

Financial Services and Markets

Countdown to AIFMD – ESMA final guidelines on remuneration

On 11 February 2013, the European Securities and Markets Authority published its final guidelines on sound remuneration principles under the Alternative Investment Fund Managers Directive. The guidelines will apply to national regulators, including the Financial Conduct Authority, and directly to AIFM. In the final guidelines ESMA has reflected some, but by no means all, of the comments made by respondents to its consultation last summer. The guidelines are open to a wide range of interpretations in several respects. Considerable work therefore still needs to be done by national regulators, trade associations, professional advisers and firms, to enable AIFM to understand the practical impact of the rules and guidance on incentive structures.

The final ESMA guidelines are available [here](#). The guidelines themselves are in Annex III, beginning on page 46. The earlier pages include feedback on the consultation exercise.

In earlier client briefing notes, we summarised:

- the relevant provisions of the "Level 1" framework Directive: our summary is available [here](#) (see page 12); and the legislation is available [here](#) (see Article 13 and Annex II);
- the ESMA consultation paper and draft guidelines; our summary is available [here](#).

Key points

- *Proportionality:* The pay regulation provisions of the Level 1 text are expressed to apply "in a way and to the extent...appropriate to [the] size, internal organisation and the nature, scope and complexity of [the AIFM's] activities". The draft ESMA guidelines accepted that all of the Directive's principles on pay were capable of "tailored application" on grounds of proportionality. Helpfully, the final guidelines go further, in expressly recognising that some of the principles (including those on deferral, payment in units and ex-post risk adjustment) can be "disapplied" in relation to the AIFM or particular staff. Whilst this possibility is heavily caveated, it may afford some flexibility for some firms. There is no real benchmark for the application of this proportionality principle and this is where further work, including engagement with local regulators, will be required.
- *Application of the remuneration principles to delegates of the AIFM:* The guidelines require AIFM to ensure that, to the extent that portfolio management or risk management activities are delegated by the AIFM, the delegate is either: (a) itself subject to pay regulation of equivalent effect; or (b) is made subject to contractual obligations which are to similar effect in order to prevent "circumvention". This is despite considerable lobbying against extending the rules to delegates. ESMA is likely to be criticised for gold-plating the Level 1 legislation.
- *Carried interest:* The final guidelines are consistent with the consultation draft in that ESMA appears to look favourably on carried interest models typically used by private equity. The industry has argued strongly that typical carried interest models already satisfy the policy objectives because they feature inherent long-term deferral and risk adjustment characteristics. That may provide strong grounds for some firms to "disapply" some of the principles in respect of certain staff on grounds of proportionality (see above) or to treat them as being inherently satisfied. ESMA gives one example of a carried interest model. It is not ideally drafted, for example because it requires that capital contributions plus hurdle returns are returned to investors before "any variable compensation" is paid to relevant staff. However, we regard this as only one example; other models have the same attractive features from a policy perspective.
- *Comment:* In this note, we give several examples of ESMA prohibiting "circumvention" or "artificial avoidance" without explaining what constitutes circumvention or avoidance. This approach is frustrating because ESMA guidelines ought to provide standards by reference to which firms can make informed judgements.

Significance of the ESMA guidelines and next steps

The FCA will implement the AIFMD remuneration guidelines through changes to its rules, most likely by creating a new Remuneration Code for collective portfolio managers. The FCA is likely to address this in its second consultation paper, now expected to be published in mid-March. It remains to be seen to what extent it will elaborate on proportionality.

The guidelines are expressed to apply to regulators on a "comply or explain" basis. They must justify any departure from the guidelines to ESMA within two months of publication of the translations from English into the other official languages of the EU. It remains to be seen whether some Member State regulators will choose not to conform to certain aspects of the guidelines and instead to explain non-compliance.

AIFM will need to comply with the pay rules and guidance, as reflected in local law, from the date the Directive applies to them. EU AIFM which expect to be authorised under the Directive on or shortly after 22 July, and which have performance years aligned to the calendar year, should start to consider how they will capture remuneration data in the present performance year. It is to be hoped that Member State regulators, including the FCA, will address transition issues sensibly.

