MANAGED FUNDS ASSOCIATION
The Voice of the Global Alternative Investment Industry
WASHINGTON, DC | NEW YORK

September 25, 2020

Via Email

Paul Rich/Hillary Neale
Strategic and Cross-cutting Policy Division
Financial Conduct Authority
12 Endeavour Square
London, E20 1JN

Re: Response to DP20/2

Dear Mr. Rich and Ms. Neale:

Managed Funds Association[1] ("**MFA**") welcomes the opportunity to provide comments to the Financial Conduct Authority ("**FCA**") in response to its discussion paper "*A new UK prudential regime for MiFID investment firms*" ("**DP20/2**") as published on 23 June 2020[2].

MFA supports the introduction of a UK prudential regime that is designed with investment firms in mind and the FCA's approach of taking into consideration the EU Investment Firm Directive ("**IFD**")[3] and accompanying Investment Firm Regulation ("**IFR**")[4] for the new UK regime.

A. Calculating K-AUM

Q3: "What are your views on how any negative values or liabilities an investment firm manages with a portfolio, for example from derivatives or leverage, should be treated when measuring AUM?"

MFA supports the adoption of an appropriate methodology for the calculation of AUM for K-AUM purposes.

[1] Managed Funds Association represents the global alternative investment industry and its investors by advocating for sound industry practices and public policies that foster efficient, transparent, and fair capital markets. MFA, based in Washington, DC, is an advocacy, education, and communications organization established to enable hedge funds 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, the Americas, Australia and many other regions where MFA members are market participants.
[2] https://www.fca.org.uk/publication/discussion/dp20-2.pdf.
[3] Directive (EU) 2019/2034 – https://eur-lex.europa.eu/legal-content/EN/TXT/?uri=CELEX:32019L2034.
[4] Regulation (EU) 2019/2033 – https://eur-lex.europa.eu/legal-content/EN/TXT/?uri=CELEX:32019R2033.

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MFA notes the FCA's acknowledgement in Paragraph 6.13 of DP20/2 that "*the IFR does not state how the investment firm should treat any negative values or liabilities it manages within a portfolio, for example from derivatives or leverage. Negative values could be either excluded from AUM, added to AUM, or offset with AUM being calculated as the net value of assets the investment firm manages.*"

That being the case, MFA respectfully suggests that the FCA utilizes, for the purposes of the new UK prudential regime, the standard approach to calculating AUM as already widely adopted by the investment management industry. In particular, this would entail off-setting negative values from AUM and excluding from consideration leverage employed. For derivatives, the amount attributable as AUM would comprise the capital that has been deployed from the portfolio to maintain the derivatives position.

This approach would result in AUM being calculated as the net value of assets the investment firm manages on behalf of its clients, which MFA considers to be a more accurate reflection of the actual risk to the firm's clients and, hence, more appropriate for the purposes of K-AUM as a "Risk-to-Client" K-factor.

B. Calculating K-COH

Q6: "Do you agree with our views on how to measure COH, and when it does not apply?

MFA notes, in Paragraph 6.41 of DP20/2, the FCA's position that "*The trades within scope of COH include transactions executed by the investment firm when providing delegated portfolio management services on behalf of investment funds managed by AIFM or UCITS management company*".

As already noted, MFA supports the FCA's proposed approach of UK investment firms being able to exclude, in their calculations of K-COH:

i. transactions handled by the investment firm that arise from the servicing of a client's investment portfolio where those assets are under the investment firm's management and already included in its K-AUM calculation; and

ii. transactions handled by the investment firm that arise from the servicing of a client's investment portfolio where that activity relates to the delegation of management of assets by a financial entity.

In the interest of clarity, it would be helpful for the FCA to confirm that the exclusions from COH in (i) and (ii) above will be applicable equally with respect to transactions relating to the provision of delegated portfolio management services on behalf of investment funds.

C. UK Intermediate Holding Company

Q31: Do you have any comments on the other competent authority options and discretions discussed in this chapter [Competent authority discretions]?

