

ESMA Publishes Final Guidelines on Sound Remuneration Policies under the AIFMD

On February 11, 2013, the European Securities and Markets Authority (“**ESMA**”) published its [final report and guidelines](#) (the “**Guidelines**”) on sound remuneration policies under Directive 2011/61/EC (the “**AIFMD**”) on Alternative Investment Fund Managers (“**AIFMs**”). The AIFMD must be implemented by Member States by July 22, 2013, when the Guidelines will also take effect (subject to incorporation into domestic supervisory practices). Although the Guidelines are not binding law, competent authorities and AIFMs must make “every effort” to comply with them.

The Guidelines closely follow the draft guidelines set out in ESMA’s July 4, 2012 [consultation](#) (the “**Draft Guidelines**”). Significant changes include: (a) strengthening certain anti-avoidance provisions (see 3 below); (b) including in the definition of Identified Staff (defined below), staff of third parties to which portfolio management or risk management activities are delegated (see 4 and 10 below); (c) strengthening and clarifying the application of the proportionality principle, including an acknowledgement that proportionality may in some cases lead to certain requirements being disappplied (see 5 below); (d) significantly increasing the portfolio value threshold below which AIFMs are not expected to form a remuneration committee (see 6 below); and (e) relaxing the scope of the general requirements on risk alignment (see 7 below) so that they apply to Identified Staff only, although application on an AIFM-wide basis is strongly recommended. Unfortunately, the Guidelines do not sufficiently address the deficiencies in the Draft Guidelines in the treatment of carried interest structures (see 3 and 8 below).

1. Background

The remuneration provisions of the AIFMD, contained principally in Annex II (the “**Rules**”), set out rules that AIFMs must comply with when establishing and applying remuneration policies and practices. The Rules are largely inspired by rules applicable to EU credit institutions and certain investment firms under the EU Capital Requirements Directive (“**CRD**”), with the notable differences that the Rules: (a) do not apply on a group-wide basis; (b) do not require establishment of a pre-determined ratio between fixed and variable remuneration for covered staff; and (c) specifically address carried interest. The Guidelines are modelled on the guidelines published by the Committee of European Banking Supervisors on the CRD remuneration rules (the “**CEBS Guidelines**”).

The Rules fall into three main categories: (a) governance; (b) risk alignment; and (c) transparency, with the stated aim of ensuring AIFMs have remuneration policies and practices that are consistent with and promote sound and effective risk management and do not encourage risk-taking inconsistent with the risk profiles, rules or instruments of incorporation of the AIFs they manage. The purpose of the Guidelines is to ensure common, uniform and consistent application of the Rules.

2. Who is affected by the Rules and the Guidelines

The Rules apply to legal persons whose regular business is managing one or more alternative investment funds (“AIFs”) that fall under the scope of the AIFMD, which include: (a) EU AIFMs managing AIFs; (b) non-EU AIFMs managing EU AIFs; and (c) non-EU AIFMs that market AIFs to EU professional investors with a passport. The only remuneration-related requirements applicable to non-EU AIFMs marketing to EU professional investors without a passport under national regimes are those relating to transparency.

There are no exceptions to the application of the Rules or Guidelines for AIFMs that are subsidiaries of credit institutions or part of banking, insurance or financial groups (*i.e.*, who may be subject to other remuneration rules and guidelines, such as those arising under the CRD and the CEBS Guidelines and ESMA’s forthcoming guidelines on remuneration policies and practices aimed at supporting the conduct of business and conflicts of interest obligations contained in MiFID). Where an AIFM is part of a group where a remuneration committee is already required, however, a second remuneration committee will not be required where the rules governing the existing committee’s composition, role and competence are equivalent to the Guidelines and that committee takes responsibility for checking compliance of the AIFM with the Guidelines. Although firms expressed concerns about having to comply with multiple sets of remuneration rules, ESMA responded that the various sets of guidelines are complementary, and that having a single set of guidelines for all entities subject to CRD, AIFMD, UCITS and MiFID is not currently feasible.

3. Which remuneration is covered (Part V, paras 10 - 18)

Solely for purposes of the Guidelines and Annex II, “remuneration” includes: (a) all forms of payments and benefits paid by the AIFM; (b) any amount paid by the AIF itself (including carried interest); and (c) any transfer of units or shares of the AIF, in each case in exchange for professional services rendered by “Identified Staff” (see 4 below).

