# The FCA AIFMD Remuneration Code

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## Introduction

Some of the most controversial provisions in the Alternative Investment Fund Managers Directive (Directive 2011/61/EU) (the AIFMD) relate to the provisions for controlling the way in which the staff of a manager (an AIFM) of an Alternative Investment Fund (AIF) (a term which encompasses all types of funds that are not regulated as UCITS, including hedge funds, private equity funds and real estate funds) can be remunerated.

In February 2013 the European Securities and Markets Authority (ESMA) published its finalised guidelines on the remuneration of alternative investment fund managers. These guidelines raised as many questions as they answered. This was followed by guidance in draft form from the FCA in the form of provisions within the FCA's quarterly Consultation Paper published on 6th September 2013. It is intended that the new draft guidance will be implemented early in 2014 by amending the FCA's Handbook at SYSC 19B which includes the FCA's AIFM Remuneration Code and associated guidance.

The FCA's draft guidance has generally been welcomed as sensible and pragmatic. It has provided answers on various questions raised by the Directive and by the ESMA Guidance.

It should be noted, however, that the FCA's guidance, once finalised, will act as a supplement to the ESMA guidelines, and does not replace the ESMA guidelines. This may lead to some uncertainty in applying sets of guidance, which are not always clearly expressed.

This briefing note provides an overview of how the AIFMD will apply to UK authorised AIFMs in the light of some of the important elements of this new guidance and its implications for AIFMs.

## Who and what does this affect?

### Which firms?

It should be noted that the remuneration provisions of the AIFMD affect all AIFMs operating within the EU. However, where non-EU AIFMs are marketing to professional investors in the EU (relying on the exemptions to the requirement for passporting in Article 42 AIFMD), only certain requirements (essentially the guidelines on disclosure) apply.

They will not apply to AIFMs that are exempt from the requirements as a result of their small size (broadly where gross assets under management are below €100 million, or €500 million if the portfolios are unleveraged and redemption rights do not apply in the 5 years from investment).

The guidelines relate to "remuneration" defined in a very broad way to include:

i. all forms of payment or benefits paid by the AIFMs
ii. any amount paid by the Alternative Investment Fund (AIF) itself, including carried interest
iii. any transfer of units or shares of the AIF

in exchange for professional services rendered by the AIFM identified staff.

Remuneration includes fixed remuneration, variable remuneration and may include benefits such as cash, shares, cancellation of loans on dismissal, pension contributions and fringe benefits.

The ESMA guidelines had already clarified that "remuneration" should not be taken as including any payment made by the AIF for the benefit of staff which consists of a pro rata return on any investment made by those staff members[1]. Similarly, remuneration does not include dividends "or similar distributions that partners receive as owners of an AIFM" "*unless the material outcome of the payment… results in a circumvention of the relevant remuneration rules*".

As discussed below, the application of these concepts has been developed further in the draft FCA guidance.

### Which staff?

The AIFM Remuneration Code applies to "AIFM Remuneration Code Staff". This is defined to include categories of staff whose professional activities have a material impact on the risk profiles of the AIFM or of the AIFs that the AIFM manages. This is taken to include senior management, risk takers, control functions, and any employees receiving total remuneration that brings



[1] (provided the staff members did not pay for the stake out of loans from the AIFM that have not been repaid at the point the return is paid)

them into the same remuneration bracket as senior management and risk takers. The definition is a shortened précis of the term "identified staff" used in the ESMA guidelines which has a longer but essentially similar definition.

Importantly, the FCA proposes applying a proportionality standard to the application to staff of some of the most controversial remuneration requirements, referred to as the "pay-out process rules" as discussed further below and the general (but subject to exceptions) ban on "guaranteed variable remuneration" (which may be considered as something of an oxymoronic concept).

