association of the
luxembourg fund industry

Luxembourg, 2 February 2017

Response to EBA discussion paper "Designing a new prudential regime for investment firms"

Introduction

The Association of the Luxembourg Fund Industry (ALFI) is the representative body of the Luxembourg investment fund community. Created in 1988, the Association today represents over 1300 Luxembourg domiciled investment funds, asset management companies and a wide range of service providers such as custodian banks, fund administrators, transfer agents, distributors, legal firms, consultants, tax experts, auditors and accountants, specialist IT providers and communication companies. The Luxembourg Fund Industry is the largest fund domicile in Europe and a worldwide leader in cross-border distribution of funds. Luxembourg-domiciled investment structures are distributed on a global basis in more than 70 countries with a particular focus on Europe, Asia, Latin America and the Middle East.

We thank the European Banking Authority for the opportunity to participate in this consultation on a new prudential regime for investment firms.

We support the submission of the European Fund and Asset Management Association (EFAMA).

Response to the consultation

ALFI's members, beside investment funds, include: UCITS management and/or investment companies, authorised under and complying with the UCITS Directive; alternative investment fund managers, authorised under and complying with the AIFM Directive.

Both the UCITS[1] and the AIFM[2] Directives also allow for their respective management companies to undertake individual portfolio management on a discretionary basis (i.e. the so-called MiFID "add-on services"), and some of the entities mentioned above have applied for these extended licences, for ancillary activities.

Entities authorised as investment firms may offer multiple services and perform multiple functions. For the purpose of this response and as representatives of the Luxembourg fund industry, we refer to "investment firms" throughout this document as entities exclusively, or at least principally, performing portfolio management services, either individually or collectively (on a delegated basis).

In light of the fact that asset management activities constitute by their very nature an "agency" business, the existing prudential requirements for investment firms sit oddly within the prudential CRD/CRR rules applicable to credit institutions. Hence, we do not agree with EBA's statement in the submitted discussion paper (on page 6) that it will also be relevant for UCITS management companies or AIF managers authorised to conduct certain MiFID investment services or activities. ALFI's members are convinced that for asset management companies an effective and risk-based

[1] See the relevant Article 6(3) letter a).
[2] See the relevant Article 6(4) letter a).

Association of the
Luxembourg Fund Industry
a.s.b.l.

12, rue Erasme
L-1468 Luxembourg
B.P. 206
L - 2012 Luxembourg

Tel: +352 22 30 26 - 1
Fax: +352 22 30 93
info@alfi.lu
www.alfi.lu

TVA LU 23710105
R.C.S. F4428

prudential regime is already in place under the respective UCITS Directive and AIFM Directive. Therefore the scope for a new prudential regime should be limited only to investment firms providing MiFID services or activities as their core business, currently falling within the prudential scope of CRR/CRD. We therefore welcome the European Commission/EBA proposal to define a more proportionate and tailored self-standing regime for investment firms that are not to be considered as "systemic and bank-like". Accordingly, our response to the Discussion Paper is limited to those questions related to "Class 2" firms as presented under Section 4.2.2 of the Discussion Paper. With regard to those "Class 3" investment management firms whose core business is to manage portfolios on behalf of third-party clients, we would welcome the proposed single prudential regime, completed with the necessary built-in proportionality. We recognise that, in view of designing a single rulebook for these firms, the EBA may "borrow" some relevant concepts and requirements from the CRD/CRR framework. We insist, however, that the EBA proceed cautiously by duly recognising the key differences between banks' versus non-banks' business models.

With regard to "size" as a firm categorisation tool to determine whether it deserves a "systemic" label, as well as a reliable proxy to calibrate its intended capital requirements – to the extent that size refers to an investment firm's total assets under management (AuM) – we would caution the EBA of the fact that there is no obvious and linear relationship between the size of a firm's AuM and the risk it poses to the broader financial system, let alone its "systemic" importance. In this regard, size should be assessed as one amongst other relevant factors, in particular, those identified as operational risks in the EBA's December 2015 *Report on Investment Firms* (EBA/Op/2015/20).

Finally, we consider that an appropriate remuneration regime, which is proportionate and tailored to the "agency" nature of the asset management business, should naturally accompany the proposed "new" prudential regime for asset management firms, marking a necessary departure from the application of bank-specific remuneration principles (i.e. those under CRD) to non-banks.

Question 2. What are your views on the principles for the proposed prudential regime for investment firms?

Designing a new prudential regime for investment firms beckons at least a couple of important preliminary considerations.