Payments (excluding reimbursements of costs and expenses) made directly by an AIF “to the AIFM for the benefit of” the relevant categories of AIFM staff for professional services is also considered remuneration if this would otherwise result in a circumvention of the Rules. Similarly, although the Guidelines acknowledge that dividends and similar distributions that partners receive as owners of an AIFM are not covered, the Rules could apply to such distributions if the material outcome of the payment results in a circumvention

of the Rules, irrespective of any intention to circumvent. Unfortunately, the Guidelines provide no indication as to when these anti-avoidance provisions could be triggered.

Whilst the definition of carried interest used in the AIFMD excludes shares of profits accrued to the AIFM “as a return on any investment by the AIFM in the AIF”, and despite strong objections made in response to the consultation, the Guidelines take a more restrictive approach and only exclude from the definition of remuneration payments made by an AIF to the benefit of Identified Staff to the extent they represent a pro rata return on any investment made by those staff members into the AIF.

The AIFMD does not apply to “employee participation schemes” or “employee savings schemes”, although the exact scope of these terms is unclear. Similarly, non-discretionary AIFM-wide ancillary payments or benefits that do not create incentives for risk assumption are not considered remuneration for the purposes of the specific risk alignment requirements (see 8 below). ESMA declined the invitation to provide examples of such payments or benefits, but these may include benefits such as health or disability insurance or health club memberships.

Remuneration is divided into: (a) fixed remuneration, which are payments made or benefits provided irrespective of performance; and (b) variable remuneration, which are additional payments made or benefits provided depending on performance or other contractual criteria. Retention bonuses are considered variable remuneration and are allowed only to the extent to which they comply with certain risk alignment requirements. Both fixed and variable remuneration can include monetary payments or monetary or non-monetary benefits.

4. How to identify the categories of staff covered (Part VI, paras 19 - 22)

Whilst the Guidelines relating to governance and transparency, and certain of the risk-alignment Guidelines are directed to AIFMs as a whole, the most onerous risk-alignment Rules and Guidelines apply only to categories of staff “whose professional activities have a material impact on the risk profile” of the AIFM or of the AIFs it manages (“**Identified Staff**”).

AIFMs are responsible for identifying Identified Staff according to the Guidelines and should be able to show competent authorities how Identified Staff were assessed and selected. In the case of the general requirements on risk alignment (see 7 below), which strictly apply only to Identified Staff, ESMA strongly recommends voluntary application on an AIFM-wide basis; AIFMs should be able to demonstrate to competent authorities why they have applied the requirements to Identified Staff only.

ESMA considers the following non-exhaustive categories as Identified Staff, unless it can be demonstrated that they have no material impact on the risk profile of the AIFM or the AIFs it manages: (a) executive and non-executive members of the governing body of the

AIFM; (b) senior management; (c) persons in control functions (*e.g.*, risk management, compliance, internal audit and similar functions); (d) staff responsible for heading portfolio management, administration, marketing and human resources functions; (e) other “risk takers,” being staff members whose professional activities either individually or collectively as members of a group (*e.g.*, a unit or part of a department) can exert material influence on the AIFM’s risk profile or on an AIF it manages, including persons capable of entering into contracts/positions and taking decisions that materially affect the risk positions of the AIFM or AIF (including, for instance, sales persons, individual traders and specific trading desks). In addition, provided they have a material impact on the risk profile of the AIFM or AIF, other persons whose total remuneration takes them into the same remuneration bracket as senior managers and risk takers should be considered Identified Staff.

5. Proportionality (Part VII, paras 23 - 31)

The AIFMD envisage AIFMs taking a proportionate approach to compliance with the remuneration requirements, with not all AIFMs giving effect to the Rules in the same way or to the same extent. For this purpose, there is a distinction between two forms of proportionality: (a) proportionality between different types of AIFMs, taking into account the size and internal organization of an AIFM and the nature, scope and complexity of an AIFM’s investment activities, which is relevant for both the general and specific requirements on risk alignment; and (b) proportionality between Identified Staff, taking into account the size of the obligations to which a risk taker may commit the AIFM, the size of the group of persons who might have an impact on the AIFM’s risk profile and the structure of the remuneration of the Identified Staff (in particular the amount of variable remuneration received and the percentage of variable remuneration over fixed remuneration), which is relevant for the specific requirements on risk alignment.

