MFA

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By email: CP16_24@bankofengland.co.uk

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Re: Remuneration Reform: Consultation Paper

Dear Sir/Madam

MFA[1] appreciates the opportunity to represent the views of the global alternative investment management industry in this written response to the joint Prudential Regulation Authority ("**PRA**") and Financial Conduct Authority ("**FCA**" and, together with the PRA, the "**Regulators**") consultation paper on remuneration reform (the "**Consultation Paper**").

MFA is fully supportive of the Regulators' objectives of making the remuneration regime for banks and dual-regulated firms ("**Dual-regulated Firms**") more effective, simple and proportionate. Such changes are vital to support the international competitiveness of the UK economy and its growth in the medium to long term, in line with the Regulators' secondary objectives, while still ensuring appropriate accountability for risk taking.

While MFA represents solo-regulated firms that are subject to the MIFIDPRU Remuneration Code and AIFM Remuneration Code rather than Dual-regulated Firms, we would like to take the opportunity to invite the Regulators to consider the position of solo-regulated firms.

MFA supports the objectives underlying the Consultation Paper; however, those objectives are likely to be undermined or unaccomplished to the extent corresponding changes are not made to align the position of solo-regulated firms subject to similar rules on remuneration. In particular, we note that a number of the remuneration rules being removed or made more proportionate for

[1] Managed Funds Association ("**MFA**"), based in Washington, D.C., New York City, Brussels, and London, represents the global alternative asset management industry. MFA's mission is to advance the ability of alternative asset managers to raise capital, invest it, and generate returns for their beneficiaries. MFA advocates on behalf of its membership and convenes stakeholders to address global regulatory, operational, and business issues. MFA has more than 180 fund manager members, including traditional hedge funds, private credit funds, and hybrid funds, that employ a diverse set of investment strategies. Member firms help pension plans, university endowments, charitable foundations, and other institutional investors diversify their investments, manage risk, and generate attractive returns throughout the economic cycle.

Dual-Regulated Firms apply also to MIFIDPRU Investment Firms[2] pursuant to the MIFIDPRU Remuneration Code in Chapter 19G of the Senior Management Arrangements, Systems and Controls sourcebook ("**SYSC**") and, in certain cases, Full-Scope UK AIFMs[3] pursuant to the AIFM Remuneration Code in SYSC 19B.

In that regard, we set out in the Annex hereto our responses to the relevant questions of the Consultation Paper, noting those cases where we consider it appropriate that corresponding changes be made to the rules for MIFIDPRU Investment Firms and/or Full-Scope UK AIFMs.

Furthermore, as noted in the Consultation Paper, the Regulators' latest proposals represent the third phase of remuneration reforms for Dual-Regulated Firms, following the removal of the 'bonus cap' in 2023 (Phase 1), and enhancements to proportionality for Dual-Regulated Firms (Phase 2). Certain of the changes made during the second phase of remuneration reforms on "proportionality" have not been made for MIFIDPRU Investment Firms. We address this issue in the sections immediately below.

Phase 2 Remuneration Reforms - Malus and Clawback

During the second phase of remuneration reforms for Dual-Regulated Firms, the following changes were made pursuant to PS16/23[4]:

- the rules requiring the application of malus and clawback in respect of variable remuneration awarded to material risk takers ("**MRTs**") were disapplied for "small" Dual-regulated Firms; and
- the total assets threshold for Dual-regulated Firms to qualify as "small" for remuneration purposes was increased to £4 billion (or, in certain cases, up to £20 billion).

MIFIDPRU Investment Firms

Conversely, for MIFIDPRU Investment Firms, the requirement to apply malus and clawback to MRTs' variable remuneration[5] applies to all firms subject to the 'standard' MIFIDPRU Remuneration Code, in accordance with the application provisions in SYSC 19G.1.1R. Pursuant to such application provisions, any MIFIDPRU Investment Firm that does not qualify as small and non-interconnected ("**SNI**") in accordance with MIFIDPRU 1.2.1R (that is, a "**non-SNI**" firm) is subject to the rules on malus and clawback.

In accordance with MIFIDPRU 1.2.1R, a firm could qualify as a non-SNI (and hence be required to apply malus/clawback requirements) if, among others, any one or more of the following conditions applies[6]:

- the firm's average assets under management ("**AUM**") is £1.2 billion or more;
- the firm's average client orders handled ("**COH**") is £100 million or more per day for cash trades or £1 billion or more per day for derivatives trades;
- the firm's on- and off-balance sheet total is £100 million or more; or

[2] As defined in the FCA Glossary.