In paragraphs 18.43 and 18.44 of DP20/2, the FCA notes that "*Competent authorities are allowed to require the establishment of an intermediate holding company within the EU where they have concerns about the third country supervision of investment firm group members (Paragraph 3 of Article 55 of the IFD)*" and that the FCA "*would be minded to replicate the effect of this discretion for a non-UK parent company having two or more subsidiaries in the UK for the purposes of applying prudential consolidation or the GCT to the UK group of firms*".

MFA supports the FCA being given appropriate supervisory tools to ensure that non-UK groups of FCA firms are sufficiently capitalized, and notes that the PRA proposes to take a similar approach to non-UK groups of PRA firms after the end of the EU Exit transition period.

In particular, in paragraph 4.9 of CP12/20[5], the PRA states:

> "*When the EU Exit Transition Period ends, the PRA proposes to remove the rules [in CRD V] requiring an [intermediate parent undertaking]*" and further notes that "*The PRA is able to monitor effectively the prudential risks arising from those operations without a requirement to establish an IPU. Where warranted, the PRA has firm-specific powers to require a UK IPU to be established*".

MFA would encourage the FCA to align its approach with that of the PRA, so that there would not be a blanket requirement for non-UK groups of UK firms to establish a UK intermediate holding company. This could otherwise create a layer of additional costs and operational complexity that may be unnecessary in most situations.

D. Exemptions for the payout process rules

Q21: "Do you think it would be appropriate for us to include in a new remuneration code a general proportionality rule similar to that contained in the IFD?

MFA supports the application of any new remuneration requirements to staff of UK investment firms only where it is proportionate to do so based upon the firm's size, internal organization and nature. For example, we believe that investment firms which are not small and non-interconnected should be permitted to disapply certain requirements, such as establishing a risk committee or remuneration committee, or rules on pay-out, deferral and pensions holding/retention periods (the "**pay-out process rules**") when it is proportionate to do so.

[5] https://www.bankofengland.co.uk/-/media/boe/files/prudential-regulation/consultation-paper/2020/cp1220.pdf?la=en&hash=DD8FE26FF43146E45BC7BE58F1CE6A5D79C77A69

Whilst the FCA proposes to allow firms to disapply certain remuneration rules based upon the size of their balance sheet assets, MFA notes that balance sheet assets may reflect the "size" of a firm but may not be an appropriate reflection of the firm's "internal organization" or "nature".

Accordingly, to accommodate for different types of firms (and, in particular, firms that may be non-complex but with a larger balance sheet asset size compared to the proposed threshold), MFA respectfully suggests that UK investment firms should be able to disapply remuneration requirements (in whole or in part) on the general basis of proportionality alone, as it is possible for UK firms to do so under the current prudential regime.

Q35: "Are there any specific areas where you believe that the requirements could be made even more appropriate for investment firms?"

a) Exemption for smaller non-SNI investment firms (Article 32(4)(a) of the IFD)

MFA supports the FCA's view that the pay-out process rules should not apply to UK investment firms with average on-and-off-balance sheet assets of EUR 300 million or less over the 4 years immediately before the given financial year, where the relevant conditions set out at Article 32(5) of the IFD are satisfied.

MFA notes and agrees with the FCA's reference to a threshold of "at least" EUR 300 million and recommends setting a threshold higher than EUR 300 million to strike a better balance in respect of the competiveness of smaller UK investment firms.

MFA considers that the existing proposed thresholds in Article 32(4)(a) and 5(e) of the IFD (of EUR 100 million or EUR 300 million) would put UK MiFID firms at a competitive disadvantage relative to other asset managers (for example, AIFMs and UCITS Management companies) that can currently disapply the pay-out process rules under their respective sectoral remuneration codes on the basis of proportionality. Additionally, such a low threshold could also result in a significant competitive disadvantage for UK firms as compared to their counterparts in non-UK/non-EU jurisdictions (such as those in the United States and in various Asian jurisdictions).

