Alternative Investment Management Association

Committee of European Banking Supervisors
Tower 42 (level 18)
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By email to: CP42@c-ebs.org

8 November 2010

Dear Sir,

CEBS Consultation Paper CP42 – Guidelines on Remuneration Policies and Practices

The Alternative Investment Management Association (AIMA)[1] welcomes the opportunity to respond to CEBS's consultation paper CP42 on Guidelines on Remuneration Policies and Practices (the CP).

Overall we welcome the main contours of the approach which CEBS has proposed. In particular, we support CEBS's conclusion that, in order to give proper effect to Recital 4 of CRD3, some of the remuneration principles should be subject to, in CEBS's terminology, 'complete neutralisation', while the remaining requirements should be subject to proportionate application.

However, there are a number of issues which we believe remain to be addressed. Indeed, we would urge CEBS to go further than in its original proposals. As we highlight in our response, the legal and structural model which is typical among hedge fund managers (HFMs[1]) is quite distinct from that found in the banking industry and a strict application of the remuneration principles by HFMs would, in some cases, be impossible to achieve and, in others, would give perverse results. We, therefore, argue that the proportionate implementation of the CRD3 amendments which is envisaged by Recital 4 provides CEBS with full justification to permit the neutralisation of further principles – in particular, the requirements relating to the ratio between fixed and variable remuneration components, to the need to considerably contract variable remuneration where a firm's performance is subdued and to assess performance in a multi-year framework.

The CRD3 amendments were a prudential measure specifically designed to address and mitigate systemic risk brought about where the structure of a trader's remuneration might incentivise him to take risks which exceed the general level of risk tolerated by the systemically important institution for which he works.

No serious study to date has suggested that any individual HFM is systemically important. If size and leverage are useful proxies for systemic importance, we would note the following (and see also Appendix 1):

- the entire **global** hedge fund industry (the majority of which is based outside the EU) manages approximately $1.5 trillion of assets. The aggregate balance sheet size of the EU banking industry alone, on the other hand, is estimated to be in excess of $40 trillion;

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1 AIMA is the trade body for the hedge fund industry globally; our membership represents all constituencies within the sector – including hedge fund managers, fund of hedge funds managers, prime brokers, fund administrators, accountants and lawyers. Our membership comprises over 1,100 corporate bodies in over 40 countries, with 11% based in the US and over 30% of AIMA members' total assets under management (AUM) managed by US investment advisers.

1 In this response, the term HFM refers also to managers of funds of hedge funds.

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- before and during the financial crisis, the range of average leverage in the hedge fund sector was between 1 and 3 times. The equivalent figure for large complex financial institutions in Europe was between 25 and 45 times.

As mentioned above, the nature and structure of HFMs and the remuneration model which they typically use together make HFMs quite different from the credit institutions which caused the problems which the CRD3 amendments seek to address. In particular, we would highlight the following:

- HFMs are typically private, owner-run firms which trade as agents on behalf of the funds they manage – unlike other financial institutions, they do not deal on their own account as principals.
- when a performance fee is paid by the fund to the HFM, this represents cash entering the HFM's business, which is realised and which must, in one way or another, be distributed among the HFM's staff. Since such fees are crystallised when received by the HFM, they are not subject to clawback by the fund or its investors in order to guard these against future losses;
- the typical fee model which is agreed between the fund and the HFM already closely aligns the interests of the manager with those of the fund's investors.
- for example:
  - o the model involves the use of a High Water Mark, so a performance fee is only payable to the HFM when the fund's Net Asset Value (NAV) exceeds its previous highest level reached – until it does so, the HFM typically receives no performance fee;
  - o co-investment in the fund by the HFM is typical (and often demanded by investors), so the manager's own money is at risk should the fund suffer losses, while the manager also shares in gains made under its management of the fund's assets; and
  - o the fund's NAV is subject to appropriate independent valuation across the EU hedge fund industry.

As a result of these differences, a disproportionate application of the CRD3 amendments would cause considerable problems to HFMs. We are pleased to note, therefore, that the interpretation of proportionality which the CP provides generally offers firms and national competent authorities sufficient latitude to implement the CRD3 amendments in a sensible and proportionate manner.

In particular, we fully agree with CEBS that:

- a number of the remuneration principles should be capable of being completely neutralised - including those relating to (i) deferral, malus and clawback arrangements (Annex V, Section 11, point 23 (q) and (r)) and (ii) the requirement (Annex V, Section 11, point 23 (o)) that at least 50% of variable remuneration be paid in shares or equivalent non-cash instruments;
- the effect of the proportionality principle in the CRD3 amendments means that "not all institutions have to give substance to the remuneration requirements in the same way and to the same extent"; and
- the category of "Identified Staff" should be restricted to those members of staff who have a "material impact on the institution's risk profile".

However, as mentioned above, a number of areas of potential concern to HFMs remain, which we would wish to see addressed by CEBS in its final report. These include:

- **the issue of the ratio between fixed and variable remuneration (Annex V, Section 11, point (l))** – we would wish this principle to be capable of complete neutralisation by HFMs;

- **the requirement that total variable remuneration be "generally considerably contracted" where subdued or negative financial performance of the firm occurs (Annex V, Section 11, point 23 (r))** – it is important that the Guidelines provide latitude for an HFM to reward a successful portfolio manager even where the performance of the firm as a whole is subdued or negative and we would argue either that (i) HFMs be given the ability to dis-apply this provision or (ii) CEBS confirms that the term 'generally' may be interpreted to allow

certain individuals to be rewarded, if appropriate, even where the firm's overall performance was subdued. As we explain in the Annex below, one consequence of a strict application of this provision to HFMs may be that a firm is obliged to reward failure, which cannot be the intention of the CRD3 measures; and

- **the requirement that "the assessment of performance is set in a multi-year framework in order to ensure that the assessment process is based on longer term performance" (Annex V, Section 11, point (h))** - while this makes sense in the context of a bank, it is far less clear what is meant by "the underlying business cycle of the firm" for HFMs in respect of payment of performance-based components of remuneration. Performance is generally assessed either quarterly or annually, in line with the period over which the HFM is rewarded for the performance of his fund, while investors tend to have the ability to redeem their investment periodically (often quarterly). We would wish to see either (i) HFMs be able to completely neutralise this requirement or (ii) for CEBS to provide additional clarity as to how the requirement is to be interpreted in the HFM context.