It considers it generally proportionate not to apply these arrangements to identified staff whose variable remuneration is no more than 33% of their total remuneration and whose total remuneration is no more than £500,000. The FCA regards this figure as being a "particularly high amount" for the purpose of the rule that at least 60% of variable remuneration should normally be deferred for a period of 3 to 5 years). However AIFMs are required also to consider whether lesser sums should be considered "particularly high" in the circumstances, such as where there are significant differences in the levels of variable remuneration paid to staff performing particular functions.

### When does this come in?

The guidance is applicable once a firm has been authorised as a full-scope UK AIFM (which, for AIFM's that are of the relevant size to require such authorisation must take place within a year of 22 July 2013). The FCA's AIFMs Remuneration Code and guidelines will apply in respect of "new awards" of variable remuneration for performance periods following that in which the firm becomes so authorised - and not any earlier awards.

The question of what is a "new award", and related concepts as what is meant by an award "vesting" is one that may not always be clear –see the discussion further below.

## Remuneration Principles

As a reminder, the AIFMD contains in its Annex II a series of principles applicable to remuneration policies, which are to be established and applied to the relevant staff "in a way and to the extent that is appropriate to the size and internal organisation of the AIFMs and to the nature, scope and complexity of the AIFM's activities", broadly these include:

a. the remuneration policy should promote sound and effective risk management consistent with the risk profiles, rules and constitutions of the relevant AIFs;
b. the policies should support the business strategy, objectives, values and long term interests of the firm and the AIFs it manages, including measures to avoiding conflicts of interests;
c. the management body of the AIFMs in it supervisory function should adopt and periodically review the general principles of remuneration policy, and is responsible for its implementation;
d. implementation of remuneration policy is subject to central and independent internal review at least annually;
e. staff engaging control functions are compensated in accordance with achievement of objectives linked to their functions, independent of business performance;
f. the remuneration of senior officers in risk management and compliance are directly overseen by the remuneration committee;
g. where remuneration is performance related, the total amount of remuneration is based on a combination of the individual's performance and that of the business unit or AIF concerned and the results of the AIFMs, and includes financial as well as non-financial criteria;
h. the assessment of performance is set in a multi-year framework appropriate to the life cycle of the AIF and the payment of performance-based components is spread over a period which takes account of the redemption policy of the AIFs it manages and their investment risks;
i. guaranteed variable remuneration is exceptional and occurs only in the context of new staff, limited to the first year;
j. fixed and variable components of remuneration are appropriately balanced and the fixed component represents a sufficiently high proportion of total

remuneration to allow the operation of a fully flexible policy on variable components, including the possibility to pay no variable remuneration component;

k. payments on early termination reflect performance over time and do not reward failure;

l. performance measurement includes a comprehensive adjustment mechanism to integrate all relevant types of current and future risks;

m. subject to the legal structure of the AIF and its rules or instruments of incorporation, a substantial proportion and in any event at least 50% of any variable remuneration consists of ownership interests, or equivalent instruments (unless the management of AIFs accounts for less than 50% of the total portfolio managed by the AIFMs). These instruments are subject to an appropriate retention policy designed to align incentives with the interests of the AIFM and the AIFs it manages;

n. a substantial proportion, and in any event at least 40% of the variable remuneration is deferred over a period which is appropriate in view of the life-cycle redemption policy of the AIF and correctly aligned with the nature of the risks of the AIF. The directive stipulates a period of at least 3 to 5 years unless the life cycle of the AIF is shorter; that remuneration payable under deferral arrangements should vest no faster than on a pro-rata basis and if there is a high variable remuneration component for 60% to be deferred;

o. the variable remuneration, including the deferred portion will there still be paid only if sustainable according to the financial situation of the AIFMs as a whole and is justified according to the performance of the business unit, the AIF and the individual, with an expectation that the total variable remuneration will be considerably contracted in the event of poor performance;

p. pension policy will be in line with business strategy, objectives, values and long-term interests, with discretionary pension benefits being held by the AIFM for a period of 5 years in the form of instruments mentioned at (m) above if the employee leaves the AIFM before retirement;

q. variable remuneration is not paid through vehicles or methods that facilitate the avoidance of the requirements of the Directive;

r. where the AIFM is significant in the terms of its size of the size of the AIFs that it manages, it should establish a remuneration committee that can exercise competent and independent judgement.

