remuneration which could be used to avoid conflicts. Or would the simple structure of remuneration itself be regarded as a "measure to avoid conflicts"?

6.16 We agree that Principle 4 as set out in 19.3.10R should also apply to all firms (though we are not sure that the addition of “in its supervisory function” adds much to the “governing body” for many firms).

6.17 We also agree that Principle 6 should also apply to all firms. In this context we note that LLP members are taxed on profits whether or not distributed so that there is an additional cost to them, unlike other firms, in retaining profits. However that should not be used to prevent the firm strengthening its capital base when necessary rather than making distributions.

6.18 We suggest that Principle 8, although it will most commonly apply as far as the aspects listed in Table 1 are concerned, should nevertheless be subject to proportionality for the following reasons:

(a) While profits are normally the best measure of performance, particularly for firms which are undertaking principal liabilities, as the FSA has pointed out accounting profits may prove illusory and need to be risk adjusted.

(b) Some firms’ cash receipts may effectively represent their fully realised profits so that calculations could be done based on certain management or performance fees received.

(c) When dealing with limited licence (and to a lesser extent limited activity) firms it may be appropriate, and assist in conflict management and alignment of interests, for some financial performance measurement to be calculated by reference to matters such as the performance of funds under management/advised, rather than just by reference to the firm's profits out of its clients.

(d) In some situations, the FSA has recognised that negative financial performance by the firm should not prevent the payment of variable remuneration. The FSA has given start ups as an example but there may be other cases.

6.19 We agree that the anti-avoidance Principle 11 should apply to all firms.

6.20 We agree that the general provision in Principle 12 set out in 19.3.33R should apply to all firms. We believe that the leverage provisions, as well as the remainder of Principle 12, should be subject to proportionality for the following reasons:

(a) Partnerships and LLPs can be said to have 100% variable remuneration.

(b) There are other situations in start ups and in owner managed situations where those involved wish to have low (or even no) fixed remuneration in order to protect the firm against risks. This should not be discouraged, provided it is still possible to pay no variable remuneration.

Table 2

Principle 4

6.21 Under Principle 4 we agree that there should be scope to relax the requirement for independent reviews of the implementation of the remuneration policy. We suggest that for some smaller firms where the governing body, or a committee of the governing body, actually implements the remuneration policy and takes the relevant decisions on a case by case basis the review of implementation of its remuneration policies and procedures and compliance with the Code may in practice be done as part of its actual implementation (or by reviewing the previous year's implementation as part of the process of implementation in the next year), rather than by carrying out a separate review process.

6.22 At the other end of the scale of significance where a larger (or indeed any) firm chooses to commission an external review we query whether it should still also be required to have an internal independent review.

6.23 We also agree that only significant firms should be obliged to have a remuneration committee. Subject to any CEBS guidance we suggest that “significant” in this context could mean either the very large firms which the FSA made subject to its original Remuneration Code or, if a somewhat wider range was required, firms which the FSA classifies as High Risk for ARROW purposes.

6.24 It would be helpful to make it clear in the proportionality guidance that if less significant firms choose to have a remuneration committee such a committee need not be subject to the requirements of 19.3.12.

Principle 5

6.25 We agree that the provisions of Principle 5 and rules relating to control functions only apply to firms which are organised with separate control functions. It is not clear to us that it is necessary for firms without separate control functions still to consider how to comply with Principle 5. It seems to us that at this point relevant systems and controls revert to being the general ones relating to risk management rather than special aspects relating to remuneration.

Principle 8

6.26 We believe that many smaller firms, limited licence, limited activity and low risk firms will find the "strenuous approach to risk adjustment" set out in 19.3.22 and related guidance disproportionately burdensome, not just those with relatively low leverage remuneration structures.

6.27 As noted above there are a number of situations, particularly in owner managed firms, where variable remuneration may be all, or a very substantial proportion of remuneration in order to manage risk, rather than increase it.

6.28 For the reasons given above we are also not convinced that it is always (as opposed to normally) appropriate, and therefore proportionate, for financial performance to be based principally on profits of the firm as provided in 19.3.25 and we note that this provision does not appear in CRD3 or the FSB Compensation Standards. This may be a "comply or explain" matter.

6.29 The FSA's own guidance in 19.3.28 relating to start ups already indicates that there are some circumstances in which it is not proportionate to contract total variable remuneration in the event of negative financial performance. This should be a "comply or explain" matter, at least in relation to firms which are not systemically important.

