The remuneration of UK fund managers: regulatory developments to look for over the next few months

"Asset Managers find themselves in a situation of unparalleled complexity regarding remuneration regulation."

ALFI response to ESMA's UCITS remuneration regime consultation

With the introduction next year of the guidelines on sound remuneration policies under the UCITS Directive, UK fund managers will be subject to one or more of the remuneration regimes set out in the Appendix to this note. This note does not consider entities that are regulated by the PRA or by both the FCA and the PRA.

The EBA's consultation on the CRD IV remuneration regime ended in June 2015 and ESMA's consultation on the proposed UCITS remuneration regime finished on 23 October 2015. The outcomes of both of these consultations, and the way in which these two European Supervisory Authorities will work together, will have an impact on UK fund managers.

Both the EBA guidelines and the ESMA guidelines were expected to be finalised by the end of 2015, although they may not be finalised until Q1 2016. The FCA's first accompanying consultation on implementing the UCITS remuneration regime in the UK (CP15/27) closed on 9 November 2015.

UK fund managers subject to the CRD IV/IFPRU remuneration regime

The CRD IV/IFPRU remuneration regime applies to credit institutions and fund managers who provide certain MiFID-regulated investment activities (e.g. safekeeping and administration of financial instruments or the nebulous activity of the placing of financial instruments without a firm commitment). The regime applies at the group, parent and subsidiary levels so any fund managers that are part of a CRD IV/IFPRU group must nevertheless comply with the CRD IV/IFPRU regime.

The CRD IV/IFPRU, AIFMD, UCITS and CRD III/BIPRU remuneration regimes in the UK all contain provisions requiring the deferral of variable remuneration, the payment of variable remuneration in instruments, the retention of variable remuneration and ex post adjustment of variable remuneration. The CRD IV/IFPRU regime, however, also contains the infamous bonus cap that restricts the ratio of fixed remuneration to variable remuneration to a maximum of 1:2, with shareholder approval.

Most fund managers that are caught by the CRD IV/IFPRU regime have been able to apply the principle of proportionality and "neutralise" all these provisions. The EBA (almost certainly egged on by the EU Commission) is of the view that this neutralisation should not be permitted.

The FCA technically has the ability to choose not to comply with EBA guidelines and explain its reasons. If neutralisation were no longer permitted under the EBA final guidelines, however, the FCA would be expected to follow them. This would have a severe impact on those fund managers that are caught by the CRD IV/IFPRU regime (at solo and/or group level) but are currently permitted to neutralise the more onerous restrictions on proportionality grounds.

In any event, it is hoped that the FCA would not take the opportunity to review the ability to neutralise the provisions relating to deferral etc. under the CRD III/BIPRU regime.

UK fund managers that will be subject to the new UCITS remuneration regime

The new UCITS remuneration regime will apply to UCITS management companies in the UK in respect of their management of a UCITS scheme. To a large extent, the draft ESMA UCITS remuneration guidelines replicate the remuneration guidelines for AIFMs. Like the AIFMD remuneration guidelines, the UCITS remuneration guidelines contain no equivalent to the CRD IV regime's bonus cap.

ESMA has taken a different approach to the EBA and is of the view that UCITS management companies may apply the principle of proportionality so as to neutralise the provisions relating to the deferral of variable remuneration, the payment of variable remuneration in instruments, the retention of variable remuneration and ex post adjustment of variable remuneration.

It will be important to see how the final ESMA guidelines will set out the manner in which the proportionality principle should be read in the context of the UCITS directive and how the key UCITS jurisdictions in the EEA will respond.

In the context of the principle of proportionality under the current AIFMD remuneration regime, the FCA's starting assumption is that (1) AIFMs which manage portfolios of less than £5 billion of AIFs that are unleveraged and have no redemption rights exercisable during a period of five years following the date of initial investment in each AIF and (2) AIFMs which manage portfolios of less than £1 billion of AIFs in other cases, including any assets acquired through the use of leverage, may neutralise the above provisions.

Hopefully, the FCA will be able to take a similar approach in the context of the UCITS remuneration regime. The approach of FCA and other EEA regulators will need to be monitored, especially given that UCITS are designed for retail investors and that there has been a great deal of political interest in the UCITS remuneration guidelines. It is worth recalling that until recently a draft of the guidelines contained the CRD IV regime's bonus cap.

