Alternative Investment Management Association

Minister of Finance
Ir. J.R.V.A. Dijsselbloem
Netherlands Ministry of Finance
Korte Voorhout 7
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2500 EE Den Haag

Submitted online via the link

8 September 2016

Dear Sir/Madam,

AIMA's response to the Dutch Minister of Finance consultation on extending the application of the CRD IV bonus cap to all asset management staff

The Alternative Investment Management Association Limited[1] (AIMA) is grateful for the opportunity to submit its comments to the Dutch Minister of Finance in relation to the proposal to extend the 100% bonus cap set out in Directive 2013/36/EU (CRD IV) beyond identified staff of firms within the scope of CRD IV to cover all staff of consolidated group asset managers and to asset managers (fund managers) outside CRD IV consolidated groups in the Netherlands.

AIMA strongly disagrees that the bonus cap should apply to asset managers or beyond identified staff and would urge the Dutch Minister of Finance to reconsider its position. In particular, we would encourage the Netherlands to take a similar approach to the UK in relation to the European Banking Authority (EBA)'s Guidelines on Sound Remuneration Policies under Articles 74(3) and 75(2) of the CRD IV and disclosures under Article 450 of Regulation (EU) No 575/2013 (EBA/GL/2015/22) (the 'EBA Guidelines').[2] We consider that smaller CRD IV firms should be able to determine an appropriate ratio between fixed and variable remuneration for their business whilst not being required to strictly apply the bonus cap.

Alternatively, we would in any case encourage the Netherlands not to apply the bonus cap in any way that is stricter than as set out in CRD IV/the EBA Guidelines as this would be detrimental to those asset managers affected, with a view to their EU and international competitiveness.

In the Annex, we set out in detail some of the fundamental differences between the investment management sector and the banking sector that make the imposition of the bonus cap inappropriate in the investment management sector both in the context of CRD IV and outside of the scope of CRD IV. For the reasons discussed in the Annex, we believe that it would cause disproportionate damage to investment management companies if investment managers were unable to set appropriate levels

[1] AIMA, the Alternative Investment Management Association, is the global representative of the alternative investment industry, with more than 1,600 corporate members in over 50 countries. AIMA works closely with its members to provide leadership in industry initiatives such as advocacy, policy and regulatory engagement, educational programmes, and sound practice guides. Providing an extensive global network for its members, AIMA's primary membership is drawn from the alternative investment industry whose managers pursue a wide range of sophisticated asset management strategies. AIMA's manager members collectively manage more than $1.5 trillion in assets.

[2] See UK Prudential Regulation Authority and Financial Conduct Authority statement on compliance with the EBA Guidelines, available at: https://www.fca.org.uk/news/sound-remuneration-policies-statement.

of variable remuneration, in addition to encouraging a misalignment of interests between investment managers and investors.

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

Yours sincerely,

Jiří Król
Deputy Chief Executive Officer
Global Head of Government Affairs

Annex

Differences between the banking sector and the investment management sector

As set out above in this paper, although some remuneration principles can and should be shared across the banking and investment management sectors, the limitation on fixed-to-variable pay ratios and deferral requirements provide examples of intervention which is not only undesirable on policy grounds but also difficult, if not impossible, to implement in practice due to the fundamental differences between the investment management business model and the banking business model. In this annex we set out some of the fundamental differences between the banking and investment management business models which should be taken into account when considering principles for sound remuneration in these sectors, including the imposition of the bonus cap.

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

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

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

Remuneration structures within the investment management sector

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

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

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

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

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

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

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

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

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

For these reasons, we believe that it would cause disproportionate damage to investment management companies if there to be any change in the ability of investment management companies to set appropriate levels of variable remuneration.