Firstly, where the EBA December 2015 Report noted that the rationale for such a regime would be justified in view of strengthening the soundness and stability of investment firms on a 'going concern' basis, as well as (i) avoid the failure of investment firms resulting in a material impact on the stability of the financial system, (ii) prevent harming investors' rights and assets, (iii) deal with the impact of failure, (iv) and/or ensure there is enough time to wind down a firm we would like to stress out that sufficient safeguards already exist without the need for additional capital requirements. Principal among these and meeting the objectives under (i) and (ii), is the requirement to segregate client assets (whether instruments or funds) under the recast "MiFID II" Directive, as well as in the relevant UCITS and AIFM Directives (see *infra*), so as to protect customers from the potential insolvency of the investment firm, while also guaranteeing market stability in parallel. It is our view, therefore, that capital requirements should firstly and more appropriately ensure the operation of a firm as a going concern, and secondly, ensure a smooth transition and orderly wind-down of the firm were it to no longer be viable, in line with objectives (iii) and (iv). Making provision for additional capital requirements to soften a firm's assumed impact on the stability of the financial system – as per point (i) above – does not recognise the core difference between bank and non-bank activities, remaining therefore a speculative consideration and one beyond the proper rationale for prudential requirements for non-banks.

Secondly, we wish to raise to the EBA's attention the fact that, as our members mainly manage portfolios in the form of UCITS or AIFs, it is of key importance that a consistent approach be applied and that an additional K-factor capital charge not be levied on the basis of the AuM of UCITS and AIF portfolios, or individual mandates, managed externally by the investment firm delegate. We would even argue that, when managing individual portfolio is ancillary to the activity of managing UCITS and AIF, UCITS/AIF capital requirements shall be sufficient.

With regard to the over-arching principles under paragraph 12 of the Discussion Paper, we have the following few reservations:

– As to principle a), we would question the assumption that an investment firm exclusively managing assets on behalf of third-parties (hence not "bank-like") may be at the same time "systemic". The EBA is aware of an ongoing global debate being led jointly at the level of the FSB and IOSCO as to whether asset management entities and/or their activities deserve to be designated as globally systemic (or "G-SIFIs"). So far, no convincing evidence has been found to substantiate such claims, hence no conclusions may be drawn in this respect. Rather, we maintain that the systemic nature of any financial institution be assessed on the basis of its own balance sheet size and activities that are conducted by employing it;

– As to principle b), we observe that risks of harm to customers and markets are phrased only very generically. It would be important in this regard for the EBA to clarify that such risks are "operational" by their very nature and that the intended new prudential regime is not aimed at treating investment risks stemming from third-party client portfolios. With regard to the latter, we note that there are multiple facets of harm to customers and/or markets that are already sufficiently addressed by existing sector-specific regulation, some of which has either been introduced *ex novo*, or amends existing norms to strengthen them further. We would encourage the EBA to elaborate more clearly on the type of operational risks intended to be addressed by the new prudential regime. In this regard, we refer the EBA back to the inventory of identified operational risks, as per its December 2015 *Report on Investment Firms*[3]. A capital regime imposed on the basis of generic assumptions around the degree of harm caused to customers and markets would certainly overrun these existing rules that are better suited to address such potential and negative outcomes. In parallel, it would almost certainly bear unwanted and unintended consequences stemming from the complex interplay of overlapping rules. As to the opportunity of devising "liquidity measures" for investment firms – as per letter ii) – we note that these should therefore only relate to those proprietary activities an investment firm conducts for itself. Although liquidity risks may also exist at the level of the single collectively-managed portfolios or individual mandates, existing EU securities law and industry best practices are sufficient and more appropriate tools to address them. Besides an extensive *corpus* of EU directives and regulations addressing these risks, we note that market supervisors and global standard setters (i.e. the FSB and IOSCO) have recently also published a set of high-level recommendations on the topic of open-end fund liquidity[4];

– In line with our arguments developed above and contrary to principle c), investment firms do not hold client assets on their own balance sheet as these are legally segregated and held in custody with a depositary institution in the name of the firm's clients The potential failure of the investment firm will therefore not impact the value of clients' assets, where these remain legally removed and free from creditor claims on the firm's own assets going to constitute its bankruptcy estate. Assuming – as per principle b) under paragraph 12 of the Discussion Paper – that "(…) the failure of investment firms may impact on customers and markets" and that

[3] We refer in particular to those listed on pages 40 to 41 of the Report.
[4] Please refer to the finalised FSB Policy Recommendations to Address Structural Vulnerabilities from Asset Management Activities, as published on 12 January 2017 and available at: http://www.fsb.org/wp-content/uploads/FSB-Policy-Recommendations-on-Asset-Management-Structural-Vulnerabilities.pdf

consequently appropriate prudential requirements should expressly apply to minimise these is at odds with the above reality by denying the purpose of segregation requirements altogether. We do however recognise – as also reflected in the EBA 2015 Report – that client money may be accounted differently in some countries, and in some instances, recorded as an "asset" onto the investment firm's balance sheet and held in a common bank account together with the firm's own funds. In this regard, it is important to distinguish instances where client money is recorded on the balance of the investment firm as an asset, compared to situations where it is not. Only in the latter case, can we deem it to be sufficiently protected to not trigger a liability (and thus a credit risk exposure) for the investment firm (*see infra*).

