efama

European Fund and Asset Management Association

EFAMA's reply to the European Commission's Public consultation on impacts of maximum remuneration ratio under Capital Requirements Directive 2013/36/EU (CRD IV), and overall efficiency of CRD IV remuneration rules

EFAMA is the representative association for the European investment management industry. EFAMA represents through its 26 member associations and 61 corporate members almost EUR 19 trillion in assets under management of which EUR 12.1 trillion managed by 55,700 investment funds at end September 2015. Just over 29,500 of these funds were UCITS (Undertakings for Collective Investments in Transferable Securities) funds, with the remaining 26,100 funds composed of AIFs (Alternative Investment Funds). For more information about EFAMA, please visit www.efama.org.

Our corporate members are both subsidiaries of an EEA parent that is a credit institution as per Article 4(1)(1) of the CRR, or stand-alone investment firms as per Article 4(1)(2) of the CRR. Both types of entities risk becoming subject to the Maximum Ratio Rule as asset management companies licensed under either a UCITS or AIFM management company license, or licensed as investment firms under the MiFID regime to provide discretionary portfolio management services on a client-by-client basis.

2. MAXIMUM RATIO RULE

2.1 IMPACT OF THE MAXIMUM RATIO RULE ON COMPETITIVENESS

2.1.1 The Maximum Ratio Rule applies to credit institutions and investment firms as defined in CRD in the EEA, as well as (indirectly) to their subsidiaries within the scope of prudential consolidation (including subsidiaries outside the EEA and asset management subsidiaries). *Please indicate for* which of the aforementioned type(s) of undertaking(s) your answer to the below question applies. My answer below applies to (multiple answers possible):

- ☐ **Credit institutions established in the EEA (directly subject to the Maximum Ratio Rule)**
- ☐ **Investment firms as defined in Art 4(1)(2) CRR established in the EEA (directly subject to the Maximum Ratio Rule)**
- ☒ **Non-EEA subsidiaries of EEA parent covered by CRD (indirectly subject to the Maximum Ratio Rule through the application at group level)**
- ☒ **EEA subsidiaries of EEA parent covered by CRD (indirectly subject to the Maximum Ratio Rule through the application at group level), such as asset management companies or other types of financial institutions**

2.1.2 *What impact, if any, of compliance with the Maximum Ratio Rule have you observed on the COMPETITIVENESS of the undertakings concerned?*

Please provide as much as possible factual, concrete and verifiable elements that support your answer. If you ticked more than one box above, please make sure to distinguish as relevant.

Firstly, from a competitiveness perspective, a considerable risk in our view is that of an uneven playing-field that would derive between those asset managers that are consolidated within a CRD parent-licensed group (or, as in certain jurisdictions, subject to CRD as investment firms, albeit benefitting from appropriate waivers), and those that would otherwise fall outside the remit of the CRD altogether, as self-standing UCITS or AIF management companies, or independent investment firms discharging a discretionary portfolio management service. This would give rise to a fundamental bi-furcation in Europe in the way strict and less-strict remuneration rules apply to the identified staff in asset management companies, depending on whether they are consolidated subsidiaries or wholly independent entities. Such outcome is against the fair treatment of such actors, underpinning the EU Single Market. The full application of all the remuneration principles of Article 94(1) CRD – including the Maximum Ratio Rule of letter g) thereof – to asset management entities moreover remains at odds with the principle of proportionality, bearing no clear legal justification and pre-empting the outstanding work of the ESMA around its future *Guidelines on sound remuneration policies under the UCITS Directive and AIFMD*, as consulted upon in July 2015 (2015/ESMA/1210). Finally, the sectoral remuneration rules under the UCITS and AIFM Directives, or those of the ESMA 2013 *Guidelines on remuneration policies and practices* for MiFID firms[1] intended to supplement the MiFID's conflict of interest provisions, do not provide for a Maximum Ratio Rule, clearly demonstrating that a clear distinction between banking and non-banking entities/activities (and their relative risks) has been duly and rightly recognised by the EU co-Legislator already.

