European Banking Authority
One Canada Square
Canary Wharf
London E14 5AA
United Kingdom

Submitted electronically via the EBA website's response to consultation form

2 February 2017

Dear Sirs,

Designing a New Prudential Regime for Investment Firms

The Alternative Investment Association Limited (AIMA),[1] the Alterative Credit Council (ACC)[2] and Managed Funds Association (MFA)[3] are grateful for the opportunity to provide feedback on the European Banking Authority's (EBA) discussion paper entitled "Designing a new prudential regime for investment firms" (the 'discussion paper').

In our detailed response in the annex to this letter, we set out our views on the EBA's proposals and the appropriate prudential regime to apply to investment firms undertaking asset management activities. We also respond to the specific questions posed in the EBA's discussion paper.

By way of summary, we consider that the most important points are as follows:

- We support the general aim of developing a prudential regime that has rules which are appropriately tailored for investment firms, rather than relying on a "one-size-fits-all" set of rules originally designed to apply to banks.

[1] AIMA, the Alternative Investment Management Association, is the global representative of the alternative investment industry, with more than 1,700 corporate members in over 50 countries. AIMA works closely with its members to provide leadership in industry initiatives such as advocacy, policy and regulatory engagement, educational programmes, and sound practice guides. Providing an extensive global network for its members, AIMA's primary membership is drawn from the alternative investment industry whose managers pursue a wide range of sophisticated asset management strategies. AIMA's manager members collectively manage more than $1.5 trillion in assets.

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

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

- We consider that it is important for the EBA to recognise that the purpose of regulatory capital in the context of asset management firms is not to ensure the continuity of the firm on a going concern basis, but to facilitate an orderly wind-down and a smooth transfer of client portfolios to an alternative manager (i.e., a gone concern basis).
- Non-bank firms are united more by the activities that they do not undertake (i.e., deposit-taking) than those which they do. While we recognise the attraction in theory of having a single set of standardised rules for non-systemic firms, we believe that the EBA proposals belie the complexities of this heterogeneous population of firms. In particular, further tailoring for the specific features of the asset management agency business model is essential. Such tailoring should make it straightforward for any given firm to apply the rules to its own business. For example, there should be *de minimis* thresholds below which a Class 2 firm need not perform calculations relating to given K-factors which have only a marginal impact on its business.
- From our engagement with the EBA and the European Commission (Commission) at the Commission's open hearing held on 27 January 2017, we note that the EBA appreciated that asset managers are agency businesses with specific business models that typically generate only a limited set of exposures for firms. The EBA appeared to acknowledge that some of the concerns raised in the discussion paper properly relate to proprietary trading operations, rather than agency businesses. Although we note that the EBA has sought to move away from a prudential regime that categorises firms based on the activities that they undertake, we consider that a simple way of differentiating between firms engaged in proprietary trading and those that are not would be by reference to whether the firm performs the activities of: (i) dealing on own account otherwise than on a matched principal basis, such that it would be subject to an initial capital requirement of EUR 730,000 under the existing CRD IV regime,[4] and/or (ii) the MiFID activity of underwriting or placing on a firm commitment basis. While there may be concern about national regulators applying different interpretations of what constitutes certain activities under MiFID and CRD IV, in our view, these two activities are reasonably clear and would form a sensible and workable basis for a distinction. A number of requirements under the prudential regime, including the leverage uplift, the large exposures rules and certain more onerous liquidity requirements could then be applied only to those firms engaged in proprietary trading. Departing entirely from an activities-based categorisation regime risks creating a set of rules that is too complex and not sufficiently tailored to accommodate the heterogeneous population of EU investment firms. Using these activities to distinguish between firms is a straightforward and elegant solution for identifying firms whose businesses are far more likely to be systemic in nature without significant disparities between Member States.
- One way in which there could be tailoring to the asset management sector would be significantly to raise the threshold for firms to qualify for Class 3 (and to remove suggested impediments to such categorisation), and to subject Class 3 firms to a much simplified set of prudential rules, which we suggest ought to be the higher of an appropriate fixed overheads requirement (FOR) or the initial capital requirement (ICR). Class 3 firms should be calibrated to include firms employing a small number of staff and posing low regulatory risk. We consider that the exception to this should be for firms which are simple "adviser" firms who only provide investment advice and/or reception and transmission services to a principal investment manager. Such firms pose no real risk to the wider financial markets or to underlying investors and we do not see any compelling justification for applying a FOR in such a situation as there would be no disruptive effect, even if such firms were to

[4] For the reasons we outline under the "Appropriately tailored regime for asset managers" heading below, we do not consider that the unmodified definition of dealing on own account under MiFID II should be adopted for these purposes, due to the effect of recital (24) to the MiFID II Directive in relation to firms that deal on a matched principal basis.

cease providing their services abruptly. In that scenario, we consider that a fixed capital requirement should be sufficient.

- We particularly support simplification of the rules on what may be recognised as regulatory capital, an increased ability to repay regulatory capital where this is no longer necessary to meet a firm's regulatory capital requirement and simplified regulatory reporting.
- However, the EBA proposals are in several important respects not sufficiently developed for us to support them whole-heartedly. In particular, the absence of detail around the K-factors and their corresponding scalars makes it very difficult to determine whether those factors are appropriately calibrated for the asset management industry. In that context, we are concerned that the data set recently gathered by the EBA is unlikely to be reliable, since we strongly suspect that the vast population of smaller investment firms will not have engaged with it, whether because of the limits to their internal resources or because the details of the policy development process were not yet sufficiently detailed for them to appreciate its full significance. Accordingly, we would welcome every opportunity closely to engage with EBA and with the Commission in the further development of this policy and we consider that the EBA or the Commission should undertake further analysis and data collection once more concrete details about the proposed K-factors and scalars are available. We believe that further public consultation and rigorous cost-benefit analysis (whether by EBA or the Commission) will be essential to the success of the initiative.
- We do not consider that levels of assets under management (AUM) are an appropriate metric for determining the level of risk posed by an asset management firm. The agency nature of asset management activities means that the ownership of the relevant assets will remain with clients and in many cases, the assets may be held with a separate custodian. In our view, the principal risk that is relevant to asset managers is the possibility of a disorderly wind-down which impedes the transfer of management of the underlying client portfolios to a new manager. We consider that this can be adequately addressed by focusing on an appropriate FOR.
- We consider that the size of a firm's AUM also does not directly correlate to the potential level of conduct risk posed by a firm, as firms with lower levels of AUM may represent higher risks if they have poor internal controls. Conversely, firms with higher levels of AUM, but which operate robust systems and controls, may represent lower levels of risk. We therefore consider that a requirement (or an option) to use professional indemnity insurance to cover potential conduct risks would be more suitable since the cost of PII is inherently sensitive to the firm's control environment and compliance history.
- It is also important to note that a firm's AUM may grow for a number of reasons. In many cases, the growth in AUM may represent the firm attracting new clients, meaning that risks of losses to underlying clients remain dispersed amongst a greater population of end customers and do not become more concentrated as AUM increases. AUM may also grow due to a firm's successful investment strategy producing returns, which represents a positive outcome for investors and does not reflect increased risk.
- In considering the relevant factors to determine the regulatory framework for non-systemic investment firms, we consider that the EBA should focus on investor protection issues, which are relevant for investment firms, and avoid factors that are likely only to be relevant to systemically important firms such as the risk-to-market factors proposed in the discussion paper.
- It is important to draw a distinction between the liquidity requirements for an asset management entity itself and the liquidity of the underlying portfolios being managed. Where investors have a right to redeem their investments in a fund or portfolio prior to the maturity of the underlying assets, there is a potential issue with liquidity mismatch. However, this issue relates to the underlying portfolio and can be addressed through mechanisms such as redemption fees or "gates", as well as

the drafting of the terms on which investors are permitted to redeem. This is an entirely separate issue from liquidity requirements applying to the asset management entity itself. If an asset management firm were required to maintain additional liquidity buffers on its own balance sheet, these would not affect the ability of investors to redeem their investments because redemptions are funded from the assets of the underlying fund or portfolio, not from the asset manager's own balance sheet resources. We consider that any potential issues relating to liquidity mismatch in relation to the underlying portfolio are being addressed by the Financial Stability Board's (FSB) ongoing work looking at fund-level liquidity and are not relevant to the prudential regime governing investment firms themselves.

The discussion paper is wide-ranging, and there are many other important points in our main response set out in the annex, to which it is impossible to do justice in this executive summary.

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

Yours sincerely,

\s\ Jiří Król

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Alternative Investment Management Association

\s\ Stuart J. Kaswell

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ANNEX

The purpose of regulatory capital in the context of asset managers

Meaning of the term "prudential"

AIMA, ACC and MFA members welcome the EBA's focus on designing a new prudential regime, but consider that it is important that any such regime uses a concept of "prudential" regulation that is appropriate for asset managers. In this regard, it is important that the EBA does not focus on the broader definition of "prudential" requirements from the banking sector (which, for example, may import implications that the rules are designed for firms with wider systemic importance) and instead focuses on an appropriate definition for asset managers. We set out below our view of the specific function of prudential rules in the asset management context.

Orderly wind-down on a "gone concern" basis

In our view, when considering the design of any new prudential regime, the EBA should begin by considering the purpose of regulatory capital and liquidity rules in the particular context. AIMA, ACC and MFA members consider that it is inappropriate to seek to apply prudential rules to asset managers that are designed to ensure the continuity of the firm on a going concern basis, as opposed to ensuring an orderly wind-down of the firm on a gone concern basis. We note that the EBA observes at paragraph 86 of the discussion paper:

> "At the same time it seems worth discussing, to which extent the permanence of capital is needed to ensure prudential concerns are met given that the EBA Report [EBA/Op/2015/20] states that the concept of ensuring going concern is not essential for the majority of investment firms, as opposed to caring for the impacts of the withdrawal of the firm from the market."

Asset managers act as agents on behalf of their clients. As a result, the transactions entered into by an asset manager on behalf of its clients do not expose the asset management firm to direct prudential risks. The failure and subsequent winding down of an asset manager does not result in any risk to the wider market and does not affect the value of assets held by investors in a fund. This may be contrasted with the risk to depositors in the event that a bank fails.[5] For this reason, we consider that it is appropriate that asset managers are subject to prudential rules which are designed to ensure an orderly winding down of the firm as a gone concern. In our view, this is most easily achieved by reference to an appropriately calibrated FOR which reflects the need for the firm to continue to service its clients during any wind-down period until a suitable replacement asset manager can be found or the asset manager provides clients with their remaining money. It is normally reasonably straightforward to substitute a new asset manager for the firm in wind-down or return capital to clients as the client portfolios will normally be held separately from the asset manager.

[5] For further information relating to prudential risks in the context of the asset management industry, please refer to AIMA's response and MFA's response to the FSB and the International Organization of Securities Commission's (IOSCO) consultation paper on Assessment Methodologies for Identifying Non-Bank Non-Insurer Global Systemically Important Financial Institutions each dated 7 April 2014, and AIMA's response dated 1 June 2015 and MFA's response dated 29 May 2015 to the second FSB and IOSCO consultation on the same issue.

Responsibility for ordinary course investment losses

At paragraph 36 in the discussion paper, the EBA states:

> "For the vast majority of investment firms, especially those which operate on an agency basis, the most important element of risk will be the potential for harm they may pose to their customers (for example, where they do not carry out the relevant investment services correctly). Therefore a range of observable K-factors for the 'risk to customer' (RtC) are required, taking into account the need for full coverage of a wide range of investment firms and different ways in which they can service, and act for or on behalf of, customers."

