



MM & K Limited
1 Bengal Court
Birchin Lane
London
EC3V 9DD

PRIVATE & CONFIDENTIAL

8 October 2010

Tel: + 44 (0)20 7283 7200

Fax: + 44 (0)20 7283 4119

www.mm-k.com

Lindsey Dawkes
Remuneration Team
The Financial Services Authority
25 The North Colonnade
Canary Wharf
London
E14 5HS

Dear Lindsey,

FSA CP10/19: Revising the Remuneration Code – MM&K Response

MM&K are strategic pay and reward consultants. We have made an input to the British Venture Capital Association (BVCA) response, which included data we prepared for the BVCA on remuneration practices in the private equity and venture capital firms. We support the points made in the BVCA response to FSA CP10/19.

In respect of **other financial services firms** we would comment as follows:

1. Before issuing the remuneration rules contained in PS09/15 last year last year, the FSA carried out a full consultation. As a result of that consultation a number of rather prescriptive rules about remuneration structure in the draft code CP09/10 were relegated to the status of guidance rather than evidential provisions. We felt the FSA had listened carefully to the responses, and we welcomed the use of guidance (for such items as the proportion of variable pay to be deferred, the period of deferment and the requirement to defer into shares) as it is in the spirit of 'comply or explain'. This was a constructive approach which allowed firms to adapt the rules to the very varied range of businesses within the financial services industry.
2. The FSB Principles and Implementation Standards and CRD3 are more prescriptive, and CRD3 particularly seems driven by a political requirement. Also the number and range of firms now covered by the rules is excessive and this degree of regulation of financial services industry remuneration does not service a useful purpose. The UK Financial Services Act (2010) reinforces the FSB standards. The FSA has had no choice but to restate much of its guidance as rules and to extend the coverage of the code.
3. Fortunately the rule relating to proportionality provides a let out, and we welcome the imaginative way that the FSA has used this rule in its *proposed approach to proportionality*. This will at least allow most companies to minimise the time they spend on what they will only see as a compliance exercise rather than a contribution to effective management of risk and talent.
4. In respect of your specific questions in the Consultation Paper we would comment as follows:

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

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

We believe the application to firms is too broad. We have no further comment.

Q3: Do you have any comments on how the proposals contained in this CP affect equality and diversity issues? – No

Q4: Do you agree with our proposals for changes to the Remuneration Principles 1 to 11?
We are in agreement generally with these changes.

We think Principle 8 should not be interpreted too prescriptively. Companies are different, as are different business units within them. Please see comments below on Questions 5 & 6.

We agree with Principle 10 and 11, but suggest you should add further provisions to Principle 11 to cover where employees receive 'soft loans' from 'associated' parties on better than arms length commercial terms.

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

We think the now prescriptive nature of the rules is unfortunate. However, this is potentially mitigated by the proportionality approach and the de minimis concession. We have some comments on aspects of this approach:

Fixed/variable balance.

The FSA has chosen to wait for the work on this by the CEBS. When the FSA comes to shape its guidance, we think the word 'appropriate' will require some careful definition, with consideration of what the total package is expected to achieve besides alignment with risk. The balance or fixed to variable does not stand alone, absolute values are also important. An individual could have a package with £250k salary and £1m bonus without it being over-gearred. Yet a package of £50k salary and £150k bonus could prove to be over-gearred. (In practice over-gearing is unlikely to apply to any Code Staff given their levels of salary.)

Deferral

Paragraph 3.81 refers to 'shares... of the firm'. We think that the new rule is drafted too tightly. We think that for many individuals their incentive remuneration should be linked to the long term success of the business unit in which they are predominately involved. This may require remuneration to be linked to the share price of a subsidiary company, via a phantom share incentive plan or other long term measures.

Similarly with respect to Paragraph 4.54 We do not think that the 50% requirement of deferred variable remuneration should have to be in shares or non-cash instruments. The alternative of payment in cash should be permitted.

We would point out that the largest financial services companies already comply for group directors, and this is not onerous. It is the smaller firms, and subsidiary divisions of large firms that will find this rule either difficult to comply with, or irrelevant to the way their people need to think about risk and performance.