The Guidelines provide that taking a proportionate approach to compliance may in certain circumstances lead to certain of the Rules being disapplied (this was not express in the Draft Guidelines). However, disapplication is not automatic; AIFMs should perform a case-by-case assessment for each of the Rules that may be disapplied and then only disapply them if it is proportionate to do so. The Rules that may be disapplied are: (a) the Rules on the pay-out process covered by the Guidelines (including the requirements relating to variable remuneration in instruments, retention, deferral and ex-post risk adjustment); and (b) the Rule on the establishment of a remuneration committee.

The Guidelines also clarify that, Rules where numerical criteria apply (minimum deferral of three to five years; deferral of 40 to 60% of variable remuneration; and minimum 50% of variable remuneration in instruments) may only be disapplied in their entirety. In other words, it will not be possible to partially disapply these Rules within an AIFM so that they operate, but with lower numerical thresholds.

6. Governance (Part X, paras 37 - 76)

The requirements relating to governance aspects apply to the AIFM as a whole. The Rules require that the AIFM's management body in its supervisory function adopt and periodically review the general principles of the AIFM's remuneration policy and is responsible for its implementation.

The Guidelines detail the way in which the management body should perform these governance functions. Ultimately, an AIFM's supervisory function must ensure that the AIFM's remuneration policy is consistent with and promotes sound and effective risk management by: (a) aligning the policy with the AIFM's business strategy, objectives, values and interests; (b) discouraging excessive risk taking; and (c) enabling the AIFM to align the interests of the AIFs it manages and their investors with those of the Identified Staff that manage such AIFs.

The Guidelines note that the (at least) annual review of the implementation of an AIFM's remuneration policy can be externally commissioned or undertaken less frequently where appropriate according to proportionality.

The Guidelines also detail the setup, composition and role of remuneration committees in AIFMs that are "significant" in size. ESMA recognizes that the requirement to establish a remuneration committee can be disapplied on the basis of proportionality. To assist in making this determination, the Guidelines contain certain specific (non-exhaustive) factors to be taken into account, including: (a) whether the AIFM is listed or not; (b) the legal structure of the AIFM; (c) the number of employees of the AIFM; (d) the AIFM's assets under management; (e) whether the AIFM is also a UCITS management company; and (f) the provision of discretionary investment management, investment advice and certain other activities. ESMA considers AIFMs with portfolios of managed AIFs not exceeding EUR 1.25 billion and with not more than 50 employees will not need to establish a remuneration committee, although they may choose to do so. Other AIFMs are not automatically required to set up a remuneration committee and should undertake their own assessment under the proportionality principle.

Finally, the Guidelines address persons in control functions, including their role in the design, oversight and review of remuneration policies, remuneration awarded to them and conflict-of-interests issues.

7. General risk alignment requirements (Part XI, paras 77 - 92)

The general requirements on risk alignment apply only to Identified Staff, although ESMA strongly recommends voluntary application on an AIFM-wide basis. The Guidelines contain a number of general statements about the alignment of an AIFM's remuneration policy with the risk profiles and rules of incorporation of the AIFs they manage and provides

that an AIFM's remuneration systems should be well designed and implemented (including a "proper balance" of variable to fixed remuneration).

The following topics are also covered in this section of the Guidelines:

- **Discretionary pension benefits:** (a) Identified Staff should not retire or leave the AIFM with vested discretionary pension benefits, without any consideration of the economic situation of the AIFs that the AIFM manages or risks that have been taken by the Identified Staff member in the long term; (b) where possible, discretionary pension benefits should be paid in the form of instruments; (c) upon retirement, vested discretionary pension benefits should be subject to a five-year retention period; and (d) upon termination other than for retirement, discretionary pension benefits should not be vested before five years and should be subject to performance assessment and ex-post risk adjustment before pay out;
- **Severance payments:** Golden parachute payments without performance and risk adjustment are considered inconsistent with the Rules. Severance payments should be related to performance over time and not reward failure, although the Guidelines confirm that this does not preclude early termination payments or termination payments made in merger and/or takeover situations; and
- **Personal hedging:** The Guidelines provide that AIFMs should maintain effective arrangements to ensure Identified Staff do not use personal hedging strategies or insurance to undermine the risk alignment effects of deferred and retained variable remuneration (for example, they should not buy an insurance contract that compensates them in the event of a downward adjustment in remuneration, or enter into a contract with a third party which requires the third party to make payments directly or indirectly linked to the amount their remuneration has reduced).

