The AIFMD Remuneration Rules: Impact on UK Alternative Investment Fund Managers and Their Delegates

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Introduction

The Alternative Investment Fund Managers Directive (AIFMD) requires alternative investment fund managers (AIFMs) within its scope to comply with rules on remuneration. The AIFMD also requires the European Securities and Markets Authority (ESMA) to develop guidelines on sound remuneration policies under AIFMD (the "Guidelines"), which it published on July 3, 2013.

The Guidelines cover a number of substantive areas such as the definitions of remuneration and identified staff, the concept of proportionality, the composition and role of remuneration committees, payment in units, shares or other instruments, and disclosure. There are also specific guidelines related to dividends or distributions made to owners of an AIFM and requirements on the AIFM when portfolio or risk management is delegated by it to a third party (a "Delegate").

In the UK, the Financial Conduct Authority (FCA) has transposed the requirements of the AIFMD and the Guidelines into its remuneration code (the "Code"), which forms chapter 19B of the FCA's Senior Management Arrangements, Systems and Controls (SYSC) sourcebook.

On September 6, the FCA published for consultation its own further draft guidance (the FCA Guidance) to assist FCA regulated firms in interpreting the Code. The FCA consultation on the FCA Guidance runs until November 6, 2013. The FCA Guidance is in effect a further refinement and nuancing of the Guidelines for FCA regulated AIFMs.

This article discusses the requirements and complexities of the Code and the FCA's Guidance in so far as they will affect both UK AIFMs and non-UK AIFMs and Delegates.

The AIFM Remuneration Code

The key requirements of the Code are discussed below.

To Whom Does the Code Apply?

The Code applies to full scope UK AIFMs and (subject as discussed below under *Delegation*) to Delegates. A Delegate could include a US investment manager or advisor to whom a UK AIFM has delegated portfolio management. The Code does not apply to small AIFMs[1] wherever they are based. In addition, the annual report disclosure requirements (see *Annual Report* below) apply to a non-UK AIFM (other than a small AIFM), such as a US AIFM, marketing alternative investment funds (AIFs) in the UK under the UK's national private placement rules. The Code does not apply to a UK investment manager that is not an AIFM and that remains a MiFID firm.

Which Staff Are Affected?

The Guidelines apply to staff whose professional activities have a material impact on the risk profiles of an AIFM or the AIF that it manages. They are known as "identified staff" or "Code Staff," and are comprised of:

- senior management
- business unit heads, portfolio managers, sales staff and HR staff
- persons performing control functions (i.e. staff responsible for risk management, compliance, internal audit and similar functions)
- staff who exert a material influence on the risk profile of the AIF or AIFM
- staff remunerated in the same bracket as any of the above

Note that variable remuneration for control functions is based on function-specific objectives not solely by AIFM-wide performance.

Key Remuneration Requirements

Although the Code applies to all remuneration, the most commercially material provisions affect variable remuneration as follows:

(a) Fixed and variable (i.e. performance-based) remuneration is to be appropriately balanced.

(b) Between 40 and 60 percent of variable remuneration must be deferred for three to five years depending on the risk profile of the AIF, the tasks performed by the relevant individual, and taking into account the amount of his or her variable remuneration.

(c) Variable remuneration must be comprised as to at least 50 percent of interests (i.e. units or shares) in the relevant AIF(s) unless management of AIFs comprises less than 50 percent of the AIFM's total AUM. The FCA Guidance recommends a retention period of six months of the

[1] A "small AIFM" is one whose aggregate AUM in AIFs does not exceed (i) €500 million where the AIFs are unleveraged and have no redemption rights exercisable during a period of five years following the date of initial investment (e.g. many private equity funds), or (ii) €100 million in other cases (e.g. hedge funds). For these purposes the AUM of AIFs managed by other group entities should be included in the calculation.

relevant fund interests, and to the extent that those interests are not subject to the deferral described in (b) above. Where there are restrictions on investing or it is not possible for Code Staff to invest in the AIF, for example where it is a closed-ended fund with no interests available, or where there are tax disadvantages to doing so, among other things, then the FCA Guidance provides that the AIFM elect to pay Code Staff in interests linked to the AIFM or its parent company or to the performance of a weighted average of the AIFs managed by the AIFM.

(d) Variable remuneration must only be payable if it is sustainable in the context of the financial situation of the AIFM as a whole.

