Building an Appropriate Regulatory Framework for Remuneration of Global Fund Managers

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Good afternoon and thank you to City and Financial Global for the kind invitation to speak today.

My name is Dan Waters. I am the managing director of ICI Global, the international arm of the Investment Company Institute. We work to advance the common interests and promote public understanding of regulated investment funds, their managers, and their investors across the globe. Our membership includes regulated funds publicly offered to investors around the world, with combined assets of more than $19 trillion US dollars.

Thus, my remarks today will be coming from the global perspective of regulated funds and their managers in the European Union, United States, and around the world.

Today I am going to share with you some of the challenges facing global fund managers as a result of prescriptive and incompatible remuneration requirements in the European Union and around the world.

As you will see, the regulatory landscape at the global level is extremely complex and daunting.

As I traverse that landscape in my remarks, I will share some thoughts on regulatory approaches to fund management remuneration that ICI Global believes are unhelpful and even counterproductive in achieving policymakers' objectives in this important area. I will also offer some thoughts on key considerations for regulators and policymakers to keep in mind in designing appropriate remuneration frameworks for fund managers.

I want to stress, up front, that this is not a debate about "regulation" versus "no regulation." The global fund industry supports policymakers' goals of promoting sound remuneration policies that do not encourage excessive risk-taking.

But as I will discuss, those rules should be appropriate to the nature of fund management businesses; including the desirability of aligning managers' and investors' interests, the need to cater to the flexible business models of asset managers, and the importance of being sensitive to the challenges of managing cross-border compensation regimes.

Imagine that you are a global fund manager that is affiliated with a bank, and you are trying to develop a global compensation programme. You have personnel all over the world, as well as management companies and funds domiciled in the European Union, the United States, and Hong Kong, which means you have to develop a global compensation plan that takes into account the remuneration regulations in each region.

Let us start with the European Union, which has a particularly complex regulatory framework. Depending on your status, you may have to consider remuneration requirements under CRD IV, and under one or more other regulatory frameworks: UCITS V, the AIFMD, and soon, MiFID II.

Next, let us move to the United States, where you must take account of remuneration requirements as proposed by the US SEC.

Finally, let us go to Hong Kong, where you must consider the Securities and Futures Commission's endorsement of remuneration principles laid out by the Financial Stability Board, or FSB. For those of you who may not know, the FSB is the international body that monitors and makes recommendations about the global financial system.

Each of these remuneration regimes has different requirements, some of which differ from each other in significant ways.

Moreover, within Europe, remuneration requirements under CRD IV differ from, overlap with, and sometimes even contradict those under the various directives applicable to fund management activities.

Designing a coherent compensation programme for a global work force, which reconciles these different regulatory regimes is a daunting challenge.

Let us first consider how we got to this point.

In the wake of the great financial crisis, global policymakers concluded that the compensation structures at some financial institutions, particularly banks, contributed to the excesses that both fractured the global financial system and damaged the real economies of many countries.

In 2009, the Financial Stability Forum — the precursor to the FSB — issued a report concluding: "high short-term profits led to generous bonuses without adequate regard to the longer-term risks that the employees had imposed on their firms."

To address the perceived problems in remuneration programmes, that same report laid out principles for sound compensation practices, and mandated that national policymakers review and revise their own remuneration regulations with those principles in mind.

The goals of the principles were three-fold:

- to ensure effective governance of compensation;
- to align compensation with prudent risk taking; and
- to foster effective supervisory oversight and stakeholder engagement in compensation.

Importantly, the Financial Stability Forum's report recognised that when it comes to regulation, one size does not fit all.

The report explained that financial firms differ in goals, activities, and culture, and as such, remuneration requirements must accommodate those differences.

National policymakers, particularly those in the European Union and United States, took these marching orders and started drafting remuneration rules. One might say they went at it with enthusiasm, introducing a dizzying number of laws and proposals within five years. Allow me to give you a list of some of the major laws and proposals.

- First, in 2010, EU policymakers adopted new remuneration requirements under CRD III.
- At the same time, the US Congress adopted the Dodd-Frank Act. This included legislation requiring the SEC and other financial regulators to adopt incentive-based compensation arrangements for financial institutions, including asset managers. The SEC then proposed such arrangements.
- Then, in 2011, spurred by CRD III, the UK Financial Services Authority, or FSA, revised its Remuneration Code. During that time, I was the FSA's Asset Management Sector Leader, and led the FSA's work on calibrating what was a very bank-focused remuneration regime, to take account of the very different nature of fund managers from banks, even if owned by them. I will come back to this important difference shortly.

