
private investment funds lawflash

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EU ESMA Proposes Remuneration Guidelines

Proposed guidelines set out policies and practices to be used by alternative investment fund managers in designing compensation plans for certain senior staff.

On 28 June, the European Securities and Markets Authority (ESMA) published a consultation paper on their proposed guidelines on the remuneration requirements (the Remuneration Guidelines) under the European Union (EU) Alternative Investment Fund Managers Directive (AIFMD). In keeping with the AIFMD requirements, the Remuneration Guidelines seek to establish and design remuneration policies and practices for certain senior staff in order to promote sound and effective risk management and to avoid encouraging risk taking which is inconsistent with the risk profiles, rules, or instruments of incorporation of an alternative investment fund (AIF).

Regulation impacting remuneration will be entirely novel for some alternative investment fund managers (AIFMs)—in particular for many private equity and real estate fund managers. Other types of AIFMs such as Markets in Financial Instruments Directive (MiFID) investment firms, which include many hedge and debt fund managers and credit institutions, became subject to similar (but not identical) requirements imposed under the EU Capital Requirements Directive from 1 January 2011. AIFMs providing certain MiFID investment services will need to monitor the upcoming ESMA draft MiFID remuneration guidelines (expected in Q3 of 2012), as will all MiFID investment firms.

One of the principal concerns for AIFMs will be whether the risk alignment provisions require changes to their pay packages. As discussed below, the Remuneration Guidelines provide further detail on which AIFMs will be affected and how their staff will be classified. However, ESMA has not addressed the treatment of AIFM staff who are owner-managers, many of whom only receive a profit share; perhaps they intend to leave that challenge to national regulators. This issue is significant in the UK, where the LLP owner-manager structure is the entity of choice for AIFMs.

ESMA has responded to industry concerns by indicating that co-investment is not subject to the requirements and by suggesting that “fund as a whole” carried interest already aligns the interests of AIFM staff with AIF investors and so would not require adjustment. However, other models of carry will need careful analysis and further guidance from ESMA or national regulators. AIFMs will be obliged to make disclosures about their remuneration policies and practices—requirements that will apply even to non-EU AIFMs who rely on the private placement route to EU market.

Background

AIFMD seeks a common EU approach to bringing within the scope of regulatory supervision (i) hedge funds, (ii) private equity funds, and (iii) other types of alternative funds that do not possess an Undertakings for Collective Investment in Transferable Securities (UCITS) passport, as well as their managers. It also seeks to bring transparency and stability to the way in which these funds operate.

Annex II to AIFMD enumerates the principles AIFMs must follow when determining the substance of their own remuneration policies and practices, which include restrictions on the structure and form of pay packages. In order to provide greater clarity on, and to ensure consistent application of, the AIFMD remuneration requirements across member states, AIFMD requires ESMA to develop guidelines on sound remuneration policies which take into account, inter alia, the size of the AIFMs and that of the AIFs they manage; their internal organisation; and

the nature, scope, and complexity of their activities. Market participants have until 27 September 2012 to respond to ESMA's consultation paper.

Key Elements of the Remuneration Guidelines

- The governing body of each AIFM must ensure that sound and prudent remuneration policies and structures exist and are not improperly circumvented.
- AIFMs should select the type of staff for which a remuneration policy is put in place and disclose the criteria according to which the staff were selected.
- Remuneration consists of all forms of payments or benefits paid by the AIFM, any amount paid by the AIF itself (including carried interest), and any transfer of units or shares of the AIF in exchange for professional services rendered by the AIFM staff.
- All remuneration should be 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 other contractual criteria).
- Both components of remuneration may include monetary payments or benefits (e.g., cash, shares, options, pension contributions, remuneration by AIFs such as through carried interest models) or nonmonetary benefits (e.g., discounts, fringe benefits, special allowances).
- Ancillary payments or benefits that are part of a general nondiscretionary AIFM-wide policy and that pose no incentive effects in terms of risk assumption can be excluded for the purposes of the risk alignment requirements.
- Any payment made directly by the AIF to the benefit of the selected staff when such payment consists of a pro rata return on any investment made by those staff members into the AIF (e.g., co-investment) should not be subject to any of the remuneration requirements.
- A "retention bonus" should be considered a form of variable remuneration and only be allowed to the extent that risk alignment requirements are properly applied.
- Fees and commissions received by intermediaries and external service providers in case of outsourced activities are not covered by the requirements.

