AIFMD - Remuneration

Directive 2011/ 61/EU on Alternative Investment Fund Managers (**AIFMD**) had to be implemented by EU member states by 22 July 2013. AIFMD is supplemented by a delegated regulation (**AIFMD Regulation**). AIFMD regulates the activities of Alternative Investment Fund Managers (**AIFMs**) and their Alternative Investment Funds (**AIFs**). The AIFMD requires AIFMs to operate sound and prudent remuneration policies and practices and organisational structures which are consistent with sound and effective risk management. AIFMD has been implemented in Ireland by the European Union (Alternative Investment Fund Managers) Regulations, 2013.

The European Securities and Markets Authority (**ESMA**) has published final Guidelines on remuneration of alternative investment fund managers (AIFMs) **(Guidelines)** The Guidelines further clarify the requirements set out in the AIFMD. The Guidelines apply from 22 July 2013, subject to the transitional provisions of the AIFMD. In developing these Guidelines, ESMA co-operated with the European Banking Authority in order to ensure alignment of guidance on remuneration policies across financial sectors.

The rationale, enunciated by Steven Maijoor, ESMA Chair, is that: "These guidelines will help promote prudent risk-taking by fund managers and help align the interests of both fund managers and investors. Making sure that these provisions on pay are applied in a common and consistent way is key to increasing investor protection and ensuring a level-playing-field in the alternative fund sector across the EU."

Principles on remuneration

These principles are set out in Annex II of AIFMD and include the following.

- AIFMs must set a remuneration policy (reviewed at least annually), following prescribed principles in a way and to the extent that is appropriate to their size, internal organisation and the nature, scope and complexity of their activities. These will apply to staff whose professional activities have a material impact on the risk profile of the AIFM or the AIF it manages.
- A substantial portion (generally at least 50%) of any variable remuneration must consist of units of the AIF or related instruments (unless the management of AIFs accounts for less than 50% of the total portfolio managed by the AIFM).[1]
- Such units or instruments must be subject to an appropriate retention policy (this should align the interests of the AIFM with the AIF and its investors).
- At least 40-60% of the variable remuneration (depending on the level of such remuneration) must be deferred over a period which is appropriate to the life cycle, redemption policy and risk profile of the AIF (at least 3-5 years unless the life cycle of the AIF is shorter).[1]
- The variable element may only be paid or vested if it is sustainable as regards the financial situation of the AIFM as a whole, and justified by the performance of the business unit, the AIF and the individual concerned[1]. Variable remuneration may be reduced by a variety of methods, including clawback and malus[2] .
- Staff are required to undertake not to use personal hedging strategies or remuneration and liability related insurance to undermine the risk alignment effects of their remuneration arrangements.

Scope

The Guidelines apply to AIFMs and self –managed AIFs. AIFs which are not self- managed and have appointed an external AIFM are not subject to the remuneration principles established in the AIFMD as well as the Guidelines. However, the Guidelines are relevant to those AIFs, as well as the AIFMs which can benefit from the exclusions and exemptions in Articles 2 or 3 of the AIFMD, to the extent that they fall within the definition of 'financial undertaking' in Commission Recommendation 2009/384/EC of 30 April 2009 on remuneration policies in the financial services sector.

Remuneration Policies and Practices

- AIFMs must adopt and operate sound and prudent remuneration policies and practices and organisational structures which are consistent with sound and effective risk management and avoid conflicts of interest, and are not circumvented.
- AIFMs must select the type of staff for which a remuneration policy is put in place and be able to demonstrate according to which criteria this selection occurred.
- Employee shareholders or partners in the AIFM may receive dividends or other distributions as owners of the AIFM, but only to the extent that they do not circumvent the Guidelines (whether intentionally or not).

1 Requirements may be disapplied, based on principals of proportionality

2 malus: arrangement that permits the AIFM to prevent vesting of all or part of the amount of a deferred remuneration award in relation to risk outcomes or performance of the AIFM as a whole, the business unit, the AIF and, where possible, the individual concerned. Malus is a form of ex-post risk adjustment.

Categories of staff covered

The Guidelines apply to identified staff[3] whose professional activities might have a material impact on the AIF's risk profile. This includes:

- senior management, risk takers, control functions[4]; and
- any employee receiving a total remuneration that takes them into the same remuneration bracket as those categories of staff.

The Guidelines state that the general requirements on risk alignment should be applied by AIFMs only to the individual remuneration packages of the identified staff, but go on to provide that a voluntary AIFM-wide application is strongly recommended. AIFMs must assess whether these requirements should be applied to the AIFM as a whole and, if required, be able to demonstrate to competent authorities why they have applied these requirements to the identified staff only. Where an individual works for 2 separate entities and, for example, one is subject to remuneration requirements under AIFMD and the other is subject to the requirements of the Capital Requirements Directive, the remuneration must be pro- rated between the two entities and the relative requirements applied accordingly.

