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Dear Sirs,

Reaction to Interim Proposal from EBA regarding the Design of a New Prudential Regime for Investment Firms

The Alternative Investment Management Association (AIMA),[1] the Alternative Credit Council (ACC)[2] and Managed Funds Association (MFA)[3] are grateful for the opportunity to provide feedback on the interim proposal presented by the European Banking Authority's (EBA) at a public meeting at their offices on 3 July 2017 and discussed a roundtable hosted by the European Commission on 17 July 2017 (the 'interim

[1] AIMA, the Alternative Investment Management Association, is the global representative of the alternative investment industry, with more than 1,800 corporate members in over 50 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 $1.5 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.

proposal') related to the EBA's initial discussion paper entitled "Designing a new prudential regime for investment firms" (the 'discussion paper').

We support the aim of developing a prudential regime that has rules which are appropriately tailored for investment firms, rather than relying on a "one-size-fits-all" set of rules originally designed to apply to banks. While we appreciate that a great deal of work and thought has gone into trying to design a new prudential regime of investment firms, we remain concerned that the interim proposal continues to be poorly tailored to investment firms, particularly asset managers.

We accept that the presentation provided by the EBA and the data collection materials necessarily do not present the full detail and nuance likely to appear in the final report from the EBA and in any proposal from the European Commission. However, the materials that have been presented in the interim do raise a number of questions and concerns which are summarised below and set out in more detail in the annex to this letter. Many of our concerns articulated below stem from a general view that alternative investment funds and their asset managers should not be treated as systemically important or too-big-to-fail for regulatory purposes. Accordingly, any prudential regime should be calibrated to facilitate an orderly wind-down and a smooth transfer of client portfolios to an alternative manager (i.e., a gone concern basis), rather than to ensure the continuity of the firm on a going concern basis.

Our concerns raised by the interim proposal include:

- **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. 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 are relevant to asset managers are (i) 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, which we strongly believe can be adequately addressed by focusing on an appropriate FOR, and (ii) potential operational risk when assessing the additional K-factor requirements.

- **Systemic and bank-like:** We are concerned that the interim proposal moves away from the proposed requirement for Class 1 that the firms in that class should be both systemic <u>and</u> bank-like and replaces that with a requirement that Class 1 contain firms that are "large <u>or</u> systemic". The term "large" is ill-defined and could be read as either reference to the size of the firm's balance sheet or its AUM, a position which had very different outcomes and levels of risk exposure. The Commission and EBA have recognised that the existing regulatory capital requirements designed for banks are not well tailored to asset managers. Because the consequence of being a Class 1 firm is that the bank regulations in CRD/CRR apply, we believe the requirement for a Class 1 firm to be bank-like is fundamental for the prudential regime to be appropriately calibrated. We also are concerned about the proposed substitution of an investment firm being bank-like with merely being "large", particularly when the proposal does not even require that such an investment firm present systemic risk. As noted above, we do not believe that the amount of AUM is relevant for prudential regulation of an asset manager because the wider market is exposed to the balance sheet and liquidity of the trading entities the asset manager works for on an agency basis, not the balance sheet of the asset manager. We also believe that bank-like rules should not automatically be applied to asset managers, even in the unlikely event they were classified as "systemic", because of the fundamental differences in business models and risk factors between banks and asset managers.

- **Artificial barrier to growth:** It is also important to note that a firm's AUM may grow for a number of reasons. In many cases, the growth in AUM may represent the firm attracting new clients, meaning that risks of losses to underlying clients remain dispersed amongst a greater population of end customers and do not become more concentrated as AUM increases. AUM may also grow due to a firm's successful investment strategy producing returns, which represents a positive outcome for investors and does not reflect increased operational risk. A K-factor for AUM that is required to be calculated constantly and without "smoothing" over time may severely constrain the growth of successful firms by subjecting asset managers to potentially significant and immediate increases in capital requirements when asset managers do not have the same access to wholesale capital markets and central bank funds that banks do. Any additional capital has to be held back from retained earnings or contributed by the partners or shareholders so should only be based on an objective assessment of operational risk. Where growth is fast, the option to raise capital from retained earnings will not be sufficient in most cases. We would encourage regulators not to impose capital requirements for investment firms where the application of the requirements has anti-growth or anti-competitive consequences.

- **Frequency of calculation:** With respect to the K-AUM factor, the definition of AUM and the required frequency of calculation are unclear. When the definition of AUM is clarified, the value of derivatives for the purposes of this calculation need to be based on market values and not on notional values. Requiring the AUM for purposes of the K-AUM factor to be calculated more frequently than the FOR would increase the costs of compliance significantly without any corresponding increase in benefits. For instance, if the final rules require that the K-AUM factor must be calculated continuously for purposes of monitoring compliance, the costs of compliance will increase significantly and would be unnecessarily burdensome.

