



# AIFMD Remuneration

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## The main objectives of the Directive, as far as remuneration policies are concerned, are to ensure that three key issues are covered: governance, risk alignment and transparency

### Context and scope

#### Context and objectives

A number of guidelines and recommendations have been issued in recent years by various authorities on the improvement of remuneration policies in the financial sector. The Alternative Investment Fund Managers Directive (AIFMD) establishes, inter-alia, a set of rules which have largely been inspired by the provisions of Directive 2006/48/EC (CRD). Alternative Investment Fund Managers (AIFMs) must comply with this Directive when defining remuneration policies.

The AIFMD framework introduces stringent requirements to ensure that the remuneration policies and practices of AIFMs are consistent and promote sound and effective risk management. The main objectives of the Directive, as far as remuneration policies are concerned, are to ensure that three key issues are covered: governance, risk alignment and transparency.

In February 2013, ESMA published the final guidelines on remuneration policies under AIFMD. The following requirements need to be implemented by AIFMs by 22 July 2014:

- *Governance:* AIFMs shall establish a remuneration policy and, where 'significant' in size (depending on their AUM and number of employees), appoint a remuneration committee. A supervisory function must oversee the policy implementation and control functions and must ensure regular reviews

- *Risk alignment:* Variable remuneration is performance-based and risk-adjusted notably through deferral, payment in instruments and claw-back measures. It can even be reduced to zero
- *Transparency:* AIFMs shall disclose quantitative and qualitative information on remuneration policies and practices. While aggregated remuneration amounts must be published in the AIF report, detailed information does not necessarily have to be made public

#### Scope

ESMA's guidelines will apply to managers of alternative investment funds including hedge funds, private equity funds and real estate funds, as well as managers of other non-UCITS regulated funds which are managed or marketed in the EU. It also applies to companies to which some functions have been delegated by the AIFM.

While EU AIFMs are subject to full remuneration requirements, non-EU AIFMs managing EU AIFs and/or marketing AIFs in the EU will only be subject to disclosure requirements until 2015 after which full remuneration requirements may apply (e.g. if a marketing passport is available and has been requested).

The concept of remuneration shall be understood in its broadest sense (fixed and variable, cash and fringe benefits, incentive plans, etc.). Carried interest schemes also fall into the scope of the requirements (with the exception of co-invest schemes, i.e. return on an actual investment).



## Governance

### What are the requirements?

The Directive introduces the requirement for management companies to set up an internal governance structure responsible for the design, implementation and supervision of an AIFM remuneration policy.

This governance structure should ensure the adequacy and appropriateness of remuneration. As a reminder, remuneration policies must be sound and prudent, and avoid conflicts of interest that may lead to excessive risk taking. Remuneration policy should therefore align the interests of both investors and fund managers. Remuneration policies shall be reviewed at least annually and updated when necessary.

The governance of remuneration includes the creation of a supervisory function. The supervisory function shall rely on controls performed internally (by risk managers, compliance officers, human resources, etc.)

In order to avoid conflicts of interest, this supervisory function is performed by relevant persons or bodies.

The supervision function could be performed by the management body of certain AIFMs, depending on their size, internal organisation and activities.

Significant AIFMs shall also implement a Remuneration Committee (RemCo), which is composed of non-executive members of the management body and enables the competent and independent consideration of remuneration of identified staff, including senior management. The chairperson of the RemCo should be an independent, non-executive member of the management body. With regard to proportionality criteria, ESMA gave some clarifications concerning minimum total assets and employee number thresholds (€1.25 billion and 50 employees respectively), below which the RemCo will not be mandatory.

AIFMs which are subsidiaries of credit institutions, banking/insurance groups and investment groups of financial conglomerates may rely on the group RemCo.

## The AIFMD framework introduces stringent requirements to ensure that the remuneration policies and practices of AIFMs are consistent and promote sound and effective risk management

Some EU jurisdictions already have general guidelines concerning company governance, including remuneration principles. Those guiding principles are mainly in line with AIFM guidelines as regards conflict of interest, the remuneration committee, independence of stakeholders, period.

### What does this mean for AIFMs?

- Each AIFM should determine who will be in charge of the supervisory functions, especially in order to avoid conflict of interest
- In the absence of precise guidelines regarding the number of persons/bodies that will compose the supervisory function, AIFMs should also define the appropriate number of members
- Significant<sup>1</sup> AIFMs would most likely appoint external consultants in the remuneration process: implementation of remuneration policies, supervision, etc. In this instance ESMA guidelines<sup>2</sup> require that the *"name of the external consultant whose services have been used for the determination of the remuneration policy [be] disclosed"*
- The AIFMD should enforce/strengthen existing professional guidelines/good practices

<sup>1</sup> Significant size, internal organisation and nature, scope and complexity of the AIFM's activities

<sup>2</sup> ESMA's final report - Guidelines on sound remuneration policies under the AIFMD, dated 11 February 2013



### Risk alignment

#### What are the requirements?

The AIFMD requires the AIF to establish a remuneration policy promoting sound and effective risk management. The Directive differentiates between general and specific risk-alignment requirements.

General requirements include the following:

- Guaranteed bonuses should be exceptional, must occur only when hiring staff and be limited to the first year
- Severance payments must not reward failure

- Employees must not use personal hedging strategies to circumvent remuneration requirements
- Discretionary pension benefits should be paid in instruments and be subject to a retention period of five years minimum

These requirements are only compulsory for Identified Staff but ESMA strongly recommends that they are applied to all staff. AIFMs must be able to demonstrate why they apply the requirements only to Identified Staff (staff having a material impact on the AIFMD risk profile) if they decide to do so.