(e) Payment can be adjusted when an AIFM is or risks becoming unable to maintain a sound financial situation, including through clawback or malus arrangements.

In addition, under the Code:

- a guaranteed bonus is not permitted except where it is exceptional and is granted only in the context of hiring new staff, and is limited to the first year of service; and
- a remuneration committee must be established by any AIFM that is significant in terms of its size, internal organization and the nature, the scope and the complexity of its activities.

However, the requirement for a remuneration committee is subject to proportionality, and for so long as UK AIFM falls below the AUM threshold (referred to under *Proportionality* below), and otherwise where justifiable on a proportionality basis, it would not be required to have a remuneration committee.

The rules in paragraphs (b) to (e) above concerning deferral, retained fund interests and performance adjustments are defined by the FCA as the "pay-out process rules."

Usefully, the FCA does not generally consider it necessary to apply the pay-out process rules or the rule on guaranteed variable remuneration to an individual whose variable remuneration is less than 33 percent of his or her total remuneration, and whose total remuneration is no more than £500,000.

What Remuneration Is Included?

The Code covers:

- all forms of payments and benefits paid by the AIFM to Code Staff, including cash, shares, options and pension contributions
- any amount paid by the AIF, including carried interest (but not return on investment)
- any transfer of interests in the AIF in exchange for professional services rendered by Code Staff

What Remuneration Is Excluded?

Where the AIFM is a company, dividend distributions fall outside the Code. In the case of a limited liability partnership (LLP), the FCA Guidance permits an analysis of members' (also referred to as partners) profit shares to enable a portion of the profit share to be treated as a return on equity and therefore not to be considered as variable remuneration for the purposes of the Code. This levels the playing field between UK AIFMs that are companies and those that are LLPs.

The FCA Guidance suggests a number of factors to take into account when assessing the true variable component of an LLP member's profit, including whether the member works full-time for the LLP, benchmarking against similar businesses, and how the member currently receives profits. Extra payments to founder partners are likely to be considered as remuneration outside the scope of the Code, whereas discretionary profits distributed to all members may be considered as variable remuneration.

Also ancillary non-discretionary payments or benefits that are part of AIFMD-wide policy are outside of the Code.

For a member of staff whose work is a mixture of AIFMD and non-AIFMD business (e.g. work relating to managed accounts), a UK AIFM could apportion his or her remuneration according to the type of business performed, and treat such portions as being in or out of scope of the Code as applicable.

Annual Report

An AIF's annual report must disclose:

- the total amount of remuneration for the financial year paid by the AIFM to its staff, split into fixed and variable remuneration, and the number of beneficiaries (which can be by reference all staff or categories of staff involved with the AIF)
- the aggregate amount of remuneration broken down by senior management and members of the AIFMs staff whose actions have a material impact on the risk profile of the AIF
- a general statement on the AIFM's remuneration policy

The overall proportionality principle applies (see below).

There is no requirement for public disclosure of remuneration: this is only disclosed to regulators, investors and staff.

For an AIFM that is authorized as such in 2014 and where the relevant AIF's financial year is the calendar year, it is likely that the first annual report of the AIF to which these requirements would apply will be the report for the financial year ending on December 31, 2015, that will not be published until early 2016.

Key Provisions of the FCA Guidance

In addition to aspects of the FCA Guidance referred to above, it also addresses the following important matters.

Timing of Compliance With the Code

The FCA expects compliance with the Code with respect to the first whole performance period following a firm's authorization as an AIFM. For example, if a UK AIFM manages one AIF whose performance period is aligned with its financial year, which is the calendar year, and if the AIFM were authorized as an AIFM in July 2014, the first period of compliance with the Code would be the twelve-month period ending on December 31, 2015.

Proportionality

The AIFMD and the Guidelines specifically allow firms to comply with the remuneration requirements in a way and to the extent that is appropriate for their size, internal organization and the nature, scope and complexity of their activities. This means that in certain cases some of the Guidelines can be disregarded, and the FCA Guidance clarifies how a firm should implement the remuneration principles proportionately.

