

## *Financial Services and Markets*

### *Fundamental change for the fund industry: AIFMD Remuneration Consultation*

On 28 June 2012, the European Securities and Markets Authority published a consultation paper "Guidelines on sound remuneration policies under the AIFMD". The AIFM Directive will regulate the pay of certain staff of alternative investment fund managers. The Directive provisions were based on EU laws developed for banks and investment banks, with minimal adaptation to the very different incentive arrangements used in the alternative funds industry. ESMA's guidelines will set out the detailed remuneration requirements. Firms planning for AIFMD implementation should read the guidelines to assess their likely impact. It will be important for firms and trade associations to respond to the consultation, which is the last chance to lobby ESMA on the AIFMD remuneration requirements. Firms may welcome some of the provisions in the draft that allow for tailoring and flexibility, but be disappointed by ambiguities which remain.

In our earlier client briefing note, available [here](#), we summarised (on page 12) the relevant provisions of the "Level 1" framework Directive (Article 13 and Annex II – see [here](#)). In this briefing note, we give our initial assessment of the proposed ESMA guidelines, and comment on some of the more controversial points.

The consultation paper is available [here](#). The consultation is open until 27 September 2012.

#### **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 guidelines outline some of the factors relevant to an assessment of proportionality. ESMA clarifies that all of the Directive's principles on pay are capable of adaptation on grounds of proportionality. Some AIFM may welcome the flexibility which ESMA appears to afford them. Others are likely to call for further clarity on how to apply proportionality in practice.
- *Carried Interest:* ESMA seems to look favourably on carried interest models used by private equity (at least on "whole fund" models used traditionally in Europe), but certain key questions on application remain unanswered.
- *MiFID Firms:* ESMA uses this paper to draw attention to a separate exercise, which it will conduct later this year to develop guidelines on pay regulation applicable to all MiFID firms. This will include "exempt-CAD" or "adviser-arranger" firms currently outside the scope of the UK Remuneration Code.

#### **Significance of the ESMA guidelines**

The UK will implement the AIFMD remuneration requirements through changes to its rules, most likely by extending the existing Remuneration Code. Those rules must comply with the final ESMA Guidelines. Unsurprisingly, the draft guidelines follow closely the guidance published by the European Banking Authority (ESMA's sister organisation) in relation to pay regulation under the Capital Requirements Directive. So those firms already subject to the FSA's Remuneration Code (including all UK hedge fund managers, most debt fund managers and a handful of private equity firms) will find many of the concepts familiar.

## Application to non-EU AIFM of non-EU AIF: Disclosure

Non-EU AIFM of non-EU AIF will not be forced to become subject to the Directive's restrictions on permitted remuneration structures until January 2019 at the earliest. For them, many of the guidelines will therefore not be immediately relevant. For more detail on offshore structures, please refer to our earlier briefing note [here](#). From 22 July 2013, if non-EU AIFM of non-EU AIF market units to professional investors in the EU, they will be obliged to make certain disclosures to prospective investors and regulators in each EU Member State into which they market. The precise content of these disclosures is yet to be specified (the European Commission is expected to publish "Level 2" implementing measures in August 2012). It is likely that the disclosures will need to include data on the aggregate remuneration (as defined in the guidelines) paid to all AIFM staff, and to the categories of "senior managers" and "risk takers" (as defined in the guidelines), as well as the number of staff in each category. This will be a new and unwelcome development for many firms. It is possible that regulators might allow information to be withheld where disclosure would be in breach of relevant data protection laws.

The remainder of the issues discussed in this briefing note are principally relevant to EU AIFM of EU AIF and/or non-EU AIF.

## Proportionality

ESMA makes clear that the effect of the proportionality principle is that, while (generally speaking) all AIFM will be subject to the remuneration requirements of the Directive, not all of them will have to comply with those requirements in the same way and to the same extent (para 35). It also makes clear that each and every aspect of Directive pay regulation is capable of adaptation on grounds of proportionality.

Whilst on the face of it this provides a welcome degree of flexibility, it may also result in uncertainty. Some AIFM will be unsure as to whether they have designed their policies within acceptable parameters, and whether they may always be at the mercy of a supervisor second-guessing them and taking a narrower view of what is proportionate. Unless ESMA provides more specific (and possibly more prescriptive) guidance as a result of consultation responses, it may be left to domestic supervisory authorities, such as the FSA, to fill in the gaps.

The freedom to adopt the proportionality principle also comes at a price: if firms deem that a "tailored application" of the remuneration requirements is appropriate, they must be "able to explain the rationale". In practice, this will mean that they will have to prepare a written justification for any flexible application of the Directive provisions on a rule-by-rule basis (para 36). This is more burdensome than the FSA's Remuneration Code requires.

