

Legg Mason Investments (Europe) Limited

Pillar 3 Disclosure

Background

The Capital Requirements Directive, enacted by the European Union in 2006 created a new framework for the management of regulatory capital. It has been implemented by the FSA in the UK through its General Prudential Sourcebook and the Prudential Sourcebook for Banks, Building Societies and Investment Firms.

The Framework consists of three 'pillars':

Pillar 1: The minimum capital requirements that the firms must meet using set criteria.

Pillar 2: Requires firms to assess the level of capital to be held given the specific risks it faces.

Pillar 3: Requires firms to publicly disclose information about its key risks, risk management and its capital resources.

Risk Management

Legg Mason Investments (Europe) Limited ("the Company") is committed to managing its affairs in accordance with and in a manner consistent with the risk management standards as set forth by the FSA. Accordingly the Company has adopted a Risk Policy to document its Risk Control Framework that is used to identify, assess, measure, manage, monitor, mitigate and report on its risks.

The Board of the Company is responsible for setting Risk Policy and Risk Appetite for the Company. The Board's ongoing responsibilities then include at least annually:

- high level monitoring of adherence to the Risk Policy and the Risk Appetite;
- approval of the Risk Policy and Risk Appetite;
- approval of the Internal Capital Adequacy Assessment Process ("ICAAP") and resulting capital needs; and
- obtaining independent assurance over the effectiveness of the Risk Management Framework.

The Board of the Company has tasked a set of operating committees with overseeing day to day running of the key areas of the business. This includes overseeing and implementing the risk control framework as it relates to the area of the business. It is the responsibility of the committee members to be familiar with the content of the Risk Policy and to exercise sound judgment to act within the Risk Control Framework set forth in the Policy in their daily work.

The Function Heads who attend the committees are responsible for risk identification for their areas of activity and for assessing the impact, likelihood and overall exposure of each risk. Key risk scenarios based on the high exposure risks are then used for the stress testing carried out to assess possible future capital needs. There is then a continuous process of evaluation and monitoring of the risks.

The Compliance and Risk functions provide for oversight and independent review of risks and controls as well as independent reporting of management information to the committees for review. The committees are responsible for escalation and recommendations to the Board.

The Company's parent company Legg Mason, Inc. has two units that provide independent review of the risks and controls including the Risk Control Framework:

- The Global Compliance Examination Unit conducts reviews to determine if the business has staffing, policies and global controls in place to enable it to meet applicable regulatory and parent company requirements. This will include review of the roles of the Compliance and Risk functions.
- The Internal Audit Unit carries out reviews on the operational effectiveness of internal controls including those for financial reporting and information technology.

Risk Types

The Company's business is the provision of investment management services for its clients. As a consequence there is no exposure to insurance or securitisation risk, nor does it have any pension obligation risk. The Company only has minimal exposure to credit and market risk as noted below. The main exposures are to the business and operational risk.

Credit Risk

The Company's exposure to credit risk is limited to its cash at bank and receivables. The majority of third-party receivables come from the Legg Mason Mutual Fund ranges in Europe, with payments being made monthly. Cash is held in accounts at institutions with investment grade credit ratings.

Market Risk

The Company's exposure to market risk is limited to its foreign exchange exposure related to accounts receivable and payable. The exposure is minimal and mitigated by monthly balance sheet revaluations and projections as well as by currency hedging.

Liquidity Risk

The Company has consistently maintained sufficient liquid resources to meet its obligations. Cash flow and forecasting is performed on a regular basis. Excess cash is held on deposit at institutions with an investment grade credit rating. The Company does not consider this risk to be material as it can call on its parent, Legg Mason, Inc. in the event of a liquidity issue.

Business Risk

The Company operates in a highly competitive industry subject to global economic conditions as well as equity and fixed income market performance. The Company's core business risk is a reduction in assets under management, which results directly in decreased fee income. Whilst this risk is mitigated by the diversified nature of the mutual funds managed, business risk factors are considered in the Company's business planning and decision making, including the modelling of market downturn and employee turnover scenarios.

Operational Risk

The Company does have operational risks, which include those risks or events that could impact people, systems, processes or external events, in such a way as to impact the achievement of the Company's objectives. The Company has in place a risk management framework to limit operational risk to an acceptable level. Insurance cover is also in place in relation to certain risks, should it be required. Risk management activities focus on understanding, monitoring and mitigating business and operational risks to the extent feasible in order to maintain a low risk profile in these areas.

Capital Resources

The Company seeks to ensure that adequate Capital is held to ensure a margin in excess of the minimum capital requirements of the FSA.

For Pillar 1 capital purposes, the Company uses the higher of the fixed overhead requirement or the sum of credit and market risks to calculate its minimum capital level. As the Company is not subject to the traditional exposures for market or credit risk, typically the fixed overhead requirement is the higher value.

Following a review of the various ICAAP scenarios and as a consequence of the robust management actions plus the ability to obtain further capital from its parent company, there is no negative impact on the Company's capital base arising from the stress test scenarios. No additional capital is therefore required under Pillar 2 as senior management believe that capital required under Pillar 1 is sufficient to cover requirements from its material risks. The most recently available audited financial statements are as at 31 March 2011. A summary of the capital resources position is shown in the table below:

| LMI (Europe) Limited 31 March 2011 (£m) | |
|--|-------|
| Ordinary share capital | 4.0 |
| Audited reserves | (7.5) |
| Preference shares | 16.2 |
| Total Tier 1 Capital | 12.7 |
| Total Tier 2 Capital | - |
| Total Capital resources | 12.7 |
| Capital requirement | 6.8 |
| Excess Capital | 5.9 |

No further disclosure relating the Capital resources are considered necessary as they are not material and their omission does not change or influence the assessment of a user relying on these disclosures for the purpose of making economic decisions.