We develop the above points in greater detail in the attached Annex.

Finally, we would make two general points regarding CEBS's work in relation to remuneration:

- we note that CEBS will provide level 3 guidance in relation to the transparency and disclosure requirements included in Annex XII of CRD3 and we understood that a separate consultation paper would be published on this topic. In the absence to date of such a consultation, we take this opportunity to note our strong belief that private arrangements regarding individual remuneration should remain private and would urge CEBS to apply the concept of proportionality in respect of these issues in an appropriate way;

- separate (although similar) remuneration provisions are contained in the forthcoming Alternative Investment Fund Managers Directive (AIFMD) and we recognise that the issue of how these will inter-relate with the CRD3 measures is still to be determined. The latter are, as we make clear in this response, easier to apply in the context of credit institutions than that of investment firms. We believe, therefore, that the final CEBS Guidelines in respect of CRD3 should expressly recognise that it is envisaged that investment firms which will also be AIFM will be subject to remuneration principles under AIFMD, the precise application of which will be clarified in the process leading to the implementation of AIFMD.

Yours faithfully

Matthew Jones
Associate Director
Regulatory & Tax Department

Alternative Investment Management Association

Annex

AIMA's comments on

the CEBS Guidelines on remuneration policies and practices (CP42) - October 2010

In this Annex, we set out AIMA's comments in respect of the Guidelines proposed by CEBS in its CP 42, Guidelines on Remuneration Policies and Practices (October 2010).

1. **Origin and nature of the CRD3 amendments**

   The CRD3 amendments were a response to the financial crisis. More particularly, they were a response to certain activities, whereby, in the words of Recital 1 of CRD3, "excessive and imprudent risk-taking in the banking sector has led to the failure of individual financial institutions and systemic problems in Member States and globally" (our emphasis).

   The CRD3 amendments build on the work of the Financial Stability Board's Principles for Sound Compensation Practices of April 2009 and further Implementation Standards (September 2009). The FSB Principles state in their introduction that they are "intended to apply to significant financial institutions, but they are especially critical for large, systemically important firms". Similarly, we believe that the measures proposed by CRD3 were developed primarily in order to mitigate the threat posed when remuneration structures incentivise a trader to take risks which exceed the general level of risk tolerated by the systemically important institution for which the trader works, and which can undermine sound and effective risk management.

   The CRD text is, therefore, a prudential measure specifically designed to address and mitigate systemic risk.

2. **HFMs and systemic risk**

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

   While excessive risks taken by banks can lead to losses at the shareholder and depositor level, ultimately leading to a taxpayer-funded government bailout (as seen in the recent financial crisis), losses suffered by private investment funds may lead to losses by investors and reduce the fees paid to the HFM (to nil if the fund's High Water Mark is not achieved), but have not led to public financial support.

   The size of the assets under management (AUM) by the thousands of businesses which make up the global hedge fund industry (the majority of which are established outside the EU), is a small fraction of the combined balance sheet of just a handful of large EU banks. The aggregate balance sheet size of the EU banking industry is estimated somewhere above $40 trillion (the size of the 23 largest EU banks alone is estimated to be around $33 trillion) while the **global** asset management industry manages only around $1.5 trillion of assets (See the first illustration at Appendix I). The balance sheet of the largest EU bank is somewhere in the region of 120 times that of the estimated AUM of the single largest EU HFM.

   Similarly, the level of leverage in the hedge fund sector is much smaller than that found in the EU banking sector. While the average leverage ratio of large complex financial institutions in Europe moved between 25 and 45 times before and during the recent financial crisis, the range of average leverage in the hedge fund sector was between 1 and 3 times (see the second illustration at Appendix 1). If size and leverage can be meaningful

proxies for systemic risk, it seems that the systemic importance of the hedge fund industry pales in comparison with other financial sectors. In our view, this is a fundamental issue which should inform the implementation of the CRD3 amendments.

3. **Why proportionality is vital for HFMs**

As CP42 recognises, the final text of the CRD3 included extremely important proportionality provisions which took into account both (a) that non-systemic institutions would also fall within scope of the remuneration principles and (b) that the remuneration rules would apply to an extremely diverse universe of businesses outside the banking sector.

Recital (4) of the amendments expressly provides that credit institutions and investment firms may apply the principles "in different ways, according to their size, internal organisation and the nature, scope and complexity of their activities". In addition, the same Recital states that:

"it may not be proportionate for investment firms referred to in Articles 20(2) and 20(3) of [the recast Capital Adequacy Directive] to comply with all the principles".

AIMA believes strongly that the final Guidelines produced by CEBS following consultation should take full advantage of the flexibility allowed by the legislators through these provisions. CEBS should have regard to the primary aim of the CRD3 measures and the fundamental differences between credit institutions, on the one hand, and asset managers, on the other hand, which make the strict application of the CRD3 principles to asset managers both inappropriate and commercially damaging.

