Commentary: The U.K. Remuneration Reform

By Stephen J Nelson; The Nelson Law Firm, LLC

Originally Published in *Traders Magazine* on September 15, 2009

http://www.tradersmagazine.com/news/fsa-sec-compensation-financial-stability-board-104372-1.html

In mid-August, the Financial Services Authority (FSA) in London released its final rules regarding compensation practices by the financial services firms it regulates. The rules must be implemented by January 1, 2010.

The final rules followed a "consultation" on earlier proposals, much like the SEC's "notice and comment" procedures, which were discussed in our earlier article published on March 17, 2009, entitled "Compensation in the New Regulatory Environment." (**http://www.tradersmagazine.com/news/103535-1.html**) As expected, the proposal received extensive comments, including some strident criticism from financial services firms. As a result, the final rules were watered down a bit. The rules now exempt smaller firms, and the compensation rules generally apply only to senior executives and managers who are important to the firm's business.

Many of the firms "consulted" on the proposed rules objected that they would cripple efforts by UK firms to attract the best talent, ultimately degrading Britain's ability to compete in the global market for financial services. As a result, three of the proposed rules were watered down to the level of "guidance," as compared to prescriptive rules. The first of these rules would have required base salaries to be large enough that it would be possible to pay zero bonuses from time to time. When base salaries are a small part of compensation, it is really not practical to withhold bonuses altogether. The second rule would have required large bonuses, in relation to base, to be paid over time. The third would have allowed the deferred portion of compensation to be "recaptured" in the event that the performance of the employee's business unit or the firm turned out to be disappointing in future periods.

Nonetheless, the FSA argued that sufficient progress had been made in the adoption of compensation regulation by the UK's international competitors to warrant making the remaining rules binding. An entire chapter of the FSA's release was devoted to describing these international developments.

At the April 2, 2009, G-20 summit meeting in London, a Financial Stability Board (FSB) was instituted that includes regulators from all of the G-20 nations, including representatives of the Federal Reserve Board, the SEC and the Treasury. The FSB is promoting a set of "Principles for Sound Compensation Practices," which was produced by its predecessor, the Financial Stability Forum (FSF), and released for publication at the April 2 summit. About two weeks ago, the G-20 nations agreed to adopt and implement these Principles.

As might be expected, the FSB's compensation principles consist primarily of broad generalizations, rather than specific proposals. Compensation is to be aligned with "prudent risk taking." Compensation committees should be independent, have risk expertise and responsibility for monitoring the success of compensation risk alignment policies. Compensation should be adjusted for all risks, including the hard to measure liquidity, reputation and cost of capital risks. It should be possible to reduce bonuses to zero in the event of poor performance. The payment of compensation should align with the "time horizon" of risks and deferred accordingly.

On July 13, 2009, the European Commission published proposed rules that would amend the Capital Requirements Directive and apply to most financial services firms operating within the European Union. This proposal generally conforms to the FSB's Principles. So, the Commission proposes that compensation committees should review compensation regularly, but does not address the risk expertise of the committee. Compensation should be adjusted for risks. And, most bonuses should be deferred to align with the time horizon of risks.

Last week, the Netherlands announced that it had adopted the Principles into legislation. Australia, France and Switzerland have also announced plans to adopt the Principles sometime this year.

Finally, on June 10, 2009, the US Treasury announced that the Fed was working on rules to implement the Principles. So far, these rules have not been proposed, and we still haven't heard anything official from the SEC.

I think it is safe to predict that the compensation rules proposed by the Fed and the SEC will look very much like the FSA's final rules. The notion that compensation should align with risks is not a new idea, and by itself, wouldn't have much impact. But, there are two elements of the FSA's proposals that strike me as game changers, and a complementary rule that will, as a practical matter, impose compensation limits.

First, the FSA's rules would increase the responsibility and power of compensation committees. We have already seen something like this proposed by the SEC to deal with executive compensation at public companies. I would expect the reach and power of these committees to be much greater at financial services firms.

Second, the FSA would not back down from its proposal to interject the views of compliance into the compensation paid to front office employees. And, investment bankers and other producers will no longer have anything to say about the salaries of compliance professionals. My guess is that this will be accomplished in practice by giving compliance professionals access to compensation committees and walling the compliance department off from the influence of producers.

In my experience, compliance professionals generally believe they are underpaid and investment bankers and traders are overpaid. Allowing compliance to express views about the value of bankers and traders will likely exert a drag on compensation.

Moreover, the high producers in our industry are known for viewing compliance much the way drivers in Italy are reported to feel about traffic laws; a fine thing in principle, but not of much value in practice. If new compensation rules have the bite that is hoped by the various international regulators participating in this process, the heavy hitter may go the way of the dinosaur.

The complementary rule would limit the percentage of compensation that could be paid as bonuses, as compared to base compensation. We have all seen traders that receive $10,000,000 annually with a base salary of $150,000. If the rule requires firms to cut the bonus to zero in bad years, it will take a lot larger base to keep these traders in place.

But, we also know that firms are not going to pay base salaries of $10,000,000. The base salaries that have attracted so much attention in the press have been in the high six figures. Larger bases will be perceived as obscene. Inevitably, total compensation will decline for the big producers.

Compensation structures, more than anything else, influence the behavior of employees. The financial services industry, and particularly investment banking, has attracted driven, creative, innovative and dynamic employees because the potential rewards were so great. It was not always so. There was a time when this sort of employee built railroads or steel mills.

If the rewards diminish, some will hang around for lack of anything better to do. But, over time, there will be a drain from the financial services industry into other areas that better reward creative potential.

Critics of these regulatory changes have correctly pointed out that the financial services industry will have difficulty attracting the same caliber of employee that it did in the past. But, they haven't done a very good job of explaining why this is a bad thing. Whether or not this is good or bad for the country as a whole, or for that matter the global economy, depends on where all of this creative energy ends up being employed.

* * * * * * *