



Alternative Investment Management Association

Oliver Wunsch
Swiss Financial Market Supervisory Authority FINMA
Einsteinstrasse 2
CH - 3003 Bern
Switzerland

And by email to: oliver.wuensch@finma.ch

12 August 2009

Dear Oliver,

AIMA's response to FINMA's Circular on remuneration systems

AIMA¹ is pleased to have the opportunity to respond to FINMA's Circular on remuneration systems (the 'Circular'). We understand FINMA's desire to examine the design, implementation and disclosure of remuneration systems within Swiss financial institutions, given the recent and ongoing market turmoil. We also applaud FINMA's efforts to "motivate employees to contribute to the long-term success of [their] institution and its stability".

Scope of Circular

Our preliminary and important observation is that no sound evidence has yet been produced to show that remuneration practices or systems at firms outside the banking sector played any significant role in the recent crisis. Recent reports have concluded that the crisis was primarily a banking crisis in which hedge funds played a marginal role, and AIMA is keen that regulators appreciate the distinction between banks (and 'bank-like' institutions) and hedge funds². We are surprised that FINMA believes it justifiable to apply the Circular to the non-banking sector. In FINMA's 'Key points' document accompanying the Circular it is acknowledged that "FINMA is going further with its proposals than any other initiatives yet seen outside of Switzerland" and we would wholeheartedly endorse the suggestion that this may "threaten the Swiss financial centre as a whole". Other key financial centres (for example the UK) are consulting widely on any extension of remuneration codes to the non-banking sector and we would urge FINMA to adopt a similar approach.

Given that the Circular is intended to apply to both the banking and non-banking sector, we believe it is important to distinguish between banks (and 'bank-like' institutions) and the wider financial services industry, and to caution against a "one size fits all" approach to regulation. As we describe below, remuneration practices within hedge fund managers (and therefore the associated remuneration risks) differ fundamentally to those found within banks. We are concerned that the Circular applies a single set of principles to cover both the banking and non-banking sectors.

Various other bodies have recently looked at remuneration issues within the financial services industry³. A common thread is that they have been driven by concerns about risk taking in the high-impact banking and investment banking sectors and the principles, guidelines and standards have generally been drafted accordingly, many of them proceeding on the assumption that a firm is large, with developed governance structures and

¹ AIMA is the trade body for the hedge fund industry globally; our membership represents all constituencies within the sector - including hedge fund managers, fund of hedge funds managers, prime brokers, fund administrators, accountants and lawyers. Our membership comprises over 1,100 corporate bodies in over 40 countries, with approximately 6% of our members based in Switzerland and, of them, 32 are hedge fund management firms.

² For example, Jacques de Larosière's report of February 2009 states at paragraph 86 that "hedge funds...did not play a major role in the emergence of the crisis". Lord Turner's review of March 2009 (*A regulatory response to the global banking crisis*) concludes at section 2.3 that "hedge funds in general are not today bank-like in their activities".

³ For example, the FSA's consultation CP 09/10 'Reforming remuneration practices in financial services' and the European Commission's Recommendation C(2009) 3159 on remuneration policies in the financial services sector

The Alternative Investment Management Association Limited
167 Fleet Street, London, EC4A 2EA

Tel: +44 (0)20 7822 8380 Fax: +44 (0)20 7822 8381 E-mail: info@aima.org Internet: <http://www.aima.org>

distinct risk management, compliance and HR functions. Some principles within the Circular may therefore be difficult to apply in a meaningful way to the significant number of firms which do not have the multi-departmental structure of an investment bank (e.g., principle 3).

Insofar as the main purpose of the Circular is to address the "asymmetry" prevailing within the banking sector, the extension of the scope of the Circular to the fund industry does not have any justification. In our view that industry, and in particular the alternative investment management industry, is not affected by the same excessive risk taking and remuneration problems. This is due to various factors, principally (i) existing regulation ensuring appropriate fee structure transparency at the level of the collective investment vehicle and (ii) "symmetrical" fee structures with strong alignment of interest between investors and managers on a medium to long-term basis.

AIMA welcomes the exemption for firms meeting at least two of the stipulated criteria as set out at paragraphs 8 - 10 of the Circular. However, we are concerned that this exemption is too narrow - it is not tailored to the non-banking sector and will leave many firms that pose no significant remuneration risk within the scope of the Circular. Even smaller boutique alternative investment management firms could easily exceed the thresholds of both paragraph 8 (20% of variable remuneration) and paragraph 9 (total remuneration exceeding CHF 800'000 per annum). The definition of "Total remuneration" at paragraph 14 is widely drafted and there is a concern that it would encompass distributions of returns to equity owners of a hedge fund business (depending on the structuring of such investment), thereby further narrowing the scope of the exemption.

AIMA is also concerned that the Circular applies to all employees within the affected firms, rather than being limited to those employees whose activities have a significant impact on the risk profile of the firm. We believe this is disproportionate and will impose unnecessary costs and compliance burdens on firms. In our view a better approach would be to address the Circular to management and other key employees - we believe this would be both more practical and more effective at motivating those employees to contribute to the long-term success and stability of their institution.

Remuneration practices in hedge fund manager firms

Remuneration practices within hedge fund managers differ greatly from those at banks, and for this reason a "one size fits all" approach to regulation in this area is wholly inappropriate. The Circular does not acknowledge the interaction or distinction between (a) bonuses paid as salary to employees and (b) "bonuses" in the form of profit share via dividend/draw for equity owners of a business. Many of the most highly-remunerated individuals at such firms are equity partners or shareholders and we consider that it is wholly inappropriate for any deferral or other remuneration restrictions to be placed on the receipt of such dividend/profit share income, not least because this may lead to people facing unfunded tax liabilities. We are glad that FINMA acknowledges this tax issue in its 'Key points' document, but would again stress that many of our members are remunerated as owners of the business rather than employees, and so the tax issues arising from both sets of relationships (i.e. employees and owners) must be considered.