Among the features which distinguish HFMs from banks and which make it vital, in our view, that the remuneration principles are applied in a proportionate manner to HFMs, we would highlight the following:

- banks deal on their own account as principals. It is, therefore, their own assets (and that of their shareholders) which are at risk. HFMs trade as agent on behalf of the funds which they manage;
- HFMs do not generally interact directly with the retail sector nor do they take deposits from the general public;
- banks' and/or large broker dealers' central role in clearing and payments systems means that they are effectively public and market utilities. HFMs are not;
- HFMs have far smaller balance sheets than banks and the funds they manage are far less leveraged;
- the principals of an HFM will ordinarily be expected by investors to co-invest in the fund - having their own money at risk further aligns the interests of the HFM and investor and obviates any advantage the HFM may have in seeking to maximise short term profits to enhance a bonus payment;
- unlike banks, hedge funds typically do not become insolvent. When in difficulty, they are merely wound down and their investors (alone) realise losses on their investment;
- no HFM or fund has received, or is likely to receive, taxpayers' money in order to avoid its collapse;
- the bank/broker dealer remuneration regime has been introduced because a significant proportion of their profits are often based on unrealised mark-to-market values of financial instruments (and, as a result, such 'profits' can subsequently turn out to be illusory). HFM are different - their profits are crystallised. They are paid over by the fund and cannot be subject to clawback, even if the fund's AUM (which gives rise to the HFM's management fee) subsequently declines or the fund's profits (which give rise to the HFM's performance fee) are not realised;

4. **Ways in which HFMs apply the spirit of the amendments**

Moreover, because of the fee structure which is typical throughout the asset management world, the interests of the HFM and those of the investors in the funds which it manages are already closely aligned. We consider,

therefore, that HFMs very largely comply with the spirit of the CRD3 amendments through their existing practices. In particular, we would draw attention to the following:

- the use of a High Water Mark (see Appendix 2 for a fuller explanation as to how the HWM works) reduces – to nil, where appropriate - the performance fee payable by the fund to the HFM where the HFM fails to deliver excess performance over the hurdle rate for the fund in any particular period;

- the different natures of 'profit' in the hands of banks and HFMs as referred to in the final bullet point of Section 3 above; and

- in the EU context, appropriate processes are in place to ensure the independent calculation of the fund's NAV. This helps avoid the potential conflict of interest which arises where the HFM itself calculates the NAV which gives rise to its own fees.

Additionally, the following risk management practices (which are routinely found among HFMs) underline and strengthen the alignment of interests between the HFM and the investor in a way which is quite distinct from the banking sector and which helps mitigate regulatory concern over excessive risk taking:

- strong disclosure practices, which provide investors with the information they need to determine whether to invest in a fund, to monitor their investment and to make a decision whether to redeem their investment;
- robust valuation policies and procedures to provide for clear and consistent valuations of the investments in the fund's portfolio, with independent oversight provided by the fund's board or other governing body, third party administrators, independent auditors and expert valuation advisers, the latter particularly in the case of hard-to-value assets;
- comprehensive risk management processes to measure, monitor, report and manage risk, including stress testing of the portfolio and liquidity risk management;
- sound operational and regulatory systems and controls; and
- a strong culture of compliance, with specific practices to address conflicts of interest.

5. Areas where AIMA has concerns with the proposed Guidelines

There are some areas in which we do not consider that the proposed CEBS Guidelines contained in CP42 go far enough to ensure a proportionate application of the CRD3 amendments by HFMs.

These are as follows:

(a) the ratio between fixed and variable remuneration - Annex V, Section 11, point 23 (l)

Annex V, Section 11, point 23 (l) provides that firms should ensure that

"fixed and variable components of total remuneration are appropriately balanced; the fixed component represents a sufficiently high proportion of the total remuneration to allow the operation of a fully flexible policy on variable remuneration components, including the possibility to pay no variable remuneration component."

While we are pleased that CEBS has resisted the option of mandating a maximum permitted ratio which might be applied as between fixed and variable remuneration components, for the reasons set out below, we would strongly urge that it permits the complete dis-application of this provision in its final Guidelines for HFMs.

The usual remuneration structure within the HFM sector is a relatively low (in terms of total compensation) fixed amount, with a potentially high variable remuneration available if the firm, and/or the relevant individual, performs well. This structure reflects the typical fee structure charged by a HFM. This consists of a

management fee which is set as a percentage of assets under management (usually between 1.5% and 2%) and a performance fee (usually around 20% of the profits generated for the fund during the performance fee calculation period) – see also Appendix 2. HFMs tend to manage their overheads so that these approximately match the expected management fee income. This means that much of the performance fee would often represent pure profit (which can then be distributed among the owners and employees of the business in the form of bonuses/distributions of profit).

The advantage of this structure is that, in a year where no performance fee is generated - either because the funds have not made a profit during the calculation period or because (as a result of losses in prior calculation periods) the fund has not yet reached its High Water Mark (HWM) - the HFM still has sufficient fee income to pay its overheads.

From a prudential perspective, this is an extremely sound model given that the income levels for a HFM can fluctuate considerably depending upon whether or not the manager has generated performance fees during the calculation period. However, in highly profitable years, this model inevitably results in a high ratio of variable remuneration to fixed remuneration.

Given the alignment of incentives between an HFM and the fund(s) it manages referred to above, positive performance for an HFM is driven largely by positive performance of the investment portfolios of the funds managed by the HFM. The use of performance fees by HFMs to pay variable remuneration, therefore, does not put at risk the assets of the managed fund. The HWM exposes the HFM to a loss of performance fee income if the net asset value (NAV) of the fund subsequently declines because no further performance fees are payable until the NAV again exceeds the previous highest NAV on which performance fees were paid.

If HFMs 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 HFMs.

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.

However, the alternative, namely raising fixed remuneration, as a number of large banks have done, is equally problematic. Having a greater amount of the firm's capital contractually committed to salary/"fixed" profit share payments would restrict the HFM's ability to limit total remuneration in difficult times – such as in 2008, when many severely restricted the bonuses which were paid out. It 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.

