

MEMO# 26323

July 23, 2012

Remuneration: ESMA Consultation Paper on Remuneration Guidelines Under the AIFMD and UCITS V

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TO: ICI GLOBAL MEMBERS

INTERNATIONAL COMMITTEE No. 26-12 RE: REMUNERATION: ESMA CONSULTATION PAPER ON REMUNERATION GUIDELINES UNDER THE AIFMD AND UCITS V

On June 28, 2012, the European Securities and Markets Authority (“ESMA”) issued a consultation paper with proposed guidelines for remuneration policies under the Alternative Investment Fund Managers Directive (“AIFMD”). [\[1\]](#) Comments are due by September 27, 2012. The guidelines will enter into force on July 22, 2013. [\[2\]](#)

Article 13 of the AIFMD requires ESMA to issue guidelines on sound remuneration policies consistent with Annex II of the AIFMD and taking account of the remuneration recommendations of the European Commission (“EC”), [\[3\]](#) the size of managers and the size of funds managed, managers’ internal organization and the nature, scope and complexity of their activities. The guidelines are intended to be consistent with other European remuneration standards for financial institutions as well as the G20 commitments on remuneration set forth in the Financial Stability Board’s Principles for Sound Compensation Practices and Implementation Standards. [\[4\]](#)

On July 3, 2012, the European Commission issued a proposal for amendments (“UCITS V”) to Directive 2009/65/EC related to undertakings for collective investment (“UCITS”). The proposed amendments include new remuneration provisions that are nearly identical to the remuneration provisions of the AIFMD. The EC states that the proposed articles reflect current policy on remuneration of senior management, risk takers and those who exercise control functions. The provisions are intended to apply to those that manage UCITS whether in the form of an investment company or management company. [\[5\]](#)

As additional context for considering these European developments, regulators in the United States proposed rules in March 2011 relating to incentive-based compensation practices at certain financial institutions, including investment advisers. No final U.S. rules have been adopted to date. The U.S. proposal (1) prohibits incentive compensation arrangements that encourage inappropriate risks; (2) requires “covered financial

institutions” to make annual non-public reports to primary regulators describing their incentive-based compensation arrangements; and (3) requires institutions to implement policies and procedures. “Covered financial institutions” include broker-dealers and investment advisers with more than \$1 billion in total consolidated assets. Additional requirements apply to larger institutions with total consolidated assets of \$50 billion or more. For investment advisers, the U.S. proposal states that asset size is not to be determined by assets under management but rather by the adviser’s total assets as shown on the balance sheet for the adviser’s most recent fiscal year end. [\[6\]](#)

Remuneration Provisions of the AIFMD

Article 13 of the AIFMD requires Member States to have remuneration policies for certain categories of staff whose activities have a material impact on the risk profiles of alternative investment fund managers (“AIFMs”) or of the alternative investment funds (“AIF”) managed by the manager.

Article 22 of the AIFMD requires specific disclosure regarding remuneration in an AIFM’s annual report (e.g., total annual remuneration, split into fixed and variable, and aggregate remuneration broken down by certain senior staff). Annex II sets forth further detail regarding remuneration policies (e.g., portions of variable remuneration that must be AIF shares or equivalent interests, minimum deferral periods, conditions for performance remuneration, periodic and annual review provisions, and oversight responsibilities).

ESMA’s Proposed AIFMD Remuneration Guidelines

Generally, ESMA states that remuneration policies and practices will apply on an AIFM-wide basis but that some specific requirements only will apply in the context of certain senior staff. Remuneration refers to all forms of payment paid by the AIFM or the AIF, including carried interest or any transfer of AIF shares, in exchange for professional services by AIFM staff. ESMA seeks comment on whether payments made by an AIF (e.g., performance fees) to the AIFM should be payments made to benefit relevant categories of staff and therefore subject to the guidelines (Question 6).

Consistent with the EC Remuneration Recommendation, the AIFMD remuneration principles do not apply to commissions or fees paid to intermediaries and external service providers. [\[7\]](#) ESMA seeks comment on whether the principles should apply to payments to external service providers, including payments to delegated investment managers (Questions 4 and 5). Such an approach, i.e., to apply the remuneration requirements to service providers or investment managers providing investment advice through delegation arrangements, would have a substantial impact.

