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UCITS V: Remuneration

The UCITS V Directive ("**UCITS V**") amends the regulatory framework for Undertakings for Collective Investment in Transferable Securities ("**UCITS**") to address issues relating to the depositary function, manager remuneration and administrative sanctions. This factsheet discusses the UCITS V provisions governing remuneration.

UCITS V Timeline

UCITS V was published in the Official Journal of the EU on 28 August 2014, and EU member states had until 18 March 2016 to transpose the directive into national law. Ireland was one of the first EU member states to implement UCITS V. As mandated by UCITS V, the European Securities and Markets Authority ("**ESMA**") published its final report on *Guidelines on sound remuneration policies under the UCITS Directive and AIFMD* in March 2016, seeking to clarify the scope of the UCITS V remuneration requirements and their practical application. On 14 October 2016, ESMA published the finalised *Guidelines on sound remuneration policies under the UCITS Directive* (the "**UCITS Remuneration Guidelines**"). The UCITS Remuneration Guidelines apply from 1 January 2017.

Remuneration Policies and Practices

According to UCITS V, each UCITS management company or self-managed investment company ("**UCITS Manager**") must put in place remuneration policies and practices that:

- are consistent with and promote sound and effective risk management of the UCITS;
- do not encourage risk-taking which is inconsistent with the risk profiles or fund rules governing the relevant UCITS; and
- do not impair compliance with the UCITS Manager's duty to act in the best interest of the UCITS.

In addition, the remuneration policies and practices must respect a number of stipulated principles, set out in Article 14(b) of UCITS V, dealing with governance, pay structure and risk alignment (the "**Principles**"). UCITS V also requires certain UCITS Managers to establish a remuneration committee. All UCITS Managers must disclose information regarding their remuneration policy, in an effort to improve transparency over pay practices.

The Principles substantially mirror those contained in the Alternative Investment Fund Managers Directive ("**AIFMD**"). They also contain a number of requirements similar to those contained in the Capital Requirements Directive ("**CRD**"), with the notable exception of a bonus cap.

Which entities / individuals are affected?

The general obligation to have sound remuneration policies and practices applies to all UCITS Managers, regardless of their size or systemic importance.

The remuneration policies and practices must cover all staff whose professional activities have a material impact on the risk profile of the UCITS Manager or of the UCITS it manages at either fund or sub-fund level ("**Identified Staff**"). These are likely to include not only fund managers and investment decision-makers but also, for example, certain persons who are paid commensurate salaries.

Which remuneration is covered?

The remuneration requirements apply to all remuneration paid either by the UCITS Manager or by the UCITS itself. The term "remuneration" covers both fixed and variable pay, early termination payments and pension payments. It also covers performance fees as well as non-cash benefits, such as share options. However, it is unlikely to encompass payments which: (a) pose no incentives in terms of risk assumption, such as gym membership; or (b) are a pro-rata return on the Identified Staff member's investments.

What are the Principles affecting governance?

UCITS V requires a UCITS Manager's non-executive board members to: adopt the remuneration policy; adopt and review at least annually the general principles of the remuneration policy; and take responsibility for and oversee their implementation.

The remuneration policy's implementation must be subject, at least annually, to a central and independent review for compliance with the remuneration policies and procedures adopted by the UCITS Manager.

What are the Principles affecting pay structure and risk alignment?

UCITS V requires UCITS Managers to comply with a detailed list of Principles when establishing and maintaining their remuneration policies and practices. In particular, UCITS Managers must:

- balance fixed and variable remuneration components appropriately and ensure that they have the option of paying no variable remuneration;
- only pay guaranteed variable remuneration in the first year following a new hire and even then only in exceptional circumstances;
- use both non-financial and financial criteria to assess performance in the context of a multi-year framework with an adjustment mechanism capable of integrating all types of current and future risks;
- only pay variable remuneration if it is sustainable according to the UCITS Manager's financial situation as a whole. It must be considerably contracted where either the UCITS Manager or the UCITS concerned performs badly;
- defer between 40 - 60% of variable remuneration over a three to five year period, subject to the over-riding requirements that the deferral period is: (1) appropriate in view of the holding period recommended to the UCITS' investors; and (2) correctly aligned with the nature of the risk of the UCITS in question;
- pay a substantial portion (of at least 50%) of the variable remuneration component in non-cash instruments such as units of the UCITS concerned, equivalent ownership instruments or other instruments with equally effective incentives. Where the management of UCITS accounts for less than 50% of the total portfolio managed by the UCITS Manager the 50% minimum does not apply, but the obligation to pay a substantial portion of variable remuneration in non-cash instruments remains. However, this is subject to the UCITS legal structure, its fund rules or instruments of incorporation;
- link early termination payments to performance; and
- hold discretionary pension benefits in non-cash instruments for five years if a staff member leaves before retirement. Following retirement, UCITS Managers must also pay discretionary benefits in the form of non-cash instruments which must be subject to a five year retention period.

