

## Investment Management Alert

September 9, 2013

### AIFM Remuneration Code Guidance

#### Summary

The UK's Financial Conduct Authority ("FCA") has published draft guidance on the application of rules on remuneration (the "AIFMD Remuneration Rules") to FCA-authorized firms, once they become authorized as alternative investment fund managers ("AIFMs") for the purposes of the UK's implementation of the Alternative Investment Fund Managers Directive ("AIFMD").

The FCA's draft guidance is:

- open for consultation until November 6, 2013;
- designed to assist firms in interpreting the European Securities and Markets Authority's ("ESMA") guidelines (the "ESMA Guidelines") on sound remuneration policies under AIFMD.

The draft guidance provides the FCA's first public disclosure, over and above confirming that the UK would substantively comply with ESMA's guidelines, on the proposed application of the AIFMD Remuneration Rules to UK AIFMs. In particular, the draft provides guidance on the FCA's proposed approach in relation to three key issues:

- the manner in which the FCA intends to apply the AIFMD Remuneration Rules in light of the proportionally provisions in the AIFMD;
- the application of the AIFMD Remuneration Rules to UK AIFMs structured as limited liability partnerships ("LLP's");
- the requirements for provisions equivalent to the AIFMD Remuneration Rules to be applied to delegates of UK AIFMs.

#### Interested groups

The information in this alert will be of interest primarily to UK-based AIFMs (in particular, chief executive officers, chief operating officers, general counsels, heads of tax and heads of compliance at UK AIFMs).

The information may also be of interest to fund managers based outside the UK, who have affiliates managing alternative investment funds ("AIFs") from the UK.

#### Immediate action points

We recommend that UK AIFMs:

- review the contents of the consultation paper on the AIFMD Remuneration Rules in detail;

- analyze the impact that the draft rules and guidance in the consultation paper will have on their business;
- engage with their legal and tax advisors to discuss whether any changes to existing operating models may mitigate any negative impact on their business if the draft rules and guidance are adopted in their current form;
- engage with trade association initiatives to respond to the consultation paper;
- make a final decision regarding the timing of their application to vary their existing FCA scope of permission, in order to “re-register” as an AIFM.

### **Summary of consultation paper**

On Friday (September 6), the FCA published its quarterly consultation paper on miscellaneous updates to rules and guidance. This consultation included draft guidance in relation to the FCA’s proposed implementation of the AIFMD Remuneration Rules to UK AIFMs. This topic was deferred for subsequent consultation during the FCA’s finalization of rules and guidance in relation to other areas of the AIFMD prior to July 22, 2013 (the “AIFMD Implementation Date”).

The AIFMD sets out a number of rules in relation to the remuneration practices of AIFMs. These were significantly influenced by rules applicable to banks and investment firms under the Capital Requirements Directive IV regime. The principles have been implemented by the FCA and are set out in Senior Management Arrangements, Systems and Controls sourcebook (“SYSC”) 19B. The rules in SYSC 19B (the “AIFMD Remuneration Code”) comprise 14 principles and a general anti-avoidance obligation. The consultation paper sets out draft guidance that the FCA proposes to adopt, in order to enable UK AIFMs to comply with the AIFMD Remuneration Code.

The key areas that the draft guidance addresses are as follows:

#### **Disapplication of the AIFMD Remuneration Code on the grounds of proportionality**

AIFMD and the AIFMD Remuneration Code respectively require that application of the AIFMD Remuneration Code to an AIFM is appropriate to the AIFM’s size, internal organization and the nature, scope and complexity of its activities. This is referred to as the “AIFM Remuneration Proportionality Rule” in the AIFMD Remuneration Code and the draft guidance.