While we acknowledge that it is obviously possible for an asset manager (or indeed any other firm operating on an agency basis) to cause harm to its customers by acting in contravention of applicable legal (including contractual) or regulatory requirements, for the reasons we discuss below, we do not agree that it is appropriate to address this issue through the use of RtC K-factors in the manner proposed by the EBA. We also think that it is important at the outset to distinguish between actions or omissions for which an asset manager may properly be held responsible (such as, for example, a breach of rules relating to the allocation between clients of securities resulting from aggregated orders, which directly results in loss to a client) and investment losses, which are an inherent risk for participants in the financial markets. In this regard, we believe it is important for the EBA to confirm that its reference to "*incorrect discretionary management of customer portfolios*" in paragraph 37(a) of the discussion paper is not intended to refer to investment losses that result from investment decisions which are taken properly in accordance with the firm's mandate and in compliance with all legal and regulatory requirements. It is not appropriate for a prudential regime to seek to impose capital requirements on an asset manager on the basis that the manager must be able to cover investment losses, as clients accept the risk of such losses in the ordinary course of investing when they engage an asset manager.

<u>General observations on the EBA proposals</u>

Appropriately tailored prudential regime for asset managers

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

We recognise the attraction in theory of having a single set of standardised rules for non-systemic, non-bank-like investment firms. However, we doubt whether, in reality, it will be possible to draft one set of rules that is appropriately tailored for such a heterogeneous population. In practice, non-bank firms that are subject to the CRR are united more by the activities that they do not undertake (i.e., deposit-taking) than those which they do. An asset manager is fundamentally different from, for example, a central counterparty or an investment bank that engages in proprietary trading or underwriting. These different activities involve different levels of risk, varying levels of interconnectedness with the wider financial system, different degrees of substitutability, and entirely different assumptions of responsibility by the relevant investment firm. It is not clear to us that the use of K-factors is sufficient on its own to ensure that the resulting prudential rules are appropriate to the relevant firm. AIMA, ACC and MFA members would therefore support efforts to tailor the general prudential regime so that it includes an appropriate level of specific rules and/or derogations for investment firms engaged in asset management activities.

During our attendance at the Commission's open hearing on the proposed new prudential regime on 27 January 2017, we noted that the EBA appeared to acknowledge that a number of its concerns that are reflected in the discussion paper are primarily relevant to proprietary trading businesses. We consider that this is particularly the case in relation to the large exposures rules, the leverage uplift and the more onerous elements of the proposed liquidity requirements.[6] In our view, any new prudential regime needs to have clear, bright-line categorisations in order to ensure that it is applied in a straightforward and consistent way across the EU. We would therefore support a distinction between investment firms based on whether they engage in proprietary trading or not. For these purposes, we consider that a firm should be classified as engaging in proprietary trading where it carries on one or both of the following activities:

- dealing on own account otherwise than on a matched principal basis (i.e., such that it would, under the current CRD IV regime, be subject to an initial capital requirement of EUR 730,000 because it does not fall within the exemption for firms undertaking matched principal trading in Article 29(2) of the CRD IV Directive); and/or
- underwriting or placing on a firm commitment basis.

We note that under Article 2(1)(d)(iv) of the MiFID II Directive, a firm which executes client orders may still be considered to deal on own account for the purposes of MiFID. This has been interpreted to mean that a firm which is engaged in matched principal (i.e., back-to-back) trading activities will still be dealing on own account for these purposes. Nonetheless, we do not consider that the MiFID definition is appropriate for the purposes of determining whether a firm is engaged in proprietary trading under any new prudential regime. Instead, we consider that the existing provisions in Article 29(2) of the CRD IV Directive (which are not being amended as part of the implementation of MiFID II) provide a suitable basis for determining whether an asset manager is dealing only on a matched principal basis (and therefore is not engaged in proprietary trading). Conversely, a firm which does not meet the requirements in Article 29(2) and therefore "truly" deals on own account (and which would, under the existing CRD IV prudential regime, have an initial capital requirement of EUR 730,000) should be considered to undertake proprietary trading activities. The CRD IV definition reflects the fact that firms dealing on a matched principal basis assume very little (in the case of imprecisely matched orders) or no balance sheet risk.[7]

We recognise that the EBA has previously expressed some reservations about the use of MiFID or CRD IV activities to delineate between different categories of investment firms on the basis that there may be divergent interpretations between Member States as to what different activities actually involve. However, we consider that in the case of the above two activities, there is unlikely to be considerable divergence between jurisdictions and therefore these activities can form a suitable basis for categorising firms as either proprietary trading or non-proprietary trading firms.

For non-proprietary trading firms, we do not consider that the prudential regime needs to provide the same rules that are applied to proprietary trading firms. In particular, in our view, non-proprietary trading firms should not be subject to the large exposures rules, leverage uplift or specific quantitative

[6] See the "*Large exposures*" heading below for further discussion as to why we consider that the large exposures regime is inappropriate in the context of asset management businesses.

[7] Where we refer elsewhere in this response to "dealing on own account", we are referring to the activity of dealing on own account otherwise than on a matched principal basis unless we expressly state otherwise.

liquidity requirements proposed in the discussion paper. We consider that those provisions are designed to address issues inherent in assuming significant risk through substantial proprietary trading activities on a firm's balance sheet. The leverage uplift ratio, in particular, may require a complex set of rules to operate as intended and we consider that such complexity is not justified for simpler firms which do not engage in proprietary trading.

If our proposed simple delineation based on MiFID and CRD IV activities is rejected, then the adjustments to the leverage uplift factor outlined by the EBA in paragraphs 66 – 68 of the discussion paper become very important. In those sections, the EBA notes that it may be necessary to adjust the application of the uplift factor for smaller firms which have a low FOR by setting a minimum threshold, based on a multiple ("y") of the ICR, below which the uplift factor would not apply. In that situation, the absolute amount of ICR under the new regime becomes critical, as if a low level of ICR is set for a particular type of firm, a higher value of y will be required to generate a sensible overall threshold figure. Since the uplift factor essentially reflects the on- and off-balance sheet risks arising from proprietary trading activities, in order to distinguish between significant non-bank-like systemic institutions (for which the uplift factor may be appropriate) and smaller firms (for which it is not), the level of y may need to be set as a multiple of several hundred or more. We do not consider that it would be helpful or desirable to set ICR at an inflated figure, as this could represent a very significant barrier to new market entrants and competition. We consider that there may be considerable technical difficulties in calibrating an appropriate uplift regime and therefore, in our view, it would be far simpler and clearer to differentiate between firms based on key MiFID proprietary trading activities.

Further detail on calibration of the new prudential regime

We note that, at the present time, certain aspects of the EBA's proposals have not been elaborated with sufficient details or granularity to permit AIMA, ACC and MFA members to ascertain the likely effect of the proposals. Therefore, while we are broadly supportive of designing a new, more proportionate regime for investment firms (and as stated above, particularly a regime that has elements that are sufficiently tailored to accommodate the specificities of the asset management industry), we reserve our position on whether the EBA's proposals are appropriate on an overall basis or whether it would be preferable to retain the current CRR rules until further details are forthcoming. We would welcome every opportunity closely to engage with the EBA and with the Commission in the further development of this policy. We believe that further public consultation and rigorous cost-benefit analysis (whether by the EBA or the Commission) will be essential to the success of the initiative.

Consistent with the EBA's recognition that prudential rules for banks should not automatically be applied to investment firms, we also consider that if the EBA's proposals in the discussion paper are not taken forward in the near future, the current CRR should not be extended to all MiFID firms (or indeed, more widely to other types of non-MiFID firm) simply in order to create one harmonised prudential system. Prudential rules must be appropriately tailored to the types of firms to which they are to be applied and address the specific risks in the most efficient and practical manner possible. Inappropriate prudential rules have the potential to cause serious harm to economic efficiency and to distort competition within markets. For this reason, if the EBA (or, later, the Commission) chooses to adopt an approach that is significantly different from that outlined in the discussion paper, we would strongly encourage it to publish a new consultation seeking further industry feedback.

Increased AUM does not automatically correlate to increased risk

AIMA, ACC and MFA members do not agree that the level of prudential risk posed by a firm necessarily increases in a linear way as the level of a firm's AUM increases. Successful asset managers frequently increase their AUM by attracting new clients, rather than by existing clients concentrating their assets in portfolios managed by the particular asset manager. In practice, this means that the risks remain dispersed amongst a wider population of end customers and do not automatically increase or become more concentrated as AUM grows. AUM may also increase as a result of an asset manager having pursued a successful investment strategy and generated positive returns for investors. An increased AUM also does not correlate to increased counterparty risk for other market participants, as the asset manager does not enter into the relevant transactions on its own balance sheet and therefore has no resulting exposure. Therefore, while we recognise that the EBA has in part proposed the use of K-factors because it considers that the applicable regulatory capital rules for Class 2 firms must be "infinitely scalable", we consider that use of inappropriate scalars has the potential to create disproportionate capital requirements that may easily become divorced from the underlying risks that they are designed to address.

Reliability of underlying data

When considering the underlying data analysis performed in connection with the discussion paper, we would encourage the EBA to keep in mind that there is very likely to have been a limited response from asset managers to the original data collection exercise. In part, this reflects the fact that many asset managers are smaller entities which have limited resources and therefore were unable to devote the necessary time to collate and provide the appropriate data. Also, given the timing of the data collection exercise, before publication of the discussion paper, and the lack of granularity in some sections of the discussion paper once published, it will have been difficult for firms or types of firms to appreciate the significance of the proposals for them. As a result, there is a risk that the EBA's current data set may be unreliable or unrepresentative as regards the asset management industry and we would caution the EBA against drawing blanket conclusions from that data which may not reflect economic reality. We would suggest that the Commission request the EBA to perform further calibration work once more detailed proposals relating to K-factors are published.

Accounting consolidation rules

For the purposes of all of our comments below, we believe it is important for the EBA to appreciate that in certain contexts, some accounting standards (including, for example, those in the United States) may require the assets of investment funds to be consolidated onto the balance sheet of the relevant asset manager – for example, on the basis of a "control" test for the purposes of statutory (shareholder) accounting. However, in such circumstances, this accounting consolidation does not imply that these assets are, in economic reality, the assets of the manager and therefore that the manager has assumed true balance sheet risk in relation to such assets that is synonymous with the risks that may result from proprietary trading. Instead, the relevant pools of assets are, in reality, held in legally separate fund entities. As a result, this form of consolidation should not result in the relevant manager being forced to treat AUM as balance sheet assets for regulatory purposes, being considered to be systemically important or being considered to pose significant risk to the market as it is merely a function of accounting rules. As the EBA will be aware, there are existing EU rules which require asset managers to ensure that client assets are separately identifiable from assets of the manager and are recorded in separate accounts. AIMA, ACC and MFA members will typically use third party custodians to hold client assets. We would therefore advise the EBA to treat the relevant portfolios of assets separately from the manager in such circumstances, particularly when considering the application of our proposals below. As a general overall point, we would emphasise that the assets and liabilities of investment funds in relation to which asset managers may provide services are not the assets and liabilities of the asset management firm itself and should not therefore impact the prudential rules that will be applicable to that firm.