[3] As defined in the FCA Glossary.

[4] PS16/23 – Remuneration: Enhancing proportionality for small firms.

[5] Principally, SYSC 19G.6.18R, SYSC 19G.6.31R and SYSC 19G.6.32R.

[6] In each case, as calculated in accordance with methodologies prescribed in the relevant chapter of MIFIDPRU.

- the firm's total annual gross revenue from investment services and/or activities is £30 million or more.

The non-SNI thresholds capture firms that are significantly smaller than firms that could classify as "small" Dual-regulated Firms under the £4 billion or £20 billion total assets thresholds. As a result, at present, a MIFIDPRU Investment Firm would be required to apply rules on malus/clawback, despite being significantly smaller than many "small" Dual-regulated Firms that benefit from the exemption from rules on malus/clawback. This is despite MiFIDPRU Investment Firms, as solo-regulated firms, having inherently simpler and lower risk business models than Dual-Regulated Firms.

The rules on malus/clawback pose a significant hindrance to firms' ability to attract and retain talented individual staff members. Any imbalance in the size thresholds at which exemptions from these rules apply for Dual-Regulated Firms and MIFIDPRU Investment Firms respectively therefore puts the latter category of firms at a competitive disadvantage.

Full-scope UK AIFMs

All Full-Scope UK AIFMs must apply rules on malus/clawback under the AIFM Remuneration Code, unless the firm determines that it is proportionate to disapply the so-called "pay-out process" rules, which include rules on malus/clawback, based on the size, internal organisation and the nature, scope and complexity of the firm's activities.[7]

However, the current guidance on the proportionality principle[8] is overly prescriptive in certain regards. The General guidance on the AIFM Remuneration Code (FG14-02) (the "**Proportionality Guidance**") provides that, for Full-Scope UK AIFMs managing any alternative investment funds ("**AIFs**") other than unleveraged closed-ended AIFs, the starting presumption is that the firm should apply the pay-out process rules if the firm's aggregate AUM exceeds £1 billion.[9] While this presumption may be rebutted by the assessment of other proportionality factors, those other factors are of a more qualitative nature than the AUM thresholds which, as the sole quantitative element, is the unintended focus of the Proportionality Guidance. As such, firms managing AUM above the specified thresholds may be deterred from disapplying the pay-out process rules, given the uncertainty involved in making a determination on the sole basis of the other more subjective factors. Firms that apply the pay-out process rules as a result of this are, as discussed above, at a competitive disadvantage to other firms (including small Dual-Regulated Firms).

We would therefore ask that the AUM thresholds in the Proportionality Guidance either be raised significantly to align with the size thresholds for small Dual-Regulated Firms or removed entirely to allow firms to assess proportionality based on a wholly qualitative set of proportionality factors.

Moreover, we believe that the scope of rules under the AIFM Remuneration Code which may be disapplied under the Proportionality Principle should be broadened in certain respects to provide firms with greater flexibility to tailor their remuneration policies to the nature, scale and complexity of their activities. We address this issue further in the Annex.

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7 SYSC 19B.1.4R(1).

8 FG 14-02, General guidance on the AIFM Remuneration Code (SYSC 19B) and ESMA Guidelines on sound remuneration policies under the AIFMD, (ESMA/2013/232).

9 Paragraph 10. For firms managing only unleveraged closed-ended AIFs, the threshold for such purposes is £5 billion.

Phase 2 Remuneration Reforms – Pillar 3 Disclosures

A further change made during the second phase of remuneration reforms for Dual-Regulated Firms was the introduction in PS15/23[10] of an exemption from Pillar 3 disclosure requirements for small Dual-Regulated Firms that do not have listed financial instruments.

MIFIDPRU Investment Firms

While there is a size-based exemption from disclosure requirements for Dual-Regulated Firms, conversely, all MIFIDPRU Investment Firms (that is, both SNIs and non-SNIs) must publish certain details of their remuneration policy and practices in accordance with MIFIDPRU 8. In turn, non-SNI firms are required to comply with yet more extensive disclosure requirements than SNI firms (including more granular quantitative disclosures).