Moreover, we wish to highlight the fact that the segregation of client assets is more than an industry best practice for investment firms. Instead, it descends from the specific requirements of the MiFID Directive as recast under the "MiFID II" (2014/65/EU) package. Accordingly, Article 16 of the Directive provides that: (…)

> *8. An investment firm shall, when holding financial instruments belonging to clients, make adequate arrangements so as to safeguard the ownership rights of clients, especially in the event of the investment firm's insolvency, and to prevent the use of a client's financial instruments on own account except with the client's express consent.*
>
> *9. An investment firm shall, when holding funds belonging to clients, make adequate arrangements to safeguard the rights of clients and, except in the case of credit institutions, prevent the use of client funds for its own account. (…)*

The relevant UCITS and AIFM Directive provisions specific to collective portfolio management are on their part even more extensive and prescriptive, both in the Level 1 and in the Level 2 legal texts, as further specified by ESMA's own accompanying *Guidelines*.

– Finally, principle e) – and consequently principle f) - appear to automatically extend the justification for bank-like prudential requirements to investment firms. The fact that these firms – where portfolio managers – operate on the basis of a completely different business model, i.e. that of offering professional investment management services, either individually through mandates or collectively in the form of open and/or closed-end funds, remains relevant. As mentioned above, we remain unconvinced of additional capital requirements as a necessary and proportionate mean to address such broad risks, unless their more granular definition by the EBA excludes there are not already existing, market-based tools or legislation that specifically address them.

Conversely, investment firms' prudential requirements should be calibrated by firstly taking into account the firm-specific and endogenous operational risks, both as an ongoing concern and during a wind-down phase, rather than exogenous market-specific risks, where the latter are intended to be borne by clients in line with an asset manager's fiduciary business model. In this regard, we therefore agree with the wording of paragraph 29 of the Discussion Paper, that "(…) perhaps the greatest source of potential risk for investment firms overall was (is) 'operational risk', in the sense of when something goes wrong with the business operations or investment services and activities of the firm (…)".

We elaborate further on these aspects in our responses to the related questions under Section 4.3 of the Discussion Paper.

Question 5. Do you have any comments on the approach focusing on risk to customers (RtC), risk to markets (RtM) and risk to firm (RtF)?

We appreciate the EBA's attempt to devise reliable capital proxies (or "K-factors") to estimate a general degree of firm-specific operational risk. More specifically, on the individual risk types identified in the Discussion Paper, we note the following:

Risk to Customers (RtC)

As per our preliminary remarks, this risk remains poorly defined in the Discussion Paper. There are potentially multiple sources of harm to clients, both endogenous and exogenous. Among these, the starting point should be for the EBA to identify those actions for which the professional responsibility of the firm – including that of its staff – is engaged, as opposed to risks that are at present sufficiently and proportionately addressed by EU securities directives and regulations. For instance, potential losses to clients via the depreciation in value of their invested portfolio would definitely not merit a corresponding capital charge for the investment firm managing it in the absence of any guarantee or agreement to repay the actual amount of any initial investment. Differently, any material harm caused by fraudulent behaviour on behalf of individual staff, gross negligence, the violation of any of the manager's internal conduct rules, or more broadly of fiduciary duties *vis-à-vis* its clients, should – absent other means (e.g. professional indemnity insurance) – be remedied with recourse to the own funds of the investment firm.

We note in this regard that it would be important for the EBA to refer to the extensive list of operational risks, as outlined in its December 2015 Report.

In view of the risk-related K-factors, we observe that the **size of AuM** and of the **assets under advice** (AuA) are not a direct proxy to determine the potential for customer harm. These assets belong to the individual clients and are thus not recorded as a balance sheet item of the investment firm. Rather, they are segregated accordingly with a depositary bank responsible for their safe-keeping and for discharging oversight functions over the investment firm, and are only managed in accordance with an investment mandate to which the investment firm should scrupulously adhere to in performing its fiduciary role. Were the investment firm to contravene such fundamental obligation, either by acts of omission or commission, its responsibility would be triggered in relation to the given "size" of AuM or AuA put into jeopardy. In this respect, one proportionate approach could consider incrementing the own funds of an investment firm by a certain percentage size once clients' AuM or AuA exceed a given threshold, as presently the case under the specific initial capital and own funds requirements for management companies under the UCITS/AIFM frameworks[5]. Such approach would considerably align the intended new regime with the existing requirements under UCITS and AIFMD, thereby contributing to a single prudential rulebook for all EU entities offering portfolio management services, which is more sensible and risk-based (compared to the current CRD/CRR requirements). Moreover, we note in this regard that the increments to a firm's own funds would be based on AuM/AuA to cover a firm's operational risks as a going concern. Although this approach guarantees a proportionate calibration of the firm's own funds, important is that the relationship between AuM/AuA and own fund amounts remain non-linear and possibly also subject to a fixed limit (e.g. €10 million) beyond which proportionality would no longer hold. This can be demonstrated by considering that beyond a fixed

[5] Accordingly, under Article 7(1) letter a) of the UCITS Directive, the minimum initial capital requirement is €125.000, topped-up by 0.02% of the amount the total AuM exceeding a threshold of €250 million. Initial capital and own funds shall in any case not exceed €10 million. For AIF management companies, Article 9(1)-(3) is almost identical, varying the amount of initial capital to €300.000 for an internally managed AIF.