Proportionality

The remuneration requirements will be applied in accordance with the proportionality principle, the effect of which is that not all AIFMs will have to give substance to the requirements in the same way and to the same extent. In determining the proportionate application of the remuneration requirements to an AIFM, the key criteria are size, internal organisation of the AIFM, and the complexity of the activities undertaken. This principle will also apply with respect to the different categories of staff within the AIFM whose professional activities have a material impact on the AIFM's risk profile or the risk profile of the AIF that it manages (Identified Staff).

Remuneration Principles and Other Requirements

Annex II to AIFMD sets out 18 remuneration principles comprising governance provisions on developing, implementing, and reviewing risk-related remuneration policies and "risk alignment" provisions. These principles include the following:

- Guaranteed variable remuneration (i.e., bonuses) is exceptional and should only be awarded in the first year of employment.
- A substantial proportion of any variable component (at least 40% and 60% for larger bonuses, which the UK Financial Services Authority (FSA) currently classifies as any amount in excess of £500,000) must be deferred over a period that is appropriate as regards the life cycle and redemption policy of the relevant AIF, and must vest no faster than on a pro-rated basis over three to five years.

- At least 50% of any variable component should be paid in units or shares in the AIF or in equivalent ownership interests, share-linked interests, or equivalent noncash instruments, which should be subject to an appropriate retention policy designed to align incentives with the interests of the AIFM, the AIFs it manages, and the investors of such AIFs.
- Over a period of several years, variable remuneration should take into account the financial performance of the AIFM, the AIF or business unit, and the individual. Where such performance is subdued, the remuneration should be subject to clawback arrangements or “malus” deductions (deductions that would occur, for example, when there is evidence of misbehaviour or serious error by the staff member, or when the AIF, the AIFM, and/or the business unit suffers a significant downturn in its financial performance).
- There must be an appropriate balance between fixed pay and variable pay, and payments on termination of a contract should reflect performance achieved over time and be designed to ensure failure is not rewarded.
- Variable remuneration is not paid through vehicles or methods that facilitate the avoidance of the requirements.
- Staff in control functions must be compensated by reference to objectives linked to those functions as opposed to the performance of business areas they control.

Remuneration Committees

AIFMs that are significant in terms of their size or the size of the AIFs they manage, their organisation, and the nature of their activities are obliged to establish a remuneration committee. The chairperson of the remuneration committee should be an independent nonexecutive member. Committee members should be nonexecutive, the majority being independent. An appropriate number must have sufficient experience concerning risk management and control activities. A proportionate approach to the application of these requirements will be key in practice because most AIFMs are relatively small in size and will not have any, or any significant number of, nonexecutives even when they have substantial assets under management.

The Remuneration Guidelines contain two examples of the types of AIFMs which need not establish a remuneration committee, namely (a) AIFMs for which the value of the portfolios of AIFs that they manage does not exceed £250 million and (b) AIFMs that are subsidiaries of a credit institution which is obliged to set up a remuneration committee that acts for the whole group.

Disclosure

Article 22(2)(e) and (f) of AIFMD provides for some specific minimum disclosures about remuneration in the annual report of the AIF. Box 107 of ESMA’s technical advice to the European Commission on implementing AIFMD clarifies the content and format of this remuneration disclosure. The annual report which an AIFM must make available in respect of each EU AIF it manages and non-EU AIF it markets in the EU is required to contain the following:

- The total amount of remuneration for the financial year split between fixed and variable remuneration paid by the AIFM to its staff and stating the number of beneficiaries and any carried interest paid by the AIF.
- The aggregate amount of remuneration broken down by senior management and members of staff of the AIFM whose actions have a material impact on the risk profile of the AIF.

