Rothstein Kass

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AIFMD: Impact of Fund Remuneration Provisions on U.S.-Based Investment Managers

The July 22, 2013, deadline for the implementation of the European Directive on Alternative Investment Fund Managers (Directive 2011/61/EU, also known as AIFMD or the Directive) is rapidly approaching. As a result, U.S.-based investment fund managers that market their alternative investment funds (AIFs) within the European Union (EU)[1] are coming to terms with the provisions regarding fund manager remuneration, which is one of the most controversial areas of the Directive.[2]

While the Directive is primarily targeted to alternative investment fund managers (AIFMs) that have their registered offices in the EU, some of its provisions will also have a significant impact on U.S.-based managers, effective July 22, 2013. Among the key provisions of the Directive's remuneration rules that U.S. managers need to consider are:

- Significant additional disclosure requirements on remuneration to investors, prospects and regulatory authorities,
- Requirements on the payout structure, particularly with reference to the variable component of remuneration, and
- Requirements on the governance of the remuneration process and the parties within the organization that need to be involved, including provisions on the appointment of a remuneration committee by certain managers.

U.S.-based managers that will be affected by the fund remuneration provisions of the Directive include:

- Managers that act as AIFMs of AIFs that are marketed to investors in the EU (for instance, Cayman feeder funds that are marketed to investors in the EU), and
- Managers that manage AIFs by delegation from an authorized EU-based AIFM.

OVERVIEW

Under Article 13 and Annex II of the Directive, AIFMs are required to establish remuneration policies that:

- Promote sound and effective risk management, and
- Do not encourage risk taking that is inconsistent with the risk profile, rules or investment policies of the AIFs they manage.

The primary goal of the fund remuneration rules under the Directive is to help align the interests of fund managers and investors as a way to increase investor protection and ensure a level-playing field in the alternative investment fund sector in the EU.[3] Annex II of the Directive sets out a series of principles that must be complied with by AIFMs "in a way and to the extent that is appropriate to their size, internal organization and the nature, scope and complexity of their activities." Article 13 also empowers the European Securities and Markets Authority (ESMA) to issue guidelines on sound remuneration policies that comply with Annex II.

On February 11, 2013, ESMA published its final report and guidelines on sound remuneration policies under the Directive (the Guidelines), which describe, among other details, the:

- Categories of staff to which the Guidelines apply (Identified Staff; see below),
- Type of remuneration that is subject to the Guidelines, and
- Internal governance arrangements that must be applied to remuneration.

Although the Guidelines are not binding law, individual member state regulators and AIFMs must make "every effort" to comply with them.

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[1] The European Union is comprised of the following 27 member states: Austria, Belgium, Bulgaria, Cyprus, Czech Republic, Denmark, Estonia, Finland, France, Germany, Greece, Hungary, Ireland, Italy, Latvia, Lithuania, Luxembourg, Malta, Netherlands, Poland, Portugal, Romania, Slovakia, Slovenia, Spain, Sweden, United Kingdom. The European Economic Area (EEA) Joint Committee is required to amend the EEA Agreement with a view to permitting simultaneous application of the Directive in the non-EU EEA States (Iceland, Liechtenstein and Norway).

[2] See Rothstein Kass *Wall Street Argus, EU Edition*, "EU AIFMD Creates New Marketing Challenges and Regulatory Burdens for U.S. Investment Managers" (February 2013)

[3] Article 13, Annex II and the Guidelines are largely based on existing remuneration rules applicable to EU credit institutions and certain EU investment firms pursuant to the EU Capital Requirements Directive, as well as on the guidelines for those rules as published by the Committee of European Banking Supervisors (CEBS), which has been replaced by the European Banking Authority (EBA).

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In addition, the Delegated Regulation (EU) No 231/213 (the Regulation) published on March 22, 2013, details, among other information, the specific remuneration disclosures that are required of U.S.-based and other non-EU-based AIFMs that will market their AIFs in the EU after July 22, 2013.

The Directive, the Regulation and the Guidelines apply to AIFMs after July 22, 2013, but are subject to the transitional provisions in the Directive. So, for EU managers performing the functions of an AIFM prior to July 22, 2013, they apply in full from the earlier of authorization or July 21, 2014 (unless their national regulator applies the remuneration requirements sooner).

On the other hand, non-EU managers that act as AIFMs of AIFs that are marketed to EU investors are only subject to the disclosure aspect of the remuneration rules until such managers become EU-authorized AIFMs, which cannot happen before 2015. In the case of non-EU managers that manage AIFs marketed to investors in the EU by delegation from authorized EU-based AIFMs, the EU-based AIFMs are required under the Guidelines to ensure that the non-EU managers acting by delegation:

- Comply with the remuneration rules outlined in the Guidelines, or
- Are subject to equally effective remuneration policies in their home jurisdiction.

