FSB FINANCIAL STABILITY BOARD

OICU-IOSCO

FSB-IOSCO Roundtable on Compensation Practices in the Securities Sector

Basel, 13 December 2016

Summary and main takeaways

The Financial Stability Board (FSB) and the International Organization of Securities Commissions (IOSCO) jointly organized a *Roundtable on Compensation Practices in the Securities Sector* on 13 December 2016.

Based on the findings of the FSB Compensation Monitoring Contact Group (CMCG)'s fourth progress report on compensation practices, the FSB agreed in 2015 that the CMCG should discuss, together with IOSCO, compensation practices in the securities sector to gather further information about current practices. As a result, the FSB and IOSCO agreed to conduct a roundtable with the industry to discuss compensation and related governance and risk management issues.

The roundtable, which was designed as a fact-finding exercise, helped to exchange views on similarities and differences in firms' approaches to compensation issues in the securities sector.

Members from the FSB CMCG and the IOSCO Compensation Experts Group (CEG), as well as around 20 senior executives responsible for compensation in internationally active securities firms and banks with securities market activities participated in the roundtable. The industry experts represented some of the major participants in securities market activities including broker dealers affiliated with global systemically important banks and managers of collective investment schemes, including hedge funds and private equity funds.

This summary reflects CMCG and CEG members' understanding of the main points raised during the roundtable discussion which was conducted under the Chatham House rule. It does not necessarily represent the views of authorities nor consensus views expressed by firms in the securities sector and banks' representatives at the roundtable. Given the nature of the roundtable this note does not represent a detailed analysis of compensation practices across the securities sector but rather a record of the points raised at an industry meeting.

Roundtable findings will inform the 2017 FSB progress report on compensation practices, which will be published ahead of the G-20 Leaders' Hamburg Summit in July 2017.

The FSB and IOSCO welcome any feedback on topics discussed at the roundtable and summarised in this note. Comments should be sent to Simonetta Iannotti (simonetta.iannotti@fsb.org) and Alp Eroglu (a.eroglu@iosco.org) by 15 May 2017.

1. Compensation in the Securities Sector – Design and Governance

One of the main objectives of the roundtable was to gather information on the design and governance of compensation practices of firms in the securities sector. To this end, industry participants explained how compensation is determined in their firms.

Industry representatives noted that compensation is driven by differences in business models as well as differences in regulation across jurisdictions. Many firms noted that they try to operate a global compensation policy, however differing regulation between the home and host (where subsidiaries exist) jurisdictions can make this difficult. Generally, firms prefer regulatory regimes that are principles-based as these make it easier to implement their compensation policies more consistently globally. At the same time roundtable participants expressed their concerns that regulation might not consider the diversity of the business models in the securities sector, and there should not be a one size fits all approach.

As general practice, the board determines the compensation policy through a senior level committee. The committee monitors performance on a regular basis (for example, the performance of the funds under management) and it defines a pool of variable compensation (for example, from the asset manager's assets from which portfolio managers are paid based on their performance). Variable compensation is usually a mixture of cash and equity, which is vested over a two-to-five-year period. While the compensation committee defines the pool of variable compensation at the firm level, discretion plays an important role while defining the amount of compensation at the individual level. The variable portion of compensation is fully discretionary and can be clawed back, including in relation to assessed adherence to the firm's stated objectives and values.

Compensation structures vary substantially across types of firms and their business models (e.g., traditional asset managers, hedge funds and private equity firms). By way of example, compensation at private equity funds is vested periodically (mostly annual) or at the end of the fundraising process depending on the success of fund raising (i.e. carried interest model) and compensation in hedge funds tends to be invested in the firm or its funds and it is therefore a type of "skin in the game", which is different to the traditional asset managers' compensation structure. The asset management sector in general operates with an "agency model" whereby the fund manager's interests are contractually aligned to those of the client and compensation is linked to the performance of the fund under management. In some cases, the non-cash portion of compensation is also invested in the fund or in assets that track the performance of the fund. On the other hand, one asset manager present noted it decided to adopt a different approach and remove the variable part of compensation because its internal analysis had shown no significant relationship between performance and bonuses. They

adopted a compensation model where the level of pay is fixed to a long-term industry trend (over five years).

Industry participants also mentioned that variable compensation is more relevant for firms that use active asset management rather than passive funds. Attracting the most talented portfolio managers is essential for generating returns for investors. As a response to the argument as to whether variable pay/bonuses were necessary, some industry participants argued that variable pay is needed for specific purposes, such as beating the benchmarks, particularly in active asset management.

In order to be able to attract and retain the best talent from the market in a competitive environment, industry participants noted that compensation for portfolio managers needs to be determined relative to the industry level, and that peer performance plays a rather big part in compensation. In some cases, particularly in the case of hedge funds and private equity funds, clients play an important role and ask for the level of compensation paid to portfolio managers, and they are ready and willing to pay for skilled portfolio managers.

