

# ***AIFMD – ESMA Guidelines finalised***

## **Final report published on Guidelines on sound remuneration policies under the AIFMD**

### **11 February 2013**

The European Securities and Markets Authority (ESMA) today published its final guidelines on sound remuneration policies under the Alternative Investment Fund Managers Directive (AIFMD). These guidelines follow a consultation paper that was released in June 2012. On review of the final guidelines it appears that ESMA has reaffirmed much of the draft regulation that initially proposed, however, the guidelines provide much needed clarity on certain aspects of scope, proportionality, and remuneration structures.

#### ***Background to guidelines***

The AIFMD is a European regulatory directive aimed specifically at the alternative investment management industry, and includes specific remuneration regulations similar to the requirements that credit institutions and investment firms are already subject to under CRDIII. As such, AIFMD seeks to extend the scope of existing EU remuneration regulations to this sector.

Article 13 (2) of the directive requires ESMA to develop guidelines that are in alignment with the remuneration requirements of AIFMD. To this end, in June 2012, ESMA published for consultation draft guidelines that sought to provide further clarity to firms as to how the directive requirements should be interpreted and applied.

ESMA has outlined their conclusive position in the final guidelines (Guidelines), and these will apply from 22<sup>nd</sup> July 2013, subject to the transitional provisions of AIFMD. The full Guidelines can be found at the following link:

[www.esma.europa.eu/news/ESMA-rules-aim-curb-excessive-risk-taking-alternative-fund-managers?t=326&o=home](http://www.esma.europa.eu/news/ESMA-rules-aim-curb-excessive-risk-taking-alternative-fund-managers?t=326&o=home)

This paper summarises the key changes in the final guidance, together with our view on the implications for firms in scope of AIFMD.

## ***Who do the Guidelines apply to?***

EU AIFMs which manage one or more Alternative Investment Funds (AIFs) irrespective of whether such AIFs are EU AIFs or non-EU AIFs will be in scope of the requirements from July of this year.

- non-EU AIFMs which manage one or more EU AIFs will be caught from 2015; and
- non-EU AIFMs which market one or more AIFs in the European Union (using the passport) irrespective of whether such AIFs are EU AIFs or non-EU AIFs will become subject to the requirements on authorisation to passport. Non EU AIFMs who continue to access Europe via private placement will not be caught by these provisions.

## ***Key highlights of the final guidance***

Much of the guidance remains intact from the original draft, however, there has been a degree of change in some important areas.

### **Proportionality**

In a significant move from the draft guidance, the final Guidelines acknowledge that the application of proportionality may lead, on an exceptional basis, to the “disapplication” of some requirements provided this is reconcilable with the risk profile, risk appetite and strategy of the AIFM and AIFs it manages.

According to the Guidelines, the different risk profiles and characteristics among AIFMs justify a proportionate implementation of the remuneration principles with the following criteria relevant to the application of proportionality.

- size of the AIFM and the value of the underlying portfolio of AIFs it manages together with exposures and liabilities; and
- internal organisation including legal structure and complexity of governance processes; and
- nature scope and complexity of activities including the type of authorised activities, investment policies and strategies, the national or cross-border nature of business activities and any additional management of UCITS funds.

Where firms do choose to disapply requirements, they must be able to explain the rationale to a competent authority. The principles that are capable of being disapplied are:

1. The requirements on pay-out processes for all (or some) Identified Staff including
  - a. the payment of variable remuneration in instruments
  - b. retention periods
  - c. deferral requirements
  - d. ex-post incorporation of risk (sometimes referred to as clawback)
2. The requirement to establish a remuneration committee

Where principles can be disapplied this must be in full i.e. there can be no partial disapplication. If it cannot be demonstrated that full disapplication is appropriate then the

principles must be applied in full. This approach mirrors the approach taken by CEBS in the implementation of CRD3.

### PwC commentary

Many firms will breathe a sigh of relief now that ESMA has provided for the disapplication of some of the more onerous provisions of AIFMD in certain circumstances. The fact that ESMA has decided not to prescribe the situations in which such proportionality applies, leaving this to national regulators, will be viewed positively. This approach mirrors that taken by CEBS in the implementation of CRD3, an approach which many asset managers will admit has proved workable.

The practical application of proportionality in the UK will ultimately be determined by the FSA through the next round of consultation - however on the face of it they are starting from a blank page. Firms should not assume that the UK implementation of the rules will follow the tiering principles used by the FSA in its existing remuneration code and there appears to be a genuine opportunity for industry to influence the way in which these rules will apply in the UK moving forward. Firms should start thinking about this now in advance of the FSA publishing its next consultation paper.

### Identified Staff

Each firm in scope will need to identify a cohort of employees as 'Identified Staff'. Subject to proportionality, AIFMD specifies that Identified Staff, will be subject to specific requirements relating to the structure and delivery of their remuneration. The final guidance confirms that the following individuals will also be considered Identified Staff:

- Executive and non-executive members of the governing body of the AIFM
- Senior management
- Control functions
- Staff responsible for heading up portfolio management, administration, marketing and HR
- Other risk takers whose professional activities have a material impact on the risk profile of the AIFM or any AIF it manages including persons capable of entering into contracts/positions and taking decisions that have a risk impact.

ESMA have specifically clarified that partners in Limited Liability Partnerships and employees who own common equity of an AIFM, whose professional activities have a material impact on the risk profile of the AIFM or an AIF that the AIFM manages will also be expected to be Identified Staff.

Where an individual works for both an entity covered by CRD3/CRD4 and an entity covered by AIFMD, their remuneration should be established pro-rata based on the services provided to each of the two entities with the relevant rules applying to the different proportions of remuneration.

