Alternative Investment Management Association

European Banking Authority
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Submitted via email to: EBA-CP-2013-11@eba.europa.eu

21 August 2013

Dear Sirs,

AIMA's response to the EBA's Consultation Paper EBA/CP/2013/11

The Alternative Investment Management Association Limited[1] (AIMA) is grateful to the European Banking Authority (EBA) for the opportunity to comment on its consultation paper on Draft Regulatory Technical Standards on criteria to identify categories of staff whose professional activities have a material impact on an institution's risk profile under Article 90(2) of the proposed Capital Requirements Directive (the 'Consultation Paper').

Key concerns

Our main concerns with the proposals relate to the following issues:

- **We believe that the proposals have been developed with insufficient attention to their implications for non-credit institution investment firms, specifically investment management firms.** We do not believe that either the EBA survey of 2012 or the Impact Assessment took this scope of application into account substantively. As a result, some of the assumptions underlying the backstop measures proposed in the draft RTS are not borne out in the investment management sector. **We therefore propose an exception for investment firms** (or possibly a subset of investment firms to include investment management firms). For such firms, all of the back-stop quantitative and qualitative criteria in Article 3 for describing Identified Staff should be subject to a qualitative assessment of the impact of the individual's professional activities on the firm's risk profile in accordance with Article 4. We note in this context that the principle of proportionality is not only about easing the burden on small firms but also assessing whether the measure proposed is the most suitable to address the policy concern (as evidenced by impact assessment) and the least restrictive of the choices available. It is not an end in itself to catch more people as Identified Staff.

- The criteria in Article 3(1)(f) and (g) are inapplicable to investment management firms and should be entirely disapplied in relation to such firms.

- We believe that some of the quantitative measures (in particular Article 3(2)(c) (total gross remuneration of €500,000 or more)) are arbitrary and too low. Any numerical threshold will be to some extent arbitrary but, if one must be included, we suggest €1,000,000 on the basis that this would reflect the threshold chosen by the co-legislature for the purposes of Article 450(1)(i) CRR in relation to disclosure.

[1] AIMA is the trade body for the hedge fund industry globally; our membership represents all constituencies within the sector – including hedge fund managers, fund of hedge funds managers, prime brokers, fund administrators, accountants and lawyers. Our membership comprises over 1,300 corporate bodies in over 50 countries.

- Article 3(2)(b) (the comparative test) could have the inadvertent effect of catching every member of staff, if a single member of senior management receives zero or nominal remuneration in a particular year, for example if they are a founder member and choose not to take remuneration during a start-up phase, or a non-executive director taking a modest fixed director fee. We propose that there should be a base level of incentive to qualify this test. We suggest €500,000.

- Although not directly relevant to the present consultation, we were concerned to learn in the Open Hearing that the EBA does not propose to update the CEBS Guidelines on Remuneration Policies and Practices until the end of 2014, despite the fact that CRD IV will take effect from 1 January 2014. In particular, we are concerned that there will therefore be no express guidance on the extent to which it is proportionate for a particular firm to disapply the new CRD IV rules on bonus ratios on grounds of proportionality. In the absence of consultation or updated guidance, we assume that where (in accordance with national implementing measures) it is disproportionate for an investment management firm to apply the CRD III guidelines on deferral and payment in shares, it is also disproportionate for it to apply the bonus cap. We reach this conclusion on the basis that the CEBS guidelines are clear that every principle is capable of neutralisation on grounds of proportionality. We would welcome interim express guidance on this point.

Approach to the rest of our response

In the attached Annex we discuss the context in which our concerns arise and our main concern, the application of the draft RTS to investment management firms, which does not fit neatly as a response to any particular question posed in the Consultation Paper and is therefore addressed in narrative format. We hope and understand that this concern will nevertheless be given due consideration. That said, we also respond to some of the individual questions posed in the Consultation Paper. We have not attempted to respond to every question in the Consultation Paper, but only those most pertinent to investment management firms.

We hope you find our comments useful and would be more than happy to answer any questions you have in relation to this submission.

Yours sincerely,

Jiří Król
Deputy Chief Executive Officer
Head of Government & Regulatory Affairs

ANNEX

<u>Context in which our concerns arise</u>

We appreciate that the EBA has developed the draft RTS in accordance with its mandate under the CRD. Nevertheless, we believe that it is important to repeat for the record and by way of context our concern that the entire thrust of pay regulation has a disproportionate and unjustified impact on investment firms.