Professional indemnity insurance

In relation to the potential harm caused by a breach of applicable legal or regulatory requirements, we do not consider that the proposed RtC K-factors would be an appropriate or effective way of ensuring that a firm is able to make good any resulting losses for which it may be held responsible. It is incorrect to assume that the risk of causing losses to clients from regulatory breaches necessarily increases in a linear way as relevant metrics such as AUM or assets under advice (AUA) increase. A firm with a relatively small AUM and/or AUA but a poor control environment is more likely to breach the applicable rules than a firm with a higher level of AUM and/or AUA that has an appropriately resourced compliance department and well-designed systems and controls. None of the K-factors listed by the EBA is a suitable proxy for determining whether the firm's organisational structure and internal monitoring are suitable for mitigating the relevant risks or not. Apart from the continued rigorous application of conduct of business rules, we consider that a professional indemnity insurance (PII) requirement would be a better way to address the risk of serious rule breaches, provided that the minimum terms and coverage of PII are appropriately calibrated. The cost of PII for each firm is inherently sensitive to the firm's control environment and its previous history of compliance breaches. As a result, PII does not penalise successful asset managers who operate rigorous control environments merely because such firms attract more clients and therefore may have higher levels of AUM and/or AUA.

<u>Classification of firms as Class 2 firms</u>

We note that the category of Class 2 firms is effectively the residual population of firms which are too small to be classified as Class 1 firms, but are too large to be classified as Class 3 firms. (We set out our separate comments in relation to Class 1 and Class 3 firms below.) It is likely that if the EBA's current proposals are adopted, the majority of asset managers will fall within Class 2. If the EBA maintains the Class 3 thresholds that it has proposed in the discussion paper, Class 2 is likely to be an extremely large and heterogeneous class of firms which are all subject to an identical set of regulatory capital rules. For this reason, we would encourage the EBA to revisit the relevant thresholds for Class 3 firms in the manner that we outline under the "*Classification of firms as Class 3 firms*" heading below in order to ensure that Class 3 is large enough to be a meaningful class and Class 2 contains firms which might justifiably be subject to a slightly more complex set of regulatory capital requirements.

General comments on K-factor approach

Further consultation required: AIMA, ACC and MFA members are concerned that the EBA's discussion paper does not contain sufficient detail on how the relevant K-factors and their corresponding scalars will operate in practice for Class 2 firms. We consider that this information is not merely a minor technical detail, but instead goes to the very heart of the question as to whether a K-factor regime can adequately capture the risks that are relevant to Class 2 asset managers without creating unduly burdensome or complex regulatory capital requirements. We would reiterate again that it is important that a "one-size-fits-all" approach is not adopted here, as K-factors and scalars that fail to distinguish between fundamentally different types of businesses are likely to lead to inappropriate regulatory capital requirements. We believe that it will be fundamental to the further development of this policy that either the EBA or the Commission consult further publicly, and conduct a full cost-benefit analysis. In our view, it is essential for the EBA or, if necessary, the Commission to conduct further consultations once they have formed a clear view of how any relevant scalar may be calibrated and may operate in practice. We look forward to engaging with any such initiatives.

We note, for example, that in paragraph 41 of the discussion paper, the EBA states:

> "Individual scalars would be identified as part of the overall calibration and impact assessment process. A scalar could be linear, which would be simple, or could be non-linear

for example if the potential impact of the firm on others is felt to be increasingly more important the larger the firm's 'footprint' in the relevant area. There is also the possibility to subsequently drill down and provide sub-factors under any given K-factor should additional granularity be deemed appropriate (and does not unduly compromise simplicity)."

The various options identified by the EBA for the calibration of the K-factor regime could produce radically different results. For example, a non-linear scalar has the potential to produce distorting "cliff-edge" effects as the relevant K-factor for the firm reaches the boundary that would result in a step up to the increased scalar. In order to avoid undesirable effects, such as the artificial and inefficient structuring of business lines to avoid such cliff-edges, the use of non-linear scalars would need to be carefully modelled and considered. Even a linear scalar, while seemingly simple, has the potential to produce results which diverge from the true degree of underlying prudential risk represented by the applicable K-factor if it is improperly calibrated. It is not clear that the risks associated with particular K-factors do in fact increase in a linear manner in all circumstances; for the reasons discussed in our letter, we doubt that this is the case. As the EBA has not provided examples of the types of sub-factors that could potentially be used, AIMA, ACC and MFA members have been unable to form a view as to whether the use of further sub-factors would be appropriate.

De minimis thresholds: We also consider that it is important for a Class 2 firm to be able to determine easily which K-factors are relevant to its business and that K-factors which can reasonably be considered *de minimis* in nature can be disregarded, in order to prevent calculations from becoming unnecessarily complex. We would therefore encourage the EBA to set appropriate *de minimis* thresholds for each K-factor below which the relevant metric may be disregarded and need not form part of the firm's regulatory capital calculations. It would be disproportionate for firms to have to conduct calculations in respect of aspects of their business which have no appreciable impact on their overall risk profiles.

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

Disproportionate requirements for smaller firms: It is also possible that if the K-factors and scalars are not appropriately calibrated, they may result in disproportionately high capital requirements for smaller firms, meaning that such firms are required to hold very large amounts of capital relative to the size of their balance sheets. This could represent a significant barrier to entry for new market participants and could also adversely affect the growth and long-term success of such firms, harming competition and innovation.

Nature of clients: The clients of AIMA, ACC and MFA members are generally sophisticated professional investors who will conduct due diligence on asset managers' operational systems and controls and have the knowledge and skills to monitor the manager's activities and performance over time. We consider that the status of a firm's clients could be a relevant K-factor (or potentially a scalar or other modifier) which operates to reduce capital requirements in appropriate cases. This is because if one of the EBA's primary concerns in relation to firms is conduct risk and its capacity to cause loss to clients, this risk is mitigated by the stronger potential ongoing oversight of professional investors.

Investment performance: As we noted above under the "*Responsibility for ordinary course investment losses*" heading above, we also consider that it is extremely important for the EBA to recognise that the RtC K-factors should not be designed with the purpose of protecting clients from investment losses which materialise in the ordinary course of investing (rather than, for example, a specific legal or regulatory breach by the relevant asset manager). We note, for example, that in paragraphs 37(a) and (b) of the discussion paper, the EBA refers to "*incorrect discretionary management*" and "*unsuitable advice*", while in paragraph 37(f), it refers to the possibility that "*the customer can lose out*" when a firm handles customer orders. It is imperative that these concepts do not cover ordinary course poor investment performance that is an inherent risk in any activity in the financial markets. Firms do not accept liability for such losses and it would be inappropriate and disproportionate to attempt to design a regime that requires investment firms to hold capital to cover them. For the reasons that we have outlined above, we consider that, apart from continued supervision of conduct of business rules, any risks arising from breach of regulatory or legal obligations can be adequately addressed through PII arrangements.

Comments on specific proposed RtC K-factors

Double-counting: With specific regard to the AUM K-factor, to the extent that AUM remains a K-factor, we note that this will need to be adjusted to avoid double-counting of AUM where an asset manager acts as a sub-manager to whom management of a portfolio has been delegated by the lead manager (including where the lead manager is subject to a different prudential regime, such as that under AIFMD). Failure to adjust for double-counting would lead to regulatory capital inefficiencies and therefore has the potential to distort existing business models which have been shown to be effective and in the customer's interest by permitting delegation to specialist managers where appropriate. We consider that the same principle should apply in relation to EU sub-managers who conduct portfolio management on behalf of a US parent so that they are not required to count the AUM of the parent, which will in any case be subject to US rules and supervision. We do not believe that there is any justification for applying two sets of capital requirements in relation to the same assets, since any conduct risk in relation to decisions taken in connection with the assets will reside with the sub-manager to whom management has been delegated and any concerns about continuity of service must also relate to that sub-manager. Where a firm is merely acting as a sub-manager and does not have any discretion to make investment decisions in relation to the portfolios of underlying clients (but instead merely provides advice to the principal investment manager), we do not consider that any of the AUM of the relevant portfolios should be attributed to the sub-manager. There must also be no double-counting between any of the other K-factors which may potentially involve overlap – for example, AUA and customer orders handled. We would therefore request that the EBA drafts specific rules which address the issue of double-counting and provide for suitable adjustments.

Double-counting may be minimised if there are clear rules relating to the measurement of relevant data points, which will be important in any respect. For example, it will be necessary in the case of many global mandates to address the fact that an EU sub-manager (providing services to a US lead manager) may in theory during European hours technically have discretion over the whole of the assets of a portfolio but it would not in practice actively exercise such discretion over any but a relatively small proportion of those assets, and it is likely to be subject to geographical concentration limits. Similarly, in the case of AUM, it will be necessary in the case of closed-ended funds to distinguish between committed capital and drawn-down capital for the purposes of measurement.

Segregation of client money and assets: With regard to the client money held (CMH) and assets safeguarded and administered (ASA) K-factors, we do not agree with the EBA's view that these factors are necessary in order to achieve "*additional protection*". In our view, existing segregation requirements for client funds and assets already adequately address the applicable risks, ensuring that such assets are adequately protected and ring-fenced in the event of the firm's failure. Imposing an additional capital requirement that increases in a linear manner as CMH and/or ASA increases would be inappropriate, as this implies that the risks that the firm poses to the customer escalate proportionately as the level of client assets and/or funds increases. Proper segregation arrangements for funds and assets ensure that this is not the case. We consider that the arguments we set out in under the "*Professional Indemnity Insurance*" heading of this response apply equally here – i.e., the relevant issue in such a situation is the effectiveness of a firm's internal governance and controls, not the value of assets being safeguarded or funds held. This is because a firm with a low level of CMH and/or ASA that has a poor control environment and therefore fails to comply with applicable segregation rules poses a greater risk than a firm with a higher level of CMH and/or ASA that has implemented robust systems and controls to ensure protection of the relevant funds or assets.

Comments on RtM K-factors

AIMA, ACC and MFA members do not consider that risk to market (RtM) K-factors should apply to asset managers that do not present systemic risks. The rationale for RtM K-factors appears to be based on concerns that a firm may pose a risk to the wider markets in which it operates, but this implies that the firm must be, at least in part, systemic in nature. As the EBA notes in paragraph 10 of the discussion paper, the vast majority of Class 2 firms are, by definition, not systemic (although we understand that the EBA considers that a small number of Class 2 firms could be systemic but not bank-like). We would therefore question this particular justification for the use of RtM K-factors. In any case, as asset managers are agency businesses which do not generally enter into proprietary trading on their own account, we consider that such firms are currently unlikely to pose a risk to the wider market and therefore should not be subject to the RtM K-factor requirements.

Many professional services businesses (e.g., international law firms, accountancy firms) which earn fee income in one currency but have expenditure in another will enter into derivatives with banks to hedge their foreign currency exposure. These businesses are purchasers of financial services products. Asset managers earning management fees in one currency but with expenditure (e.g., offices or staff costs) in another may wish to purchase derivatives to hedge these liabilities. In doing so, they are purchasers of financial services just like other professional services firms. They are not using their balance sheet to trade on a proprietary basis against the market. We do not consider that an asset manager that enters into derivatives on its own balance sheet solely for the purpose of hedging non-trading exposures arising in the normal course of its business in this way should be subject to the RtM proprietary trading activity (PTA) requirements. The use of hedging helps reduce risks for the investment manager and therefore the EBA should not design regulatory capital rules which would have the effect of penalising (and therefore potentially discouraging) hedging arrangements.

Securitisation risk retentions: We also do not consider that there should be a specific RtM K-factor in relation to securitisation risk retentions. Where a firm holds a securitisation risk retention (for example, in its capacity as sponsor of a CLO arrangement), the relevant notes issued by the securitisation are no different from any other asset held on the firm's balance sheet. In our view, it is neither necessary nor appropriate to design a specific metric and scalar in relation to such assets. The key issue is that the manager is required to maintain the relevant exposure for risk alignment purposes. We also note that holding a risk retention does not involve firms dealing on own account or underwriting. They are held for the medium to long term and not with trading intent.