Consider a firm that has made €5m of management fees and €10m of performance fees in a given year. The firm has overheads of around €5m, i.e., approximately matching the management fee. Let us say that these consist of circa €4m of general overheads plus £1m staff salaries/fixed partner profit shares. In this year, the ratio of fixed to variable remuneration would be 1:10. If this was deemed to be an inappropriate ratio and the ratio was, instead, required to be set at 1:1, this would mean that staff salaries/fixed profit shares would need to be increased to €5.5m (i.e., half of €1m fixed salaries + €10m performance fees). If, in the following year, the funds managed by the firm suffered modest losses, the firm would receive no performance fee. Now the firm has a problem. It needs to pay €9.5m of salaries and other overheads out of €5m of management fees. This would seriously deplete the firm's capital and could make it insolvent (unless the firm had the flexibility to

make large numbers of its staff redundant). Setting a ratio between fixed and variable remuneration in an owner-managed business remunerated through management and performance fees makes no sense.

Given that the CRD3 is a prudential measure intended to prevent firms failing, it is ironic that its impact on HFMs in this respect would, in fact, be to increase the risk of a HFM's failure in difficult trading conditions since the HFM would be contractually committed to pay out more by way of employee salaries than at present. With higher ratios for bonuses, HFMs have greater latitude to 'soak up' lean periods without making redundancies as they can choose to exercise their discretion and reduce bonus payments. Removal of this flexibility by having salaries which must be paid regardless of financial conditions may lead to staff, who might otherwise have been kept, being laid off in order to reduce overheads.

The importance of talented staff to the hedge fund industry cannot be overstated. The services provided by HFMs 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 HFMs to reward staff appropriately through bonuses would impact on the firm's ability to attract and retain talent and would substantially and adversely affect the industry. If a HFM loses its highly skilled staff, the likelihood of the HFM failing again increases greatly.

For these reasons, we believe that the CEBS proposal (paragraph 79 of the CP) that an institution should set explicit maximum ratio(s) on the variable component in relation to the fixed component is disproportionate in the context of HFMs and we advocate that CEBS should permit the complete neutralisation of this provision where this is appropriate and within the spirit of the remuneration principles.

(b) **the requirement that total variable remuneration be "generally considerably contracted" where subdued or negative financial performance of the firm occurs - Annex V, Section 11, point 23 (r)**

As previously mentioned, the variable remuneration paid to staff within an HFM is typically paid out of fees generated by the firm as a result of an increase in the assets of the fund under management during the period in question and beyond any previous HWM. The performance fee is paid by the fund after the fund's NAV has been independently calculated. The fees paid by the fund to the HFM are crystallised and 'real' in that, once the fees are paid to the HFM by the fund, they are no longer subject to market risk, dependent on future performance or available for clawback. Investors are able to redeem their interest in the fund on any redemption date (often these occur quarterly) - and, by doing so, crystallise their gains as a result of fund's performance since they made their investment - or choose to remain invested.

Where, in a particular year, no performance fees are generated, either because no increase in NAV has been achieved or because past periods' losses have not yet been fully recovered (and so the NAV remains below the HWM), there is accordingly nothing, or very little, for the typical HFM to pay out by way of variable remuneration (although in this, as in many other areas, practices vary among different HFMs). In this way, we consider that HFMs would be in compliance with the requirement at Annex V, Section 11, point 23 (r).

However, we do have a significant concern. In some instances, portfolio managers within a firm are remunerated based on the performance of the book or portfolio for which they are responsible, rather than on the performance of the firm as a whole. Where this is the case, the portfolio manager would expect to be compensated for his or her success. Provided it complies with the spirit of the remuneration principles, we believe it is crucial for a HFM to retain the flexibility to reward success through variable remuneration awards. Clearly, the ability to attract and retain high-performing staff is in the interests of both the HFM and the fund.

Bearing in mind that HFMs are firms which are trading as agent, rather than principal, and that the profits available for distribution among staff are, as mentioned above, derived from fee payments (rather than the value of financial instruments on balance sheet) and are therefore 'realised' when paid to the HFM, we believe that it would be disproportionate not to allow HFMs the latitude to make such remuneration provisions, provided

they remain within the overall spirit of the remuneration principles. We also consider that this is entirely consistent with the intention of the performance assessment aspect of Annex V, Section 11, point 23 (g), which states that, in addition to the overall results of the firm, performance-related remuneration should be based on the individual and the business unit concerned.

Further, a strict application of this provision could have the unintended consequence that an HFM is obliged to reward failure. Take the example of an HFM which comprises two portfolio managers (PMs), each managing his own book. One is successful and makes reasonable returns for the fund, the other makes a loss. As a result of the loss, the performance fee which the HFM receives from the fund is reduced – the firm suffers a subdued financial performance within the meaning of point 23 (r). However, the HFM has still received a fee, which it must distribute between its two PMs. If, because a strict interpretation of the principle is applied, the HFM is unable to preferentially reward the successful PM in respect of the returns which he has made, the less successful PM would benefit from his failure to produce positive returns.

Our primary case is that the provision at point 23 (r) should be capable of being dis-applied in respect of HFMs. If this is not accepted, we would strongly urge CEBS to provide comfort in its final Guidelines that firms may rely on the word 'generally' in this context to permit variable remuneration payments to be made to an individual or business unit which does well even where the firm as a whole has done less well.

(c) the requirement that "the assessment of performance is set in a multi-year framework in order to ensure that the assessment process is based on longer term performance" - Annex V, Section 11, point 23 (h)

We would wish to see either (i) HFMs be able to completely neutralise this requirement or (ii) for CEBS to provide additional clarity as to how the requirement is to be interpreted in the HFM context. While the terminology may make sense in the context of a bank, it is unclear what would constitute "the underlying business cycle of the firm", for an asset manager in respect of the payment of performance-based components of remuneration. Performance is generally assessed in line with the period over which the fund manager is rewarded for the performance of his fund – generally, this tends to be either annually or quarterly (though there is nothing to prevent the period being shorter or longer). Further, investors tend to have the ability to redeem their investment periodically (often quarterly), taking the benefit of performance generated and accrued as at the date of redemption.