Specific requirements are applicable to the remuneration of Identified Staff and include the following:

- There should be an appropriate balance between fixed and variable remuneration
- Variable remuneration should decrease as a result of negative performance (down to zero where appropriate). Performance assessment criteria used to determine the amount of variable remuneration should be defined upfront and include both quantitative and qualitative elements (notably related to risk management)
- At least 50% of variable remuneration should be paid using instruments such as units or shares of the AIF or equivalent
- At least 40% to 60% of variable remuneration should be deferred over a minimum period of three to five years, and vest no faster than on a pro-rata basis
- Variable remuneration should be subject to overall financial performance and downward adjustment by way of malus (pre-vesting) or claw back (post-vesting) adjustments

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Some EU jurisdictions already have general guidelines concerning company governance, including remuneration principles

### What does this mean for AIFMs?

The AIFMD requirements create a number of challenges for AIFMs. The main following impacts can be identified at this stage:

- AIFMs will have to identify 'Identified Staff' for the purposes of the remuneration rules. The following must be considered as Identified Staff, unless it is demonstrated that they have no material impact on the AIFM's risk profile: members of the governing body of the AIFM, senior management, other responsible staff, members of controls functions and other risk takers as well as staff within the same remuneration bracket as that of the senior management
- AIFMs may need to change the form of rewards so that they are paid in Fund units (or equivalent). In addition, the practicality of making rewards of units in the AIF will need to be considered
- AIFMs will need to define how to value the carry for the purposes of assessing the deferred proportion of variable pay
- AIFMs may have to increase their use of deferred remuneration (e.g. deferring bonuses) and the tax implications of this deferral will need to be reviewed
- Malus provisions (ex-ante adjustments) will need to be implemented in addition to the commonly used claw back provisions (ex-post adjustments) for carried interest

### Transparency

#### What are the requirements?

AIFMs will face new disclosure duties as regards remuneration. This information will have to be disclosed externally (to investors/prospective investors), and internally (to the AIFM staff members).

The total remuneration of AIFM staff must be disclosed in the annual report. However, additional qualitative and quantitative information regarding the decision-making process to determine the remuneration policy, supervision function, the connection between pay and performance, and performance criteria are to be disclosed at least annually, whether in the annual report or any other form (e.g. a remuneration policy statement).



For AIFMs that have a RemCo, its members and their respective roles are also to be disclosed.

These requirements mean that AIFMs need to explain and justify their remuneration practices, potential evolutions and the management of conflict of interest inside the AIFM. They therefore become part of the AIF's risk profile assessment that each (prospective) investor should fully understand.

However, while disclosing the above information, proportionality principles may be observed, and confidentiality and data protection principles apply. This means that the level of detail will vary for small or non-complex AIFMs, and according to EU jurisdictions.

The remuneration disclosures are the responsibility of the management body of the AIFM.

In addition, the AIFM must ensure all of their employees have access, as a minimum, to the same level of information which is disclosed externally and also to the AIFM's remuneration policy.

#### **What does this mean for AIFMs?**

- *Investor protection:* Remuneration policy is disclosed to investors and is considered to be a part of the AIF's risk profile assessment
- *Verification issue:* Information disclosed in the annual report should be reviewed by the AIF's auditors, while information disclosed in any other form may not be checked
- *Homogeneity and granularity:* A varying level of detail is to be expected for remuneration disclosures, according to jurisdictions and laws concerning data protection and confidentiality, as well as proportionality principle interpretations

### Proportionality

The proportionality principle allows AIFMs to disregard some of the requirements. Nevertheless, a detailed assessment should be performed on each requirement.

The following factors should be considered together to assess how the proportionality principle can be applied for AIFMs:

- *AIFM size* – Capital, value of assets under management of the AIFs that the AIFM manages or the liabilities and risk exposure of both, number of staff, number of branches or subsidiaries
- *Nature, scope and complexity of the AIFM activities* – Type of authorised activity, type of investment policies and strategies of the AIFs the AIFM manages, national or cross-border nature of business activities, additional management of UCITS subject to authorisation under the UCITS directive
- *AIFM internal organisation* – Legal structure of the AIFM or the AIFs it manages, complexity of the AIFM's internal governance, listing on regulated markets of the AIFM or the AIFs it manages

In the final guidelines, ESMA has clarified that only the following requirements can be disregarded:

- Payment of variable remuneration in instruments
- Retention periods
- Deferral requirements
- Malus/clawback provisions
- Appointment of a remuneration committee

ESMA has stated that, while these features can be disregarded, they may only be disregarded in their entirety, i.e. it will not be possible to apply lower thresholds based on proportionality.





To the point:

The Directive introduces stringent requirements as regards remuneration governance, risk-alignment and disclosure. We believe that these requirements may represent significant change and challenges for the industry as a whole. In particular:

- The requirements are far reaching as they apply to a wide range of entities (EU-AIFMs and AIFMs managing and/or marketing AIFs in the EU, in addition to delegated entities) and to the remuneration elements concerned within those entities (notably carry and some co-investment)
- A governance of remuneration has to be implemented in each AIFM, which entails challenges in terms of independence and conflict of interest for those involved
- Remuneration risk-alignment criteria will represent implementation challenges for the AIFMs, notably to define 'Identified Staff' and value carried interest for deferral purposes. Tax implications of deferral, malus and claw back measures will also need to be considered
- The remuneration guidelines will also force AIFMs to justify and adapt their remuneration policy and place the AIF's risk dimension at the very heart of the remuneration process
- AIFMs may entirely disregard certain requirements by applying the proportionality principle. Nevertheless, a detailed assessment should be performed on each requirement

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