Comments on RtF uplift factor

In relation to the proposed risk to firm (RtF) uplift factor, AIMA, ACC and MFA members agree with the position identified in paragraph 48 of the discussion paper – i.e., that firms should not be required to apply any additional RtF uplift factor because any relevant risks will already have been captured either through the K-factor approach or (as we advocate for Class 3 firms, and potentially for all asset managers) through an appropriate fixed overhead requirement designed to support an orderly wind-down process. We do not agree with the assessment that an RtF uplift is necessary to recognise the potential increased behavioural risk that may result when a firm is in a financially weakened position. If such a risk does in fact materialise during periods of financial stress, it is not clear to us that imposing a higher regulatory capital requirement will address this issue. Any risk of misconduct in such a situation should be addressed through appropriate conduct rules and heightened supervisory attention from competent authorities.

We do not consider that the CRR leverage ratio is an appropriate measure for determining the RtF uplift for an agency business such as asset management. In so far as the RtF uplift is apparently connected to an increased risk of poor behavioural outcomes in a financial stressed situation, we do not see that there is a direct connection with the firm's leverage. Leverage at the level of the asset management firm is not the sole cause, nor for most asset managers a likely cause, of firms entering into periods of financial stress and we are doubtful that the presence of leverage would lead to any increased misconduct in such a situation. In any case, we consider that the CRR leverage ratio is a fairly blunt calculation that is insufficiently risk sensitive for these purposes.

For firms that are not systemic in nature and whose services are readily substitutable, we do not consider that any form of RtF uplift is necessary. In our view, the application of a leverage ratio RtF uplift is only likely to be appropriate for firms dealing on own account or underwriting on a firm commitment basis or that create wider systemic implications.

Practical considerations for K-factor calculations

We note that the EBA has not specifically proposed any form of transitional period for Class 2 firms in relation to the adoption of the K-factor approach. In our view, if the K-factor approach is adopted, firms should be able to rely on transitional arrangements while they collect the necessary data to perform the relevant calculations.

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

Proposed alternative regulatory capital calculations for Class 2 asset managers

We would support a simplification of the capital requirements for asset managers which recognises that the overriding objective of such requirements is an orderly wind-down and a smooth transfer to a replacement manager. We consider that this justifies the same capital requirement as for Class 3 firms which we suggest under the "*Proposed appropriate regulatory capital requirements for Class 3 firms*" heading below – i.e., the higher of 25% of FOR or the firm's ICR. If necessary, this could be accompanied by an appropriately calibrated PII requirement to reflect the potential for a modestly elevated level of risk as compared with Class 3 firms. In such a case, we would suggest that Class 2 firms should also have the option of holding additional capital in place of PII.

Classification of firms as Class 1 firms

We note the EBA's proposal to divide investment firms into three broad classes, with Class 1 firms being those which are considered to be "systemic and bank-like". We agree with the EBA that it is likely to be appropriate for existing firms which are classified as G-SIIs or O-SIIs on the basis of the criteria set out in the relevant EBA guidelines to remain subject to the full requirements of the current CRR. We do not consider that any member of AIMA, the ACC or MFA is a systemically important institution for these (or indeed any other) purposes, even on the basis of its membership of a wider group.[8] In support of this conclusion, we would emphasise the following non-exhaustive factors:

- ***Asset managers act as agent for their clients:*** Asset managers do not engage in proprietary trading in the financial markets on their own account, but act as agents employing the capital of their clients. As a result, there is an in-built diversification of the investors taking risk in asset management activities, as the relevant capital invested is drawn from a number of different underlying sources.
- ***Substitutability of managers:*** Although investors will choose alternative asset managers based on their particular expertise and track record, generally speaking if one asset manager were to fail, it would be straightforward for clients to select another asset manager to manage their assets going forward.
- ***Size relative to the financial sector as a whole****:* Alternative asset managers are a comparatively small part of the overall financial sector and employ significantly lower levels of leverage than the banking sector.
- ***Post financial crisis regulation has further reduced the systemic impact of alternative investment managers:*** After the various reforms introduced by the financial crisis, hedge funds themselves are now even more unlikely to be of systemic relevance. The managers of such funds are many times less likely to be systemically important given their size and substitutability.
- ***The impact of stress on the hedge fund industry has already been tested:*** The 2008 financial crisis resulted in large number of funds being liquidated or failing and this did not result in any widespread systemic impact on the financial sector as a whole.

On this basis, even if the EBA decides to revisit the existing G-SII and O-SII guidelines, we consider that it would not be appropriate to categorise any alternative asset management firm (either on the basis of a solo assessment or by virtue of its membership of a wider group) as a Class 1 firm.

Classification of firms as Class 3 firms

Basic criteria

At the other end of the spectrum, we note that the EBA has proposed that Class 3 firms should be assessed by reference to the criteria established by the Commission for identifying "nano" enterprises. If that proposal is adopted, this would mean that only firms that have a balance sheet of less than EUR 2

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[8] For further discussion of the relevant factors relating to systemic importance in the context of asset managers, please refer to the joint MFA and AIMA response to the FSB consultation on Proposed Policy Recommendations to Address Structural Vulnerabilities from Asset Management Activities dated 21 September 2016, and the consultation responses to the FSB and IOSCO's consultation papers on Assessment Methodologies for Identifying Non-Bank Non-Insurer Global Systemically Important Financial Institutions referred to in footnote 5 above.

million and an income or turnover of less than EUR 2 million would qualify for this treatment (although we also note that the EBA has also proposed that this could be increased to the criteria for "small" enterprises, which would raise each of those respective thresholds to EUR 10 million). In our view, either of these proposed thresholds would be too low to provide for a meaningful population of Class 3 firms. The use of such low thresholds effectively would result in almost the entire population of EU investment firms being classified as Class 2 firms, which risks substituting the existing "one-size-fits-all" regime under the CRR with another by making almost all firms subject to the Class 2 requirements.

AIMA, ACC and MFA members consider that it would be more appropriate to introduce a specific threshold for asset management firms to be classified as Class 3 firms. This recognises that whether or not an investment firm is "very small" depends upon its size relative to firms undertaking similar activities, and that some firms can be larger in terms of balance sheet size and income but can still remain "non-interconnected" due to the nature of their businesses. In our view, it would be appropriate to adopt a test for Class 3 asset management firms based on a combined AUM and AUA threshold of EUR 1 billion, to the extent the EBA continues to use AUM and AUA as relevant factors. We consider that this threshold would be sufficiently large to create a meaningful population of Class 3 asset management firms, while still resulting in a sizeable population of Class 2 firms. We also consider that there are strong justifications from a competition perspective for raising the eligibility thresholds for Class 3 firms, as it would be harmful to innovation and the development of new asset management businesses if newly established firms (such as spin-offs from existing managers or wholly new market entrants) fell within Class 2 immediately or shortly after they begin their operations. We also consider that there should be an alternative test for Class 3 firms based on the number of staff employed, so that firms with 75 employees or fewer may also be classified as Class 3 firms on the basis that they are likely to have a simple internal structure and wind-down would be straightforward.

In our view, sub-managers should also be classified as Class 3 firms on the basis that such firms only provide investment advice to the principal asset manager and/or receive and transmit orders from the manager and it is the manager itself that makes the relevant investment decisions. The manager will not automatically accept the advice of the sub-manager and therefore there will be a fresh level of scrutiny at the level of the principal manager, which will ultimately determine whether to enter into the relevant transaction on behalf of the underlying client. The activities of sub-managers are therefore very limited in scope and do not involve any direct assumption of risk on behalf of underlying investors. Such firms do not hold client assets or money and pose very little risk of disruption to underlying investors as the principal asset manager would continue to be in a position to take investment decisions in respect of its clients' portfolios if the sub-manager ceased its activities. On this basis, we consider that it would be inappropriate to require sub-managers to hold levels of regulatory capital that may be equivalent to the principal asset manager.

Criteria precluding a firm from being a Class 3 firm

In paragraphs 16 - 20 of the discussion paper, we note that the EBA refers to certain criteria which could automatically preclude a firm from being eligible to be classified as a Class 3 firm. In our view, none of the following should prevent a firm from being classified as Class 3:

- ***Controlling client assets:*** Asset managers will often have the ability to control (as distinct from the ability to hold) client assets (including securities and cash) by exercising a mandate over an account established in the name of the client with an institution such as a bank or custodian. This is typically necessary to facilitate the investment of the client's funds efficiently. We wish to emphasise this distinction between holding and controlling assets in light of comments in the 2015 EBA report which suggested that there was some lack of clarity around the relevant legal concepts. We do not consider that the ability to control client funds creates a specific prudential risk, as such funds will not be held by the manager itself. To the extent that there is considered to be a possibility of conduct risk in connection with a firm's ability to hold client funds, we refer back to our earlier statements under the "*Professional Indemnity Insurance*" heading above as to how this should be addressed appropriately under the prudential regime.

- ***Exercising passporting rights:*** We agree with the EBA's observation in paragraph 19 of the discussion paper that a firm's exercise of the MiFID passport should not by itself be relevant to its prudential classification. The activities carried on by the firm in reliance on the passport will, by definition, be no more extensive than the activities that it is authorised to carry on in its home Member State. Penalising the exercise of the passport would also be contrary to Treaty freedoms and the aims of the Capital Markets Union. We would therefore argue that the exercise of passporting rights should not have any effect on the applicable prudential rules.
- ***Membership of a wider national or international group***: In our view, simply because a firm may be a member of a wider corporate group, this should not mean that it is considered to be "interconnected" for these purposes and therefore ineligible to be classified as a Class 3 firm. As the EBA notes in paragraph 18 of the discussion paper, any potential risks that may arise from group membership can be adequately addressed through consolidated supervision (if this is deemed necessary, although we note that there are also strong arguments for imposing only solo capital requirements upon members of groups consistently only of asset management entities). We consider that the assessment of "interconnectedness" for the purposes of categorising investment firms should relate to whether the relevant firm has significant connections with counterparties in the wider financial markets.
- ***Having MiFID tied agents:*** We do not consider that whether or not a firm has any MiFID tied agents is relevant to determining whether it may be classified as a Class 3 firm. Irrespective of whether a firm operates through tied agents or solely through its own legal entity, the firm will remain responsible for the relevant activities undertaken. The use of tied agents only reflects the particular method through which the firm provides the relevant services, but it does not allow any consistent conclusions to be drawn about the nature or extent of the activities provided and the risks that they entail. As the EBA notes in paragraph 20 of the discussion paper, if tied agents are used as a criterion which precludes a firm from being classified as a Class 3 firm, this may result in biasing the type of business models adopted by firms without there being any significant difference between the risks associated with the underlying business activities.

We consider that the question of whether a firm providing the ancillary activity of safekeeping and administration may be classified as a Class 3 firm could depend on the applicable custody regime as different jurisdictions may approach the legal mechanics of custody in different ways. Generally, we consider that where the applicable custody regime requires full segregation of client assets such that these are protected in the event of the firm's insolvency, holding client assets should not be considered as a bar to being a Class 3 firm.

Proposed appropriate regulatory capital requirement for Class 3 firms

For firms that fall within the expanded Class 3 that we have proposed above, we consider that the most appropriate ongoing capital requirement should be the higher of 25% of the firm's annual fixed overheads (i.e., the FOR) or the firm's ICR. This is because such firms will almost invariably be substitutable, will not have significant connections with the wider financial market, will not have assumed any significant risk on their own balance sheets and will manage relatively low levels of assets. The purpose of regulatory capital in such circumstances should be to facilitate an orderly wind-down of the firm on a gone concern basis, which strongly suggests that the FOR is an appropriate measure, subject to the ICR floor. We consider that by applying this straightforward capital requirement, the prudential regime will be kept simple for smaller firms, assisting new market entrants and those firms with more limited resources while also ensuring an appropriate continuity of service in a wind-down scenario.