In cases where it is justified in accordance with the AIFM Remuneration Proportionality Rule, an AIFM may choose not to apply some or all of the AIFMD Remuneration Code. The draft guidance sets out the basis on which a UK AIFM may do so. Most significantly, the draft guidance sets out the basis on which a UK AIFM may be excused from compliance with some of the most challenging provisions of the AIFMD Remuneration Code, namely:

- the obligation that a proportion of remuneration be retained as units in the relevant AIF(s);
- the obligation to defer payment of a proportion of remuneration over a period of time;
- the requirement that remuneration structures enable the firm to subsequently adjust an individual’s remuneration (in particular to claw back some element of remuneration already awarded).

The draft guidance refers to these particular provisions as the “Pay Out Process Rules”. The draft guidance clarifies that, if the relevant proportionality criteria are satisfied, a UK AIFM may choose not to apply the Pay Out Process Rules to its remuneration practices. This is not an automatic outcome, however, and UK AIFMs will need to determine positively to “opt out” of the application of the Pay Out Process Rules if they determine that they satisfy the proportionality requirements.

The first criteria for assessing the availability of the proportionality relief relates primarily to the assets under management of the AIFM in products which are AIFs. There are principles in the draft guidance for determining this AUM threshold, which exclude some assets from the calculation (e.g., assets which are managed under a delegated mandate are to be excluded from the calculation). The relevant threshold amounts of AUM are yet to be finalized, but the FCA currently envisages that the threshold for most hedge fund managers will be set somewhere between AUM equivalent to £500 million and £1.5 billion. Where this threshold ought to be set is the primary open question for consultation with industry.

In addition to the threshold amount the AIFM must consider additional criteria, relating to the size of the AIFM itself (determined by reference to the number of individuals involved in the business), the internal organization of the AIFM itself (with the nature of the AIFM's ownership being significant) and the nature, scope and complexity of the AIFM's operations (which include a number of criteria regarding the operation of the AIFM itself).

Although further consideration will be required as the guidance evolves, and while the FCA will want to ensure that not too great a percentage of managers avoid the Pay Out Process Rules, our initial view is that it is likely that a significant number of hedge fund managers who are regarded as UK AIFMs will be able to apply the AIFMD Remuneration Proportionality Rules so as not to have to apply the Pay Out Process Rules, mitigating the most significant impact of the AIFMD Remuneration Code.

### **Application of the AIFMD Remuneration Code to LLPs**

The applicability or otherwise of the AIFMD Remuneration Code to payments made to partners in UK AIFMs structured as LLPs has been one of the most significant areas of consideration for the FCA. The potential tax consequences of the Pay Out Process Rules to payments to partners have been controversial, as their application could cause situations where partners' tax liabilities on a given date exceed the payments received.

The FCA has been working closely with Her Majesty's Revenue & Customs (“HMRC”) and the UK Treasury in seeking to address this point. Potential approaches to these difficult taxation issues have been put forward in the context of the current consultation on changes to rules on UK taxation applicable to LLPs and other forms of partnership by HMRC. The results of this taxation consultation are expected to be finalized by the time of the 2013 Autumn Statement and later Finance Bill 2014 (although we note that a number of professional bodies are recommending HMRC defer implementing changes in this area until 2015).

One indication of the interaction between the FCA, HMRC and UK Treasury is demonstrated by the inclusion in the draft guidelines of the suggestion that portions of deferred remuneration for LLP partners should be on a net-of-tax basis. We are aware that discussions with HMRC on this point, and the precise mechanics for how this might operate in practice, are ongoing.

The definition of “remuneration” used in the AIFMD and ESMA’s subsequent guidelines on remuneration is very broad. Payments to partners in UK LLPs could quite easily fall within this definition, even though, for UK tax purposes, they would not normally be regarded as remuneration and are ordinarily treated as profits received by self-employed individuals.

The FCA has not adopted the hedge fund industry’s preferred approach of issuing guidance to, effectively, exempt payments to partners in LLPs from the applicability of the AIFMD Remuneration Code. Instead, the draft guidance contemplates a much more complex analysis, where different elements of the payments to a partner in a UK LLP are treated as analogous to traditional remuneration packages. The draft guidance, effectively, proposes that the AIFMD Remuneration Code should not apply to the element of payments to partners that can be characterized as “return on equity”.