In line with the discussion above, this means that non-SNI MIFIDPRU Investment Firms may be significantly smaller in size than "small" Dual-Regulated Firms, and have no listed financial instruments, yet may be subject to detailed qualitative and quantitative remuneration disclosure requirements. As noted in PS15/23, the benefits of these disclosures in respect of unlisted firms – in particular with regard to the potential extent and effectiveness of market discipline on the firm through the disclosure – are generally limited compared to that of listed firms. Furthermore, firms that classify as SNI are still subject to remuneration disclosure requirements, despite meeting conditions indicative of their being the smallest and least complex MIFIDPRU Investment Firms.

Finally, MIFIDPRU Investment firms typically have a smaller employee headcount than Dual-Regulated Firms, such that it may be possible for competitors to draw reasonably accurate inferences about a given firm's remuneration from its MIFIDPRU 8 disclosures, placing them at an unreasonable competitive disadvantage. While the FCA during consultation acknowledged the issue of disclosing sensitive information on individuals, and certain exemptions included in the final rules to address this[11], those exemptions are limited to cases where a quantitative disclosure item would relate to one or two individuals. Firms still must disclose aggregated remuneration data that may relate to a group of three individuals. While the risk of disclosing a specific individual's remuneration is more limited as a result of these exemptions, the aggregated remuneration data that firms must publish is still commercially sensitive, given the data still allows competitors to infer average compensation paid to MRTs and senior management.

Phase 2 Remuneration Reforms - Proposed solutions for MIFIDPRU Investment Firms

Option 1 – Proportionality Principle

To address the issues regarding malus/clawback above, MFA proposes that guidance be issued to the effect that MIFIDPRU Investment Firms may disapply the rules on malus/clawback in accordance with the principle of proportionality. This could be in the form of a guidance provision inserted in SYSC 19G, stating that a MIFIDPRU Investment Firm may disapply the rules on malus/clawback[12] where deemed appropriate in accordance with the principle of proportionality set out in SYSC 19G.1.26R. Any such guidance provision could also refer firms to the Proportionality Guidance[13], with its AUM commentary updated as discussed above, as a broad guide to the types of factors to consider (albeit to be considered as relevant in the context of MiFID business, as opposed

10 *See* PS15/23 – The Strong and Simple Framework: Scope Criteria, Liquidity and Disclosure Requirements.

11 MIFIDPRU 8.6.8R(7). See also paragraphs 2.51 to 2.54 of Policy Statement (PS21/17) (Nov. 2021).

12 *See* n. 4 above.

13 FG 14-02, General guidance on the AIFM Remuneration Code (SYSC 19B).

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to AIFM business). This might include, for example, references to "AIFs" being construed instead as references to client mandates comprising discretionary management or investment advice of an ongoing nature.

While this approach may be a considerable option in respect of rules on malus/clawback (given the precedent of the application of proportionality to the pay-out process rules under the AIFMD framework), Option 2 below would be the more appropriate means of addressing the disclosure issue discussed above.

Option 2 – Limiting application to large non-SNI firms

An alternative means of addressing the above would be to limit the application of the relevant requirements to 'large' non-SNI firms (that is, MIFIDPRU Investment Firms that do not meet the conditions in SYSC 19G.1.1R(2)-(3) or MIFIDPRU 7.1.4R(1)-(2)). This is an approach that Regulators could adopt in respect of the requirement to apply malus and clawback to MRTs' variable remuneration (as an alternative to Option 1 above), as well as the remuneration disclosure requirements in MIFIDPRU 8.6.

If this approach were adopted, MIFIDPRU Investment Firms would be subject to the rules on malus/clawback and remuneration disclosures only where the following conditions are satisfied:

- the value of the firm's on-balance sheet assets and off-balance sheet items over the preceding 4-year period is a rolling average of £100 million or less; or
- the value of the firm's on-balance sheet assets and off-balance sheet items over the preceding 4-year period is a rolling average of £300 million or less and, where relevant to the firm;
    - the exposure value of the firm's on- and off-balance sheet trading book business is equal to or less than £150 million; and
    - the exposure value of the firm's on- and off-balance sheet derivatives business is equal to or less than £100 million.

We ask in addition that the Regulators consider whether the above thresholds for large non-SNI status remain appropriate, given these remain considerably below the corresponding thresholds for small Dual-Regulated Firm status.