As has been highlighted above, in the HFM sector, historic revenues are not at risk in future years - profits derived from HFM management and performance fees are fully crystallised in the hands of the HFM – the fees are paid by the fund to the HFM and, thereafter, the profits derived from them form the remuneration pool available for the HFM to distribute among the owners of the business and its staff. If the value of the assets of the fund upon which such performance fees have been calculated later declines, the fees do not become repayable to the fund. Instead, in accordance with the High Water Mark principle, no further performance fees are payable. Further, taking into account the normal process of investors redeeming and making new investments from time to time, those investors who had profited from a "good" year may be different from those in a year when the assets' value declines. The concept of clawback does not, therefore, have the same applicability in the HFM sector as it does in the banking industry, where profits may give rise to bonuses in one year, only for the relevant 'profit' (often based on an unrealised mark to market asset value) to turn in later years to loss.

6. Specific areas where AIMA supports the proposals set out in CP42

As set out in our covering letter, AIMA very largely welcomes the way in which CEBS seeks to apply proportionate implementation of the remuneration principles. We limit our comments below to a number of areas where, although we fully support the proposals set out in CP42, we would wish to draw attention to issues which would be caused for HFMs were CEBS to move away from its initial position.

(a) Deferral - CEBS proposal to allow complete neutralisation of Annex V, Section 11, point 23 (q)

A deferral of at least 40% (and, in some cases, up to 60%) over three years bears no obvious relevance to the 'life cycle' of the typical fund manager. Performance fees, as mentioned above, tend to be payable on a quarterly or annual basis. Investors may, at specified times (again typically, but not universally, quarterly or annually), choose to redeem their interest and leave the fund at that time. The deferral of some part of the HFM staff's variable remuneration would, therefore, have no impact on the investor – it would not, for example, provide an additional source from which payments could be made back to the investor should investment performance go down in subsequent periods. In such circumstances, the High Water Mark model would ensure that the HFM does not receive further fees until the NAV of the fund has exceeded its previous level.

The requirement to defer 40% of remuneration for at least three years would also have profound and negative tax implications for those UK-regulated HFMs which are structured as Limited Liability Partnerships (LLPs) or limited partnerships. Since we estimate that (a) nearly 80% of EU HFMs are UK-based and (b) around 85% of UK-regulated HFMs are structured as LLPs or limited partnerships, this clearly has relevance to the overall European hedge fund industry.

Put simply, the issue is this: under UK tax law, individual partners of LLPs or limited partnerships are generally subject to tax on their entire profit allocation for a year (as adjusted for tax purposes) when this amount is declared rather than when it is actually paid; i.e., it does not matter, from a tax perspective, whether or not the profit allocation has been physically distributed to the partners.

LLPs are taxed on a 'look through' basis, so all of the profit made by the partnership must be allocated to partners at the end of the year. If profit is retained as capital within the business, that is on an effective post-tax basis for the individual partners.

So, if, because of the remuneration principles, a partner does not receive 40% (or, in some instances, 60%) of his or her variable remuneration for at least three years but remains liable for tax on the basis that the remuneration had been paid in full, that partner may well be liable to pay more in tax in a given year than he or she receives by way of income.

(This consequence will be exacerbated if the view of the European Parliament - that the 50% payment in equity requirement applies equally to the deferred and the non deferred portions of variable remuneration – prevails. On this point, we disagree with CEBS and consider that the 50% requirement should apply to the deferred portion only.)

It is important, then, to go back to the principal aims of the amendments made to the CRD. These were to ensure that the remuneration structures in banks would not again contribute to systemic risk as a result of poor alignment with risk management within the bank. The amendments did not come about because of perceived failings within HFMs, or within asset managers more generally. Therefore, complete neutralisation of this provision - which would be hugely onerous and damaging for HFMs if strictly applied - is a wholly proportionate position.

(b) Share based awards – Annex V, Section 11, point 23 (o)

The majority of HFMs are small, privately owned businesses, structured either as LLPs or (less frequently) as private unlisted companies. With very few exceptions, HFMs do not issue publicly tradable equities or equity like instruments for which there is a secondary market.

Awarding staff equity or equity-like instruments, therefore, raises complex issues in the context of HFMs which do not apply to publicly traded banks and, in any event, it is far from clear what could constitute 'equivalent non-cash instruments' or 'hybrid capital'. CP42 refers in passing to phantom share schemes, whereby members

of staff are issued with notional shares whose value is determined by a third party valuer who values the business of the firm periodically. However, these are not an appropriate solution for small privately owned businesses such as HFMs. Such schemes introduce an unacceptable degree of risk arising from the need for the business to be able to redeem the phantom shares at their revaluation price (even though, where the price has increased, there may be no additional cash to fund that redemption).

Also, since the remuneration principles include a requirement that any award of equity be subject to "an appropriate retention policy", the requirement to award Identified Staff 50% of their variable remuneration in the form of equity potentially results in the same (negative cash flow) tax consequences for members of LLPs and limited partnerships (who make up the vast majority of the UK HFM industry) as the deferral provisions referred to above.

Given that the purpose of the share-based awards is to strengthen the link between the staff member's remuneration and the longer term future of the firm, we would argue that the existing alignment between the HFM performance fee structure and investment return has already created the conditions whereby the best interests of the member of staff, so far as remuneration is concerned, lie in ensuring a long term, consistent and non-volatile growth of the fund's NAV year on year.

For this reason, we would wish to see no change to CEBS's original proposals, allowing a firm to completely neutralise this provision where such a step is appropriate.

(c) The definition of "Identified Staff"

The imposition of regulatory limits on how an individual may be paid is an extremely serious intervention in the operation of any business. It is, therefore, essential that the appropriate individuals are identified and that the number of those affected is kept to the bare minimum necessary to achieve the measure's intended result. We consider that CEBS's proposals in this area draw the correct balance.