ESMA gives examples of the grounds upon which proportionality might operate as regards the different types and characteristics of AIFM (para 41). These are high-level and not particularly sophisticated (e.g. size, internal organisation and nature, scope and complexity of activities). Respondents may wish to offer up other and more detailed criteria, such as the markets and instruments in which the AIFM deals on behalf of the AIF and with what frequency, and the extent to which decisions are made by committee. Similarly, ESMA's examples of the elements that might be taken into account in applying the proportionality principle to different categories of staff could be more detailed.

## Which staff?

### *Identified Staff*

The remuneration provisions of the Directive are expressed to apply to senior management, "risk takers" and employees whose remuneration takes them into the same bracket as senior management and risk takers. ESMA refers to these people as "Identified Staff" (which broadly equates to the "Code Staff" label used in the FSA's current Remuneration Code).

ESMA underlines that individuals must only be included in this category if their functions have a material impact on the AIFM's risk profile (or, presumably, the risk profile of the AIF they manage) (para 31). It is helpful that ESMA confirms that this is the threshold question.

Predictably, ESMA proposes to include in this category senior managers of the AIFM, portfolio managers and members of investment committees which decide on the composition of the AIF's portfolio. More controversially, ESMA proposes also to include staff in "control" departments such as risk, compliance and internal audit (apparently not limited to the heads of those departments, as is the case under the FSA Remuneration Code), and the heads of administration, marketing and human resources functions (unless in each case they can be shown not have a material impact on risk) (para 31). While the material impact on risk threshold is to be the determining factor, it does mean that the Identified Staff list may (at the outset at least) be much longer than one might imagine.

### *Restrictions for all staff*

ESMA proposes that restrictions on golden hellos and other guaranteed bonuses should apply to all staff of the AIFM (not only "Identified Staff"). The same is true of the firm's overarching remuneration policy and a limited number of other more detailed provisions. This is consistent with the position under the FSA's Remuneration Code.

Without any preamble or commentary, ESMA asks whether pay regulation should be extended outside the AIFM to staff of delegates of the AIFM (Q5) even though it acknowledges that the provisions of the Directive itself "seem" to limit the scope of the

remuneration principles to payments to AIFM staff. Equally oddly, ESMA asks whether payments made by the AIF to the AIFM, such as performance fees, should be treated as remuneration for the purposes of the Directive (Q6) (i.e. even if not distributed to staff). Both proposals will be very controversial, have no basis in the Level 1 text, and will be hotly contested.

## Governance in relation to remuneration

### *Non-executive involvement*

In the context of governance, the Directive provides that the remuneration policy must include measures to avoid conflicts of interest. It also sets out requirements as to the role of the management body in the design, adoption and periodic review of the policy and for the policy to be subject to a "central and independent internal review" at least annually.

The design, approval and oversight of the remuneration policy is the responsibility of the management body "in its supervisory function". That body should include non-executive members who collectively "have sufficient knowledge of remuneration policies and structures", although this is not further explained. The remuneration policy should not primarily be controlled by executive members of the supervisory function. In its draft guidance and commentary, ESMA stresses the importance of non-executive members in the process. Many alternative asset management firms do not have non-executives. Whilst the guidance is subject to the application of the proportionality principle (see above) ESMA does not specifically address how this might apply in this context.

In terms of management remuneration, ESMA provides that, *where appropriate depending on the size and complexity of the AIFM*, the management function should not determine its own remuneration and the supervisory function should instead determine and oversee such remuneration. ESMA also notes that, for AIFM which have a separate supervisory function, it may be more appropriate for members of the supervisory function to be compensated by fixed remuneration only.

### *Annual review*

The remuneration policy must be subject to a central and independent review at least on an annual basis; amongst other things, ESMA says, that review should assess whether the overall remuneration system is compliant with national and international regulations, principles and standards. This incorporation by reference of the panoply of disparate international regulations and standards threatens to make the AIFM's compliance task even harder, if not impossible. The purpose of the guidelines should be to clarify, not to bewilder. The object of compliance should be to comply with AIFMD (and its associated measures) not to have to be aware of, and comply with, all national and international measures on the subject of remuneration.

### *Remuneration Committee*

Whether the AIFM must have a remuneration committee (RemCo) will depend upon whether it is significant in terms of its size, or of the size of the AIFs it manages, internal organisation and the nature, scope and complexity of its activities. Helpfully (if somewhat self-evidently) ESMA states in the consultation paper that it follows that AIFM which are not significant are not required to set up a RemCo; slightly less helpfully, it goes on to say that even for these AIFM it can be considered good practice to do so and this is reflected in paragraph 47 of the draft guidelines. ESMA only goes so far as to say that AIFM with Euros 250 m or less do not need to establish a RemCo; neither do AIFM which are subsidiaries of credit institutions required to set up a RemCo which operates on a group basis. It calls for respondents to provide additional examples.

In terms of composition, the RemCo (if required) should comprise members of the supervisory function who do not perform executive function and the chairperson should be an independent, non-executive member. An "appropriate number" of RemCo members should have sufficient expertise and professional experience with regards to the mechanism for aligning the remuneration structure to the AIFM's risk and capital profiles.