Additionally, MFA believes the much greater diversity in the size and ownership structure of UK investment firms has the potential to make compliance with the pay-out process rules significantly more costly for such firms. In this regard, MFA agrees with the European Commission's assessment that the requirements on deferral and pay-out in instruments, when applied to small institutions, are too burdensome and not commensurate with their prudential benefits[6].

For the above reasons, MFA supports increasing the threshold to at least EUR 500 million.

[6] Report from the Commission to the European Parliament and the Council – assessment of the remuneration rules under CRD IV: https://eur-lex.europa.eu/LexUriServ/LexUriServ.do?uri=COM:2016:0510:FIN:EN:PDF, p.8.

MFA considers this amount to be appropriate and notes that, even with a threshold of EUR 500 million, this would be a significant departure from the status quo. The FCA acknowledges in paragraph 13.34 of DP20/2 that "*Currently, BIPRU firms, IFPRU limited licence firms, IFPRU limited activity firms, and full scope IFPRU investment firms with relevant total assets* ***not exceeding £15 billion****, fall into proportionality level 3.* ***This means it may currently be appropriate for them to disapply certain remuneration rules, including those on retained shares or other instruments, and deferral***" (emphasis added).

Finally, as a technical matter, MFA suggests that the threshold currency be expressed in sterling rather than euro; *i.e.* £500 million.

b) Calculation method for exemption for smaller non-SNI investment firms (Article 32(4)(a) of the IFD)

Article 32(4)(a) of the IFD provides that the pay-out process rules shall not apply to an investment firm, where the value of its on- and off-balance sheet assets is "*on average equal to or less than EUR 100 million [or EUR 300 million, if discretion is exercised] over the four-year period immediately preceding the given financial year*."

Paragraph 13.27 of DP20/2 reflects the same approach:

> *"Firms would need to recalculate annually what their average assets were over the previous 4 financial years to determine whether they may disapply the provisions on pay-out, deferral and pensions holding/retention periods in the new financial year."*

However, MFA notes that paragraph 13.29 of DP20/2 then provides:

> *"If a firm does not have audited accounts available for the complete 4-year period immediately preceding the given financial year, we would expect the firm to use:*
> - *its provisional, unaudited accounts for the financial year immediately preceding the given financial year…"*

Paragraph 13.29 thus indicates that a firm should use audited accounts for the complete 4-year period immediately preceding the given financial year.

MFA acknowledges that the proposed calculation method would ensure that the annual calculation firms will need to undertake to determine whether they qualify for the pay-out process rules exemption is relatively straightforward in practice. However, we believe measuring a firm's assets only at year-end frequently will significantly overstate a firm's asset size. This is because many firms – including many firms which are part of larger international groups – will receive injections of additional assets close to the end of their financial years to cover variable compensation amounts that accrue on the firm's balance sheet at that time.

MFA believes that these firms should have the flexibility to adopt an alternative methodology, such as using 48 monthly data points over the four-year period. This would likely result in a more appropriate and accurate assessment of the true average asset levels of these firms, consistent with the intended policy objective. We note that there are other aspects of the proposals to the UK prudential regime (and in the IFR) that adopt a calculation methodology using monthly figures.

c) Exemption for individuals (Article 32(4)(b) of the IFD)

MFA wishes to highlight that small and non-complex UK MiFID investment firms have a relatively high number of identified staff, compared to larger investment firms, to whom the remuneration requirements could apply, and therefore the administrative costs for complying with the pay-out process rules will be higher in relative terms. MFA believes a one-size-fits-all approach is not appropriate and would not strike an adequate balance in respect of competitiveness of such firms.

MFA considers the proposed threshold of EUR 50,000 is too low and would place UK firms at a significant competitive disadvantage, particularly when seeking to attract the best talent.