## Applying proportionality to the pay-out process rules

The rules that have been most controversial and which are the most difficult to apply are those which the FCA defines as the "Pay-out Process Rules". These include the requirements that:

- a substantial proportion and in any event at least 50% of any variable remuneration should consist of units or shares of the AIF concerned or equivalent ownership interests
- such units, shares or interests must be subject to an appropriate retention policy designed to align incentives to the long-term interests of the AIFM and the AIFs it manages
- a substantial portion, and at least 40% of variable remuneration must be deferred over a period that is appropriate to the life cycle of the AIF concerned;
- variable remuneration is paid or vests only if it is sustainable according to the financial situation of the AIFM and justified according to the performance of the AIF; and

The FCA' guidance is helpful in applying the concept of proportionality to these provisions.

The FCA approach is to apply a (rebuttable) presumption based on the size of assets under management as to whether these rules are appropriate. The presumption is as follows at the tope of p5.

However these presumptions cannot be applied simplistically and the guidance lists a series of other "*proportionality elements*" that firms should take into account in deciding whether the presumption created by these thresholds should apply. These elements include the **size** of the firm (and in particular of its management team); its **internal organisation** (including whether the AIFM is a quoted company or has a significant proportion of its equity held by investors not working in the business - both indications that the rules should not be disapplied); the **nature scope and complexity of its activities** (including its risk profile, the delegation arrangements and the **nature** of fee structures such as performance fees or carried interest, particularly where the design of the structures may satisfy the object of aligning interests with investors).

| Type of firm | *AuM* threshold | Presumption |
|---|---|---|
| *AIFMs* which manage portfolios of *AIFs* including assets acquired through use of leverage | Less than [£500 million -£1.5 billion] | it is appropriate to disapply *Pay-out Process Rules* |
| | Greater than [£500 million -£1.5 billion] | it is not appropriate to disapply *Pay-out Process Rules* |
| | | |
| *AIFMs* which manage portfolios of *AIFs* that are unleveraged and have no redemption rights exercisable during a period of 5 years following the date of initial investment in each *AIF* | Less than [£4-6 billion] | it is appropriate to disapply *Pay-out Process Rules* |
| | Greater than [£4-6 billion] | it is not appropriate to disapply *Pay-out Process Rules* |

## Some difficult issues

### FCA approach generally

Applying the AIFM Remuneration Code to the wide range that exists of AIFM structures, including carried interest structures, is problematic. The latest FCA guidelines seek to clarify some of these difficulties.

It should be noted, however, that many of these difficulties were recognised by ESMA when it sought consultation on its original draft guidelines, and despite receiving persuasive lobbying in relation to many of these issues, ESMA declined to do much to respond to some of the areas of difficulty as it considered itself to be constrained by the drafting of the Directive, or by policy issues.

As discussed below, the FCA has gone further in its latest draft guidance. The clarity, and pragmatism of the FCA guidance is welcome but this does raise the interesting question whether its guidance will be considered at European level to be consistent with the text of the Directive and with the ESMA guidance.

### Carried Interest as remuneration

The FCA appears to have accepted a much-lobbied for view that carried interest arrangements as used within traditional private equity structures are already designed to create an alignment between the interest of investors and of management. In one of a series of examples provided within it's the draft guidance as to the application of the principle of proportionality, it accepts an argument that where carried interest arrangements may reasonably be thought of as creating this alignment the principle of proportionality may be used to exclude the operation of the pay-out process rules.

This approach seems neatly to sidestep the conclusion that ESMA had reached that it had no scope but to treat carried interest as remuneration for the purpose of applying these rules.

### Excluding business owners from the definition of "*identified staff*"; treatment of partnerships

Responses to the consultation asked ESMA to reconsider the position of business owners (such as the members of an LLP or owners of the small company) to be excluded from the definition of "*identified staff*", given their obvious alignment to the interests of the AIFM. ESMA did not accept that this category of staff should be included, but did agree to clarify the dividends paid to shareholders and profit allocations to members of an LLP should not be considered to constitute remuneration as long as this is not being used as a means of circumventing the requirements of the Directive.