The CRD3 amendments are intended to address the issue of remuneration structures which might incentivise a member of staff to take excessive risk in order to benefit individually while putting at risk the viability of the systemically significant institution which he represents, thereby leading to the possibility of systemic risk. The CRD3 amendments are a prudential measure and the questions of (i) who is a 'risk taker?' and (ii) what is the 'risk'? must, therefore, be addressed in the context of the mitigation of systemic risk.

Who is a 'risk taker'?

CRD3 identifies the categories of staff whose role is such that it could help cause the harm which is to be addressed. These categories include "senior management, risk takers, control functions and any employee receiving total remuneration that takes them into the same remuneration bracket as senior management and risk takers, whose professional activities have a material impact on their risk profile" (CRD3, Annex 1, section 11, point 23). We agree with CEBS's interpretation of this provision and, in particular, its conclusion that the key element as to which staff are within scope of the remuneration principles should be whether a given staff member has a material impact in the firm's risk profile.

We prefer this approach to that of the UK's FSA which, in its recent consultation paper, CP10/19, widened the categories of staff who would be within scope in such a way as to potentially include some who cannot reasonably be viewed as "risk takers". By way of example, the FSA's proposals would include within its definition of Code Staff anyone who performs a significant influence function (SIF). Since the large majority of HFMs are structured as Limited Liability Partnerships (LLPs) or Limited Partnerships (LPs), and since all partners would, by definition, be SIFs, then all partners would be within scope. We regard this as wholly disproportionate - we fail to see why the remuneration of, say, an analyst or a person who works on an LLP

firm's execution desk or an in-house lawyer and who happened to be Members of the LLP should be subject to the remuneration principles.

What is the 'risk'?

No serious study has suggested that any individual EU-regulated HFM could be regarded as posing a systemic risk. Indeed, the CRD itself recognises this by requiring larger amounts of capital to be held by firms who risk their own money (such as banks) than by those who risk the money of others (such as asset managers). Rather than being large, deposit-taking public institutions which trade their own balance sheet and thereby put at risk not only the shareholders' capital but also depositors' funds, HFMs are typically private, owner-managed firms which trade as agent on behalf of the funds which they manage.

As was demonstrated in the recent financial crisis, while excessive risks taken by banks can lead to losses at the shareholder and depositor level (and ultimately leading to a taxpayer-funded government bailout), losses suffered by private investment funds may subject investors to losses and reduce the performance fee paid to the HFM (to nil if the fund's High Water Mark is not achieved), but have not led to a public bailout.

It should also be noted that the 'risk profile' of the HFM is very specific, being limited almost exclusively to legal and operational risk. If, for example, the HFM invests in breach of the mandate it has agreed with the fund and the fund suffers a consequential loss, there may well be a contractual or tortious liability to the fund, which can be pursued at law. If the HFM breaches a conduct of business rule in its operations, this will be a supervisory issue for its regulator to deal with. If a HFM fails, it is wound up with little impact on the wider market. In that situation, either the portfolio management of the funds under its management would be taken over by another manager or those funds would be wound up (in a solvent manner).

For these reasons, we believe that the CEBS proposals provide sensible and proportionate guidance as to who is and who is not to be regarded as Identified Staff and we would urge CEBS not to alter its position on this issue in its final Report.

(d) Application of the Guidelines to groups – Annex V Section 11, point 23 (v)

We agree with CEBS's analysis, set out in paragraphs 27 to 30 of the CP, that staff at non-EEA parent companies will fall outside the scope of the CRD3 provisions, provided (broadly) that they perform their duties outside the EEA and that the firm has not created special group structures or offshore entities in order to circumvent the remuneration principles.

Given the global nature of the hedge fund industry, we consider it important that CEBS provides clear guidance on this issue in its final Report. We note, for example, that, in CP10/19, the UK FSA considers the possibility that staff employed at a non-EEA parent investment firm might be classified as SIF (see point (c) above) for the UK subsidiary and would, therefore, fall within scope of the CRD3 provisions. As we made clear in our response to CP10/19, we believe that this would be an erroneous and inappropriate jurisdictional over-reach, and goes beyond the intention of the CRD3 amendments;

(e) Remuneration committees – Annex V Section 11, point 23 (f)

While a number of AIMA's HFM members have separate remuneration committees, many are too small for this to be proportionate – there are simply not enough members of staff for this to be a practical step. The same point may be made regarding non-executive directors. Other members have their remuneration determined by parent companies which themselves may not have, or be required to have, separate remuneration committees.

We would also note that the better (and more usual) practice – especially among owner-managed firms - is for the governing body of the firm to determine appropriate compensation, with the role of the remuneration committee (if any) being to recommend an overall framework (and subsequently to review and challenge it).

We are pleased that CEBS's guidance permits a sensible and practical solution by allowing for the complete neutralisation of this provision and does not impose unnecessary and costly requirements on smaller, non-complex firms.

