

ESMA Publishes Final AIFMD Remuneration Guidelines

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On 11 February 2013, the European Securities and Markets Authority (ESMA) published its final Guidelines on remuneration of alternative investment fund managers (AIFMs) under the Alternative Investment Fund Managers Directive (the Directive). The Guidelines, which clarify and expand on the remuneration requirements contained in the Directive, will apply to European Economic Area (EEA)-based managers of alternative investment funds (AIFs) including hedge funds, private equity funds and real estate funds.

The Guidelines must be implemented from 22 July 2013, subject to the Directive's transitional arrangements which will allow certain currently operating fund managers a one-year grace period in which to seek authorisation. Further, if the Directive's passporting arrangements are extended in mid-2015, non-EEA AIFMs who market funds to investors in the EEA under the passport will also be subject in full to the Guidelines.

In line with the trend among European financial markets regulators to push for a single rulebook across Europe, ESMA notes that the Guidelines were developed in cooperation with the European Banking Authority to ensure alignment of guidance on remuneration policies across financial sectors, particularly in relation to rules and requirements applicable to the banking industry under corresponding European legislation. As a result, many of the requirements contained in the Guidelines are similar or virtually identical to those imposed on banks and large investment firms, to the frustration of many in the funds industry.

Internal governance and remuneration

Under the Guidelines, the governing body of each AIFM must ensure that sound and prudent remuneration policies and structures exist and are not circumvented. AIFMs must select the type of staff for which a remuneration policy is put in place and should be able to demonstrate the criteria used to make this selection.

Categories of staff covered

The Guidelines apply to "identified staff" whose professional activities might have a material impact on the AIF's risk profile. "Identified staff" includes:

- senior management, risk takers, control functions; and
- any employee receiving total remuneration that takes them into the same remuneration bracket as the aforementioned categories of staff.

Importantly, in a deviation from ESMA's views as set out in their consultation of June 2012, "identified staff" now also includes staff of the entities to which portfolio management or risk management activities have been delegated by the AIFM, whose professional activities have a material impact on the risk profiles of the AIF that the AIFM manages, as explained further below.

Delegation arrangements

Perhaps not unsurprisingly, delegation arrangements are now caught by the Guidelines. These arrangements are not directly covered by the requirements in the Guidelines themselves but rather indirectly covered in one of two ways: either (a) the AIFM must ensure that entities to which portfolio or risk management activities have been delegated are subject to regulatory requirements on remuneration that are equally as effective as those under the Guidelines; or (b) the AIFM must put in place contractual arrangements with such delegates in order to ensure there is no circumvention of the Guidelines' requirements, which should cover payments made to delegates' identified staff as compensation for the performance of portfolio or risk management activities on behalf of the AIFM.

Types of remuneration covered

Under the Guidelines "remuneration" consists of all forms of payments or benefits paid by the AIFM, of any amount paid by the AIF itself, and of any transfer of units or shares of the AIF, in exchange for professional services rendered by the identified staff. Payments (excluding reimbursement of costs and expenses) which are made directly by the AIF to the AIFM for the benefit of the relevant categories of staff of the AIFM also fall within the scope of remuneration whenever they may otherwise result in a circumvention of the relevant remuneration rules.

Carried interest remains covered by the Guidelines as a form of remuneration, with ESMA's position virtually unchanged from the view taken in its consultation despite heavy lobbying from the industry. Additionally, ESMA's position remains unchanged on vehicles and methods that artificially evade the provisions of the Directive and the Guidelines such as, for example, the use of persons not considered employees, or improper use of performance fees. Interestingly, new guidance has been inserted in relation to the position of partnerships and similar structures, providing that dividends or similar distributions that partners receive as owners of the AIFM are not covered by the Guidelines, unless the material outcome of the payment of such dividends results in a circumvention of the relevant remuneration rules, regardless of whether there was any intent to circumvent.

