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European Banking Authority
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Submitted via online portal

4 September 2020

Dear Sir/Madam

AIMA's response to EBA/CP/2020/09 – Draft Regulatory Technical Standards on classes of instruments reflecting the credit quality of the investment firm and alternative arrangements for the purposes of variable remuneration

The Alternative Investment Management Association Limited (AIMA)[1] appreciates the opportunity to submit its comments to the European Banking Authority (EBA) in relation to its consultation on the Draft Regulatory Technical Standards (the 'draft RTS') on the classes of instruments that adequately reflect the credit quality of the investment firm as a going concern and possible alternative arrangements that are appropriate to be used for the purposes of variable remuneration (the 'Consultation Paper').

We appreciate that the EBA has developed the draft RTS in accordance with its mandate under Article 32(8) of Directive (EU) 2019/2034 ('IFD'). We support most of the draft RTS in principle. In particular, we have no comments on draft Articles 1 to 5 concerning instruments that satisfy the conditions set out in point (j)(iii) of Article 32(1) of the IFD.

However, we consider the proposed conditions set out in draft Article 6 to be much too prescriptive (concerning alternative arrangements that may be used by investment firms for the pay out of variable remuneration under point (k) of Article 32(1) of the IFD).

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[1] AIMA, the Alternative Investment Management Association, is the global representative of the alternative investment industry, with more than 1,900 corporate members in over 60 countries. AIMA's fund manager members collectively manage more than $2 trillion in assets. AIMA draws upon the expertise and diversity of its membership to provide leadership in industry initiatives such as advocacy, policy and regulatory engagement, educational programmes and sound practice guides. AIMA works to raise media and public awareness of the value of the industry. AIMA set up the Alternative Credit Council (ACC) to help firms focused in the private credit and direct lending space. The ACC currently represents over 170 members that manage $400 billion of private credit assets globally. AIMA is committed to developing skills and education standards and is a co-founder of the Chartered Alternative Investment Analyst designation (CAIA) – the first and only specialised educational standard for alternative investment specialists. AIMA is governed by its Council (Board of Directors). For further information, please visit AIMA's website, www.aima.org.

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If an AIMA member investment firm is required to comply with Article 32(1)(j) (i.e., to pay 50% of variable remuneration otherwise than in cash), we consider that it is most likely to do so by paying variable remuneration by the following means (in descending order of preference/likelihood):

1. non-cash instruments which reflect the instruments of the portfolios managed (Article 32(1)(j)(iv));

2. its own shares or equivalent ownership interests (Article 32(1)(j)(i)); and

3. share-linked instruments or equivalent non-cash instruments (Article 32(1)(j)(ii)).

We think it likely that the vast majority of our member investment firms will be able to comply in one of those ways.

However, in the event that the investment firm does not or cannot issue any such instruments, it may need to rely on the derogation in Article 32(1)(k).

In these already attenuated circumstances, significant flexibility will be required about the qualifying conditions for alternative arrangements, otherwise the derogation will be rendered purposeless. We note that, in order to rely on the derogation, the approval of the investment firm's competent authority will always be required. We believe that this is an important check.

Please consider the example of an AIMA member which is: (i) a small MiFID investment firm segregated discretionary portfolio manager; (ii) taking the form of a limited company wholly owned by its founder; (iii) managing a portfolio of assets under delegation from an AIFM; (iv) which assets belong to a closed-end AIF fully subscribed by external investors. In this example, there are no units in the AIF available for use in variable remuneration (such units having all been issued), there are no shares or equivalent ownership interests of the manager in issue (being all held by the founder), and it may be impossible or impractical for tax or other reasons to create share-linked instruments or equivalent non-cash instruments, such as rights under a phantom-bonus arrangement.

We think that the conditions set out in draft Article 6 are too narrow because they presuppose the issuance of an equity-like instrument, for example in that they contemplate deferral and retention of the amounts of variable remuneration received (which is duplicative of the independent requirement in Article 32(1)(l) of the IFD), and specify a minimum retention period of at least six months; they assume that value will be measured annually, they prohibit growth in value, and they prohibit the transfer of the part of variable remuneration paid in instruments.

Investment firms design remuneration structures and variable remuneration instruments to reflect and align with client experience (including in light of fees). Investment firms should retain flexibility in relation to awarding alternative arrangements which accurately reflect performance. The number and detail of the proposed qualifying conditions puts a straight-jacket around creative incentives (which must always be approved by a competent authority on a case-by-case basis).

