ALERT MEMORANDUM

# ESMA Publishes Final Remuneration Guidelines under UCITS and AIFMD

*12 April 2016*

On 31 March 2016 and following its consultation on draft guidelines in summer last year (the "**Consultation**"), the European Securities and Markets Authority ("**ESMA**") published its final report and guidelines on sound remuneration policies (the "**Final Guidelines**") under Directive 2009/65/EC (the "**UCITS Directive**") as amended by Directive 2014/91/EU (the "**UCITS V Directive**") and Directive 2011/61/EU (the "**AIFMD**"). Despite referring to both directives in its title, the Final Guidelines principally establish remuneration guidelines for management companies of EU collective investment funds for retail investors subject to the UCITS Directive ("**UCITS**"). They do, however, also include one amendment to ESMA's guidelines on sound remuneration policies under the AIFMD (the "**AIFMD Guidelines**") relating to the outreach of different sectoral rules (see further, Part D).

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## A. Background

The Final Guidelines (including the amendment to the AIFMD Guidelines) apply from 1 January 2017 (not 18 March 2016, as originally proposed), meaning that ESMA's guidance on the rules affecting variable remuneration must be applied to new awards made in respect of the first full performance period commencing on or after that date (for example, to awards made in 2018 for the financial year ending 31 December 2017). The deadline for transposition of the UCITS V Directive in Member States recently passed on 18 March 2016 and so the rules themselves[1] are already in force.

1 January 2017 will mark the sixth anniversary of the implementation of the CEBS guidelines on remuneration policies and practices under CRD III (to be finally replaced by the European Banking Authority's (the "**EBA**") equivalent guidelines under Directive 2013/36/EC ("**CRD IV**"), also on 1 January 2017; the "**CRD Guidelines**"), and will be almost three and a half years since the implementation of the AIFMD Guidelines. In this respect, the Final Guidelines bring a certain degree of long-awaited certainty to management companies of UCITS but, despite this path being a reasonably well-trodden one, the Final Guidelines are not without their ambiguities (see, in particular, Part B; Proportionality and Part C; Different Sectoral Rules).

ESMA was tasked in the UCITS V Directive with preparing guidelines that were aligned, to the extent possible, with the AIFMD Guidelines. Comparing the two reveals that ESMA used the AIFMD Guidelines as a starting point and the majority of changes merely reflect the structure and terminology of UCITS (for example, referring to management companies instead of alternative investment fund managers ("**AIFM**"), to investment management instead of portfolio management, addressing performance fees specifically and removing references to carried interest structures[2], and so on). There are, however, a small number of more significant differences (see further, Part C).

[1] Article 1 of the UCITS V Directive inserts new Articles 14a and 14b into the UCITS Directive.

[2] In particular, there is no safe harbour for carried interest structures in the Final Guidelines.

## B. Changes arising from the Consultation

**Proportionality**

The most significant change made in the Final Guidelines is the removal of express language envisaging that some of the most onerous remuneration rules affecting the pay-out process (the "**Pay-out Rules**") could be "disapplied" on grounds of proportionality, namely:

— *The instruments rule:* the requirement to provide a substantial portion and, in any event, at least 50% of any variable remuneration in the form of units of the UCITS concerned, equivalent ownership instruments or share-linked instruments (or equivalent non-cash instruments constituting an equally effective incentive), unless the management of UCITS[3] accounts for less than 50% of the total portfolio managed by the management company, in which case the minimum of 50% does not apply;

— *The deferral rule*: the requirement to defer a substantial portion and, in any event, at least 40% of variable remuneration (or, at least 60% of a "particularly high amount[4]" of variable remuneration) over a period which is appropriate in view of the holding period recommended to the investors, and is correctly aligned with the nature of the risk, of the UCITS in question, and is at least 3 years;

— *The retention rule*: the requirement to subject the aforementioned instruments (whether the deferred or up-front portion) to an appropriate retention policy, post-vesting, designed to align the incentive with the interests of the management company and the UCITS that it manages, and the investors in those UCITS; and

— *The ex-post adjustment rule*: the requirement to considerably contract total variable remuneration where subdued or negative financial performance of the management company or of

[3] The wording of the instrument rule was slightly amended on 27 February 2016.