8. Specific risk alignment requirements (Part XII, paras 93 - 159)

The specific requirements on risk alignment apply only to Identified Staff, but it is open to AIFMs to consider voluntary application on an AIFM-wide basis. Key aspects of this section of the Guidelines are highlighted below:

- **Fully-flexible policy:** The Guidelines restate the Rule that a fully-flexible policy on remuneration means that variable remuneration should decrease as a result of negative performance and in some cases this means that no variable remuneration will be paid at all.

- **Risk alignment of variable remuneration:**
 - Variable remuneration should be awarded at the end of or during an accrual period of at least one year;
 - A specified award process should be used to relate performance to the variable remuneration award for each Identified Staff member. Ex-ante risk adjustment should be applied at this stage to adjust remuneration for potential adverse developments in the future;
 - Variable remuneration should be partly paid upfront and partly deferred (see further below). Before paying out the deferred portion, performance should be reassessed and, if necessary, an ex-post risk adjustment applied to reflect risks and errors that have appeared since the award was made;
 - Risk and performance measurement should be aligned with the life-cycle and redemption policy of the AIFs and their investment risks. The accrual and pay-out periods should be appropriate in total;
 - Variable remuneration should be determined based on individual performance, the performance of the business line or AIF concerned and the performance of the AIFM;
 - Both quantitative and qualitative approaches should be used in the risk-alignment process, but whenever judgment is used for risk and performance measurement or risk adjustment, this should be pursuant to a clearly written policy, the decision should be well documented and the AIFM should be prepared to disclose any judgmental elements incorporated into their risk alignment process;
 - Both on- and off-balance sheet risks should be taken into account; and
 - Both quantitative and qualitative criteria should be used to assess individual performance.

- **The award process:**
 - The award process and determinations should be documented; and
 - When measuring the profitability of the AIFM, its business units and the AIF, measurement should be based on net revenue where all direct and indirect costs are included. AIFMs should not exclude IT costs,

research costs, legal fees, marketing costs and costs for outsourced activities.

- **The pay-out process:**

- Deferral periods should be calculated on the basis of the life cycle and redemption policy of the AIF and the potential impact of the Identified Staff member on the risk profile of the AIF. A minimum deferral of three to five years should be applied, unless the AIFM can demonstrate that the life cycle of the AIF concerned is shorter. AIFMs should consider longer deferral periods for members of the management body;
- Vesting should not take place more frequently than yearly;
- 40-60% of variable remuneration should be deferred, depending on the impact of the Identified Staff on the risk profile of the AIF, the responsibilities and tasks performed and the amount of variable remuneration awarded;
- The first amount should not vest sooner than 12 months after the accrual period;
- Staff should only be remunerated using “instruments” (that is, units or shares of the AIF managed by the AIFM or equivalent ownership interest, or share-linked instruments or equivalent non-cash instruments) if this does not trigger interest misalignment of interests or encourage risk-taking, which could be the case for Identified Staff not involved in portfolio management or for Identified Staff awarded instruments in a single AIF only;
- No dividends or interest should be paid on instruments before vesting;
- Once deferred remuneration awarded in instruments has vested, it must be subject to an additional retention period, during which it cannot be sold. Retention periods are also required for up-front remuneration awarded in instruments. The retention period can be shorter or longer than the deferral period, but longer periods should be applied for Identified Staff with the most material impact on risk profiles, and large and complex AIFMs should consider longer periods for their most senior Identified Staff;
- Instruments should be valued on the date of the award (at the end of the accrual period);