Always from a competitiveness perspective, a second order of concerns EFAMA cares to point out are those tied to the international recognition of the "UCITS" product brand - and to a lesser extent, that of Alternative Investment Fund (AIFs) and of discretionary mandates, allowing European investors to access the best talent pools and most accurate local information when they choose to invest outside the EEA (e.g. into Japanese equity portfolios managed out of Japan). Here, the fact that non-EEA subsidiaries of EEA parents, or of self-standing MiFID investment firms, would be indirectly covered by the "specific" CRD requirements (e.g. the Maximum Ratio Rule), as per the EBA's final *Guidelines on sound remuneration policies* of December 2015(EBA/GL/2015/22) destined to become applicable as of January 2017, could undermine the important recourse EEA-based managers have to non-EEA external expertise via delegation arrangements to their non-EEA subsidiaries. External non-EEA delegates are often appointed to manage portfolios on the back of their proven expertise in one particular asset class, strategy or region that the delegating management company may not necessarily have in-house. As an outcome of the disproportionate application of CRD remuneration rules, non-EEA managers (always as consolidated subsidiaries of an EEA-based entity subject to CRD) may well not accept to be subject to these when negotiating the delegation arrangement, thereby reducing choice for European investors, including the diversification of their holdings. Consequently, the main opportunity cost for the European (especially UCITS) fund industry could see a significant contraction in terms of the size and diversity of its product offer, stifling European investors' access to key growth markets (especially

[1] Please refer to *Guidelines on remuneration policies and practices* (MiFID) published on 11 June 2013; available at https://www.esma.europa.eu/sites/default/files/library/2015/11/2013-606_final_report_guidelines_on_remuneration_policies_and_practices_mifid.pdf

in Asia). In parallel, external expertise will not only become rarer, but also more expensive and less efficient, in the sense that non-EU managers will necessarily have to be "imported" to operate from within the EU/EEA and away from the relevant market. It is conceivable that some of the best (and thus better remunerated) portfolio managers may decide to depart and obtain employment at non-EEA firms not subject to the Maximum Ratio Rule. Again, this would deprive EU investors from access to some of the best management talent. Non-EEA firms, including those based in other G-20 countries, would consequently also develop a competitive advantage over EEA firms.

2.2 IMPACT OF THE MAXIMUM RATIO RULE ON FINANCIAL STABILITY

2.2.1 The Maximum Ratio Rule applies to credit institutions and investment firms as defined in CRD in the EEA, as well as (indirectly) to their subsidiaries within the scope of prudential consolidation (including subsidiaries outside the EEA and asset management subsidiaries). ***Please indicate for*** **which of the aforementioned type(s) of undertaking(s) your answer to the below question applies. My answer below applies to (multiple answers possible):**

- ☐ **Credit institutions established in the EEA (directly subject to the Maximum Ratio Rule)**
- ☐ **Investment firms as defined in Art 4(1)(2) CRR established in the EEA (directly subject to the Maximum Ratio Rule)**
- ☒ **Non-EEA subsidiaries of EEA parent covered by CRD (indirectly subject to the Maximum Ratio Rule through the application at group level)**
- ☒ **EEA subsidiaries of EEA parent covered by CRD (indirectly subject to the Maximum Ratio Rule through the application at group level), such as asset management companies or other types of financial institutions**

2.2.2 ***What impact, if any, of compliance with the Maximum Ratio Rule have you observed on FINANCIAL STABILITY?*** **Please provide as much as possible factual, concrete and verifiable elements that support your answer. If you ticked more than one box above, please make sure to distinguish as relevant.**

As a fundamental premise, in light of an asset manager's fiduciary duties vis-à-vis its clients to invest their savings into funds and/or separate mandates in line with mutually agreed investment guidelines, and in the case of UCITS, very strict statutory investment restrictions, financial risks are segregated from the balance sheet and own assets of the asset management company. Because the clients' assets are required to be segregated into separate accounts and entrusted to a third-party depositary (granted with a specific license), there are *de facto* no risks that investment losses spill-over onto the asset managers' balance sheet and, logically, onto that of the consolidating parent institution. Attempting to contain financial stability risks by occasionally applying the Maximum Ratio Rule to identified staff of asset management entities (i.e. once the qualitative or the quantitative criteria enclosed respectively under Articles 3 and 4 of the implementing Regulation EU No. 604/2014 are met) would translate therefore into a fundamental misrepresentation of an asset managers' business model, as well as of broader market realities.

The possible imposition of the Maximum Ratio Rule on the remuneration of asset managers contradicts the same rationale for aligning managers' interests with those of its clients. The global market for hiring top portfolio management talent is extremely competitive, as for talent employed in other functions by asset management companies. Such competition exists not only within the asset management industry, but also among other providers of financial services, allowing individuals to move freely from one industry (and, in the case of top managers, from one region) to the next. Competitive remuneration packages to attract and retain a talented pool of individuals have therefore become a necessity.