November 2010

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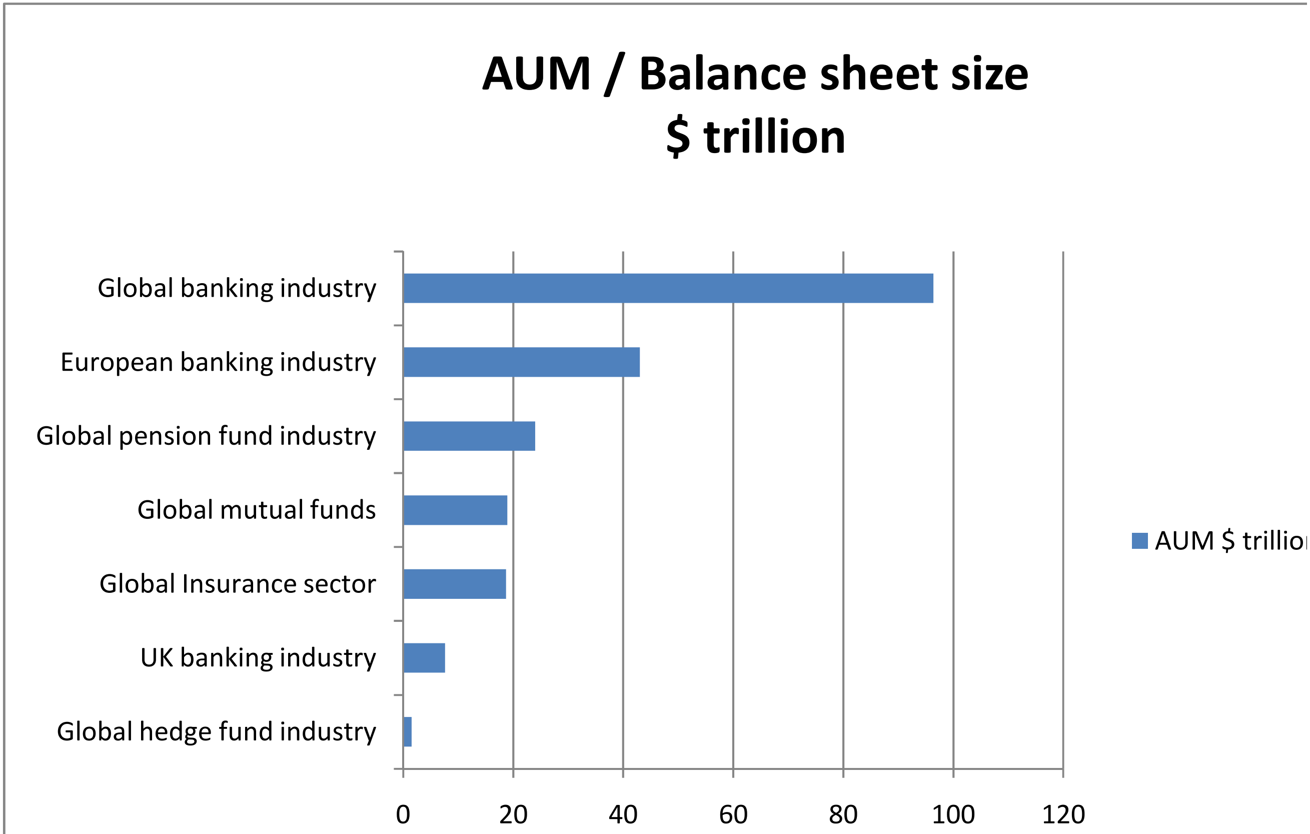
Appendix 1

The comparative size of the hedge fund and other financial industries (year ended 2009)



Source: Bloomberg, the Banker, Hedge Fund Intelligence

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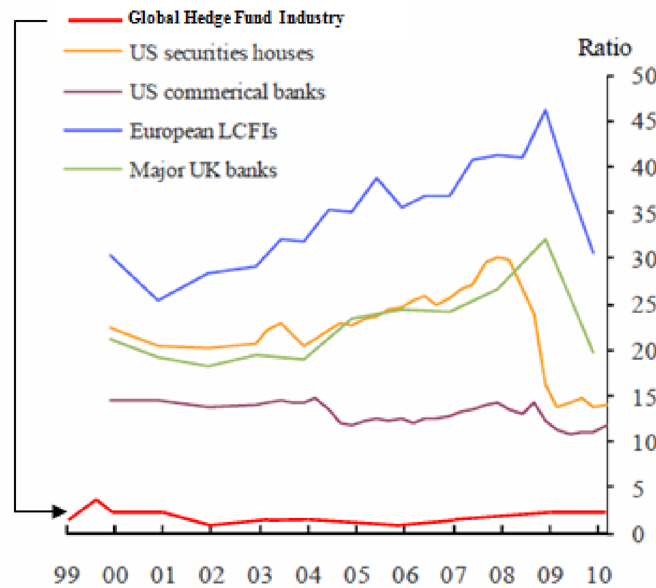
Leverage analysis of large complex financial institutions (LCFI's) versus hedge fund industry.



Source: Bloomberg, published accounts and bank calculations, Hedge Fund Research, BIS.

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Appendix 2
AIMA's Note on
Remuneration in the Hedge Fund Industry

Introduction
Within the hedge fund industry, the existing remuneration model is widely seen by managers and investors alike as providing strong alignment of interests between (a) the investors in a given hedge fund and (b) the principals within that fund's investment management company (the Fund Manager). This is because those principals will ordinarily be expected to co-invest some part of their own money in the funds which they manage and will, therefore, stand to benefit or suffer with the other investors as the fund's assets increase or decrease in value.

Indeed, a lack of material co-investment is often regarded as a 'red flag' by potential investors in hedge funds.

Fees are also structured to provide an alignment of interests: if investment performance is strong, then both the Fund Manager and the investor benefit. Thus, the Fund Manager has an incentive to deliver consistent positive absolute returns.

A Fund Manager's compensation typically comprises two constituent elements:

- a management fee; and
- a performance fee.

All compensation to staff, whether by way of salary or bonus, is paid out of fee pools that are created from formulae for these two elements. These fee formulae are completely transparent, being explained clearly in the offering documentation which is received by all investors prior to subscription.

The management fee
In the case of investment management fees, an ad valorem charge (typically 2 per cent) is earned on the net assets of a fund; this model is universally used by every type of investment management business, not just by hedge funds. The management fee is accrued regardless of investment performance and is sometimes regarded as the fee that meets the fixed costs of the investment management firm.

The management fee is earned only on net assets. Consequently, there is no incentive for the Fund Manager to use leverage in order to boost the management fee, even if leverage or borrowing is employed by a fund as part of its investment strategy, since doing so will not affect the size of the fund's net assets.

