MANAGED FUNDS ASSOCIATION
The Voice of the Global Alternative Investment Industry
WASHINGTON, DC | NEW YORK

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<u>Via Electronic Mail</u>: cp42@c-ebs.org

Jo Swyngedouw
Chair, Remuneration Task Force
Committee of European Banking Supervisors
Tower 42 (level 18)
25 Old Broad Street
London EC2N 1HQ

Re: Consultation Paper on Guidelines on Remuneration Policies and Practices

Dear Mr. Swyngedouw:

Managed Funds Association ("MFA")[1] welcomes the opportunity to respond to the Committee of European Banking Supervisors' ("CEBS") Consultation Paper 42 – Guidelines on Remuneration Policies and Procedures (the "Guidelines"). MFA and its members strongly support the primary principle underlying the Guidelines, that remuneration policies must be consistent with and promote effective risk management. Indeed, we believe that this principle underlies the governance structure and the revenue and remuneration models utilized by hedge fund advisers.

MFA and its members also strongly support the principle of adopting a proportional approach to implementing the remuneration provisions, as provided for in the most recent amendments to the Capital Requirements Directive ("CRD3"). We understand that CEBS takes the view that the proportionality principle should not be interpreted to exempt firms from application of the principles discussed in the Guidelines entirely. We believe, however, that the Guidelines should allow member state regulators to limit the application of or provide exemptions from those provisions that are not necessary or appropriate for hedge fund advisers. We acknowledge that the Guidelines specifically provide for proportional application of the principles, including the possibility of complete neutralization for certain of the principles. We support this approach and we encourage CEBS to consider providing additional flexibility with respect to several principles, including: the definition of "Identified Staff"; multi-year assessment of performance; *ex-post* adjustments and reductions in remuneration; required ratios of variable and fixed remuneration; and public disclosure.

We believe it is also important for CEBS to ensure that there is an appropriate transition period for hedge fund advisers that are becoming subject to regulations with respect to remuneration policies for the first time. We are concerned that the timelines for implementation, which begin as early as January 1,

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[1] MFA is the voice of the global alternative investment industry. Its members are professionals in hedge funds, funds of funds and managed futures funds, as well as industry service providers. Established in 1991, MFA is the primary source of information for policy makers and the media and the leading advocate for sound business practices and industry growth. MFA members include the vast majority of the largest hedge fund groups in the world who manage a substantial portion of the approximately $1.5 trillion invested in absolute return strategies. MFA is headquartered in Washington, D.C., with an office in New York.

2011, do not provide sufficient time to allow firms to implement changes that may be required as a result of CRD3, the Guidelines and member state implementing regulations.

In considering the appropriate application of the Guidelines to hedge fund advisers, we believe it is important to consider some fundamental differences between the structures of hedge fund advisers and other types of financial companies. Dan Waters, Director, Conduct Risk, and Asset Management Sector Leader at the U.K. Financial Services Authority made this point in a recent speech, when he said, "how do regulators implement for asset managers the CRD's remuneration provisions, which were built upon a detailed analysis and understanding of a business model fundamentally different from asset management?".[2] Hedge fund advisers are not depository institutions and do not maintain accounts that have government insurance. They typically do not have significant amounts of assets themselves, but rather manage assets on behalf of client investment funds. Further, most hedge fund advisers are privately-owned businesses and the funds they manage are sold through private placements only to sophisticated investors. We believe that these features as well as the structure, revenue model and remuneration model of hedge fund advisers, each of which are discussed below, should be considered by regulators as they determine which remuneration principles should apply to hedge fund advisers, and how to tailor those principles that are applied to hedge fund advisers.