At the same time, asset management firms do not want to depend excessively on "star portfolio managers" (portfolio managers that have a long track record of very successful performance). They would like to incentivise adherence to a firm's risk and conduct culture and do not want to put the franchise at risk because of excessive dependence on certain portfolio managers. One firm mentioned that they are trying to address possible risks that may arise from star portfolio manager culture by moving their portfolio managers from an employee mindset to an investor mindset.

Conduct and adherence to the firm's culture and values has been reported by industry participants as one of the main drivers for performance assessment in relation to satisfying clients' best interests. One firm noted that they collect quantitative data points on whether people are "buying into the culture". This directly impacts an individual's compensation, which - starting from the bonus pool established at the firm level on the basis of the realized performance - can only be adjusted downwards depending on the quantitative metrics for conduct (metrics such as breaches tracked and scored through the year, self-reporting or repetitive poor behaviour were mentioned). One participant noted that in the hedge funds industry in particular the relevance of the "one man risk" speaks to the importance of developing indicators and monitoring behaviour.

Industry participants also stated that the higher the performance, the higher the percentage of compensation through equity as opposed to cash. Some asset managers are trying to develop a shareholder mind set in individual portfolio managers rather than an employee mind set, which encourages investment of their compensation in the asset management company even if not publicly listed. One participant noted that compensating managers with the stock of the company implies a long-term investment in the company.

Industry participants highlighted that although compensation practices are longstanding and respond to the objective of aligning portfolio managers incentives to the performance and investment horizon of the clients (and pre-date the introduction of the FSB Principles and

Standards) there have been substantial changes in compensation practices in the industry recently through the introduction of malus and clawback, more use of deferred compensation, and having different checks and balances in place. However, it was also mentioned that although clawbacks are included in employment contracts, in practice there has been no application of these tools, mainly because of the agency model in asset management, which confines the portfolio manager to a contractually defined investment mandate. Being restricted to an investment mandate reduces the probability for clawbacks to be triggered, including for misconduct.

2. Risk Perspective: Financial Stability Risks

The session examined potential risks that could emerge from compensation structures and whether and how securities firms align their compensation practices with long-term prudent risk taking. It also sought to understand the type of securities market activities undertaken, as well as the risks that might emerge from these activities where compensation could play a role.

Industry participants were of the view that there is no direct link between compensation in asset management and financial stability. This is mainly because the use of own balance sheet and leverage is highly limited in traditional asset management business. Being confined to an investment mandate that is contractually defined ensures that portfolio managers effectively reflect the risk appetite of their clients. Industry participants reiterated that asset management is an agency business and there is little opportunity to act outside the investment mandate and client instructions. Furthermore, managed assets are segregated from the asset manager's own assets and kept in a custodian bank. Therefore, asset managers' compensation incentives are aligned with the investment mandate and client interests. One major asset management firm stated that asset managers were not involved in any major financial scandal and asset management activities did not pose a threat to financial stability.

Additionally, asset managers highlighted the various checks and balances that were in place in asset management activity. By way of example, they mentioned that portfolios are monitored on a daily basis to check whether portfolio managers act in line with the investment mandates and thus whether they respect the firm's risk policy and culture. Relatedly, the role of compliance and risk control functions are becoming more relevant in portfolio management. These functions are more actively involved in investment decisions to make sure that portfolio mandates and risk tolerance limits are respected. In case a portfolio manager starts to take excessive risk, the risk control function would intervene and ask the portfolio manager to reduce such risk.

Although financial stability risk was not seen as an issue by industry participants, operational risk was mentioned as a concern. As described by the participants, operational risk relates to the risk of not doing a trade effectively or precisely as well as misconduct-related and other reputational issues that can ultimately have an impact on the firm's balance sheet. One firm noted the increasing sophistication of surveillance software for monitoring employees, which

is able to assess behaviour patterns by tracking e-mail. However, it was also noted that it is important for compliance and risk functions to have deep trading knowledge as well. Key performance indicators would now also include number of incidents, such as breaches of investment limits, to cover for these operational risk events.

Industry participants saw compensation as a possible tool in the overall risk management toolbox. However, they did not see it as the only tool for effective risk management. On the other hand, compensation is seen as a very valuable tool for managing misconduct risk, as well as a powerful driver for implementing the desired culture (see next section). A holistic and multi-faceted approach to risk management and conduct is seen as necessary and the focus should be on improving a firm's culture since it shapes individual behaviour. In this context, industry or firms' self-regulation, tone from the top, and sound firm culture were highlighted as major tools in avoiding excessive risk taking and addressing misconduct risk. One industry participant mentioned that embedding culture into compensation can send a clear and important message about a board's expectation about culture within the firm. Industry participants also stated that when determining compensation levels, adherence to the firm's risk culture by employees is taken into account including to ensure alignment with performance and conduct expectations. However, such consideration happens mostly on a qualitative basis and is mostly discretionary. Roundtable participants generally agreed that there was scope for more alignment of compensation with risk management, however it was not clear how such alignment could be achieved in practice.

