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CRD IV and UCITS V remuneration rules – their impact on asset managers

Subhead

CRD IV¹ and UCITS V² are the latest iterations of the Directives governing EU credit institutions and investment firms and UCITS funds and management companies. European Economic Area (“EEA”) Member States were required to apply CRD IV on 1 January 2014 and will be required to apply UCITS V on 18 March 2016.

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Both CRD IV and UCITS V contain rules on the manner in which staff are remunerated, which are designed to promote sound and effective risk management. This Alert focuses on the impact of the new remuneration rules in these Directives on asset managers. Following their original introduction in CRD III, remuneration rules were introduced for alternative fund managers in 2013 under the Alternative Investment Fund Managers Directive (“AIFMD”). AIFMD provides the “blueprint” for the rules in UCITS V for fund managers regulated under the UCITS Directive.

Remuneration rules under CRD IV

CRD IV remuneration rules apply to credit institutions (broadly, EU deposit-taking banks) and some types of EU investment firms.³ Broadly, the types of investment firms that are subject to CRD IV are investment firms that have permission to engage in proprietary trading (encompassing broker-dealers) or certain corporate finance activities (such as “placing” or underwriting). In addition, there are a number of asset managers that have sought to be subject to CRD IV to qualify as a “sponsor” for securitization risk retention purposes.

CRD IV makes a number of changes to the existing remuneration rules that apply to EEA firms that are subject to the CRD. In particular, CRD IV imposes the bonus cap, which imposes a ratio of fixed and variable remuneration of 1:1, or 1:2 with shareholder approval (with a quorum of 50% of shareholders, 66% of votes in favour would be required, and, if that quorum is not reached, 75% of votes must be in favour).⁴ CRD IV also requires that all variable remuneration should be subject to “clawback” arrangements (in light of subsequent poor performance by the individual).⁵

CRD IV includes the proportionality principle, which is that the rules must be applied in a manner appropriate to the size of the firm and the types of activities that it undertakes.⁶ The European Banking Authority (“EBA”) is responsible for publishing guidelines on, amongst other things, the precise application of this principle. The EBA

¹ Directive 2013/36/EU on access to the activity of credit institutions and the prudential supervision of credit institutions and investment firms, amending Directive 2002/87/EC and repealing Directives 2006/48/EC and 2006/49/EC (together known as “CRD IV”).

² Directive 2014/91/EU, amending Directive 2009/65/EC on the coordination of laws, regulations and administrative provisions relating to undertakings for collective investment in transferable securities (UCITS) as regards depositary functions, remuneration policies and sanctions (known as “UCITS V”).

³ See definition of investment firm in Article 4(2) of Regulation 575/2013.

⁴ Article 94(1)(g).

⁵ Article 94(1)(n).

⁶ Recital 66.

published a consultation paper and draft guidelines in March 2015, where it outlined its proposed approach in regard to proportionality. In this paper, the EBA expressed its view that proportionality cannot act to disapply individual requirements of CRD IV (such as the bonus cap and the requirement to pay a portion of the remuneration “in kind” in equity). In the EBA’s view, all remuneration requirements must be applied to at least the minimum thresholds set by CRD IV, and that proportionality means application of all the rules in a manner appropriate to the institution’s size, internal organization and nature, scope and complexity of its activities.

It is currently unknown whether the EBA will adopt this approach in its final guidelines. The EBA has acknowledged that its interpretation will have a significant impact on small and less risky firms. The European Commission’s recent (October 2015) announcement of two consultations on the impact of the CRD IV remuneration rules suggests that it will not release final remuneration guidelines until the results of these consultations, meaning that resolution of this issue may not take place until early next year.