Additionally, MFA considers a lower threshold may result in an increase in fixed remuneration as a percentage of total remuneration among smaller UK investment firms. As the FCA has previously noted, an increase in "*fixed remuneration makes it more difficult for firms to adjust variable remuneration to reflect their financial health, and limits deferral arrangements that put remuneration at risk should financial or conduct risks subsequently come to light*"[7]. MFA considers this would be inconsistent with both the prudential objectives of the IFD and the alignment of interest between asset managers and their investors.

The European Commission's assessment of the effectiveness of the pay-out process rules has similarly shown that:

> *"if the rules on deferral and pay-out in instruments were actually to be applied within small and non-complex institutions and to staff with a non-material level of variable remuneration, this would probably lead to the disappearance of variable remuneration in many cases, and thus of the link between pay and performance. In such a case, the objective of aligning remuneration with the risk profile of the institutions concerned would not be achieved"*[8].

For the above reasons, MFA supports increasing the threshold to at least EUR 250,000. As with our response to Q35 above, MFA suggests that the threshold currency be expressed in sterling rather than euro; *i.e.* £250,000.

[7] https://www.fca.org.uk/news/statements/pra-and-fca-statement-compliance-eba-guidelines-sound-remuneration-policies

[8] Report from the Commission to the European Parliament and the Council – assessment of the remuneration rules under CRD IV: https://eur lex.europa.eu/LexUriServ/LexUriServ.do?uri=COM:2016:0510:FIN:EN:PDF, p.8.

d) Non-cash instruments under the pay-out process rules

MFA supports the FCA's conclusion in paragraph 13.91 of DP 20/2 that it would not be proportionate to require firms to issue financial instruments "*purely for use in variable remuneration*". In that regard, we encourage the FCA to ensure that any guidance regarding "alternative arrangements" provides UK portfolio managers with sufficient flexibility in selecting appropriate alternative arrangements, including permitting arrangements where the variable remuneration reflects the performance of assets managed by the firm, with or without the issue of instruments by a parent company or affiliate of the portfolio manager (including third country entities).

MFA notes the FCA's proposal in paragraph 13.92 of DP 20/2 to "*[require] an investment firm that wants to use alternative arrangements to apply for a modification of the rule on paying out in shares or other non-cash instruments. This would require a firm to show how its proposed arrangements would effectively align the interests of staff with other stakeholders' longer-term interests, and help to align variable remuneration with the risk profile of the firm. We do not foresee being able to approve any alternative arrangement that would prevent or hinder a firm from complying with other applicable remuneration requirements such as deferral, retention, malus and clawback*".

Whilst MFA supports the ability to use alternative arrangements, given this issue will be pertinent to all UK portfolio managers (with the exception perhaps of large UK portfolio managers whose shares are publicly traded, but which make up only a minority of UK portfolio managers), the FCA's proposals above would require each UK portfolio manager to obtain separate approval from the FCA to use "alternative arrangements". The application process would be time consuming for firms and processing the applications may be time consuming for the FCA.

In the interest of efficiency and simplicity, MFA respectfully suggests that the FCA grants UK portfolio managers with an ability to use alternative arrangements where the variable remuneration reflects the performance of assets managed by the firm, without the firm having to first obtain FCA approval for such alternative arrangements.

We note that alternative arrangements where the variable remuneration reflects the performance of assets managed by the firm would be consistent with the EBA's proposals in its Consultation Paper on the "*Draft RTS on classes of instruments that adequately reflect the credit quality of the investment firm as a going concern and possible alternative arrangements that are appropriate to be used the purposes of variable remuneration*" ("**Draft IFD RTS**"). [9] In particular, MFA notes that Article 6(g) of the Draft IFD RTS provides that "*… where the alternative arrangement allows for predetermined changes of the value received as variable remuneration during deferral and retention periods, based on the performance of the investment firm or the managed assets; the following conditions shall be met: … (iv) where the value change is based on the performance of assets managed, the*

[9] https://eba.europa.eu/calendar/consultation-paper-draft-rts-classes-instruments-adequately-reflect-credit-quality.

