Alternative Investment Management Association

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Submitted electronically via the EBA website at: http://www.eba.europa.eu/

4 June 2015

Dear Sir/Madam,

AIMA's response to the EBA Consultation Paper EBA/CP/2015/03

The Alternative Investment Management Association Limited[1] (AIMA) welcomes the opportunity to submit its comments to the European Banking Authority (EBA) Consultation Paper regarding Draft Guidelines (the 'Draft Guidelines') on sound remuneration policies under Article 74(3) and 75(2) of Directive 2013/36/EU ('CRD IV') and disclosures under Article 450 of Regulation (EU) No 575/2013 ('CRR') (the 'Consultation Paper').

We welcome the consideration that the EBA is giving to remuneration policies for CRD IV group companies. However, we have some serious concerns with a few points in the Draft Guidelines that we would like to see addressed in the final guidelines. We set out our detailed responses to the questions posed in the Consultation Paper in Appendix A, which raise the following concerns:

- Proportionality: We strongly disagree with the interpretation of the proportionality principle that is presented in the Consultation Paper. The approach set out in the European Commission's opinion is both contrary to the express wording of the CRD IV text as well as the concept of proportionality under the Treaty of the European Union (TEU), Regulation No 1093/2010 (the EBA Founding Regulation) and case law. The proposed change to the application of the proportionality principle would also have serious negative implications for our membership. We therefore encourage the EBA to retain the possibility for firms to neutralise certain provisions of the remuneration principles, on a case-by-case basis, where it is proportionate for them to do so;

- Scope: We also strongly disagree that the guidelines on remuneration under the CRD IV should be applicable to staff of delegate entities of a CRD IV group company. The CRD IV states that the CRD IV remuneration provisions shall apply to "institutions at group, parent company and subsidiary levels, including those established in offshore financial centers." Nowhere in the Level 1 text is there any mention of certain requirements applying to the staff of entities who are not within the CRD IV group;

- Unintended Tax and Regulatory Impacts: Many firms that will be alternative investment fund managers ('AIFMs') or management companies of Undertakings for Collective Investment in Transferable Securities ('UCITS') which may be part of a CRD IV group are established as limited liability partnerships ('LLPs') or limited partnerships. AIMA considers that dividends paid to a CRD IV group company's shareholders (and profit allocations to partners or members of a CRD IV group company structured as LLPs or limited partnerships) who are otherwise Identified Staff as well are not remuneration and are therefore not subject to CRD IV remuneration regulation. However, in the event that such payments are considered remuneration, AIMA asks the EBA to consider the fact that the profits of such entities are required for tax purposes to be allocated to the members or partners each year, whether or not the profits are distributed, thus a

[1] As the global hedge fund association, the Alternative Investment Management Association (AIMA) has over 1,500 corporate members (with over 9,000 individual contacts) worldwide, based in over 50 countries. Members include hedge fund managers, fund of hedge funds managers, prime brokers, legal and accounting firms, investors, fund administrators and independent fund directors.

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requirement to defer payment of any such amount will result in an unfunded tax obligation for the relevant member or partner. This unintended result will disproportionately affect the members and partners of LLPs and limited partnerships. We discuss in more detail the key tax and regulatory issues in Appendix B.

We hope you find our comments useful and would be more than happy to answer any questions you may have in relation to this letter.

Yours sincerely,

Jiří Król
MD, Deputy Chief Executive Officer
Global Head of Government & Regulatory Affairs

Appendix A
AIMA's response to the questions posed in the Consultation Paper

Q 1: Are the definitions provided sufficiently clear; are additional definitions needed?

Whilst we have no comments on the majority of the definitions provided in the Draft Guidelines, we do not agree that the definition of "staff" should be as broad as it is currently drafted. We comment further on this in our response to Question 6.

We also have concerns with the definition of 'remuneration' set out in the Draft Guidelines and how partnership allocations may be dealt with under this definition, which are discussed in response to this Question 1 below.

'Remuneration' and partnership allocations

The Draft Guidelines define 'remuneration' in broad terms so that it would include:

> "payments made or benefits, monetary or non-monetary, awarded directly by or on behalf of institutions in exchange for professional services rendered by staff, … and other payments made via methods and vehicles which, if they were not considered as remuneration, would lead to a circumvention of remuneration requirements."

Section 13.4 of the Draft Guidelines gives more detail of what might be considered to be "circumvention" in this context. However, there is no discussion in the Draft Guidelines of how payments made to partners in a partnerships should be treated. This has particular relevance to investment firms (including hedge fund managers) captured by the CRD IV requirements as, unlike banks or other entities which are likely to be credit institutions under the CRD IV, many senior staff of an investment firm (for example, portfolio managers, senior analysts and traders) are typically not employees, do not have employment contracts and are not remunerated by way of salary plus bonus. Instead, they are members or partners in the organisation, their remuneration is governed by a partnership or LLP agreement and they are entitled to a share of the investment firm's profits in the relevant financial year. If variable remuneration is clawed back, or reduced under malus arrangements, this would (in an LLP-type structure) result in a build-up of funds within the investment firm which ultimately belong to those partners/owners of the business who are entitled to share in its profits. In many cases, these are likely to be the same individuals as are covered by the proposed EBA Guidelines. If the effect of the performance adjustment provisions is to prevent distribution of the retained funds to those individuals, we note that they must nonetheless be allocated for tax purposes (although tax treatment is dependent on the jurisdiction) and that this would leave the relevant individuals with an unfunded tax liability under the tax regulations in some jurisdictions.

More generally speaking, given the level of alignment between a partner or shareholder who is an employee and the investment firm, a fund and its investors, both (i) partners or members in an investment firm that is organised as a limited liability partnership or limited partnership and (ii) employees who own common equity of an investment firm where the investment firm is organised as a limited liability company, should be excluded from the scope of Identified Staff. This should be independent of their share in either the partnership or the common equity.

AIMA considers that all dividends or similar distributions that partners receive as owners of an investment firm should not be considered to be remuneration under the guidelines without the partnership necessarily having to impose arbitrary classifications of portions of such amounts as fixed remuneration, variable remuneration and other. This is because a partner would generally only have an entitlement to any such amounts if the partnership makes a profit (which is akin to dividends only being payable if a company has distributable profits). If such an approach is not adopted, investment firms structured as partnerships will become subject to a disproportionate burden when the remuneration guidelines come into effect.

Notwithstanding the above, if the EBA are unable to provide an interpretation whereby partnership profits are not considered to fall entirely outside the scope of remuneration under the guidelines, it would be helpful if clarification could be given as to the circumstances in which a partnership profit would not be considered to be within scope. For example, partnerships often provide for a fixed amount to be paid to each individual partner as a first charge on the profits (assuming there are profits) in any year (and to receive drawings on account of his fixed priority share throughout the partnership's financial year). We would see this as falling outside the scope of the rules. While the drawings are at risk of clawback, if partnership profits are insufficient to meet them, the amounts payable are nevertheless "fixed" for these purposes, as this element of partnership profit is generally fixed without consideration of any performance criteria.

AIMA also has four principal tax and regulatory concerns associated with extending certain remuneration principles to small firms that are subject to CRD IV, namely (i) tax timing differences for Identified Staff partners; (ii) tax timing differences for Identified Staff employees; (iii) the impact on regulatory capital; and (iv) the impact on the Investment Manager Exemption. These are discussed in more detail in Appendix B.

