

## AIFMD Factsheet on Remuneration

### What is the AIFMD?

The Alternative Investment Fund Managers Directive (“**AIFMD**”) introduced a new passport system for the marketing of alternative investment funds (“**AIFs**”) in the European Union (“**EU**”) and creates a legal framework operating at European level to monitor and supervise alternative investment fund managers (“**AIFMs**”) within a harmonised system for the first time. This factsheet discusses the provisions governing remuneration policies and practices of AIFMs contained in the AIFMD.

### Remuneration Policies and Practices

The AIFMD provides that each AIFM must have remuneration policies and practices for prescribed categories of staff (see further below) that are:

- consistent with and promote sound and effective risk management; and
- do not encourage risk-taking which is inconsistent with the risk profiles, rules or instruments of incorporation of the AIFs they manage.

The AIFM must determine the remuneration policies and practices in accordance with a detailed list of principles set out in Annex II to the AIFMD (the “**Annex II Principles**”). The European Securities and Market Authority’s (“**ESMA**”) “[Guidelines on Sound Remuneration Policies under the AIFMD](#)” sets out guidance explaining how firms may comply with the Annex II Principles (the “**Remuneration Guidelines**”).

### Which Entities / Individuals are Affected?

The remuneration provisions in the AIFMD apply to all AIFMs that fall within its scope. The AIFMD provides that AIFMs shall comply with the remuneration principles “*in a way and to the extent appropriate to their size, organisation and the nature, scope and complexity of their activities.*” The Remuneration Guidelines provide guidance on how this concept of proportionality is to be applied.

The remuneration principles apply to the remuneration for those “*categories of staff, including senior management, risk takers, control functions and any employee receiving total remuneration that takes them into the same remuneration bracket as senior management and risk takers, whose professional activities have a material impact on the risk profile of the AIFM or the risk profiles of the AIF they manage.*”

The Remuneration Guidelines define the “**Identified Staff**” of the AIFM to whom the Remuneration Guidelines will apply to include “*categories of staff of the entity(ies) to which portfolio management or risk management activities have been delegated by the AIFM*”. When delegating portfolio management or risk management, the Remuneration Guidelines require that either:

- (i) the entities to which portfolio management or risk management activities have been delegated should be subject to regulatory requirements on remuneration that are equally as effective as those applicable under the Remuneration Guidelines; or
- (ii) appropriate contractual arrangements should be put in place in order 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 AIFM.

In relation to (ii), ESMA’s questions and answers document on the Application of the AIFMD (the “**ESMA Q&A**”) clarifies that the “appropriate contractual arrangements” must only be in place in respect of the delegate’s identified staff who have a material impact on the risk profiles of the AIFs it manages as a result of the delegation, and only in respect of the remuneration for such delegated activities. ESMA also states that where the delegate’s identified staff are subject to the Capital Requirements Directive remuneration rules, the delegate will be deemed to be subject to regulatory requirements on remuneration that are equally as effective as those applicable under the Remuneration Guidelines.

## **Which Remuneration is Covered?**

The provisions apply to “remuneration of any type”, whether paid by the AIFM or paid directly by the AIF itself. The Remuneration Guidelines provide that, remuneration consists of:

- (i) all forms of payments or benefits paid by the AIFM,
- (ii) any amount paid by the AIF itself, including carried interest, and
- (iii) any transfer of units or shares of the AIF,

In exchange for professional services rendered by the AIFM Identified Staff.

## **What are the Annex II Principles?**

AIFMs are required to comply with a detailed list of principles when establishing and maintaining their remuneration policies and practices. Some of the key provisions of the Annex II Principles are set out below.

- The remuneration policy must include measures to avoid conflicts of interest.
- The management body of the AIFM must periodically review the remuneration policy and is responsible for its implementation.
- The implementation of the remuneration policy must be subject to central and independent review at least annually.
- Guaranteed bonuses should be “exceptional” and may only occur in the context of hiring new staff for the first year of service.
- Payments related to the early termination of a contract must reflect performance over time and not reward failure.
- The fixed and variable components of total remuneration should be appropriately balanced. The fixed component should represent a sufficiently high proportion of the total remuneration to allow the operation of a fully flexible policy on variable remuneration components, including the possibility of paying no variable remuneration component at all. It may therefore be necessary to increase base pay and reduce bonus multiples.
- At least 50% of any variable remuneration must consist of non-cash variable payments such as units or shares of the AIF concerned, which will be subject to an appropriate retention policy designed to align incentives with the interests of the AIFM, the AIFs it manages and the AIF’s investors.
- At least 40% of variable remuneration should be deferred over a period which is appropriate in view of the life cycle and redemption policy of the AIF. The period must be at least three to five years unless the life cycle of the AIF concerned is shorter. Where the variable remuneration component is particularly high, at least 60% of the amount should be deferred.
- The variable remuneration must be paid or vest only if it is sustainable according to the financial situation of the AIFM as a whole. The total variable remuneration must generally be “considerably contracted” where subdued or negative financial performance of the AIFM or the AIF concerned occurs, including through reducing payouts of amounts previously earned (including by malus or clawback arrangements).
- AIFMs that are significant in terms of their size or the size of the AIFs they manage, their internal organisation and the nature, the scope and the complexity of their activities must establish a remuneration committee. The chairman and members of the committee shall be members of the management body who do not perform any executive functions in the AIFM.

## **Transparency Requirements**

Each AIFM must produce an annual report for each EU AIF it manages and for each AIF marketed in the EU, which must be provided to investors on request and made available to national regulators. The annual report must contain details of:

- the total remuneration for the financial year (split into fixed and variable remuneration) paid by the AIFM to its staff, the number of beneficiaries and, where relevant, carried interest paid by the AIF; and

- the aggregate amount of remuneration broken down by senior management and members of staff of the AIFM whose actions have a material impact on the risk profile of the AIF.

