New City Initiative

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29th September 2010

Dear Lindsey,

Response to the FSA's proposed revisions to the Remuneration Code under CRD3

About Us

NCI is a think tank whose members are some of the leading independent asset management firms in the City. It was established in the context of the ongoing financial reforms to give a voice to the many City entrepreneurs who have created successful businesses by remaining entirely focused on and aligned with their clients and investors. The members of NCI collectively employ several thousand staff and manage some £150 billion.

The recent financial crisis has led to renewed focus on curbing what many have regarded as excessive risk-taking in specific areas by financial managers. The reputation of the City has been damaged by recent events, and its governance and actions are under unprecedented scrutiny. We aim to be an active participant in the resulting discussions.

Introduction

We would like to emphasise at the outset that we are strongly sympathetic to the FSA's intention, as stated in the Consultation Paper, that "remuneration policies must be consistent with and promote effective risk management". In fact, one of the objectives of our grouping is to work with regulators and policymakers to promote this very aim. (For a more comprehensive presentation of our philosophy, please see the attached positioning paper published by NCI: "Alignment of interests: fixing a broken City".) In that vein, we would like to offer the following observations.

Application and Proportionality

We consider that the proposals may be appropriate for banks, which we define here as deposit-taking institutions, or other financial institutions which are judged by the Regulator to pose systemic risk. These institutions have the potential to destabilise the financial system, are often managed by individuals with limited or no ownership of their companies, and benefit from the very significant advantage of being 'too big to fail'.

However, we believe that the regulation of remuneration practices alone will be insufficient to prevent excessive risk-taking in banks. We would also advocate a greater focus on the principles of accountability and disclosure in order to promote effective risk management in all types of financial institution. As an example, the directors of large financial institutions deemed to be systemically significant should be held more accountable for the appropriateness and effectiveness of the compensation structures in place in the firms which they are supposed to oversee. If necessary, compensation committees of the firms should seek outside opinion on these topics and the conclusions should be made publicly available. Banks should be compelled to disclose what actions they are taking to create long term incentives for their employees.

In contrast, we do not believe that the majority of these proposed regulations are suitable for other, typically smaller, financial institutions, and in particular for owner-managed firms where the owners are aligned with their clients for the reasons set out below. We focus here on the case as it relates to investment management firms which are owner-managed, although much of the argument will be applicable to larger asset managers also.

1. Systemic risk: Investment management firms do not pose a systemic risk in the same way as banks do, because they employ capital as agent and not principal. The impairment of investors' capital, while highly regrettable, does not pose a risk to financial system in anything like the same way as the impairment of a bank's capital.

2. Alignment: The management and shareholders of owner-managed firms are one and the same, and are therefore completely aligned with one another. This results in decisions being taken by managers with a long-term perspective in order to safeguard their ownership interests, rather than to maximise a short-term bonus payout. The effect of this is especially beneficial in asset managers which invest alongside their clients and share in the performance of the funds under their control. We would argue that a deferred compensation scheme is unnecessary in the case of an owner-managed firm where the senior management often have a considerable proportion of their net wealth invested in the business and alongside their clients. This is particularly true for limited liability partnerships.

3. Practicality: There are instances in which owner-managed firms may be unable to comply with the proposed regulations for practical reasons. One such instance is that owner-managed firms are typically structured as partnerships and therefore have no readily available currency, other can cash, for offering long-term equity incentive plans.

4. Equitability: We are concerned that the combination of restrictions on guaranteed bonuses with strict rules regarding deferral of bonus payments will result in a substantial raising of base salaries relative to performance-related pay. This would have three undesirable consequences:

   a. First, it risks the development of a two-tier system, whereby talented individuals gravitate towards the higher base salaries which large (and less well-aligned) firms would be able to offer. Rather than reducing systemic risk, this would instead weaken those smaller firms which would help to disperse it, and further concentrate it in the hands of the same large financial institutions whose threat to the financial system has recently been made abundantly clear.

   b. Second, it has the perverse effect of increasing in aggregate the guaranteed element of compensation which is unrelated to long-term performance and client satisfaction. This 'disalignment' may moreover be compounded by support for stock options as a significant component of bonuses, which we have argued in our recent positioning paper are too distant from the daily decisions being made on behalf of clients to be a meaningful source of protection against excessive risk-taking by managers and advisers.

   c. Third, the largest financial institutions will have a greater ability to relocate specific teams out of the UK to escape regulation, which not only creates an unfair advantage relative to smaller firms, but also further imperils the position of London as a preeminent global financial centre.

We urge that those 'non-bank' financial firms which do not pose systemic risk should not be included within the scope of the proposed regulations.

However, if this is unfeasible we feel equally strongly that proportionality (beyond the 'de minimis' clause already within the proposals, which we welcome) should be applied, with attention paid to the size and ownership structure of the firms involved, the nature of their activities, and the risks they create individually for the whole financial system.

Yours sincerely,

Daniel Pinto

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