Submitted by email

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Comments on the Design of a New Prudential Regime for Investment Firms

The Alternative Investment Management Association Limited (AIMA),[1] the Alternative Credit Council (ACC)[2] and the Managed Funds Association (MFA)[3] are providing the following comments in response to the publication by the European Banking Authority's (EBA) on 29 September 2017 of its opinion on the design of a new prudential framework for investment firms (the 'recommendations') and its related annex (the 'annex').

We take note of the policy objective to develop a prudential regime tailored for investment firms. However, we are concerned that several key recommendations are not well tailored to investment firms, even less to asset managers. Accordingly, we encourage the European Commission (EC, Commission) to engage in additional consultation on some aspects of the proposal before proceeding.

Our concerns are summarised below and set out in more detail in the annex to this letter.

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[1] AIMA, the Alternative Investment Management Association, is the global representative of the alternative investment industry, with more than 1,900 corporate members in over 60 countries. AIMA works closely with its members to provide leadership in industry initiatives such as advocacy, policy and regulatory engagement, educational programmes, and sound practice guides. Providing an extensive global network for its members, AIMA's primary membership is drawn from the alternative investment industry whose managers pursue a wide range of sophisticated asset management strategies. AIMA's manager members collectively manage more than $2 trillion in assets.

[2] ACC, the Alternative Credit Council, is a group of senior representatives of alternative asset management firms, and was established in late 2014 to provide general direction to AIMA's executive on developments and trends in the alternative credit market with a view to securing a sustainable future for this increasingly important sector. Its main activities comprise of thought leadership, research, education, high–level advocacy and policy guidance.

[3] MFA, Managed Funds Association, based in Washington, DC, is an advocacy, education and communications organization established to enable hedge fund and managed futures firms in the alternative investment industry to participate in public policy discourse, share best practices and learn from peers, and communicate the industry's contributions to the global economy. MFA members help pension plans, university endowments, charitable organizations, qualified individuals and other institutional investors to diversify their investments, manage risk and generate attractive returns. MFA has cultivated a global membership and actively engages with regulators and policy makers in Asia, Europe, North and South America, and all other regions where MFA members are market participants.

Cap on capital requirements linked to AUM: We do not consider that levels of assets under management (AUM) are an appropriate metric for determining the level of risk posed by an asset management firm. We consider that use of inappropriate scalars, particularly in a linear fashion, has the potential to create disproportionate capital requirements that may easily become divorced from the underlying risks that they are designed to address. Therefore, rather than a coefficient applied on a linear basis to AUM, we recommend a non-linear calculation that would avoid overstating the capital requirement on many investment firms. We, therefore, encourage the European Commission to propose a €10 million cap on the capital requirement, similar to the cap imposed in both the AIFMD and the UCITS Directive, as this would provide a more risk-based approach to capital requirements that are based on an investment firm's AUM. This approach also would avoid putting MiFID asset managers on an unlevel playing field with other types of asset managers, which we believe would not be justified as a policy matter.

AUM calculations for derivatives should be clarified: We understand that the EBA recommends that AUM in relation to derivatives and other assets be based on their market values rather than their notional values. However, this principle was not stated clearly in the recommendations. We would appreciate confirmation in any proposal from the Commission that the AUM in relation to derivatives and other assets would be based on market values rather than notional values.

Client money held factor needs further clarification: The new regime should clarify that "holding" client money in this context excludes controlling client money. Indeed, asset managers will often have the ability to control client assets (including securities and cash) by exercising a discretionary mandate over an account established in the name of the client with an institution such as a bank or custodian, without however, bearing the same risks as an entity holding client money directly.