Q 2: Are the guidelines in chapter 5 appropriate and sufficiently clear?

No comment.

Q 3: Are the guidelines regarding the shareholders' involvement in setting higher ratios for variable remuneration sufficiently clear?

No comment.

Q 4: Are the guidelines regarding remuneration policies and group context appropriate and sufficiently clear?

The guidance for firms that may be subject to the remuneration requirements of multiple directives is unclear. We would welcome clarification that a firm that complies with sector-specific legislation should be deemed to satisfy the relevant remuneration requirement of the CRD IV, save that any officer of the firm who posed a material risk on a consolidation basis would have to comply with the CRD IV requirements.

Investment firms may be subject to national regulations implementing the remuneration requirements of multiple directives (i.e., both CRD IV and also sector-specific legislation such as the AIFMD or UCITS Directive). This possibility is recognised at paragraph 63 of the Draft Guidelines, under which we understand the position to be as follows:

1. Firms in this situation are required to comply with any remuneration provision of the CRD IV which is not included in the relevant sector-specific legislation. Our understanding is that this refers only to the bonus cap. On this issue, please see our comments on proportionality in response to Question 5 below and Appendix C.

2. Where there is a conflict between the remuneration requirement under the CRD IV and under the sector-specific legislation, then the firm's remuneration policy should set out which requirements should apply. This does not provide such firms with any guidance as to which regime should apply, so it would be helpful for the position to be clarified. In our view, where a firm complies with the legislation tailored to its sector (such as the remuneration requirements of the AIFMD or the UCITS Directive) then it should be deemed to satisfy the relevant requirement of the CRD IV, and would suggest that the guidelines clarify this.

Q 5: All respondents are welcome to provide their comments on the chapter on proportionality, with particular reference to the change of the approach on 'neutralisations' that was required following the interpretation of the wording of the CRD. In particular institutions that used 'neutralisations' under the previous guidelines for the whole institution or identified staff receiving only a low amount of variable remuneration are asked to provide an estimate of the implementation costs in absolute and relative terms and to point to impediments resulting from their nature, including their legal form, if they were required to apply, for the variable remuneration of identified staff: a) deferral arrangements, b) the pay out in instruments and, c) malus (with respect to the deferred variable remuneration). In addition those institutions are welcome to explain the anticipated changes to the remuneration policy which will need to be made to comply with all requirements. Wherever possible the estimated impact and costs should be quantified, supported by a short explanation of the methodology applied for their estimation and provided separately for the three listed aspects.

In the Consultation Paper, the EBA has stated that its and the Commission's preliminary legal view is that the pay-out process rules (namely the rules relating to deferral, payment in instruments, ex-post risk adjustment and bonus caps) must be "*applied at least at the minimum thresholds set by the CRD IV. The principle of proportionality cannot lead to the non-application of these rules*" (paragraph 3, Executive Summary of the Consultation Paper).

We consider this view to be contrary to the express wording of the CRD IV text as well as the concept of proportionality under the TEU, the EBA Founding Regulation and case law. This view would also have serious negative implications for our membership, so we encourage the EBA and the Commission to consider their preliminary position at greater length.

I Proportionality

A. Better Regulations Package

The EBA should consider the terms of the Commission's recently published Better Regulations Package. Specifically, in the 19 May 2015 Communication from the Commission[2], the Commission sets out its vision for how the Commission will approach regulation. The communication discusses the applicability of proportionality and specifically contemplates proportionality applying (particularly to SMEs) in a manner that would lighten the requirements (rather than what is contemplated in the Draft Guidelines regarding only upward proportionality adjustments). Specifically, the communication states:

> "We are paying particular attention to the rules that affect SMEs, which too often feel held back by red tape. However, not all of these rules come from Brussels. And, many EU rules are as pertinent for smaller businesses as they are for larger companies: a worker in a small business making artisan products has the same right to health and safety protection as someone on the shop floor in a huge factory. But if the legislative framework is too complicated, too burdensome, or too bureaucratic, the risk is that smaller business are simply not able to follow it – so workers are not protected, or scarce company resources are spent just applying the rules, rather than growing the business and creating jobs.
>
> We will apply the "Think Small First" principle more thoroughly when preparing initiatives: taking the interests of small- and medium-sized businesses into account when designing and evaluating policies, and envisaging a lighter regime for them including an outright exemption for micro-businesses wherever it is possible and makes sense. Where either is not possible, for instance because it would not allow an effective achievement of the social, environmental and economic objectives of the proposed legislation, the Commission will explain why."

The Commission legal service opinion appears to be in direct conflict with the approach being taken by the Commission itself in the Better Regulations Package as it contemplates a scenario whereby the application of the proportionality principle would only serve to increase burdens rather than decreasing burdens where the application of the requirement has a disproportionate effect.

In addition, the Better Regulations Package focusses a lot of attention on what the process should be for developing new Directives and regulations and the need for impact statements and public consultation.

The Commission's original proposed text for CRD IV[3] stated in Recital (48):

> "The provisions on remuneration reflect differences between different types of credit institutions and investment firms in a proportionate manner, according to their size, internal organisation and the nature, scope and complexity of their activities and, in

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[2] Communication from the Commission to the European Parliament, the Council, the European Economic and Social Committee and the Committee of the Regions: Better regulation for better results - An EU agenda (COM(2015) 215 final) dated 19 May 2015.

[3] Proposal for a Directive of the European Parliament and of the Council on the access to the activity of credit institutions and the prudential supervision of credit institutions and investment firms and amending Directive 2002/87/EC of the European Parliament and of the Council on the supplementary supervision of credit institutions, insurance undertakings and investment firms in a financial conglomerate (2011/0203 (COD) dated 20 July 2011.

> particular, *it could not [sic] be proportionate for certain types of investment firms to comply with all of the principles*." (Emphasis added)

With that recital, the fact that the Commission's proposed text did not vary materially from the CRD III approach in relation to the proportionality wording and the then-existing CEBS Guidance on remuneration for entities regulated under CRD III, it would not be reasonable to conclude that, even if the proposal had been made subject to the Better Regulation principles, stakeholders would have been on notice that they should comment on the possible impacts of an application of the proportionality wording that only allowed for upward adjustments and did not allow for a lightening of the burden in accordance with an institution's size, internal organisation and the nature, scope and complexity of its activities. If it was the intention of the Commission to change the interpretation of the CRD III measures (given also that the CEBS Guidance was in force and publicly available when the Commission proposal was being drafted), the Commission could easily have done so and more clearly communicated the intended change in policy allowing stakeholders an opportunity at that time to provide feedback. That they did not indicates that the interpretation of proportionality was, in the Commission's view at the time, correctly settled under CRD III and the CEBS Guidance.

B. CRD IV Level 1 text

The operative provisions in Article 92(2) and 94(1) of CRD IV state that:

> "institutions [must] comply with the following principles in a manner and *to the extent* that is appropriate to their size, internal organisation and the nature, scope and complexity of their activities". [Emphasis added].

The phrase "to the extent" refers to the width or limits of application of a principle. It is the natural reading of the phrase "comply with the...principles...to the extent...appropriate" that it may not be appropriate to comply with all of them. Synonyms for "to the extent" would be "to the degree" or "so far as". Compliance "so far as appropriate" might not require full compliance with every detail of every provision. In other words, neutralisation or disapplication of a particular principle is one way in which the principles as a whole may be applied proportionately.