We believe that the starting point when considering any aspect of the regulation of remuneration practices amongst hedge fund management firms should be the conclusions of the Turner Review of March 2009, and in particular the three findings there that:

- the great crisis was primarily a banking crisis and regulatory efforts should be focused on banks and 'bank-like' financial institutions;

- "hedge funds in general are not today bank-like in their activities"; and

- "a reasonable judgment is that while inappropriate remuneration structures played a role [in the market crisis], they were considerably less important than other factors...[such as]...inadequate approaches to capital, accounting and liquidity."

The last point was endorsed by the UK Financial Conduct Authority (then FSA) in CP09/10: "It is not possible to prove a direct causal link between remuneration practices and the market crisis."

By extension of the previous point, the FCA has acknowledged that it does not think there is "a strong case to suggest that inappropriate remuneration practices in other firms in the financial sector played a significant role in the present crisis." We do not believe there is any evidence (whether empirical, circumstantial or anecdotal) which suggests that remuneration practices in firms other than the big banks had any material part to play in the financial crisis.

Indeed, to date, we believe no serious study has suggested that any individual EU-regulated hedge fund manager could be regarded as systemically important. In contrast to large, deposit-taking public institutions which trade their own balance sheet and thereby put at risk not only the shareholders' capital but also depositors' funds, hedge fund managers are typically private, owner-run firms which trade as agent on behalf of the funds which they manage.

The size of the assets under management (AUM) by the thousands of businesses which make up the global hedge fund industry (the majority of which are established outside the EU) is a small fraction of the combined balance sheet of just a handful of large EU banks. In 2012 the aggregate balance sheet size of the EU banking industry was estimated somewhere above $45 trillion (the size of the 23 largest EU banks alone was estimated to be around $33 trillion) while the European hedge fund industry managed only around $440 billion of assets. The balance sheet of the largest EU bank was somewhere in the region of 76 times that of the estimated AUM of the single largest EU hedge fund manager.

Similarly, the level of leverage in the hedge fund sector was much smaller than that found in the EU banking sector. While the average leverage ratio of large complex financial institutions in Europe moved between 25 and 45 times before and during the recent financial crisis, the range of average leverage in the hedge fund sector was between 1 and 3 times. If size and leverage can be meaningful proxies for systemic risk, it seems that the systemic importance of the hedge fund industry pales in comparison with other financial sectors.

We acknowledge that it might be argued that, under the AIFM Directive, pay regulation is applied to AIFMs as an aspect of conduct risk and investor protection, as opposed to it being a prudential measure. Nevertheless, the present consultation is in the context of the application of CRD IV to investment management firms, and CRD is a prudential measure.

The existence of any inappropriate remuneration practices is nevertheless a matter for concern. However, from a costs/benefits perspective, we continue to query what additional benefits are achieved by additional regulation and, in particular, extension of the category of Identified Staff.

Nevertheless, as already noted, we do appreciate that the EBA has developed the present draft RTS in accordance with its mandate under the CRD. Therefore, we invite the EBA to extend the category of Identified Staff, if at all, proportionately and fairly and not simply by imposing a "one size fits all" set of requirements on non-banks. Remuneration practices within the European hedge fund industry differ considerably from those within large UK banks and broker dealers. This means that the nature of the risks associated with remuneration practices within the banking sector simply do not apply in the case of the hedge fund sector – any RTS applicable to the industry must therefore be calibrated accordingly.

<u>Main concern: application of the draft RTS to investment management firms</u>

Why the RTS affects investment management firms

When considering the detail of the RTS, we invite EBA to keep clearly in mind that CRD IV applies to non-bank investment firms, including investment managers. This may be because they fall within the scope of a consolidation group triggered by a credit institution, or on a solo basis.

(We note in passing that the fact that Article 4(2)(c) of the CRR narrows somewhat the definition of "investment firm" compared to CRD III may reduce somewhat the number of investment managers in direct scope, but that it will not exclude all of them – some will have custody of fund assets, others may engage in the MiFID investment service of "placing", and still others will need to remain CRD investment firms in order to qualify as "sponsors" of their managed CLOs for the purposes of Article 405(1) CRR.)

In addition, we invite EBA to bear in mind that its RTS are also very likely in practice to set a precedent for future work by ESMA on similar concepts under any UCITV V or AIFMD II measures.

As noted above, we fully recognise that the scope of application of the RTS is defined by the Level 1 text, and that it therefore necessarily includes all CRD investment firms. Hence we argue below for express *differentiated treatment* in the RTS for investment firms, as opposed to carving them out of the scope of the RTS.