On third country AIFM, ESMA states that as long as national private placement regimes remain in place, non-EU AIFMs without passports will not be subject to the AIFMD remuneration requirements in Article 13 and Annex II but will be subject to the disclosure requirements (Article 22). ESMA states that Member States may apply remuneration requirements to non-EU AIFMs.

The principles and guidelines apply to:

- external managers or,
- where the legal form of an AIF permits an internal manager and where the AIF’s

governing body has not appointed an external AIFM, the AIF itself.

ESMA states that an AIF itself - i.e., not internally managed and with an external manager - is not subject to the principles or guidelines but the principles in the EC Remuneration Recommendation are relevant. [\[8\]](#)

AIFMs providing individual portfolio management and non-core services are subject to MiFID remuneration policies. [\[9\]](#) AIFMs not providing such services are subject only to the AIFMD remuneration guidelines. Nevertheless, ESMA is seeking to align the AIFMD guidelines with the MiFID guidelines. [\[10\]](#)

Identified Staff

ESMA seeks comment on the categories and descriptions of “Identified Staff” (Question 7). ESMA states that unless shown to have no material impact on the manager’s risk profile, the following staff categories (not an exclusive list) must be included as staff whose professional activities have a material impact on the risk profile of the manager or the funds they manage (“Identified Staff”):

1. AIFM governing members. Members of the governing body or management body of the AIFM, depending on the legal structure, meaning those components of the governance structure with ultimate jurisdiction and power of direction, e.g., the board of directors or an equivalent body. The governing or management body is distinct from senior management, whom it directs, but some or all members of senior management may comprise this body which may also contain nonexecutive members.
2. Senior management. The person(s) effectively conducting the business of the AIFM
3. Control function staff. Staff in control functions (other than senior management) responsible for risk management, compliance, internal audit and similar functions within an AIFM.
4. Senior management of other important operating functions. Staff responsible for heading portfolio management, administration, marketing and human resources. These staff members will have remuneration requirements that are specific to their category of staff.
5. Other risk takers. Staff members, whose professional activities, either individually or collectively as members of a group, can exert material influence on the AIFM’s risk profile or on an AIF it manages, including persons capable of entering into contracts/positions and taking decisions that materially affect the risk positions of the AIFM or of an AIF it manages (e.g., sales persons, individual traders and specific trading desks). Such staff can include those that do not earn high remuneration but could have a material impact on the AIFM or AIF.

Proportionality

ESMA states that a proportionality principle permits the appropriate matching of remuneration policies with the risk profile of the AIFM and the AIF managed. [\[11\]](#) ESMA states that the proportionality principle permits AIFM to give substance to the remuneration requirements differently; however, an AIFM must be able to explain the basis for tailoring and offers the following examples of requirements that may be tailored:

1. Pay-out process requirements, meaning some managers either for their Identified Staff or categories within their Identified Staff can tailor requirements for variable remuneration in shares, retention, deferral and ex-post risk adjustment.
2. Remuneration requirements for management and supervisory functions and the annual implementation review.

3. The requirement to have a fully flexible policy on variable remuneration.

ESMA states that different characteristics among AIFM justify proportionate implementation (e.g. size, nature, scope and complexity of activities, internal organization). In addition, ESMA states that the proportionality principle also operates within an AIFM and its staff (e.g., size of obligations entered into by risk taker, size of staff group, remuneration structure).

ESMA seek comment on the clarifications that it believes that it has proposed for the application of the proportionality principle based on different criteria (e.g., size internal organization and nature, scope and complexity of activities) (Question 9) as well for application to different categories of AIFM staff (Question 10).

AIFMs and Groups

ESMA states there is no exception to the remuneration principles for entities that are part of a group. [\[12\]](#) ESMA also recognizes that in some cases a manager may already be subject to other remuneration requirements as a result of being part of a group, e.g., principles in the Capital Requirements Directive for credit institutions and subsidiaries. ESMA states that the AIFMD requirements and the proposed guidelines are intended to be equivalent to those imposed on financial groups through other European legislation.

ESMA seeks comment on its intent to maintain a consistent approach on the application of the provisions to AIFMs that are members of a group (i.e., proposed alignment with CRD provisions) (Questions 12 and 13).

