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Dear Sirs,

Consultation Paper on Guidelines on Remuneration Policies and Practices (CP42)

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 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 CP42 and appreciates CEBS' endeavour both to include a full consultation process within the tight timescales set by CRD3 and to provide for a proportionate application by CAD3. We have already made extensive comments to the UK Financial Services Authority ("**FSA**") on its own proposals for implementation of the remuneration requirements of the Capital Requirements Directive. We set out in the attached Annex particular comments, which echo some of those we have already made to the FSA, and which are relevant to particular aspects of CP42. We have sent a courtesy copy of this letter to the FSA for the sake of completeness.

As a general principle, we welcome the recognition by CEBS of the importance of proportionality and in particular its recognition that the application of proportionality may lead to the complete neutralisation of some requirements. The new remuneration requirements affect not only smaller credit institutions but a huge range of investment firms, which will vary considerably both in their size and the nature of their business. It will be essential that supervisors recognise the importance of a consistent application of the

proportionality principle, if they do not, then the burden and anti-competitive effect of the proposals will be significant.

We also welcome the recognition that the proposals extend, in a group context, to an EEA consolidation group. We have, however, further comments in relation to group issues which we set out in the Annex.

The final general point that we would emphasise, which we expand on in the Annex, is the importance of recognition that the range of firms caught by the proposals means that owner managed firms will be caught as well as larger institutions with public or a wide range of shareholders. The payment of dividends/profit shares to owners in such situations is not an avoidance mechanism to avoid the application of remuneration rules. It is a natural consequence of a return paid to the investor/founder of the firm. Whether or not any part or all of such payments should be treated as remuneration will be a factual question to be determined in the particular circumstances.

As a final comment, we note with some concern the reference to carried interest schemes having the potential to be an avoidance mechanism. Carried interest arrangements are a well established form of arrangement, particularly in the context of private equity fund managers, and are generally required by investors to ensure that there is alignment between the interests of the persons managing the fund and the investors. When used properly they are the exact opposite of an avoidance mechanism.

We would be happy to discuss any of our comments with you. Please contact Margaret Chamberlain on +44 (0)20 7295 3233 or by e-mail at: margaret.chamberlain@traverssmith.com.

Yours faithfully

Pp.

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Schedule
Specific Responses to CEBS Guidance

Which Remuneration? (1.1.1)

There is a basic problem in discussing remuneration principles and structures, 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.

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.

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.

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).

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 return on equity/investment (including the investment which originally arose out of their past work) as if it was all simple remuneration.

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 as a matter of employment law count as fixed remuneration.

Guaranteed variable remuneration (3.2.1)

There seems to be a degree of confusion in the rules and guidance over guaranteed variable remuneration and in particular 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. We would welcome further clarity on this point.

The relevant rules identified in paragraph 3.2.1 of the consultation paper expressly state that guaranteed variable remuneration can be granted on an exceptional basis in the context of hiring new 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.

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 (4.1.2)

We have noted below 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 and owner managed private companies. 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. We noted in our response to the FSA that variable remuneration may be justified in some such situations, even if losses are being made. We would welcome CEBS' recognition of this and also to recognise in its guidance 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.

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?

Non-cash instruments (4.4.2)

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.

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.

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 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.

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 proposed new remuneration rules and would certainly impose burdens on the unlisted company which would not be suffered by a listed company.

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.

Where the relevant staff and the shareholders/members/partners are, in whole or in part, the same people, issuing new equity or quasi-equity interests to relevant 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?

As noted below 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.

We note that the FSA has, in its consultation paper (at paragraphs 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. We agree with that interpretation and trust that CEBS will consider revising its stance in section 4.4.2 c. of its draft guidance.

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 certain 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 in the implementation of CRD3 that there should be both consistency of approach and sufficient flexibility and proportionality to allow for different structures and satisfying investor requirements.

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.

However, certain other 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 such firms 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 CEBS were to disagree.

Deferral (4.4.1)

We note and generally agree with the (CRD 3 concept) "malus" or reduction of unvested deferred remuneration approach, rather than clawback of amounts actually paid, as the main technique of ex post risk adjustment. The clawback of sums already paid will clearly have major practical difficulties.

In some asset management firms, 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 CEBS 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.

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 relevant 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.

1.2 Proportionality

Proportionality in General (1.2.1)

We welcome the recognition that the application of the proportionality principle may lead to the complete neutralisation of some requirements. In this regard 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."

We welcome CEBS taking full account of these recitals and the general need for proportionality in its guidance. For example, we agree that only significant firms should be obliged to have a remuneration committee. 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 any specific rule requirements.

Proportionality among institutions (1.2.2)

In terms of whether metrics and thresholds are appropriate to determine how different firms can apply the specific rules of proportionality, 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.

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; and

d) unlisted companies.

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.

We would recommend using existing classifications relating to systemic risk as far as possible when determining the proportionality of application of remuneration rules. Foe example, using the FSA's terminology, there might 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 FSA's 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 FSA's 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 proposed new remuneration code.

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 numbers of employees and activities and the transactions undertaken/assets under management.

Proportionality among categories of staff (1.2.3)

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.

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 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.

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.

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 new remuneration rules:

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.

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 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 not likely 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.

Group Context (1.3)

Relevant 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 regulated 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/regulated firm.

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.

The jurisdictional impact, particularly in the context of multinational groups is less clear. This issue has a particular relevance to the competitiveness of European firms outside Europe. Why would a firm choose a European headquarters if, say, its Asian offices have to comply with the European driven remuneration rules? Some of our members have already seen evidence of this effect.

We should note that, quite apart from the competitive impact on groups headed by a European 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 new remuneration rules 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.

A further question relates to the treatment of regulated 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.