AuM/AuA limit – as currently under the UCITS/AIFM rules – a firm would be large and sophisticated enough to adequately manage its operational risks.

The additional application of an appropriate scalar coefficient – to be later quantified through the future work of the EBA/EC – would need to reflect the non-linear relationship between the ultimate capital charge and the two K-factors (AuM and AuA). We strongly recommend that the weighting for the K-factors through the scalar coefficients be determined by firms themselves, in view of a series of important specificities; e.g. a retail vs. a professional investor base, a concentrated client portfolio vs. one with a large and diversified population of clients, etc.).

Regarding **assets safeguarded and administered** (ASA), we note that mandatory EU requirements prevent investment firms from directly safeguarding and administering customer assets. Rather, the EBA should recognise the role of depositary institutions in this regard, as further strengthened by an *ad hoc* strict liability regime, addressing *inter alia* losses of client assets and extending it throughout sub-custody holding chains. The same segregation and oversight standards apply to **client money held** (CMH) which is typically monitored by, and booked into separate cash accounts with a credit institution. We would also refer the EBA to the specific UCITS/AIFM cash monitoring rules, whereby the depositary ensures that the funds cash flows are properly monitored, that all payments made by or on behalf of investor clients have been received and that all the cash of the fund has been booked in cash accounts opened in the name of the fund, or of the manager (acting on behalf of the fund), or in the name of the depositary, at an entity that is either a central bank, a European credit institution, or a bank authorised in a third country, provided that such entities are subject to effective prudential supervision[6]. In sum, EFAMA would stress that where client money is legally segregated and duly monitored by the depositary/custodian (inclusive of eventual sub-custodians), there would hardly be a rationale to justify related capital add-ons for client compensation purposes. Differently, were client money to be accounted as an asset of the investment firm itself and recorded as a debit *vis-à-vis* clients, we presume that a firm’s capital requirements should be calibrated accordingly.

Finally, with respect to **liabilities to customers** (LTC), investment firms managing client assets deem these negligible. Securities lending, as a securities financing transaction (SFT), is required under present EU and global FSB standards to be duly collateralised. Moreover, there is substantial care and due diligence that an investment firm would exercise prior to appointing its securities lending agent. Client indemnifications for potential losses fall for the most part on these agents, which are typically global custody banks, responsible at present for intermediating the bulk of lendable securities on a global scale. The above-cited EU depositary-specific rules on the liabilities for losses of client assets would in our view largely address such risks.

The final K-factor – i.e. **customer orders handled** (COH) is negligible, where not relevant at all, in light of our industry’s agency business.

Risk to Markets (RtM)

As investment firms offering third-party portfolio management services to clients, the “agency” nature business precludes them from dealing on their own account. Consequently, the proposed “K-factor” of **proprietary trading activities** (PTA) would not be relevant. As the investment management industry remains a highly competitive and substitutable one, both in Europe and globally, the market impact of any, even large, investment firm ceasing its operations as a going concern would be negligible. Where this occurs, the investment firm is obliged to issue advance communications to clients, proposing possible options. Typically, for clients there would be a choice between (i) continuing to

[6] Please refer to Article 21(7) of the AIFM Directive, as also reflected under Article 22(4) of the revised “UCITS V” Directive.

remain invested under a new mandate with another investment management firm; or (ii) recoup the value of their investment via gradual sell-off of the underlying assets in the portfolio.

Risk to Firm (RtF)

EFAMA understands this third risk type as aiming to capture any potential residual risk that has not been addressed by the RtC or RtM “K-factors”. Conforming to the fact that investment firms offering portfolio management services do not typically employ their own balance sheet to take-on market exposures – with a number of negligible exceptions outlined below – they remain immune to adverse market price movements, counterparty defaults and/or credit downgrades, as exemplified in paragraph 47 of the Discussion Paper. For the most part, such risks are borne directly by the firms’ investor clients and prudently managed by the investment firm in line with existing EU securities law requirements. In Luxembourg, the regulator has imposed restrictions on management company own investments. For those asset management firms that are part of a broader, usually bank-dominated, financial group, we agree with the EBA – as per paragraphs 18 and 158 of the Discussion Paper - in that counterparties of the firm would already count on the relevant CRD/CRR protections (*in primis* via prudential consolidation) in place against an investment firm’s potential failure.