Financial Status of AIFM

The AIFMD includes requirements to mitigate risks to the sound financial situation of a manager, including capital. There must be a prudent balance between a sound financial situation and variable remuneration. [\[13\]](#)

Governance and Shareholders

The AIFMD includes governance principles, including related to avoiding conflicts and responsibilities for oversight and review of remuneration policies and procedures. ESMA states that the management or governing body of the AIFM, which is typically the board in a corporation, is understood as the governance component with ultimate jurisdiction and power of direction. The governing body is distinct from senior management although some members of senior management may comprise the governing body. ESMA states that the governing body should include non-executive members. [\[14\]](#)

This body in its supervisory function (i.e. [\[15\]](#) The remuneration policy is also expected to encourage alignment of the risks taken by staff with those of the AIF and the AIF investors. [\[16\]](#)

Remuneration of the members of the management body or supervisory function should be consistent with tasks and powers. When possible, the members of the management body should not determine their own remuneration rather the supervisory function should determine this remuneration. For managers with a separate supervisory function it may be more appropriate for members of the supervisory function to be compensated on a fixed basis. Incentive based compensation would need to be strictly tailored. ESMA seeks comment on its proposed approaches for remuneration of members of management and those within the supervisory function (Question 17). [\[17\]](#)

ESMA states that the remuneration policy and decisions relating to the remuneration of management body members may be reviewed at an AIFM shareholder meeting. Any shareholder vote may be either consultative or binding. The supervisory function would be responsible for proposals submitted at a shareholder meeting as well as for implementation and oversight of any changes. ESMA seeks comment on its proposal for shareholder involvement (Question 18). [\[18\]](#)

The supervisory function is expected to review the implementation of the remuneration policy annually. The review is contemplated to be an overall review with the involvement of internal control functions and key supervisory function committees. Reviews by external service providers is permissible subject to certain conditions; however the supervisory function remains ultimately responsible for the review and ensuring a follow-up on any results. [\[19\]](#)

Remuneration Committee [\[20\]](#)

The AIFMD requires a remuneration committee for certain AIFM, i.e., those of significant size or size of AIFs managed by the AIFM and the nature, scope and complexity of activities. Other AIFM may set up a remuneration committee as a good practice

The proportionality principle factors should be used to evaluate the need to establish a remuneration committee. For “significance,” the presence of three factors – (1) size; (2) internal organization; and (3) nature, scope and complexity of activities – should be considered. For example, a manager of significant size but not significant organization or nature, scope or complexity of activities would not need a remuneration committee. Other examples of AIFM not needing a remuneration committee include (but are not limited to): AIFMs with AIF assets not exceeding EUR 250 million or AIFM that are subsidiaries of credit institutions that have a remuneration committee for the whole group. ESMA seeks comment on its approach for when a remuneration committee is required as well as whether more examples would be helpful (Questions 19-22).

To operate independently, a remuneration committee should be members of the supervisory function who are not executives and at least a majority should be independent. The chair of the remuneration committee should be independent and a non-executive. The chief executive of the manager should not participate in meetings regarding his or her compensation.

The role of the remuneration committee is generally to prepare recommendations for the supervisory function and to provide support, review and oversight for the design and operation of the remuneration policy. The remuneration committee needs unfettered access to relevant data and information and to collaborate with other relevant persons and groups.

Control Functions [\[21\]](#)

Control functions are expected to actively participate in the design, ongoing oversight and review of remuneration policies. The risk management function should assess how variable remuneration structures affect the risk profile of the AIFM and the compliance function should similarly assess how remuneration structure impacts compliance with legal requirements and internal policies.

Remuneration of control function staff should enable the manager to hire qualified, experienced persons. If these staff receive variable remuneration, the remuneration structure should not compromise their independence or create conflicts (e.g., not

determined by the performance of the business unit they monitor). If the AIFM is required to have a remuneration committee, remuneration of senior control function staff should not be left solely to the supervisory function but overseen by the remuneration committee. If there is no remuneration committee, the remuneration of these staff should be overseen by the management body or, if that does not exist, the person(s) in charge of the management body.

General Requirement - Risk Alignment [22]

Generally, risk alignment refers to aligning remuneration with prudent risk taking and the interests of the manager and the AIFs and their investors. ESMA states that variable remuneration may encourage staff to take undesirable risks to increase profits and variable remuneration. Connecting risk management to remuneration can mitigate these dangers.