The Remuneration Guidelines will also give force to the disclosure provisions in the Commission Recommendation of 30 April 2009. Broadly, AIFMs will be required to disclose publicly detailed information on their remuneration policies and practices for Identified Staff and general information about the basic characteristics of their AIFM-wide remuneration policies and practices.

Which AIFMs?

The AIFMD remuneration requirements, including the Remuneration Guidelines, apply to all AIFMs which are within the scope of AIFMD, including the following:

- EU AIFMs which manage one or more AIFs, whether EU or non-EU based
- Non-EU AIFMs which manage one or more EU AIFs
- Non-EU AIFMs which market one or more AIFs in the EU, whether EU or non-EU based

However, as long as the national private placement regimes continue to survive, which will likely be at least until 2018, non-EU AIFMs without a marketing passport under AIFMD that market AIFs in the EU to professional investors will *not* be subject to the AIFMD remuneration requirements save for the disclosure requirements. AIFMs which benefit from the exclusions and exemptions in Article 2 or 3 of AIFMD are not subject to AIFMD and thus are not covered by the Remuneration Guidelines.

AIFMs providing the MiFID services of individual portfolio management and certain noncore services are subject to MiFID organisational requirements and conduct of business obligations for the provision of these services. Therefore, such AIFMs will also be subject to the principles relating to MiFID organisational requirements and conduct of business obligations in the separate guidelines focused on remuneration policies of MiFID investment firms on which ESMA intends to consult in Q3 2012. These MiFID remuneration guidelines will be based on the MiFID requirements for conflicts of interests and best interests of the client and will be prepared from an investor protection perspective. We understand ESMA will seek to ensure an alignment of the principles in the Remuneration Guidelines with the relevant principles of the MiFID remuneration guidelines; this is likely to be particularly appropriate for AIFMs that perform marketing activities.

Which Staff?

The Remuneration Guidelines provide clarification as to how AIFMs should identify those members of staff that would fall under the definition of Identified Staff and thus be subject to the guidelines.

ESMA considers that, unless an AIFM is able to demonstrate that they have no “material impact” on the AIFM’s risk profile, Identified Staff will include the following groups of employees:

- Members of the governing body of the AIFM (e.g., directors, the chief executive officer, partners)
- Senior management (i.e., the persons who effectively conduct the business of an AIFM)
- Control functions which include staff (other than senior management) responsible for risk management, compliance, and internal audit within an AIFM
- Staff responsible for heading portfolio management, administration, marketing, and human resources
- Other risk takers such as staff whose professional activities, whether on an individual basis or as members of a department, can exert material influence on the AIFM’s risk profile or an AIF it manages (e.g., sales persons, individual traders, specific trading desks)

Further, other employees or persons whose remuneration takes them into the same earnings bracket as senior managers or risk takers—from the highest paid to the lowest paid in those categories—and whose professional activities have a “material impact” on the risk profile of the AIFM or the AIF it manages will also be Identified Staff. An AIFM will need to be able to justify its classification of Identified Staff to regulators.

ESMA does not, however, tackle the treatment of AIFM staff who are “owner-managers” (e.g., UK LLP members who only receive a profit share). This area remains unclear; given that LLPs are primarily UK vehicles, it will likely fall to the FSA to provide clarification.

Which Types of Remuneration?

Paragraph (2) of Annex II of AIFMD provides for the scope of application of the remuneration principles as follows:

The principles set out in paragraph 1 shall apply to remuneration of any type paid by the AIFM, to any amount paid directly by the AIF itself, including carried interest, and to any transfer of units or shares of the AIF, made to the benefits of those categories of staff, including senior management, risk takers, control functions and any employee receiving total remuneration that takes them into the same remuneration bracket as senior management and risk takers, whose professional activities have a material impact on their risk profile or the risk profiles of the AIF that they manage.