In addition, in respect of the remuneration disclosure requirements specifically, we request that an additional condition be added to exclude firms without listed financial instruments from remuneration disclosure requirements. This would help align the position for MIFIDPRU Investment Firms with that of Dual-Regulated Firms and is justified on the same grounds set out by the Regulators in PS15/23 in respect of Dual-Regulated Firms. As such, only "large" non-SNI firms with listed financial instruments would be subject to remuneration disclosure requirements.

With the above changes, the criteria for the application of malus/clawback and remuneration disclosure requirements would be more closely aligned with those for small Dual-Regulated Firms. This would help address the current imbalance between the remuneration rules for Dual-Regulated Firms and MIFIDPRU Investment Firms, respectively.

Phase 2 Remuneration Reforms - Proposed solutions for Full-Scope UK AIFMs

As discussed above (and in the Annex), we believe the corresponding issues for Full-Scope UK AIFMs would be most appropriately addressed by revisions to the Proportionality Guidance.

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MFA appreciates the opportunity to provide these comments to the Regulators in response to the Consultation Paper. If you have any questions about these comments, or if we can provide further information, please do not hesitate to contact the undersigned at rhailey@mfaalts.org or 020 3585 2300.

Respectfully submitted,

/s/

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ANNEX

CHAPTER 2. CHANGES TO THE FCA HANDBOOK CHAPTER SYSC 19D AND BUY-OUTS RULE

Proposal to exempt small dual-regulated firms from buy-outs

MFA Comment

Buy-outs

MFA supports the proposal to exempt small Dual-Regulated Firms from rules on buyouts, for the reasons discussed by the Regulators in Chapter 2 of the Consultation Paper, including the following:

> "*while the FCA's rule on buy-outs is high-level and non-prescriptive, the FCA recognises that in practice, applying the rule for small firms could be complex. Therefore, the FCA think this change, overall, will be beneficial for small firms*";
>
> […]
>
> "*if small firms are not able to match the rules, senior individuals could be dissuaded from moving to smaller firms. Removing buy-out requirements on small firms may therefore make them more attractive to MRTs from other financial service firms. This could help sustain healthy competition in the industry and increase the mobility of labour and talent*".
>
> […]
>
> "*this proposed change also helps with the objective of achieving greater alignment and consistency between the regulators' rules*".

While an exemption for Dual-Regulated Firms is supported by the Regulators, equivalent rules on buy-outs apply to all non-SNI MIFIDPRU Investment Firms.[14] Each of the arguments cited above in favour of the proposal to exempt small Dual-Regulated Firms from buy-out rules would support the corresponding change being made to the rules for MIFIDPRU Investment Firms. Given the imbalance between the thresholds for non-SNI and "small" Dual-Regulated Firm status discussed in the main body of this letter, the current position places MIFIDPRU Investment Firms at a competitive disadvantage to Dual-Regulated Firms.

This issue could be addressed by taking either the Option 1 or 2 approach, as set out in the main body of the letter. In other words, the FCA could address this imbalance by introducing guidance to state the rule on buy-outs may be disapplied by MIFIDPRU Investment Firms under the proportionality principle, or alternatively by limiting its application to large non-SNI firms.

Guaranteed variable remuneration

Regarding non-standard forms of variable remuneration more broadly, we believe the issues the Regulators identify on buy-outs apply equally to rules on guaranteed variable remuneration. In particular, both the MIFIDPRU Remuneration Code and AIFM Remuneration Code prohibit the award, payment or provision of guaranteed variable remuneration unless, among other conditions, it is limited to the first year of service.[15] This significantly constrains firms' hiring capabilities, as it prohibits sign-on bonuses or other awards deferred for longer than one year, despite a longer deferral period being a common market practice among firms not subject to such restrictions.

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[14] SYSC 19G.6.13R.

[15] SYSC 19G.6.8R and SYSC 19B.1.14R, respectively.

We believe this issue could be addressed for MIFIDPRU Investment Firms by taking the Option 1 or 2 approach in respect of the guaranteed variable remuneration rule.

For Full-Scope UK AIFMs, the issue could be addressed by revising the Proportionality Guidance to broaden the scope of rules capable of being disapplied under the proportionality principle to include the rule on guaranteed variable remuneration.

CHAPTER 4. ENHANCING PROPORTIONALITY FOR MRTS

The new MRT proportionality threshold

MFA Comment

MFA supports the proposal to amend the remuneration threshold at which Dual-Regulated Firms may disapply certain remuneration rules (such as deferral or payment in instruments) in respect of individual MRTs to more accurately reflect current remuneration levels in the UK.

