

## Investment Management Alert

February 2, 2014

### **FCA Publishes Final Guidance on AIFMD Remuneration Requirements**

This alert will be of interest to FCA-authorized investment management firms that are registering, or are currently considering registering, as alternative investment fund managers (“AIFMs”).

#### **Executive summary**

On Friday, the FCA published its final guidance regarding the remuneration regime introduced by AIFMD (the “AIFM Remuneration Guidance”). The purpose of the AIFM Remuneration Guidance is to expand upon the framework rules which the FCA has already adopted, governing the remuneration arrangements of AIFMs. These rules are set out in the FCA’s Systems and Controls Handbook. The AIFM Remuneration Guidance has been finalised following responses to the FCA’s earlier consultation on the topic, which is summarised in our client alert [here](#).

The AIFM Remuneration Guidance addresses a number of areas in relation to the AIFM Remuneration Code. It covers:

- when the AIFM Remuneration Code takes effect, the remuneration payments to which it will apply and its scope;
- the application of proportionality in respect of compliance with the AIFM Remuneration Code;
- the treatment of payments to partners in partnerships or members of limited liability partnerships under the AIFM Remuneration Code;
- remuneration in the form of units, shares or other instruments; and
- minimum retention periods in respect of remuneration in the form of units, shares or other instruments.

In general, the AIFM Remuneration Guidance does not deviate significantly from the draft circulated with the FCA’s earlier consultation paper. However, there are some areas of adjustment that many AIFMs will be interested in.

#### **When the AIFM Remuneration Code takes effect, the remuneration payments to which it will apply and its scope**

The AIFM Remuneration Guidance clarifies a number of points regarding the application of the AIFM Remuneration Code.

As anticipated in the consultation draft, the AIFM Remuneration Guidance makes clear that the AIFM Remuneration Code will only apply to remuneration payments in respect of the first full “performance period” after the relevant firm becomes registered as an AIFM. For many hedge fund managers, this will mean that the remuneration requirements will first be effective in respect of payments in relation to the financial year of the funds that they manage (“AIFs”) ending on 31 December 2015. This guidance is in line with expectations.

The AIFM Remuneration Guidance goes on, however, to address disclosure requirements in relation to remuneration. In particular, it explains how the FCA reconciles the effective deferral of implementation of the rules (achieved by its guidance on performance periods) with the requirements for the AIFM to include information on remuneration in the annual reports of AIFs. The FCA has adopted a pragmatic approach which seems to allow firms to omit information about remuneration in the annual report of AIFs that it manages for the financial years ending on 31 December 2014 and 31 December 2015, provided that they are able to explain the basis on which they are doing so.

### **The application of proportionality**

A significant area covered by the AIFM Remuneration Guidance, is the provision of detailed guidance on the bases upon which an AIFM may rely on proportionality to mitigate the impact of certain provisions of the AIFM Remuneration Code. Proportionality is most significant in considering the applicability of the provisions of the AIFM Remuneration Code requiring that:

- at least 50% of variable remuneration (both the deferred and undeferred elements) must be paid in units in a relevant fund (the "Retained Unit Rule");
- at least 40% (and in some cases 60%) of variable remuneration shall be deferred over a period of at least three years (the "Deferral Rule"); and
- these entitlements to be subject to adjustment for inappropriate risk taking or poor performance (before vesting "malace", and after-vesting "claw-back") (the "Performance Adjustment Rule").

These rules are referred to together as the “Pay-out Process Rules”, which have been the most contentious provisions of the AIFM Remuneration Code since AIFMD was first published in draft.

The AIFM Remuneration Code permits a firm to dis-apply the Pay-out Process Rules on the basis of a proportionality assessment, which is described further below.

### **Partial compliance?**

The AIFM Remuneration Code does not permit firms to dis-apply the Pay-out Process Rules on a piecemeal basis. A firm must either dis-apply the rules in their entirety or apply them on a wholesale basis. However, the final AIFM Remuneration Guidance includes a recognition that, whilst this is the case, an AIFM may choose to apply some provisions of the payout process on a “voluntary” basis, having dis-applied the Pay-out Process Rules on the basis of proportionality.

This provision seems to be a tacit recognition by the FCA of the fact that many AIFMs already operate remuneration and deferral policies that address areas similar to those covered by the Pay-out Process Rules, but which are not “fully compliant” with the requirements of the rules. This reference may assist those firms who are intending to rely on pre-existing deferral and reinvestment programs as one of their grounds in considering whether or not they are able to rely on proportionality to dis-apply the Pay-out Process Rules in full.

### **AUM thresholds**

The AIFM Remuneration Guidance sets out a rebuttable presumption that AIFMs should rely on in their proportionality assessment. Where the firm’s AUM is below certain thresholds (which depend on the nature of the AIFs it manages), there is a presumption that it would be disproportionate for that firm to apply the Pay-out Process Rules to its remuneration structures.

The most significant divergence in the AIFM Remuneration Guidance from the drafts in earlier consultation is that the FCA has determined to set this threshold for hedge fund managers at £1 billion. This threshold is in the middle of the range proposed by the FCA in its earlier consultation and it is clear that the FCA has not been convinced by arguments put forward by the industry that it was appropriate to set this threshold at a much higher level. The FCA has also confirmed that it expects AUM to be assessed on an “aggregate NAV” basis, rather than using any of the other more complex tests for assessing AUM in other provisions of AIFMD.