Delegation

AIFMs must ensure that

- entities to which portfolio management or risk management have been delegated (wherever located) are subject to equivalent regulatory requirements on remuneration; or
- contractual arrangements are put in place with the delegates to ensure that there is no circumvention of the Guidelines.

Types of remuneration covered

- For the purposes of the Guidelines, remuneration consists of all forms of payments or benefits paid by the AIFM, of any amount paid by the AIF itself, including carried interest, and of any transfer of units or shares of the AIF, in exchange for professional services rendered by the identified staff.
- All remuneration must be categorised as 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).
- Remuneration policy should cover all aspects of remuneration including fixed components, variable components, pension terms and other similar specific benefits. The pension policy (the fixed as well as the variable pension payments) must be aligned with the long term interests of the AIFM and the AIFs it manages.

Both components of remuneration (fixed and variable) may include monetary payments or benefits (such as cash, shares, options, remuneration by AIFs e.g. through carried interest models) or non-monetary benefits (such as discounts, special car allowances etc.).

Remuneration Committee

An AIFM must establish a remuneration committee[1] if it is significant in terms of

- the size of the AIF it manages;
- its internal organisation; and
- the nature, scope and complexity of its activities

The Guidance sets out examples of circumstances where a remuneration committee may not be required, such as where the AIFM is managing AIFs of €1.25 billion or less and has 50 employees or less.

Proportionality

In exceptional cases, taking into account size, internal organisation, scope and complexity, some of the remuneration requirements may be disapplied where this fits with the risk profile, risk appetite, the strategy of the AIFM and the AIFs it manages and is within the limits set by the Guidelines. Each disapplication must be justifiable to the competent authority. Certain requirements may only be disapplied in their entirety.

- variable remuneration in instruments;
- retention; and
  deferral;
- ex post incorporation of risk for variable remuneration (such as clawbacks);
- remuneration committee

3 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 the AIFM's risk profile or the risk profiles of the AIF that it manages and categories of staff of the entity(ies) 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.

4 staff (other than senior management) responsible for risk management, compliance, internal audit and similar functions within an AIFM (e.g. the CFO to the extent that he/she is responsible for the preparation of the financial statements).

Disclosure

Unless member states so require, remuneration policies and practices do not have to be publicly disclosed.[5]

Non – EU AIFMs

Non-EU AIFMs which market units or shares of AIFs to professional investors in member states without a passport will only be subject to the disclosure provisions in the Guidelines. These non-EU AIFMs will be subject to the full set of remuneration provisions in the Guidelines as soon as private placement ceases and the passport regime is in operation.

Next steps

The Guidelines will be translated into the official languages of the EU. Within two months of the publication of the translations on ESMA's website, competent authorities must confirm to ESMA whether they will or will not comply with the Guidelines by incorporating them into their supervisory practices. Subject to this process, the Guidelines will apply from 22 July 2013, subject to the transitional provisions of the AIFMD.

[5]An AIFM must produce annual reports for each of the AIFs it manages, and for each of the AIFs it markets in the EU, which must contain details of

- total remuneration for the financial year (split into fixed and variable remuneration) paid by the AIFM to its staff members, the number of beneficiaries and, where relevant, carried interest paid by the AIF; and
- the aggregate amount of remuneration broken down by senior management and members of staff whose actions have a material impact on the risk profile of the AIF.

Article 107 of AIFMD Regulation further elucidates that this disclosure should specify whether it relates to any of the

following:

- the total remuneration of the entire staff of the AIFM, indicating the number of beneficiaries;
- the total remuneration of those staff of the AIFM who in part or in full are involved in the activities of the AIF indicating the number of beneficiaries;
- the proportion of the total remuneration of the staff of the AIFM attributable to the AIF, indicating the number of beneficiaries.

Where this is disclosed at the level of the AIFM, a breakdown should be given for each AIF, where possible, with an indication of how the breakdown

was provided. AIFMs must provide information on the remuneration criteria for relevant categories of staff to enable investors to assess the incentives created and to understand the risk profile of the AIF and its conflicts of interest arrangements.

KEY CONTACTS

Brian McDermott
Partner
T: +353 1 649 2307
E: bmcdermott@algoodbody.com

Michael Barr
Partner
T: +353 1 649 2327
E: mbarr@algoodbody.com

Mary McKenna
Partner
T: +353 1 649 2344
E: mmckenna@algoodbody.com

Niamh Ryan
Partner
T: +44 20 73 820 820
E: nryan@algoodbody.com

Elaine Keane
Partner
T: +353 1 649 2544
E: elkeane@algoodbody

Nollaig Greene
Professional Support Lawyer
T: +353 1 649 2359
E: ngreene@algoodbody.com

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IFSC, North Wall Quay, Dublin 1, Ireland
T. +353 1 649 2000 | F. +353 1 649 2649 | E. info@algoodbody.com | W. www.algoodbody.com

A&L Goodbody