Implementing measures adopted under the AIFMD (the “**Level 2 Regulation**”) provide some further detail on remuneration disclosure including how total remuneration should be disclosed and the content and format of the disclosure of remuneration where information is presented at the level of the AIFM.

## **When do the Remuneration Rules Apply?**

The ESMA Q&A provides guidance on when remuneration requirements apply for the first time. ESMA states that once a firm becomes authorised under the AIFMD, it becomes subject to the AIFMD remuneration rules and the Remuneration Guidelines. Therefore, the relevant rules apply from the date of authorisation. However, in relation to the rules on variable remuneration, AIFMs should apply those rules to the calculation of payments relating to new awards of variable remuneration to their identified staff for performance periods following that in which they become authorised. That is, the AIFMD regime on variable remuneration should apply only to full performance periods and should apply to the first full performance period after the AIFM becomes authorised.

## **Application of the Proportionality Principle**

The Remuneration Guidelines set out specific guidance on how the proportionality concept set out in the AIFMD will apply. ESMA states that, in taking measures to comply with the remuneration principles, AIFMs should comply in a way and to the extent that is appropriate to their size, internal organisation and the nature, scope and complexity of their activities. The application of the proportionality principle may lead to some AIFMs being able to disapply certain provisions, provided the AIFM can explain to the national regulator, if requested, the rationale for the disapplication of the requirement.

### *Requirements that may be disapplied*

The Remuneration Guidelines set out the limited number of requirements which may be disapplied, if it is proportionate to do so. These are:

- the requirements on the payout process. Some AIFMs, either for the total of their Identified Staff or for some categories within their Identified Staff, can disapply the requirements on (a) variable remuneration in instruments; (b) retention; (c) deferral; and (d) ex post incorporation of risk for variable remuneration; and
- the requirement to establish a remuneration committee. The Remuneration Guidelines state that all AIFMs should consider the setting up of a remuneration committee “as a matter of good practice”. When assessing whether an AIFM is significant in size, consideration should be given to the cumulative presence of size, internal organisation and nature, scope and complexity of the activities of the AIFM. An AIFM which is significant only with respect to one or two of the three factors should not be required to establish a remuneration committee.

The specific numerical criteria set out in Annex II of the AIFMD (eg, the minimum portion of 40% to 60% of variable remuneration that should be deferred), if disapplied, may only be disapplied in their entirety. If it is not possible to proportionately disapply a requirement in its entirety, it must be complied with in full without variation.

When drafting equivalent remuneration guidelines under the UCITS Directive, ESMA remained silent on the possibility of disapplying certain remuneration requirements on the grounds of proportionality. This change in approach by ESMA in the UCITS remuneration guidelines follows differing interpretations of the proportionality principle by both the European Commission and by the European Banking Association in drafting remuneration guidelines under the Capital Requirements Directive, which has led to ambiguity as to whether the application of the proportionality principle may operate to disapply certain remuneration requirements in full. In a letter to the European Commission, European Parliament and Council of the EU dated 31 March 2016, ESMA expresses its view that that it should be possible to disapply the requirements relating to the pay-out process under specific circumstances and that it should also be possible to apply lower thresholds whenever minimum quantitative thresholds are set for the pay-out requirements. ESMA suggests that legislative change may be required in order to provide clarity on this issue. ESMA has stated that it will not amend the AIFMD Remuneration Guidelines to bring them into line with the UCITS remuneration guidelines pending clarification on the application of the proportionality principle.

## Comment

Many of the remuneration rules provided for in the AIFMD are similar to the remuneration rules for banks and investment companies set out in the Capital Requirements Directive. The application of these rules to the alternative fund management industry presents practical challenges given the differences in the nature and structure of remuneration in AIFMs as compared with banks and large financial institutions. The traditional fee models operated by AIFMs prior to AIFMD implementation already generally contained mechanisms to align the interest of investors and fund managers. Private equity funds typically provide for a deferral of carried interest until the fund has achieved certain levels of performance, while the traditional hedge fund fee model involves an annual management fee and a performance fee once a certain high water mark has been realised.

Full details of the Asset Management and Investment Funds Group, together with further updates, articles and briefing notes written by members of the Asset Management and Investment Funds team can be accessed at [www.matheson.com](http://www.matheson.com).

## Contacts



**Tara Doyle**

PARTNER

D +353 1 232 2221  
E tara.doyle@matheson.com



**Michael Jackson**

MANAGING PARTNER

D +353 1 232 2000  
E michael.jackson@matheson.com



**Dualta Counihan**

PARTNER

D +353 1 232 2451  
E dualta.counihan@matheson.com



**Joe Beashel**

PARTNER

D +353 1 232 2101  
E joe.beashel@matheson.com



**Anne-Marie Bohan**

PARTNER

D +353 1 232 2212  
E anne-marie.bohan@matheson.com



**Shay Lydon**

PARTNER

D +353 1 232 2735  
E shay.lydon@matheson.com



**Liam Collins**

PARTNER

T +353 1 232 2195  
E liam.collins@matheson.com



**Philip Lovegrove**

PARTNER

D +353 1 232 2538  
E philip.lovegrove@matheson.com



**Elizabeth Grace**

PARTNER

D +353 1 232 2104  
E elizabeth.grace@matheson.com



**Oisín McClenaghan**

PARTNER

T +353 1 232 2227  
E oisinncclenaghan@matheson.com



**Michelle Ridge**

PARTNER

T +353 1 232 2758  
E michelle.ridge@matheson.com



**Barry O'Connor**

PARTNER

T +353 1 232 2488  
E barry.oconnor@matheson.com

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