Under the Remuneration Guidelines, remuneration comprises (a) all forms of payment or benefit paid by the AIFM; (b) any amount paid by the AIF, including carried interest; and (c) any transfer of units or shares of the AIF in exchange for professional services carried out by AIFM staff. Further, remuneration can include monetary payments or benefits (e.g., cash, shares, options, cancellation of loans to staff, pension contributions, remuneration by AIFs through carried interest or other means) and nonmonetary benefits (e.g., discounts, fringe benefits, or allowances).

ESMA considers all remuneration is divisible into either (a) fixed remuneration (payments or benefits without consideration of any performance criteria) or (b) variable remuneration (additional payments or benefits which depend on performance or other contractual criteria).

Carried Interest and Co-Investment

According to Article 4(1)(d) of AIFMD, “carried interest” shall be understood as “a share in the profits of the AIF accrued to the AIFM as compensation for the management of the AIF, but it shall not include any share in the profits of the AIF accrued to the AIFM as a return on any investment by the AIFM into the AIF”. ESMA understands that carried-interest vehicles are typically limited partnerships—which are themselves limited partners in the AIF, together with third-party investors—and are used by senior executives either to regulate executives’ entitlements to carried interest among themselves as a consequence of modest capital contribution or to commit capital which is more than merely nominal—i.e., co-investments—in transactions along with the AIF.

Therefore, ESMA considers that any payment made directly by the AIF to Identified Staff consisting of a pro rata return on an investment made by Identified Staff into the AIF is not remuneration under AIFMD and is therefore not subject to any of the remuneration requirements. Crucially, the investment needs to consist of an actual disbursement made by the Identified Staff. Therefore, a loan from the AIFM to the staff member to allow investment would not fall within this exemption if it has not been reimbursed by the staff member by the time the return is paid.

AIFMs should be able to identify clearly and make the relevant distinctions in the treatment of the following:

- The portion of the payment made by the AIF to Identified Staff which exceeds the pro rata investment return for the investment made by the Identified Staff and represents carried interest (subject to the AIFMD remuneration requirements and the Remuneration Guidelines).
- The portion of the payment made by the AIF to Identified Staff which represents a share in the profits of the AIF accrued to the Identified Staff as a pro rata return on any investment by the Identified Staff through the carried interest vehicle into the AIF (not subject to the AIFMD remuneration requirements and the Remuneration Guidelines).

ESMA recognises that certain remuneration structures have been set up in a way that aims to align the interests of the AIFM’s staff with those of the AIF’s investors, which is the aim of the remuneration requirements. It proposes to exempt such structures from the risk alignment requirements, provided the following conditions are met:

- The AIFM returns all capital contributed by investors plus any agreed hurdle rate to the investors of the AIF before Identified Staff receive compensation.

- Compensation received by Identified Staff is subject to clawback arrangements until liquidation of the AIF.

The structure ESMA has in mind appears to be a typical “fund as a whole” carried interest. There are outstanding questions concerning how deal-by-deal or modified deal-by-deal carry will be addressed, and it will fall to the industry to seek to create structures which meet both commercial and regulatory imperatives.

Fees, Commissions, and Retention Bonuses

Fees and commissions received by intermediaries and external service providers for outsourced activities are not caught; however, ESMA is considering whether to apply the remuneration requirements to payments made by the AIFM or AIF to a delegate of the AIFM. Retention bonuses are considered variable remuneration and will only be allowed where the risk alignment requirements are properly applied.

Other Payments

Ancillary payments or benefits which pose no incentive effects as regards risk assumption and are part of a general, nondiscriminatory, AIFM-wide policy will not qualify as remuneration.

The consultation is open until 27 September 2012, and ESMA aims to publish the final version of the Remuneration Guidelines before the end of 2012 with a commencement date of 22 July 2013, the deadline by which member states must have transposed AIFMD into domestic law. We are closely monitoring developments in AIFMD implementation and will keep you informed.

Contacts

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