MIFIDPRU Investment Firms

However, we note that the equivalent provision for MIFIDPRU Investment Firms[16] sets the remuneration threshold at a lower level. Under the MIFIDPRU Remuneration Code, the exemption for individual MRTs from rules on instruments, retention, deferral and discretionary pension benefits applies where the MRT's annual variable remuneration: (a) does not exceed £167,000; and (b) does not represent more than one-third of the MRT's total compensation. This contrasts with the new proposed threshold for Dual-Regulated Firms, under which the MRT's total compensation must not exceed £660,000 (of which variable remuneration must not represent more than 33%). Accordingly, for Dual-Regulated Firms, a variable remuneration cap of £220,000 (compared to £167,000) applies for the purposes of the exemption.

MFA is therefore of the view that the £167,000 threshold should be increased to £220,000 to align the rules for Dual-Regulated Firms and MIFIDPRU Investment Firms.

Full-scope UK AIFMs

Similarly, for Full-scope UK AIFMs, the condition for the corresponding exemption[17] is total remuneration of no more than £500,000 (of which variable remuneration represents no more than 33%). As such, as part of any FCA Handbook changes to address the above, a corresponding adjustment of the threshold from £500,000 to £660,000 (which, as noted in the Consultation Paper, reflects an inflation adjustment) would be appropriate to ensure alignment among the remuneration rules for different types of firms.

CHAPTER 6: DEFERRAL AND RETENTION PERIODS

Retention of Instruments

MFA Comment

MFA supports the proposal to introduce guidance to reflect that Dual-Regulated Firms are not expected to set a retention period for deferred instruments. MFA concurs with the industry feedback cited in the Consultation Paper, that requiring firms to set retention periods is disproportionate, given deferral requirements already ensure a long-term perspective, and requiring individuals to retain variable remuneration paid in instruments for longer periods decreases the perceived value of the relevant award. In the Consultation Paper it is noted by way of conclusion

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[16] SYSC 19G.5.9R.

[17] SYSC 19B.1.13AG.

that "*it is now within the PRA's risk tolerance that firms are not expected to set a retention period for deferred instruments*".

MIFIDPRU Investments / Full-Scope UK AIFMs

However, we would like to highlight that:

- 'large' non-SNI firms are subject to rules on retention periods under the MIFIDPRU Remuneration Code (in particular, requiring them to establish a policy on retention periods for variable remuneration paid in instruments that is designed to align the interests of the staff member with the longer-term interests of the firm, its creditors and clients);[18] and
- Full-Scope UK AIFMs that apply the pay-out process rules are subject to similar rules on retention of instruments.[19]

In light of the proposal to remove retention requirements entirely for Dual-Regulated Firms, and the rationale outlined in the Consultation Paper, it would be appropriate to remove the corresponding requirement for MIFIDPRU Investment Firms and Full-Scope UK AIFMs to address the competitive disadvantage at which such firms would be placed with regard to the ability to compete with the broader UK financial services market on compensation.

Prohibition on Payment of Dividends or Interest on Deferred Remuneration

MFA Comment

MFA supports the proposal to remove the ban on the payment of dividends or interest on deferred remuneration, noting the observation that the primary purpose of the prohibition was to prevent mechanistic breaches of the 2:1 bonus cap that has since been removed, and the Regulators' anticipation that the removal of the ban will not negatively impact firms' safety and soundness.

MIFIDPRU Investment Firms

We note that restrictions remain in place for MIFIDPRU Investment Firms with regard to the payment of interest or dividends on deferred instruments.[20] In particular, such payments are permissible only where:

- the rate of interest or level of dividends paid on that instrument is no higher than would have been paid to an ordinary holder of such an instrument; and
- payment is not made before the date on which the instrument vests.

Given the wholesale removal of restrictions on interest and dividend payments on instruments for Dual-Regulated Firms, and the underlying rationale described above, it would be appropriate for the corresponding restriction for MIFIDPRU Investment Firms to be removed, in the interest of aligning the remuneration rules for such firms and removing rules that serve no useful purpose.

18 SYSC 19G.6.22R.

19 SYSC 19B.1.17R(2) and SYSC 19B.1.22R(3).

20 SYSC 19G.6.29R.