We nevertheless do not share the opinion of the EBA under paragraph 49, whereby “(…) a firm that is financially weak or in trouble itself can be more susceptible to poor behaviour, weaker controls and greater risk-taking as it seeks to correct its fortunes. This in turn suggests that any RtF could increase the probability that RtC occurs, and/or amplify its impact if it does occur, and so should not be overlooked.” Unless an investment firm is authorised to operate exclusively on its own account, when discharging portfolio management services, portfolio managers are required to adhere to their investment mandate, designed to take into account existing regulatory requirements (e.g. in terms of portfolio diversification, investment risk limits, leverage, collateral quality, etc.) while adhering to clients’ instructions in line with their specific risk tolerances and desired risk-adjusted returns.

Secondly, such returns are monitored constantly and thoroughly assessed, not only by managers themselves, but also by their clients (either directly or through client-hired investment advisors or consultants) and increasingly by a range of third-party service providers (e.g. Morningstar for the retail fund universe). Such assessments are conducted with reference to market benchmarks and/or industry peers, such that poor performance – whatever its cause – will inevitably and eventually drive clients to entrust less of their savings to the firm over the medium- to longer-term. Given the highly substitutable nature of the professional investment management industry – save perhaps for a very negligible number of smaller firms advertising bespoke strategies – poor performance, coupled with poor behaviour, weak controls or poor financials, etc. carry a significant reputational toll for any firm. Such indicators are unlikely to remain undetected for long, eventually forcing poor performers to wind-down their business and exit the market. Taken together, the regulatory requirements, the limits defined in the investment mandate, combined with the reputational firm-specific factors at play, would incentivise individuals to refrain from, and firms to pre-empt, the type of reckless behaviour described under paragraph 49.

Question 6. What are your views on the initial K-factors identified? For example, should there be separate K-factors for client money and financial instruments belonging to clients? And should there be an RtM for securitisation risk-retentions? Do you have any suggestions for additional K-factors that can be both easily observable and risk sensitive?

As acknowledged with regard to assets safeguarded and administered (ASA) and subject to the considerations made in our response to Question 5 above, both client money and financial instruments should be segregated separately from the own assets of the investment firm.

With regard to a proposed specific RtM to cover exposures emanating from securitisation-related risk-retentions, we observe that asset managers typically do not operate a principal business as that of originating, sponsoring or of granting direct loans which are then securitised. Common, however, is that securitised instruments may be invested into by asset management firms in executing their investment mandates, in line with regulation and with clients' specific risk tolerances. The latter activity should therefore be appreciated in light of the agency business model asset managers operate and would therefore not call forth specific capital charges.

Question 7. Is the proposed risk to firm 'up-lift' measure an appropriate way to address the indirect impact of the exposure risk a firm poses to customers and markets? If not, what alternative approach to addressing risk to firm (RtF) would you suggest?

Analogously, we question the rationale for applying the so-called "up-lift factor" to investment firms offering portfolio management services, as for the arguments developed above, these do not employ their own balance sheet in the markets and consequently do not make use of leverage. Where employed, leverage and the resulting exposure is relevant only at the level of the individually managed investment portfolio, where risks are entirely borne by the investors. Although undoubtedly relevant for those investment firms operating leverage from their own balance sheet, we do not consider it being relevant for those offering portfolio management services as their core business.

Question 9. Should a fixed overhead requirement (FOR) remain part of the capital regime? If so, how could it be improved?

For simplicity and given that most among the proposed K-factors would not be relevant for asset management firms (as they do not exhibit the diverse profit & loss structures of trading firms), we would opt for maintaining the status quo, in view of calculating a minimum "floor"; i.e. the calculation of fixed-overhead requirements as the eligible capital of at least one quarter of the fixed overhead requirements (FOR) of the preceding year, as per Article 97 of the CRR.

Question 10. What are your views on the appropriate capital requirements required for larger firms that trade financial instruments (including derivatives)?

Concerning derivative instruments, as these are not traded on an investment firm's own account, we believe that capital requirements calibrated on these related exposures are not relevant. Trading of derivatives under EU securities laws (*in primis* EMIR and its related Level 1 and Level 2 acquis) is subject to sufficient safeguards and risk-mitigating techniques to not require additional capital requirements, especially for portfolio management firms that do not trade against their own book.

Question 11. Do you think the K-factor approach is appropriate for any investment firms that may be systemic but are not ‘bank-like’?