Which UCITS Managers must establish a remuneration committee?

Significant UCITS Managers must establish a remuneration committee. The term "significant" is to be understood in terms of: (1) the UCITS Manager's size or the size of the UCITS it manages; (2) the UCITS Manager's internal organisation; and (3) the nature, scope and complexity of its activities. The UCITS Remuneration Guidelines provide that, in assessing whether a management company is significant, a management company should consider the cumulative presence of all three of these factors. A UCITS Manager which is significant only with respect to one or two of the three factors should not be required to set up a remuneration committee. The UCITS Remuneration Guidelines suggest that the setting up of a remuneration committee should be considered, as a matter of good practice, even by those management companies that are not obliged to set up such a committee.

The members of the remuneration committee must be non-executive members of the management body. Where national law provides for employee representation on the management board, there must also be one or more employee representative(s) on the remuneration committee. When preparing its decisions, the remuneration committee must take into account the long-term interests of investors and other stakeholders, and the public interest.

What are the disclosure requirements?

Under UCITS V, details of the remuneration policy must be included in the prospectus, the key investor information document (the "**KIID**") and the annual report.

The prospectus must include either details of the remuneration policy itself, or a summary of that policy and a statement that the details of the policy are available on a specified website and that a paper copy will be made available free of charge upon request. The KIID must include a statement to the same effect.

The UCITS' annual report must disclose the aggregate remuneration paid by the UCITS Manager and by the UCITS to Identified Staff, together with the number of beneficiaries and, where relevant, performance fees paid by the UCITS. The aggregate amount of remuneration must be broken down by category of employees or other staff members. The annual report must also describe how the remuneration and benefits have been calculated, detail the outcomes of the periodic reviews of the remuneration policy and its implementation and contain any material changes to the adopted remuneration policy.

ESMA has clarified in its questions and answers document on the application of the UCITS Directive that for annual reports relating to periods that end on or after 18 March 2016 but before the UCITS Manager has completed its first annual performance period in which it has to comply with the remuneration rules, the UCITS Manager should include the remuneration-related information in the report on a best efforts basis and to the extent possible, explaining the basis for any omission.

What is the principle of proportionality?

The proportionality provisions in UCITS V and the AIFMD require UCITS Managers and alternative investment fund managers ("**AIFMs**") to comply with 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*". In the context of the AIFMD, ESMA had made it clear in its remuneration guidelines that the proportionality principle could operate so as to dis-apply certain specific requirements of the pay-out process on an exceptional basis. Taking a contrasting position, in its March 2015 consultation paper on remuneration guidelines under CRD IV, the European Banking Authority ("**EBA**") stated "*the preliminary assessment of the EBA is that a full waiver of the application of even a limited set of remuneration principles for smaller and non-complex institutions would not be in line with CRD.*" The final EBA guidelines are silent on the possibility of dis-applying any of the CRD IV remuneration requirements but were accompanied by an opinion of the EBA suggesting changes to the CRD to clarify that certain provisions on variable remuneration do not apply to certain firms and / or their staff.

In drafting the UCITS Remuneration Guidelines, ESMA was required to cooperate closely with the EBA in order to ensure consistency with the requirements developed for credit institutions and other financial services sectors and also to align the UCITS Remuneration Guidelines to the extent possible with the equivalent guidelines issued under the AIFMD. This put ESMA in the difficult position of having to reconcile two diverging approaches on the issue. The final UCITS Remuneration Guidelines do not provide guidance on the possibility of the proportionality principle operating to dis-apply certain specific requirements of the pay-out process.