In the French language version, the concept is expressed as

> *"les établissements respectent les principes suivants d'une manière et dans une mesure qui soient adaptées à leur taille et à leur organisation interne ainsi qu'à la nature, à l'échelle et à la complexité de leurs activités"*, [Emphasis added]

which may be translated as "so far as" or "insofar as".

The German version states:

> *"die nachstehenden Grundsätze in einer Art und einem Ausmaß anwenden, die ihrer Größe, ihrer internen Organisation und der Art, dem Umfang und der Komplexität ihrer Geschäfte angemessen sind,"* [Emphasis added]

which may be translated as "to the extent" or "to the degree".

Recital 66 of CRD IV clearly supports this interpretation:

> "The provisions of this Directive on remuneration should reflect differences between different types of institutions in a proportionate manner, taking into account their size, internal organisation and the nature, scope and complexity of their activities. *In particular it would not be proportionate to require certain types of investment firms to comply with all of those principles*." [Emphasis added]

It is also relevant that the co-legislator chose to adopt the word "principle" as opposed to "rule" to describe the obligations on firms.

If all institutions were to apply the principles without neutralisation, then they would be obliged to comply with them all in the same way, contrary to this provision. From what was said at the open hearing at the EBA on 8 May 2015 (the Open Hearing), we understand that the EBA contends that the recital finds no support in the operative provisions of the legislation and/or that the operative provisions are ambiguous. We disagree strongly: that would be to render otiose the words "to the extent" which, on the EBA's reading, add nothing to "in the manner", and to ignore the description of the requirements of the legislation as "principles".

Parallels are drawn below between the remuneration provisions of CRD IV and of CRD III. An equivalent recital in CRD III expressly provided that

> "it may not be proportionate for investment firms referred to in Article 20(2) and (3) of Directive 2006/49/EC [e.g. MiFID investment managers] to comply with all of the principles" (Recital 4, Directive 2010/76/EU)."

Through its equivalent guidelines under CRD III the Committee of European Banking Supervisors (CEBS) permitted certain firms to treat certain principles as having been neutralised on the basis of proportionality. We consider that CEBS' position was correct.

We understand that the EBA is concerned the CEBS (and our preferred) legal reading could mean that certain institutions might not comply with the remuneration principles at all. We believe that this concern is misplaced. Legislation is applied proportionately only if it is applied in a way which reflects and is designed to achieve the legitimate aim of the legislature and in a way which reflects the size and internal organisation of the firm and the nature, scope and complexity of its activities. For example, it would be extremely unlikely that a firm had complied with the obligation to apply the remuneration principles proportionately if it had purported to neutralise the requirement under Article 92(2)(a) of CRD IV that its remuneration policy should be consistent with and should promote sound and effective risk management and if in fact it encouraged risk-taking which exceeded the tolerated level of risk as the institution. In other words, certain principles may be neutralised, and others not, and there should be no automatic application of proportionality.

C. <u>Proportionality generally</u>

All EU law must be proportionate (TEU Article 5(4)). The Parliament, Council and Commission are bound by the principle of proportionality. Consistent with the Meroni doctrine (*Meroni v High Authority of the European Coal and Steel Community (Case 10/56) [1958]*), so too is EBA when exercising its powers under CRD IV and the EBA Founding Regulation.

The EBA's guidelines addressed to institutions and competent authorities must therefore be necessary to achieve a legitimate aim and there must not be a less onerous way of achieving the aim; the guidelines must also be reasonable, taking into account the competing interests of different groups *(Internationale Handelgesellschaft (Case 11/70) [1970])*.

If the EBA and the Commission were to interpret the pay-out process rules as setting the lowest common standards which all institutions must apply, "proportionality" would mean that certain institutions (e.g., those that are more complex, large or trade in complex products) would only be free to set more onerous standards. This form of "upward only" proportionality would be contrary to the wider principle of subsidiarity/proportionality established by case law and the TEU.

D. <u>Travaux préparatoires / legislative process</u>

It might be argued that it is inherently proportionate to apply strictly to all institutions the whole of each and every provision related to remuneration adopted by the Parliament and the Council in the Level 1 text. This would be overly simplistic and wrong for three key reasons:

- First, because of the qualification of the principles "to the extent" appropriate to the size and internal organisation of the institution and the nature, scope and complexity of the institution's activities (see above);
- Second, because the EBA's interpretation of proportionality fundamentally conflicts with the principle of proportionality established under the TEU, the EBA's Founding Regulation and case law (see above); and
- Third, because the circumstances of the legislative process are relevant to an assessment of the proportionate application of the remuneration principles in CRD IV (see below).

It is highly relevant that Article 92 and Recital 66 were not substantively amended from the text in CRD III. The provisions relating to proportionality were lifted from the CRD III measures and if it was ever the intention of the Parliament, Council or Commission to change the interpretation of the CRD III measures (given also that the CEBS Guidance was in force and publicly available during the trialogue process), there was sufficient opportunity for the legislature to have changed the operative provisions in CRD IV. That they did not indicates that the interpretation of proportionality was correctly settled under CRD III and the CEBS Guidance.

The travaux préparatoires made no reference to the interpretation proportionality being construed in the manner which the EBA has proposed in its recent consultation paper. Further, in the context of the bonus cap, the discussion in the travaux préparatoires related only to credit institutions, not investment firms and, when the co-legislator debated the introduction of the bonus cap to UCITS management firms, there was no suggestion that other investment managers were already subject to it under CRD IV.

E. <u>Legitimate expectation and legal certainty</u>

Regulatory stability and predictability is central to the fundamental EU law principles of legal certainty and the protection of economic participants' legitimate expectations. The ECJ has repeatedly stated that rules should be clear and precise, and their application predictable (See Ireland v Commission (325/85) [1987] E.C.R. 5041 at [18]; Gebroeders van Es Douane Agenten BV v Inspecteur der Invoerrechten en Accijnzen (C-143/93) [1996] E.C.R. I-431 at [27]; Duff v Minister for Agriculture and Food (C-63/93) [1996] E.C.R. I-569 at [20]; Vereniging voor Energie, Milieu en Water v Directeur van de Dienst uitvoering en toezicht energie (VEMW) (C-17/03) [2005] E.C.R. I-4983; [2005] 5 C.M.L.R. 8 at [80]).

As explained above, the proposed interpretation of proportionality under CRD IV by the EBA and/or the Commission is different from financial institutions' understanding of proportionality under similarly cast rules in CRD III and from the textual interpretation of the Level 1 CRD IV text. There is also a degree of unpredictability in departing from the existing interpretation of proportionality in the manner which the EBA and/or the Commission has proposed. Should the EBA/Commission's interpretation of proportionality be taken forward into new EBA guidance, this would represent a clear departure from what financial institutions have up to now legitimately expected of the law and may promote legal uncertainty.

II Implications of the contrary interpretation for AIMA member investment firms

There are a number of reasons why AIMA considers that it would be inappropriate to no longer permit AIMA member investment firms that are within the scope of CRD IV to neutralise certain remuneration requirements which, under the CEBS Guidelines, it is currently possible for them to neutralise on the grounds of proportionality. Although some remuneration principles can and should be shared across the banking and asset management sectors, the limitation on fixed-to-variable pay ratios and deferral requirements provide examples of intervention which is not only undesirable on policy grounds but also difficult, if not impossible, to implement in practice due to the fundamental differences between the asset management business model and the banking business model.

