

October 2015

Practice Group:

*Investment
Management, Hedge
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ESMA Consults on Guidelines on Sound Remuneration Policies under the UCITS V Directive and AIFMD

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On 23 July 2015, the European Securities and Markets Authority (**ESMA**) launched a consultation on proposed guidelines on sound remuneration policies under the EU's UCITS V Directive (the **UCITS Remuneration Guidelines**) and the Alternative Investment Fund Managers Directive (**AIFMD**).

The UCITS V Directive includes rules regarding the remuneration of firms managing Undertakings for Collective Investment in Transferable Securities (**UCITS**) funds together with a number of other amendments (see our Legal Insight: [UCITS V Directive—Overview and Practical Implications](#)). The proposed UCITS Remuneration Guidelines aim to clarify the UCITS V Directive provisions in order to ensure a convergent application of the remuneration provisions with the AIFMD and to provide guidance on certain provisions such as those relating to proportionality, the governance of remuneration, risk alignment and disclosure.

The UCITS V remuneration provisions are based on, and broadly reflect those, under the AIFMD (the **AIFMD Remuneration Guidelines**). In developing the UCITS Remuneration Guidelines, ESMA is co-operating with the European Banking Authority (**EBA**) with a view to aligning guidance on remuneration policies across financial sectors.

Key aspects of remuneration provisions under UCITS V

- **General principles:** UCITS managers must establish and apply remuneration policies and practices that are consistent with, and promote sound and effective risk management. Remuneration policies and practices must be in accordance with the remuneration principles set out in the UCITS V Directive.
- **Who?** The remuneration policies and practices must apply to categories of staff whose professional activities have a material impact on the risk profile of the management company or the UCITS - referred to as "identified staff". This may include portfolio managers, members of the management body, senior management and staff performing control functions (e.g., risk management, compliance, internal audit).
- **Remuneration committee:** Certain UCITS management companies may be required to establish a remuneration committee.
- **Components of remuneration:** There are specific provisions regarding the payment of fixed and variable remuneration:
 - overall remuneration must reflect an appropriate balance between fixed and variable components;
 - a substantial proportion (at least 50%) of any variable remuneration should consist of units of the UCITS concerned, equivalent ownership interests, or share-linked instruments or equivalent non-cash instruments with equally effective incentives;

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- a substantial proportion (at least 40%) of any variable remuneration should be deferred over an appropriate period of time (at least 3 years); and
- there should be disclosure of details of the UCITS manager's remuneration policy and practices either in the UCITS' prospectus or website, and disclosure of the amount of remuneration paid for the financial year in the UCITS' annual report.

Proportionality

UCITS managers are required to comply with the remuneration 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. The UCITS Remuneration Guidelines provide guidance on the application of the proportionality principle.

There was a concern that ESMA would adopt the conservative approach to proportionality taken by the EBA in its consultation on the CRD IV remuneration principles (published on 4 March 2015). The approach expressed by the EBA is that proportionality may affect the way the CRD IV remuneration principles are applied, but the principles themselves cannot be disapplied (i.e., under the EBA approach proportionality cannot be used to justify switching off any of the specific remuneration requirements). However, the draft UCITS Remuneration Guidelines, in common with the AIFMD Remuneration Guidelines, propose permitting the disapplication of certain remuneration principles provided it is proportionate to do so.

Under the draft Guidelines, the requirements that may be disapplied - indeed the only ones that may be disapplied - are requirements relating to:

- the payment of variable remuneration in instruments;
- the retention of variable remuneration;
- the deferral of payments of variable remuneration;
- ex post incorporation of risk for variable remuneration (malus or clawback); and
- the requirement to establish a remuneration committee.

Application to delegates

The definition of "identified staff" under the draft UCITS Remuneration Guidelines includes *"categories of staff at the entity(ies) to which investment management activities have been delegated by the management company, whose professional activities have a material impact on the risk profiles of the UCITS that the management company manages"*.

