The Sierra Group

OCCUPATIONAL ALERT

"Competition is a by-product of productive work, *not* its goal. A creative man is motivated by the desire to achieve, *not* by the desire to beat others." *Ayn Rand*

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COMPENSATION and OTHER PROPOSED CHANGES in the FINANCIAL FIELD, FOLLOWING the MARKET MELTDOWN

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Now that the US has experienced an economic meltdown that has required the Taxpayer to subsidize the financial markets, elected officials have been outspoken in their calls to regulate compensation policies at financial service firms. On 3/26/09, Treasury Secretary Timothy Geithner testified before the House Financial Services Committee to describe the Administration's proposals to reform the regulation of the Financial Services Industry. He proposed a "systemic regulator" which calls for far reaching oversight and global cooperation. This article will review how different financial firms have typically compensated Traders, and will analyze what is being proposed in the new regulatory environment.

They can expect a further increase in claims from insured's in the financial field, as people move to exit the field and have little incentive to try to return to following a disability. Indeed the Security Traders Association (STA) has reported fewer members due to both the current economic difficulties and the continued increase of electronic markets.

While firms have different approaches to how they compensate their Traders, they generally pay them based on the profits from their *trading book* minus operational costs. Traders also have to share profits with the Sales Desk, and more conservative firms require profits to be realized before they are considered for compensation - while other firms mark to market unrealized profits. Large firms and investment banks pay a small base salary, and then a large bonus is paid at the end of the year based on profits. The Head

Trader generally gets to decide how the profits will be divided among the Traders. This approach has not only established incentive for Traders to create profits, but it established realistic expectations in down markets and hopefully eliminated the need to layoff off Traders.

Traders are paid their bonuses in stocks and cash, and heretofore the cash represented the larger percentage. Previously the typical stock to cash ratio was 40/60, but the 2008 ratio was more like 70/30. To add insult to injury, a lot of the stock portion of the bonus was deferred up to 5 years. Since a Trader does not know if the stock will be worth $10/share or $100/share in that timeframe, it made for a lot of dissatisfied professionals.

Regulatory reform is now being considered for several reasons, not the least of which is the Taxpayer bailout to some firms even as they paid huge bonuses to their Traders. Ultimately it will not matter which firms received a bailout, the call for overall new regulatory reform has reached fever pitch. Indeed, U.S. regulators are currently considering the proposed “Turner Review” which was published on February 26th, 2009 by the Financial Services Authority (FSA – the UK’s version of the SEC). This proposal also calls for a “systemic regulator” and suggests that the small base salaries and extremely large bonuses are replaced by higher bases with bonuses that would be a smaller percentage of the base. These bonuses are to be pegged to actual realized profits, and they would reflect *firm-wide profits* not just profits earned by the trading desk. Bonuses would also be deferred to reflect a Trader’s overall performance not just profits generated during one year. That is to say the bonus will reflect performance over several years, as well as adherence to risk management and compliance policies. Obviously the point of this approach is to have Traders rewarded for consistent performance based on the total profits of the firm over a longer period of time.

The segmented regulatory approach (that still remains in practice) resulted in no one set of Regulators understanding the amount of leverage that was being build up. Banking regulators were focused on capital requirements and excess leverage, securities regulators focused on sales practices, and hedge funds were generally unregulated. This led to banking regulators overseeing a department that was selling asset-backed securities, but not being involved in the regulation of the asset-backed securities purchased by a different department. The point of a “systemic regulator” is to ensure that all regulators are seeing the whole picture, and that companies are not operating in a vacuum - especially in an economy that has become increasingly global. Industry professionals note that this level of intervention is unprecedented in the U.S., but it just may be an idea whose time has come.

What does this mean to those managing disability claims?
They can expect a further increase in claims from insured’s in the financial field, as people move to exit the field and have little incentive to try to return following a disability. Indeed the Security Traders Association (STA) has reported fewer members due to both the current economic difficulties and the continued increase of electronic markets. John Giesea, CEO and President of the STA has reported current membership at 5,200 – a huge drop from the 7,000 members it had in the 1990’s. According to Bob Iati of the Tabb Group, a financial markets research and advisory firm, the trading industry has been losing 5-7% of its professionals per year since the 1990’s. Indeed the STA, along with its New York Chapter (STANY), held a breakfast meeting for its members on 3/11/09 titled “Is There Life After Trading? Transition in a Difficult Market”. This was the first ever employment session that STANY has ever held, but they felt their members needed some concerted assistance in the current difficult market.

References:

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