However, this does not mean that ESMA believes that entities in the fund management sector should be subject to the same remuneration rules as credit institutions. In a letter sent by ESMA to the EU law-making institutions on 31 March 2016 setting out ESMA's views on the application of the proportionality principle (the "**Letter**"), ESMA draws particular attention to the differences between the two sectors, noting in particular that:

> *"Fund managers operate according to an agency model and do not accept deposits or deal on their own account. As a consequence, fund managers, unlike credit institutions, do not issue liabilities to fund investors. Fund investors have a claim on the investment portfolio which is ring-fenced from the fund manager. Fund managers manage a portfolio of securities on behalf of a fund, in the interest of the investors in such fund, under an investment mandate. Their discretion on how to dispose of the assets in the relevant portfolio is constrained by the investment objectives and specific limits and restrictions set out in the investment management mandate and in specific product regulation (eg, UCITS concentration limits). ESMA recalls that remuneration rules under the UCITS Directive and the AIFMD are aimed to align the interests of, including the risks taken by, the fund managers with those of the investors of the funds that they manage.*
>
> *Given the nature of activities of fund managers, and the variety of funds they manage and strategies they implement for those funds, it is appropriate to recognise the possibility to tailor the rules on the pay-out process of variable remuneration when these do not, in the specific circumstances, achieve the goal of aligning the interests of the fund manager's staff."*

ESMA notes that recent work and legal analysis has called into question the existing understanding that the proportionality provisions set out in the UCITS Directive and the AIFMD may lead to a result where:

(a) under specific circumstances, the requirements of the pay-out process are not applied; or

(b) it is possible to apply lower thresholds whenever minimum quantitative thresholds are set for the pay-out requirements (for example, the requirement to defer at least 40% of variable remuneration).

ESMA states in the Letter that it considers that the scenarios under (a) and (b) should remain possible in certain situations and that further legal clarity on this possibility could be beneficial to all interested parties.

ESMA provides a number of examples in the Letter of circumstances in which it believes it should be possible to tailor the rules on the pay-out process and concludes that it would be inappropriate for the following fund managers to be subject in all circumstances to the requirements of the pay-out process:

- smaller fund managers (in terms of balance sheet or size of assets under management);
- fund managers with simpler internal organisation or nature of activities; or
- fund managers whose scope and complexity of activities is more limited.

The Letter also states that it would be disproportionate to apply the requirements to relatively small amounts of variable remuneration and to apply certain requirements to certain staff when this would not result in an effective alignment of interests between the staff and the investors in the funds.

In the Letter, ESMA also notes:

> *"that both the AIFMD and UCITS Directive prescribe that proportionality shall apply to the full set of remuneration principles set out under these Directives. This is made clear by the language in both Directives stating that management companies and AIFMs "shall comply with 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"."*

ESMA then goes on to confirm in the Letter that it considers that *"proportionality applies to the full set of requirements"* in respect of remuneration set out in UCITS V *"and the corresponding provisions of AIFMD"*.

It is unfortunate that there is no clear guidance on this issue at European level and the current position is somewhat unclear. In the absence of legislative amendment at European level, or clarification at member state level, it may be necessary for the relevant UCITS Manager to make its own assessment as to application of the proportionality principle. In doing so, we believe it would be appropriate for UCITS Managers to have regard to ESMA's views in the Letter regarding the circumstances in which a UCITS Manager may rely upon proportionality.

The UK Financial Conduct Authority's ("**FCA**") *General Guidance on the AIFM Remuneration Code*, which was published in January 2014 (the "**FCA's Guidance**"), may suggest a possible approach to be taken by member states in applying the remuneration principles. According to the FCA's Guidance, if an AIFM's assets under management are less than a specified threshold, then the presumption arises that they may dis-apply the rules dealing with variable instruments in remuneration, retention, deferral and ex-post incorporation of risk for variable remuneration, subject to a review of the other criteria. According to the FCA's Guidance, the thresholds are:

- less than £5 billion in the case of AIFMs which manage portfolios of alternative investment funds ("**AIFs**") that are unleveraged and have no redemption rights exercisable during a period of 5 years following the date of initial investment in each AIF; and
- less than £1 billion in the case of AIFMs which manage portfolios of AIFs in other cases, including any assets acquired through the use of leverage.

The FCA have not published separate guidance in respect of the UCITS V requirements and have indicated that they do not plan to do so. They have stated, however, that UCITS Managers may find it useful to consider the principles in the FCA's Guidance to understand the FCA's expectations in the UCITS context.

How will the UCITS V remuneration provisions impact on delegates?

One of the more controversial issues in the debate preceding the adoption of UCITS V related to its application to delegates. This issue is not dealt with in the substantive text of UCITS V, however according to its recitals, the remuneration policies and practices should also apply in a proportionate manner "*to any third party which takes investment decisions that affect the risk profile of the UCITS because of functions delegated to it….*".