The FCA Guidance suggests an AUM threshold for AIFMs based on the net amount of AIF assets under their management below which the pay-out process rules (see *Key Remuneration Requirements* above) may be disapplied. For UK AIFMs that manage portfolios of AIFs that are unleveraged and have no redemption rights exercisable during a period of five years following the date of initial investment in each AIF, the FCA suggests a threshold in the range of £4-6 billion. For all other UK AIFMs, the FCA proposes a threshold in the range of £500 million to £1.5 billion. The FCA intends to specify a single threshold in the final FCA Guidance. The FCA says the AUM figure is a guide, and in some cases it will expect a firm to apply the pay-out process rules even where its AUM is below the threshold, and other firms may be able to justify a higher threshold. Where the pay-out process rules are disapplied, the remainder of the Code still applies.

Other matters to take into account in the context of proportionality are as follows:-

- The size of the AIFM and its relative size compared to competitors.
- An AIFM's internal organization and ownership structure so that profits that go to owners not working in the business can be taken into account. Where a UK AIFM is a subsidiary of, e.g., a US fund manager, that is a factor that can be taken into account in assessing the impact of the Code. If the AIFM is listed or traded on an organized market, that would favor application of the pay-out process rules.
- The nature, scope and complexity of a firm's activities. This includes factoring in the number of AIFs managed by the AIFM, the complexity of the strategies and the level of risk taken by the AIFM.
- Where the discretion of an AIFM or any Delegate is strictly controlled within certain pre-defined narrow parameters and/or investment decisions are rules-based (such as where

there is a mandate to track an index), this may justify disapplication of the deferral and retention requirements.

- Fee structures: this factor may be taken into account when fee structures satisfy the objectives of alignment of interest with investors and avoid incentives for inappropriate risk taking.

UK AIFMs should, if requested, be able to explain to the FCA the rationale for how they apply the AIFM remuneration proportionality rule, particularly where they have concluded that it is appropriate for certain rules to be disapplied.

In its Guidance the FCA has provided some helpful examples of when and how proportionality may or may not apply taking account of the factors above. These include:

- applying the pay-out process rules to a hedge fund AIFM whose AUM is under the threshold for application of the pay-out process rules, but who carries out complex strategies, uses significant human capital, deploys significant leverage and the returns of whose AIFs are volatile
- disapplying some or all of the pay-out process rules to an AIFM with £2 billion AUM invested in open-ended funds and investment trusts, which has fewer staff than its competitors, uses limited leverage, invests according to strict and diverse investment restrictions and, among other things, does not pay performance fees
- indicating that carried interest payable to staff of a private equity AIFM, where the fee structure is intensively negotiated with investors, senior managers co-invest, and there is no incentive for inappropriate risk taking, may be paid outside the pay-out process rules

In the last case, the FCA does not mention an AUM figure, inferring that however large the AUM to which the carried interest relates, proportionality could apply in the circumstances described.

Delegation

The Code is extended to those to whom the functions of risk or portfolio management have been delegated and who are subject to the application of the proportionality principle.

The Code requires that:

- delegates must be subject to regulatory requirements on remuneration that are equally effective as those under the Guidelines (such as the CRD and MiFID requirements); or
- contractual arrangements are put in place with the Delegate to ensure that there is no circumvention of the Guidelines and covering any payments made to the Delegate's identified staff as compensation.

In addition, the FCA Guidance provides that the requirements on AIFMs when delegating portfolio or risk management may be subject to proportionality. We therefore expect that the proportionality tests described above may be extended to a delegation by a UK AIFM. That being so, the contractual arrangements referred to above would require compliance by a Delegate with the Code on a subjective, proportional basis, and the delegation agreement would set out the extent of the remuneration requirements on that basis.

For example, a UK AIFM need only put arrangements in place with respect to those staff of its Delegate who have a material impact on the risk profiles of the AIF, and in respect of remuneration that is connected with the delegated activities.

UK Tax Treatment of Deferred Payments for LLPs

The deferral of any remuneration would give rise to a tax charge in the UK in the base year of deferral in accordance with UK partnership tax rules. This means that partners of an LLP are taxed on all their profit shares when they arise in the base year, even when these profits are not yet distributed or received by the partners, i.e. prior to that remuneration vesting with those individuals. Effectively this tax charge would not be funded in the base year as individual partners do not have immediate access to the deferred remuneration.

The FCA is discussing with HMRC and industry representatives proposals to put in place a statutory tax mechanism as part of HMRC's partnerships tax review consultation in order to address the unfunded tax charge issue. Subject to further tax guidance to be published later this year, references in the Code to the portions of deferred variable remuneration should be read as being on a net of tax basis and should be calculated on that basis where the LLP is liable for tax on deferred sums as a result of the use of the proposed mechanism, but with credit subsequently being available for the individuals.