The FCA has gone further in providing guidance as to how one distinguishes between "*remuneration*" and profit allocation in the case of an AIFM that is structured as a partnership or LLP. It suggests various possible approaches to such an allocation.

The first approach would be to look at how profit-sharing is carried out to see if this discernibly breaks down into an equivalent of fixed salary, bonus and residual profit share. For example if there are senior or founding partners who receive residual profit share (and other partners working within the business do not), their share could be regarded as the true profit element and not regarded as remuneration. If there are arrangements for a fixed drawing taken out in advance of profits being earned, this can be regarded as a fixed element of remuneration. This approach seems a little confused from the strict legal viewpoint (it confuses drawings, which technically may be a borrowing against future profit allocations, with the allocation of profit). However, the approach could be a practical one in some circumstances as it will often accord with how the partners in question see their remuneration being structured.

The second possible approach is based on benchmarking against what is paid as salary by competitor companies; or considering what can be regarded as a reasonable return on investment; or looking at how the payout of partnership earnings occurs and how profits are shared.

The concept of benchmarking in this context seems an extremely difficult one to apply. First as a practical matter the accounts of general partnerships are not publicly available and the accounts of LLPs do not break down the remuneration of members between salary equivalent, bonus and other profit share[2]. Even if figures can be obtained (and one can see some of the remuneration consultancies looking forward to good times ahead in compiling and charging for these figures), there is no agreed basis on which the benchmarks will apply. For example the precise scope of the function of a staff member may not be clear from his or her job title. There may be different levels of responsibility according to the arrangements in place for delegation of functions. The responsibility levels may be very different from different sizes of fund. Founder members of an LLP with an ownership arrangement may be happy to take a very small fixed remuneration and have no arrangements for bonus houses factored in.

It will be interesting to see how firms respond to these alternatives – one rational response might be to finesse the arrangements for sharing profits within an LLP or other partnership to create something that clearly falls within the model of fixed remuneration, bonus tranche and variable profits tranche and to sidestep the difficult questions raised by the concept of benchmarking.

The FCA acknowledges that insofar as the pay-out process rules apply and require the deferral of a profit payout, or a pay-out otherwise than in cash, this could give rise to a difficult tax position, as the taxes payable by partners or members of an LLP whether or not profits are paid out. The FCA is discussing this issue with HMRC (which is independently pursuing a review of partnership taxation more generally), but meanwhile seeks to ameliorate this potential difficulty by allowing deferrals of income to apply on a net-of-tax basis.

## What is an "*award*"; when is "*vesting*"?

In order to know how these rules (and especially the pay-out process rules) apply, it is necessary to determine when an award is made and when it is vested. These concepts are recognisable in the context of the type of traditional bonus scheme such as an LTIP, STIP or share option scheme that one might see operated within a major institution, but may be less easy to apply to the messy and bespoke arrangements that one can find with smaller firms, or when dealing with remuneration through a carried interest scheme. Disappointingly, the FCA has not put forward detailed guidance on this point.

In our opinion the broad concept is that an award can be regarded as having been made whenever a specific payment, or fixed method of calculation of the payment is agreed. If there are no conditions or clawback arrangements, then the award is regarded as vested at the same time (even if it is paid out only later). If there are significant conditions, then vesting occurs when these conditions are met. It may be difficult in applying the analysis to make a distinction between conditions that determine vesting has taken place and conditions that would cause the imposition of malus or clawback (which is recognised as something that happens at a later stage than vesting). As new arrangements are designed with the AIFMD Remuneration Principles in mind, no doubt appropriate language will be used to characterise the different stages of making awards so that it is clear how these arrangements apply.