Whereas until this day asset managers have been able to count on competitive pay packages capable of reflecting both good or bad investment performance via the flexible adjustment of the variable remuneration component, the imposed application of the Maximum Ratio Rule will necessarily remove the intrinsic flexibility of current pay structures, rendering an individual's pay rigid and less responsive to the market environment. As a result, in order to recruit and retain their pools of talent, asset management companies – as has been observed elsewhere in the financial industry where hard ceilings have been applied to variable pay – will most probably increase their identified staff's fixed remuneration component. This will inevitably act as a drag on the performance of the company by implying higher operating expenses and, in parallel, also be less sensitive to the investment performance of the products sold to investors, as well as to the contingencies of the market cycle. For instance, a bear market during a protracted economic slump will most likely lead an investment manager to cut fixed costs by letting off staff, rather than adjust their variable remuneration component accordingly to reflect the broader market environment. Moreover, unlike in the banking industry, certain profiles in the asset management space tend to be more "sticky", as a portfolio managers' investment expertise and reputation are built only across time and where ties to important investors wish to be nurtured and held stable. As the largest amounts invested belong to long-term institutional investors and are managed under ad hoc mandates which not only reflect a clients' specificities, but also a portfolio manager's very own investment style and expertise, an asset management company would inevitably seek to retain such individual also from a reputational perspective.

For their part, investors will choose to maintain a relationship with an investment manager and remain invested if the manager performs well over time, i.e. increases the value of the underlying investment portfolio. The interests of both investment manager and investor remain aligned, as both parties ultimately share the same goal, i.e. to achieve the best investment performance for the investor within the parameters of the investment objective and investment mandate. We urge the Commission to acknowledge that the progressive growth of the assets under management (AuM) entrusted to an asset manager also depends on meeting these investment objectives consistently, while acting within the boundaries set by the investment mandate. This fact adds to the quality and length of investor relationships, much unlike a common misperception suggesting managers would pursue short-term and apparent gains by freely deciding to take-on additional risks in the attempt to enlarge the size of their AuM almost arbitrarily. Unlike the banking models that characterised the years leading up to the 2008 global financial crisis, the asset management business – being of a "fiduciary" nature – has fundamentally remained counter-cyclical.

Further to these important considerations, there is no substance behind allegations which assume asset managers jeopardise financial stability. The application of the Maximum Ratio Rule to the remuneration of the identified staff has therefore no link with considerations around financial stability. The Rule's (negative) implications are to be appreciated in terms of misaligning the interests of investors with those of the portfolio manager/asset management company via the fact that through an inevitably larger fixed remuneration component, investors will end-up paying for performance that over a relevant period has been either flat or even negative. In all confidence, we urge the Commission to bear in mind that what provoked and amplified the gravity of the last financial crisis was first and foremost the considerable amounts of leverage and access cheap credit throughout the financial system, fuelled by the short-termism of the prevalent banking models. For the asset management industry, where leverage is – unlike for credit institutions - tightly controlled and monitored via binding regulatory requirements that apply to the European asset management industry as a whole (as reflected in the UCITS and AIFM Directives), where high base salaries are uncommon as believed they misalign the remuneration incentives of the investment teams and prove difficult to adjust during negative market cycles, and where variable remuneration components are in turn established and paid-out over a multi-year horizon in relation to long-term benchmarks, we fundamentally do not and cannot see any link between a manager's pay and financial stability. We kindly remain at the Commission Staff's disposal to discuss any evidence it may draw to the contrary.

Remuneration requirements as a tool to curb "excessive risk-taking" are therefore not only blunt instruments, but additionally also inappropriate to our industry where risks are deliberately taken on by investors and where managers may take on risk only within the prescribed parameters of an investment mandate agreed with investors, or within the even stricter regulatory confines of a retail product such as a UCITS fund. As a first line of defence against any eventual "excessive risk-taking" - which would *de facto* broadly translate into a breach of fiduciary duties - a management company's risk management function (i.e. independent from the portfolio management function as per UCITS and AIFMD requirements) would be alerted, followed by the eventual intervention of the internal compliance function, which may in turn decide to escalate concerns to the attention of senior management, and ultimately to the competent domestic regulator in particularly grave cases which may call forth an enforcement action and/or potential sanctions against the firm or individual. Investors can, and do, take legal action against asset management companies for such breaches. Finally, the depositary of the fund has an obligation to ensure the fund is being managed in accordance with the applicable EU/national laws and regulations, with the fund's own articles of incorporation, as well as with the investor disclosure documents, *in primis* the fund prospectus. As such, the depositary – as per the UCITS and AIFM Directives – stands as an additional safeguard to discourage any form of "excessive risk-taking" beyond that mandated by the above regulatory instruments.