The banking and asset management business models are very different from each other and we would request that the features of the asset management sector, rather than simply the features of the banking sector, be taken into account when considering principles for sound remuneration under the CRD IV. Set out in Appendix C are some reasons why certain CRD IV remuneration requirements should not be imposed on firms subject to CRD IV requirements and UK firms that are not subject to CRD IV requirements but are regulated in a manner consistent with the requirements under CRD III.

[In addition, requiring asset managers to comply with the bonus cap would have adverse implications because fixed pay would need to be increased in a manner which cannot necessarily be funded out of an asset managers management or performance fee. This could destabilize an asset manager from a prudential perspective, which is contrary to the policy objective of CRD IV and it would create a misalignment with the interests of investors. Further, as raised above in our response to Question 1 and below in our response to Question 6, it is also unclear how the application of the bonus cap to non-EU delegates of the manager would apply.]

Q 6: Are the guidelines on the identification of staff appropriate and sufficiently clear?

As mentioned above, we do not consider that the definition of "staff" is appropriate. Under the definition of "staff" set out in the Draft Guidelines, "other persons acting on behalf of the institution and its subsidiaries" would be subject to the CRD IV remuneration rules. This would mean that not only would any staff of a delegate entity of a CRD IV entity be subject to the CRD IV remuneration rules, but also that the staff of any delegate entity of the CRD IV entity or an AIFM or UCITS management company which are part of a CRD IV group would have to be subject to the CRD IV remuneration rules. We would strongly disagree that this should be the case and would like to highlight that introducing a requirement that staff of delegate entities must comply with the CRD IV remuneration rules:

- exceeds the Level 1 remuneration requirements and is therefore not capable of being introduced via EBA guidance;
- is arbitrary in that only one set of rules is being contemplated to be extended to delegates; and
- is harmful from a competitiveness perspective as it will render delegation of portfolio or risk management to non-EU entities impracticable.

The Definition of 'Staff' Exceeds the Level 1 Remuneration Requirements

The definition of staff goes beyond the requirements of the CRD IV text and does not reflect the legislative intent in this area. Recital 62 of the Level 1 text introduces the concept of remuneration policies and practices. In particular, it requires that:

> "This Directive aims to implement international principles and standards at Union level by introducing an express obligation for credit institutions and investment firms to establish and maintain, for categories of staff whose professional activities have a material impact on the risk profile of credit institutions and investment firms, remuneration policies and practices that are consistent with effective risk management."

Recital 67 states that:

> "In order to protect and foster financial stability within the Union and to address any possible avoidance of the requirements laid down in this Directive, competent authorities should ensure compliance with the principles and rules on remuneration for institutions on a consolidated basis, that is at the level of the group, parent undertakings and subsidiaries, including the branches and subsidiaries established in third countries."

These recitals make clear that the remuneration provisions of the CRD IV should be applied to the CRD IV group but does not make any reference to applying the remuneration rules to delegate entities.

Article 92 of the CRD IV introduces the CRD IV requirements relating to the remuneration policy. This Article states that the CRD IV remuneration rules "shall be ensured by competent authorities for ***institutions*** at ***group, parent company and subsidiary levels***, including those established in offshore financial centres" (emphasis added). The EBA Guidelines should therefore be limited to staff which are part of a CRD IV group company. Since the EBA Guidelines would require CRD IV entities and their subsidiaries contractually to impose remuneration guidelines in other sectors (e.g. among delegates who are not themselves subject to the CRD IV), the EBA is seeking to impose the CRD IV remuneration rules on a wider group than is envisaged by the CRD IV text.

We also note that Article 75(2) of the CRD IV refers to the EBA guidelines on remuneration being formulated to take into account Commission Recommendation 2009/384/EC - which is the Commission Recommendation on remuneration policies in the financial services sector. The 2009 Recommendation made no reference to delegation by financial service firms. One may therefore infer that there was no intention in relation to the 2009 Recommendation (and, by implication, regarding the CRD IV) for EU firms subject to the Recommendation to impose equivalent remuneration rules on their delegates.[4]

Article 75(2) states, in relevant part, that:

> "EBA shall issue guidelines on sound remuneration policies which comply with the principles set out in Article 92 to 95."

Nowhere in Articles 92 to 95 does the CRD IV discuss delegation, applying the requirements to staff of delegates, or extending the guidelines to cover entities that are otherwise not required to apply the remuneration requirements under Articles 92-95. Accordingly, the proposed definition of "staff" exceeds the EBA's remit in respect of its authorisation under CRD IV to provide guidelines.

While the EBA clearly has an interest in forestalling avoidance of the provisions of the CRD IV, the concept of anti-avoidance cannot be used to extend the requirements beyond the Level 1 requirements, which would clearly be the case with respect to the definition of staff as discussed here.

Extending Remuneration Rules to Delegates is Arbitrary

The CRD IV in no way limits the EBA to provide guidance in areas other than those where EBA has been expressly asked to provide such guidance. If the EBA's view is that it has the power to extend the remuneration requirements to the staff of delegates in the name of anti-avoidance, then presumably there is no limit to EBA's ability to require a delegate to contractually agree to abide by all of the terms of the CRD IV, regardless of whether the delegate would otherwise be in scope. If that is the case, then choosing to require the application of the remuneration requirements but not other requirements is arbitrary.

Negative Effect on EU Competitiveness

Introducing a requirement in the course of implementing the EBA Guidelines which seeks to extend the remuneration requirements to entities outside Europe will put European entities that are part of a CRD IV group at a competitive disadvantage. First, there are no major jurisdictions that contemplate introducing such prescriptive and restrictive remuneration requirements to their credit institutions. This means that it will be difficult for entities which are part of a CRD IV group to delegate functions to entities outside Europe. In the United States, remuneration provisions may be introduced for entities with a balance sheet size (not assets under management) of at least US$1 billion and more stringent requirements (coming closer to the EU requirements but not equalling them) may be introduced for entities with a balance sheet size of at least US$50 billion. The US Securities and Exchange Commission estimates put the number of advisers with over US$1 billion at fewer than 100 and those with greater than US$50 billion at fewer than 20. Accordingly a substantial portion of the US asset management industry will not be affected by these requirements. Other major non-EU fund management jurisdictions, such as Hong Kong, also do not impose remuneration or compensation limits on asset managers.

This means that CRD IV groups wanting to use independent third party providers established in a third country would have to extend the CRD IV remuneration provisions to their third country delegate staff contractually. Given that remuneration plays a key consideration in competition for talent, entities within a CRD IV group would be at a major disadvantage in either recruiting staff for their affiliates or in finding asset managers whose staff would be willing to take on the burden of the CRD IV remuneration provisions voluntarily. The effect would be that CRD IV groups would be at risk of only providing a geographically limited service as investors would understand it is not capable of attracting top local portfolio managers in different regions of the world where a CRD IV entity is seeking exposure.

Q 7: Are the guidelines regarding the capital base appropriate and sufficiently clear?

No comment.

[4] See: http://eur-lex.europa.eu/LexUriServ/LexUriServ.do?uri=OJ:L:2009:120:0022:0027:EN:PDF.

Q 8: Are the requirements regarding categories of remuneration appropriate and sufficiently clear?

No comment.

Q 9: Are the requirements regarding allowances appropriate and sufficiently clear?

No comment.

Q 10: Are the requirements on the retention bonus appropriate a sufficiently clear?

No comment.