However, we do not consider that the FOR should apply to firms which are classified only as "adviser" firms – i.e., those that do not hold client money or assets and only perform the MiFID activities of reception and transmission and/or investment advice. Such firms are subject to varying regulatory capital treatment across the EU, but in the UK, for example, they have a fixed initial capital requirement of EUR 50,000 and are not subject to a FOR. As these firms generally provide investment advice to the principal asset manager, they do not pose a direct risk to underlying investors or customers and are highly substitutable. If such firms were to become subject to a FOR, this would result in a sudden and very significant increase in their regulatory capital requirements which would be disproportionate to the very low level of risk that they represent. Since these adviser firms could fail without causing any disruption to portfolio management services provided by the principal asset manager to its underlying clients, we do not consider that such firms should be subject to a FOR as a proxy for a wind-down requirement.

Initial capital requirements

AIMA, ACC and MFA members generally support the EBA's proposals in section 4.3.3 of the discussion paper to increase ICRs to take account of inflation since the levels were set in the original Capital Adequacy Directive. An increase in the capital requirements of portfolio managers who do not hold client money or assets to EUR 125,000 would also align the position of those firms with the ICR of external AIFMs under Article 9(2) AIFMD, reducing regulatory arbitrage. However, we do not consider that firms holding client money or assets should be subject to a higher ICR (which, in the EBA proposals, would be EUR 250,000), as the segregation requirements for client funds or assets already ensures adequate protection without the need for a separate increased capital requirement.

Use of professional indemnity insurance

We do not agree with the EBA's suggestion in paragraph 110 of the discussion paper that PII should not be regarded as a substitute for regulatory capital requirements in appropriate cases. The EBA states:

> "Given that insurance relies on a third-party who is incentivised to try to reduce the circumstances in which they will pay out, or only after delay, it is suggested that such insurance (being more suited as a risk mitigant a firm may choose to hold itself) should not be regarded as a 'substitute' for regulatory capital. Accordingly, the option to use insurance may be deleted."

We consider that this analysis is not a sufficiently compelling justification to prevent firms from being able to rely on appropriate PII to cover part of their regulatory capital requirements. The insurance industry has frequently disputed the common view that insurers generally attempt to avoid paying out on legitimate claims, noting that such an approach would be highly prejudicial to an insurer's reputation in the market and would be harmful to its long-term business interests. In any case, if there are legitimate questions about the circumstances in, and the speed with which, insurers will settle claims on PII policies, that is an issue that is more appropriately addressed through the engagement of insurance regulators and appropriate conduct standards for insurers.

In our view, there is a strong argument for permitting the use of PII to cover potential professional liabilities arising from breach of legal or regulatory requirements which result in losses to a client. We note that AIFMD explicitly recognises that such insurance is appropriate to cover liabilities of this nature. In addition, as we have already outlined under the "*Professional Indemnity Insurance*" heading above, premiums paid for PII are likely to be a more sensitive to the conduct and organisational risk within a firm than blanket regulatory capital requirements and incentivise firms to operate appropriately robust control environments.

Simplified requirements relating to definition and quality of capital

We support the EBA's proposals in section 4.3.2 of the discussion paper that any new prudential regime must have appropriate rules relating to the quality and definition of capital that are capable of being applied to investment firms that are not established as companies, but have some other legal form, such as a partnership or limited liability partnership. The current rules for the recognition of regulatory capital (and particularly CET1 capital) in the CRR are difficult to apply to certain legal forms. This results in increased legal complexity and difficulty in establishing and operating such firms when their constitutional rules have to be drafted in certain non-commercial ways in order to satisfy each of the criteria for members' capital to be recognised as regulatory capital. We would therefore strongly support appropriate rules which are simple, clear and specific to each type of legal structure.

We also agree with the EBA's observation in paragraph 86 of the discussion paper that it is frequently difficult to apply the concept of permanence to partners in firms and that greater flexibility in withdrawing surplus capital would be desirable. As the EBA notes, the current restrictions on withdrawing surplus capital have the undesirable effect of acting as a disincentive to partners making further capital contributions. We consider that relaxing the administrative burdens in this area may encourage further investment by partners in investment firms in the future.

We would also support the EBA's observations in paragraphs 88 – 90 of the discussion paper that the tiering of regulatory capital instruments (i.e., between CET1, AT1 and T2) and the complex criteria that apply for recognition as capital in each class could be simplified. For smaller asset managers, these rules are disproportionately complex, given that such firms are typically funded through CET1 ordinary shares or partnership capital contributions and potentially simple subordinated T2 debt. The current requirements are extensive and are contained not only in the CRR but also in certain complex pieces of subordinate legislation. We consider that the EBA should focus on the core elements that are required to ensure that capital instruments have the required degree of permanence and will be effective to fund an orderly wind-down of simpler firms. It is not necessary for these rules to include all criteria that might be relevant in the context of regulatory capital for banks and this has resulted in the current unnecessary levels of complexity.

Liquidity requirements

Balance sheet liquidity requirements of an asset manager distinguished from the liquidity of the underlying portfolio

AIMA, ACC and MFA members consider that when designing any new prudential regime, it is critical that the EBA keeps in mind the distinction between liquidity issues that may arise in relation to the underlying portfolio and the liquidity requirements that apply to the management entity itself.

Depending upon the redemption rights of investors, it is possible that there may be issues relating to the liquidity mismatch between the underlying assets in the portfolio and the investors' ability to redeem their investments. This is generally a relevant consideration for open-ended funds where investors have frequent opportunities to redeem, whereas in closed-ended funds investors must typically commit their investment for the entire lifetime of the fund without any opportunities for early redemption. Any issues of liquidity mismatch in this context are typically addressed through the use of devices such as redemption fees or "gating" whereby only a certain proportion of investors can redeem on any given redemption date. The FSB has considering liquidity issues relating to underlying portfolios as part of its ongoing work. We do not consider that this issue has any significant relevance to the prudential regime that applies to investment firms themselves, particularly asset managers acting on an agency basis.

The liquidity requirements that are relevant to the asset management entity itself are entirely different. While asset managers clearly need to be able to meet their outgoings (for example, staff costs, rent on premises, etc.) on an ongoing basis, liquidity requirements applied to the asset manager will not address the issue of liquidity mismatch in the underlying portfolio. This is because investor redemptions will need to be funded from the portfolio itself, not by the asset manager from its own balance sheet. While there may be a limited link between redemptions from open-ended funds and a possible decline in an asset manager's level of AUM-based fee income, this is no more significant than for other business lines where customers could transfer their business to other entities and reduce the prospective level of fees due to a firm. We do not consider that there is any justification for imposing specific liquidity requirements to reflect that general risk in the context of asset managers. Where the asset manager manages only closed-ended funds, the risk of reduced future fee income from early redemptions does not arise at all.

Requirements under general law

AIMA, ACC and MFA members consider that if specific liquidity requirements are considered necessary, the proposed "counter-balancing capacity approach" is the most appropriate regime. This essentially reflects existing requirements under general law that companies and similar entities must be able to settle their liabilities as they fall due. As asset managers operate agency businesses and are generally readily substitutable, we do not consider that additional liquidity requirements over and above this basic obligation are appropriate. The liabilities of asset managers are generally incurred in connection with payments to employees, suppliers and service providers, as opposed to other financial markets participants and therefore do not create wider systemic market risk. It is for asset managers to determine how they fund these liabilities, subject to the applicable requirements under the general law which impose duties in respect of the solvency of the relevant firm.

We consider that additional liquidity requirements such as buffers or specific minimum amounts of liquid assets would impose unnecessary costs on asset managers, increasing barriers to entry for new market participants and not necessarily resulting in commensurate increases in the financial stability of the relevant firms. Many asset management firms are at least partly owned by their senior managers and therefore there is a natural alignment of interests in ensuring the ongoing solvency of the relevant firm which does not need to be supplemented with additional "one-size-fits-all" liquidity rules. As asset managers generally have relatively simple business structures, it would be disproportionate to apply a series of complex liquidity requirements.

If the EBA were to disagree with this position, we would advocate only modest buffers set as a proportion, say 1/12 of the FOR – i.e., one month's liquidity. We also consider that credit should be given for the use of parent company guarantees, cost plus pricing models and prior funding arrangements.

We do not consider that binding quantitative liquidity requirements should ever be applied to "adviser" firms which only provide investment advice and/or reception and transmission services to a principal asset management firm.

Qualitative liquidity requirements

We recognise that qualitative requirements for liquidity management have an important role to play in prudential requirements for all firms, including asset managers. Nonetheless, we consider that these should be proportionate to the level of risk involved in the firm's activities and whether or not it is interconnected in the context of the wider financial markets. In the context of asset managers, the liquidity associated with the portfolios being managed is crucial in so far as firms may need to fund redemption requests or withdrawals, but this is clearly separate from the balance sheet liquidity of the manager itself. In relation to the asset manager, it is only necessary for there to be minimal liquidity requirements that would support an orderly winding up. For the reasons set out above, we consider that the requirements under the general law are sufficient to support such an objective.

We therefore support the use of internal liquidity management policies instead of binding liquidity requirements for asset management firms, as these will allow the firm to tailor its approach to liquidity in a way that is appropriate to its business model. Although we agree that oversight of liquidity is an important function within a firm, we consider that it would be disproportionate to require a specific individual to be named as a "liquidity oversight function" or similar. Instead, in order to reflect the varying size of asset managers and their differing management structures, we would encourage the EBA to leave sufficient flexibility in the rules to allow firms to allocate responsibility for liquidity issues in a way that best suits their business structure.

The EBA's discussion paper lacks detail in paragraph 136(a) where it refers to "*systems and controls for management of liquidity risk*". However, for the reasons set out above, we do not consider that specific additional systems and controls requirements are necessary for an agency business. Firms are already subject to a legal obligation to ensure that they can meet their liabilities as they fall due and in simple firms which do not engage in proprietary trading on their own account, we consider that this duty is sufficient to ensure that firms will manage liquidity appropriately, without imposing additional prescriptive systems and controls. Due to their non-systemic nature, we do not consider that asset managers should be required to apply particular funding diversification requirements, although funding diversification will, where appropriate, normally be considered by the firm as part of its approach to complying with the general law. In our view, intra-day liquidity risk requirements are designed for investment banks assuming risk through proprietary trading on their own account: intra-day liquidity risk is irrelevant to asset managers as they will be acting in an agency capacity and the assets and liabilities that form part of their balance sheets will not generally be subject to such risk.

Definition of liquid assets

If specific liquidity requirements were to be imposed on asset managers, we consider that it is important that a suitable range of assets are recognised as being "liquid assets" for these purposes. We note the indicative assets listed by the EBA in Annex 4 to the discussion paper and consider that this should be expanded to include short-term receivables that fall due within 60 days, and other assets (such as interests in money-market funds) convertible into cash within 60 days. More generally, we consider that the term "readily convertible into cash" should include any assets that can be converted into cash within 60 days.