The final AIFMD remuneration guidance also reiterates the FCA’s view that the AUM threshold is not the “be all and end all” of the proportionality assessment. It is clear that the FCA expects firms whose AUM is below the relevant threshold nonetheless to undertake a further analysis of whether or not the application of the rules is appropriate. It is also clear that the FCA acknowledges there will be circumstances in which a firm whose AUM is above the AUM threshold may still dis-apply the Pay-out Process Rules, on another basis of proportionality.

### **Other proportionality elements**

The AIFM Remuneration Guidance sets out a non-exhaustive list of other considerations that an AIFM should assess for the purposes of its proportionality assessment. These are

- the size of the AIFM;
- the internal organisation of the AIFM;
- the nature scope and complexity of the AIFM's activities.

Each of these considerations is expanded upon in some detail. There have not been any significant amendments to these more detailed considerations from the draft text contained in the earlier consultation. In addition, the AIFM Remuneration Guidance has not made any changes to the various examples of how the proportionality assessment might operate in particular circumstances. These examples are annexed to the guidance.

## **The treatment of payments to partners in partnerships or members of limited liability partnerships under the AIFM Remuneration Code**

The AIFM Remuneration Guidance also contains explicit provisions on how the AIFM Remuneration Code requirements should apply to individuals who are within the scope of the AIFM Remuneration Code, but who are partners or members of an AIFM that is structured as either a partnership or a limited liability partnership.

There have not been any significant amendments to the draft guidance that was published in the consultation paper. The FCA still expects payments to in scope partners to be subjected to the code based on an analogy between different elements of payments to partners and more traditional remuneration concepts of fixed and variable compensation.

However, some of the changes are also of interest as they may be relevant for those AIFMs who are currently considering the impact of Her Majesty's Revenue & Customs ("HMRC") current initiatives relating to whether or not an individual member is to be regarded as self-employed for the purposes of UK taxation. In particular, there is a suggestion that an assertion that payments to senior or founding partners should be outside of the scope of the AIFM Remuneration Code can be made more robustly when the relevant payment is structured "*as an automatic allocation with no adjustment for performance*". This suggests that there is a possibility that an AIFM's determination as to the applicability of the AIFM Remuneration Code in respect of payments to UK LLP members may have some bearing on the tax analysis in respect of those payments, assuming HMRC's new rules come into force as proposed.

There is some further overlap in the proposed tax and regulatory concepts, in that the FCA state that:

- any drawings taken in advance may be considered fixed remuneration. HMRC note in their current guidance that this might also be the case under the proposed new tax rules; and
- where a partner has invested capital in the AIFM, the return on equity or return on capital expected in a similar investment context to that of the partner could be considered an ownership share. Firms may find any transfer pricing analysis performed in respect of the proposed tax rules for profit allocations to corporate members of mixed partnerships useful here, particularly where individuals have directly contributed material levels of capital.

The AIFM Remuneration Guidance also addresses some of the areas covered by HMRC's ongoing consultation as to the basis on which deferred payments to partners should be taxed. The FCA notes that where HMRC's statutory deferral mechanism does not apply, partnership deferral should be on a gross (rather than net) of tax basis. This point, in tandem with the FCA's comments at paragraph 3.14, highlights the need for HMRC to widen the application of the proposed statutory deferral mechanism. This is a significant issue which continues to be raised in ongoing consultation with HMRC.

There also continues to be some uncertainty under the final AIFM Remuneration Guidance as to how the various statements regarding the treatment of partners' remuneration are to be reconciled with each other. For example, notwithstanding the statements above regarding the applicability of the AIFM

Remuneration Code to payments to senior and founding partners, there is a further statement to the effect that the FCA expects “*a reasonable portion of the partner’s profit share to be considered as remuneration under the AIFMD*” where the relevant partner devotes his or her full time and attention to the AIFM. The drafting suggests that this consideration takes priority over the supposition in relation to senior and founding partners, but it is not clear that this is the intention.

### **Remuneration in the form of units, shares or other instruments**

The AIFM Remuneration Guidance addresses a number of the difficulties arising from the requirements of the “Retained Unit Rule”. The AIFM Remuneration Guidance sets out a number of practical examples, designed to assist those AIFMs who are subject to the rule, but who are unable to comply with it in a straightforward fashion. For example, the guidance deals specifically with situations where the firm manages a number of AIFs and relevant individuals play a role in respect of more than one AIF. Although the guidance is not materially different on these topics to the draft issued in consultation, there are a number of helpful amendments which take account of some of the issues raised by respondents to the consultation.

### **Minimum retention periods in respect of remuneration made in the form of units, shares or other instruments.**

The AIFM Remuneration Guidance has not made any significant changes to the draft text on this issue set out in the earlier consultation paper. The FCA has determined that, in most cases, a retention period of six months in respect of any relevant unit or other instrument will be sufficient for the purposes of compliance with the AIFM Remuneration Code.

### **Conclusion**

The AIFM Remuneration Guidance has been one of the most eagerly-anticipated elements of the FCA's implementation of the AIFMD. Overall, the guidance demonstrates a pragmatism on the part of the FCA in seeking to implement AIFMD in this contentious area in a manner which does not result in wholesale disruption to existing AIFMs. It is to be hoped that this pragmatism and sensitivity continues to be adopted by the FCA in their assessments of AIFMs compliance with the requirements, once the regime becomes fully applicable.

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