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Dear Sophia

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FSA Consultation Paper CP/09/10: Reforming remuneration practices in financial services (the Consultation Paper)

1. **THE CITY OF LONDON LAW SOCIETY**

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 to FSA CP09/10 (Reforming remuneration practices in financial services) 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.

2. **GENERAL COMMENTS**

Before commenting specifically on certain of the consultation and discussion questions, we have two areas of general concern, which are not wholly captured by the questions, on which we wish to comment.

2.1 **First-to-market regulation**

We refer to our responses to FSA's Consultation Papers 08/22 and 08/24, in which we raised our concern in relation to FSA taking a "first-to-market" approach to regulation.

That concern applies equally in relation to these proposals. FSA has noted the various international initiatives which have commenced in this area. Though FSA considers that the proposed Code, the FSF/CEBS sets of principles and the European Commission's recommendations are all "broadly consistent", it is clear that the Code is significantly more detailed and prescriptive, and contains a number of additional provisions which, to a greater or lesser extent, reveal substantive differences to the approaches taken by the Commission, FSF and CEBS respectively. FSA itself has noted some examples of this (pages 11 and 12 of the CP). Though some ideas contained in the Commission's recommendations are, not surprisingly, similar to those contained in the Code, the Code is significantly stronger and more prescriptive (for example, compare Principles 2 and 6 in the Code against paragraphs 5.4 and 6.3 in the recommendation). Further, Principle 9 suggests that any vesting period is dependent on the ratio of fixed remuneration to variable remuneration, rather than on any link to the time horizon of risks (which seems philosophically different to the approach taken by the international organisations). The guidance accompanying Principle 9 (in particular, the requirement for "two-thirds deferral") is also more restrictive than the Commission's approach).

In sum, if FSA were moving ahead of international developments, but on a basis that was consistent in all material respects, we would consider that approach to be unnecessary but not necessarily prejudicial to the UK's competitive position. However, the level of prescription advocated by FSA, and the apparent existence of some important differences of approach when compared to international initiatives, suggests that these proposals have the potential to damage the competitive position of affected UK firms unless they are significantly modified. Paragraph 30 of Annex 4 to the Discussion Paper expressly acknowledges that it is not possible to quantify the magnitude of the potential adverse effects of the application of the Code given current uncertainties about international policy. As a minimum, we think that it would have been preferable to have awaited the Commission's recommendation, and then to have adopted the high-level proposals in that document more closely. FSA has been involved in the preparation of the recommendation and, we assume, will be comfortable with its essential elements. We also note that the Commission's consultation on amendments to the CRD in relation to remuneration policies follows a similar approach to the recommendation.

2.2 **Employment law**

We are concerned that FSA's proposals have been framed without adequate consideration being given to their potential consequences under employment law. For example, FSA's transitional proposals (paragraph 5.19) suggest that a firm whose service contracts do not expressly permit amendments to be made so as to enable the firm to comply with the Code will be required, come what may, to make and enforce the relevant changes by not later than 6 November 2010, notwithstanding that such steps may well put the firm in breach of contract. Further, despite its level of detail and prescription, the Consultation Paper (the **CP**) does not consider the substantial procedural and other legal implications for firms when they seek to make major changes affecting large numbers of employees; firms are likely to have to consider whether, in all or certain cases, proposed changes may amount to constructive dismissal, and what form of individual or collective consultation will be required. At the very least, we would expect that the Principles or FSA guidance would acknowledge the prime requirement for firms to comply with their existing obligations to employees, whether those obligations arise by contract, statute or common law.

2.3 **Market failure analysis**

FSA has said on a number of occasions that it will only take regulatory action of this kind where there is convincing evidence of market failure that would be addressed by the regulatory response. In this case, FSA acknowledges in the CP that, though it may not endorse some existing remuneration practices among regulated firms, there is no proof of a direct causal link between these practices and the market crisis. Against this background, and in the light of the intervening documents published by the Commission, we would hope that FSA's response will be limited to implementing the Commission's proposals, and that aspects of the CP which are additional to and/or inconsistent with these proposals will not be taken forward.