Remuneration is either fixed remuneration (payments or benefits without consideration of any performance criteria) or variable remuneration (additional payments or benefits depending on performance or, in certain cases, other contractual criteria). Both components of remuneration (fixed and variable) may include monetary payments or benefits (such as cash, shares, options, remuneration by AIFs for example through carried interest models) or non-monetary benefits (such as discounts, special car allowances etc).

However, remuneration does not include any payment made directly by the AIF to the benefit of identified staff which consists of a pro-rata return on any investment made by those staff members into the AIF. In order for a return on an investment made by the staff member into the AIF to be considered as exempted from the remuneration provisions, the investment must consist of an actual disbursement made by the staff member. In other words, any loans granted by the AIFM to the staff member in order to allow a co-investment into the AIF should not be considered as an investment for the purposes of the exemption on such co-investment if the loan has not been reimbursed by the staff member by the time the return is paid.

The risk alignment process

The Directive requires that remuneration is paid in both fixed and variable components, with at least 50% of the variable components consisting of equity or equity-linked instruments in the AIF(s) concerned and subject to mandatory deferral periods. Industry feedback to ESMA's consultation indicated the complex difficulties of awarding identified staff equity or equity-linked instruments in the case of small privately-owned AIFMs or of awarding payment in shares or units in AIFs managed. The feedback also highlighted that the mandatory three- to five-year deferral period of 40% to 60% of variable remuneration bears little resemblance to the life cycle of the fund and as such is not tied particularly well to risk alignment. ESMA, however, elected not to modify its consultation views when setting out the requirements in the final Guidelines. For many fund managers this may mean devising new alternative equity-linked instruments reflecting the value of the AIF in question.

Proportionality and disapplication

The Directive's remuneration requirements recognise the principle of proportionality in their application. In ESMA's view, proportionality may lead, on an exceptional basis and taking into account specific facts, to the disapplication of some requirements if this is reconcilable with the risk profile, risk appetite and the strategy of the AIFM and the AIFs it manages. Any disapplication must be within the limits set by the Guidelines (such as if the funds under management are small or not complex) and the only requirements that may be disappplied on the basis of proportionality are:

- the requirements on the pay-out process, whether disappplied for all or only some categories of identified staff, including only the requirements on variable remuneration in instruments; retention; deferral; and ex post risk adjustment mechanisms (e.g., malus or clawback); and
- the requirement to establish a remuneration committee.

However, where specific numerical criteria are set out in the Directive – the minimum deferral period of three to five years, the minimum portion of 40% to 60% of variable remuneration that should be deferred and the minimum portion of 50% of variable remuneration that should be paid in instruments – such criteria, if disapplied, may only be disapplied in their entirety. This means that an AIFM cannot lower these numerical thresholds based on proportionality; if, for example, the AIFM does not pass the proportionality test for the disapplication of the deferral requirement, it must apply at least a 40% deferral, or a 60% deferral in the case of a variable remuneration component of a particularly high amount. This restriction is virtually identical to a similar restriction placed on the banking sector.

Impact and next steps

Although ESMA's clarification that the transitional arrangements in the Directive also apply to the application of the remuneration requirements is welcome news and should provide a bit of breathing space, the publication of these final Guidelines should now provide enough detail for fund managers who anticipate falling within the scope of the Directive to begin examining their own remuneration arrangements for compliance. The position on carried interest and delegation arrangements, in particular, may require some fund managers to restructure their current arrangements to ensure no circumvention takes place; fund managers should also take care to assess performance fee arrangements and other structures in light of the requirements of the Guidelines. The strict requirements regarding payment in equity-linked instruments may also be particularly problematic, and fund managers may wish to closely examine whether disapplication on the basis of proportionality is available to them.

Finally, in the UK, the FSA has indicated in CP12/32 that, once the Guidelines have been finalised, it intends to establish a proportionality framework specific to firms "incorporating European requirements and guidelines". The FSA further states that "the framework for AIFMs will take account of the remuneration code in SYSC 19A". It will be interesting to see whether the statements underpin a desire to soften the Guidelines in the case of private equity fund managers in particular, whose remuneration structures do not sit easily within the remuneration principles of the Directive.

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