Justification for differentiated treatment of investment management firms

As reflected clearly in the CEBS Guidelines, prudential concerns in the investment management sector are different from those applicable in the banking and investment banking sectors.

More specifically, some of the assumptions underlying the backstop measures proposed by the EBA in the RTS are not borne out in the investment management sector. For example, Article 3(1)(e) of the draft RTS deems heads of legal, tax and IT to be Identified Staff, irrespective of their actual impact on the risk profile of the firm concerned. Taking this example, it should not be assumed that because the head of IT for a credit institution is likely to have a material impact on the institution's risk profile that the same goes for investment firms. In a hedge fund investment management firm, the head of IT *might* have a material impact on risk, for example if the firm employs algorithmic trading strategies which rely heavily on IT. But he or she might well not even in those specific circumstances.

The problem of insufficient tailoring does not arise solely because many investment management firms are likely to be extremely small, even by comparison with the smallest banks. But that fact exacerbates the impact.

In particular, we are concerned that there is an insufficient evidence base

There is in our view no or not a sufficient evidence base for extending the scope of Identified Staff in the ways proposed.

No evidence base in relation to investment management firms

Whether or not the EBA agrees with those concerns as they apply to banks and investment banks, there is certainly insufficient evidence to justify application of the RTS to investment management firms.

Whilst the EBA's 2012 survey on national implementation of CRD III did consider the application to investment firms from a legal perspective, it appears that the quantitative aspects of the survey were focused on banks and investment banks. Page 9 of the EBA report suggests that the survey focused on *"three categories of banks…: 'all institutions', 'investment banks', and 'retail banks'."*

The examples of good practice in relation to selection criteria for Identified Staff mentioned in that report are mainly concerned with balance sheet businesses: *"credit competence; trading limits; bounded economic capital on business unit level; Value at Risk, Risk Weighted Assets-, revenue- or Profit & Loss impact; risk capital, total remuneration, ratio fixed to variable remuneration, and various thresholds (threshold above which staff are allowed to operate; amounts of revenue; assets under management)"*.

Similarly, the data survey mentioned in paragraph 11 *et seq.* of the Impact Assessment appears to have covered *"30 institutions ranging from large to small and including universal, retail and investment banks"* but apparently no asset managers.

Proposed solution

We therefore propose differentiated treatment for investment firms (as opposed to credit institutions). **For investment firms, all of the back-stop quantitative and qualitative criteria in Article 3 for describing Identified Staff should be subject to a qualitative assessment of the impact of the individual's professional activities on the firm's risk profile in accordance with Article 4.**

As an alternative to treating all investment firms differently for the purposes of the RTS, the EBA may decide to treat differently *investment management firms* specifically. These could be described as "investment firms which are not authorised to provide the services listed in points 3, 7 or 8 of Section A of Annex 1 to MiFID".

Responses to specific questions

Q1: Is the list of specific functions listed appropriate or should additional functions be added?

We consider the list of functions to be inappropriate in relation to investment management firms, for the reasons given above, and we propose that this aspect of Article 3, along with all others should be made expressly subject to Article 4 in the case of investment firms (or, if the EBA prefers, in the case of investment management firms specifically).

Q2 and Q3: Can the above criteria be easily applied and are the levels of staff identified and the provided threshold appropriate?

Article 3(1)(f) and (g) are inapplicable to investment management firms and should be entirely disapplied in relation to such firms.

Q4 a) Is this criterion appropriate to identify risk takers?

No – we consider this criterion to be arbitrary. Certain staff may be incentivised substantially by reference to performance without them necessarily posing a material risk to the firm (or, in the case of an asset management firm, to its funds).

Q5 a) Can the above criterion be easily applied?

Yes – subject to our concern that Article 3(2)(b) could have the inadvertent effect of catching every member of staff, if a single member of senior management receives zero or nominal remuneration in a particular year, for example if they are a founder member and choose not to take remuneration during a start-up phase, or a non-executive director taking a modest fixed director fee. We propose that there should be a base level of incentive to qualify this test. We suggest €500,000.

Q5 b) Would it be more appropriate to use remuneration which potentially could be awarded as a basis for this criterion?

No – it is better to base rules on measurable and objective standards.

Q6: Can the above criteria be easily applied and are the levels of staff identified and the provided threshold appropriate?

No - we believe that the figure of €500,000 in Article 3(2)(c) is arbitrary and too low. Any figure will be to some extent arbitrary but, if one must be included, we suggest €1,000,000 on the basis that this would reflect the threshold chosen by the co-legislature for the purposes of Article 450(1)(i) CRR in relation to disclosure.