[4] In the UK, Financial Conduct Authority (the "**FCA**") guidance confirms that £500,000 should be considered a particularly high amount, but management companies should also consider whether lesser amounts should be considered particularly high.

the UCITS occurs, taking into account both current compensation and any reductions to amounts previously earned, including through malus or clawback arrangements.

Although the AIFMD Guidelines expressly permit the Pay-out Rules to be disapplied on grounds of proportionality and ESMA was required, to the extent possible, to align the Final Guidelines with the AIFMD Guidelines, the UCITS V Directive also required ESMA to closely cooperate with the EBA to ensure consistency with the CRD Guidelines, and the final version of the CRD Guidelines published on 21 December 2015 were controversially silent on this issue, following statements from the EBA in its consultation that the principle of proportionality cannot lead to the non-application of the Pay-out Rules[5]. In both cases, we are left solely with the text of the directives themselves, which provide that relevant firms shall comply with the remuneration rules in a way and to the extent that is appropriate to their size, internal organisation and the nature, scope and complexity of their activities.

Aware that the Final Guidelines provide little guidance on how to apply this proportionality principle in practice, ESMA has, parallel to the publishing of the Final Guidelines, shared its recent letter to the European Commission, European Parliament and Council of the European Union, calling for legislative changes to clarify the position on the application of proportionality in practice and to align it across the different sectors. It is clear that ESMA strongly supports the disapplication of the Pay-out Rules and, further, contrary to the position presented in the Consultation and the AIFMD Guidelines, the possibility of applying lower quantitative thresholds (for example, the deferral of at least 40%) under the Pay-out Rules on grounds of proportionality. ESMA's position is wholeheartedly supported by the Securities and Markets Stakeholder Group (the "**SMSG**"), a body mandated to provide high level advice to ESMA in formulating the Final Guidelines. In its opinion, the SMSG writes: "*Where the intended effect of the legislation – alignment of interest between investors, managers and their identified staff – is already achieved via established and proven business models, an alternative that seeks to impose "one size fits all" type of arrangements…is neither necessary, nor effective, nor proportionate to attain the legislature's intended purpose*". The SMSG then cautions that the alternative position (as expressed by the EBA), would lead to additional costs, introduce inconsistency and instability in the EU and could distort competition. Although many strong opinions have been heard on this issue, in the meantime, there remains significant legislative uncertainty on this issue[6].

**Other changes**

ESMA made minor changes in the Final Guidelines to clarify the following:

— that performance fees paid by the UCITS itself can be considered remuneration under the Final Guidelines to the extent paid directly or indirectly for the benefit of identified staff;

— that the steps which need to be taken when delegating investment management functions (namely, ensuring that delegates are subject to regulatory remuneration requirements that are equally as effective as the Final Guidelines, or putting in place appropriate contractual arrangements to ensure there is no circumvention of the Final Guidelines), apply also when delegating risk management;

[5] In its final report published with the CRD Guidelines, the EBA confirmed that the European Commission will be submitting to the European Parliament and the Council by the end of June 2016 a report on the review of the CRD remuneration rules, including the operation of proportionality and, further, that the EBA has submitted an opinion to the European Commission on which specific situations it considers justify the "*introduction of explicit exemptions for some of the remuneration provisions or other CRD amendments needed to enable institutions to apply the requirements in a meaningful but more proportionate way*".

[6] There has been a similar reaction in the United Kingdom in respect of the EBA's position in its CRD Guidelines that the so-called bonus cap cannot be disapplied on grounds of proportionality and must instead be applied by all CRD firms, with the UK regulators recently publishing a statement (available here) that they will not comply with that requirement and will instead retain the flexibility under English law for smaller firms to themselves determine an appropriate ratio between fixed and variable components of remuneration.