3. **CONSULTATION QUESTIONS**

Consultation question 1: Do you agree with our analysis on the need for change and the gaps in the current regulatory approach?

We are not convinced that there are significant gaps in the current regulatory framework; and to the extent that any gaps do exist, we do not consider that the Code as drafted is a proportionate means of filling those gaps. The Principles for Businesses (in particular, Principles 2 and 3) and SYSC contain requirements for effective risk management by firms. It is strongly arguable, we believe, that these existing Principles and rules, supplemented by general guidance drawn from the Commission's recommendations, should be sufficient to enable firms to design effective remuneration policies, and to enable supervisors to encourage and, if necessary, enforce the adoption and maintenance of such policies. If FSA identifies shortcomings on a firm's part under this approach, the regulator would have a full "toolkit" of responses available to it, including most obviously, a potential increase in the firm's overall capital requirement under the SREP process in Pillar 2. As far as both regulated firms and individual approved persons are concerned, there are also substantial powers available to FSA to deter and punish inappropriate or reckless risk-taking. We note that the proposed amendments to the CRD on which the Commission has recently consulted would clarify and further strengthen regulators' powers in this regard. It is not clear to us that a gap exists which would justify a further rule and a suite of detailed evidential provisions and guidance on the scale proposed, which may in themselves create an additional and disproportionate regulatory risk for firms.

Consultation question 2: Do you think that introducing this Code into the Handbook as proposed would have adverse implications for the UK as a financial centre? Or do you think its introduction might have neutral or positive implications?

Please see our comments in section 2. We are concerned that the introduction of the Code as proposed would have adverse implications for the UK as a financial centre, and that these are likely to outweigh any relevant benefits. We also note that the Discussion Paper acknowledges in 6.1 that its proposals to extend the Code to all FSA regulated firms would have to be subject to constraints where EU legislation reserves such matters to home state regulators. As a minimum, we believe that the Code should be re-drafted, and its scope reduced, so that its provisions are not materially broader than, and are not inconsistent with, the Commission's recommendation.

Consultation question 3: No comment.

Consultation question 4: Do you have comments on the content or the scope of the draft Code?

We have commented on certain aspects of the content and scope of the draft Code in section 2 above. In addition, we have the following specific comments:

(i) Principle 1 in the Code envisages that a firm's remuneration committee would take the leading role in designing, approving and periodically reviewing the firm's remuneration policy. While this may appear to be an obvious and uncontentious proposal, we would observe that, though many larger firms which are part of publicly listed groups are likely to have such a committee, in practice the existing terms of reference of the committee will typically encompass consideration of the remuneration of directors of the listed holding company, and other senior management, only. The business of such committees is not normally concerned with the remuneration and incentivisation of employees as a whole. Consequently, we believe that, if it wishes such committees to assume, in many cases, a more significant and wide-reaching role than at present, FSA should be clearer in its public statements that this is the case, and should warn firms that they are likely to be required to review the constitution and terms of reference of such committees as a corollary of these proposals. For example, it is likely that such committees will require significantly expanded membership, as to include the various constituencies within a firm's executive management referred to in the principles, as well as non-executive directors. We do not believe that paragraphs 17-20 (inclusive) of the FSA's cost benefit analysis is sufficiently clear in this regard. We also note that the Commission's recommendation is more flexible in this regard.

(ii) In relation to the proposed application of the Code to "larger banks and broker dealers", we note that, in each case, the combination of a UK and an international capital resources test has resulted in the UK test being set at a relatively low level. As drafted, a UK banking or broker dealer subsidiary which is a small part of a far larger international group will be caught, even though it may not be a part of a substantial UK consolidation group, and may be of relatively little systemic interest to the FSA and other UK authorities. If FSA wishes to retain separate provisions for larger banks and broker dealers, we would suggest that either the UK capital threshold is raised, or alternatively that a bank/broker dealer would only be caught if it is part of a substantial UK consolidation group. Our members are not convinced that, as drafted, the Code would apply to the relatively small number of firms indicated in the FSA's cost benefit assessment. Alternatively, FSA may elect to reduce the level of prescription and detail in the Code, and to apply it, on a differentiated basis, to most FSA authorised firms in the manner envisaged by the Commission's recommendation and consultation (we comment further on this in section 4 below).