By way of illustration, one way in which a firm may incentivise staff in these circumstances is by means of a carried interest. Such an arrangement is typically heavily negotiated with investors in the fund. It involves the member of identified staff subscribing for or acquiring an instrument or

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set of contractual rights linked directly or indirectly to the performance of the portfolio under management which has little or no value on award but which will blossom in value assuming that a pre-determined threshold rate of return is achieved for the fund, and then in proportion (albeit not necessarily in straight-line proportion) to the excess returns enjoyed by investors in the fund. Carried interest returns will diminish to reflect fund losses.

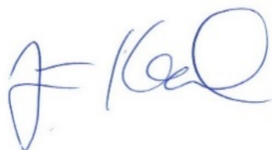
Depending on the precise facts, such an arrangement *may* fall within Article 32(1)(j)(iv) (non-cash instruments which reflect the instruments of the portfolios managed) but it may not. If it does not, it will have to satisfy the criteria under Article 32(1)(k). However, this arrangement does not technically feature *deferral* of variable remuneration which had value on award, but rather a blossoming increase in the value of the interest after grant. It expressly and deliberately does feature an increase in value over time (albeit not over a period of deferral). Value is often not measured annually but is based on the realised value of assets over the remaining life of the fund. Carried interest participations are often transferable, and the investment firm may wish to have the right to require their transfer, for example in the event that the member of identified staff becomes a leaver.

We, therefore, ask the EBA to allow for greater flexibility in the allowance of alternative instruments and to take a more nuanced approach for asset managers (and other investment firms that may need to use similar compensation structures). We set out in the annex proposed changes to draft Article 6 (additions underlined, deletions struck through).

In addition, Article 32(1) (j) and (k) of the IFD implies that the instruments available for variable remuneration must be issued by the investment firm itself. This requirement does not correspond to the practices currently permitted for a large number of EU financial institutions that are subsidiaries of parent undertakings that are not subject to prudential regulation in the EU. We would suggest that, in addition to the concerns noted elsewhere in this letter and the flexibility requested, the guidance issued by the EBA regarding instruments under Articles 32(j)(iii) and (k) should specifically permit instruments that meet the requirements of Articles 32(1)(j)(i)-(iv) when issued by either the parent undertaking or an affiliate of the in scope investment firm.

We would be happy to elaborate further on any of the points raised in this letter. For further information please contact Jennifer Wood, Managing Director, Global Head of Asset Management Regulation & Sound Practices, at +44 (0) 20 7822 8380 or jwood@aima.org.

Yours faithfully,



Jiří Król
Deputy CEO, Global Head of Government Affairs
AIMA

ANNEX

Article 6

Alternative arrangements

Alternative arrangements that may be used by investment firms for the pay out of variable remuneration under point (k) of Article 32(1) of Directive (EU) 2019/2034 subject to the approval of the competent authority shall comply with all of the following conditions:

(a) the alternative arrangement contributes to the alignment of the variable remuneration with the risk profile of the investment firm **<u>and/or its clients</u>**;

~~**(b) the alternative arrangement allows the application of deferral and retention of the amounts of variable remuneration received;**~~

(c) the amount received under an alternative arrangement and the applicable conditions, including the application of deferral and retention, are well documented and transparent to the staff member receiving variable remuneration under such an arrangements [sic];

~~**(d) for amounts received under deferral and retention arrangements the alternative arrangement ensures that staff cannot access, transfer or redeem the deferred part of variable remuneration;**~~

~~**(e) the alternative arrangement is subject to an appropriate retention policy designed to align the incentives of the individual with the longer-term interests of the investment firm, its creditors and clients. The retention period shall be at least six month**~~ [sic]~~;~~

~~**(f) the alternative arrangement does not foresee the increase of the variable remuneration received during deferral periods by interest payments or other similar arrangements other than by arrangements that fulfil the conditions under point (i);**~~

(g) where the alternative arrangement allows for predetermined changes of the value received as variable remuneration during deferral and retention periods, based on the performance of the investment firm or the managed assets; the following conditions shall be met: (i) the change of the value is based on predefined performance indicators that are based on the credit quality of the institution or the performance of the managed assets; ~~**(ii) value changes should at least be calculated annually and at the end of the retention period;**~~ (iii) the rate of possible positive and negative value changes should equally be based on the level of positive or negative credit quality changes or performance measured; ~~**(iv) where the value change is based on the performance of assets managed, the percentage of value change should be limited to the percentage of value change of the managed assets; (v) where the value change is based on the credit quality of the investment firm, the percentage of value change should be limited to the percentage of net revenue in relation to the investment firms total own funds;**~~

(h) the alternative arrangement does not hinder the application of point (m) of Article 32(1) of Directive 2019/2034/EU.