REMUNERATION

Under the Directive, fund remuneration consists of all forms of payments or benefits paid by the AIFM in exchange for professional services rendered by Identified Staff to the AIF, including:

- Any amount paid by the AIF itself, including carried interest,[4] but excluding payments that represent a pro rata return on investment made by Identified Staff into the AIF,
- Any transfer of units or shares of the AIF, and
- Other compensation for services, including forgivable loans, pension contributions and non-monetary payments.

Dividends or similar distributions that partners receive as owners of an AIFM are not remuneration unless the material outcome of such dividends results in a circumvention of the relevant remuneration rules. In other words, the rules typically do not apply to dividends paid.

Also, any payment that consists of a pro-rata return on investment made by any staff members into the AIF does not qualify as compensation under the Directive. For instance, the pro-rata net income allocation received by a staff member on its investment in an AIF set up as a limited partnership is excluded from the definition of remuneration. The "investment" of the staff member must be represented by an actual cash disbursement; any loans granted by the AIFM to the staff member and then "invested" in the AIF do not qualify as an investment and any related profit is considered compensation under the Directive.

IDENTIFIED STAFF

While the guidelines relating to governance, the remuneration committee and transparency, and certain of the risk-alignment guidelines are directed to AIFMs as a whole, the most onerous risk-alignment guidelines apply only to Identified Staff. AIFMs are responsible for identifying Identified Staff according to the Guidelines. Identified Staff whose compensation falls under the Directive's provisions typically include:

- Members of the governing body of the AIFM; for instance, directors, CEOs and partners
- Senior management
- Risk takers, such as individual traders and specific trading desks
- Control functions, including the risk management, internal audit and compliance functions, and including the CFO responsible for the preparation of financial statements
- Staff responsible for heading the portfolio management, administration, marketing and human resources functions
- Employees receiving total remuneration that takes them into the same remuneration bracket as senior management and risk takers
- Categories of an entity's staff to which portfolio management or risk management activities have been delegated by the AIFM, whose professional activities, either individually or collectively, as members of a group (e.g., a unit or department) have a material impact on the risk profiles of the AIF that the AIFM manages.

KEY PRINCIPLES UNDER ESMA GUIDELINES

Governance

AIFMs are required to have a remuneration policy that encourages the alignment of risk taken by their staff with the risk profile of the:

- AIFs they manage,
- Investors of such AIFs, and
- AIFMs themselves.

The supervisory function should be responsible for approving and maintaining the remuneration policy of the AIFM and overseeing its implementation. The supervisory function should also ensure that the implementation of the AIFM's remuneration policy is reviewed on an annual basis at a minimum, subject to the proportionality criteria (discussed below).

[4] Carried interest is defined as a share in the AIF's profits accrued to the AIFM as compensation for the management of the AIF.

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AIFMs are required to establish a remuneration committee if they are significant in terms of:

- Their size,
- The AIFs they manage,
- Their internal organization, or
- The nature, scope and complexity of their activities.

A remuneration committee is not required for AIFMs if:

- The value of the AIF portfolios they manage does not exceed €1.25 billion (EUR), and
- They have no more than 50 employees.

The Payout Process – Fixed and Variable Remuneration

The Directive does not impose a limit with regard to variable compensation versus fixed compensation in an absolute sense. However, it does require that the fixed component represents a sufficiently high proportion of the total remuneration to allow the operation of a fully flexible policy, with the possibility of not paying any variable component for AIFMs where a more simple compensation structure is warranted.

The Directive is more prescriptive in the case of the make-up of the variable remuneration itself. For example:

- At least 40 to 60 percent of the variable remuneration must be:
  - Deferred over a period appropriate to the life cycle and redemption policy of the AIFs concerned, and
  - Aligned with the nature of the risks of the AIFs in question.

  Unless the lifecycle of the AIF concerned is shorter, the period of deferral should be at least 3 to 5 years.
- At least 50 percent of any variable remuneration must consist of units or shares of the AIF (or equivalent), except where the AIF accounts for less than 50 percent of the total portfolio managed by the AIFM. If that is the case, the minimum 50 percent figure does not apply.
- The variable remuneration can be paid and/or can vest only if it is:
  - Sustainable according to the financial situation of the AIFM as a whole, and
  - Justified according to the performance of the business unit, the AIF and the individual concerned.
- Before paying out the deferred portion, a reassessment of the performance and, if necessary, a risk adjustment is required in order to align the variable remuneration with:
  - Risks and errors in the performance, and
  - Risk assessments that have appeared since the staff members were awarded their variable remuneration component (the "ex post risk adjustment").
- Golden parachute arrangements for staff members who are leaving the AIFM, and which generate large payouts without any performance and risk adjustment, should be considered inconsistent with the Guidelines. Any such payments should be related to performance achieved over time and designed in a way that does not reward failure.
  - This should not preclude termination payments in situations such as early termination of the contract due to changes in the strategy of the AIFM or of the AIFs it manages, or in merger and/or takeover situations.
- Personal hedging of the risk related to the variable remuneration is prohibited (e.g., through insurance payments if the variable remuneration falls below a certain amount).