3. Compensation Practices, Misconduct Risk and Investor Protection Issues

Industry participants were asked to discuss how oversight of misconduct risk is organised within firms in the securities sector to help reduce incentives for misconduct, which can be detrimental to public trust and confidence in the financial system, as well as investor protection.

Industry participants highlighted that conduct risk mostly emanates from individual level behaviour, rather than firm level structural issues. Therefore, firms closely monitor trading behaviour of portfolio managers. The system of daily monitoring of portfolio positions relative to the mandate prevents portfolio managers who have performed poorly for a certain period of time from taking excessive short-term focused risks to improve their performance. Firms noted that they are alert to small breaches, which may signal impending instances of misconduct, and they monitor employee behaviour carefully in this context. They noted the importance of having tools to effectively prevent bad behaviour in the first place. Additionally, as indicated above, in some cases firms closely monitor portfolio managers' e-mails and communications to detect anomalies.

In regards to the criteria used in determining compensation, industry participants mentioned that performance is not the only criterion used. In addition to the performance component, other aspects such as the observance of firm's culture are also factored in determining

compensation. The appraisal system takes into account how the employee responds and implements the core values of the firm and non-financial incentives such as training and promotions are seen as playing an important role.

Firms stressed that it is impossible to eliminate all types of risks with detailed prescriptive regulation, especially misconduct risk. Therefore, focus should be on improving culture, rather than regulating compensation, which might have limits. One participant noted that "firms have to be bigger than the set of individuals they manage – no one can be immune from the risk culture". Another made the point that the fiduciary duty implies that there is a system of incentives in place, which is preventative in nature through daily oversight of portfolio positions, and mentioned the firm's "zero tolerance on breaking the fiduciary rule". Firms believed that self-regulation is a powerful tool in this context. For example, one major asset manager defined misconduct as violation of the firm's internal rules, fiduciary duty and firm culture.

Participants discussed also the role of variable compensation with respect to addressing misconduct risk. One participant noted that the employee's rating and bonus provide an opportunity for the managers to speak about performance, delineate expectations, review employees' development vis-à-vis these expectations, and that differentiation is an important incentivizing tool, including to keep talent.

Firms use internal sanctions as a deterrent factor inside the firm, because the message impacts a large cross section of employees and enhances their understanding of what type of behaviour is acceptable and what is not. In order to achieve good conduct and embed a sound firm culture, firms consider the whole employee life cycle from hiring to training and screening employee behaviour. Additionally, firms use real life examples as case studies during employee training so that employees are informed about bad examples.

Many asset managers have training and qualification requirements for portfolio managers, particularly for those who are dealing with more risky products. For example, high yield fixed income or infrastructure asset management qualifications are higher than the ETF space, which mostly involves passive investment strategies.

One firm looks at other sectors to compare how they have effectively improved levels of conduct. The firms noted the difficulties that data protection and employment law can present in limiting background checks that can be carried out.

In relation to investor protection, roundtable participants drew attention to reputational risks which may arise from mis-selling of financial products. One roundtable participant gave the example of MiFID 2 product governance rules, which regulate the relationship between the asset manager and product distributor and bring responsibility to asset managers to avoid mis-selling. One firm noted that investors do not read disclosure information and therefore it becomes incumbent on firms to see how best to address appropriateness for the client, improve consumer protection and address reputation risks.

4. Regulatory Considerations and Compensation in the Securities Sector

Participants were asked to discuss regulatory provisions or restrictions related to compensation in the securities sector, particularly the differences and commonalities between the securities and banking sectors. They highlighted that banking rules should not be applied to them, since their business model (agency) is substantially different than that of banks.

Many industry participants, in particular those of firms in banking groups, highlighted level playing field concerns among the most important issues. Fragmentation and multiple layers of regulation related to compensation in asset management are seen as creating an unlevel playing field, which in turn challenges the implementation of a global remuneration policy within the group structure. There is differential treatment of the same type of activity being performed by asset managers that are part of a banking group vis-à-vis other asset managers that are not part of a banking group. One firm spoke about the challenge created by the one size fits all approach on the one hand, and the need for a level playing field on the other, and highlighted the challenge for global groups to find a balance between the two and find an approach that is internally manageable.

Asset managers also urged for consistency in compensation related regulatory requirements. They highlighted that the industry is very competitive and well-regulated and needs a global level playing field to enable competition within the sector. Firms called for further progress in homogeneity across jurisdictions and noted the application of multiple regulations that apply to the asset management sector. There was some criticism of the EU regulatory framework on compensation, which derives from different EU acquis (CRD IV, UCITs, AIFMD, etc.). One major concern regarding the EU regulation is the CRD IV and the EU bonus cap, which applies to asset managers that are part of a banking group. Firms flagged concerns that if it is applied without discrimination, the regulation is not sensitive to the specific risks in asset management, which are very different to those in banking. Prescriptive and onerous regulation is particularly challenging for smaller firms to comply with. A "one size fits all approach" should be avoided.

Another key message regarding regulation was that it should consider the heterogeneity of the securities sector. There are different business models being applied by traditional asset managers, hedge funds and private equity firms, which are reflected in their compensation structures.

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