Balance sheet higher than €100 million is not well tailored as a determinant of whether a firm is categorised as class 2 or class 3: For many alternative asset managers, a portion of their balance sheet is comprised of assets invested in the alternative investment funds they manage, for reasons like employee deferred compensation rules. Manager investments alongside investors and deferred compensation programs are both designed to mitigate risks and better align the employees of the manager with investors. We encourage the Commission not to use this threshold for classification as a Class 2 firm, as it creates disincentives for managers to use these risk mitigating arrangements, particularly for asset managers that would not likely meet any of the other thresholds for Class 2 classification.

Total gross revenue higher than €30 million is not well tailored as a determinant of whether a firm is categorised as class 2 or class 3: We further encourage the Commission to not use the gross revenue threshold for Class 2 classification, which we believe is not well suited for distinguishing between larger and smaller asset managers. Because many alternative asset managers receive a significant portion of their income based on the investment performance of their investment funds, we are concerned that many smaller asset managers, who would otherwise not likely meet any of the other thresholds for Class 2 classification, will nonetheless meet this threshold in years of good investment performance. Further, because manager revenue is highly dependent on investment performance, this factor could lead to asset managers frequently fluctuating between Class 2 and Class 3.

Categorisation of Class 1 firms is too broad: We note the following Class 1 criteria in the EBA recommendations: "systemic investment firms or investment firms which are exposed to the same types of risks as credit institutions". We remain troubled by the change in approach toward identification of Class 1 firms moving away from the requirement that Class 1 firms be both systemic and bank-like as we believe that this change potentially represents a significant expansion of the Class 1 category. Secondly, we would very much welcome clarification as to which risks are considered here, which we believe should be focused on the types of risks presented by systemically important investment firms as distinct from other types of investment firms.

Transitional period: As regards the EBA mandate to issue a report during the transitional period, and since the increase in capital requirements for many of our members is likely to be significant, we would very much support the requirement for the Commission to act upon this report and either possibly extend the transitional period depending on the results of the EBA report or provide that the transitional period shall extend until such time as the Commission, following consideration of the EBA report, determines that the transitional period is no longer needed.

Remuneration: Given the complexity of the policy questions regarding capital requirements and because remuneration requirements raise distinct policy considerations, we encourage the Commission to focus its initial proposal on the recommended capital framework and consider a separate and additional consultation on any proposals regarding remuneration requirements for asset managers and other investment firms. Any new remuneration requirements should recognise that there are frequently existing alignments of interest between the asset manager and the client (particularly alternative asset managers which typically invest significant capital in the investment funds they advise) and that remuneration regulations should not be aimed at addressing wider systemic risks that are not applicable to the asset management industry.

We hope that you will find our comments useful and we would be happy to discuss them further with you and/or your colleagues should that be desirable.

Yours sincerely,

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ANNEX

Appropriately tailored prudential regime for asset managers

AIMA, ACC and MFA take note of the policy objective of developing an appropriately tailored prudential regime for investment firms (and more specifically, for asset managers), rather than relying on a universal "one-size-fits-all" set of rules that was originally designed to apply to banks. We are concerned, however, that the several aspects of the proposed application of banking prudential rules to asset managers under the EU Capital Requirements Regulation (CRR) are not well tailored to investment firms, particularly asset managers, resulting in unnecessary complexity for entities that have relatively simple, non-systemically important business operations. The CRR also uses concepts which are not relevant in the context of agency, rather than proprietary trading, businesses (for example, rules relating to the "trading book" and "banking book"), which are frequently difficult to apply in practice and which may result in divergent approaches due to the need to interpret these in a meaningful way. We consider that there would be a large number of advantages to moving away from a bank-centric model to a new regime with clear rules and/or derogations designed with asset managers in mind.

As previously mentioned in our letter dated 29 August 2017, we do not consider that levels of AUM are an appropriate metric for determining the level of risk posed by an asset management firm and would therefore suggest a cap to the AUM k-factor. The agency nature of asset management activities means that the ownership of the relevant assets will remain with clients and in many cases, the assets may be held with a separate custodian. In our view, the principal risk that is relevant to asset managers is the possibility of a disorderly wind-down which impedes the transfer of management of the underlying client portfolios to a new manager or the return of assets to clients.