Application to non-EU AIFM of non-EU AIF, and annual reports by all AIFM

Non-EU AIFM of non-EU AIF will not be forced to become subject to the Directive's pay regulation rules until Q1 2019 at the earliest. For them, the guidelines will not be directly relevant. Rather, they must look to the Level 2 Regulation which explains the disclosures about aggregate remuneration to be made to investors and EU regulators in the annual report of AIFs they market in the EU. The guidelines may nevertheless help to inform their approach to disclosure.

Such disclosures in annual reports must also be made by EU AIFMs.

In summary, the annual report for each relevant AIF will need to contain:

- a general statement on remuneration policy, approach to risk and management of conflicts of interest;
- the total amount of remuneration paid by the AIFM to its staff, including: (a) the split between fixed and variable; (b) number of recipients; and (c) carried interest, where relevant;
- of the above, the aggregate amount of remuneration attributable to "risk takers" and senior management respectively and the number of recipients in each category (noting that there is likely to be overlap between them); the final guidelines help to identify these people;
- these last two items must be broken down by AIF, where possible, with a description of how the allocation has been arrived at; and
- also by AIF: (a) the total remuneration of those staff of the AIFM fully or partly involved in the activities of the AIF, including the number of recipients; and (b) the proportion of the total remuneration of the staff of the AIFM attributable to the relevant AIF (to the extent this can be worked out), and the number of recipients.

Some AIFM may withhold some of this data if disclosure would otherwise breach applicable data protection laws.

The Directive requires that an annual report must be drawn up and audited within six months of the year end of the relevant AIF. We hope they will not need to be prepared for periods beginning before the Directive came into force. Assuming not, it may be some months before the first disclosures about remuneration need to be made.

Annual reports must be made available to relevant regulators and investors. Some information must be shared with staff. There is no requirement for public disclosure of remuneration.

Proportionality

Please refer to our Key Points above. ESMA suggests that particular remuneration principles can be disapplied only: "on an exceptional basis and taking into account specific facts...[and] if this is reconcilable with the risk profile, risk appetite and the strategy of the AIFM and the AIFs it manages and within the limits set by the...guidelines". In Annex II to the guidelines there is a table showing which principles can be disapplied. They are few, but they are amongst the most difficult. Each firm must be ready to explain to its regulator, if required, the rationale for every single requirement that is disapplied.

ESMA says that disapplication is to be on an "all or nothing" basis. For example, the requirement that at least 50% of the variable remuneration of certain staff must be paid in units in the fund can only be switched off in its entirety. Firms cannot decide, on grounds of proportionality, to pay a lower percentage in units.

ESMA has not elaborated on what will constitute grounds for the application of proportionality. This is where domestic implementation will be key.

In the particular context of whether or not a firm must establish a remuneration committee, ESMA does give a non-exhaustive list of criteria (see below). Firms and regulators may wish to refer to these criteria when assessing proportionality in other contexts but

they are not binding in other contexts and should not necessarily be used as a direct proxy.

Remuneration committee

ESMA acknowledges that, for some firms, it may be disproportionate to establish a remuneration committee. It gives a non-exhaustive list of factors to be taken into account, including (a) whether or not the AIFM is listed; (b) the legal structure of the AIFM; (c) the number of employees of the AIFM; (d) the AIFM's assets under management; (e) whether the AIFM is also a UCITS manager; and (f) whether or not the AIFM has obtained "top-up" permission to provide certain MiFID investment services.

In elaborating on the factor of size, ESMA gives examples of firms which may not need to establish a remuneration committee. They include AIFM with AUM not greater than €1.25bn and not more than 50 employees. However, even a firm which is larger than this may conclude that it would be disproportionate to establish a remuneration committee taking into account other factors.

ESMA acknowledges that AIFM which are part of banking, insurance or investment groups may look to a group remuneration committee external to the AIFM, provided that the rules governing its composition, role and functions are equivalent to those required by the guidelines.

Application only to Identified Staff or firm-wide

The table in Annex II to the guidelines gives guidance about which of the remuneration principles apply to all staff and which apply only to senior management, "risk takers" and employees whose remuneration takes them in to the same bracket as senior management and risk takers (known as "Identified Staff").