Furthermore, ESMA has stated that it is appropriate for firms to consider the amount of variable remuneration and the proportion of variable remuneration received by an employee when determining whether an employee will be subject to these more onerous structural requirements.

### **PwC commentary**

Little has changed around the definition of Identified Staff however there has been specific clarity that non executive directors together with partners operating in Limited Liability Partnerships (LLPs) are expected to be included as Identified Staff unless the firm can demonstrate that such individuals do not have a material impact on the risk profile of the AIFM or of the AIFs managed.

The concept of proportionality can be extended to individuals and so it may be possible for firms to justify different approaches to different subsets of Identified Staff provided this is allowed under any structure implemented by national regulators. This may well include de-minimis provisions for more junior Identified Staff.

### **Impacted remuneration**

There has been little in the way of change to ESMA's definitions of the remuneration covered by the rules. The definition of carried interest remains intact and the Guidelines reinforce that variable remuneration should not be paid through vehicles or methods that are employed at artificially evading the remuneration provisions of AIFMD including, amongst others, the outsourcing of professional services to firms that fall outside of the scope of AIFMD and the setting up of structures or methods through which the remuneration is paid in the form of dividends or similar pay outs.

Dividends or similar distributions that partners receive as owners of an AIFM are not covered by the Guidelines unless the material outcome of the payment of such dividends circumvents the remuneration rules.

### **Delegation of activities**

The Guidelines specifically state that an AIFM should ensure that the entities to which portfolio management 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, that appropriate contractual arrangements are entered into to ensure there is no circumvention of the remuneration rules in the Guidelines with respect to payments to Identified Staff within the delegate.

### **PwC commentary**

ESMA have held firm on their view of the types of remuneration to be included under AIFMD. A specific definition of carried interest remains intact meaning uncertainty remains around many of the carry plans in operation that do not conform to the defined structure. It remains to be seen whether the FSA will be able to apply the principles of proportionality to deal with other similar arrangements flexibly.

One new addition is the exclusion of dividends or similar distributions that partners receive as owners from the definition of remuneration. On the face of it this is excellent news for those firms structured as partnerships however our view is that this should be treated with caution. It is our understanding that regulators view partner drawings as a combination of a return on ownership of the business together with 'remuneration'. The FSA is likely to place the onus on firms to separate out dividend like returns from remuneration for partners and to treat these two components independently. It is unlikely that partner drawings in full will fall outside of scope for most firms.

### Remuneration committee requirement

An AIFM which is significant will be required to establish a remuneration committee. In order to establish whether or not an AIFM is significant firms will need to consider the three key principles under proportionality above as well as:

- whether the AIFM is listed or not;
- the legal structure of the AIFM;
- the number of employees of the AIFM;
- the level of assets under management of the AIFM; and
- whether the AIFM is also a UCITS management company

Examples of AIFMs that may not be required to establish a remuneration committee include those where

- the value of the portfolio of AIFs that they manage does not exceed €1.25 billion **and** not having more than 50 employees, or
- they are part of a broader group with a remuneration committee which performs tasks and duties for whole group, provided roles governing composition, roles and competencies are equivalent to those set out in the Guidelines

The remuneration committee should:

- be comprised of non-executives with a majority qualifying as independent including the Chair;
- include an appropriate number of members with sufficient expertise and professional experience concerning risk management and control activities; and
- seek both external and internal expert advice

It is ESMA's view that the establishment of a remuneration committee is considered a matter of best practice regardless of any requirement to do so.

### PwC commentary

The potential exemptions will be welcomed although many firms in scope of AIFMD will already operate remuneration committees. It is important for firms to assess whether or not the composition and competencies of committee members meets the required standards under the Guidelines. If not then changes will be required. Changes to governance processes can take time and it is important that firms start considering these requirements as soon as possible.

### What next?

AIFMD requires that transposition of requirements into local EU Member State legislation must take place no later than 22<sup>nd</sup> July 2013. ESMA has confirmed that this transposition date remains the same. Regulatory bodies in Member States will now be required to implement rules and regulations that are aligned with Appendix II of the AIFMD by this date. Although there are some transitional arrangements around the authorisation process, once authorised, firms will need to be compliant.

To this end, the Financial Services Authority (FSA) released a Consultation Paper in November 2012, titled 'Implementation of the Alternative Investment Fund Manager

Directive,' which includes draft regulation on the implementation of AIFMD in the UK. This proposes a distinct AIFM Remuneration Code, which outlines the remuneration specific requirements to apply to in-scope firms. A second Consultation Paper is due to be released shortly by the FSA, which will incorporate ESMA's final Guidelines.

## ***Actions for firms***

There is clearly a great deal of information in this final report for firms to digest. This does however provide most of the information required to begin work in earnest ahead of 22 July 2013.

Firms should act now to understand how the guidance applies to them and to critically assess their governance structures and remuneration frameworks they operate. Although there may be some benefit in the transition provisions around the timing of the introduction of required changes to remuneration structures, the associated policies and governance will take time to develop properly and firms should act now to understand the changes they will need to make.

The next FSA Consultation Paper will also provide a great opportunity for firms to influence the manner in which the UK regulator transposes the AIFMD and associated ESMA Guidelines into UK regulation. Firms and trade bodies should prepare themselves to engage with the FSA when the time comes particularly around the approach taken by the FSA to applying proportionality given the flexibility afforded by the Guidelines.

## ***How we can help?***

We can use our experience and expertise to help you review the current design and governance arrangements in place with regard to AIFMD. We will bring insight into our work from extensive experience in helping clients deal with the impacts of regulation on remuneration, incentive design, governance and process optimisation. We have developed a comprehensive assessment framework, based on our work with the FSA Remuneration Code.

## ***Contacts***

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