Classification of firms exposed to the same risks as credit institutions as Class 1 firms is too broad

We agreed with EBA's initial proposal[4] to divide investment firms into three broad classes, with Class 1 firms being those which are considered to be "systemic and bank-like". We agreed with the EBA that it was likely to be appropriate for existing firms which are classified as G-SIIs or O-SIIs on the basis of the criteria set out in the relevant EBA guidelines to remain subject to the full requirements of the current CRR. We continue to consider that no asset manager is a systemically important institution for these (or indeed any other) purposes, even on the basis of its membership of a wider group.[5]

We note that the Recommendation 3 now refers to “systemic investment firms or investment firms which are exposed to the same types of risks as credit institutions” for Class 1 firms. First of all, we remain troubled by the change in approach toward identification of Class 1 firms moving away from the requirement that Class 1 firms be <u>both</u> systemic and bank-like to a requirement that Class 1 firms be <u>either</u> systemic or exposed to the same risks as credit institutions. We believe that this change potentially represents a significant expansion of the Class 1 category to firms for whom the larger part of the CRD/CRR requirements will not be relevant because their business is an agency business and not a bank-like business. Secondly, we would very much welcome clarifications as to which risks are considered to

[4] Designing a new prudential regime for investment firms, 4 November 2016.

[5] For further discussion of the relevant factors relating to systemic importance in the context of asset managers, please refer to the joint MFA and AIMA response to the FSB consultation on Proposed Policy Recommendations to Address Structural Vulnerabilities from Asset Management Activities dated 21 September 2016, and to AIMA's response and MFA's response to the FSB and the International Organization of Securities Commission's (IOSCO) consultation paper on Assessment Methodologies for Identifying Non-Bank Non-Insurer Global Systemically Important Financial Institutions each dated 7 April 2014, and AIMA's response dated 1 June 2015 and MFA's response dated 29 May 2015 to the second FSB and IOSCO consultation on the same issue.

be the “same types of risks as credit institutions”, which we believe should be focused on the types of risks presented by systemically important investment firms as distinct from other types of investment firms. We believe Level 2 would be the appropriate level to address this matter and bring more certainty among market players, so that they understand which criteria apply and in which category they fall, or would fall according to the evolution of their business. We understand from the EBA that Class 1 is not meant to capture more than 10 firms identified as systemically important based on criteria established in a different regulatory context. While we understand the desire to develop criteria based on the policy goals underlying this regulation, we would welcome level 2 criteria that would reflect the intended scope of firms previously indicated by the EBA.

Cap on AUM k-factor - Increased AUM does not automatically correlate to increased risk and success should not be penalised

AIMA, ACC and MFA members do not agree that the level of prudential risk posed by a firm increases in a linear way as the level of a firm's AUM increases. Successful asset managers frequently increase their AUM by attracting new clients, rather than by existing clients concentrating their assets in portfolios managed by the particular asset manager. In practice, this means that the risks remain dispersed amongst a wider population of end customers and do not automatically increase or become more concentrated as AUM grows. AUM may also increase as a result of an asset manager having pursued a successful investment strategy and generated positive returns for investors. An increased AUM also does not correlate to increased counterparty risk for other market participants, as the asset manager does not enter into the relevant transactions on its own balance sheet and therefore has no resulting exposure.

Therefore, while we recognise that the EBA has in part proposed the use of K-factors because it considers that the applicable regulatory capital rules for Class 2 firms must be "infinitely scalable", we consider that use of inappropriate scalars, particularly in a linear fashion, has the potential to create disproportionate capital requirements that may easily become divorced from the underlying risks that they are designed to address. We understand that the EBA continues to believe that a risk factor based on AUM is nonetheless appropriate. Therefore, rather than a coefficient applied on a linear basis to AUM, we recommend a non-linear calculation that would avoid overstating the capital requirement on many investment firms. We encourage the European Commission to propose a €10 million cap, similar to the cap imposed in both the AIFMD and the UCITS Directive, as this would provide a more risk-based approach to capital requirements that are based on an investment firm’s AUM. This approach also would avoid putting MiFID asset managers on an unlevel playing field with other types of asset managers, which we believe would not be justified as a policy matter.