Hedge Fund Adviser Structure and Remuneration

Unlike many banks and other large financial institutions, hedge fund advisers are typically privately owned and, therefore, do not have public shareholders. Moreover, the principals who own the hedge fund adviser are also typically senior management of the adviser with primary responsibility for the portfolio management activities and oversight of other employees of the adviser. Unlike financial institutions with public shareholders, therefore, management and ownership of hedge fund advisers are integrated, not separated. This integration of ownership and management ensures an alignment of interest, which provides strong incentives to appropriately manage risks. Because the structure of hedge fund advisers promotes alignment of interests between management and ownership, we believe that hedge fund advisers do not need to be subject to those provisions in the Guidelines that are designed to achieve the same result.[3] We also believe that payments tied to a person's ownership stake in a hedge fund adviser should not be treated as remuneration and should be deemed outside of the scope of the Guidelines. Treatment of these types of payments as remuneration under the Guidelines would unfairly subject the owners of one type of business structure to restrictions on their ownership interests.

The revenue model for hedge fund advisers is also distinct from that of many other financial institutions. Hedge fund advisers do not generate revenue by trading their own assets; they generate profits by receiving management and performance fees for successfully managing client assets. The variable remuneration earned by senior employees of hedge fund advisers (those likely to be deemed subject to the Guidelines) also is tied to the performance fees generated by the adviser. Hedge fund

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[2] Speech by Dan Waters: Remuneration: Tailoring the European Regulatory Regime to the Alternative Investments Industry, September 23, 2010, available at: http://www.fsa.gov.uk/pages/Library/Communication/Speeches/2010/0923_dw.shtml.

[3] Economists have described "agency" phenomenon, *i.e.,* the separation of ownership and management for decades. See *e.g*., Berle and Means, The Modern Corporation & Private Property, (1932). There are numerous economic studies and papers examining the relationships between executives and their compensation incentives over the years. *E.g*., Yesterday's Heroes: Compensation and Creative Risk-Taking, Ing-Haw Cheng, Harrison Hong, and Jose A. Scheinkman, NBER Working Paper No. 16176, July 2010 (discussion of "cowboy cultures" and short term expectations of investors as well as economic incentives for management).

adviser fees are generally not subject to claw-back or other future adjustment. As such, the revenue and profits earned by the adviser are not subject to the risk of future loss, unlike revenue earned by a financial institution that trades its own assets (because those assets can decrease in value in the future). Further, because the principals of the hedge fund adviser typically have significant amounts of their own capital invested in the funds they advise, and because the performance fees earned by the adviser typically are subject to high-water marks,[4] the fee structure for advisers is designed to encourage generating long-term risk-adjusted returns and to discourage excessive short-term risk taking.

Problematic Provisions in the Guidelines

While MFA and its members are supportive of the overall goals of the Guidelines, we believe that there are several principles that, if applied to hedge fund advisers, would be inconsistent with the stated principle of proportionality. As discussed in more detail below, we are concerned that the scope of "Identified Staff" is likely to be overly broad as applied to many hedge fund advisers and we believe that the multi-year assessment, remuneration ratio, and public disclosure requirements are not well suited for hedge fund advisers.

Definition of "Identified Staff"

We understand the goal of including senior management and primary risk takers at financial institutions within the scope of the Guidelines. We are concerned, however, that the definition of "Identified Staff", as set out in the Guidelines is overly broad. The reference to "risk takers" in the guidance in paragraph 16 potentially includes relatively junior persons within a hedge fund adviser and also potentially includes persons who do not make material risk judgments on behalf of the adviser. We encourage CEBS to expand the discussion in paragraph 18 to provide further guidance on the types of persons intended to be picked up by the term "risk taker," which we believe should provide flexibility based on the different types of business models and structures of firms subject to the Guidelines.

