

## *Financial Services and Markets*

### *AIFM Directive – FCA consultation on amendments to the AIFM Remuneration Code and draft guidance on proportionality*

On 6 September 2013, the UK Financial Conduct Authority published for consultation draft amendments to its AIFM Remuneration Code and draft supplementary guidance addressing the circumstances in which it would be disproportionate for an authorised AIFM to have to comply with aspects of that code. It is extremely important that alternative asset managers and their trade associations respond to the consultation (which closes on 6 November 2013). Those firms which have already obtained authorised AIFM status, and those who intend to apply, should consider the application of the draft guidance to their businesses. Broadly, the guidance is helpful and it appears that the FCA has taken appropriate account of concerns raised by trade associations about numerous areas of uncertainty.

The proposals are contained in Chapter 14 (pages 50 to 55) and Appendices 14A and 14B (pages 152 to 174) of FCA CP13/9 Quarterly Consultation No. 2, available [here](#).

You can find our earlier client briefing notes on the remuneration aspects of AIFMD [here](#) and [here](#).

#### **Background**

The current AIFM Remuneration Code is set out in SYSC 19B of the FCA Handbook, available [here](#).

There are certain high level rules about the governance of remuneration, and about the alignment of staff incentives with sound and effective risk management and appropriate risk taking. There are also rules restricting the use of golden hellos and retention bonuses. However, most importantly, there are also prescriptive and onerous rules about the structure of pay of certain senior staff and risk takers ("Code Staff"). In summary, those rules require:

- at least 40% (and in some cases 60%) of variable remuneration to be deferred over a period of at least three years;
- at least 50% of variable remuneration (both the deferred and undeferred elements) to be paid in units in a relevant fund; and
- these entitlements to be subject to adjustment for inappropriate risk taking or poor performance (before vesting "malus", and after-vesting "claw-back").

For the purposes of the draft guidance statement, these prescriptive rules are referred to as "Pay-out Process Rules".

European Securities and Markets Authority [guidelines](#) on remuneration policies under the Directive acknowledged that firms could choose not to comply with some or all of the Pay-out Process Rules where it would be disproportionate to do so in light of the nature, scale and complexity of their activities. However, they did not provide any yardstick against which to measure proportionality.

The principal purpose of the FCA's consultation proposals, therefore, is to provide guidance on that concept for UK authorised AIFMs.

#### **Draft amendments to the AIFM Remuneration Code**

The FCA proposes that the deferred element of variable remuneration should be 60% (as opposed to 40%) where an individual receives variable remuneration of £500,000 or more.

The FCA also proposes a *de minimis* rule: where an individual receives total remuneration of no more than £500,000 **and** where that person's variable remuneration is no more than 33% of their total remuneration, there should be a presumption that it would be disproportionate to apply the Pay-out Process Rules to that individual, even if the firm is large or complex.

## Draft guidance on the AIFM Remuneration Code

The FCA proposes to give eighteen pages of guidance on the application of the AIFM Remuneration Code. Most of the guidance centres on the concept of proportionality.

### **Proportionality**

In summary, the FCA proposes a two-stage test to determine whether it is proportionate or disproportionate for a particular firm to comply with the AIFM Remuneration Code.

The first stage test is to consider whether the firm is small or large, by reference to its total AIF assets under management, measured on the basis of net asset value.

Where an AIFM manages at least one AIF which is leveraged for Directive purposes, the FCA proposes to say that it will be appropriate for a firm to disapply the Pay-out Process Rules if its net AuM is less than a prescribed threshold, to be set somewhere in the range between £500 million and £1.5 billion. Where, precisely, that threshold should be set is open to consultation. This is a key point on which firms and trade associations will wish to respond.

Where an AIFM manages AIFs that are all unleveraged and investors have no redemption rights exercisable during the first five years (for example where they are all typical closed-ended private equity funds), then the FCA proposes to say that it will be appropriate for a firm to disapply the Pay-out Process Rules if its net AuM is less than a threshold set somewhere in the range £4 billion to £6 billion (again, this is open for consultation).

The draft guidance does not address what threshold is to be used by an AIFM of open-ended but unleveraged AIFs and this is a point which is likely to be raised in responses to consultation.

There is to be a presumption that a firm need not apply the Pay-out Process Rules to any member of staff if its AuM is below the prescribed threshold, and a presumption that it should apply those rules to all Code Staff (other than those staff subject to the de minimis rule) if its AuM is above the relevant threshold. That presumption may be rebutted by reference to the second stage test.

The second stage test requires the firm to consider a number of other proportionality elements against the characteristics of the firm in terms of its size, internal organisation and the scale and complexity of its activities. Such factors include:

- the number of staff;
- whether the AIFM is listed or traded or owned substantially by its partners;
- the number of investment strategies and styles employed and the number of AIFs;
- whether or not there are strict risk management constraints;
- the level of risk which is run (including by reference to the FCA's conduct and prudential supervisory risk categories C1-C4 and P1-P4);
- the nature and extent of any delegation by the AIFM; and
- the nature of certain fee structures such as performance fees or carried interest.

In particular, the FCA acknowledges that where a firm employs a carried interest model which is agreed with investors and which aligns interests over the long term with investors, this may be an important factor in the proportionality assessment, because the carry scheme may already satisfy the policy objectives behind the rules.

The FCA gives seven illustrative examples of how firms might apply the two-stage test.

### **Other matters addressed in the draft guidance**

There is also helpful guidance on:

- how to apply the remuneration rules to delegates of the AIFM;
- how to stream remuneration received by staff of an AIFM who spend part but not all of their time on AIF-related activities;
- how to treat distributions of profit to partners of AIFMs structured as limited liability partnerships;
- how to avoid dry tax charges on profits of LLPs allocated but deferred (subject to changes being made in parallel to tax legislation);
- how to satisfy the requirement to pay a proportion of variable remuneration in units where, for example, the relevant AIF is closed-ended and there are no further units to allocate, or securities marketing laws inhibit their offering to staff; and
- retention periods in relation to units so awarded.

As mentioned above, consultation closes on 6 November 2013.

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