UK fund managers that are delegates of UCITS management companies

Like the AIFMD guidelines, a UCITS management company will need to ensure that any investment management delegate complies with the UCITS remuneration guidelines unless the delegate is subject to regulatory requirements on remuneration that are "equally as effective" as those applicable under the UCITS remuneration guidelines. The FCA's approach, and those of the other key regulators in the EEA (e.g. the CBI in Ireland and the CSSF in Luxembourg), will therefore need to be monitored by UK fund managers that are delegates of UCITS management companies.

ESMA is of the view that the AIFMD and the CRD IV remuneration regimes are "equally as effective" as the UCITS remuneration guidelines. It is expected that the FCA and other EEA regulators will also be able to designate all non-CRD IV MiFID investment firms as being subject to regulatory requirements on remuneration that are "equally as effective" (i.e. including those UK firms that are subject to the CRD III/BIPRU regime and/or the MiFID guidelines on remuneration policies and practices).

In the unlikely event that the BIPRU Remuneration Code in SYSC 19C is not designated as being equally as effective as the UCITS remuneration guidelines then a firm, which is subject to SYSC 19C in respect of its delegated management of a UCITS but which is able to neutralise the provisions relating to deferral etc., may nevertheless be required to contractually agree to apply the corresponding provisions relating to deferral etc. in the UCITS remuneration guidelines in respect of its delegated management of the UCITS.

UK AIFMs and UK UCITS management companies with top-up MiFID permissions

Of particular concern to UK AIFMs and UK UCITS management companies will be the fact that ESMA's consultation relates to them in so far as they provide any MiFID-regulated investment activities.

ESMA says in the UCITS consultation: "[f]or the performance of [MiFID-regulated investment activities], personnel of a [UCITS] management company or an AIFM should be subject to (i) the remuneration principles under the UCITS Directive or AIFMD, as applicable and (ii) the relevant MiFID rules, including the ESMA Guidelines on remuneration policies and practices (MiFID) (ESMA/2013/606)."

The FCA has picked this up in relation to UCITS management companies in the UK and stated in its corresponding consultation that such a management company "…when undertaking [MiFID-regulated investment activities]… will be subject to both the new UCITS Remuneration Code and the relevant remuneration code under SYSC 19A (for IFPRU firms) or SYSC 19C (for BIPRU firms)."

Presumably, the FCA will also pick this up in relation to UK AIFMs. If so, it will not be legally possible for a UK UCITS management company or a UK AIFM to have separate remuneration policies for its UCITS/AIFM business and its non-UCITS/non-AIFM MiFID business.

Furthermore, UK AIFMs, (a) who are subject to the full suite of AIFMD remuneration provisions but who have separate remuneration policies for their AIFM business and their non-AIFM MiFID business and (b) who are able to neutralise the provisions relating to deferral etc. under the current BIPRU regime, may find that their MiFID-regulated investment activities should be governed by the FCA's BIPRU Remuneration Code in SYSC 19C AND the FCA's AIFM Remuneration Code in SYSC 19B. This will mean that the provisions relating to deferral etc. under the AIFMD regime will apply to remuneration in respect of their MiFID-regulated investment activities.

UK fund managers who are subject to more than one remuneration regime

ESMA and the EBA are looking at how different sectoral remuneration principles should apply when employees of the management company perform services subject to different directives. This is long overdue.

The EBA has confirmed that UK fund managers that are subject to the CRD IV remuneration regime must apply the group-wide CRD IV remuneration policies to the relevant staff members. The EBA says: "[t]his applies to specific requirements of [CRD IV], which have not been included in other sectoral legislation (e.g. staff within entities that fall within the scope of the AIFMD and UCITS Directive and are part of a group have to comply with the [CRD IV bonus cap] if their professional activities have a material impact on the group's risk profile on a consolidated basis. Where specific CRD requirements conflict with the sectorial requirements (e.g. under the AIFMD or UCITS Directive), the remuneration policy should set out for the concerned identified staff which requirements should apply within the entity on an individual basis, taking into account the specific sectoral legislation (e.g. entities subject to the AIFMD or the UCITS Directive should pay the variable remuneration in the alternative investment funds instruments or UCITS instruments (Annex II (1) (m) of AIFMD and Article 14(b)(m) of UCITS V))."

ESMA has proposed that where some employees or other categories of personnel of UCITS management companies perform services subject to different sectoral remuneration principles (e.g. an individual performs services subject to the UCITS Directive and services subject to CRD IV and/or the AIFMD), it is proposed that they should be remunerated either: (a) based on the activities carried out and on a pro rata basis; or (b) when there is a conflict between different sectoral remuneration principles, by applying the sectoral remuneration principles which are "deemed"[1] more effective for discouraging excessive risk taking and aligning the interest of the relevant individuals with those of the investors in the funds they manage.