What is remuneration?

Payments by the AIF to the AIFM for the benefit of staff

ESMA has given new guidance on payments made by the AIF to the AIFM. For example, some firms route a portion of co-investment or carried interest through the AIFM, as opposed to it being distributed directly to individuals or through separate co-investment or carried interest vehicles.

The guidance provides that such payments should be treated as remuneration "whenever payments...are made directly by the AIF to the AIFM for the benefit of relevant categories of staff of the AIFM for professional services rendered, which may otherwise result in a circumvention of the relevant remuneration rules". Reimbursement of costs and expenses is disregarded. It is entirely unclear how the rules are to be applied to such payments. For example, must they be deferred before being received in the hands of the AIFM? Or only when onward distributed? What if the flows are mixed up in the AIFM with other separate income or profits? These questions will need to be explored with Member State regulators.

Co-investment funded by loan from the AIFM

ESMA provides that returns on co-investment funded by loan from the AIFM should be considered to be remuneration for the purposes of the rules and guidelines "if the loan has not been reimbursed by the time the return is paid". Whatever the policy merits of this stance, it makes it very difficult to assess whether, at the point co-investment is made, it should be subjected to the rules.

Owner-managers

ESMA has clarified that distributions received by partners of AIFM should not be treated as remuneration for the purposes of the rules and guidance unless "the material outcome of [such payments is] a circumvention of the relevant remuneration rules, any intention to circumvent such rules being irrelevant...".

The same principle should apply to dividends paid to owner-managers of AIFM not structured as partnerships but having similar characteristics.

Application of the remuneration principles to delegates of the AIFM

Please refer to our Key Points above.

In applying the new requirements concerning delegates, it will be important for firms to establish to whom the AIFM delegates "portfolio management or risk management". For example, in some structures, an AIFM may procure investment advice from an affiliate. This may not involve the delegation of either portfolio management or risk management activities.

Where delegation happens, if the delegate is an investment firm subject to the Capital Requirements Directive (for example a UK BIPRU limited licence investment manager), it is likely already to be subject to EU pay regulation (reflected in the UK in the current Remuneration Code). Other delegates (for example exempt-CAD firms) may soon be made subject to separate ESMA guidelines on remuneration practices – final guidelines are due to be published in Q2 2013. If those rules and guidelines are deemed to be

equivalent to the ESMA guidelines under AIFMD, this may mitigate any concerns.

Otherwise, the guidelines require contractual arrangements to cover any payments made to the delegates' "Identified Staff". That term is defined to include staff of the delegate "whose professional activities have a material impact on the risk profiles of the AIF that the AIFM manages". In some delegation arrangements, the role of the delegate will not be sufficiently important for any of the delegate's staff to fall into this category.

Staff in control functions, such as risk management, compliance or legal

The guidance on the pay of staff in control functions differs from the consultation proposals. Previously, the proposal was that variable remuneration of staff in control functions should not be determined by the financial performance of the business areas they monitor; the final guidelines now provide that such variable pay should not be determined "solely by AIFM-wide performance". This affords flexibility and seems to allow such staff to participate in carried interest arrangements, for example.

Payment in units

Where a proportion of variable remuneration must be paid in units, the draft guidelines had suggested that these should be units only of the AIF managed by the particular member of Identified Staff. The final guidelines are more liberal, in that they recommend that the units should relate "mainly" to the AIF managed by the individual. There is an odd caveat, though, that this should not lead to excessive concentration "facilitating an excessive risk-taking" by the individual. It is not clear what this means. It may be grounds to staff to participate more widely in the funds managed by the AIFM and not exclusively in funds managed by the individual.

Where an AIFM manages closed-ended funds or otherwise cannot award or transfer units in AIF to Identified Staff, it may award "equivalent ownership interests". There is no more guidance than there was in the earlier proposals as to what this means. Presumably it could therefore encompass "phantom" fund interests or shares in the AIFM or its parent undertaking, particularly where the AIFM or its parent has shares admitted to trading on a public market.

For further information on how we may be able to help you in respect of these issues and other AIFMD questions please contact one of the following partners in our Financial Services and Markets Department or your usual contact at Travers Smith.

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