(iii) Though we would expect trade associations and other parties to raise detailed comments, our general observation is that the content of the Code, both in terms of suggested evidential provisions and guidance, is more detailed than seems appropriate (assuming that the need for additional regulation exists, on which we have commented above). For example, the draft guidance relating to Principles 4 and 5 contain suggestions of methods which firms may wish to adopt in order to comply with the rule and the related principle. Inevitably, the methods suggested are not, and are not intended to be, exhaustive, but some firms will nonetheless be concerned if they are proposing to adopt another, legitimate method which is not expressly contemplated in the guidance; which, in turn, suggests in our view that such guidance should be avoided unless it is necessary or desirable in order to clarify the meaning or effect of the rule (which should not be the case in this instance). In the case of the draft guidance relating to Principle 9, the FSA's statement of an example of good practice ("that at least two-thirds of bonus should

be deferred") is highly prescriptive and, in our view, more akin to a "rule by a different name" than guidance. Whether such a statement is framed as guidance or not, it is clearly too specific and fact-dependent to be applied to all types of businesses and firms which are concerned with the Code. We believe it would be preferable to proceed on the basis of a single rule of the kind proposed, supported by higher-level guidance incorporating some or most of the Commission's recommendation and the amendments to the CRD which are agreed in Europe. Importantly, the Code should also contain clear provisions indicating that its application to firms in practice will depend on a variety of factors (on which we comment further in section 4 below).

(iv) The scope of the Commission's recommendation is limited to the remuneration of those categories of staff whose professional activities have a material impact on the risk profile of a financial undertaking. This limitation of scope is absent from FSA's proposals. It seems counter-intuitive that firms might be required to apply the Principles to advisory and administrative personnel in the same way as they would to proprietary traders. Accordingly, we would hope that the Commission's approach is adopted by FSA when it implements the recommendation.

(v) In relation to Principle 3, we think that firms are likely to have difficulty in deciding how they should design and measure "performance metrics" for control functions. It would be useful, in our view, to adopt the Commission's wording on the subject (section 6.6 of the recommendation).

Question 5: Do you agree with our proposal to make the general requirement into a rule and the specific principles into evidential provisions, so that the Code becomes enforceable?

We are very concerned by the proposal that a single, high-level rule (which as drafted, is itself akin to a general statement of principle) should be linked to ten prescriptive, evidential provisions. FSA has said that the Principles will be made as evidential provisions in order to make the Code "enforceable". However, FSA has evidently concluded that it would be inappropriate, by virtue of their content, for the Principles to be cast as rules, contravention of which will give rise to disciplinary and other consequences (section 149(1) and (3) FSMA). Given this, we think that it is inappropriate that the Principles should be made as evidential provisions for the following reasons:

(i) if it is not appropriate for the Principles to give rise to the direct consequences mentioned in section 149(1), it seems illogical in this context for FSA to conclude that it is nonetheless appropriate that they should include the provision mentioned in section 149(2), given the specific and prescriptive nature of the Principles;

(ii) in addition, section 149 envisages the enactment of rules, which provide that contravention of the rule does not give rise to any of the consequences provided for by other provisions of this Act, and notes that for this provision to apply (i.e. to have the effect envisaged in section 149) the rule must also provide that either:

  (a) contravention may be relied on as tending to establish contravention of such other rule as may be specified; or

  (b) compliance may be relied on as tending to establish compliance with such other rule as may be specified.