Multi-year Assessment of Performance

As discussed above, hedge fund adviser fees are generally not subject to claw-back, and profits earned for the adviser are not subject to the risk of future loss, unlike profits earned on assets owned by a financial institution (because those assets can decrease in value in the future). Hedge fund advisers typically earn their fees on an annual basis, and the structure of the funds they manage is based on this model. Further, because the principals of the hedge fund adviser typically have significant amounts of their own capital invested in the funds they advise, and because the performance fees earned by the adviser typically are subject to high-water marks, the fee structure for advisers is designed to encourage long-term risk-adjusted returns and to discourage excessive short-term risk taking. The variable remuneration earned by senior employees of the adviser is, in turn, based on the adviser's ability to earn those performance fees. It is important to note that this fee structure is agreed upon by sophisticated investors prior to investing in the fund who can and do exercise their redemption rights if they believe the fee structure no longer aligns their interests with the interests of the adviser. Requiring an adviser to consider the performance of employees in a multi-year framework, as set out in principle (h),[5] would

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[4] High-water marks are part of the performance fee structure and prevent a hedge fund adviser from collecting a performance fee unless the investors in the fund have recouped prior losses. They ensure that an adviser collects a performance fee only when it has generated profits for its investors.

[5] For ease of cross-reference to the Guidelines, we refer to the relevant letter accompanying each principle in the table contained in Annex 2 to the Guidelines.

impair this alignment of interests. We believe that the requirement for a firm to consider employee performance in a multi-year framework should be subject to complete neutralization, for example, for firms in which the relevant time period for employee performance is aligned with the revenue model for the firm.

Ex-Post Adjustment

Principle (r) and the related guidance in paragraphs 131-141 require financial institutions to provide for *ex-post* risk adjustments to remuneration that has already been awarded to employees. Paragraph 132 of the Guidelines states that financial institutions should make adjustments to variable remuneration already awarded in light of the actual risk outcomes of employee actions, which can occur after the remuneration has been awarded. As discussed above, the fees generated by hedge fund advisers generally are not subject to claw-back or risk of future loss. As such, there does not appear to be a policy rationale for requiring such advisers to have an *ex-post* adjustment component to the variable remuneration awarded to employees. We encourage CEBS to consider permitting complete neutralization of this requirement in principle (r).

Ratio of Variable and Fixed Compensation

Similarly, we are concerned about a requirement that hedge fund advisers set maximum ratios between fixed and variable remuneration. This requirement would require most advisers to pay their employees a higher percentage of fixed remuneration and increase fixed overhead along with other associated costs, such as benefits based on salary. Contractually committing more capital to salary payments would have the unintended consequence of restricting the adviser's ability to limit total remuneration in difficult times, such as in 2008 when many hedge fund advisers severely reduced bonuses that were paid out. This would also limit advisers' flexibility to maintain profitability (or potentially break even) in periods of underperformance, a result that seems inconsistent with the goals of the Guidelines. Higher fixed remuneration also disrupts the alignment of interests among the adviser, the adviser's employees and the adviser's clients that results from the current revenue and remuneration structures of hedge fund advisers. As such, we encourage CEBS to permit complete neutralization of principle (l).

Reduction of Remuneration

Principle (r) and the related paragraphs provide that an institution must considerably contract its total variable remuneration when the firm has subdued or negative financial performance. The principle also states more generally that variable remuneration should be justified in light of the performance of the institution, the relevant business unit and the individual concerned. It is important for hedge fund advisers to be able to appropriately compensate certain individuals who performed well and made a positive contribution to the adviser, even if the overall performance of the adviser was negative during that period. We encourage CEBS to provide additional guidance to clarify that a financial institution may pay appropriate variable remuneration to certain employees based on the individual's performance, even if the institution's overall performance was subdued or negative during that period, provided that such remuneration does not threaten the institution's capital requirements or overall financial stability.

Public Disclosure

Section 5 of the Guidelines sets out requirements regarding various disclosure obligations of firms, including public disclosure of their remuneration policies and aggregate information about the remuneration for employees whose actions have a material impact on the risk profile of the firm. We

acknowledge that paragraph 145 provides guidance that these disclosure requirements may be subject to neutralization, and we agree with CEBS that neutralization should be permitted in appropriate circumstances. MFA supports disclosure of information to regulators (with appropriate confidentiality protections for sensitive and confidential information); however, we do not believe there is a public policy rationale for public disclosure of the remuneration policies or aggregate quantitative information about privately-owned hedge fund advisers. We encourage CEBS to expand on its guidance to provide that privately-owned firms should not be subject to public disclosure.