Q 11: Are the provisions regarding severance payments appropriate and sufficiently clear?

No comment.

Q 12: Are the provisions on personal hedging and circumvention appropriate and sufficiently clear?

No comment.

Q 13: Are the requirements on remuneration policies in section 15 appropriate and sufficiently clear?

No comment.

Q 14: Are the requirements on the risk alignment process appropriate and sufficiently clear?

No comment.

Q 15: Are the provisions on deferral appropriate and sufficiently clear?

No comment.

Q 16: Are the provisions on the award of variable remuneration in instruments appropriate and sufficiently clear? Listed institutions are asked to provide an estimate of the impact and costs that would be created due to the requirement that under Article 94(1)(l)(i) CRD only shares (and no share linked instruments) should be used in parallel, where possible, to instruments as set out in the RTS on instruments. Wherever possible the estimated impact and costs should be quantified and supported by a short explanation of the methodology applied for their estimation.

No comment.

Q 17: Are the requirements regarding the retention policy appropriate and sufficiently clear?

No comment.

Q 18: Are the requirements on the ex post risk adjustments appropriate and sufficiently clear?

No comment.

Q 19: Are the requirements in Title V sufficiently clear and appropriate?

No comment.

Q 20: Are the requirements in Title VI appropriate and sufficiently clear?

No comment.

Q 21: Do institutions, considering the baseline scenario, agree with the impact assessment and its conclusions?

No comment.

Q 22: Institutions are welcome to provide costs estimates with regarding the costs which will be triggered for the implementation of these guidelines. When providing these estimates, institutions should not take into account costs which are encountered by the CRD IV provisions itself.

No comment.

Appendix B

Note on Key Tax and Regulatory Issues

The purpose of this note is to set out the key tax and regulatory issues for asset managers in relation to the Draft Guidelines and also suggested resolution. It focuses principally on the situation in the United Kingdom, but we note that some or all of these considerations will also be relevant in other jurisdictions.

Issues

There are four principal tax and regulatory concerns, namely:

1. Tax Timing Differences for Identified Staff Partners;
2. Tax Timing Differences for Identified Staff Employees;
3. Impact on Regulatory Capital; and
4. Impact on the Investment Manager Exemption.

We deal with each of these in turn below:

1) Tax timing differences for Identified Staff Partners

In the case of partnerships, it is our view that partnership profit share should not be regarded as variable remuneration. However, if the Draft Guidelines are applied to the profit allocations of partners deemed to be Identified Staff, a profound tax timing difference will arise for many of them, particularly if their entire profit allocation is deemed to be variable compensation.

The tax timing difference will arise because individual partners are generally subject to tax on their entire profit allocation for a year (as adjusted for tax purposes), irrespective of when it is physically distributed to them by the partnership.

LLPs are taxed on a look through basis and consequently all of the profit must be allocated to all members at the end of the year. If profit is retained within the business, that is on an effective post tax basis for the individual partners. It makes no different to the amount of tax payable by the partner.

Accordingly, if the provisions relating to "Deferral" within the Draft Guidelines are applied to all of a partner's profit share (such that up to 60% would be deferred and at least 50% be awarded in shares or equivalent ownership interests), it is highly likely that, in the first year of operation of these rules, the partner will have to make a tax payment without any corresponding receipt of income to fund it i.e., suffer a negative cash flow or a "net liability"[5]. An aggregate net liability may continue for a number of further years. This cannot be what is intended and is clearly disproportionate.

A similar net liability will arise for any new member joining post implementation of these rules in their current form and could also arise in a year where an individual's profit share significantly increases. We have provided an example below for an illustration of the potential for a net liability in the first year of allocation.

[5] Applying an illustrative tax rate of 50%

Example 1: Partner Cash Flows under Deferral
Assumes 60% of profit share for Y0 deferred over three years, payable in Y1, Y2 and Y3.
Assumes 50% of both deferred and non-deferred profits received in fund shares subject to 1 year retention
Assumes no tax adjustments i.e., taxable profit is same as profit allocation.
Assumes income tax at 50%.

Partner	Profit Allocation	Cashflows			
		Y0	Y1	Y2	Y3
	£	£	£	£	£
Profit allocation	600,000				
Deferred Cash & Shares @ 60%	360,000		120,000	120,000	120,000
Non-deferred Shares	120,000		120,000		
Non-deferred - Cash	120,000	120,000			
Taxable profit in Current Year	600,000				
Tax @ 50%	-300,000	-300,000	0	0	0
Net profit after tax	300,000	**-180,000**	240,000	120,000	120,000

Conclusion

It is unacceptable for partners to be expected to fund a net cash outflow (as shown in the example above). We believe this would be inequitable and an unintended consequence of the Draft Guidelines as it stands. We recommend this issue is resolved to avoid asset managers finding alternative means of alleviating this issue for affected partners. Given the significant number of financial services businesses within the UK structured as LLPs or limited partnerships, it is crucial that the discrimination inherent within the Draft Guidelines, as currently drafted, is resolved.

2) Tax Timing Differences for Identified Staff Employees

Employees are generally only subject to tax in respect of remuneration at the earlier of the date on which it is paid or when the employee becomes entitled to it. At this time tax is withheld and paid over to HMRC under the operation of Pay As you Earn ("PAYE"), such that the tax inequality outlined above for partners is not applicable to cash amounts deferred. Therefore, it would seem that the more material tax issues arising from the proposed revisions to the Draft Guidelines fall on the employer.

The employer, be it a corporate or a partnership, is subject to specific provisions with respect to the timing of any tax deduction available for the expense that relates to the deferred and/or share based awards.

Broadly, an employer, be it a corporate or a partnership, may only obtain a tax deduction for amounts "paid" within nine months of the year end. If bonuses are deferred beyond 9 months, then they become "disallowable" expenses and a tax deduction will only become available when the amount eventually vests. Accordingly, the deferral arrangements and share based awards required are unlikely to attract a tax deduction in the year of award but in later periods of account (given the proposal within the Draft Guidelines that bonuses must be deferred over a period of at least three years). However, the accounting treatment may require provision for the expense at the date of award or spread over the period of the award to vesting.

The same treatment will generally apply with contributions to Employee Benefit Trusts and other methods of ring fencing the deferred awards for employees i.e., a tax deduction is only allowed if paid out from the Trust within nine months of the year end of award.

This will give rise to a tax timing difference as shown in example 2 below:

Example 2: Employer Tax Implications
Assumes 60% of variable remuneration for Y0 deferred over three years, payable in Y1, Y2 and Y3.
Assumes accounting treatment differs from tax treatment which is common.
Assumes deferred bonus spread over time from award to vesting for accounting purposes.
Assumes tax deduction only available where vests within 9 months of award or on vesting and that award vests more than 9 months after year end.

Employer	**Bonus**		**Cashflows**	
	Y0	**Y1**	**Y2**	**Y3**
	£	£	£	£
Deferred Bonus Award	150,000			
P&L Expense		91,667	41,667	16,667
Tax Deduction		50,000	50,000	50,000
Taxable Mismatch		41,667	-8,333	-33,333

Taxable mismatch is the difference between the accounting deductions in the accounts versus tax deductions allowed for tax purposes. A positive tax mismatch is effectively additional income over and above accounting profits subject to tax.

There are a number of implications of this for in scope businesses.