Position of asset managers that are part of a group that is subject to CRD IV

Many alternative investment fund managers (“AIFMs”) and UCITS managers are part of a group (such as a banking group) that is subject to CRD IV. CRD IV requires a group-wide remuneration policy to apply to all staff at group, parent and subsidiary levels, and states that CRD IV’s requirements for the contents of remuneration policies should apply at least to those staff members whose professional activities have a material impact on the group’s risk profile.⁷

According to the EBA’s draft guidelines:

- Staff within an AIFM or UCITS manager **whose professional activities have a material impact on the group’s risk profile on a consolidated basis** are subject to CRD IV remuneration rules, including the bonus cap. Firms will need to identify any such staff and determine whether, for instance, the activities of an individual portfolio manager within an AIFM or a UCITS manager can be said to have an impact on the group’s risk profile. It is likely that an individual in an AIFM or a UCITS manager would need to exercise significant influence either within the firm or at the group level to be subject to CRD IV, such as a board member of an AIFM or UCITS manager.
- Where specific CRD requirements conflict with the “sectoral” requirements (meaning the specific remuneration rules put forward under the AIFMD or the UCITS Directive), the remuneration policy should set out for the relevant individuals which requirements should apply within the entity on an individual basis. This means that, for instance, the requirement in the AIFMD or UCITS Directive to pay part of the variable remuneration in units in the fund would “trump” the equivalent requirement in CRD IV to pay part of the variable remuneration in equity in the firm.

Subject to these qualifications, staff within an AIFM or UCITS manager that is within a group that is subject to CRD IV are subject to the rules in the AIFMD and UCITS Directive (which are broadly similar, but not identical, to the rules in CRD IV).

The European Securities and Markets Authority (“ESMA”), the pan-EEA regulator, published a consultation paper on guidelines on sound remuneration policies under the UCITS V Directive on 23 July 2015. According to ESMA’s draft guidelines (which form part of the consultation):

- There should be no exception to the application of the UCITS remuneration principles to any management company which is a subsidiary of a credit institution.
- Where staff of the UCITS management company or the AIFM are “identified staff” for the purpose of CRD IV rules, they should be remunerated either:

⁷ Articles 92(1) and 92(2).

- On activities carried out on a pro rata basis between CRD IV, UCITS and AIFMD (based on, for instance, time spent on each service); or
- Where there is a conflict between CRD IV and UCITS (or AIFMD) remuneration principles, by applying “sectoral” remuneration principles which are deemed more effective for discouraging excessive risk taking. Where the firm determines that compliance with CRD IV is more effective, this should deem compliance with remuneration requirements under UCITS and AIFMD. However, where specific CRD IV requirements conflict with requirements under UCITS or AIFMD, the remuneration of the individual should follow the specific requirements under UCITS or AIFMD. This is in line with the EBA’s guidance.

Remuneration rules under UCITS V

To date, UCITS management companies have not been subject to specific rules on staff remuneration. UCITS V introduces remuneration rules that are similar to the rules for AIFMs under the AIFMD, requiring UCITS management companies to put in place remuneration policies that are consistent with sound risk management.⁸

The following is a summary of the UCITS V remuneration principles⁹:

- the manager must have a remuneration policy that is consistent with and promotes sound and effective risk management and does not encourage risk-taking that is inconsistent with the UCITS’ risk profiles or rules;
- the remuneration policy should be in line with the business strategy, objectives, values and interests of the UCITS, the manager and the investors in the UCITS, and include measures to avoid conflicts of interest;
- the management body of the manager should adopt the remuneration policy and perform at least an annual review (according to UCITS V, this can only be undertaken by members of the management body who do not perform any executive functions and who have expertise in risk management and remuneration);
- the compliance function should, at least annually, review implementation of the remuneration policy;
- staff in control functions (such as senior legal and compliance staff) should be compensated in accordance with their functions’ objectives, independently of the performance of the business areas that they control;
- a remuneration committee should oversee remuneration of senior officers in risk management and compliance;
- performance-related remuneration must be based on a combination of the assessment of the performance of the individual and of the business unit or fund concerned and the overall results of the UCITS manager, taking into account financial and non-financial criteria;
- performance must be assessed in a multi-year framework (appropriate to investors’ recommended holding period in the fund), so that the assessment is based on longer-term performance of the fund;
- guaranteed variable remuneration must only be paid in the first year following a new hire and even then only in exceptional circumstances;
- fixed and variable remuneration components must be balanced appropriately, and the manager must have the option of paying no variable remuneration;
- payments for early termination reflect the performance achieved over time and are designed in a way that does not reward failure;
- variable remuneration must be put in place with an adjustment mechanism that integrates all types of current and future risks;
- a substantial portion (at least 50%) of the variable remuneration component must be paid 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 funds accounts for less than 50% of the total portfolio managed by the manager, the 50% minimum does not apply, but the obligation to pay a substantial portion of variable remuneration in non-cash instruments remains. This requirement is subject to

⁸ Articles 14a and 14b of Directive 2009/65/EU, as amended by UCITS V.