Principle 12

6.30 As noted above there are some circumstances, particularly in relation to asset management and advisory firms, for the performance of particular funds or assets under management to be taken into account and even given a greater weighting than the overall results of the firm. It may be that this is covered by the general reference to performance in 19.3.34, or that the term business unit can be read widely for this purpose, but it would be helpful to have guidance and an indication of proportionality on the question.

6.31 We agree that there are likely to be a number of low and medium risk firms for which it may be too onerous to set up monitoring systems to gauge longer term performance under 19.3.36. They would still have to take account of the more general risk management obligations.

Table 3

Principle 7 government intervention

6.32 We agree that this principle should only apply to firms that have received exceptional government intervention. The phrase "benefits from" should relate to the direct receipt of such intervention under recapitalisation arrangements, asset protection schemes and the like, rather than broader government or Bank of England action such as quantitative easing.

Principle 9 pensions

6.33 We agree that this principle should generally be applied only to the most highly remunerated Code Staff in large/systemically important firms. Further guidance on its application would be welcome.

Principle 10 personal hedging

6.34 We agree that this principle should only apply to firms and to Code Staff which apply share based awards and/or deferral.

Principle 12

6.35 Smaller firms may find their staff particularly vulnerable to poaching in a way which leaves them with no cover if they are unable to match offers of guaranteed variable remuneration yet consider that that their cost base cannot tolerate the longer term impact of increasing fixed remuneration.

6.36 We agree that the severance/early termination provisions should apply only to the most highly remunerated Code Staff in large high impact firms and more guidance on this and on the application of notice provisions as noted above is necessary.

6.37 While CRD3 clearly envisages that there will be some circumstances where unlisted firms may be required to apply share or non-cash based remuneration provisions we agree for the reasons given above that proportionality is very important in this context and agree that the provisions should be disapplied for some types of firm.

6.38 We also agree that there are some circumstances where it is disproportionate to apply deferral provisions.

6.39 As noted above there are a number of circumstances, particularly LLPs and other owner managed businesses, where it may be disproportionate to require a particular ratio between fixed and variable remuneration as is normally required by 19.3.42.

6.40 We also agree that performance adjustment provisions should apply principally to firms which apply deferral.

6.41 See also our comments on proportionality elsewhere in this response to consultation.

7 Q.7: Which metrics and thresholds do you believe are appropriate to determine how different firms can apply the specific rules of proportionality?

7.1 We do not have specific proposals. We agree that it is helpful, in order to reduce the amount of work required of firms in situations where it would clearly be disproportionate to apply certain rules, to have some simple measures, such as the FSA's proposed de minimis threshold. Generally we recommend the use of metrics which are clear and simple to apply, ideally drawing on classifications which already exist in the regulatory system rather than creating new thresholds.

7.2 We have suggested above that there are a significant number of rules and guidance which are (to a greater or lesser degree depending on the entity type) disproportionately difficult or inappropriate to apply to:

(a) LLPs and partnerships;

(b) mutuals

(c) other owner managed firms

(d) unlisted companies

7.3 In some cases it may be that the only effective means of achieving proportionality is to refer to the type of business entity because of very special structural considerations relating to, for example, LLPs and partnerships, and possibly also mutuals. However we think it is generally undesirable to allow the form of business entity to dictate its regulatory treatment.

7.4 We recommend that the main metrics used by the FSA when determining the proportionality of application of remuneration rules should relate to systemic risk and use, so far as possible, existing classifications. There might for instance be a hierarchy of application with:

(a) certain rules applying only to the largest and most systemically important firms, such as those which are already subject to the current Remuneration Code;

(b) others, such as those relating to deferral and share based remuneration, also applying to those credit institutions and full scope firms which are classified as high impact firms under the ARROW classifications

(c) others also applying to medium high/medium low risk credit institutions and full scope firms and high risk limited licence and limited activity firms;

(d) the remainder would apply to all firms subject to the Code.

7.5 There will also be many other situations where thresholds will be appropriate. Some could again be simple, such as excluding from certain rules all limited licence firms, or all limited licence firms other than the very largest or most complex in terms of both their own number of employees and activities and the transactions undertaken/assets under management.

8 Q8: Do you agree with our proposed approach to risk adjustment?

8.1 We understand that the FSA's approach to risk adjustment has to date rightly been focussed on the largest organisations currently subject to the Remuneration Code. This has understandably influenced its comments on the subject in the CP and draft rules. Even the starting point of taking the risk adjusted cost of capital tends to be most relevant for firms taking own account balance sheet risk.