- **Remuneration:** We do not support the proposed extension of the CRD IV remuneration to investment firms that are asset managers, many of which fall within the scope of the grandfathered CRD III regime today. 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. In particular, we note that UCITS managers and AIFMs are subject to a tailored remuneration regime set out in ESMA Guidelines which use the CRD principles as a starting point but then apply them in a more proportionate manner. Furthermore, there are significant client benefits in aligning remuneration provisions for asset managers with the ESMA Guidelines. The same individual portfolio managers will frequently find themselves managing assets for UCITS, AIFs and separately managed accounts and to avoid conflict of interests it would be highly beneficial for these individuals to be subject to a consistent set of rules.

It will remain difficult to assess fully the proposed three-class categorisation of covered firms until further information is available on the criteria for such categorisation. Accordingly, we look forward to additional opportunities to engage with the EBA, the European Commission, and other stakeholders before any legislation is proposed.

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

Yours sincerely,

/s/ Jiří Król	/s/ Stuart J. Kaswell
Jiří Król Deputy Chief Executive Officer Global Head of Government Affairs Alternative Investment Management Association	Stuart J. Kaswell Executive Vice-President and Managing Director, General Counsel Managed Funds Association

ANNEX

Appropriately tailored prudential regime for asset managers

AIMA, ACC and MFA support the general aim 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. The current application of banking prudential rules to asset managers under the EU Capital Requirements Regulation (CRR) is not well suited for 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. While we appreciate that a great deal of work and thought has gone into trying to design a new prudential regime of investment firms, we remain concerned that the interim proposal continues to be poorly tailored to investment firms, particularly asset managers.

We do not consider that levels of AUM are an appropriate metric for determining the level of risk posed by an asset management firm. 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 are relevant to asset managers are (i) 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, which we strongly believe can be adequately addressed by focusing on an appropriate FOR, and (ii) potential operational risk when assessing the additional K-factor requirements.

Classification of “large” firms as Class 1 firms

We agreed with EBA's initial proposal 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.[4] In support of this conclusion, we continue to emphasise the following non-exhaustive factors:

- ***Asset managers act as agent for their clients:*** Asset managers do not engage in proprietary trading in the financial markets on their own account, but act as agents employing the capital of their clients. As a result, there is an in-built diversification of the investors taking risk in asset management activities, as the relevant capital invested is drawn from a number of different underlying sources.

[4] 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.

Investors also seldom invest all of their assets with one asset manager, which further reduces the risk of serious issues for any one investor in the event of a problem at an individual asset manager.

- ***Substitutability of managers:*** Although investors will choose alternative asset managers based on their particular expertise and track record, generally speaking if one asset manager were to fail, it would be straightforward for clients to select another asset manager to manage their assets going forward.
- ***Size relative to the financial sector as a whole****:* Alternative asset managers are a comparatively small part of the overall financial sector and global capital markets and the client capital managed by these asset managers employs significantly lower levels of leverage than the banking sector.
- ***Post financial crisis regulation has further reduced the systemic impact of alternative investment managers:*** After the various reforms introduced by the financial crisis, alternative asset funds themselves are now even more unlikely to be of systemic relevance. The managers of such funds are many times less likely to be systemically important given their agency business model, size and substitutability.
- ***The impact of stress on the alternative asset fund industry has already been tested:*** The 2008 financial crisis resulted in large number of funds being liquidated or failing and this did not result in any widespread systemic impact on capital markets or the broader economy.

We are troubled by the apparent 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> large or systemic. The term "large" is ill-defined and could be read as either reference to the size of the firm's balance sheet or its AUM, a position which had very different outcomes and levels of risk exposure.

As stated above, our members are not systemic firms and levels of AUM are not an appropriate proxy for the level of risk posed by an asset management firm. However, depending on how the "large" requirement is measured, it is possible that some asset managers might be considered Class 1. 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.

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 has the potential to create disproportionate capital requirements that may easily become divorced from the underlying risks that they are designed to address. Rather than a potentially infinitely increasing capital requirement, we believe the €10 million cap imposed in the AIFMD provides a more balanced approach to additional capital versus the risks from additional AUM.