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

We think the approach is constructive and helpful, and goes a long way to reducing the inevitable bureaucracy that will arise from the new rules. We have some specific comments:

Table 1, Principle 8: Some clarity is required about the intention of Malus. The wording here requires that deferred amounts are subsequently withheld (or clawed back) if the performance of the *firm* is subsequently poor. Other parts of the code require that they are clawed back if the performance that led to the deferred bonus is

later found to have been overstated. Add to this the requirement to defer into shares that can drop in value, and there is a danger of killing any motivational effect of incentives. We think that Malus should be limited to overstated performance.

Table 1, Principle 12 (2): we have given above our view that there is an absolute level of remuneration aspect to allowing the operation of a fully flexible policy. We consider that fixed remuneration of £250k, which is 10 times median earnings in the UK, is sufficient for this purpose, and paying amount above this in genuinely variable amounts is in everyone's interest.

Table 2, Principle 4 (1): The FSA propose to issue guidance on which firms the different rules apply to. This will be essential, and the sooner this is drafted the better, as firms are already unsure how to prepare.

Table 2, Principle 8 (2): We found the wording 'allocation of variable remuneration components' difficult to understand. We think it means the 'allocation of bonus pools (and similar) to teams and individuals'. If this is correct our wording may be preferable.

Table 3, General. This useful table is described as providing a 'comply or explain' approach. Some more explanation of its intention will be needed when the guidance is issued about which rules apply to what firms. Most of the items in the table indicate exception, and firms would merely have to demonstrate they were an exception on size and complexity rather than 'explain' non-compliance.

Table 3, Principle 12:

Guarantees. It is unclear what a guarantee pushing the individual above the specified leverage means. Presumably that the fixed bonus shall be treated as variable for the purpose of the 25% rule – this could be clarified.

Severance. 'Reward for failure' We do not agree that this is only likely to be relevant in large firms.

Share-based awards. Proportionality should also reflect the nature of ownership. The aim of deferral into shares seems now to be to link the individual's fortunes to the value of the capital base of the firm. Is this always relevant?

Deferral. We think the words 'deferral over a period' are slightly confusing. The context (and application by the group of 26) seems to indicate that this means the award vests over the period, not at the end of the period. A change of wording would clarify this.

Performance adjustment. Again there is the requirement that variable remuneration, *including a deferred portion* is paid or vests only if it is sustainable according to the financial situation of the firm as a whole, and justified according to the performance of the firm, business unit and individual. We have commented that this has the danger of killing any motivation. But once again firms need to be able to argue what is appropriate for the circumstances of particular business units. The FSA distinction between sustainability and justification is helpful in this. At the moment the rules seems to be requiring firms to meet all of the following objectives for all Code Staff:

Justifiability

- Reflect long business cycles in incentive measures and payouts
- Be able to claw back bonuses if eventual cash returns do not match booked profits
- Remove the asymmetry in bonuses by effectively paying negative bonuses in times of poor performance.

Sustainability

- Only pay out when the firm as a whole is doing well
- Link pay to the long term success of the firm as a whole.

We don't think you can have all of these without seriously damaging the performance of the firm at the same time because of a failure to meet the other objectives of recruitment, retention and motivation/incentivisation of staff.

Q7: Which metrics and thresholds do you believe are appropriate to determine how different firms can apply the specific rules of proportionality?

The views of different industry segments are most relevant here. We support the BVCA response.

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

We support your overall approach. However individual companies will need to report to the FSA in different ways in how they deal with this highly complex subject. Again we think it is important that the FSA handles this in a proportionate way, particularly for those companies that choose to explain their approach rather than comply 100% with the FSA code.

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

The proposed arrangements will apply the new code to remuneration awarded for services provided in 2010 but which is not paid until after 1 January 2011. This is effectively retrospective legislation. Requiring deferral, deferral into shares and clawback for amounts that people have already earned appears to us to be an additional punitive measure, like bonus tax, for which there can be, in many cases, no justification in either the actions of firms or their senior employees.

We think this application should not apply."

Finally, on some points of language, we noticed that in places CP10/19 refers to 'deferment' and in others to 'deferral'. Nowadays either is acceptable, but we should all stick to one. And on a light-hearted note, 'bonus' in Latin is an adjective – the noun is 'bonum'. By useage, bonus is now a noun. Similarly 'malus' is an adjective, and the Latin noun is 'malum'. Unfortunately in this case, the Latin noun 'malus' means an 'apple tree'. Perhaps its new application in remuneration is appropriate, carrying as it does an allusion to the instrument by which Paradise was lost!.

Yours sincerely,

Cliff Weight
Damien Knight