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ESMA publications
UCITS V and AIFMD

ESMA publishes draft guidelines on sound remuneration policies under UCITS V

On July 24, 2015 the European Securities and Markets Authority (ESMA) launched a consultation on proposed guidelines on sound remuneration policies under the UCITS V Directive, which will affect retail investment fund managers.

The draft UCITS guidelines are largely based on those already issued on remuneration under the AIFMD, with a few changes which we have highlighted below. This approach is aimed at achieving a level-playing field in the funds sector across the EU.

The proposed guidelines provide guidance on issues such as application of the payout process rules, categorisation of Identified Staff, proportionality, risk alignment, governance of remuneration and disclosure, and will apply to UCITS management companies and national competent authorities.

Responses to the consultation paper are encouraged and should be sent by 23 October 2015.

In what follows, we will provide a summary of the key developments which may impact remuneration arrangements at affected financial services firms.

Go to the ESMA publication on AIFMD below

Proportionality

In line with the existing approach under AIFMD and in contrast to the recent approach taken by the EBA on CRD IV, the ESMA guidelines state that for the purposes of UCITS V, the proportionality principle should permit the **disapplication of specific UCITS remuneration requirements** under certain circumstances and conditions, for example, where management of UCITS accounts for less than 50% of the portfolio managed, the requirement to pay in instruments does not apply.

ESMA notes the provisions common to the UCITS V, AIFMD and CRD IV Directive texts which state that firms should apply 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.'

Whereas the EBA stated in its March 2015 consultation paper that this meant that all CRD IV remuneration principles should apply to all firms as a minimum, ESMA considers that UCITS legislators "envisaged the possibility" that UCITS fund managers would be able to disapply certain remuneration principles.

ESMA supports this interpretation by noting the different nature of UCITS compared to credit institutions. It also notes that applying the EBA interpretation of proportionality to UCITS firms would have adverse cost impacts, not least because it would create a misalignment between the AIFMD and UCITS V remuneration regimes for fund managers.

Guidelines

The UCITS V guidelines on sound remuneration are broadly similar to the AIFMD guidelines, and include the following requirements based on the directive:

- At least 40 to 60% of variable remuneration should be deferred over a period of at least 3 years (annual pro-rata vesting is permitted);
- 50% of variable remuneration should be awarded in instruments (UCITS fund units, equivalent ownership interests or share-linked instruments or equivalent non-cash instruments), to which a post-vesting retention period should be applied; and
- Any variable remuneration award is subject to malus and clawback provisions.

As highlighted above, the UCITS guidelines generally follow the same approach as the AIFMD guidelines. The major differences between the two are summarised below.

Specific UCITS V remuneration rules

Definition of 'performance fees'

UCITS V specifically includes "performance fees" among the categories of payments that fall within the scope of the remuneration principles in the same way that carried interest falls under the scope of the AIFMD.

ESMA proposes that the definition of "performance fees" should be based on the one provided in the IOSCO report on fees and expenses of investment funds; i.e. a variable fee linked to the performance of the UCITS. Performance of the UCITS includes capital appreciation as well as any income linked to the UCITS's assets.

Application of different sectoral rules

Where staff perform activities which fall under more than one regime (e.g. UCITS V and CRD IV), ESMA has set out two alternative approaches, either of which may be adopted depending on which is felt to be more suitable. The two approaches are:

1. Sectoral remuneration principles (CRD, AIFMD or UCITS V) should be applied on a pro-rata basis using an objective method of apportionment such as time spent on each activity.

2. The sectoral remuneration principles which are deemed to be more effective in discouraging excessive risk-taking and aligning the interest of the relevant individuals with those of the investors in the funds they manage, should be applied.

Where approach 2. is taken, ESMA makes it clear that where there is a conflict between different sectoral legislation, the most effective principles should apply. For example, the requirement to pay in fund instruments for AIFMD and UCITS V should prevail over the requirement to pay in CRD instruments for CRD IV.

ESMA also considers that the performance of MiFID ancillary services should be subject to the UCITS/AIFMD remuneration principles.

Application of rules to delegates

The guidelines relating to delegation are similar to those found in AIFMD. The overall aim is to ensure that the remuneration principles are not circumvented and so firms must ensure that:

- Entities to which investment management is delegated are subject to regulatory requirements that are equally as effective as those found in UCITS V; or
- Appropriate contractual arrangements are in place which prevent circumvention of the remuneration regulations.

However, there is some additional guidance provided in that ESMA consider that the entity is subject to equally effective remuneration requirements where:

- The delegate is subject to CRD IV or AIFMD remuneration rules; and
- The delegate staff who are UCITS Identified Staff are subject to the CRD or AIFMD rules.

Payment in instruments

Subject to the legal structure of the UCITS and its fund rules or instruments of incorporation, at least 50% of variable remuneration of identified staff should be paid in fund units, share-linked instruments, or equivalent non-cash instruments under UCITS V.

This requirement does not apply where the management of the UCITS accounts for less than 50% of the total portfolio managed by the management company.