(i) For partnerships, there are particular tax issues around deferring compensation for employees: The tax mismatch for partners outlined in section 1 above may be exacerbated by the inability to claim a tax deduction in respect of highly paid employees who are Identified Staff, if amounts are not paid within nine months of award. This is because the profit allocation on which the partners are taxable would be adjusted for any disallowed expenses in relation to deferred/share based awards. This is shown in Example 3 below.

Example 3: Partner Cash Flows Under Deferral with Employee Deferred Bonuses
Assumes 60% of profit share for Y0 deferred over three years, payable in Y1, Y2 and Y3.
Assumes 50% of both deferred and non-deferred profit share received in fund shares subject to 1 year retention.
Assumes partnership must award shares/pay deferred bonuses to employees which are deferred over three years.
Assumes tax deduction only available for employee bonuses where vests within 9 months of award or deferred to vesting.
Assumes income tax at 50%.

	Profit Allocation	Cashflows			
		Y0	Y1	Y2	Y3
	£	£	£	£	£
Profit allocation	600,000				
Deferred Cash & Shares @ 60%	360,000		120,000	120,000	120,000
Non-deferred - Shares	120,000		120,000		
Non-Deferred - Cash	120,000	120,000			
Non-deductible employee deferred bonuses	150,000				
Taxable profit in Current Year	750,000				
Tax @ 50%	-375,000	-375,000			
Tax deduction for employee deferred bonuses @ 50%	75,000		25,000	25,000	25,000
Net profit	300,000	**-255,000**	265,000	145,000	145,000

(ii) For companies, the issues are different: this will put increased pressure on working capital, and therefore potentially regulatory capital, as the tax deduction is deferred, yet the expense and associated cash flow may have been incurred (for example, where shares have been acquired or cash is "ring fenced").

(iii) Given the potential volatility of performance fees, it is conceivable that a business could have an inflated taxable profit due to tax disallowable costs in the period of award but a taxable loss in a later period when a tax deduction is finally obtained, where strong performance in one year is followed by flat performance for a few years (or the business is wound up). However, given the restriction on carry back or other offset of tax losses' it may not be possible to obtain concurrent tax relief, such that the tax losses created can only be carried forward to offset future profits, if these arise.

Conclusion

Whilst the above implications have long been the case for an employer awarding deferred bonuses or share based awards, the employer has had control over its remuneration policy and therefore the implications on the business. The Draft Guidelines will potentially change this: the regime will create a disproportionate impact on partnerships and reduce the control all managers have over their businesses and working capital.

3) Impact on Regulatory Capital

As management and performance fees are realised income, if amounts are required to be deferred in cash and/or shares, the manager will either need to retain that cash and/or shares or contribute it into a trust for safe keeping for the Identified Staff. The liability to pay the deferred amount and the asset to back that liability is therefore likely to remain on the balance sheet of the manager, even in the event of contribution to a trust given accounting treatment under UITF 32.

These assets – the cash and/or shares – are assets which will result in a higher regulatory capital requirement for the firm. This will need to be matched by increased regulatory capital. This will either require a fresh capital injection from the owners or (more likely) retention of prior year profits on the balance sheet, rather than paying these out to partners.

There are three ways in which this could typically be calculated.

First, if the asset is cash held at a bank, there will be an additional credit risk requirement of 1.6% of the cash value using the standardised approach. If the cash is held in a currency other than the currency in which it must be paid out, there would be a further 8% requirement.

Second, if the asset is shares or units in a hedge fund which does not constitute a "material holding", the credit risk requirement using the simplified approach would be 12% of the value of the hedge fund interests held (i.e., a risk weighting of 150% x 8. In a simple case this will mean that the negative cash flow for partners is further exacerbated if partners are expected to self-fund any further regulatory capital requirements, which is effectively the case for owner managed businesses. See Example 4 below, which assumes an investment in the hedge fund shares to be distributed.

Example 4: Regulatory Capital Retention
Assumes 60% of profit share for Y0 deferred over three years in fund shares, payable in Y1, Y2 and Y3.
Assumes 50% of both deferred and non-deferred profit share received in fund shares.
Assumes partnership also makes deferred awards of shares to employees.
Assumes shares awarded are hedge fund shares attracting 12% Pillar 1 capital requirement.

Partner	Current Year Total	Cashflows			
		Y0	Y1	Y2	Y3
	£	£	£	£	£
Fixed profit share	100,000				
Variable profit share	0				
Total	100,000				
Deferred fund shares @ 60%	60,000		20,000	20,000	20,000
Non-deferred - Cash	20,000	20,000			
Non-deferred Shares	20,000		20,000		
Non-deductible employee deferred bonuses	50,000				
Taxable profit in Current Year	150,000				
Tax @ 50%	-75,000	-75,000			
Tax deduction for employee deferred bonuses in Year 1-3	-50,000				

Tax deduction for employee deferred bonuses @ 50%	25,000		8,333	8,333	8,333
Profit retained in firm to increase capital		-13,200	4,400	4,400	4,400
Net profit received by partner	50,000	-68,200	52,733	32,733	32,733

The above two examples only apply where a fund manager calculates its capital requirement using credit risk plus market risk. However, the third example below, applies also to managers using ¼ fixed overheads. This example produces an entirely absurd result, but one which appears to be required by a literal application of the regulatory capital rules together with the share based payment and deferral rules.

Third, if the asset is shares or units in a hedge fund which constitutes a "material holding", the investment in the hedge fund must be deducted in full from regulatory capital. This produces the absurd result that the firm is forced to substantially increase the capital it is required to have in order to meet regulatory requirements which are notionally designed to preserve and improve a firm's capital position. It would lead to a significant deterioration in partner cashflow, especially if the partners are supporting shares paid to other staff. This is illustrated in Example 5 below.

Example 5:
Assumes 60% of profit share for Y0 deferred over three years in fund shares, payable in Y1, Y2 and Y3.
Assumes 50% of both deferred and non-deferred profit share received in fund shares.
Assumes partnership also makes deferred awards of shares to employees.
Assumes shares awarded are hedge fund shares deducted in full as a material holding.

Partner	Current Year Total	Cashflows			
		Y0	Y1	Y2	Y3
	£	£	£	£	£
Fixed profit share	100,000				
Variable profit share	0				
Total	100,000				
Deferred fund shares @ 60%	60,000		20,000	20,000	20,000
Non-deferred - Cash	20,000	20,000			
Non-deferred - Shares	20,000		20,000		
Non-deductible employee deferred bonuses	50,000				
Taxable profit in Current Year	150,000				
Tax @ 50%	-75,000	-75,000			
Tax deduction for employee deferred bonuses in Year 1-3	-50,000				
Tax deduction for employee deferred bonuses @ 50%	25,000		8,333	8,333	8,333
Profit retained in firm to increase capital		-10,000	36,666	36,666	36,666
Net profit received by partner	50,000	-165,000	84,999	64,999	64,999

4) Impact on Investment Manager Exemption

Many UK based alternative investment managers, who manage funds which may be regarded as trading, need to meet the conditions set out in the Investment Manager Exemption ("IME") to prevent the profits of the fund being subject to tax in the UK. In other jurisdictions the manager will need to show that it is an independent agent in relation to its funds that it manages, which will raise similar issues to the IME.

There is a real risk that it may become difficult for UK firms to meet the conditions of this exemption if they are also required to meet the share based award requirements of the Draft Guidelines through award of shares in the funds.