The remuneration policy should cover all aspects of remuneration, including discretionary pension benefits. This means the pension policy should be aligned with the long-term interests of the manager and its AIF. For discretionary pension benefits (as part of variable remuneration), staff should not retire or leave with vested benefits without consideration of the AIF managed or the risks taken by the staff in the long term. Consequently, ESMA states to align this type of pension benefit with the economic situation of the AIFs, discretionary pension benefits, where permitted by pension laws, should be paid in AIF units or shares or equivalent instruments. Further for retirement, vested discretionary pension benefits should be subject to a 5 year retention period. If a person is terminated and leaves before retirement, the discretionary pension benefit should not be vested before 5 years and should be subject to a performance assessment and ex post risk adjustment before being paid out. ESMA seeks comment on the approach to discretionary pension benefits (Question 30).

General Prohibitions [23]

ESMA provides additional description regarding certain prohibitions in the AIFMD:

- Severance pay. Payments for early termination must not reward failure. Arrangements should include mechanisms that provide for performance and risk adjustments while also remaining consistent with the purpose of a safety net in the case of an early termination.
- Personal hedging. Effective risk alignment is undermined if staff can transfer downside risks through hedging or insurance. The prohibition on such personal hedging should apply to variable remuneration (deferred and retained) and there should be policies to ensure compliance.

Risk Alignment and Risk Measurement [24]

ESMA expects a fully flexible policy on variable remuneration, meaning pay will decrease when there is negative performance. ESMA expects managers to take into account all risks, whether on or off balance sheets, and differentiate among risks affecting the AIF, the manager, business units and individuals. For fixed remuneration, it means compensation must be sufficiently high to attract and retain expertise and relevant skills but there is no set number.

In describing risk alignment in the context of variable remuneration, ESMA describes a performance and risk measurement process, an award process and a payout process. Incentives to take risks must be constrained by incentives to manage risk. ESMA also describes common requirements within the risk alignment process including time horizon (e.g., appropriate to the life cycle of the AIF), levels of measurement (e.g., links to risk and

performance of AIF, the business unit and the AIFM), quantitative and qualitative measures (e.g., mix of approaches) and judgmental measures subject to controls to limit the inherent risks of judgmental inputs. ESMA identifies acceptable quantitative measures such as the internal rate of return, earnings before interest, taxes, depreciation and amortization, assets raised, the alpha ratio and the Sharpe ratio. Qualitative factors include achievement of strategic targets, investor satisfaction, adherence to risk policy, leadership or creativity. Non-compliant behavior should lower variable pay. ESMA seeks comment on the criteria (Question 37).

ESMA provides significant detail regarding the development of performance measurement. ESMA describes the qualitative and quantitative measures as well as relative/absolute and internal/external measures. ESMA also provides detail on the award process, including the establishment and allocation of pools and risk adjustment in the award process. ESMA states that profitability of a manager should be based on net revenue but exclude costs such as IT, research costs, legal, marketing and costs for outsourced activities. On the payout process, ESMA describes features of appropriate deferral arrangements, including time horizons, vesting and accrual as well as cash versus non-cash. ESMA also addresses a retention policy and the need to explain how that relates to other risk alignment measures and how it relates to instruments paid upfront and deferred instruments.

On the AIFMD requirement that at least 50% of any variable remuneration consist of equity-like instruments, ESMA states that if the management for the AIFs accounts for less than 50% of the total portfolio managed by the manager than the 50% does not apply. The 50% applies to both a deferred and non-deferred component. ESMA provides more detailed examples in the Paper.

ESMA also describes the requirement for ex post risk adjustments or malus and clawbacks. These should be performance related and need to be sufficiently tied to the individual. ESMA also states that adjustments need to be explicit not implicit (e.g., changes in net asset value). ESMA also states that retention periods are not a substitute for a longer deferral. ESMA also describes concerns with explicit risk adjustments that provide exposure to both a positive and negative outcome as such an arrangement provides staff with an incentive to take more risk than is prudent.

ESMA seeks comment on 15 questions regarding the specific requirements for risk alignment and measurement (Questions 34-48).