Proportional Application of the Guidelines

MFA and its members believe that the structure and remuneration policies of hedge fund advisers are well designed to achieve the objectives of the CRD3 and the Guidelines. We also believe that the application of rules designed for banks and other financial institutions that trade their own assets and have publicly traded securities are not well suited for privately-owned hedge fund advisers. We agree with CEBS that certain of the Guidelines should be subject to complete neutralization and that those principles not subject to neutralization should be applied in a manner consistent with the principle of proportionality. Specifically, for the reasons discussed below, we agree with CEBS that the principles of deferral, and remuneration in shares should be subject to complete neutralization. We also agree with CEBS that employees of non-EU parent companies should not be deemed within the scope of the Guidelines.

Deferral Requirements

As discussed above, the fees earned by hedge fund advisers are based on gains earned on behalf of their clients. These fees realized by the adviser once they have been earned and generally are not subject to claw-back or other future adjustments. Hedge fund advisers typically earn their fees on an annual basis, and the structure of the funds they manage is based on this model. It is important to note that this fee structure is agreed upon by sophisticated investors prior to investing in the fund who can and do exercise their redemption rights if they believe the fee structure no longer aligns their interests with the interests of the adviser.

We also believe that deferral requirements could have significant adverse tax implications for many senior employees of hedge fund advisers. Because the senior employees of the adviser are often owners of the adviser, much of what may be deemed variable remuneration is related to their ownership stake. As a result, if the deferral requirements were applied to hedge fund advisers, it could result in these senior employees having tax liabilities in excess of the amount of cash they are permitted to earn under the Guidelines in a given year. In light of the fee structure of hedge fund advisers, we believe they generally should not be subject to a deferred remuneration requirement. We agree with CEBS that the requirement in principle (q) to defer 40%-60% of variable remuneration over a period of at least three years should be subject to complete neutralization.

Required Remuneration in Instruments

We agree with CEBS that principle (o), which requires payment of 50% of variable remuneration in instruments, should be subject to complete neutralization, as appropriate. We believe that such a requirement would not be appropriate for privately-owned hedge fund advisers. Because most hedge fund advisers are not publicly traded companies, there is no active market for the ownership interests in the adviser. This creates complications (*e.g.*, valuation) if those interests (or instruments linked to those interests) have to be used as remuneration for employees. Moreover, employees that receive those interests would be extremely limited in their ability to dispose of them at a future date. As such, we

encourage CEBS to maintain its guidance that would permit firms to completely neutralize this requirement.

Treatment of employees of non-EU parent companies

We also agree with the guidance provided in paragraphs 27 and 29 (principle (v)) with respect to the treatment of employees of non-EU parent companies and global groups. We believe that, without such guidance, there are global hedge fund advisers who have personnel within their international groups registered with member state regulators who could fall within the definition of "Identified Staff" (because they perform significant influence functions). This may be the case even when those persons are not employees of the European entity and do not receive any remuneration from the European entity. As such, we encourage CEBS to continue to include guidance that a person who is an employee of a non-European parent entity of an EU entity should not be deemed Identified Staff, unless (and then only to the extent that) such person receives material remuneration from the EU entity. We believe that this is the appropriate treatment even if that person is registered with a member state regulator as a person performing a significant influence function.

Conclusion

MFA and its members support the goal of developing remuneration policies that are consistent with and promote effective risk management. We agree with CEBS that certain of the principles should be subject to complete neutralization, when appropriate. For the reasons discussed above, we believe that there are additional principles that should be subject to complete neutralization, when neutralization can be accomplished in a manner that is consistent with the primary goal underlying the Guidelines. We encourage CEBS to consider amending the Guidelines to provide that these additional principles may be subject to complete neutralization.

If you have any questions regarding any of these comments, or if we can provide further information with respect to these, or other regulatory reform or market issues, please do not hesitate to contact me or Benjamin Allensworth at (202) 367-1140.

Respectfully submitted,

/s/ Stuart J. Kaswell

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