percentage of value change should be limited to the percentage of value change of the managed assets …". From Article 6(g) of the Draft IFD RTS, it can be inferred that the EBA already sees alternative arrangements where the variable remuneration reflects the performance of assets managed by the firm as being appropriate to meet the variable remuneration requirements under the IFD.

e) Remuneration cycle

MFA respectfully suggests that the remuneration rules should apply only to the first full performance year after the new UK prudential regime comes into effect and, as a corollary, these rules would only apply to variable compensation awarded with respect to the first full performance year after the new UK prudential regime has taken effect. This is in order to grant firms with sufficient time to prepare for implementation of the new UK prudential regime and to avoid the operational complexities with having to start applying new remuneration rules half-way through a remuneration cycle.

For example, were the new regime to take effect in Q3 2021, then, for a firm with a financial year starting on 1 January and running until 31 December of each year, the new remuneration rules would only apply to that firm with respect to staff performance during 2022. Hence, the new rules would not apply to any payment of variable remuneration as relating to staff performance for 2021, notwithstanding such remuneration being paid in 2022.

E. Application of remuneration rules to subsidiaries established in third countries

Q34: "Do you have any other comments on the content of a new prudential regime for investment firms as described in this DP?"

MFA supports the proposed approach of exempting subsidiaries (but not branches) of UK investment firms that are established in third countries and are included in a prudential consolidation group from applying the IFD remuneration requirements on an individual basis. We note that this proposal is consistent with Article 25 of the IFR.

However, MFA respectfully disagrees that the availability of this exemption should be predicated on the parent entity being able to demonstrate that it would be unlawful under the laws of the third country where those subsidiaries are established to apply the remuneration requirements.

The application of UK remuneration rules to third country subsidiaries would cause these subsidiaries to be subject to the UK remuneration rules as well as the remuneration rules imposed by their home jurisdiction. Accordingly, this would create a competitive disadvantage for these third country subsidiaries as compared with other firms in their home jurisdictions.

For the reasons above, MFA respectfully suggests that the FCA does not subject third country subsidiaries of UK investment firms to the UK remuneration rules in the first instance.

F. Calculation of Fixed Overhead Requirement

Q12: "Do you have any comments on how to calculate consolidated FOR, consolidated PMR, and consolidated KFR? (See paragraphs 7.22 to 7.46)"

MFA believes that the FCA should specifically provide that investment firms may deduct discretionary variable remuneration for purposes of calculating their fixed overhead requirement (**"FOR")**. These types of remuneration payments are, by definition, not part of a firm's fixed costs. We further note that this approach is consistent with Article 13(4) of the IFR, which provides that the calculation of a firm's FOR shall include a deduction for at least "staff bonuses and other remuneration, to the extent that they depend on the net profit of the investment firm in the respective year".

G. Gender Neutrality

Q22: "Do you agree with our interpretation of gender-balanced remuneration committee? Do you think it would be appropriate for us to include it as a requirement in a new remuneration code? (See paragraphs 13.71 to 13.72)"

MFA agrees with the FCA's interpretation of a gender-balanced remuneration committee in paragraphs 13.71 and 13.72. We also note the FCA's discussion of remuneration policy design in paragraphs 13.64 to 13.67. With respect to the IFD's requirement that remuneration policies and practices be gender neutral, we believe this is best accomplished through existing UK law. Specifically, as noted in paragraph 13.66, the UK's Equality Act of 2010 already applies the principle of equal pay for equal work or work of equal value to employers in the UK. We encourage the FCA to rely on this existing legal framework to implement the IFD requirement rather than adopting a new set of rules solely in the context of the IFD.

MFA would be pleased to discuss the issues addressed in this letter with ESMA. If you have any questions regarding any of these comments, or if we can provide further information with respect to these or other issues, please do not hesitate to contact the undersigned at (202) 730-2600.

Respectfully submitted,

/s/ Michael Pedroni	/s/ Benjamin Allensworth
Michael Pedroni Executive Vice-President & Managing Director, Head of International Affairs	Benjamin Allensworth Managing Director & Counsel, Tax and Finance