We also encourage the Commission to consider using AUM ranges (for example, €2 billion to €3 billion in AUM), rather than specific AUM calculations, for purposes of determining a firm’s capital requirements. This approach would simplify manager compliance with the capital requirements, while providing scalability as the EBA has recommended. While we recognise this approach would be a less precise method for calculating a firm’s capital requirement, because risk does not increase in a linear manner with increases in AUM (particularly with respect to relatively small changes in AUM), we believe this approach is consistent with the intended objective of using AUM as a k-factor, while providing a simpler compliance framework for asset managers.

Calculation of K-AUM factor should be clarified

We welcome the recommendation by the EBA to introduce some smoothing mechanisms for the calculation of K-factors, and notably the 3 months deferral period to calculate the AUM factor, aligning the frequency with the FOR calculation. In terms of calculation methodology, we would advise that the value of derivatives be based on market values and not on notional values (in line with Article 3 of the AIFMD and Article 2 of the AIFMD Level 2 Regulation). This is also to be put in relation with the classification of firms: if gross notional values were to be included there would be very few alternative investment managers in Class 3.

We would also welcome some clarifications regarding the calculation of AUM for closed-ended funds and suggests that AUM should be equivalent to net asset value (NAV) as opposed to committed capital. This suggested approach would make the calculation of AUM in this context consistent with ESMA's recommended approach for calculating AUM under the AIFMD, which would count drawn amounts rather than committed amounts in the equivalent context. See Q&A 3 under "Section IX: Calculation of the total value of assets under management" of the ESMA AIFMD Q&A.

K-AUM calculation for multiple manager structures

We welcome and support language in the EBA's annex that recommends the AUM factor should include AUM or AUA that the firm in question has formally delegated to another firm, but at the same time should exclude AUM or AUA that another firm has formally delegated to it. We encourage the Commission to propose similar language to exclude assets delegated to a firm from the k-AUM calculation for purposes of classifying investment firms and for purposes of determining a firm's capital requirement.

We also would welcome further clarifications regarding the calculation of AUA for a wholesale advisor advising its manager affiliate, where the advisor does not behave like a manager (para 129 of the annex) – for example, where the manager does not routinely follow the advice of the advisor without undertaking its own additional consideration. We also welcome the recommendation to avoid double counting between K-AUM/AUA and K-COH (para 143 of the annex).

Client Money Held Factor (K-CMH) needs further clarification

In our response to the EBA discussion paper last February, we noted that the EBA proposal would appear to automatically preclude a firm from being eligible to be classified as a Class 3 firm if it was holding or controlling client money. In our view, the new regime should clarify that "holding" client money in this context excludes controlling client money. Indeed, asset managers will often have the ability to control client assets (including securities and cash) by exercising a discretionary investment management mandate over an account established in the name of the client with an institution such as a bank or custodian. This is typically necessary to facilitate the investment of the client's funds efficiently. We wish to emphasize this distinction between holding and controlling assets in light of comments in the 2015 EBA report (EBA/Op/2015/20) which suggested that there was some lack of clarity around the relevant legal concepts. We do not consider that the ability to control client funds creates a specific prudential risk, as such funds will not be held by the manager itself. To the extent that there is considered to be a possibility of conduct risk in connection with a firm's ability to hold client funds, we believe these should be covered by the professional indemnity insurance (PII) or as part of a Pillar 2 assessment (which will be more sensitive to the specific operational risks within the firm) if applicable. From a prudential perspective, it would also make little sense to treat control of client money and holding client money as equivalent, since this would impose identical capital requirements on firms which only control client money through a mandate, even though that situation does not give rise to insolvency risk.