2.3 IMPACT OF THE MAXIMUM RATIO RULE ON STAFF WORKING OUTSIDE THE EEA

What impact, if any, of compliance with the Maximum Ratio Rule have you observed on staff working effectively and physically in subsidiaries established outside the EEA of parent institutions established within the EEA?

Please refer to our reply to Question 2.1.2 above.

3. EFFICIENCY OF THE OVERALL CRR AND CRD IV REMUNERATION PROVISIONS

3.1 Against this background, how would you assess the efficiency of the following remuneration rules of CRD IV and CRR? Please always back up your views with specific evidence:

3.1.1 The requirement set out in Article 94(1)(a) CRD that the *assessment of performance* is based on a combination of the individual's performance (taking into account financial and non-financial criteria), the performance of the business unit concerned and of the overall results of the institution; the requirement set out in Article 94(1)(b) CRD that the assessment of the performance is set in a multi-year framework

This requirement is consistent with and satisfied by the corresponding remuneration rules applicable to asset managers in line with EU regulation:
UCITS Directive - see "UCITS V" under Article 14b(1) letters g) and h); and
AIFM Directive – see Annex II, paragraph 1, letters g) and h)

3.1.2 The requirement set out in Article 94(1)(m) CRD to *defer* at least 40% of the variable remuneration.

This requirement is consistent with and satisfied by the corresponding remuneration rules applicable to asset managers in line with EU regulation:
UCITS Directive - see "UCITS V" under Article 14b(1) letter n; and
AIFM Directive – see Annex II, paragraph 1, letter n)

3.1.3 The requirement set out in Article 94(1)(l) CRD to *pay out* at least 50% of variable remuneration in *instruments*, whereby there will be a balance of shares or equivalent ownership interests, subject to the legal structure of the institution concerned or share-linked instruments or equivalent non-cash instruments, in the case of a non-listed institution, and where possible other instruments adequately reflecting credit quality of the institution as a going concern.

This requirement is consistent with and satisfied by the corresponding remuneration rules applicable to asset managers in line with EU regulation:
UCITS Directive - see "UCITS V" under Article 14b(1) letter m); and
AIFM Directive – see Annex II, paragraph 1, letter m)

3.1.4 The requirement set out in Article 94(1)(n) CRD that up to 100% of the variable remuneration is subject to malus and claw back.

This requirement is consistent with and satisfied by the corresponding remuneration rules applicable to asset managers in line with EU regulation:

UCITS Directive - see "UCITS V" under Article 14b(1) letter o); and
AIFM Directive – see Annex II, paragraph 1, letter o)

3.1.5 The requirements set out in Articles 94(1)(f) and 94(1)(g) that fixed and variable components of remuneration are appropriately balanced; that the fixed component should represent a sufficiently high proportion of the total remuneration to allow the operation of a fully flexible policy on variable remuneration components, including the possibility to pay no variable remuneration component; and that the variable remuneration cannot exceed 100% (or 200% with shareholders' approval) of the fixed remuneration.

This requirement, i.e. the Maximum Ratio Rule, has no merit nor justification for it to be applied to any identified individual, regardless of whether the asset management company is or is not a consolidated subsidiary of a CRD parent institution, for the reasons explained above.

Moreover, from a purely legal standpoint, extending this requirement to European asset managers would require a legislative amendment to the AIFM Directive's and to the "UCITS V" Level 1 texts, overturning the explicit will of the EU Legislator to not introduce a Maximum Ratio Rule for the asset management industry at the time the "UCITS V" amendments were voted precisely with the intent to guarantee the application of proportionality in light of the different *nature* of our industry.

3.1.6 The requirement for significant institutions to establish a *remuneration committee* (Article 95 CRD) as well as a *risk committee* (Article 76 CRD) which shall assist in the establishment of sound remuneration policies and practices.

This requirement is consistent with and satisfied by the corresponding remuneration rules applicable to asset managers in line with EU regulation:
UCITS Directive - see "UCITS V" under Article 14b(4); and
AIFM Directive – see Annex II, paragraph 3

3.1.7 The requirements set out in Article 96 CRD and Article 450 CRR on the *public disclosure* concerning remuneration policy and practices.