We appreciate that a firm will need a certain level of liquid assets during any wind-down period. However, imposing binding liquidity requirements which can only be satisfied by very narrow categories of assets, such as cash or highly liquid debt securities, has the potential to result in significant cost increases for asset managers who would not typically hold shares or debt instruments on their balance sheets. Requiring a firm to maintain large reserves of cash creates an inefficient drag on the firm's financial performance and may represent a very significant barrier to the establishment of new firms, harming innovation and prejudicing new market entrants and the development of competition. If liquidity requirements are to be imposed, the eligible liquid assets should specifically take into account the broad type of firm – in this case, the particular situation of asset managers – and ensure that there is sufficient flexibility to avoid creating situations which may render business activities uneconomic.

Large exposures

We note the EBA's proposals in section 4.4.1 of the discussion paper in relation to reintroducing a large exposures regime for all firms within the scope of the new prudential requirements. We do not consider that such a regime is necessary or desirable for asset managers or other firms which act in an agency capacity and do not pose wider systemic risk. The large exposures of asset managers tend to be intra-group (for example, where the manager provides services as part of portfolio management delegated by a fund manager) or exposures to managed funds over which the manager may exercise control. As a result, although asset managers may have some large exposures, these do not represent significant risks, are readily manageable and have no wider systemic significance. We are doubtful that national regulators would find reporting of such exposures useful in connection with their ongoing supervisory activities.

We note that in December 2007, the Committee of European Banking Supervisors (CEBS) published a consultation paper in connection with its review of the large exposures regime in the original Capital Requirements Directive (Directive 2006/48/EC). At the time, CEBS noted that asset managers were caught by the large exposures requirements as they then stood. When considering whether the application of the large exposures rules to asset managers was appropriate, CEBS stated (beginning at paragraph 237):

> "...[I]nvestment management firms do not appear to represent a significant risk of contagion because of the nature of their contracts. Instead, they act as agents for an investor who has delegated portfolio selection and administration to the asset manager. Exposures taken by an investment manager itself (as opposed to exposures incurred on behalf of a client or fund) are generally incidental to its investment management business. They do not tend to have large unsecured exposures. Their large exposures are often accrued management and performance fees against which they are likely to have recourse to the assets under management (as the result of a client agreement / contract).
>
> ...
>
> Investment management firms are not funded by depositors. The costs associated with failures of investment firms are likely to be relatively limited. If an investment manager were to fail, the client assets would continue to belong to the clients. Client assets if required could be transferred (at a cost) from one manager to another. Provided that asset managers do not take positions on their own account, interlinkages between firms are likely to be limited and so the collapse of an asset manager would not be expected to impact or have wider implications for consumer protection.
>
> Evidence from the [cost benefit analysis] on the current large exposures regime suggests the rules do create a compliance burden for these firms. A number of respondents, while reporting some difficulty in providing cost data, did describe arrangements, systems and controls they have implemented to ensure compliance with the large exposures rules, which implies costs are incurred.
>
> Some respondents questioned the value of reporting large exposures that arise from accrued fees. They said that a large exposure arises as a result of timing differences between the recognition of the fee and its settlement and there was no doubt that the fee would be paid, for example because the client agreement permitted payment by direct debit from the client assets in the investment manager's control after a specified time had elapsed... Another commented that the nature of the business reduced, to a material extent, the ability of the firm to manage the occurrence of the an [sic] large exposures arising from accrued fees. For example, in times of good performance an investment manager could accrue a

> significant unpaid performance fee which would result in them breaching the large exposures rules.
>
> The range of activities undertaken by an investment manager is also a consideration. For those investment managers that deal on own account only for the purpose of fulfilling or executing a client order or when acting in an agency capacity etc. ... the credit risk would appear principally to arise in connection with accrued fees, etc."

We would respectfully agree with this analysis. We note that on the basis of the above reasoning, CEBS concluded at paragraph 242:

> "Based on the analysis and consideration of the costs and benefits, the CEBS' current view is that the case for including all investment managers within the scope of the large exposures regime is not made. The application of an [sic] large exposures regime to investment managers may be an example of regulatory failure since the regime imposes a burden of investment firms (including a reporting burden) without delivering benefits to consumers."

An exemption for firms which did not undertake the activities of dealing on own account or placing of financial instruments on a firm commitment basis was subsequently introduced by the CRD II Directive (Directive 2009/111/EC). In our view, all of the reasons outlined by CEBS which justified the introduction of this exemption for asset managers remain equally valid today. Given that CEBS explicitly noted that such rules were an "example of regulatory failure" because they imposed a burden without a corresponding benefit for consumers, we consider that it would clearly be inappropriate to reintroduce such requirements for asset managers under any new prudential regime.

If the EBA is unwilling to exempt asset managers from the entire large exposures regime, we consider that such firms should not be subject to hard limits on incurring large exposures without regulatory authorisation. As we have explained above, large exposures may arise in the ordinary course of an asset manager's business due to the manner in which it provides services (for example, under delegation arrangements), but these exposures are easily managed. Instead, we consider that the obligations of asset managers should be limited to ongoing monitoring of large exposures and, at the most, periodic reporting of such exposures to regulators.

Remuneration rules

We agree with the EBA's suggestion that there should be a more tailored remuneration regime that is appropriate for non-systemic, non-bank-like firms. However, we note that, at the present time, the EBA has not put forward specific proposals for replacement remuneration rules and therefore we are unable to assess whether a replacement regime would in fact be more appropriate for asset managers. We would encourage the EBA (and/or the Commission) to conduct a full public consultation before designing any new requirements in order to ensure that the relevant rules are simple, justified on cost-benefit grounds, effective and do not result in undesirable distortions to competition.

New remuneration requirements should recognise that there are frequently existing alignments of interest between the asset manager and the client and should not be aimed at addressing wider systemic risks which are not applicable to the asset management industry. As there is considerable diversity within the asset management industry in terms of size, organisational structure and business models, we consider that it would be more appropriate and ultimately more effective for any new remuneration requirements to be structured as broad principles rather than overly prospective rules. Firms would then be able to apply internal rules which conform to those principles, but which are effective and tailored to their own particular circumstances.

Any new principles should be focused on the alignment of interest between asset managers and their clients, funds and investors and should take into account the industry's structure and practices, many of which are designed to achieve the same goals as regulatory proposals. We believe that the MiFID II remuneration rules (Article 9(3)(c) and Article 24(10) of the MiFID II Directive) provide a reasonable starting point for the development of policy in this area, albeit that it would be helpful to frame new rules in a way which applies more obviously to the wholesale asset management context, as well as the retail distribution context.

Prudential consolidation

We consider that there are strong arguments for imposing the relevant prudential requirements on asset managers only at a solo-level, rather than subjecting such firms to consolidated prudential supervision, where the relevant group consists only of asset management firms (as opposed to, for example, groups including one or more banks or insurers). We note in particular the main issues that the EBA considers are addressed by consolidation supervision at paragraph 146 of the discussion paper, which are as follows:

- ***Entities with the potential to create losses for other group entities:*** Since asset managers do not engage in proprietary trading on their own account, there is a limited risk that such firms could incur significant losses that would require other group members to offer financial support or which might otherwise affect the financial stability of the wider group. To the extent that losses incurred by a specific asset manager could result from conduct-related issues, we have already outlined above under the "*Professional indemnity insurance*" heading why we consider that PII is suitable to cover any potential conduct risk.
- ***Parent entities issuing debt and pushing down proceeds in the form of equity to subsidiaries:*** It is very uncommon for asset management groups to issue significant levels of debt at parent company level such that this would result in excessive group leverage that could potentially affect the stability of individual firms.
- ***To guard against double or multiple gearing:*** The EBA notes that double or multiple gearing occurs where the same capital is used simultaneously as a buffer against risk in two or more legal entities. To the extent that capital may be double-counted on multiple firms' balance sheets, we consider that this can be adequately addressed through the use of appropriate prudential filters at the solo-level without necessarily requiring prudential consolidation.

In our view, the simple structure of the balance sheets of asset managers and the fact that they do not engage in proprietary trading that might create significant group-wide risks justifies the application of prudential requirements on a solo-only basis.

Regulatory reporting and Pillar 3 disclosures

AIMA, ACC and MFA members agree with the EBA's observation in paragraph 166 of the discussion paper that the current regulatory reporting regime under the CRR (i.e., COREP and, where applicable, FINREP) can impose an excessive burden upon firms without corresponding benefits for the market. We would strongly encourage the EBA to design a more proportionate system for periodic prudential reporting which is appropriately tailored for firms undertaking different types of business and, in particular, for asset managers. We note that the EBA refers to new reporting being desirable "*particularly for Class 3 firms*", but in our view revised reporting requirements should also be applied to Class 2 firms, and particularly those who operate on an agency basis and therefore do not have significant balance sheet positions to report. We consider that by simplifying reporting and focusing on more relevant data, the reporting regime can also be made more useful for national supervisors. We see little value in regulators receiving COREP reports from asset managers which are often expensive and time consuming to compile, but contain data that is not particularly relevant in the context of the ongoing supervision of such firms.

We also note the EBA's observations in paragraph 168 of the discussion paper in relation to Pillar 3 disclosures and their lack of usefulness for both professional counterparties and retail clients. We would endorse those observations and encourage the EBA to remove the requirement for Pillar 3 disclosures from any future prudential regime, at least in relation to asset managers and other agency businesses whose clients do not assume credit risk in relation to the relevant firms. The clients of AIMA, ACC and MFA members are sophisticated investors who, as the EBA recognises in the discussion paper, may often require the relevant asset manager to provide appropriate bespoke information before they enter into a business relationship. We consider that the disclosure of any information about the asset manager's activities is a matter for discussion between the client and the firm, thereby ensuring that the client receives information that is appropriately tailored and relevant to its concerns. The excessively rigid, formulaic and onerous Pillar 3 requirements under the CRR have resulted in standardised documents which do not aid clients in assessing metrics that are likely to be key considerations when selecting an asset manager.

Pillar 2 requirements

We note that, at the public hearing, EBA representatives commented that the future role of Pillar 2 requirements would depend upon the extent to which the new regulatory capital requirements can be appropriately calibrated. In our view, assuming that the EBA continued in its direction of travel, the existing Pillar 2 requirements would be unnecessary for non-complex, non-systemic firms which act as agents, such as simple asset managers, and which are unlikely to be managed by regulators on a relationship basis. We suspect that, for at least some smaller and medium-sized firms, the ICAAP process has become a formulaic exercise, with over-reliance in the development of the ICAAP being placed on external consultants. We do not consider that such firms should be subject to a formal SREP process if an appropriate prudential regime is designed for such firms which adequately captures the relevant risks. Instead, the general governance and risk management rules applicable to such firms would still require them to consider any additional risks and take these into account, but this would not require supervisors to spend valuable resources undertaking SREPs of small, non-systemic firms on a regular basis. At the least, any Pillar 2 requirement should not be extended to firms not currently subject to it under the current regime. If Pillar 2 is to be retained, firms and supervisors should have the ability to reduce capital requirements below the Pillar 1 minimum in appropriate circumstances in order to reflect the actual level of risk to which a firm is subject.

CLO collateral managers and securitisation retentions

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

Responses to specific questions in the EBA discussion paper:

Question 1.

What are your views on the application of the same criteria, as provided for G-SIIs and O-SIIs, for the identification of 'systemic and bank-like' investment firms? What are your views on both qualitative and quantitative indicators or thresholds for 'bank-like' activities, being underwriting on a firm commitment basis and proprietary trading at a very large scale? What aspects in the identification of 'systemic and bank-like' investment firms could be improved?

We agree with the EBA's suggestion that Class 1 "systemic and bank-like" investment firms should be determined by reference to the existing criteria for G-SIIs and O-SIIs. We consider that the current complexity of the rules in the CRR may be justified for firms meeting such thresholds, but not for other firms that have lower systemic importance, including all asset managers. Please refer to our comments under the "*Classification of firms as Class 1 firms*" heading above for a discussion of why we consider that asset management firms and groups should not be considered to constitute systemic and bank-like firms.