AIMA, ACC and MFA members are also concerned that the K-factor approach and the use of scalars may operate to penalise the success of larger firms or successful, fast-growing smaller firms. Metrics such as AUM and AUA generally increase over time because an asset manager has shown itself to have a reliable track record. With regard to the alternative investments sector, the relevant clients are sophisticated investors who will normally conduct their own due diligence on the manager in order to satisfy themselves that the manager has the necessary expertise and the relevant systems and controls in place to conduct investment activities in an effective way. Therefore, instead of representing an increased operational risk, higher levels of AUM and AUA are often the result of market participants endorsing an asset manager's strategy and business operations. We would emphasise again that in an agency business, increased AUM and AUA does not result in any increased exposure of the asset manager. The K-factor approach may also encourage inefficiency, as it may act as a disincentive to pooling operations within a particular firm, even though economically this may be the most appropriate business structure (for example, due to the potential to realise economies of scale). Regulatory capital rules should not have the result of leading to unnecessary distortions in business structures, particularly where the resulting inefficiencies may increase costs to the end customer without a commensurate increase in customer protection.

A K-factor for AUM that is required to be calculated constantly and without "smoothing" over time may severely constrain the growth of successful firms by subjecting asset managers to potentially significant and immediate increases in capital requirements when asset managers do not have the same access to wholesale capital markets and central bank funds that banks do. Any additional capital has to be held back from retained earnings or contributed by the partners or shareholders so should only be based on an objective assessment of operational risk. Where growth is fast, the option to raise capital from retained earnings will not be sufficient in most cases. We would encourage regulators not to impose capital requirements for investment firms where the application of the requirements has anti-growth or anti-competitive consequences.

Calculation of K-AUM factor

We also note that the EBA has not specified how AUM is to be defined for this purpose or the frequency with which K-factor calculations should be performed in order to determine a firm's overall regulatory capital requirement. When the definition of AUM is clarified, the value of derivatives for the purposes of this calculation need to be based on market values and not on notional values. Requiring the AUM for purposes of the K-AUM factor to be calculated more frequently than the FOR would increase the costs of compliance significantly without any corresponding increase in benefits.

Due to the potential complexity of the relevant calculations and the fact that the K-factor approach can only operate as an approximate proxy for the risk posed by a firm, we consider that it would be appropriate for asset managers to perform the relevant calculations on the basis of annual average figures from the preceding year, calculated within 120 days of the year-end in order to allow for sufficient time for auditing and confirmation of the relevant figures. In light of the EBA's stated intention to design a proportionate regime that is appropriate for non-systemic investment firms, we would strongly emphasise the importance of ensuring that the resulting calculation rules are simple and do not result in unduly onerous administrative requirements.

Requiring the AUM for purposes of the K-AUM factor to be calculated more frequently than the FOR would increase the costs of compliance significantly without any material increase in benefits to prudential oversight. For instance, if the final rules require that the K-AUM factor must be calculated continuously for purposes of monitoring compliance, the costs of compliance will increase significantly and would be unnecessarily burdensome.

It would be a helpful to see a clear statement that the K-AUM factor is the only factor that will apply to a standard discretionary investment management business. This should be accompanied by a clear statement that the K-GIA factor does not apply to the value of an investment firm's managed portfolios where responsibility for discretionary investment management has been delegated from another regulated firm.

Remuneration rules

We do not support the proposed extension of the CRD IV remuneration to investment firms that are asset managers. 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.

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. In particular, we note that UCITS managers and AIFMs are subject to a tailored remuneration regime set out in ESMA Guidelines which use the CRD principles as a starting point but then apply them in a more proportionate manner. Furthermore, there are significant client benefits in aligning remuneration provisions for asset managers with the ESMA Guidelines. The same individual portfolio managers will frequently find themselves managing assets for UCITS, AIFs and separately managed accounts and to avoid conflict of interests it would be highly beneficial for these individuals to be subject to a consistent set of rules.

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.

Reducing the level of variable compensation is inconsistent with the structure of an owner-managed business where variable remuneration is 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).

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.

However, the alternative, namely raising fixed remuneration, is equally problematic. 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.

Requiring asset managers to impose a fixed 1:1 ratio of the amount of fixed to variable remuneration that they can award to employees would increase the risk of a manager's failure in difficult trading conditions since the asset manager would be contractually committed to pay out more by way of employee salaries than at present. With higher ratios for bonuses, asset managers have greater latitude to 'soak up' lean periods without making redundancies as they can choose to exercise their discretion and reduce bonus payments.

In addition, the ratio reduces the flexibility of asset managers to set total remuneration in alignment with performance (ex-ante risk adjustment) and reduces the amount that will be subject to malus and clawback arrangements (ex-post risk adjustment). The remuneration structures operated by asset managers are typically closely aligned to the performance of the funds, so a higher percentage of variable pay enhances the alignment of an employee's pay with the returns generated for investors and avoids rewards for failure.

It is also very unclear how the fixed 1:1 ratio would work in asset managers which are structured as partnerships. In partnerships, it is very difficult to fix salaries or cap variable pay as any payment is dependent on there being a profit to disburse amongst the partners. Moreover, in the partnership context, any retained earnings will also normally be taxed as if they were not retained.

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.