Regarding the alleged “systemic” nature of non-bank entities, we would refer the EBA to carefully consider the ongoing discussions around the “structural vulnerabilities from asset management activities” being carried out jointly under the aegis of the FSB and IOSCO[7]. Prior to the latest FSB consultation on this topic in June 2016, both global standard-setters had consulted in 2014 and 2015 on the appropriateness of an assessment methodology to identify non-bank, non-insurer, globally systemic financial institutions (“NBNI G-SIFIs”). For all three consultations, substantial arguments and in-depth analytical evidence has been provided to substantiate claims that asset managers – regardless of how large the size of their AuM – are not systemic. As the AuM remains hugely diversified and at all times distinct and legally segregated from the balance sheet of the asset management company, the failure of the asset management company, or the eventual cyclical underperformance of any managed asset class, could not reasonably provoke a “systemic” crisis of confidence in the industry itself or in financial markets more broadly.

We note, on the contrary, that given the very diversified and competitive nature of our industry, as also characterised by an extremely heterogeneous client base, together with the extensive regulatory enhancements that have been ushered in post-2008 in Europe and abroad (specific to our industry, but also touching upon critical pieces of market infrastructures, together with stricter capital requirements for major banks and broker/dealers), the alleged systemic nature of asset managers – as for any other financial entity – would deserve to be assessed under a completely different paradigm. Such, we believe, is still not the case enough within the global regulatory community.

Such considerations, we care to point out, should however not preclude the EBA’s further analysis to identify systemic investment firms on the basis of their own balance sheet use and proprietary activities, as per the criteria developed for designating Global Systemically Important Institutions (G-SIIs) and Other Systemically Important Institutions (O-SIIs).

Question 20. Do you see any common stress scenario for liquidity as necessary for investment firms? If so, how could that stress be defined?

Regarding the considerations made under the title “Qualitative requirements for liquidity management” in paragraph 136 of the Discussion Paper, we wish to draw an important distinction; i.e. that of stressing liquidity on the investment firm’s own balance sheet vs. that of stressing liquidity at the level of individual client portfolios. We recall that most relevant to all professional asset management firms are the specific liquidity management requirements applied to the individual portfolios managed on an agency basis for external clients. Relevant in this regard are the comprehensive liquidity risk management rules common to both EU UCITS and AIFM frameworks (including inter alia liquidity stress-tests performed at the individual fund level), as further enhanced by a range of different liquidity management tools (e.g. from “swing-pricing” to the suspension of investor redemptions).

[7] In this regard, please refer to the published responses to the latest FSB consultation on “Proposed Policy Recommendations to Address Structural Vulnerabilities from Asset Management Activities” of June 2016; available at: http://www.fsb.org/2016/10/public-responses-to-the-june-2016-consultative-document-proposed-policy-recommendations-to-address-structural-vulnerabilities-from-asset-management-activities/

Such requirements and tools are largely sufficient to manage potential liquidity mismatches materialising from the portfolio depending on the specific redemption policies in place. For the reasons explained above, as the investment firm does not take investment risks (cum liquidity ones) onto its balance sheet, Questions 21 to 24 are thus not pertinent to the types of firms we represent.

Question 22. What types of items do you think should count as liquid assets to meet any regulatory liquidity requirements, and why? (Please refer to Annex 4 for some considerations in determining what may be a liquid asset).

With regard to the definition of what constitutes a “liquid” asset, we would invite the EBA to refrain from attempting to define “liquidity” on the basis of a fixed set of parameters, as liquidity is a multi-dimensional factor that may vary greatly depending on myriads of factors which are both qualitative and quantitative. In the experience of our members, there is also a substantial degree of judgment which goes into assessing contingent liquidity conditions for specific asset types, when not instrument by instrument individually. Differently, exercises of the type envisaged by this specific question could be useful to the extent that they may – albeit only indicatively – list some of the key factors driving liquidity of one or more instruments.

We are of the view that it is firstly market players themselves which are best able to assess liquidity conditions as these evolve. Secondly, investor clients are also able to appreciate the liquidity risks of the portfolios of assets in which they invest, both from pre-contractual and regulatory disclosures ahead of committing their capital, as well as ex-post while monitoring the performance of their investments on an ongoing basis (especially when institutional investors are involved).

Question 26. What are your views on the proposed approach to addressing group risk within investment firm-only groups? Do you have any other suggested treatments that could be applied, and if so, why?

Relevant to investment firm-only groups is that each subsidiary, including the parent holding company, be assessed on a “solo” basis to determine its own specific operational risks, as a derogation to any group consolidation practices found elsewhere. In this, we agree with the narrative presented under paragraphs 149 *et seq*.

Question 27. In the case of an investment firm which is a subsidiary of a banking consolidation group, do you see any difficulty in the implementation of the proposed capital requirements on an individual firm basis? If so, do you have any suggestion on how to address any such difficulties?

With regard to investment firms such as UCITS or AIF management companies being subsidiaries of bank-owned, consolidated groups, we would agree with the approach of the EBA, as outlined under paragraphs 18 and 158 of the Discussion Paper, whereby prudential consolidation would sufficiently address the potential group risks stemming from the operations and/or wind-down of individual investment firm subsidiaries.