- At least 50% of deferred variable remuneration and at least 50% of upfront variable remuneration should be provided in the form of instruments. The same ratio between cash and instruments should be applied to the upfront and deferred parts. This requirement is disapplied where the management of AIFs accounts for less than 50% of the total portfolio managed by the AIFM, and the Guidelines confirm that the 50% threshold should be based on the net asset value of the AIFs;
 - AIFMs must undertake ex-post risk adjustment through “malus” or “clawback” clauses. These are defined in the Guidelines respectively as an arrangement that permits the AIFM to prevent vesting of deferred remuneration, and a contractual arrangement in which the Identified Staff member agrees to return remuneration under certain circumstances;
 - Ex-post risk adjustment based on share price evolution is insufficient. The effect of maluses should not be inflated by paying out artificially high interest on deferred cash;
 - The criteria for determining whether malus or clawbacks apply should include evidence of misbehaviour or serious error by the Identified Staff member, a significant downturn in financial performance or significant failure of risk management of the AIF, AIFM and/or business unit and significant changes in the AIFM’s overall financial situation. Clawback should also typically operate in the case of fraud or misleading information; and
 - Under no circumstances should ex-post risk adjustment for cash or instruments result in an increase of the deferred part.
- **Carried interest structures:**
 - Paragraph 159 of the Guidelines contains a safe-harbour for certain carried interest models, whereby ESMA acknowledges that if: (a) an AIFM must first return all capital contributions to AIF investors together with an agreed preferred return (if any) before the Identified Staff receive any variable compensation for the management of the relevant AIF (effectively, an EU-style whole-fund model); and (b) compensation received by Identified Staff is subject to clawback until the liquidation of the AIF, the requirements relating to: (x) risk alignment of variable remuneration; (y) the award process; and (z) the pay-out process (each as described above) may be considered as met.

- ESMA failed to respond to significant criticisms, including that the Draft Guidelines did not take sufficient account of the different forms of carried interest models (such as US-style deal-by-deal models); carried interest models may also be relevant to the satisfaction of other requirements, including those relating to governance and the requirement to have a fully flexible policy on remuneration; and limbs (a) and (b) should be treated as alternative requirements.

9. Transparency (Part XIII, paras 160 - 170)

The AIFMD requires AIFMs to make available to competent authorities and to investors upon request, an annual report that contains details of: (a) the total amount of remuneration for the financial year split into fixed and variable remuneration, the number of beneficiaries and, where relevant, carried interest paid by the AIF; and (b) aggregate remuneration broken down by senior management and members of staff whose actions have a material impact on the risk profile of the AIF.

Sympathetic to the large number of respondents who disagreed with a public disclosure requirement, ESMA acknowledges in its report accompanying the Guidelines that such disclosure should not necessarily be public, although this is without prejudice to disclosures to prospective investors required elsewhere by the AIFMD. AIFMs are, however, encouraged by ESMA to consider making additional disclosures in-line with Commission Recommendation 2009/384/EC of April 30, 2009 on remuneration policies in the financial services sector. An AIFM who wishes to make such additional disclosures has flexibility in the manner in which they are made and the proportionality principle applies (although in all cases disclosure should be clear, easily understandable and accessible, and ESMA recommends that disclosures be published at least annually and as soon as practicable after the information becomes available).

Remuneration policies should also be made available to staff members on an internal basis, and information disclosed internally should reveal at least any details that are disclosed externally.

10. Delegation

Unlike in the Draft Guidelines, staff of entities to which portfolio management or risk management activities are delegated by the AIFM are included in the definition of Identified Staff in the Guidelines (provided they meet the material impact on risk profile test). These provisions are arguably inconsistent with the plain text of the AIFMD, under which the Rules apply only to staff of the AIFM.

In addition, the Guidelines provide that, when delegating portfolio management or risk management activities AIFMs should ensure that: (a) the delegated entities are subject to regulatory requirements on remuneration that are “equally as effective” as those

applicable under the Guidelines; or (b) that “appropriate contractual arrangements” are put in place to ensure that there is no circumvention of the requirements of the Guidelines in relation to payments made to the delegates’ Identified Staff as compensation for the performance of portfolio or risk management activities on behalf of the AIFM. The requirements of (a) are unlikely to be met where such functions are delegated to US entities, and so appropriate contractual arrangements would need to be put in place.

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If you have any questions, please feel free to contact any of your regular contacts at the firm or any of our partners and counsel listed on our website at www.clearygottlieb.com.

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