The draft UCITS Remuneration Guidelines, in line with the approach adopted under the AIFMD Remuneration Guidelines, require management companies to ensure that:

- delegates are subject to regulatory requirements on remuneration that are equally as effective as those applicable under the UCITS Remuneration Guidelines; or
- appropriate contractual arrangements are put in place to ensure there is no circumvention of the remuneration rules.

ESMA indicates that delegates subject to the AIFMD or CRD IV rules may be regarded as being subject to equally effective regulatory requirements. The UCITS Remuneration Guidelines do not address the position for firms subject to CRD III or non-EU delegates. As with other provisions of the UCITS directive, it will be important to monitor the

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development of the application of the remuneration requirements by local regulators, particularly in the UK, Ireland and Luxembourg, in relation to delegates, such as sub-advisers to UCITS, and/or U.S. sponsors or promoters of UCITS funds.

Disclosure requirements

Under UCITS V, certain disclosures regarding remuneration are required:

- details of the remuneration policy and practices are required to be disclosed either in the UCITS' prospectus or on the manager's website (provided that if disclosed on the manager's website, a summary is provided in the UCITS' prospectus); and
- the annual report of a UCITS must disclose the amount of remuneration paid by the UCITS manager for the financial year (split into fixed and variable), the number of beneficiaries and any amount paid out of the assets of the UCITS, including any performance fee.

Amendment to AIFMD Remuneration Guidelines

ESMA is also taking the opportunity to consult on revisions to certain aspects of the AIFMD Remuneration Guidelines. It is proposed to clarify that in a group context, non-AIFM sectoral prudential supervisors of group entities may deem certain staff of an AIFM in that group to be identified staff for the purpose of their sectoral remuneration rules.

Providing comments to ESMA

ESMA invites comments on all elements of the consultation paper, and in particular:

- compliance impacts and costs for management companies in applying the remuneration principles in any circumstances;
- compliance costs and impediments if management companies that also hold an AIFMD licence and benefit from disapplication of certain of the remuneration rules under the AIFMD Remuneration Guidelines were required to apply, for the variable remuneration of identified staff, deferral arrangements, retention, the pay out of instruments and the malus (with respect to the deferred variable remuneration);
- definition of "performance fees";
- overlap between the proposed definition of "supervisory function" in the UCITS Remuneration Guidelines and the definition of "management body" in the UCITS V Directive text;
- practical performance of services subject to different sectoral remuneration principles;
- operational difficulties of the proposed "pro rata" approach;
- proposed alternative approach providing for management companies to decide to voluntarily opt for the sectoral remuneration rules, deemed as being more effective in terms of avoiding excessive risk taking and ensuring risk alignment, and apply them to all the staff performing services subject to different sectoral remuneration rules;
- submission of the performance of ancillary services by personnel of a management company or an AIFM to the remuneration principles under UCITS Directive or AIFMD;
- proposal to look at individual entities for the purpose of the payment instruments of at least 50% of the variable remuneration;

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- need to include some transitional provisions relating to the date of application of the UCITS Remuneration Guidelines;
- assessment of costs and benefits for the proposal on proportionality;
- assessment of costs and benefits above for the proposal on the application of different sectoral rules to staff.

Timetable for finalisation of UCITS Remuneration Guidelines

ESMA will consider all comments received by 23 October 2015 and will finalise and publish the UCITS Remuneration Guidelines based on the feedback received to the consultation. Although the deadline for transposition of the UCITS V directive is 16 March 2016 and it was expected the final version of the UCITS Remuneration Guidelines to be published prior to that date, recent reports indicate that the final text may not be issued until after the transposition deadline which may create challenges and uncertainty for many UCITS managers. UCITS managers would be in a situation where they would be required to comply with the text of the UCITS V Directive, but not have the benefit of the “level two” rules or sufficient time to implement such rules into their policies and procedures.

For managers wishing to provide comments on the consultation to ESMA, or seeking advice on the impact of the UCITS V Directive, please contact your usual Investment Management contact at K&L Gates LLP.

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