8.2 We have no specific comments on the FSA's approach to risk adjustment as it applies to high impact firms which are credit institutions or own account dealers. However, a number of the matters addressed both in CP paras 4.21-4.48 and the related rules and guidance assume a detailed assessment of various factors, formulaic calculation and adjustment which may be less relevant for smaller firms and limited licence firms. Guidance and proportionality provisions could be of assistance on this question.

9 Q9: Do you agree with our proposed transitional arrangements for implementation of the amended Code?

9.1 The time scale for implementation set by CRD3 is very tight and the remuneration provisions involve interaction with existing contractual, employment, pensions and shareholder or other constitutional rights for each entity. We agree with the FSA that it would be disproportionate for firms which have not previously been subject to the Remuneration Code to be obliged immediately to set in place detailed compliance arrangements. This is particularly, but not exclusively, so for the matters covered by Principle 12. Given the timing of production of CEBS guidance and the final FSA rules it is likely to be difficult even to assess in detail the proportionality of application of such provisions to the individual circumstances of each firm. Some other matters which are likely to take time to implement, particularly for firms not previously subject to the Remuneration Code, are those contained in Principle 8 relating to profit based measurement and risk adjustment, which is closely related to remuneration structures.

9.2 We believe that unless considerable further assistance is given on proportionality, on the lines discussed in this letter, it will also be disproportionate to expect them to do so fully by 1 July 2011. A more normal implementation period would be 12-18 months and we suggest that the FSA considers such a period for firms to achieve full compliance under TP3(5) and extends that TP to include at least Principle 8. Whatever period is given we note that it will also need to apply to reporting obligations so that a firm is not, for instance, required to confirm under the GABRIEL system to certify that it is compliant at a point when it is still working through implementation..

9.3 However our main legal concern relating to the transition to the new regime is the impact of the Remuneration Code on existing contracts. CRD3 expressly states in Recital 7 that the remuneration principles should be without prejudice to the exercise of fundamental rights under the Treaties, general principles of national contract and labour law, applicable legislation regarding shareholder rights and involvement and the rights, where applicable, of social partners to conclude and enforce collective agreements.

9.4 In this context we note that under UK employment and contract law individuals may have developed rights under their contracts to certain payments and benefits, even if they are described in the contract as discretionary, or to have discretion exercised in a particular manner. Amendments to their terms or changes to practices which have generated such rights could render firms liable to constructive dismissal claims.

9.5 We welcome the statement in 19.1.4G that 19.1.3R does not require firms to breach requirements of applicable contract law or employment law. That statement is in line with the recitals to CRD3. However, unlike that recital it is qualified. It is not clear to us whether the statement that it is "subject to" the requirements of 19.1.5R means that it is the FSA's view that 19.1.3 does require firms to break existing contracts in order to comply with 19.1.5R. We do not believe that to be the FSA's intention and we should be grateful if the FSA could make it clear that firms are not compelled to break existing contracts in order to comply with 19.1.5.

9.6 Even once that point is clarified we still have concerns over the requirement in 19.1.5 for firms to take "reasonable steps" as soon as possible to terminate or amend such contracts in order to be compliant with the Code. We believe these requirements are super-equivalent to the CRD3 requirements and could cause huge disruption within firms and to employer/employee relationships.

9.7 Amendment negotiations can take time and hurrying them is likely to result in making concessions which will themselves place other burdens on firms. This is in part recognised by the requirement to take "reasonable" steps. However, most contracts will have some form of termination by notice provision which can be operated without breach of contract. Is the firm obliged to give notice to terminate in all cases where the Code Staff member does not agree to an appropriate amendment within a reasonable period? Doing so could result in the loss of valuable staff and/or industrial unrest. Or is it only when it is "reasonable" to do so that the firm is required to give notice to terminate? If the latter, should reasonableness be determined by a balance of the seriousness of the non-compliance with the Code, the risks involved of loss of key staff, the risks generated by non-compliance, the length of time the non-compliance is likely to persist and the strength and effectiveness of the other measures taken to manage risk? Further guidance on this issue is needed.

10 Effect of breaches of the Remuneration Code

10.1 Although there is no question in the CP directly addressing the voiding provisions we should like to make some comments on these proposals.