Should the K-CMH factor include client money controlled by investment firms, there will be very few asset managers in the Class 3 category, in the end affecting the proportional approach sought by this new regime.

Balance sheet higher than €100 million is not well tailored as a determinant of whether a firm is categorised as class 2 or class 3

For many alternative asset managers, a portion of their balance sheet is comprised of assets invested in the alternative investment funds they manage, for reasons like employee deferred compensation rules (or other similar arrangements). Manager investments alongside investors and deferred compensation programs are both designed to mitigate risks and better align the employees of the manager with investors. Deferral of remuneration can be a valuable risk management tool for asset managers, which is consistent with the policy goals of the EBA's recommendation. Further, we believe that assets invested in funds managed by the asset manager serve to align the interests of the adviser and investors, which encourages managers to seek prudent long-term, risk-adjusted gains and avoid inappropriate short-term risk taking. Accordingly, we encourage the Commission not to use this threshold for classification as a Class 2 firm, as it creates disincentives for managers to use these risk-mitigating arrangements, particularly for asset managers that would not likely meet any of the other thresholds for Class 2 classification.

Total gross revenue higher than €30 million is not well tailored as a determinant of whether a firm is categorised as class 2 or class 3

We further encourage the Commission not to use the gross revenue threshold for Class 2 classification, which we believe is not well suited for distinguishing between larger and smaller asset managers. Because many alternative asset managers receive a significant portion of their income based on the investment performance of the funds they manage, we are concerned that many smaller asset managers, who would otherwise not likely meet any of the other thresholds for Class 2 classification, may nonetheless meet the revenue threshold in years of good investment performance. We do not believe that managers should be subject to heightened regulatory requirements simply because they generate good investment returns for clients and are compensated accordingly. Further, because manager revenue is highly dependent on investment performance, this factor could lead to asset managers frequently fluctuating between Class 2 and Class 3.

AIFMs holding MiFID licenses

We understand that the EBA has collected data from authorised AIFMs who hold additional MiFID licenses which enable them to perform certain activities, but that it has not yet analysed it. AIMA would welcome a clarification on how the Commission will apply the EBA recommendations to such firms and would request that such new provisions be submitted to public consultation should the impact be material.

Transitional cap

We understand that the intention of the EBA is that the three year transitional relief - during which the capital impact on any given firm would be capped at maximum twice the current capital requirements - would expire automatically. However, the EBA would be mandated to report to the Commission before the expiry of the transitional period on the impact on the markets and particular types of firms. Since the increase in capital requirements for many of our members is likely to be significant, we would very much support the requirement for the Commission to act upon this report and either possibly extend the transitional period depending on the results of the EBA report or provide that the transitional period shall extend until such time as the Commission, following consideration of the EBA report, determines that the transitional period is no longer needed.

We would also welcome further clarifications as to how this provision inter-relates with provisions on group capital requirements and whether group capital requirements would be the sum of the capped capital requirements at a solo level.

Definition of the trading book

As the definition of a trading book is still being discussed as part of the CRR II proposal debate, we would like to clarify that an alternative investment fund manager might seed a new fund from its own balance sheet. We understand it was not the intention of the EBA to apply to these amounts to RtM or RfT K- factors and we would welcome that this be specified in the Level 1 or Level 2 texts.

CLO collateral managers and securitisation retentions

In our view, it is extremely important that the Commission gives proper consideration to how any new prudential regime would interact with requirements under the proposed Securitisation Regulation so that asset managers can continue to act as sponsors of securitisations and are permitted to hold the relevant retention. It would be disruptive to the securitisation markets if the proposed prudential reforms have an adverse impact on firms' ability to qualify as sponsors and this would run counter to the clearly stated objective of the Securitisation Regulation (and the Capital Markets Union project more generally) to reinvigorate EU securitisation markets.