ESMA says:

"The approach under [option (a)] means that, for instance, the remuneration of an individual which performs services subject to the UCITS Directive and services subject to CRD IV and/or the AIFMD, should be determined applying the remuneration principles under the UCITS Directive, CRD IV and AIFMD on a pro rata basis based on objective criteria such as the time spent on each service.

[1] It is not clear whether this will be done by ESMA and/or the FCA or the management company?

The approach under [option (b)] means that, for instance, where the remuneration of an individual which performs services for various entities (including management companies and/or AIFMs) that are subsidiaries of a parent company that is subject to the CRD IV, is determined – on a voluntary basis – in compliance with all the remuneration principles under the CRD IV for all the services performed by such an individual, this should be deemed to also satisfy the requirements on remuneration under the UCITS Directive and AIFMD. However, where specific CRD requirements – such as those relating to the payment of variable remuneration in instruments – conflict with the requirements under the AIFMD or UCITS Directive, the remuneration of the individual concerned should in any event follow the relevant specific sectoral legislation conflicting with the CRD requirements. This means that, for instance, for individuals performing services subject to the AIFMD or UCITS Directive the variable remuneration should always be paid in the AIF instruments or UCITS instruments (Annex II (1) (m) of AIFMD and Article 14(b)(m) of UCITS V)."

Either option presents practical difficulties. It is hoped that the final guidelines will permit fund managers to take a pragmatic approach to applying the different remuneration rules in a manner that is appropriate and suitable to their structure.

It can only be assumed that the final approach that is taken in the UCITS remuneration guidelines will be carried over to the AIFMD regime and relevant firms should be prepared to review their policies next year for compliance with the final approach.

Tax developments

This note considers regulatory developments but there are also certain UK tax developments that will be relevant to the remuneration of UK fund managers. The UK government is proposing to introduce legislation to determine when performance awards received by fund managers will be taxed as income or capital gains. In relation to this latter proposal, please refer to our note "The UK's taxation of carried interest and performance allocations: a sea change" (August 2015) for more details. On 9 December 2015, HM Revenue & Customs published a policy paper that contained a proposed legislative test. Pursuant to the test, any sum of carried interest arising will be eligible for full capital gains treatment if the fund holds investments, on average, for at least four years. Partial capital gains treatment will be available where the average holding period is between three and four years.

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Appendix: High-level table of the remuneration regimes applicable to UK fund managers

EU Directive	FCA Rules	Application	Bonus cap?	Neutralisation of provisions relating to deferral etc. (and bonus cap) through proportionality?
CRD IV (EBA guidelines)	IFPRU Remuneration Code in SYSC 19A of the FCA Handbook	Credit institutions and fund managers who provide certain MiFID-regulated investment activities (e.g. safekeeping and administration of financial instruments or the activity of the placing of financial instruments without a firm commitment). The regime applies at the group, parent and subsidiary levels.	Yes	Currently: Yes, subject to the firm's proportionality level Proposal: No (subject to final EBA guidelines and FCA's approach)
AIFMD (ESMA guidelines)	AIFM Remuneration Code in SYSC 19B of the FCA Handbook	Full-scope UK AIFMs (in respect of their AIFM business)	No	Yes If AuM is less than £5 billion or £1 billion, as appropriate, then the presumption is that neutralisation would be appropriate.

UCITS (ESMA guidelines (draft))	UCITS Remuneration Code in SYSC 19E of the FCA Handbook (draft)	UCITS management companies (in respect of their UCITS business)	No	Proposed: Yes FCA to provide more details as to when neutralisation would be appropriate.
CRD III[1]	BIPRU Remuneration Code in SYSC 19C of the FCA Handbook	(a) UK fund managers that are not AIFMs or UCITS management companies (b) UK AIFMs and UCITS management companies where they are providing any MiFID-regulated investment activities[2]	No	Yes A BIPRU firm may comply with the Code in a way and to the extent that is appropriate to its size, internal organisation, and the nature, the scope and the complexity of its activities.

In addition to the above, (a) UK fund managers that are not AIFMs or UCITS management companies and (b) UCITS management companies and external AIFMs when they are providing any MiFID-regulated investment activities are required to comply with ESMA's guidelines on remuneration policies and practices (MiFID).

1 CRD III has been superseded by CRD IV but the FCA has retained the BIPRU remuneration regime that implemented the CRD III requirements
2 For example, "individual portfolio management", i.e. managing the portfolio of a client that is not an AIF or a UCITS or managing the portfolio of an AIF/UCITS without also being the AIFM/UCITS management company of the relevant AIF/UCITS.