⁹ Article 14b of Directive 2009/65/EU, as amended by UCITS V.

the fund's legal structure, its fund rules or instruments of incorporation. In practice, managers are likely to take a pragmatic approach to satisfy this requirement;

- pay-out of between 40% and 60% of variable remuneration must be deferred over a period of three to five years, subject to the requirements that the deferral period is (1) appropriate in the view of investors' holding period, and (2) correctly aligned with the nature of the risk of the fund in question;
- variable remuneration (including the deferred portion) must only be paid if it is sustainable according to the manager's financial situation as a whole and the individual's and fund's performance, and provide for variable remuneration to be reduced where either the manager or the fund concerned performs badly, or where the individual performs a "bad act" (including clawback of remuneration already paid);
- discretionary pension benefits must be held in non-cash instruments for five years if a staff member leaves before retirement. Following retirement, the manager must also pay discretionary benefits in the form of non-cash instruments which must be subject to a five-year retention period;
- staff may not use personal hedging strategies or insurance to undermine the risk alignment in the remuneration arrangements; and
- variable remuneration may not be paid through vehicles or methods that facilitate avoidance of the requirements in UCITS V.

The remuneration provisions apply to senior management, risk takers (such as portfolio managers, traders and senior sales staff), control functions (such as senior legal, compliance and finance staff) and any other staff member whose remuneration falls in the remuneration bracket of senior management, and other risk takers whose professional activities have a material impact on the risk profile of the management company or UCITS.¹⁰

Remuneration committee

UCITS management companies that are significant in terms of their size or the size of the funds managed, their internal organization and nature, scope and complexity of their activities, must establish a remuneration committee.¹¹

Proportionality principle

In AIFMD and UCITS V, remuneration principles are subject to the proportionality principle, which is that the rules must be applied in a manner appropriate to the size of the firm and the types of activities which it undertakes. UCITS V states that UCITS management companies must comply with the rules "in a way and to the extent that is appropriate to their size, internal organisation and nature, scope and complexity of their activities"¹² – noting at the same time that UCITS management companies must "apply all the principles governing remuneration policies."¹³

According to ESMA's draft guidelines, proportionality may lead "on an exceptional basis" to the disapplication of some requirements, if this fits with the risk profile, risk appetite and strategy of the management company and the UCITS. Managers must be able to explain the basis for disapplication to competent authorities, if requested. The following requirements may be disappplied:

- the requirements on the pay-out process, namely the requirements on (i) variable remuneration in instruments; (ii) retention; (iii) deferral and (iv) ex-post incorporation of risk for variable remuneration; and
- the requirement to establish a remuneration committee.

According to the draft guidelines, the management company should assess its own characteristics and develop and implement remuneration policies and practices that align with the risks faced and provide adequate and effective

¹⁰ Article 14a(3) of Directive 2009/65/EU, as amended by UCITS V.

¹¹ Article 14b(4) of Directive 2009/65/EU, as amended by UCITS V.

¹² Article 14b(1) of Directive 2009/65/EU, as amended by UCITS V.

¹³ Recital 3 of UCITS V.

incentives. In applying the proportionality principle, the types of factors that a manager may take into account will include the manager's total assets under management (AuM); the average ratio between its fixed and variable remuneration paid to staff; the complexity of its investment strategy (in this regard, index or tracker funds are regarded as lower risk); and the percentage of UCITS assets under management relative to other fund assets under management.

Application of remuneration rules to delegates

Under AIFMD, ESMA required, in its remuneration guidelines, the application of the AIFMD remuneration rules to portfolio management delegates (i.e., sub-advisors) of an AIFM, including delegates established **outside** the EEA. Although UCITS V did not include this principle within its provisions, a recital to the Directive mentions the possibility of this being required, referring to remuneration rules applying to third parties that "take investment decisions that affect the risk profile of the UCITS", with such rules applying "in a proportionate manner".

