Compensation in the New Regulatory Environment

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The Financial Services Authority (FSA), the UK's equivalent to the SEC, published a draft of its proposed Code of Practice on Remuneration Policies on February 26, 2009. There have been strident calls by elected officials to regulate compensation policies at financial services firms in the United States. Since US regulators tend to share ideas with their British counterparts, the FSA's proposals are a harbinger of things to come for traders in the States.

Traders generally expect to receive part of the profits from their trading book. There are many variations on this theme. Traders and firms haggle over how much operational overhead will be deducted from profits; the trading book is often charged for the use of certain services, such as Bloomberg. Institutional sales-traders expect to receive compensation from orders they bring to the desk. Sometimes that means a part of the trading profits. Other firms compensate sales traders on revenues. Either way, the traders have to share with the sales desk. More conservative firms require profits to be realized before they are used for compensation; others mark to market unrealized profits.

Larger firms tend to pay traders the way they do investment bankers. During the year, a small base salary is paid. At year-end, traders are paid a large bonus that is typically many multiples of their base. The bonus is often derived from a pool based largely on the profits earned by the desk, with some minor components reflecting department and firm profitability. The head trader generally decides how the goodies will be divided among traders on the desk.

These compensation policies reflect practical realities at most firms. Profits are volatile within trading and investment banking enterprises. Moreover, most firms are a collection of divisible business enterprises. It is relatively easy, in most cases, to determine which operations are making money, as compared to those that are charity cases. Even in these hard times, some trading desks within the industry are making money, in some cases, a lot of money. Paying traders a piece of the action, rather than being committed to a large base salary, permits firms to scale down their compensation expense during difficult market conditions without laying people off or knocking down salaries, which has a negative effect on morale. Finally, paying traders part of the profits earned on their book provides an incentive for them to treat the business as their own.

Similarly, investment bankers expect to receive munificent rewards reflecting deals for which they are responsible. Sometimes, the transactions are enormous, rewarding investment bankers with riches beyond all visions of avarice. Other times, the pickings are slim. As with traders at large firms, investment bankers receive a small base salary. If the transactions are enormous, so is the bonus. In lean years, the third house in Aspen hits the market, and the girlfriend hocks the jewels.

As might be expected, the FSA would do away with the practice of paying small base salaries and large bonuses. Bonuses would be a relatively small percentage of the base. Bonuses based on performance would be based on actual profits, not revenues, and reflect firm-wide profits, rather than the profits earned by a desk. And, they would be deferred, so that actual payments reflect several years of good performance, rather than one. Finally, bonus payments would significantly reflect non-financial performance, including the trader's adherence to risk-management and compliance policies.

People are far and away the largest expense for firms within the securities industry. The FSA's proposals therefore reach into the heart of the investment banking and trading industries, threatening to change it in ways that would render it unrecognizable to current employees. The operations professionals within firms, dubbed the "back office," more or less fit the FSA's model. One way to think about the FSA's proposals is that they would transform the industry into one vast back office.

The FSA takes pains to emphasize that its proposals are not intended to limit the amount of compensation that can be paid to anyone. Fact is, the natural volatility of the business will limit compensation without the need for further regulation. Very few trading firms, or investment banks, would be willing to commit to a large base salary that is anywhere close to the compensation many traders and investment bankers expect to receive in good years.

The industry's compensation practices were just dandy until the US taxpayer was asked to subsidize the process. To say the least, it has been difficult to justify paying large compensation, whether as bonuses or profit shares, to traders of a firm that has received a huge bailout from the federal government. The tax paying worker on an assembly line who thinks she has died and gone to heaven when she receives a $4,000 year-end bonus on top of a $40,000 base salary will never in a lifetime understand why her tax dollars are going to support the life style of a trader earning $4 million plus.

Industry executives have been arguing that compensation proposals along the lines recommended by the FSA will result in a talent drain from the industry. This is, of

course, basic economics. Talented people leaving business school will be drawn to enterprises outside of financial services if the pay and prospects are better.

Taxpayer subsidies are a powerful counterargument that the industry is undeserving of the best and brightest. The "talent drain" argument is hopelessly irrelevant.

Paying the government back will not fix this. It is now accepted wisdom that the taxpayer will be required to support the financial services industry whenever things go off the rails because of the industry's importance to the economy. Having once accepted a handout, the industry can now expect for a long time to come that the US taxpayer and their elected politicians will have plenty to say about its compensation practices.

It is also a mistake to imagine that compensation regulations will only affect those firms that partook of government largess. The force of public policy argues for no such exceptions. All firms in the industry, great and small, are likely to face the same regime. Since small firms are much more likely to be threatened by volatile earnings than larger, diversified investment banks, the new compensation regime can only hasten the demise of the small firm, already an endangered species.

The FSA's compensation proposals are a fire bell in the night for US traders.

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