Question 31. What are your views on the relevance of CRD governance requirements to investment firms, and what evidence do you have to support this?

We would consider that governance requirements should be proportionately tailored to the specific *nature* of a firm's core line of activity. With regard to those investment firms offering portfolio management services as their core function, we advocate the application of the relevant MiFID I and II conduct requirements, rather than the corresponding CRD/CRR ones as in certain jurisdictions until this day. Among these requirements, we consider that a more proportionate calibration of the principles governing remuneration practices away from the current CRD rules (in particular those under Articles 92 and 94, as re-interpreted by the European Commission's Report to the European Parliament and the Council of 28 July 2016) is of particular relevance, as it reinforces the creation of a separate remuneration regime for asset management firms, alongside a "new" prudential one.

Question 32. As regards 'systemic and bank-like' investment firms, do you envisage any challenges arising from the full application of the CRD/CRR remuneration requirements, and if so, what evidence do you have to support this? For all other investment firms, what are your views on the type of remuneration requirements that should be applied to them, given their risk profiles, business models and pay structures?

Recalling the EBA's own December 2015 *Report on Investment Firms* (EBA/Op/2015/20), we much welcomed the recognition of different pay structures being natural to business models other than those of banks, as well as the opportunity for "specific exemptions" to be introduced for investment firms. At present, we firstly and openly support a more proportionate regime that grants such exceptions to asset management firms on the basis of the very "agency" *nature* of their core business. In this regard, it is important for the EBA to distinguish between two rationales: (i) remuneration rules for asset managers, aimed at ensuring such optimal alignment, *versus* (ii) those for credit institutions, meant to mitigate risks from dealing on their own account, to reconstitute their capital base, all while warding-off systemic risks.

Building on the above arguments, we would advocate a harmonised and coherent single remuneration regime for all firms conducting asset management activities at their core. In this regard, we believe that the EBA should build on the work of ESMA, as it already has sufficiently harmonised, via three separate remuneration Guidelines – intended respectively for UCITS/AIF management companies and MiFID investment firms – the key requirements to appropriately design firm-specific and internal remuneration codes for the asset management industry as a whole. Such sector-specific requirements, we wish to recall, stem from the European Commission's own *Recommendation 2009/384 on remuneration policies in the financial services sector* of April 2009, which has become the blueprint for all remuneration principles inserted into EU financial regulation, whether bank-specific (as in CRD), insurance-specific (as in implementing regulations to the Solvency II Directive) or asset management-specific (as in the UCITS and AIFM Directives).

In brief, we see merit in recalling the following main principles common to all frameworks below. These aim to align the remuneration of asset managers with the investment horizons of their investors, reflecting their fiduciary duty underlying their agency business model, rather than to protect shareholders from potential abuses of a firm's own balance sheet, as per a principal (proprietary trading) model (see *infra*):

- The need to promote a remuneration policy which is consistent with and promotes sound and effective risk management at a firm-wide level, in line with its business strategy, objectives, values and long-term interests of the financial undertaking;

- In terms of structure, between fixed and variable components, the latter shall represent a sufficiently high proportion of the total remuneration to allow the operation of a flexible variable remuneration component, with the possibility for the variable component to be withheld altogether when performance criteria are not met, including the possibility for additional *malus* and/or clawback clauses to apply. Moreover, the award of the variable component is deferred over minimum period and must also include non-cash instruments;
- In terms of performance assessment, this should be set in a multi-year framework geared towards the long-term and where the award of variable components reflect the performance of the individual, of his/her business division, as well as that of the entire firm over a business cycle. Non-financial assessment criteria (e.g. compliance with conduct rules, or other professional standards vis-à-vis clients) are also taken into account;
- In terms of governance, remuneration policies should be clearly detailed and documented, aimed at avoiding conflicts of interest, and placed under the authority of supervisory boards. The latter may be complemented by *ad hoc* remuneration committees. The implementation of the remuneration policy should, at least on an annual basis, be subject to an independent internal review by the designated control functions;
- Finally, in terms of disclosures, these should be periodic and carried out at least on an annual basis to informed relevant stakeholders. *Inter alia*, information should include details as to the decision-making process when awarding compensation, information on linkages between pay and performance, on criteria for its measurement and adjustment, on parameters for awarding annual bonuses and non-cash benefits, etc.

To reflect the varied universe of non-bank, market actors, these over-arching principles have been intended to apply proportionately on the basis of the size, internal organisation, *nature*, scope and complexity of their activities. National supervisors have, more importantly, therefore exercised some degree of discretion when applying such principles to market actors in light of their activities and business models. The requirements regulating compensation practices for credit institutions in Europe – in particular, the deferral of variable compensation, payments in non-cash instruments and application of a *malus* and/or clawback when performance objectives are not met – have been absorbed and duly reflected into our own asset management legislation by the co-legislators and later ESMA, albeit with a series of necessary adaptations to account for the "agency" business model which characterises our industry.