It gives further detail on this 50% threshold. It should be based on the value of an individual UCITS fund against the total portfolio of managed UCITS funds. AIFMD portfolios are not to be taken into account in this calculation.

The guidelines also state that neither dividends nor interest should be paid on instruments before vesting.

Guidelines for management companies which are part of a CRD IV group – UCITS and AIFMD guidelines

ESMA has amended both the UCITS V guidelines and the AIFMD guidelines to reflect the EBA's assertion in its recent CRD IV consultation that staff in UCITS or AIFM subsidiaries of a credit institution may be identified as material risk takers at the group level for the purpose of their sectoral remuneration rules.

Next steps

ESMA encourages responses to specific questions posed in the consultation paper. These primarily relate to:

- The proposed proportionality approach, and in particular the costs of a different approach (e.g. requiring firms to implement the deferral, payment in instrument and malus/clawback requirements, regardless of size);
- The proposed definition of performance fee;

- How services subject to different sectoral remuneration principles are performed in practice, and the proposed approach to either apportion pay pro rata and/or apply the most effective sectoral remuneration principles;
- The test for whether the management of UCITS accounts for less than 50% of the total portfolio managed by the UCITS management company; and
- Whether there is any specific need for transitional provisions.

Responses should be received by 23 October 2015. ESMA then aims to publish the final guidelines by early Q1 2016, ahead of the transposition deadline for the UCITS V directive (i.e. 18 March 2016). The guidelines would then take effect from the transposition date of the UCITS directive.

ESMA has published its Opinion on the functioning of the passport and NPPRs and its Advice on the application of the AIFMD passport

The Alternative Investment Fund Managers Directive ("AIFMD"), which entered into force on 22 July 2013, has introduced the EU marketing passport for EU domiciled Alternative Investment Fund Managers ("AIFM") managing and marketing EU domiciled Alternative Investment Funds ("AIF"), whereas non-EU domiciled AIFMs remain subject to the national placement regimes ("NPPRs") of each Member State where the AIFs are marketed.

In accordance with the provisions of the AIFMD, the European Securities and Markets Authority ("ESMA") has published on 30 July 2015, two documents:

- its Opinion on the functioning of the EU passport for EU domiciled AIFMs and of the NPPRs; plus
- its Advice on the application of the AIFMD passport to non-EU domiciled AIFMs and AIFs.

Both documents have been sent to the European Commission, European Parliament and European Council. The European Commission now has three months to consider whether or not to extend the AIFMD passport to non-EU domiciled AIFMs. Should the European Commission decide to extend the AIFMD passport to third countries, it shall adopt a Delegated Act specifying the date when this would become applicable in all Member States. Until then, the current situation will not change and non-EU domiciled AIFMs will remain subject to the NPPRs of each Member State.

Opinion

With its Opinion, ESMA has taken into consideration the responses received to its call for evidence launched in November 2014. These responses and ESMA's comments thereon are included in appendices to the documents released today and are rich in detailed information concerning some of the practical difficulties and even incoherencies encountered by market participants. After a first analysis on the functioning of the AIFMD passport and NPPRs, ESMA considers that the AIFMD has not been in force for a sufficient period of time to allow it to reach a final assessment. ESMA has also already identified several issues relating to the current situation with the passport such as different definitions of "professional investor", "marketing" and "material changes" in various Member States. ESMA believes that a second opinion after a longer period of implementation in all Member States would be useful and permit to reach a final assessment, a comment that comes back several times in the documents.

Advice

ESMA's Advice is mixed in that it esteems that AIFMD has been in force for too short a time for a balanced judgement to be possible, and in several of the cases under review, ESMA comments that it will need more time to adequately complete its analysis. In this Advice, ESMA has analysed the possible extension of the AIFMD passport to third-country AIFMs by conducting a country-by-country assessment. Only six non-EU jurisdictions have been considered – Guernsey, Hong-Kong, Jersey, Singapore, Switzerland and the United States of America (“US”) – are analysed in detail. Again ESMA comments it will need more time and more information with regards to these before even considering all the other jurisdictions upon which it must opine. It also notes that it will continue its work to finalise Memoranda of Understanding with other jurisdictions not yet covered. Nevertheless it is not anticipated that the process will be completed by the end of the year.

For Guernsey and Jersey, ESMA is of the opinion that there are no significant obstacles to the extension of the AIFMD passport to these two countries. The same will apply to Switzerland once the remaining obstacles identified by ESMA are resolved; this should happen once pending legislation comes into force. Regarding Hong-Kong, Singapore and the US, ESMA requires more time and information to reach a final conclusion.

Finally ESMA invites the European Commission to consider delaying approval and the attendant delegated Acts until such times as more in-depth analysis is available and raises the possibility that since only three non EU-jurisdictions have been “approved”, the European Commission may consider deferring any action until such time as more analyses have been completed.

The European Commission now has 90 days to consider ESMA’s Advice, and then the task of preparing the text for receiving approval from the European Parliament and European Council for the relevant Delegated Acts, if it decides to move forward on this basis.

Contact

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