Applying these concepts to an existing carried interest structure is particularly interesting. If a carried interest vehicle is used then awards and vesting will probably be recognisable according to the rules used to provide interests to individuals out of carried interest vehicle. However in cases where the carried interest is apportioned out to named individuals, and is a true interest in the fund vehicle, then there may be a strong argument that the award was made at that early point (and perhaps already is vested). Such an analysis may be helpful where the arrangements were designed in the past without anticipating the new rules since it may allow one to conclude that these are can be regarded as having happened before the new rules come into effect.

[2] Under the SORP applicable to LLPs a distinction is made in statutory accounts between profit share received by way of remuneration and other profit share but this is not applied in a way that would be relevant to the breakdown required for these purposes.

### Dealing with situations where it is impractical to pay variable remuneration in the form of shares, units or other instruments

The FCA accepts that there may be practical difficulties in paying remuneration in the form of shares, units or other instruments resulting from the nature of the fund or marketing or tax restrictions and applies the proportionality principle to allow a firm not to apply this rule in such a situation. It also recognises that this rule may be inappropriate for some staff (for example senior management or compliance or audit staff). It recommends that firms in such situations instead make the payment in shares or other interests in the AIFMD itself , its parent company or in an instrument linked to the weighted average of AIFs managed by the AIFM.

### Application to delegates

The ESMA guidelines extended the scope of the remuneration principles so that they would apply to cover staff working for firms to which the AIFM delegates portfolio management or risk management where those activities have a material impact on the AIF's risk profile. However this requirement does not apply where the delegate is complying with the rules and guidelines that are "*equally effective*" as the remuneration principles. The FCA has adopted a wide interpretation of what is meant by "*equally effective*". It considers the CRD and MiFiD remuneration regimes to be "*equally effective*" and will accept a delegate as being subject to such an equally effective regime even if it is in a member state that has not applied the full CRD remuneration regime to that firm.

### Application to Groups

The principles are required to apply to any AIFM, even where it undertakes other activities such as managing a UCITS or is a subsidiary of a bank or insurance company, so that other remuneration codes apply. The FCA proposes an approach to deal with this so that an individual who works across different businesses where different codes apply should (notionally at least) have his remuneration split between those different businesses, and allow some flexibility in deciding in what proportions to split such remuneration.

### Requirements for a remuneration committee

Full scope UK AIFMs that are "significant" in terms of their size, internal organisation and the nature, scope and complexity of their activities must establish a remuneration committee (i.e. the proportionality elements discussed above). The FCA has provided more detailed draft guidance as to how to apply this requirement. It says that all three of these proportionality elements need to be satisfied for the obligation to have a separate remuneration committee to apply and proposes also applying the size thresholds as discussed above to provide a (rebuttable) presumption as to the proportionality of requiring a remuneration committee.

## Conclusion

The FCA's guidance will be broadly welcomed as it is bringing a clearer approach to dealing with many issues whilst at the same time allowing flexibility in application to suit the requirements of a diverse industry.

Any relief at seeing the FCA's pragmatic approach should, however, be tempered by some caution. Where the FCA appears to have gone further than ESMA in dealing with thorny issues such as the treatment of carried interest or the ability to disapply the pay-out process rules, it has done so by placing heavy reliance on the principle of proportionality that is included within the AIFMD.

The proportionality principle in the AIFMD is that AIFMs 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*".

ESMA has been reluctant to recognise that this principle allows any of the rules in the AIFMD to be entirely disapplied (rather than applied with appropriate modification). In its final guidance, ESMA accepted that proportionality may lead to the disapplication of certain rules including the pay-out process rules and the requirement for a remuneration committee, but stated that this should be "on an exceptional basis". Whether the way the FCA has applied the proportionality principle is in accord with this part of the ESMA guidelines is open to some doubt. If this is an issue, then, in theory at least,

it would be an issue for firms as well as for the FCA because the FCA guidance is meant to supplement the ESMA guidelines rather than replace them.

Nevertheless, the FCA is to be applauded for being willing to take a sensible approach to rules which applied too literally may have caused enormous difficulties for the alternative investment fund industry.

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