The UCITS Remuneration Guidelines follow the approach under the AIFMD remuneration requirements and provide that, where a UCITS Manager has delegated activities to service providers, such service providers should be subject to "*equivalent regulatory requirements on remuneration that are equally as effective as [the UCITS remuneration guidelines]*" or appropriate contractual arrangements should be put in place to ensure that there is no circumvention of the UCITS remuneration requirements. Where this approach may lead to an individual being subject to several regulatory regimes eg, AIFMD, CRD IV and UCITS V, compliance with one regulatory regime will be sufficient for the purposes of the other regimes' requirements.

One of the main concerns surrounding the application of the UCITS V remuneration requirements to delegates is the requirement to pay a minimum of 50% of any variable remuneration, including deferred remuneration, in units of the UCITS concerned, equivalent ownership interests and share-linked instruments or equivalent non-cash instruments with equally effective incentives.

This concern is attributable to the fact that, in some cases, a fund may not be open to individual investors or may have high minimum subscription requirements. In addition, non-EU delegates may be restricted from owning fund units because of regulatory requirements. For example, the payment of a UCITS' units to an employee who is a national of a third country may trigger reporting requirements under the law of that country, and / or give rise to tax issues.

It should be noted that the principle regarding non-cash payments only applies in so far as such payments are compatible with the UCITS' legal structure and its fund rules or instrument of incorporation. Finally, the requirement to pay at least 50% of variable remuneration in non-cash instruments only applies where the management of a UCITS accounts for more than 50% of the total portfolio managed by the UCITS Manager, which should minimise the burden for many non-EU investment managers.

In the Letter, ESMA acknowledges that there may be cases where the application of the pay-out process rules to the staff of the delegate would not be proportionate and would not achieve the outcome of aligning the delegates' staff interests with those of the investors in the UCITS. It also acknowledges the risk that the unwillingness of delegates outside the European Economic Area ("**EEA**") to be subject to some requirements which they consider disproportionate, could prevent access of UCITS Managers to certain investment strategies. It remains to be seen whether the additional clarifications on proportionality requested by ESMA in the Letter might extend to delegates but we believe that the factors mentioned by ESMA above should be regarded as relevant for UCITS Managers when considering the application of the UCITS Remuneration Guidelines to their delegates.

Comment and Next Steps for UCITS Managers

Following the introduction of UCITS V, UCITS Managers are required to evaluate their pre-existing governance practices and adapt those practices to the relevant UCITS V requirements. They should also consider which of their staff are likely to be Identified Staff for the purposes of those requirements and review their existing remuneration and recruitment practices and relevant contractual arrangements to ensure compliance with UCITS V. Many UCITS Managers may well find that they are already in substantive compliance with the UCITS V requirements as they are already subject to the equivalent CRD remuneration requirements pursuant to the Markets in Financial Instruments Directive. However, non-EU managers acting as delegates may need to take additional measures to ensure compliance with UCITS V.

As noted above, the UCITS Remuneration Guidelines apply from 1 January 2017. The UCITS Remuneration Guidelines state that the guidance on the rules on variable remuneration should apply for the calculation of payments relating to new awards of variable remuneration for Identified Staff for the first full performance period after 1 January 2017. For example, a UCITS Manager whose accounting period ends on 31 December should apply the guidance on the rules on variable remuneration to the calculation of payments relating to the 2017 accounting period. However, a management company whose accounting period ends on 30 November may be in a position where the provisions in relation to variable remuneration will only apply for the accounting period commencing 1 December 2017.

If you require detailed advice relating to UCITS V, please get in touch with your usual Asset Management and Investment Funds Group contact or any of the contacts listed in this publication. Further briefing notes and updates on UCITS V may be accessed on our website.

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.

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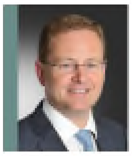

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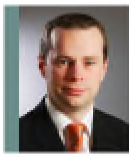

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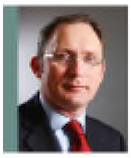

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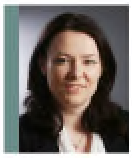

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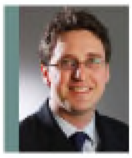

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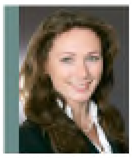

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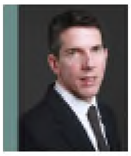

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