— that the ability to award a substantial portion of variable remuneration in the form of equivalent non-cash instruments instead of units of the UCITS concerned, provided those instruments constitute an equally effective incentive, is further limited to instruments whose performance is correlated with the performance of the portfolios managed by the identified staff and where such an instrument is appropriate to ensure a better alignment of interest with investors; and

— that the exemption from the requirement to pay at least 50% of variable remuneration in UCITS instruments arises where management of UCITS accounts for less than 50% of the total portfolio managed[7] by the management company, based on the total net asset value of all the UCITS management by the management company[8].

## C. A comparison with the AIFMD Guidelines[9]

### Different Sectoral Rules

One of the most significant differences between the AIFMD Guidelines and the Final Guidelines is the welcome introduction of a section seeking to address the problem of potentially overlapping and conflicting rules and sectoral guidelines, for example, where an individual performs services subject to more than one regime. Introduced in the Consultation and only slightly modified in the Final Guidelines, ESMA has set out two alternative approaches that may be applied to both employees and other categories of personnel, such as secondees (but not to the employees of delegates). The two approaches are as follows:

— to remunerate them under each relevant regime on a pro rata basis by reference to their activities carried out, judged by objective criteria such as the time spent on particular activities and the assets under management for each service, provided it is possible (and, we would suggest, practicable) to single out individual activities; or

— to remunerate them under the regime that is deemed most effective for achieving the outcomes of discouraging inappropriate risk taking and aligning their interests with those of investors, provided that any specific rules contained in the relevant sectoral rules which conflict with the chosen regime are nonetheless followed. The example given is the requirement in CRD IV to pay a portion of variable remuneration in instruments, which would, if a UCITS management company chose to comply with the CRD IV rules, be overridden by the requirement under the UCITS V Directive that instruments comprise units or shares of the UCITS managed.

Respondent reactions to the Consultation were unsurprisingly mixed, with many expressing concerns with the pro rata approach, in particular, as being impracticable and likely to raise operational challenges (particularly where certain activities, such as research, may not easily be attributable to a single service). One of the respondents described this approach as not impossible to implement, but as extremely complex to do so. Despite the criticisms, and taking into account the optional nature of the approach, ESMA retained the pro rata option, with the addition of the proviso.

ESMA also emphasised in its report accompanying the Final Guidelines, that the "most effective" approach described above does not simply allow management companies to make a choice between the CRD IV, AIFMD and UCITS V Directive remuneration rules without giving them due consideration. Indeed, ESMA expects management companies to consider carefully which remuneration principles would be most effective, taking into account its specific activities and circumstances. ESMA notes that this exercise could, in theory at least, result in a management company applying the

[7] Being the portfolios collectively and individually management by the management company under the UCITS Directive and the AIFMD Directive.

[8] ESMA also clarified in the report accompanying the Final Guidelines that, if no single UCITS fund makes up more than 50% of the total UCITS funds managed, the instruments rule still applies, but only the "substantial portion" test and not the minimum quantitative threshold of 50%.

[9] The Final Guidelines also differ from the AIFMD Guidelines by their omission of express language envisaging that the Pay-out Rules can be disapplied on grounds of proportionality, see Part B; Proportionality.

CRD IV remuneration rules in full, including the so-called bonus cap.

As with the rest of the Final Guidelines, this particular guidance is stated to relate to employees or other personnel of UCITS management companies and not also to employees or other personnel of AIFM, and ESMA did not reproduce this guidance in its amendment to the AIFMD Guidelines (on which, see Part D). On its face, therefore, neither the pro rata approach nor the "most effective" approach can be relied on by AIFM within a broader banking group who employ or engage staff to perform services subject to both CRD IV and the AIFMD but not the UCITS V Directive.

Although ESMA has at least attempted to grapple with this challenging issue, it clearly will continue to be difficult to manage in practice for individuals who perform services under one or both of the AIFMD and the UCITS V Directive for entities within a wider banking group. This is particularly so when ESMA has also confirmed in the Guidelines that the MiFID remuneration rules must, in addition, be complied with in respect of any individual performing ancillary services subject to the MiFID conduct of business and conflict of interest requirements.