The performance fee
Performance fees have historically operated in the ratio of 4:1. This means that, for all performance over and above an agreed and pre-determined hurdle rate (usually the 'high water mark'), investors retain 80 per cent of the excess returns whilst 20 per cent of the excess returns accrue to the Fund Manager as performance fees (hence, this is termed the '2 and 20' model – 2 per cent of AUM for management fees, 20 per cent of excess performance for the performance fee).

Conversely, if the Fund Manager does not deliver any excess performance over the hurdle rate for the fund in any particular year, then it earns no performance fee in that year.

This model of using a combination of management fees and incentive/performance fees by hedge funds is widely accepted by investors and managers alike and has not led to any accusations of asymmetry of risk-taking such as in the debate over executive compensation at commercial and investment banks. Additionally, the approach has been

actively encouraged by regulators internationally because of the strong alignment of interests between owners, managers and their investors that it produces.

Negotiation of percentages for management and performance fees
Investors in hedge funds will be professional or sophisticated investors, often institutional in nature, who will decide whether or not to commit their money only after consideration of the offering documentation and following appropriate due diligence of the Fund Manager. The hedge fund will enter into an agreement with the Fund Manager, setting out, among other things, the terms on which the latter is to be remunerated. This will be a matter of private contract between two commercial counterparties and, therefore, subject to negotiation in light of market conditions – as borne out by anecdotal evidence from the recent financial crisis, which has seen some variation to the usual '2 and 20' model referred to above.

Inappropriateness of clawback under the hedge fund model
Fund Managers are fundamentally different from banks in a number of ways which make it inappropriate simply to transfer proposed rules for banks across to the hedge fund sector wholesale.

A significant proportion of the bank's profits are often based on unrealised mark-to-market values of financial instruments. As a result, such 'profits' can subsequently turn out to be illusory. Fund Manager's profits, in contrast, are crystallised in the hands of the Fund Manager when paid by the fund, to be then distributed among the Fund Manager's owners and staff.

One means of seeking to restrain excessive risk-taking by banks is to impose a clawback, to the benefit of the shareholders, where performance bonuses are paid out in one year but losses accrue subsequently. Such measures are inappropriate under the hedge fund model, even if the fund's AUM or its profits are not realised because of subsequent movements in the mark-to-market value of the relevant fund assets. The reason for this is that, with few exceptions, Fund Managers are not publicly traded companies, nor do they have public shareholders who would benefit from the windfall of clawing back bonus remuneration in subsequent years.

In any event, as mentioned above, most European Fund Managers are privately owned businesses – usually structured as limited liability partnerships or limited partnerships. Their most senior staff (such as the portfolio managers) are typically not employees and are remunerated not by way of salary plus bonus but, instead, they are paid a share of the Fund Manager's profits in the relevant financial year. If the bonuses were to be clawed back by the Fund Manager, this would result in the Fund Manager's principals (usually, the same individuals) being entitled to that windfall.

Protection of investors' interests – independent valuation and high water marks
Nevertheless, the investor faces the risk of the fund being valued on a day when asset prices are high (with the Fund Manager's performance fee being calculated and paid out on the basis of that valuation) only for the mark-to-market price of the fund's assets to decline shortly thereafter. The hedge fund model guards against this risk in two ways:

- in order to avoid the conflict of interest which arises when the Fund Manager values the fund's assets on which its own performance fee is to be based, valuation is typically undertaken by an entity appointed by the fund and independent of the Fund Manager; and
- by use of the 'high water mark'.

By setting a high water mark, the Fund Manager receives its performance fees only on increases in the Net Asset Value (NAV) of the fund which exceed the highest NAV previously achieved. Thus, where a fund is launched with a NAV per share of, say, €100 and this rises to €120 by the end of the first year, the Fund Manager is paid a performance fee of 20 per cent of the €20 increase in share value. If, the following year, the NAV falls to €110, no performance fee would be payable (because a loss has been made). If, in year three, the NAV then rises to €130 per

share, a performance fee is again payable – but only on the €10 by which the share price exceeded the previous high water mark (i.e., €120) and not on that year's full increase from €110 to €130.

This measure links the Fund Manager's interests more closely to those of the fund's investors and reduces the incentive for managers to seek volatile trades. If a high-water mark was not used in association with a performance fee, a fund which ended alternate years at €100 and €110 would generate a performance fee every second year, enriching the Fund Manager but without adding significantly to the value of the fund.

This is not how the hedge fund industry works.

Distribution of performance fees within the Fund Manager

Where returns are above the pre-agreed hurdle and a performance fee accrues, this fee is paid by the fund to the Fund Manager and is then available for distribution among the Fund Manager's staff. Practices vary as to how Fund Managers determine the appropriate distribution – due diligence prior to investment will provide investors with information regarding the practices within a specific Fund Manager – but in general terms, staff will be compensated by way of a combination of:

- a base salary;
- a bonus payable at the discretion of the Fund Manager; and
- some form of longer-term capital incentive linked to the Fund Manager's business.

Different firms use different principles in determining compensation payments but a discretionary bonus paid to a portfolio manager would ordinarily reward strong returns made on behalf of the funds. Discretionary bonuses paid, for example, to the Fund Manager's compliance staff or administrative staff may be based on different considerations.

The three elements referred to above combine so that, at a well-run Fund Manager, staff are incentivised to produce long-term good returns for the funds being managed and enhance the long term health of the Fund Manager's business. Thus, it is in the best interest both of the Fund Manager's staff and also of the investors within the funds being managed to achieve a steady and consistently good return on investments.

NB: The Note above seeks to explain the typical remuneration structure found within the hedge fund sector.

The Note is, as a result, generic and does not seek to cover all situations. For example, the situation of an investor who joins a fund in the course of a performance period will be treated differently from one already invested at the start of that period.

Equally, while the Note above describes the 'typical' remuneration structure, others exist which differ in certain aspects (including where the Fund Manager receives a lower than usual performance fee while the fund's returns are below the high water mark, but cannot revert to its usual performance fee until both the losses and an agreed additional percentage of the losses, have been made up).

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