10.2 The first point is that the FSA's power to make these rules stems from s139A Financial Services Act 2010 ("FSA 2010). It provides in s139A(2) that a remuneration policy for these purposes is a policy about the remuneration by the authorised person of officers, employees and other persons of a description specified in the rules. Section 139A(9) allows general rules to prohibit certain types of remuneration, provide that contravening provisions are void and provide for the recovery of payments made or property transferred under a void provision. Under s139A(10) and (11) prohibitions can only be imposed to ensure remuneration is consistent with the effective management of risks or the FSB implementation standards and provisions contained in an agreement made before the rules are made cannot be rendered void unless subsequently amended to contravene.

10.3 Moreover the rules to be made under s139A(9) are themselves described as general rules. The general rule-making power under Section 138 FSMA is only to make rules which apply to authorised persons.

10.4 It appears that the draft Remuneration Code so far as it extends to entities other than the authorised firm, and remuneration paid by persons other than the authorised firm, is wider than a remuneration policy under s139A FSA 2010. We believe that in implementing CRD3 the FSA may make remuneration policy rules which go further than those authorised by s139A. However we do not consider that the FSA is able to exercise the powers given by s139A(9) in respect of those aspects of the Remuneration Code which go wider than a remuneration policy as described in s139A(2).

10.5 Section 139A(2) would allow the FSA to extend a remuneration policy to cover persons other than true "officers" and "employees" of the authorised firm and therefore allow it to cover Code Staff falling within the wide FSA definition of "employees" and apply voiding and recovery provisions to any remuneration paid by the authorised person. It may be open to question whether such provisions could also be applied to remuneration which is indirectly paid by the authorised firm, for instance by reimbursing a seconding firm, although prima facie this would not be the case. However Section 139A would not in our view allow the FSA to apply voiding and recovery provisions to remuneration by any person other than the authorised firm. It also does not appear to us to be capable of applying to other group members since they are not authorised persons.

10.6 Accordingly, 19.3.51 and Annex 1 to SYSC 19 should be amended to apply more narrowly than the FSA's full proposed application of the Remuneration Code.

10.7 We note that the simple statement in paragraph 4 of Annex 1 that it is immaterial whether the governing law of the relevant provision is that of the UK or a part of the UK will not necessarily mean that the relevant provision is actually made void under applicable law. Normal conflict of law rules will apply and we anticipate that there may be significant legal challenge to any purported avoidance of a contractual entitlement in any but the simplest case of a contravening payment or benefit granted by a UK authorised firm under a UK contract to an individual located in the UK. In this context we consider that the FSA is correct to provide only that the firm should take reasonable steps to recover payments made or property transferred.

10.8 It is obviously particularly important to ensure clarity in any provisions which strike down contractual rights and we appreciate the care that the FSA has taken to reduce areas of uncertainty by:

(a) specifying that the voiding rule does not apply to the SYSC19.3.38 rule if the conditions in paragraphs (2) and (3) of that rule are met; and

(b) giving more detail to calculations under the de minimis provisions.

10.9 We suggest that further clarification is needed:

(a) that where the relevant rule (e.g. deferral) does not apply by reason of proportionality nor does the voiding provision since there is no contravention;

(b) over the application of the deferral provisions under SYSC 19.3.46 as noted above. At present they appear to us to be too uncertain to be applied as a basis for voiding contractual provisions;

(c) of 19.3.51(4)(c) which states that if remuneration is subject to a condition, restriction etc which reduces its value that condition should be ignored in arriving at its value. While we appreciate the anti-avoidance nature of this provision it should not be used to attribute value beyond the actual value, for instance where a substantial performance condition is imposed which may never be met, or where shares in the firm are subject to long term restrictions on sale or transfer.

10.10 If it is not possible fully to clarify the deferral provisions consideration might be given to drafting a more precise provision to which the voiding provisions apply, even if it does not capture the whole of 19.3.48. For instance a provision setting a hard limit of 40% deferral, and specifying the earliest time it could be paid could be used as the basis for voiding contractual terms rather than trying to enforce voiding of provisions by reference to vague terms such as "substantial portion", "at least", "period not less than", "no faster than", "a particularly high amount", "firm that is significant".

We would be very happy to engage with FSA in constructive dialogue in respect of any of the above issues. You may contact me on +44 (0)20 7295 3233 or by email at margaret.chamberlain@traverssmith.com.

Yours faithfully

Margaret Chamberlain
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