The mechanism for determining what element of payments to partners ought to be regarded as this “return on equity” proposed in the draft guidance is opaque and is likely to be an area where respondents to the consultation seek to obtain greater clarity. It appears likely, though, that, subject to the earlier proportionality commentary, the majority of wholly discretionary awards of partnership profits to individuals will be regarded as “variable remuneration” for the purposes of the AIFMD Remuneration Code and subject, therefore, to the Pay Out Process Rules in relevant firms.

The above, along with the parallel consultation on two aspects of the UK taxation of partnerships by HMRC, favors hedge fund managers who operate different partnership models. The practical impact of the AIFMD Remuneration Code on payments to partners in LLPs with a small number of partners and a more formulaic approach to the attribution of partnership profit should be limited. This reinforces certain of the principles that HMRC is seeking to encourage in the consultation on the taxation of partnership. There, HMRC is seeking to penalize the use of partnership structures in which the relevant partners are, in effect, employees whose relationship has been reclassified for tax purposes. These factors together may lead to a number of UK AIFMs considering the operational model that they currently use for allocation of profit distributions amongst partners in LLPs and amending them significantly.

### **Applicability of the AIFM Remuneration Code to delegates**

Another highly controversial area of the AIFMD remuneration regime has been provisions in the ESMA Guidelines that, effectively, require an AIFM to apply the AIFMD Remuneration Code to any person to whom it delegates portfolio or risk management, even where that person is outside the European Union. This has been a sufficiently controversial area that one EU member state (Malta) has determined to implement the ESMA Guidelines without including the obligations in relation to delegates (which is an unusual position for an EU member state to take, as guidance issued by bodies such as ESMA tends to be adhered to at the national level).

This is another area where the industry has lobbied the FCA and the Treasury assertively. Industry has, without success, sought to persuade the FCA and the Treasury that the UK's implantation of the AIFMD Remuneration Rules should not include the provisions on applicability of the rules to delegates set out in the ESMA Guidelines.

The draft guidance goes on, however, to clarify the manner in which UK AIFMs, in line with the AIFMD Remuneration Proportionality Rule, should apply the obligation. This guidance should, subject to the comments below regarding US delegates, have the effect of mitigating quite significantly some of the impact of the provisions for many UK AIFMs. In particular:

- There will be no need to apply a contractual obligation to comply on a delegate where that delegate is subject to "remuneration requirements that are equally as effective". This means that any delegate who is authorized in the EU and subject to the remuneration rules under the Markets in Financial Instruments Directive and CRD will not have to be subject to contractual provisions. The position in relation to non-EU delegates is less clear, however it seems likely to be the case that contractual obligations would need to be included in a delegation to an entity that is registered with the Securities and Exchange Commission in the US as an investment advisor.
- The application of the proportionality test could allow delegates to be excused from adherence to particular provisions of the AIFMD Remuneration Code. In particular, the Pay Out Process Rules may not be appropriate in all cases, particularly if the delegate has limited investment discretion.

### **Immediate Actions**

The consultation on the draft guidance is open until November 6, 2013. For most UK hedge fund managers, the intimate link between the issues raised by the consultation paper and the as-yet unfinalized consultation on issues relating to two aspects of the UK taxation of partnerships means that there is still a limited amount which UK AIFMs can do to plan for compliance with the AIFMD Remuneration Code, or to seek to change their business models in order to mitigate negative impacts of the AIFMD Remuneration Code.

However, we would recommend that UK AIFMs:

- review the consultation paper in detail, to determine the likelihood that the AIFMD Remuneration Proportionality Rule will result in the Pay Out Process Rules not being applicable to them;
- engage with trade associations in formulating responses to the consultation paper, particularly in relation to the AUM threshold to be used in assessing the applicability of the AIFMD Remuneration Proportionality Rule;
- engage with legal and tax advisers to assess the options available to them to restructure their LLP operations and documentation to mitigate some of the negative consequences of the AIFMD Remuneration Code for them.

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