This requirement is consistent with and satisfied by the corresponding remuneration rules applicable to asset managers in line with EU regulation:

UCITS Directive - see "UCITS V" under the amended Article 69(1) regarding disclosures in the prospectus, including:

(a) *the details of the up-to-date remuneration policy, including, but not limited to, a description of how remuneration and benefits are calculated, the identities of persons responsible for awarding the remuneration and benefits including the composition of the remuneration committee, where such a committee exists; or*

(b) a summary of the remuneration policy and a statement to the effect that the details of the up-to-date remuneration policy, including, but not limited to, a description of how remuneration and benefits are calculated, the identity of persons responsible for awarding the remuneration and benefits, including the composition of the remuneration committee where such a committee exists, are available by means of a website – including a reference to that website – and that a paper copy will be made available free of charge upon request.;

While Article 69(3) has extended those disclosures for the purposes of the annual report, including:

(a) the total amount of remuneration for the financial year, split into fixed and variable remuneration paid by the management company and by the investment company to its staff, and the number of beneficiaries, and where relevant, any amount paid directly by the UCITS itself, including any performance fee;

(b) the aggregate amount of remuneration broken down by categories of employees or other members of staff as referred to in Article 14a(3);

(c) a description of how the remuneration and the benefits have been calculated;

(d) the outcome of the reviews referred to in points (c) and (d) of Article 14b(1) including any irregularities that have occurred;

(e) material changes to the adopted remuneration policy.

And finally, Article 78(4) has been revised as follows, with the addition of mandatory disclosures regarding remuneration in the key investor information document:
Key investor information shall also include a statement to the effect that the details of the up-to-date remuneration policy, including, but not limited to, a description of how remuneration and benefits are calculated, the identity of persons responsible for awarding the remuneration and benefits including the composition of the remuneration committee, where such a committee exists, are available by means of a website – including a reference to that website – and that a paper copy will be made available free of charge upon request.

AIFM Directive – see Article 22(2), letters e) and f)

3.2 How would you assess the overall efficiency of the remuneration rules of CRD IV and CRR collectively? Also, please indicate whether you have identified any lacunae in the existing rules. Please back up your views with specific evidence.

From our industry's perspective, although the CRD IV and the sectoral remuneration requirements (whether those of the UCITS, AIFMD or MiFID frameworks) share the same root in the European Commission's *Recommendation 2009/384/EC* of 30 April 2009 *on remuneration policies in the financial services sector*, the EU Legislator has duly recognised the key factual differences between the activities and resulting business models of non-bank financial intermediaries (as asset managers are *inter alia*). At the cornerstone of EU policy-making since its origins, the principle of proportionality has translated these fundamental differences consistently into the three relevant frameworks which are applicable to asset management activities as regulated under EU law and further interpreted and refined by the ESMA. This is reflected by the fact that the applicable rules under the sectoral remuneration

requirements are already fully consistent with the CRD ones, in that these already share near identical requirements in terms of deferrals of the variable remuneration component, its payment in non-cash instruments and application of malus/clawback arrangements In this regard, we see no *lacunae* that would warrant any legislative action.

Finally, from a regulatory standpoint, when considering asset management companies as subsidiaries within a broader financial group context, or as stand-alone investment firms, the denial of the proportionality principle would substantially alter the existing level treatment, for instance, between those asset management companies belonging to a financial group and those that do not. In fact, where the unduly prescriptive CRD IV remuneration principles apply to a group's asset management subsidiaries, the latter's ability to attract and retain management talent would be sensibly hindered. This conclusion is clearly at odds with a common, uniform and consistent application of EU law across the Internal Market and with the main tenets of the European Commission's Better Regulation agenda.

EFAMA does not wish to comment on the overall efficiency of the CRD IV/CRR remuneration requirements when applied to credit institutions. As per our previous submissions to the European Commission, the EBA and, more recently, even the ESMA, we remain highly critical of the full application of some of the CRD's minimum remuneration requirements to subsidiary asset managers or even to stand-alone investment firms - as per the EBA's December 2015 Guidelines (EBA/GL/2015/22) – and of its underlying rationales that we deem carry neither a factual justification nor a convincing legal basis.

In preparation of its report to be submitted to the EU co-Legislators by 30 June 2016 and likely to call for a legislative review of the relevant CRD remuneration principles, we invite the Commission to carefully consider all of the factual and the legal objections that have been moved by our industry against the application of the full CRD remuneration rules to all licensed asset management entities in the absence of proportionality and cooperate closely with ESMA in the process.

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Brussels, 22 January 2016

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