Question 33. What is your view on a prudential remuneration framework for other than 'systemic and bank-like' investment firms that should mainly aim to counteract against conduct related operational risks and would aim at the protection of consumers?

For the reasons outlined above, we do not believe that a remuneration regime applied to the staff employed by an asset management company deserves to be qualified as "prudential". Unlike for other (systemic and bank-like) financial market players, remuneration rules for the agency nature of professional portfolio management services should not be employed as a risk-mitigating tool. For the industry we represent, financial risk must be appraised in its own context, and primarily, in the exercise of investing clients' savings on the basis of mutually agreed investment mandates and resulting in the constitution of individual portfolios built of cash and securities that clients own as ultimate beneficiaries. Sound and prudent risk management accompanies the exercise of such fiduciary duty in line with each investors' own risk tolerance.

In our view, the above question appears to confuse the purpose of "prudential" capital requirements regulation with the purpose of conduct rules, whereas the two are in fact distinct. Operational risks and their potential detrimental effects on consumers – for us, our own investor clients – ought to be tackled, first and foremost, by a robust set of conduct requirements, among which remuneration principles naturally fall. To ensure the protection of our clients, our industry's remuneration practices have naturally evolved to guarantee a long-term managerial incentive alignment with the formers' interests. This is best guaranteed by multi-annual review periods to assess an individual's performance, complemented by the performance of his/her business division, as well as of the entire firm itself. Variable pay-outs, as a component of the total remuneration package, remain flexible for an important reason, i.e. not only are adjustments made to reflect performance over a given period and on the basis of pre-set benchmarks, but also to enable the ongoing costs (fixed overheads) of the asset management firm to better adapt to swings in the economic cycle. Client protection is complete with additional requirements to subject variable pay-outs to lengthy deferrals (even up to 10 years for specific asset management styles like for instance private equity), payments in non-cash instruments (between 40 to 60% under UCITS/AIFMD requirements) and by allowing for malus or even clawback clauses to recoup an individual's remuneration entitlements under specific circumstances. Ensuring the design and ongoing implementation of these practices are key internal governance functions entrusted to non-executive (supervisory) Board members, remuneration committees, all acting in concourse with additional control functions, i.e. audit, risk management, compliance and human resources.

We observe that over time our industry has been best served via the application of these key conduct tenets, where even the rare but most egregious violations of these rules and of a firm's own internal "culture", have neither provoked harm to clients or markets enough to justify the additional imposition of *ad hoc* capital requirements. Where such unfortunate events have occurred, the consequential negative fallouts have been heaviest on the firms themselves, tarnishing their reputation and often ending their business prospects altogether against the backdrop of a very competitive global industry.

Question 34. What are your views on having a separate prudential regime for investment firms? Alternatively, should the CRR be amended instead to take into account a higher degree of proportionality? Which type of investment firms, if any, apart from systemic and bank-like investment firms, would be better suited under a simplified CRR regime?

In line with our preliminary remarks, we favour a separate prudential regime for investment firms offering professional portfolio management services for third-party clients as their core business. We justify our main position as one based on the need to realise a clean "break" with the current and bank-specific CRD/CRR regime, currently being applied inappropriately to our agency business model in a number of individual jurisdictions. A clear separation will also undoubtedly lead to a simplification of the present *acquis* related to asset management activities that is long overdue, allowing all supervisors (prudential and non) to better exercise their respective functions over a population of very different firms, whilst avoiding the temptation to "gold-plate" and realise a level playing-field over the long-term within the Single Market.

Question 35. What are the main problems from an investment firm perspective with the current regime? Please list the main problems with the current regime.

As per our earlier responses, the current regime creates significant ambiguities in that rules presently applicable in Europe to asset management firms and their activities straddle multiple regimes, among which the CRD/CRR is particularly ill-suited to reflect the specificities of our industry's agency business. Unmistakably, this fact has been laid bare over the past few years in light of the regulatory debate over the most appropriate application of the proportionality principle related to the remuneration of identified key individuals employed by bank-owned asset management companies.

As the EBA is aware, there are certain jurisdictions which have applied the full CRD/CRR regime to investment management firms, albeit with a range of necessary waivers tailored to their non-bank business models and justified on grounds of proportionality. Other jurisdictions have for the most part opted to authorise investment management firms by granting UCITS and/or AIFM company licenses, subjecting the latter to a regime that has been designed *ad hoc* around the “agency” nature of our business.

In sum, our industry would greatly welcome the proposed “migration” of the prudential regime for investment firms (i.e. those authorised under the MiFID regime to provide portfolio management services) from the current bank, or bank-like, regime under CRD/CRR rules to a new regime that is aligned to the existing rules for UCITS/AIF management companies. We would also see the additional merit of dispelling recent confusion around an appropriate remuneration regime for the “identified staff” employed by asset management firms within larger, bank-owned financial groups.