Question 2.

What are your views on the principles for the proposed prudential regime for investment firms?

We agree that the vast majority of investment firms are not systemic and bank-like and therefore that an appropriate prudential regime does not need to provide the same rules that would be required for firms meeting that description. We note that the EBA refers to the possibility of some firms being systemic without being "bank-like". In our view, this category of firms does not include asset managers which are agency businesses, are substitutable and do not pose risks to the wider financial system. Please refer to our comments under "*The purpose of regulatory capital in the context of asset managers*" heading above for a discussion of our views on the purpose of regulatory capital requirements in the context of asset management firms.

In our view, capital requirements for asset managers should focus on ensuring that the relevant firm has sufficient own funds to wind-down in an orderly fashion in order to ensure continuity of service to clients during that period. The principal risk to customers of an asset management firm would be disruption to the services provided in the event of a disorderly wind-down. Please refer to our comments under the "*Orderly wind-down on a gone concern basis*" heading above for a discussion of why wind-down requirements are appropriate in this context.

We do not agree that additional binding liquidity measures are necessary for asset managers, given the requirements that apply to such firms under the general law to ensure that they can meet their liabilities as they fall due. In addition, asset managers that do not engage in proprietary trading on their own account or accept deposits do not face the same potential liquidity pressures as firms engaged in banking activities or proprietary trading. Please refer to our comments under the "*Liquidity requirements*" above for a discussion of our views on binding liquidity requirements.

We do not agree that holding client money and securities necessarily results in increased risks which must be addressed through prudential requirements (as opposed to, for example, systems and controls and/or conduct requirements). We consider that appropriate segregation of client money and assets is sufficient to mitigate the key prudential risks arising from safeguarding activities. Please refer to our comments under the "*Segregation of client money and assets*" sub-heading above for a further discussion of this issue.

We agree that the prudential regime should ensure a harmonised set of requirements across the EU for similar investment firms based on their activities, business models and relevant risks. We do not agree that a "one-size-fits-all" prudential regime for every investment firm is appropriate and consider that such an approach is likely to replicate some of the shortcomings of the current CRR. In particular, in order to ensure that the any new regime can be applied in a clear and straightforward manner, we would support distinguishing between firms which engage in proprietary trading on their own account or undertake the activity of underwriting or placing on a firm commitment basis, and those firms which do not. We consider that such a distinction is an easily understood method of delineating firms whose activities may, in certain cases, have a systemic impact from those operating on an agency basis which are generally extremely unlikely to be systemic in nature. Please refer to our general observations under the "*Appropriately tailored prudential regime for asset managers*" heading above.

Question 3.

What are your views on the identification and prudential treatment of very small and non-interconnected investment firms ('Class 3')? If, for example, such class was subject to fixed overheads requirements only, what advantages and drawbacks would have introducing such a Class 3? Conversely, what advantages and drawbacks could merging Class 3 with other investment firms under one single prudential regime with 'built-in' proportionality have?

We agree that most Class 3 firms should be subject to a simple FOR, particularly where such firms are asset managers and therefore the principal concern in connection with such firms will be ensuring an orderly wind-down. We consider that there is a case for recognising a separate category of smaller firms which are subject to simplified rules and, provided that such rules are clearly drafted and appropriately calibrated, we would prefer this approach to a unified regime with "in-built" proportionality. A FOR is simple, scalable and can be applied in a straightforward manner, meaning that new market instruments and small, non-complex firms can easily understand the basic requirements. We consider that the use of proportionality in this context would necessitate further guidance, complicating the final regime for firms of this nature.

As we have outlined under the "*Proposed appropriate regulatory capital treatment for Class 3 firms*" heading above, we do not consider that "adviser" firms (i.e., those which do not hold client money or assets and are only permitted to carry on the MiFID activities of reception and transmission of client orders and/or investment advice) should however be subject to a FOR. Such firms will generally only provide investment advice to the principal investment manager and therefore pose no real risk to underlying investors as the principal manager remains responsible for all investment decisions taken. In such circumstances, the principal manager could continue to provide portfolio management services to its clients without any disruption if the adviser ceased to operate. We therefore consider that a FOR (which is designed to facilitate an orderly wind-down to prevent disruption to clients) would not be justified and could result in a disproportionate increase in regulatory capital requirements.

Question 4.

What are your views on the criteria discussed above for identifying 'Class 3' investment firms?

As a general observation, we consider that the criteria for identifying Class 3 firms have set the relevant thresholds at too low a level to result in a meaningful population of such firms. This would have the knock-on effect of pushing a very large number of firms of all sizes into Class 2, resulting in an excessively heterogeneous population of Class 2 firms in respect of which it would be difficult to draft appropriate rules. Please refer to our comments under the "*Classification of firms as Class 3 firms*" heading above.

Question 5.

Do you have any comments on the approach focusing on risk to customers (RtC), risk to markets (RtM) and risk to firm (RtF)?

We do not consider that RtM or RtF factors are relevant to asset managers. In our view, those measures appear more appropriate for firms that are systemic in nature and/or firms that engage in proprietary trading on their own account. Agency businesses such as asset managers do not pose a wider risk to the market. We disagree that an RtF uplift is necessary at all, if other elements of the prudential regime are properly calibrated.

We consider that any approach involving RtC, RtM and RtF elements must be sufficiently simple to be applied in practice by firms of varying sizes, without becoming unduly burdensome. We would also encourage the EBA to introduce suitable transitional arrangements to ensure that firms have sufficient time to gather the necessary data in order to apply such a regime.

For a further discussion of these issues, please refer in particular to our comments in "*Comments on specific proposed RtC K-factors*", "*Comments on RtM K-factors*" and "*Comments on RtF uplift factor*" headings above.

Question 6.

What are your views on the initial K-factors identified? For example, should there be separate K-factors for client money and financial instruments belonging to clients? And should there be an RtM for securitisation risk-retentions? Do you have any suggestions for additional K-factors that can be both easily observable and risk sensitive?

We have a number of concerns about the appropriateness of the initial identified K-factors and how these will operate in practice. Please refer to our comments under the "*Comments on specific proposed RtC K-factors*" heading above. With regard to the potential use of an RtM K-factor in relation to securitisation risk retentions, please refer to our comments under the *'Securitisation risk retentions*" sub-heading above.

Question 7.

Is the proposed risk to firm 'up-lift' measure an appropriate way to address the indirect impact of the exposure risk a firm poses to customers and markets? If not, what alternative approach to addressing risk to firm (RtF) would you suggest?

We do not consider that an RtF uplift factor is necessary, at least not in the context of asset management firms. In our view, the particular risks posed by such firms are already adequately addressed through RtC requirements or, if our proposals are accepted, through a fixed overheads requirement that addresses the main risk of a disorderly wind-down. Please refer to our comments under the "*Comments on RtF uplift factor*" above.

Question 8.

What are your views on the 'built-in' approach to delivering simpler, proportionate capital requirements for Class 3 investment firms, (compared to having a separate regime for such firms)?

We consider that it would be more appropriate to have a separate, simplified regime for Class 3 asset managers and note that the "built-in" approach may be unnecessarily complex for these purposes. This is in part the result of the complex interaction of the different RtC and RtM requirements and how these relate to the FOR and the RtF uplift. Given the small, non-complex and non-interconnected nature of Class 3 firms, we would favour a simplified FOR regime. Please refer to our discussion under the "*Proposed appropriate regulatory capital requirement for Class 3 firms*" above.

Question 9.

Should a fixed overhead requirement (FOR) remain part of the capital regime? If so, how could it be improved?

We consider that there are compelling arguments for retain the FOR in the context of asset management firms where the principal risk resulting from the firm's activities is the risk of a disorderly wind-down and a disruption in the services provided to clients. Please refer to the "*Proposed alternative regulatory capital calculations for Class 2 asset managers*" and "*Proposed appropriate regulatory capital requirement for Class 3 firms*" headings above for a discussion of our views on this issue in relation to Class 3 and Class 2 firms respectively.

We do not consider that it is necessary to improve the basic FOR in the context of asset management firms. We recognise that there may be an argument for specifying clearly which items should or should not be included as fixed overheads for these purposes to ensure consistency, but we do not otherwise consider that the FOR should be further complicated by additional rules. A key benefit of the FOR is its simplicity and the fact that it directly addresses the principal risk of a disorderly wind-down in the asset management context.

Question 10.

What are your views on the appropriate capital requirements required for larger firms that trade financial instruments (including derivatives)?

We do not express a view on this issue, as AIMA, ACC and MFA members do not engage in large-scale proprietary trading on their own account.

Question 11.

Do you think the K-factor approach is appropriate for any investment firms that may be systemic but are not 'bank-like'?

We do not consider that any asset managers are "systemic" in nature. For an explanation of why asset managers should be considered to be non-systemic, please refer to our comments under the "*Classification of firms as Class 1 firms*" above. For this reason, we do not express a view on this issue.

Question 12.

Does the definition of capital in the CRR appropriately cater for all the cases of investment firms that are not joint stock companies (such as partnerships, LLPs and sole-traders)?

No. As we explain under the "*Simplified requirements relating to definition and quality of capital*" heading above, the current rules are complex and difficult to apply in the context of firms that are established using structures other than companies. This leads to unnecessary complexity when such firms seek to comply with the current regulatory capital rules in the CRR, as well as uncertainty about the eligibility of some arrangements to be recognised as own funds.

Question 13.

Are the cases described above a real concern for the investment firms? How can those aspects be addressed while properly safeguarding applicable objectives of the permanence principle?

Yes – in practice, the legal complexity of ensuring that interests in non-corporate structures can satisfy the requirements to be recognised as regulatory capital result in increased costs and in certain circumstances, the need to use arrangements which are not efficient from a commercial or operational perspective. We consider that the rules could be simplified by focusing on core requirements that ensure permanence and by having different provisions that are appropriately tailored for different types of legal structures.

Question 14.

What are your views on whether or not simplification in the range of items that qualify as regulatory capital and how the different 'tiers' of capital operate for investment firms would be appropriate? If so, how could this be achieved?

We consider that there is a compelling case for simplification of the range of items qualifying as regulatory capital and the tiering of capital instruments for non-complex investment firms. The vast majority of asset managers have a very simple capital structure and do not use contingent convertible instruments or instruments containing write-down triggers. As the EBA has noted, principally such firms structure their regulatory capital as CET1 shares or partnership capital contributions and, in certain cases, as simple T2 subordinated debt. It would therefore be helpful if the regulatory capital rules applying to asset managers focused on the core requirements for instruments of that nature to be eligible for treatment as CET1 or T2 capital and drafted simplified rules accordingly. Please refer to our comments under the "*Simplified requirements relating to definition and quality of capital*" heading above.

Question 15.

In the context of deductions and prudential filters, in which areas is it possible to simplify the current CRR approach, whilst maintaining the same level of quality in the capital definition?

We have no comments to offer in relation to this question.

Question 16.

What are your views overall on the options for the best way forward for the definition and quality of capital for investment firms?

We consider that it would be better to adopt the second option proposed by the EBA and to introduce new rules on what constitutes regulatory capital specifically for investment firms. These new rules should specifically address the issue of what qualifies as regulatory capital in partnerships and similar vehicles such as UK limited liability partnerships and Delaware limited liability companies. These are structures commonly adopted by asset management firms (as well as other non-bank investment firms). Appropriate grandfathering or transitional arrangements should be applied for any existing capital instruments that qualify as regulatory capital under the CRR in order to prevent disruption. We would strongly support removing non-essential elements of the definitions and using the essential core concepts only.