Two of the conditions which require consideration in light of the proposed revisions to the Draft Guidelines are as follows:

(a) Independent Capacity – the UK manager, when acting on behalf of the fund, is required to do so in an independent capacity. This test may not be met if the fund is not "widely held", subject to the fund being actively marketed. As a direct result of the UK manager adhering to the Draft Guidelines, Identified Staff may own a significant interest in the fund. This may result in UK firms breaching the independent capacity test.

(b) The 20% Test – broadly this requires the UK manager, and persons connected with it, to not be entitled to more than 20% of the profits of the fund over any five year period (excluding management and performance fees). It may become difficult for UK managers to meet the requirements of this test as a result of the requirement for Identified Staff to receive a percentage of their remuneration in shares in the fund.

Please note that the use of derivatives or other interests linked to the value of the fund shares is not a suitable alternative as this would create a significant unfunded financial risk for the firm, unless the awards were hedged through purchase of underlying fund shares, which then again risks a breach of the investment manager exemption.

Suggested resolutions

We are of the view that there is no single measure which would resolve all the tax issues.

1) Disaggregation of profit shares

Guidance should be added to clarify that profit shares are not variable remuneration for the purposes of the Draft Guidelines. Alternatively, there should be clarification that the principle of "proportionality" should be applied to the profit share of a partnership through the 'disaggregation' of a profit share. A partnership profit share will typically represent both remuneration for duties and services and a return on capital and risk. This is akin to an employee who is also a shareholder.

Partnerships employ a wide variety of profit sharing arrangements. There are, however, broadly three key mechanisms which are used either individually or in different combinations into which almost all arrangements may be classified: a) Fixed, b) Discretionary and c) Unit Linked. We recommend that each partner's profit share should be disaggregated into the different underlying elements, if present, and treated as below:

(a) Fixed Profit Shares – any element of a profit share which is fixed at the beginning of the period of account and is only subject to the profitability of the partnership should be treated as "fixed remuneration" for the purposes of the Draft Guidelines.
(b) Discretionary Profit Shares – any element of a profit share which is discretionary, i.e., subject to the performance of the individual partner, their team and or the discretion of a partner/remuneration committee should be treated as "variable remuneration".
(c) Equity Linked Profit Shares – any element of a profit share which is linked to shares/units/capital/points in the partnership which are awarded prior to the beginning of the year or commencement of duties and which provide a right to share in the residual profits of the partnership should be treated as akin to a dividend on shares held by an employee i.e., a return on share capital or reward for risk and therefore excluded for the purposes of the Draft Guidelines.

In line with the presumption that the Draft Guidelines should not favour a particular legal structure, we would expect that any element of a profit share which demonstrates the features set out in under (a) or (c) should fall outside the scope of the Draft Guidelines.

2) Partnership Tax Netting Principle

Partnerships may comply with the deferral and share based award requirements for partners, subject to proportionality, on an after tax basis, i.e., allocate profits to its members net of tax. Example 6 below provides an illustration.

Example 6: After Tax Deferral for Partners
Assumes 60% of profit share for Y0 deferred over three years, payable in Y1, Y2 and Y3.
Assumes 50% of both deferred and non-deferred profit share paid in fund shares subject to 1 year retention.
Assumes no tax adjustments i.e., taxable profit is same as profit allocation.
Assumes income tax at 50%.

Partner	Profit Allocation	Cashflows			
		Y0	Y1	Y2	Y3
	£	£	£	£	£
Profit allocation	600,000				
Tax @ 50%	-300,000	-300,000			
Net of Tax	300,000				
Deferred fund shares @ 60%	180,000		60,000	60,000	60,000
Non-deferred - Shares	60,000		60,000		
Non-deferred - Cash	60,000	60,000			
Distribution for Tax		300,000			
Net profit after tax	300,000	60,000	60,000	60,000	60,000

The combination of (1) and (2) above would be a significant step to putting partners on more of an even playing field and would be as valid for alternative asset managers as any other financial services businesses structured as partnerships.

3) Ring fencing of assets

We would recommend that the requirement to provide further regulatory capital for assets backing liabilities in respect of assets ring fenced for bonus deferral arrangements is removed where the liability is clearly linked to the value of those assets such that there is no real credit risk to the organisation.

4) Appropriateness of share based awards

We would recommend that the Guidelines clarify that award of shares in the funds is only appropriate in the event it would not disadvantage third party investors in the funds.

Appendix C

Why certain CRD IV remuneration requirements should not be imposed on asset managers

The introduction of regulatory requirements regarding remuneration structures in the financial services industry began as a result of the financial crisis and, more specifically, as a result of perceived "excessive and imprudent risk-taking in the banking sector."[6] Although some remuneration principles can and should be shared across the banking and asset management sectors, the limitation on fixed-to-variable pay ratios and deferral requirements provide examples of intervention which is not only undesirable on policy grounds but also difficult, if not impossible, to implement in practice due to the fundamental differences between the asset management business model and the banking business model. The banking and asset management business models are very different from each other. Accordingly, we request that the features of the asset management sector, rather than simply the features of the banking sector, be taken into account when considering principles for sound remuneration under the CRD IV. Whilst imposing a restriction on the amount of variable remuneration an employee of a bank may receive may be appropriate under the circumstances where the banking sector enjoys wholesale government guarantees, applying this restriction to the regulation of asset managers' remuneration structures would be inappropriate.

The table below sets out some of the significant differences between the banking model and the asset management business models:

	Banking model	**Asset management model**
Who are the key stakeholders?	Depositors Bondholders Shareholders Public	Investors
Stakeholder expectations of risk and reward	Bank depositors generally do not seek exposures to bank loans, trading portfolios or other risk portfolios, but rather seek to have the bank hold their money (with perhaps nominal rates of interest) until they come back to withdraw it and to have a relationship that permits the use of their bank accounts to make payments for goods and services. Although depositors understand that their money is then used by the bank to make loans and for other purposes, it is expected that amounts deposited will be available to the depositor upon demand. Bank bondholders expect that banks will take risks sufficient to generate the returns required under the terms of the bonds in issue, however, types of risks being taken are often not transparent or fully disclosed to bondholders ex ante or even ex post. Bondholders are typically less concerned than shareholders, but more concerned than most depositors, about the overall levels of risk a bank undertakes since bondholders are creditors who will rank ahead of shareholders if the bank fails. When a government steps in to support a	Investors in funds seek particular risk exposures which are disclosed to them ex ante. Investors bear the full benefit and burden of market risk and the profits and losses associated with investments made by the managers on their behalf. Investors are routinely advised that they should hold no expectation for the return of the full principal amounts invested.