The Guidelines provide that carried interest models can be deemed to satisfy the requirements relating to: (1) risk alignment of variable remuneration, (2) the award process, and (3) the payout process where:

- The AIFM must first return all capital contributions to AIF investors, together with an agreed preferred return (if any), before the Identified Staff can receive any variable compensation for the management of the relevant AIF, and
- Compensation received by Identified Staff is subject to clawback until the liquidation of the AIF.

Proportionality

Under the proportionality criteria, the implementation of the Guidelines by member states should allow AIFMs to apply the Guidelines by taking into account their size, internal organization, nature, scope and complexity of activities. Based on proportionality, smaller and less complex AIFMs may be eligible to "disapply" certain requirements of the Guidelines.

ESMA provides a list of the requirements that may be disapplied under the proportionality principles, including the:

- Payout process:
  - Variable remuneration in instruments
  - Deferral
  - Ex post risk adjustment for variable remuneration
- Requirement to have a remuneration committee
- Annual policy review

ESMA notes that the provisions on the payout process may only be disapplied in full. For instance, a small AIFM with a basic compensation structure may decide not to defer any of the variable remuneration component; it may not, however, decide to apply a 20 percent deferral (a percentage below the minimum).

Disclosures

AIFMs should comply with the disclosure requirements on fund remuneration under Art. 22 of the Directive in the Annual Report (see below). AIFMs have the flexibility to disclose any additional

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information on fund remuneration required under other provisions of the Directive through:

- An independent remuneration policy statement,
- An additional periodic disclosure in the Annual Report, or
- Any other form.

They are not required to make any remuneration information publicly available (unless individual member states require this). In all cases, however, AIFMs should ensure that the disclosures are clear and easily understandable and accessible. The disclosures should be prepared at least on an annual basis and as soon as practicable after the information becomes available.

IMPLEMENTATION GUIDANCE FOR U.S.-BASED MANAGERS

The application of the fund remuneration provisions depends on the remuneration rules that apply to the individual manager under the Directive. While EU-based AIFMs are required to be in compliance with the full remuneration rules, including the Guidelines, U.S.-based managers need to perform a scope analysis to determine which requirements, if any, apply to their situations based on their circumstances.

Below are two situations that would typically apply to U.S.-based managers under the Directive.

U.S.-Based AIFMs That Market Their AIFs in One or More EU Member States Under the Private Placement Regime

U.S.-based AIFMs that market their AIFs in one or more EU member states after July 22, 2013, under the private placement regime will maintain full discretion as to their remuneration policies, subject to the relevant member state provisions.

However, these U.S.-based AIFMs will be required to comply with the Directive's remuneration <u>disclosure</u> requirements starting July 22, 2013, subject to any transition period that any relevant member state may permit.

Under Art. 22 of the Directive, U.S.-based AIFMs are required to prepare an Annual Report for any EU-based AIF and for their non-EU based AIFs that that are marketed to EU investors. The Annual Report must include information on the fund manager remuneration that spells out, at a minimum:

- The total amount of remuneration, including:
  - The total amount of remuneration paid by the fund manager to its staff for the financial year, split into fixed and variable remuneration,
  - The number of beneficiaries, and
  - The carried interest paid by the AIF, when relevant.
- The aggregate amount of remuneration, broken down by senior management and members of the AIFM's staff whose actions have a material impact on the risk profile of the AIF.

Where information is disclosed at the level of the fund managers:

- An allocation or breakdown must be provided in relation to each AIF, and
- A description of how the allocation or breakdown has been provided must be included in the Annual Report.

AIFMs are not required to provide compensation information for individual staff members. However, they are required to aggregate this information in appropriate buckets as described above.

AIFMs also have to provide general information relating to the financial and non-financial criteria of the remuneration policies and practices for relevant categories of staff. This requirement is to enable investors to assess the incentives created. At a minimum, AIFMs have to disclose the information necessary to provide an understanding of the risk profile of their AIFs and the measures they adopt to avoid or manage conflicts of interest.