Remuneration rules

Given the complexity of the policy questions regarding capital requirements and because remuneration requirements raise distinct policy considerations, we encourage the Commission to focus its initial proposal on the recommended capital framework and consider a separate and additional consultation on any proposals regarding remuneration requirements for asset managers and other investment firms. To the extent the Commission determines to move forward with remuneration proposals together with capital proposals, we encourage the Commission to consider the principles discussed below. First, any new principles should be focused on the alignment of interest between asset managers and their clients, funds and investors and should take into account the industry's structure and practices, many of which are designed to achieve the same goals as regulatory proposals.

Among the potential new requirements being proposed is the bonus cap. A bonus cap may be an effective risk reducing tool when the relevant risk is to the institution making the remuneration payments. However, for investment firms focused on asset management activities, the most relevant risks being addressed by remuneration regulation are directed at the risks to clients and aligning the interests of the investment firm and its staff with the interests of investors. This is the clear policy basis for the remuneration guidelines under AIFMD and the UCITS Directive and should the basis on which remuneration guidelines are established for MiFID investment firms that are in the same asset management business.

Although some remuneration principles can and should be shared across the banking and asset management sectors, the fixed-to-variable pay ratio requirement is not only undesirable on policy grounds but also difficult, if not impossible, to implement in practice due to the fundamental differences between the asset management business model and the banking business model. The banking and asset management business models are very different from each other. Accordingly, we request that the features of the asset management sector (which includes MiFID investment firms primarily engaging in portfolio management services), rather than simply the features of the banking sector, be taken into account when considering principles for sound remuneration as applied to asset management firms. While imposing a restriction on the amount of variable remuneration an employee of a bank may receive may be appropriate under the circumstances where the banking sector enjoys wholesale government guarantees, applying this restriction to the regulation of asset managers' remuneration structures is inappropriate.

Remuneration structures within the asset management sector

If asset managers have to set their "appropriate" maximum ratio as a percentage of total remuneration, this presents some significant potential issues. Essentially, there are two ways of changing the fixed/variable ratio – raising the fixed element or reducing the variable element of employee compensation. Either would raise fundamental issues for asset managers.

Raising fixed remuneration, is problematic because having a greater amount of the firm's capital contractually committed to salary/"fixed" profit share payments would restrict the asset manager's ability to limit total remuneration in difficult times and would also permit less flexibility to the firm to maintain its levels of profitability – or even merely to break even - in periods of underperformance or market downturns, not to mention increasing the amount of capital required to meet the FOR. Higher fixed remuneration requirements also create potential misalignment of interests between a firm's employees and the firm's investors as dislocation between the employee's remuneration and investors' returns is more likely than if the employee's remuneration is more closely tied to investors' returns.

Reducing the level of variable compensation is not possible in the context of an owner-managed business where that variable remuneration constitutes the profit of the firm (payable to the senior members as a profit distribution in their capacity as members or partners) or as a dividend (in their capacity as shareholders). A firm cannot simply make its profits disappear and since the employees and risk takers, whose remuneration would be subject to the remuneration principles, are usually also the owners of the business, reducing the level of variable remuneration would make little or no sense.

Even for asset managers that are not owner-managed, reducing the level of variable compensation would significantly impact the ability of the firm to attract and retain key talent in a global market. The importance of talented staff to the asset management industry cannot be overstated. The services provided by managers to the funds they manage are based almost entirely on the knowledge, skill, and experience of highly trained and specialised staff. These staff members are often highly mobile both between firms and internationally. Constraints on the ability of asset managers to reward staff appropriately through variable remuneration would impact on the firm's ability to attract and retain talent and would substantially and adversely affect the industry. If a manager loses its highly skilled staff, investors' risk-adjusted returns will be negatively impacted.

For these reasons, we believe that it would cause disproportionate damage to asset management companies if the new prudential regime for investment firms were to lead to any change in the ability of asset management companies to set appropriate levels of variable remuneration.