- Also in 2011, EU policymakers included new remuneration provisions under the AIFMD.
- In 2013 and 2014, EU policymakers included stricter remuneration provisions in CRD IV and UCITS V, respectively.
- Last year, the EBA, issued final guidelines on implementing remuneration requirements under CRD IV.
- And finally, four months ago, ESMA, issued its final guidelines on implementing remuneration requirements under UCITS V.

This rather painfully long list not only illustrates how active policymakers have been, but also the potential overlap, conflict, and uncertainty facing global fund managers as a result of these remuneration regulations.

Although the FSF, when it launched all this activity, began with the idea that one size does not fit all, some of the remuneration proposals and regulations that I just listed are ill-suited for certain financial institutions, particularly fund managers. We especially see this in Europe, specifically with the EBA's guidelines on remuneration under CRD IV. These guidelines are creating inconsistencies and potential conflicts with regulatory approaches elsewhere around the world and even within the European Union.

Let me delve a little deeper into this. The EBA's guidelines are problematic for two reasons.

First, they threaten to change fundamentally how regulatory authorities in Member States and firms can interpret proportionality under the directive.

Proportionality is an overarching principle of European lawmaking. As applied to remuneration, it enables firms to apply regulatory requirements in a way that is proportionate to the size and scope of an institution and the nature of its activities. Historically, Member State regulators have been able to interpret proportionality to allow the waiver of some remuneration requirements, based on the size, scope, and complexity of a fund management company.

The EBA, however, expressed a position that would turn the traditional interpretation of proportionality on its head, stating that covered firms could not waive remuneration requirements or apply them to a lesser degree. Instead, the EBA said that firms could only apply proportionality in an "upward" manner; meaning they would have to apply at least the minimum requirement — or more.

In contrast, when ESMA originally proposed its remuneration guidelines for UCITS managers, it upheld the traditional interpretation of proportionality, following its established practice in the AIFMD.

Yet when ESMA published its final guidelines, it pulled back from its interpretation, based on the EBA's work. Helpfully, however, ESMA did send a letter to the European Commission, explaining its view that the AIFMD approach was the correct one for fund managers. The issue rests with the Commission. It would be very troubling if the EBA's counterintuitive and indeed eccentric interpretation of proportionality achieved wider applicability in Europe.

When you consider the matter from the perspective of a global fund manager that has to design a compensation programme which not only takes account of rules in the European Union but also the United States, you find immediate conflict.

In April, the US SEC re-proposed incentive-based compensation arrangements for financial institutions, including asset managers.

The SEC's remuneration proposal has its own version of proportionality, which explicitly scales up the intensity of remuneration rules, based on the size of a financial institution. This means that the rules only capture institutions with balance sheet assets that reach certain thresholds, and the rules are adjusted based on the size of those assets. In other words, the SEC adopts an approach on proportionality that is quite different from what the EBA suggested, but quite consistent, at least philosophically, with the traditional understanding of proportionality in European law.

Let me turn to the second major concern we have, from a global perspective, with the EBA's guidelines. The second problem is that the EBA would impose the CRD IV bonus cap on all subsidiaries of a covered bank, including fund managers that are already subject to comprehensive remuneration requirements under UCITS V, the AIFMD, or both. Neither UCITS V nor AIFMD imposes a bonus cap on fund managers.

The Commission's proposed remuneration requirements under UCITS V did not include a bonus cap. Moreover, when an amendment to impose a bonus cap was introduced in the debate in the European Parliament, the Parliament explicitly rejected it. I note, in passing, that it is astonishing that the EBA, a body with no legislative authority, has purported in guidance to override the decision of the co-legislators of a European directive. It is particularly astonishing given that the Commission and Parliament had sound reasons for rejecting a bonus cap for fund managers under UCITS V.

First and perhaps foremost, imposing a bonus cap would weaken the alignment of interests between the portfolio manager and the fund investors, by downgrading the importance of fund performance as a factor in the manager's remuneration.

Second, the use of variable remuneration enables fund management companies to be more financially flexible in responding to economic events. By this, I mean moving compensation up or down, including in response to market or business downturns.

If fund managers have to operate under a bonus-cap regime, they will inevitably rely more upon fixed salaries to attract and retain talent. This creates higher fixed costs for the asset management firm, making its balance sheet less flexible and adaptable to changing economic and business circumstances.

This scenario is not purely theoretical. Last December, the Bank of England published a report stating that the application of bonus caps had ultimately caused banks to increase bankers' salaries, making bankers' pay less flexible. This rigidity, the Bank argued, made the banks — and by extension the financial system — more fragile.

The European Systemic Risk Board, or ESRB, has expressed similar concerns about the impact of the increase in fixed pay in the European banking sector more broadly.

The EBA, however, has ignored the analysis of its colleague authorities. It asserts in a recent report that bonus caps do not have a significant effect on banks' fixed costs and therefore do not affect financial stability.

