Commentary: Why We Should Care About European Curbs on Compensation

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On Wednesday, July 7, 2010, the European Parliament approved an amended series of rules to restrict compensation for employees of financial institutions. The European Council, effectively the legislative upper house, has agreed to approve the Parliamentary version on July 13, 2010.

Under European rules, legislation originates with the European Commission. The European Parliament, the only elected body for the European Union, and the European Council, can only react to legislation that has been drafted by the Commission. In this case, Parliament thought the Compensation Directive proposed by the European Commission was "only a cautious first step." So, Parliament made substantial amendments to the European Commission's draft, resulting in a much more specific and restrictive regime.

The Compensation Directive consists of amendments to the Banking Consolidation and Capital Adequacy Directives. Strictly speaking, it therefore applies to institutions that are regulated under the Markets in Financial Instruments Directive (MiFID) and required to maintain capital, which includes banks and other credit institutions, as well as most hedge funds. While private equity and real estate managers are not affected by the Compensation Directive, these other fund managers that have escaped compensation restrictions for now will be subjected to a similar regime when the Alternative Investment Fund Managers Directive is adopted as expected later this year.

The financial press has focused on provisions that enable national authorities some discretion to relax the compensation restrictions for local firms. It has been argued that this should relieve the panic the Compensation Directive has caused within the community of hedge fund managers.

I believe the magnitude of this relief has been overstated. National authorities are permitted to grant relief where necessary to satisfy the principle of "proportionality." The idea is to avoid hardship to smaller, local firms, while maintaining the essential principles embodied in the Compensation Directive. However, the European Parliament expressed great concern about the need to avoid "regulatory arbitrage" within Europe. Any relief that would induce a firm to relocate from Paris to London, for example, to take advantage of beneficial local

rules, would fail this test. The European Banking Authority (EBA), which is soon to be established, has been charged with a duty to make sure the Compensation Directive is applied uniformly throughout the European Union.

The Compensation Directive's provisions generally will apply to employment contracts entered into after January 1, 2011. However, to avoid firms creating contracts before the end of the year that are intended to escape the restrictions, the rules will apply to any compensation earned after the first of next year, even under pre-existing contracts, or compensation earned prior to January 1, 2011 that has not yet been paid to the employee. I would expect a big rush to pay bonuses in December, rather than waiting until January or February, when they will be caught by the new rules.

The Compensation Directive does not limit the amount of compensation that can be paid directly. Instead, its goal is to restrict compensation schemes that encourage undue risk-taking. So, "variable compensation" cannot be greater than 50% of total annual compensation. Between 40 to 60% of a bonus must be deferred for at least three years, and it must be recoverable by the firm if investments do not perform as expected. At least 50% of the bonus is to be paid as "contingent capital," which means that if an institution fails, other creditors would be paid first.

In addition to the specific limitations imposed by the Compensation Directive, a number of principles are to be imposed by national regulators under the watchful eye of the EBA. My personal favorite is the principle of "social justice" that there should not be too large a gap between the compensation of the most highly paid and the lowest paid in any firm. I am old enough to recall a time when it was considered shocking in these United States for a CEO to receive compensation greater than 25 times the compensation of the average employee. In 2005, the average CEO's compensation in major companies was more than 260 times that of the average worker. To say the least, things have changed considerably, and it will be interesting to observe how social justice is applied under the Compensation Directive.

Finally, in a non-binding resolution, the European Parliament called on the European Commission to extend the reach of the Compensation Directive to all companies listed on stock exchanges.

Investment bankers, traders and hedge fund managers, all of whom are accustomed to generous compensation packages, typically with a munificent bonus component, may wonder why they should care about the European Compensation Directive. This is, after all, America.

In the first place, the Compensation Directive will apply by its terms to subsidiaries of any European financial institution. US employees of Societe Generale, Deutsche Bank and BNP Paribas are therefore caught within its grasp. My advice is to enjoy it while you can.

More worrying, the European Parliament made much out of their reliance on the pronouncements of the Financial Stability Board, a wing of the G-20. The inference is that the members of the G-20, including the United States, have agreed to impose similar requirements. As we have noted in prior articles, the public statements made by the G-20 tend to lack the details imposed by legislation like the Compensation Directive. It is nonetheless worth noting that many of the details hinted at by other European pronouncements showed up in the Conference Report for the "Dodd-Frank Wall Street Reform and Consumer Protection Act."

Some have argued, particularly in London, that the effect of the Compensation Directive will be to drive hedge funds, and any other institution that can relocate, into jurisdictions, especially the United States, that lack similar restrictions. Similarly, financial institutions in the United States have argued that compensation restrictions would result in a talent drain from important investment banks. The Compensation Directive suggests that any compensation restrictions adopted in the United States will not cause a talent drain to European financial institutions.

I believe that traders and other industry participants severely underestimate the extent of public rage over the recent financial crisis. I hear from many influential quarters the notion that a talent drain from financial services wouldn't be such a terrible thing if it meant that smart people were forced to spend their time solving the energy crisis or curing cancer, rather than managing hedge funds. And, the European Parliament was convinced that the primary effect of bankers fleeing to the United States would be that the US taxpayer bears the privilege of bailing them out. I don't think that irony will be lost on politicians from either party. For these reasons, it may very well be that the United States and other G-20 members will adopt compensation restrictions that mirror the Compensation Directive to prevent financial services talent from flowing to their shores, in what would be a perverse form of immigration reform.

The implementation of the Compensation Directive will have an immediate impact on the way things are done in Europe, as well as traders in the United States that work in subsidiaries of European institutions. If, as I expect, something like it is adopted in the United States and elsewhere throughout the G-20, the financial services industry will be radically changed from the one to which we have grown accustomed. I can only hope that the world is a better place to live in as a result.

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