Where the mechanism is not used, then deferral of remuneration would, under the consultation and related discussions, be on a gross of tax basis. This is because it would not be considered to be compliant with the Code for firms to allow their members to have immediate access to part of the deferred remuneration on the assumption that this immediate access would be used to fund payment of tax.

The net of tax basis may take into account both income tax and national insurance that arise on the deferred remuneration under the partnership tax rules.

These provisions form a marked departure from established partnership tax law.

UK Tax Treatment on AIF Interests

Where Code Staff receive variable remuneration in the form of interests in an AIF (see paragraph (c) of *Key Remuneration Requirements* above), retention may be applied on a net of tax basis where all the tax owed is deducted at source (as is the case under the UK's PAYE system), or paid on a self-assessment basis using the proposed statutory tax mechanism for partnerships referred to in the section above. Where a tax liability arises under the PAYE system on the vesting of a deferred portion of AIF interests, the tax owed may be deducted at source to facilitate the payment of tax owed, and the remainder of units forming part of the variable remuneration award should be subject to the retention period.

The FCA notes that AIFMs may fund the PAYE liability that arises from paying a bonus in AIF shares by selling AIF shares to a third party and using the proceeds to pay that liability to facilitate the payment of tax owed. There may be cases in certain jurisdictions where the tax rate on the shares is lower than the tax rate on cash, in which case the FCA will not consider it acceptable for AIFMs to sell shares that are subject to retention to meet tax liabilities on the cash amount, and thereby effectively avoiding or reducing an upfront UK tax payment in respect of the cash amount.

The Effect of the Code on UK AIFMs and Their Delegates

The Code will not apply to a UK AIFM until it is authorized by the FCA as an AIFM.

The pay-out process rules will not apply:

- to fixed remuneration; and
- for as long as the net AUM of the AIF is under the threshold amount prescribed by the FCA in the final FCA Guidance (i.e. at least £500 million and up to £1.5 billion for hedge funds, and £4-6 billion for private equity funds), subject to proportionality, which could allow a UK AIFM to use a higher threshold figure by applying the proportionality tests set out above.

Following the FCA authorization of a UK firm as an AIFM, the Code will not apply:

- with respect to a performance period of the AIFM/the AIF that is partially elapsed as of the date of approval by the FCA of the AIFM as an AIFM
- to a member of Code Staff whose variable remuneration is less than 33 percent of his or her total remuneration and whose total remuneration is no more than £500,000 (and subject to the proportionality requirements)
- to any employee or consultant of the UK AIFM who is not a member of Code Staff
- to a member of Code Staff to the extent that he or she works for clients other than the AIF, such as managed account clients;
- generally, to the extent that any of the proportionality tests described above applies and can be justified by the UK AIFM, or
- to a Delegate to whom risk management or portfolio management has been delegated:
    - to the extent that it does not apply to the UK AIFM for any of the above reasons
    - if an equivalent regulatory regime applicable to remuneration applies to the Delegate currently or in future

  - to the extent that the Delegate is overseen by the UK AIFM's risk management personnel and is not able to make investment decisions for the AIFs that fall outside of any clear mandate within which the Delegate is required to operate, or

- to any employee of the Delegate other than any senior employee(s) responsible for the portfolio management of the AIF, and only to the extent of their time devoted to the AIF as a proportion of their overall duties.

A UK AIFM is not required to establish a remuneration committee for so long as the Pay-out Process Rules apply and subject to proportionality.

Final Guidance and Compliance

The FCA is to be commended in producing comprehensive and pragmatic guidance, the effect of which will be both to delay the full impact of the Code on UK AIFMs and to reduce its scope by applying the proportionality principles. There are many relatively smaller AIFMS who will benefit from this approach.

Meanwhile the opportunity to comment on the FCA Guidance remains open until November 6, and, in particular, AIFMs are likely to have views on the FCA's suggested threshold for disapplying the pay-out process rules.

On tax, while HMRC, HM Treasury and the FCA remain in discussion with the industry, a not inconsiderable number of issues remain unresolved.

Finally, UK AIFMs will need to adopt Code compliance procedures, and should explain the reasons for and extent of their compliance with the Code, taking into account applicable FCA Guidance exclusions and the application of proportionality. These procedures should also cover affected staff at Delegates where applicable.

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