Question 17.

What are your views on the definition of initial capital and the potential for simplification? To what extent should the definition of initial capital be aligned with that of regulatory capital used for meeting capital requirements?

We agree that the definition of "initial capital" should be simplified so that it is aligned with the definition of capital recognised as own funds on an ongoing basis. We do not see any justification for using differing definitions in these contexts and agree that such a change would be easier for firms and supervisors.

Question 18.

What aspects should be taken into account when requiring different levels of initial capital for different firms? Is there any undesirable consequence or incentive that should be considered?

We do not agree that holding client money or securities should automatically result in a higher ICR. Please see our comments under the "*Segregation of client money and assets*" sub-heading above for our views on this point.

Question 19.

What are your views on whether there is a need to have a separate concept of eligible capital, or whether there is potential for simplification through aligning this concept with the definition of regulatory capital used for meeting capital requirements?

We agree that it should not be necessary to maintain a separate concept of "eligible capital" and would support a move to a single, unified definition of regulatory capital based on own funds for all purposes. This would result a simplified and more intuitive prudential regime.

Question 20.

Do you see any common stress scenario for liquidity as necessary for investment firms? If so, how could that stress be defined?

No. There is significant variation between the businesses of different investment firms and operational liquidity requirements may therefore vary enormously. We consider that asset managers are best placed to determine their own liquidity needs and do not believe that it would be possible to determine a single common stress scenario for these purposes. In any case, we do not support the idea of imposing binding liquidity requirements on asset managers and consider that a firm's general legal obligations to ensure that it can meet its liabilities as they fall due should be sufficient for such firms. Please refer to our comments under the "*Liquidity requirements*" heading above for further discussion of this point.

Question 21.

What is your view on whether holding an amount of liquid assets set by reference to a percentage of the amount of obligations reflected in regulatory capital requirements such as the FOR would provide an appropriate basis and floor for liquidity requirements for 'non-systemic' investment firms? More specifically, could you provide any evidence or counter-examples where holding an amount of liquid assets equivalent to a percentage of the FOR may not provide an appropriate basis for a liquidity regime for very small and 'non-interconnected' investment firms?

As outlined in our response to question 20, we do not consider that there should be any form of binding liquidity requirements for asset managers.

Question 22.

What types of items do you think should count as liquid assets to meet any regulatory liquidity requirements, and why? (Please refer to Annex 4 for some considerations in determining what may be a liquid asset).

We consider that it is important that short-term receivables should be recognised as liquid assets for these purposes. Please refer to the "*Definition of liquid assets*" above for our comments on this issue.

Question 23.

Could you provide your views on the need to support a minimum liquidity standard for investment firms with the ability for competent authorities to apply "supplementary" qualitative requirements to individual firms, where justified by the risk of the firm's business?

As stated in response to question 20 above, we do not support the idea of imposing binding minimum liquidity standards on asset managers. Please refer to our comments under the "*Qualitative liquidity requirements*" heading above in relation to potential qualitative liquidity requirements for asset managers.

Question 24.

Do you have any comment on the need for additional operational requirements for liquidity risk management, which would be applied according to the individual nature, scale and complexity of the investment firm's business?

We do not consider that there are strong justifications for imposing additional operational requirements for liquidity risks on asset managers. Please refer to our comments under the "*Qualitative liquidity requirements*" heading above for our comments on this point.

Question 25.

What are your views on the relevance of large exposures risk to investment firms? Do you consider that a basic reporting scheme for identifying concentration risk would be appropriate for some investment firms, including Class 3 firms?

We do not consider that large exposures generally pose a significant risk in the context of alternative asset managers, where such exposures are typically either intra-group receivables or fees owed by funds which are managed by the manager or another member of its group. As we explain under the "*Large exposures*" heading above, CEBS previously considered whether the application of large exposures rules to asset managers was appropriate and concluded that it was not. In our view, this is a compelling reason not to introduce a reporting regime for concentration risk for asset managers. We also do not consider that national regulators would find reports in respect of such exposures useful from a supervisory perspective.

Question 26.

What are your views on the proposed approach to addressing group risk within investment firm-only groups? Do you have any other suggested treatments that could be applied, and if so, why?

We consider that the existing consolidation rules in the CRR and the availability of waivers from consolidation where appropriate, are sufficient for these purposes.

Question 27.

In the case of an investment firm which is a subsidiary of a banking consolidation group, do you see any difficulty in the implementation of the proposed capital requirements on an individual firm basis? If so, do you have any suggestion on how to address any such difficulties?

Generally, we consider that membership of a banking group should not result in particular difficulties for an investment firm that is subject to individual capital requirements under a revised prudential regime. We note that groups may contain firms subject to differing prudential regimes today (containing, for example, firms that are subject to the CRR, firms that are subject to the pre-CRR CRD III rules and firms that are subject to the AIFMD prudential regime) and that generally this does not pose significant difficulties.

Question 28.

What other aspects should the competent authorities take into account when addressing the additional prudential measures on an individual firm basis under the prudential regime for investment firms?

As we have outlined under the "*Pillar 2 requirements*" heading above, if the new prudential regime is appropriately calibrated, we do not consider that it would normally be necessary for competent authorities to apply additional prudential requirements on an individual firm basis for simple firms such as asset managers.

Question 29.

What examples do you have of any excessive burden for investment firms arising from the current regulatory reporting regime?

The current COREP reporting regime contains extensive templates with many hundreds of pages of accompanying guidance notes. Frequently, the majority of the content of these templates and notes is not relevant to asset managers who have simple balance sheets, but in order to identify this, they are required to review the relevant materials in full. Firms have been required to implement complicated reporting solutions that are capable of accommodating the extensive and technical COREP validation rules. Those rules and templates are updated on a frequent basis, necessitating ongoing relationships with reporting solution providers or the continued involvement of back office functions within the firm. This has led to increased demands on management time and significantly increased costs. The COREP returns contain little information that is of assistance in monitoring the activities of asset managers and large parts of the template are frequently blank, indicating that the data requirements are not appropriately calibrated to these types of firm.

Question 30.

What are your views on the need for any other prudential tools as part of the new prudential regime for investment firms? And if required, how could they be made more appropriate? In particular, is there a need for requirements on public disclosure of prudential information? And what about recovery and resolution?

We do not consider that there is any need for other prudential tools to be available in relation to the prudential regime applying to asset managers. We consider that capital buffers are not necessary or appropriate for firms that operate on an agency basis and we doubt the value of Pillar 3 or other public disclosure requirements in this context. Please refer to our comments under the "*Regulatory reporting and Pillar 3 disclosures*" heading above for further information.

We do not consider that recovery and resolution plans should be required for asset managers. Such firms are not systemic in nature and an orderly wind-down can be facilitated by the application of appropriate FOR rules. In the case of simple "adviser" firms, we consider that a fixed capital requirement is sufficient.

Question 31.

What are your views on the relevance of CRD governance requirements to investment firms, and what evidence do you have to support this?

We consider that the existing CRD IV governance requirements have tended to adopt a "one-size-fits-all" approach that fails to recognise that firms may have structured their governance arrangements in different ways that are equally effective in the context of their own businesses. We note that many asset managers currently rely on proportionality carve-outs from governance requirements such as risk committees or nomination committees, but still operate effective internal controls. We also note that there are basic governance requirements under MiFID II which will apply to MiFID firms, irrespective of the prudential rules to which they are subject.

We therefore do not consider that it is necessary or desirable for any new prudential regime to contain overly prescriptive rules relating to governance arrangements. Firms should have the flexibility to structure their governance arrangements in a manner which is appropriate to how they operate their business, subject to the possibility of supervisory review.

Question 32.

As regards 'systemic and bank-like' investment firms, do you envisage any challenges arising from the full application of the CRD/CRR remuneration requirements, and if so, what evidence do you have to support this? For all other investment firms, what are your views on the type of remuneration requirements that should be applied to them, given their risk profiles, business models and pay structures?

We do not express a view on the potential challenges of the full application of CRD IV remuneration requirements to systemic and bank-like firms, as we consider that few, if any, AIMA, ACC or MFA members will fall within that category.

We do, however, consider that there is a compelling case for a more proportionate remuneration regime to be applied to asset managers, but would encourage the EBA to provide further details of any proposals in this area in order to ensure that they are appropriate and can be applied in a simple and practical way. Any remuneration rules should take into account the high degree of risk alignment that already exists between asset managers and their clients, the difficulty of asset managers remunerating staff using units or shares and the need to ensure that the overall requirements are proportionate. Please refer to our comments under the "*Remuneration rules*" heading above in relation to this issue.

Question 33.

What is your view on a prudential remuneration framework for other than 'systemic and bank-like' investment firms that should mainly aim to counteract against conduct related operational risks and would aim at the protection of consumers?

We agree that any remuneration rules for firms that are not systemic and bank-like should focus on conduct risk and customer protection, rather than broader prudential issues such as the financial position of the relevant firm. In this regard, we think that it is important that any applicable remuneration regime for asset managers recognises where there is already a high degree of alignment of risks between the firm's employees and its clients. For these purposes, we consider that the remuneration regime for asset managers should be modelled on the regime under MiFID II which is specifically designed to address conduct risk.

Question 34.

What are your views on having a separate prudential regime for investment firms? Alternatively, should the CRR be amended instead to take into account a higher degree of proportionality? Which type of investment firms, if any, apart from systemic and bank-like investment firms, would be better suited under a simplified CRR regime?

We consider that asset managers would be particularly suited to appropriately tailored rules within a separate prudential regime for investment firms, rather than simply an amended CRR with a higher degree of proportionality. Fundamentally, the rules in the CRR are rules designed for the banking industry and we are doubtful that merely amending the existing provisions to provide for further instances in which a firm may rely on proportionality will result in a simpler and more appropriate prudential regime.

Prudential regimes should be designed to address the particular risks that arise in the context of the business activities of firms that are subject to the regime. The CRR's focus on credit risk and proprietary trading activities is inherently unsuitable for agency businesses such as asset managers. We do not consider that simplifying the existing rules will solve this fundamental problem with the CRR in this context.

However, as we have outline under the "*Further detail on calibration of the new prudential regime*" heading above, the EBA's current proposals in the discussion paper do not contain sufficient granular detail for us to assess whether the sort of regime that the EBA has outlined is in fact more appropriate than the current CRR. Therefore, while we support a bespoke prudential regime for asset managers in theory, we must currently reserve our position on whether any particular regime would be preferable to the existing CRR until we have seen the specific details.

Question 35.

What are the main problems from an investment firm perspective with the current regime? Please list the main problems with the current regime.

In summary, we consider that for alternative asset managers, the principal problems with the current regime are as follows:

- The CRR is too complex for simple firms that do not engage in proprietary trading on their own account. Such firms have limited resources and should not be required to incur the significant costs of obtaining professional advice in order to comply with rules that do not in any case specifically address the risks to which they are subject.
- The current regime is too focused on firms that engage in proprietary trading on their own account, not agency businesses.
- The remuneration rules under the current regime are too complex and are not appropriately tailored for asset managers.
- The existing rules on the criteria for recognising regulatory capital are too complex and are not well suited to businesses structured as anything other than a company.
- The reporting and compliance requirements under the CRR and CRD IV are too onerous and are not properly adapted for asset management businesses.

- The current Pillar 3 disclosure requirements are onerous, requiring firms to make disclosures that do not assist their clients, but which take considerable time and resources to prepare.