AIFM must ensure that there is an active participation of control functions (i.e. the risk management, compliance and internal audit functions) in the design, oversight and review of the remuneration policies for other business areas (i.e. not their own).

## Co-investment

The Level 1 text provides that "remuneration" does not include "any share in the profits of the AIF which accrue to the AIFM as a return on any investment by the AIFM into the AIF". In fact, it is relatively unusual for an AIFM to invest in its AIF but, in our view, the specific provision ought to illustrate the general principle that a return on investment is not remuneration. ESMA does not quite follow this principle. Instead, ESMA suggests that only a "pro-rata" return on investment should be left out of account (para 20). It is not clear what this means but presumably it must mean a return which is equivalent to the return enjoyed by a third party investor on arm's length terms.

ESMA also takes the view that, if co-investment is funded by a loan from the AIFM, returns on that investment will be considered to be remuneration (even if "pro rata") "if the loan has not been reimbursed by the staff member by the time the return is paid". Firms may object to the policy but, whether or not the policy is right, the time of assessment will need to be changed so that it is possible to establish at the outset whether a loan-funded commitment is co-investment or remuneration.

## Carried interest

The Level 1 text contains a definition of "carried interest" which is arguably deficient (in that it does not describe accurately industry-accepted carried interest models). Nevertheless, it has long been the clear policy intent that carried interest should be treated as remuneration for the narrow purposes of the Directive.

ESMA appears to approve of some carried interest models (para 191 *et seq*). The draft guidelines appear to contemplate that some such models could go much of the way towards satisfying the Directive rules requiring that, of the variable remuneration of Identified Staff: (a) 40% is deferred over three to five years; and (b) 60% is paid in units of the AIF. This partially allays fears that distributions from carried interest structures might need to be further deferred.

However, ESMA's paper could be read to support only the "whole-of-fund" carried interest model commonly used in Europe, and not also "deal-by-deal" arrangements which have traditionally been used in the United States. Respondents may argue that at least some "modified" "deal-by-deal" structures exhibit features of risk alignment and deferral which should lead to the same policy outcome.

Respondents are likely to point out that ESMA's description of a "whole-fund" carried interest model is not perfect. First, it appears to contemplate that AIFM staff who participate must receive "no compensation" at all until the hurdle is achieved. This is unrealistic, since they will of course receive salary and bonus (or equivalents) in the earlier years of the life of the fund. Second, it does not contemplate that staff may receive a distribution before the hurdle in tightly controlled circumstances, for example to pay tax bills as they fall due, which distributions may not be subject to claw-back.

It is unclear whether, if an AIFM employs an "approved" carried interest model, ESMA considers that to satisfy the Directive requirements in relation to the whole of the firm's incentive arrangements for Identified Staff. There remains a risk that other elements of variable incentive, such as annual bonuses, might need to be deferred and/or paid partly in units, even where carried interest is designed to provide the overwhelmingly important element of incentive.

## Payment in units

ESMA recognises that it may be difficult to pay a proportion of variable pay in units in the AIF in some cases, for example in the case of a closed-end AIF or an open-ended AIF with infrequent redemption periods where units are not traded on a market. In these cases ESMA suggests that alternative instruments may be used which reflect the AIF's value and have the same effect as payment in units (para 165). ESMA does not elaborate on this concept and it is not clear whether it refers to derivatives or phantom investments.

## More pay regulation to come

In the consultation paper, ESMA emphasises that it will be conducting a further and separate exercise later in 2012 to develop remuneration guidelines for all firms subject to the Markets in Financial Instruments Directive (as an elaboration on MiFID rules relating to organisational requirements and conduct of business). Those separate guidelines could come to apply to "exempt-CAD firms", which arrange transactions and give advice to AIFM or other investment managers, which are currently outside the scope of the FSA's Remuneration Code and will remain outside the scope of the AIFM pay regulation provisions.

Apart from this it should be noted that the political mood, in some quarters at least, may be hardening in relation to remuneration: the most recent indication of this was seen in the published media reports of proposals in the CRD IV negotiations that banks and investment banks should be subject to a "hard-wired" cap on the ratio of variable to fixed remuneration, and this might be as stringent as 1:1 (although there have been suggestions that politicians may be gravitating away from this and there is still a long way to go). Whilst it would require primary legislation to amend the Directive to allow for anything quite so quantitative and dogmatic in the sphere of alternative investment managers, the European political climate regarding remuneration should be a warning to firms to be careful about what they wish for if they seek more clarity and possibly more prescription from ESMA.

## What is not covered

ESMA does not address some aspects of pay regulation which have proved problematic in the context of the FSA's Remuneration Code. Such issues include:

- the timetable according to which AIFM will need to comply with pay regulation if (as in most cases) their incentive year end does not correspond to the date upon which the Directive comes to affect them; and
- how to treat the remuneration of Identified Staff received otherwise than from the AIFM, and otherwise than in respect of functions performed in relation to the AIFM, but rather from and in relation to affiliates.

For further information on how we can help you prepare for the AIFM Directive, 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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