

Deloitte regulatory news alert

ESMA publishes its final guidelines on sound remuneration policies under UCITS V

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Overview

The European Securities and Markets Authority (ESMA) published on March 31st 2016 its final guidelines on sound remuneration policies under the UCITS V Directive. This follows the Consultation Paper on guidelines on sound remuneration policies issued July 23rd 2015.

The final UCITS guidelines are mainly unchanged from the draft guidelines, however, some changes have been observed in terms of:

- The Proportionality Principle, where the ESMA aligns its approach to the one proposed by the European Banking Authority (EBA);
- The payment in instruments, which ought to be mandatory unless the total net asset value of all the UCITS managed accounts for less than 50% of the total portfolio managed;
- Sectoral rules, where the ESMA provides two approaches, as how to manage and define remuneration principles for staff performing activities which fall under more than one regulatory regime;
- Transitional period, where the ESMA confirms that the pay-out process rules come into effect for the first full performance period after 1 January 2017.

Overview of the final guidelines

The final UCITS V guidelines on sound remuneration is closely aligned to the guidelines on AIFMD. As of today, management companies as defined under Article 2 (paragraph 1, point b) of the UCITS Directive, as well as investment companies that have not designated a management company authorised pursuant to the UCITS Directive, will have to apply remuneration principles to all its staff with specific provisions applicable to their identified staff.

Requirements applicable to all staff

- Balance between fixed and variable remuneration
- Variable remuneration should be linked to **an evaluation process** which takes into account **quantitative and qualitative criteria**

Requirements applicable to Identified Staff

- **Identification of Staff**, where entities in scope should be able to demonstrate to competent authorities the criteria used as to their identification;
- Multi-year evaluation framework, where variable remuneration should be awarded, taking into account (i) qualitative and quantitative performance criteria and (ii) performance assessments of previous business cycles;
- **Deferred payments**, where 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);
- **Payment in instruments**, 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;
- Any variable remuneration award is subject to **malus and clawback provisions**

Key Outcome of the Consultation

Even though UCITS V, is closely aligned to the requirements set under AIFMD, there are some differences that have been observed.

Proportionality Principles

ESMA cooperated closely with the EBA in the development of its final guidelines as to ensure a consistency throughout the requirements developed for the other financial services sectors.

As a consequence, there is no guidance on the possibility not to apply certain remuneration requirements in their entirety (the pay-out process rules).

Such consideration has indeed raised many questions, as to how the guidelines should be understood. The ESMA is well aware of the concerns raised and in addition to the guidelines, has written an official letter to the European Commission, Council and European Parliament setting out ESMA's views on proportionality and is calling for further clarity on whether requirements can be neutralised entirely.

Indeed the ESMA considers, that the disapplication of specific provisions to their full extent should be possible in certain situation, claiming a dis-balance, in terms of cost effectiveness and competitiveness when applying the same provisions to all market players, irrespective of their size and nature of activities.

Sectoral rules

Where staff perform activities which fall under more than one regime (e.g. UCITS V and CRD IV), the entities are able choose from two approaches:

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

On this second alternative, ESMA has stated that, rather than simply making a choice between CRD IV, AIFMD and UCITS V, the management company should consider carefully, taking into account its specific activities and circumstances, which remuneration principles would be most effective.

This approach could lead to circumstances where CRD IV applies in full (e.g. including the bonus cap to all staff performing services under different sectoral rules) without having line-by-line compliance with the corresponding principles under AIFMD or UCITS V. However, notwithstanding this, where specific requirements of CRD IV conflict with those under AIFMD or UCITS V, the specific sectoral legislation should prevail (e.g. the use of units or shares of the alternative investment fund concerned or units of the UCITS concerned).

Applicable rules to delegates

Where an entity chooses to delegate investment management functions, including risk management, where the remuneration rules would otherwise be circumvented, management companies should ensure that:

- delegates are subject to regulatory requirements on remuneration that are equally as effective as those UCITS V guidelines (e.g. CRD IV or AIFMD); or
- appropriate contractual arrangements are put in place with entities to which investment management activities have been delegated in order to ensure that there is no circumvention of the remuneration rules, as defined under UCITS V.

In its letter to the European Commission, the ESMA however raised the point that it might not always be proportionate and would not achieve the outcome of aligning the delegates' staff interests with those of the investors in the UCITS. The authority also points out that if delegates outside of the EEA deem remuneration provisions as disproportionate, this could potentially prevent European management companies to certain investment strategies.

Payment in instruments

The final guidelines link the performance of funds managed by the manager, to the variable remuneration by imposing payment in instruments. Such non-cash payment may be disapplied for cases where the management of UCITS is not the major activity of the manager. Therefore management companies may only disapply the payment in instruments requirement where the total net asset value of all the UCITS managed equals less than 50% of the total portfolio managed (i.e. UCITS and AIFs).

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 left the definition of "performance fees" broadly unchanged in that they feel "performance fees" should be based on the definition provided in the IOSCO report on fees and expenses of investment funds, i.e. a variable fee linked to the performance of the UCITS. However, it saw merit in clarifying that the definition relates to performance-related payments made by the clients to the management company or the UCITS itself.

Next Steps

Entities should set-up a compliant remuneration policy as soon as possible. The implementation of the policy should be effective as of January 1st 2017.

We are there to help

Deloitte would be happy to set up individual workshop sessions with its clients as to ensure clarity on remuneration requirements under UCITS V and other applicable sectoral rules.

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