Remuneration Code Disclosures (unaudited)

The Remuneration Code (the Code) was revised to implement the requirements of the third Capital Requirements Directive (CRD3) and came into force on 1 January 2011. The aim of the Code is to ensure that firms have risk-focused remuneration policies, which are consistent with and promote effective risk management and do not expose them to excessive risk.

The Company is within the scope of the Code and falls within Proportionality Tier four. The Board is committed to managing its affairs to comply with the applicable requirements of the Code applicable to Tier four firms.

These disclosures refer to the year ended 31 March 2011.

Code Staff

The Company has 12 Distribution Employees, who are employed in the Company's European branches. Other personnel engaged in the activities of the business are employed by Legg Mason & Co (UK) Ltd, Legg Mason's European shared services entity. When considering the application of the Code to the Company, the Board have considered all Legg Mason personnel employed by the Company and Legg Mason & Co (UK) Ltd and will refer to these employees as Staff.

All Staff are engaged in the Company's principal activity of asset management services, including fund management and distribution, whether as client facing personnel or in support functions such as marketing, legal, finance, compliance etc. Therefore the Company has a single business area.

| Company | Staff | | Remuneration (£'000) | |
|-------------------------------------|-------|-------------------|----------------------|-------------------|
| | Total | Code ¹ | Total ² | Code ³ |
| Legg Mason Investments (Europe) Ltd | 12 | 0 | 996 | 0 |
| Legg Mason & Co (UK) Ltd | 106 | 12 | 13,060 | 1,874 |
| Total | 118 | 12 | 14,056 | 1,874 |

Decision Making Processes

The Company's compensation policies and practices are determined at a Group level, proposed by the global Human Resources function and agreed and adopted by the Executive Committee of the Company's ultimate parent company,

¹ There are no Code Staff who have a material impact on the risk profile of the Company who are not Senior Management.

² Wages, salaries and pension contributions accrued per accounts. The monetary value of benefits are immaterial for these purposes.

³ Remuneration paid to code staff. Note that no bonuses were paid to UK Staff during the year (bonuses were paid to UK Staff in March 2010 and May 2011).

Legg Mason, Inc. The Company's compensation structure and practices are overseen by the Group's Compensation Committee. Further information on the Group Compensation Committee can be found in Legg Mason, Inc's statutory accounts and regulatory filings, which are available at www.leggmason.com.

The compensation practices of the Group and the Company are based on the following core principles:

- Aligning compensation to profitability, risk and capital;
- Recognition of individual performance in line with the Company's corporate Vision & Values;
- Rewarding and retaining the best talent, who deliver services which meet external and internal client objectives;
- Differentiating between individuals according to competencies and levels of responsibility;
- Straightforward compensation design, mindful of equality legislation and non discrimination; and
- Complying with regulatory requirements.

The Company and Group uphold these principles to balance the interests of staff, management and shareholders and also to motivate staff to continue to act in the best interests of the Company, Group and our clients.

The Link between Pay and Performance

All Staff are eligible to participate in the Group discretionary bonus pool. The Group discretionary bonus pool amount is determined by the Executive Committee of Legg Mason, Inc. and approved by the Compensation Committee annually. Following approval of the overall pool size, it is allocated between business units, for those business unit heads to determine further allocations by country, company or individual.

In determining the overall size of the pool, consideration is given to both financial metrics of the Group and market data on compensation within the industry. Whilst a wide range of metrics and data are considered, priority is given to the impact of the overall size of the bonus pool on the following primary metrics:

- Group operating margin
- Group total compensation to revenue ratio

Both of these metrics are profitability based (not revenue based), are disclosed quarterly in the Group's earnings releases and SEC filings and are subject to considerable focus by stakeholders and market analysts. These metrics and the anticipated size of the Group discretionary pool are reviewed by the Executive Committee and communicated to the Compensation Committee at least quarterly.

The nature of the business of the Group as a whole and of the Company means that revenues and profits are typically accounted for in the year in which they are earned, for example performance fees are only recognised when they are earned (they are not accrued prior to being triggered). This means that the Group is able to align compensation in any one year with the revenues of that year. No account is taken of future earnings streams and there is very little risk that revenues recognised in any year might subsequently be clawed-back.

The allocation of the Group discretionary bonus pool between Staff (either at a business, country, company or staff level) does not explicitly take into account the profitability of a particular company or country as the Group is run on a Global basis. Consequently, there may be occasions where bonus pools in a specific country or company cause that company to be loss-making. In these situations, Legg Mason, Inc. arranges for appropriate funding to be provided to that company in full consideration of liquidity and regulatory capital requirements.

Note to readers:

The required Pillar 3 disclosures for the year ended 31 March 2011 were originally made by the Company in its financial Statements for that year. In compliance with the Remuneration Code, additional Remuneration Code disclosures have now been included and these expanded Pillar 3 disclosures for the year ended 31 March 2011 are published on the Company's website. For the year ended 31 March 2012 onwards, all Pillar 3 disclosures will be made in the Company's financial statements.