6 See recital 1 of the CRD III.

	Banking model	Asset management model
	bank that is failing, bondholders will often be made whole. It is only in rare cases that government support to a banking institution has lead to the write-down or conversion of bondholder claims. Shareholders of banks own the banks and expect that the employees of the banks will take risks as principal to increase the value of the shares of the banks. The types of risks being taken are often not transparent or fully disclosed to shareholders ex ante or even ex post. Shareholders understand that they may some (or all) of the value of their investment depending on the nature of the risks undertaken by the bank and the willingness of the relevant governments to keep banks from failing. The public expects banks to lend money to finance the real economy. In cases of excessive risk taking that goes wrong, the public is harmed when taxpayers are required to support banks that have incurred losses (in lieu of other stakeholders bearing that loss) and when excessive risk taking leads to less money being available to finance the real economy.	
Transparency of the consequences of risk taking	Bank stakeholders do not have the benefit of frequent, transparent disclosure of the activities of the bank. Moreover, the accounting rules applicable to a bank differ significantly from those applicable to funds making it more likely that the effect of (or even perhaps the existence of) losses will not be clear to stakeholders for a substantial period of time following the incurrence of the particular loss.	The value of an investor's stake in a fund will fluctuate over times. Fund investors are given full transparency via the calculations of NAV which must be done at least twice a month.
Segregation of assets?	Banks hold depositors assets on their balance sheets and can use depositors' assets to make loans or for other proprietary purposes.	Asset managers do not themselves hold client assets but, instead, use third party depositaries. Depositaries are subject to rules requiring the general safekeeping of client assets and must assume strict liability for any lost assets.
Alignment of interests	The remuneration model in the banking sector does not necessarily create a direct alignment of interests between employees and the financial success of the bank. A bank employee's remuneration may bear no relation to the profits or losses he generates for the bank or its stakeholders. In addition, the interests among various stakeholders are also not necessarily aligned. Shareholders who benefit from the upside over and above that necessary to finance the obligations to bondholders and	Asset managers rely upon a predictable percentage fee based income stream, based on the net asset value of the managed portfolio, which facilitates the stability of the management firm. When the net asset value increases, the absolute amount of the fees received increases as well. As a result, asset managers share directly in the appreciation or depreciation in the value of a fund.

	Banking model	Asset management model
	other liabilities of the bank, and who control the corporate governance of banks but make up on average less than 2% of the capital structure of banks, are likely to benefit from further risk taking. This relatively small ownership interest creates a more indirect sharing of the appreciation and depreciation in value of the investments made by the bank. Bondholders, who do not have control over the banks beyond the terms permitted under the bonds themselves and who represent a much more significant portion of the average bank's capital structure, are likely to want more prudence. Bondholders want enough risk to be taken to generate the returns needed to make the required payments of interest and principal, but not more than that since more can lead to great risk that the required payments will not be made.	Employees of asset managers will also be investing their own money in fund units and so the employees of the asset manager will, alongside the investors, face not only upside but also downside of their investments. This creates a direct alignment of interests between the employees of the asset manager and the investors in the fund for which the employees work.
Systemic importance	Banks act as principals for their shareholders and hold significant amounts of assets on their balance sheets. Banks are able to accept deposits, which must be capable of being returned to investors upon demand. There is a fundamental mismatch between the need to be able to return depositor funds on demand and traditional uses of those funds such as residential and commercial lending which tend to tie up funds for long periods of time. This mismatch is exacerbated by banks maintaining large amounts of leverage of their balance sheets. These features make banks prone to de-stabilising depositor runs. This is one of the reasons why government-guaranteed deposit insurance has developed in most markets as a way of mitigating the risk of de-stabilising depositor runs.	Asset managers invest as agents on behalf of their clients and do not generally hold significant amounts of assets on their own balance sheets. The AIFMD and the UCITS directive also require managers to align investor liquidity through redemptions with the liquidity characteristics of the underlying portfolio specifically to avoid destabilising liquidity mismatches. Asset managers are, therefore, less susceptible to (and will be less likely to contribute to) any systemic distress in the broader financial system.
Government support	The leverage under which banks operate means that banks suffering even relatively small losses on their investments are capable of becoming insolvent very rapidly. The EU banking sector is not, and, in the foreseeable future, will not be capable of operating without a strong measure of government and central bank support.	Asset managers are safe to fail and not in need of official government support.

Remuneration structures within the asset management sector

A common remuneration structure within the asset management sector is a relatively low (in terms of total compensation) fixed amount, with a potentially high variable remuneration available if the firm, and/or the relevant individual, performs well. This structure reflects the typical fee structure charged by an asset manager. This consists of a management fee which is set as a percentage of assets under management - often between 1% and 2% - and, sometimes, a performance fee – which typically varies from 5% to 20% of the profits generated for the fund during the performance fee calculation period. Some asset managers tend to manage their overheads so that these approximately match the expected management fee income. This means that much of the performance fee would often represent pure profit, which can then be distributed among the owners and employees of the business in the form of bonuses/distributions of profit.

The advantage of this structure is that, in a year where no performance fee is generated - either because the funds have not made a profit during the calculation period or because (as a result of losses in prior calculation periods) the fund has not yet reached its HWM or hurdle - the manager still has sufficient fee income to pay its fixed overheads. Preventing the payment of a performance fee by a fund to its manager would prevent the alignment of interests which the performance fee seeks to introduce between the manager and the fund and its investors. It may also lead to increases in the amount charged as a management fee, thereby creating a considerable drag on fund performance and investor returns.

From a prudential perspective, this is a sound model given that the income levels for an asset manager can fluctuate considerably depending upon whether or not the manager has generated positive performance during the calculation period. However, in highly profitable years, this model inevitably results in a ratio of variable remuneration to fixed remuneration in excess of the proposed 1:1 cap.

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

If asset managers have to set their “appropriate” maximum ratio as a percentage of total remuneration, this presents some significant potential issues. Essentially, there are two ways of changing the fixed/variable ratio – raising the fixed element or reducing the variable element of employee compensation. Either would raise fundamental issues for asset managers.

Reducing the level of variable compensation is not possible in the context of an owner-managed business where that variable remuneration constitutes the profit of the firm (payable to the senior members as a profit distribution in their capacity as members or partners) or as a dividend (in their capacity as shareholders). A firm cannot simply make its profits disappear and since the employees and risk takers, whose remuneration would be subject to the remuneration principles, are usually also the owners of the business, reducing the level of variable remuneration would make little or no sense.

However, the alternative, namely raising fixed remuneration, is equally problematic. Having a greater amount of the firm’s capital contractually committed to salary/”fixed” profit share payments would restrict the asset manager’s ability to limit total remuneration in difficult times and would also permit less flexibility to the firm to maintain its levels of profitability – or even merely to break even - in periods of underperformance or market downturns. Above all, it would lead to automatic diminution of returns to investors.

Requiring asset managers to impose a fixed 1:1 ratio of the amount of fixed to variable remuneration that they can award to employees would increase the risk of a manager’s failure in difficult trading conditions since the asset manager would be contractually committed to pay out more by way of employee salaries than at present. With higher ratios for bonuses, asset managers have greater latitude to ‘soak up’ lean periods without making redundancies as they can choose to exercise their discretion and reduce bonus payments. Removal of this flexibility by having salaries which must be paid regardless of financial conditions may lead to staff, who might otherwise have been kept, being laid off in order to reduce overheads.

It is also very unclear how the fixed 1:1 ratio would work in asset managers which are structured as partnerships. In partnerships, it is very difficult to fix salaries or cap variable pay as any payment is dependent on there being a profit to disburse amongst the partners. The importance of talented staff to the asset management industry cannot be overstated. The services provided by managers to the funds they manage are based almost entirely on the knowledge, skill, and experience of highly trained and specialised staff. These staff members are often highly mobile both between firms and internationally. Constraints on the ability of asset managers to reward staff appropriately through variable remuneration would impact on the firm's ability to attract and retain talent and would substantially and adversely affect the industry. If a manager loses its highly skilled staff, investors' returns will be negatively impacted.

For these reasons, we believe that it would cause disproportionate damage to asset management companies if the Draft Guidelines were to lead to any change in the ability of asset management companies to set appropriate levels of variable remuneration.