What this conflict shows, at the very least, is that EU policymakers need to conduct more thorough analysis of the effects of bonus caps.

The possibility of a bonus cap on some or all European UCITS managers puts Europe at odds with the rest of the world. The SEC's remuneration framework, for example, makes no mention whatsoever of a bonus cap. The possible presence of a bonus cap in Europe is already threatening to prove problematic for European managers who delegate the management of portfolios overseas. Anecdotal information from ICI Global member firms suggests that portfolio managers in the United States or elsewhere may become reluctant to manage UCITS assets if they have to operate under remuneration requirements that differ from those in their home jurisdiction — especially if those requirements are prescriptive and ill-suited for funds.

Consider as well that UCITS funds are meant to be and have successfully become global investment vehicles. Surely applying prescriptive and inappropriate regulations to UCITS funds that differ from and conflict with those around the world risks damaging the attractiveness of the UCITS brand internationally. That must be one of the last things that either the United Kingdom or Europe needs as we attempt to navigate the fallout from Brexit and climb out of the economic hole created by the Great Financial Crisis.

I have mainly been talking about the differences between the US and EU rules in terms of proportionality and bonus caps, but they differ in other ways as well, including on specifics governing deferral amounts and deferral periods. All of these possible differences between the US and EU regulations, and indeed between EU and other nation's regulatory requirements in this area, highlight just how difficult it can be to design clear, coherent, and consistent global compensation plans.

It is critical, however, for global fund managers to have such plans, and ICI Global has been working with policymakers to help them better understand the key considerations that they need to think about when designing a regulatory framework for fund manager remuneration.

What are those key considerations?

First and foremost, asset management is fundamentally different from banking, and remuneration requirements should take into account the unique nature of asset management.

What do I mean by the “unique nature of asset management?” For these purposes, there are three features that distinguish fund managers from banks.

First, fund managers act as agents. They invest on behalf of their clients. The assets of a fund are strictly separated from the balance sheet of the fund manager. The end investors — the owners of the fund — fully and knowingly bear all of the gains and losses that the fund experiences.

Second, funds and the fund managers are comprehensively regulated. Under the UCITS Directive in the European Union, and under the Investment Company Act of 1940 in the United States, funds are subject to a wide range of rules governing everything from diversification, to custody of assets, to limitations on the use of leverage, to liquidity management tools. These regulations also ensure that investors are fully informed about funds’ investment objectives, expenses, and policies, and limit the range of risks to which the fund can be exposed.

Finally, fund managers must adhere to an investment mandate, which includes the fund’s investment objectives and governs how the portfolio manager manages a fund.

The investment mandate, coupled with the structure and comprehensive regulation of the fund, defines and controls the risks that portfolio managers can take. The danger of excessive risk-taking, which clearly was prevalent in certain banking activities that led to the great financial crisis, is carefully constrained in the framework of regulated funds, whether in the European Union, the United States, or indeed in many jurisdictions globally with comprehensive regulation of investment funds.

The second consideration that policymakers need to think about when designing a regulatory framework for fund manager remuneration is the importance of aligning investors’ and managers’ interests. This alignment of interests between a manager and its fund and investors does not have a counterpart in the world of investment banking, where, in the great financial crisis, short-term trader self-interest was the order of the day.

Yet as I have shown, this alignment is crucial in fund management. One important way in which asset management firms foster this alignment is through flexible, incentive-based compensation arrangements.

We know that global and national policymakers are paying close attention to the issue of having sound compensation policies that avoid excessive risk-taking. Indeed, since 2011, the FSB’s Compensation Monitoring Contact Group has been reviewing and analysing remuneration policies for financial institutions around the world. Every year the FSB publishes its findings in progress reports. Now, the FSB is focusing more intently on compensation practices in the securities sector so that it can better understand current practices and present its findings in the next progress report. Importantly, the FSB is working closely with the International Organization of Securities Commissions, or IOSCO, on this review.

IOSCO and its members have specialist expertise and knowledge, combined with longstanding, hands-on experience with asset management, which is why we encourage and support IOSCO's active participation in this review of remuneration practices. Its participation will hopefully ensure that any analysis takes fully into consideration fund managers' perspectives and long experience. If IOSCO and the FSB feel more action is warranted, ICI Global encourages them to conduct a rigorous cost-benefit and global market impact analysis before advancing remuneration policies.

Above all, it is of paramount importance that any proposed policies take full account of the unique nature of asset management business.

Having such policies will ultimately enable fund managers to design clear, coherent, and consistent compensation plans for a global workforce. That should be a goal that all parties—legislators, regulators, and fund managers alike—should share.

Thank you for your time and attention.

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