The information in the Annual Report, including the details on remuneration, is subject to an annual audit requirement.

It is also important to note that the remuneration disclosures can be included in a document separate from an AIF's audited financial statements, such as an addendum to the financial statements in the Annual Report. AIFMs may elect to:

- Distribute this information to investors together with the financial statements, or
- Maintain it as a separate document in their files and make it available upon request.

The Annual Report, including the remuneration information, must be made available to regulators and to current investors upon request within six months from year end. In addition, the Annual Report must be made available to prospects ahead of their investment in the fund. Based on a July 22, 2013, implementation date, it is expected that the first filings of the Annual Report will apply to the December 31, 2013, year-end, subject to a transitional period to be defined under each member state law.

U.S.-Based Managers That Operate by Delegation From an AIFM Authorized Under the Directive

EU-authorized AIFMs may, subject to certain requirements, appoint a non-EU based manager to manage:

- An EU-based AIF, or
- A non-EU-based AIF that is marketed in the EU.

For instance, a UK-authorized AIFM of an Irish Qualifying Investor Alternative Investment Fund (QIAIF) may delegate the portfolio management of some or all of the QIAIF to a U.S.-based fund manager that is not registered under the Directive.

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Under such circumstances, the Guidelines provide that the AIFM – in this case, the UK manager – maintains full responsibility for compliance with the Directive's remuneration provisions (as well as the other Directive provisions). However, some significant compliance requirements also arise for the U.S.-based manager that has assumed portfolio management responsibilities by delegation.

As noted in the Guidelines, AIFMs should ensure that:

- The entities to which portfolio management or risk management activities have been delegated are subject to regulatory requirements on remuneration that are equally as effective as those applicable under the Guidelines, or
- Appropriate contractual arrangements are put in place with entities to which portfolio management or risk management activities have been delegated to ensure that there is no circumvention of the remuneration rules.
  - These contractual arrangements should cover any payments made to the delegates' Identified Staff as compensation for the performance of portfolio or risk management activities on behalf of the AIFMs.

The requirements of the first bullet point above are not likely to be met by U.S. entities. In other words, a U.S.-based manager acting by delegation may effectively be required by contract to be in compliance with the Directive's fund remuneration provisions. This includes the provisions on the payout process and fund governance <u>to the extent they pertain to the AIF that the U.S.-based manager is managing under delegation</u>.

Significantly, these U.S. managers may find themselves asked to enter into these contractual arrangements at any time after July 22, 2013, if they are appointed to act as portfolio managers of an AIF by delegation from authorized AIFMs.

The delegating AIFMs are responsible for:

- Preparing appropriate disclosures of fund remuneration in the AIF's Annual Report, and
- Ensuring that their U.S.-based delegate maintains compliance vis a vis its investors and the EU regulatory authorities.

STEPS THAT U.S. MANAGERS SHOULD TAKE NOW

The impact of the AIFMD remuneration provisions, and particularly its Guidelines, will depend on how they are implemented by national regulatory authorities in each of the EU's member states. Member states have been given express authority by the Directive to impose more stringent requirements under their national laws in relation to non-EU AIFMs that are marketing their AIFs in the EU.

In addition, member states have a certain amount of discretion to determine whether to follow the precise requirements of the Guidelines, subject to an overriding requirement that each member state use its "best efforts" to comply. Member states can also interpret some of the more loosely crafted Guideline provisions (particularly the concept of "proportionality") in different ways.

In preparation for final implementation of the Directive, U.S.-based managers should perform a scope analysis to determine whether, and to what extent, they fall under the AIFMD remuneration rules based on whether they:

- Act as AIFMs of an AIF that is marketed in the EU, or
- Manage one or more AIFs by delegation from an EU-based AIFM.

If a manager falls under the Directive's remuneration rules, it should consider taking the following preparatory steps:

- Determine the types of compensation that qualify as remuneration under the Directive.
- Prepare a list of Identified Staff.
- Prepare a list of the AIFs that generate compensation that needs to be reported under the Directive.
- Determine how to bucket compensation by categories of staff and fixed/variable components in the Annual Report.
- Determine which qualitative disclosures on fund remuneration to include in the Annual Report.
- Consult with auditors and legal counsel to ensure that the information the AIFM expects to gather to prepare the fund remuneration disclosures meets audit and AIFMD reporting requirements.
- Determine how the proportionality principle applies to its organization and how it affects the application of the Directive's provisions.

Also, it's important to note that fund managers expecting to manage AIFs by delegation of an authorized AIFM may be subject to more extensive remuneration requirements. These managers should review their remuneration policies and procedures and make sure that, to the extent they apply to the AIFs managed by delegation, they are in compliance with the Directive.

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