Finally and reassuringly, ESMA has confirmed in the Final Guidelines its view that, where a management company engages in activities subject to both AIFMD and the UCITS V Directive, compliance with a firm-wide requirement under one regime should at the same time satisfy the equivalent firm-wide requirement under the other: for example, the requirement to compensate staff engaged in control functions in accordance with the achievement of the objectives linked to their functions, independent of the performance of the business areas they control.

**Delegation**

In the section on delegation and for purposes of interpreting the phrase "equally as effective", ESMA has added a deeming provision that applies wherever both the delegate and the identified staff (for purposes of the Final Guidelines), are subject to the remuneration rules under either CRD IV or the AIFMD.

**Group Context**

ESMA has maintained the position on wider banking groups set out in the AIFMD Guidelines, namely, that where a management company is a subsidiary of a credit institution, the remuneration rules set out in the UCITS V Directive and the Final Guidelines nonetheless apply; no exceptions are made (although, see Different Sectoral Rules below). With new text, ESMA has further illustrated this principle by saying that non-UCITS sectorial prudential rules applying throughout a group may lead staff of a UCITS management company to be identified staff for purposes of those other rules. This illustration has also been made to the AIFMD Guidelines (see part D).

**Review of the Remuneration Policy and its Implementation**

Smaller and less complex management companies may decide to outsource the entire periodic review of the implementation of their remuneration policy and practices but, in contrast to the AIFMD Guidelines, ESMA has not supported on grounds of proportionality those same firms performing internally the review but less than annually, or carrying out an annual assessment not amounting to a full review.

**Deferral**

The minimum deferral period in the Final Guidelines is three years, whereas it is stated as three to five years in the AIFMD Guidelines (which also permit a shorter period where an AIFM can demonstrate that the life cycle of the alternative investment fund is shorter). As mentioned above, the deferral period should be calculated on the basis of the holding period recommended to the investors of the UCITS.

**Disclosure**

Finally, whilst generally the guidelines relating to remuneration disclosures in the AIFMD Guidelines and the Final Guidelines are aligned, there was one omission in the Final Guidelines, which is the requirement to disclose general information about the basic characteristics of a management company's firm-wide remuneration policies and practices. The requirement to disclose detailed information about

remuneration policies and procedures for identified staff has been retained.

## D. Change to the AIFMD Guidelines

The change to the AIFMD Guidelines is limited to the insertion of a statement that non-AIFM sectorial prudential rules applying throughout a group may lead staff of an AIFM to be identified staff for purposes of those other rules. Somewhat confusingly and potentially unhelpfully, in doing so ESMA has removed a statement that compliance with the AIFMD Guidelines by an AIFM belonging to a wider banking or other group (and so subject to other sectorial prudential rules) should be considered as ensuring the respect of those other rules.

In its final report accompanying the Final Guidelines, ESMA explains that those other sectoral rules are not for ESMA to interpret, and so the more limited formulation is deliberate and intended to merely note the possible outreach of other sectoral prudential rules.

## E. Next steps and conclusion

National regulators will no doubt be reviewing the Final Guidelines and considering whether to amend or supplement any existing domestic guidance. The UK Financial Conduct Authority mentioned in its policy statement on the implementation of the UCITS V Directive that, following the publication of the Final Guidelines, it will consider whether any further guidance on applying the UK UCITS Remuneration Code is required and, if so, it will publicly consult on that further guidance. In any event, UCITS management companies will need to ready themselves for implementation of the Final Guidelines at the end of the year. In the meantime, we eagerly await a reaction from the European institutions on ESMA's letter calling for legislative clarity on the practical application of the proportionality principle. We also watch with interest to see whether ESMA may give its latest approach to different sectoral rules a wider application, including by harmonising the AIFMD Guidelines with the Final Guidelines on this point.

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