In its draft guidelines, ESMA has taken the same approach on this point as it did under AIFMD, and (based on the draft) will require the application of remuneration rules to portfolio management delegates of UCITS management companies, by either of the following means:

- satisfying the condition that the delegate is "subject to regulatory requirements on remuneration that are equally as effective as those applicable under these guidelines"; or
- the UCITS management company including a provision in the contract appointing the delegate, which states that the delegate must follow, to an appropriate degree, UCITS remuneration rules.

A delegate that is already governed by EU remuneration rules (such as a manager governed by AIFMD or CRD IV) will likely comply with whatever requirement is imposed on it by virtue of UCITS.

There are questions as to the degree to which a delegate of a UCITS management company will be subject to the new rules. In particular:

- Under AIFMD, ESMA clarified that a delegate, in applying AIFMD remuneration rules, need only have regard to those staff who have a material impact on the fund's risk profile and only in respect of the portion of the remuneration they receive for the delegated mandate. ESMA may provide the same guidance under UCITS.
- It seems sensible to apply the proportionality principle to the application of the remuneration rules to delegates. The UK Financial Conduct Authority's ("FCA") guidance under AIFMD allowed managers to disapply the "pay-out process rules"¹⁴ to delegates where the delegate acts with limited investment discretion, and subject to the risk management of the appointing manager. It is unknown whether the FCA or ESMA will adopt a similar approach for UCITS remuneration rules. The FCA has stated that it will consider publishing further guidance once ESMA's guidelines are finalised.

In practice, managers should consider the following possible approaches to address the requirement to apply remuneration rules to its delegates:

- It may be possible to argue that, in view of the strict regulatory risk controls to which a UCITS management company and its delegate are subject to, none of the delegate's staff have a material impact on the fund's risk profile.
- It may be possible to limit the identified staff within the delegate to a sub-set of the staff involved in the delegation, excluding for instance individual portfolio managers with limited investment discretion.

¹⁴ The "pay-out process rules" comprise the rules on payment in kind in fund units, deferral of payment and adjustment of awards based on subsequent performance.

- It may be possible to argue that rules should be applied in a proportionate manner, because the UCITS mandate only represents a small portion of the delegate's activities.
- It may be open to managers to take the FCA's approach under AIFMD, which allows managers to dis-apply the "pay-out process rules" to delegates where the delegate acts with limited investment discretion, and is subject to the risk management of the appointing manager.

In the absence of any regulatory guidance, it is likely that the precise application of remuneration rules to delegates will be a matter for the principal and the delegate to discuss and tailor according to their interpretation of the rules and the risks that the principal perceives.

Remuneration disclosures

UCITS V includes the following requirements for remuneration disclosure.

Prospectus¹⁵

The prospectus must include:

- details of the remuneration policy, including a description of how remuneration and benefits are calculated, the persons responsible for awarding the remuneration and benefits, including the composition of any remuneration committee; and
- a statement that the details of the remuneration policy (outlined above) are available on a website and by a paper copy.

The key investor information document must also contain a statement that the details of the up-to-date remuneration policy is available on a website and on request.

Annual report¹⁶

The fund's annual report must include:

- the total amount of remuneration during the fund's financial year, split into fixed and variable remuneration, paid by the management company to its staff, the number of beneficiaries, and any amount paid by the UCITS itself;
- the aggregate amount of remuneration broken down by categories of employees or other members of staff that are subject to the remuneration rules. This appears to require a break-down of remuneration by each category of staff, including senior management, other risk takers and control functions;
- a description of how the remuneration and benefits have been calculated;
- the outcome of the annual review of the remuneration policy; and
- details of any material changes to the policy.

UCITS V is not explicit as to whether this disclosure includes remuneration paid to portfolio management delegates – it is possible that UCITS management companies may take the view that it does, and may request details of remuneration paid by their delegates in order to satisfy this disclosure.

¹⁵ Article 69(1).

¹⁶ Article 69(3).