Although the practical details as to how the remuneration is calculated differs amongst different types of hedge fund manager firms - for example, between the larger, listed fund managers and the smaller, private fund managers run by entrepreneurial stakeholders - the following features can be observed:

- the remuneration arrangements involve payments out of fees realised in the hands of the hedge fund manager and constitute the firm's audited income accounted for in its annual accounts;
- importantly, therefore, the bonus pool is derived from a combination of the fund's investment management fee and performance fees (i.e., a percentage of the fund's increase in NAV) - so that there is an alignment of interests, as between the investor and the individuals taking the investment management decisions. It is important to distinguish this incentive to take appropriate risk from the incentive to take excessive risk which bonuses may give in a banking context;
- bonuses are often co-invested in the funds, increasing the alignment of interests between managers and investors;
- small hedge fund manager firms - particularly start-ups - will tend to structure their remuneration packages around an element of fixed salary and a flexible, discretionary annual bonus, determined by reference to a discretionary assessment of an individual's performance and value to the business

but with the firm retaining the ability to withhold bonuses in times of financial difficulty. Remuneration is demonstrably “fully flexible”, despite the potentially high proportion of bonuses in good years;

- some larger firms will tend to operate deferred payment terms, with more formulaic means of calculating the discretionary element and with payment in tranches over a number of years, with payments forfeited on resignation or termination of employment - a “rate of return adjustment” is applied to reflect performance of the hedge fund each year before the next tranche is paid out, so that payment is directly linked to future performance;
- listed companies will tend to offer company employee share plans for specific key employees, with additional special arrangements for fund managers under which the latter may subscribe for preference shares;
- although there are differences as to remuneration methodology amongst different firms, the hedge fund industry as a whole operates in a professional wholesale market, where investors have accepted and understand the risks associated with hedge fund investment strategy in return for the potential reward of greater returns; and
- the fact that most hedge funds are owner-manager businesses means that the profits inevitably accrue to the managers.

Transparency as to the remuneration charged to the hedge fund (and, indirectly, to the investors) by the investment manager is already ensured at the level of the investment vehicle itself through disclosures in the offering documentation and prospectuses. The internal allocation rules within the hedge fund manager amongst its employees have no bearing on the risk profile for the investors and additional regulation in this field would only create an additional and unnecessary compliance burden on the hedge fund industry.

Because the norm is that remuneration is linked to the fees and commissions paid by clients to the hedge fund manager, we believe that there is a clear distinction to be made between the hedge fund industry and the excessive risk taking that has been made in the banking/investment banking sector. It is clear that a regulatory “one size fits all” approach would be wholly unsuitable for an industry where the remuneration pool is derived from fees paid to the firm for investment management.

The hedge fund industry is exceptional in the level of manager co-investment (which investors insist on) and this is precisely the sort of alignment of interest which is being searched for in the banking sector. Investors are placing pressure on managers to put in place performance fee structures which further align the medium term interests of managers with those of investors. As a result of this alignment of interests, the relationship between risk taking and remuneration is “symmetrical” by design in the hedge fund industry, contrary to what prevails in the banking sector, where the risk/reward profile of commissions and incentives is highly “asymmetrical”⁴ and encourages excessive risk taking.

For these reasons we are very concerned that principle 7 is too prescriptive, particularly with regard to the “blocking period” of “at least 3 years”, and would argue that such a measure is wholly appropriate for hedge fund managers.

Conclusion

AIMA welcomes and understands FINMA’s current regulatory focus on remuneration practices within the banking sector. However, AIMA does not believe that a case has been made for extending regulation of remuneration practices to the wider financial services sector, and in particular hedge fund managers.

Given that the Circular adopts a “one size fits all” approach, we are concerned that it does not recognise the concept of proportionality and that some principles may not be practical or appropriate of firms of a certain size or structure. For example, principle 3 will not be appropriate for firms without distinct HR or risk control functions. We are concerned that the Circular’s exemption is too narrow and will not be effective at identifying those firms whose size or structure or activities make it unsuitable to be covered by the Circular. Although

⁴ The asymmetry of the risk/reward profile results from the absence of any downside to the relevant business unit/employees insofar as this downside risk is exclusively borne by the client.

principle 10 introduces a “comply or explain” requirement we are concerned that it is to apply only in “well-founded exceptional circumstances”.

Some of the principles are sound and sensible ways to manage and identify remuneration risk and will already be practiced by many of our members as part of sound business practice. However, some of the principles are overly prescriptive; for example, principle 7 which stipulates that at least some of the remuneration of the management board must be deferred for at least 3 years. Mandatory deferment is also wholly inappropriate for managers remunerated by way of dividend or equity draw, as is common within the hedge fund industry.

We hope that FINMA will reconsider the application of the Circular to the non-banking sector, and hedge fund managers in particular, in light of these comments. Should you have any comments on our response, or wish to discuss it further, please do not hesitate to contact me.

Yours sincerely,

A handwritten signature in black ink, appearing to read "Mary Richardson". The signature is fluid and cursive, with the first name "Mary" and last name "Richardson" clearly distinguishable.

Mary Richardson
Director of Regulatory and Tax Department