Disclosure [\[25\]](#)

ESMA describes the minimum disclosure requirement set out in the AIFMD. ESMA recognizes that the AIFMD directs disclosure to be included in the annual report but also states managers must consider the additional disclosure in the EC Remuneration Recommendation to the extent it is relevant. The disclosure under the EC Remuneration Recommendation may be done on a proportionate basis. For example small or non-complex managers would provide some qualitative information or basic quantitative information or some managers may not need to provide all the information. ESMA states that a manager should ensure the disclosure is clear and understandable. Also without prejudice to laws on confidentiality and data protection, managers should publicly disclose detailed information on remuneration policies for staff whose professional activities have a material impact on the risk profile of the AIFs managed by the manager. Managers also should provide general information about the basic features of their policies. Disclosure should be at least annual.

The disclosure report should describe the decision-making process to determine the pay for individuals to whom the policy applies, including governance, the role of stakeholders and the scope of the policy. There also should be a description of how pay and performance are linked.

On disclosure, ESMA seeks comment on the appropriateness of requiring similar internal and external disclosure and cost/benefit information (Questions 49 and 50).

For additional information, please contact Susan Olson (1-202-326-5813; solson@ici.org), Giles Swan (011-44-203-009-3101; giles.swan@ici.org) or Eva Mykolenko (1-202-326-5837; emykolenko@ici.org). A call with members will be scheduled in early August to discuss a comment letter.

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endnotes

[1] ESMA, Consultation Paper, Guidelines on Sound Remuneration Policies under the AIFMD, ESMA/2012/406, June 28, 2012 ("Paper") available at <http://www.esma.europa.eu/system/files/2012-406.pdf>. The text of the AIFMD is available at <http://eur-lex.europa.eu/LexUriServ/LexUriServ.do?uri=OJ:L:2011:174:0001:0073:EN:PDF>.

[2] Paper at paragraph 34,

[3] See European Commission Recommendation 2009/384/EC, Remuneration Policies in the Financial Sector, April 30, 2009 ("EC Remuneration Recommendation") available at <http://eur-lex.europa.eu/LexUriServ/LexUriServ.do?uri=OJ:L:2009:120:0022:0027:EN:PDF>.

[4] Financial Stability Board ("FSB"), Principles for Sound Compensation Practices and Implementation Standards, September 25, 2009 available at http://www.financialstabilityboard.org/publications/r_090925c.pdf. See also FSB, Implementing the FSB Principles for Sound Compensation Practices and their Implementation Standards, Progress Report, June 13, 2012 available at http://www.financialstabilityboard.org/publications/r_120613.pdf and FSB, 2011 Thematic Review on Compensation, Peer Review Report, October 7, 2011 available at http://www.financialstabilityboard.org/publications/r_111011a.pdf.

[5] European Commission, COM(2012) 350/2, Proposal for a Directive of the European Parliament and of the Council amending Directive 2009/65/EC on the coordination of laws, regulations and administrative provisions relating to UCITS as regards depositary functions, remuneration policies and sanctions.

[6] Incentive-based Compensation Arrangements, Release No. 34-64140 (March, 29, 2011) available at <http://www.sec.gov/rules/proposed/2011/34-64140.pdf>. See also Letter from Karrie McMillan, General Counsel, Investment Company Institute, May 31, 2011 available at <http://www.ici.org/pdf/25232.pdf>.

[7] Paper at paragraph 25.

[8] Paper at paragraph 28.

[9] Paper at paragraph 29. Article 6(4) of the AIFMD provides that member States may authorize an external AIFM to provide certain services including management of portfolios of investments, investment advice, safekeeping and administration of fund shares.

[10] Paper at page 15.

[11] See generally Paper at pages 17-20.

[12] See Paper at paragraphs 44-47.

[13] See Paper at Section VII.

[14] Paper at paragraphs 54 and 55.

[15] Paper at paragraph 57.

[16] Paper at paragraph 56.

[17] Paper at Section VIII.I.B (page 24).

[18] Paper at Section VII.I.C (page 24).

[19] Paper at Section VIII.I.D (page 25)

[20] See generally Paper at Section VIII.II (pages 25-28).

[21] See generally Paper at Section VII.III (pages 28-30).

[22] See generally Paper at Section IX (pages 30-33).

[23] See generally Paper at Section IX.II (pages 32-33).

[24] See generally paper at Section X (pages 33-48).

[25] Paper at pages 49-52.