Here the proposed SYSC 19.3.21R purports to provide both consequences to each of the evidential provisions. Yet section 149(3) is clearly expressed in the alternative. The statute does not contemplate that a single evidential provision should have both consequences. If compliance with the principle tends to establish compliance with the rule, and contravention of the principle tends to establish breach of the rule, the effect of the principle is that of a rule rather than an evidential provision;

(iii) for the reasons set out in (i) above and this paragraph, we do not consider that, when it made section 149, Parliament can be taken to have intended that evidential provisions should be used in this way. The rule itself is a high-level principle, while the "evidential provisions" which purport to be related to it add a succession of requirements which, in a number of cases, cannot be deduced from the rule itself and which are written as if they were separate and distinct rules. In reality, firms will read these provisions separately from the related rule, because they have substance which is not reflected in that rule and because FSA's statements, and the presentation of the Principles, make it clear that firms are intended to comply with the Principles as if they stood alone;

(iv) in our view, the use of evidential provisions in the manner proposed is not compatible with the FSA's stated regulatory approach. FSA says that "… the Code would be implemented in a principles–and risk-based way. We recognise that not every principle would apply in the same way to every firm….". As drafted, the ten evidential provisions make no such distinction. Further, even if they were all to be re-drafted to reflect the differentiated approach that FSA favours, we believe that the resulting provisions would not look like evidential provisions of the kind contemplated in section 149 (2), because the provisions will have to admit (expressly or by implication) that different approaches may be permissible, and that different firms may choose to comply in different ways depending upon their size, the nature of their businesses and other relevant factors. The Principles would not be in the true nature of evidential provisions, and therefore should not be labelled as such.

Consultation Questions 6-8 (inclusive): no further comments.

Consultation Question 9: Do you have any comments on our proposals for the implementation of the Code and transitional issues?

As noted in section 2 of this letter, we strongly believe that the proposed transitional provisions are inadequate and fail to take proper account of firms' contractual and other legal obligations.

Consultation questions 10-12: we have no specific comments.

4. **DISCUSSION QUESTIONS**

For the ease of reference, we will respond to these questions at the same time as the consultation questions.

Discussion question 13: no comment.

Discussion questions 14 and 15: do you think that the scope of the Code should be extended to all FSA-authorised firms?

As noted above, on the assumption that the Code would only apply to large banks and broker dealers, our view is that the structure, and the level of detail and prescription, in the draft Code is inappropriate. We hold this view more strongly still in relation to other authorised firms. The Principles do not, as drafted, provide for the differentiated, proportionate approach that FSA seeks. Further, there is much in the Code that is either of limited relevance to medium-sized or smaller firms or which could easily be enforced through existing SYSC rules and a smaller amount of suitable guidance. There is little doubt, in our view, that applying the Code in its current form to such firms will result in substantial, incremental costs for most firms (without material regulatory benefits being gained) and in such firms facing unnecessary contractual and other legal risks as a result.

There is a contrast, in this regard, with the Commission's recommendation, which recognises explicitly in its preamble that the general principles set out therein "may be of more relevance to certain categories of financial undertakings than others", and that "the remuneration policy of a particular financial undertaking should also be linked to the size of the financial undertaking concerned, as well as the nature and complexity of its activities". These principles are reflected in the recommendation itself. Further, the scope of the recommendation is sensibly limited to the remuneration of those categories of staff whose professional activities have a material impact on the risk profile of the financial undertaking (this concept is far less explicit in FSA's draft Code). This approach is echoed by the Commission's draft amendments to the CRD, which also take a differentiated approach as far as credit institutions and investment firms are concerned. We would favour an overall approach under which high-level principles, of the kind proposed by the Commission and the FSF, would apply to credit institutions, investment firms and (probably) insurers. Preferably, this would be achieved, in the main, through FSA guidance, subject to the UK's obligation to transpose amendments to the CRD effectively. This would provide for the proportionate and differentiated approach taken in the Commission's documents. Additional guidance may also be provided to the effect that other firms may wish to apply its provisions on a proportionate basis, depending on the factors referred to in the Commission's recommendation. We would, however, certainly not favour an approach under which any firm is advised that it **"should"** comply with Principles of the kind appearing in the draft Code or in the Commission's document (which was the approach taken to the application of certain SYSC rules to non-MiFID firms), irrespective of the firm's "size, internal organisation and the nature and scope of [its] activities" (being relevant factors set out in the draft CRD amendments).

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We would welcome further dialogue with FSA in connection with the Paper and, specifically, the matters raised above.

Yours sincerely

Margaret Chamberlain
Chair CLLS Regulatory Law Committee

Members of the CLLS Regulatory Law Committee:

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