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Alternative Investments and Funds Client Service Group
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To: Our Clients and Friends

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AIFMD – ESMA Publishes Remuneration Guidelines

Who do the guidelines apply to?

The European Securities and Markets Authority (ESMA) published on 11 February 2013 its final guidelines on sound remuneration for alternative investment fund managers (AIFMs) under the Alternative Investment Fund Managers Directive (AIFMD). The AIFMD sets out in Annex II remuneration requirements applicable to European based managers of alternative investment funds (AIFs). The guidelines will apply from 22 July 2013, subject to the transitional provisions under the AIFMD which allows some fund managers one year in which to seek authorisation. The scope of the guidelines remains largely in the same form as for the draft guidelines.

ESMA points out that the remuneration polices were inspired by the banking industry, specifically the provisions of the Capital Requirements Directive 2006/48/EC (CRD) and these guidelines could be seen as a step towards a single set of remuneration principles across Europe. As a result, many of the policies mirror those applied to banks. There are however no specific guidelines to deal with potential overlaps in the rules where a manager may be caught by both the CRD and AIFMD.

What is covered?

The underlying aim of the guidelines is to ensure that an AIFM establishes remuneration policies and structures to promote effective risk management in line with the objectives and strategy of the AIFM and the AIF which it manages. The AIFM must also have ‘identified staff’ whose professional activities may have a material effect on the risk profile of the AIFMs, this includes other staff to which portfolio or risk management activities may have been delegated by the AIFM.

Categories of 'identified staff' include senior management, risk takers, control functions and any employee receiving total remuneration in the same remuneration bracket as senior management.

Delegated arrangements are caught indirectly through the need for the AIFs to ensure delegates are subject to all regulatory requirements or to ensure that a contractual arrangement with these delegates is entered into to ensure non-circumvention of the guidelines.

What remuneration is covered?

(i) All forms of payments or benefits paid by the AIFM.

(ii) Any amount paid by AIF itself including carried interest, risk profile or the risk profiles of the AIF that it manages. Any transfer of units or shares of the AIF in exchange for professional services rendered by the AIFM identified staff.

All remuneration is divided into 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 fixed and variable components may include monetary payments or benefits (such as cash, shares, options, cancellation of loans to staff members, remuneration by AIFs through, for example, carried interest models) or non (directly) monetary benefits (such as discounts, fringe benefits or special allowances for cars, mobile phones, etc).

However, remuneration does not cover payments 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 exempt from the remuneration provisions, the investment needs to consist of an actual disbursement made by the staff member. For example, 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 purposes of the exemption if that loan has not been reimbursed by the staff member by the time the return is paid.

Proportionality

A particular concern is how the guidelines can be applied in a proportionate way and how the different characteristics of each AIFM may alter the requirements applicable to it. The level of detail provided however may be of a disappointment to some AIFMs.

The guidelines set out which requirements may be disapplied (but only where proportionate to do so). Any disapplication of the requirements must be within the limits set out in the guidelines (eg. for small or non-complex funds).

The only requirements that may be disapplied as a result of proportionality are:

(i) the requirements on the pay-out process for some AIFMs, either for the total of their identified staff or for some categories within their identified staff, including variable remuneration in investments, retention, deferral, ex post incorporation of risk for variable remuneration (clawbacks); and

(ii) the requirement to establish a remuneration committee (as set out in paragraph 55 of the guidelines which states that AIFMs that manage AIFs that do not exceed EUR 1.25 billion and do not have more than 50 employees, or which are part of a group which is obliged to set up a remuneration committee, do not need a remuneration committee at AIF level).

If the specific numerical criteria set out in the AIFMD (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 investments) are disapplied, these criteria may only be disapplied in their entirety. This results in an AIFM being unable to lower these thresholds based on proportionality, they have to be disapplied in their entirety. If the AIFM does not pass the proportionality test for the disapplication of the deferred requirement, it has to apply at least 40% deferral, (or 60% deferral in the case of a variable remuneration component of a particularly high amount), these are similar restrictions to those found in the banking sector.

It is important to note these provisions are not automatically disapplied, the AIFM must assess its own characteristics. Feedback from the competent authorities (FSA) is awaited and it is thought specific thresholds in relation to what is deemed proportionate or not may be set.

Conclusions and action points

The guidelines, whilst not only overly detailed, do give AIFMs detail enough to begin to take steps to examine their current remuneration provisions. It is important for AIFMs to consider the guidelines (and once published, the FSA's AIFMD Remuneration Code) to ensure their current structures and fee arrangements do not circumvent the application of the guidelines, particularly in relation to delegation and carried interest. AIFMs should also be considering and compiling lists of identified staff.

The FSA's AIFMD Remuneration Code, when released, may also provide further detail on the issue of proportionality and specific thresholds to enable AIFMs to apply any relevant disapplication automatically.

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Bryan Cave's Alternative Investments and Funds group represents alternative investment managers, investment vehicles such as hedge funds and private equity funds, and institutional investors on a wide variety of transactional and regulatory matters across Europe and the US. We take a leadership role on legal issues impacting alternative investment managers and institutional investors.

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