Investment Adviser Remuneration Regulation – Update

Remarks to the International Committee of the Investment Adviser Association
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Setting the Stage

- G-20 and FSB Remuneration Guidelines
  - G-20
  - FSB
    - FSB Sound Compensation Principles (April 2009)
    - FSB Implementation Principles (Sept. 2009)
      - Applies to: "Covered Employees" (Directors, Officers, PMs, traders, risk managers and compliance officers)
      - Substantive Standards
        - Firm Performance Affects Compensation – A significant portion of compensation is variable and measured against individual, business unit, and firm-wide performance.
        - Unvested Variable Compensation - A significant portion of variable compensation (ranging from 40-60%, with an even higher percentage for very senior personnel) should be unvested and deferred for at least three years.
        - Claw-Backs - Unvested portions of compensation should be subject to claw-backs and depending on business unit and firm-wide performance in subsequent periods. This defers a Covered Employee from taking excessive risk in one period that contradicts with long-term risk management.

Implementing the FSB Implementation Principles – CRD III

- CRD III (July 7, 2010), as implemented by the UK's Financial Services Authority's ("FSA") Revised Code of Practice
  - Substantive remuneration regulation consistent with the FSB Implementation Principles
  - Applies to: All firms that fall within the scope of MiFID
    - EU-based investment advisers, fund managers, broker-dealers, and EU-regulated subsidiaries of non-EU entities
  - Does Not Apply to: UCITS; non-EU entities (e.g., US advisers)
  - "Proportionality Principle" – Four-tiered approach generally "carves out" discretionary investment managers from substantive requirements

Implementing the FSB Implementation Principles – US Joint Agency Proposal

- Sec. 956 of Dodd-Frank Act – proposed rule published in Federal Register Apr. 14, 2011 (final rule yet to be adopted)
  - Applies to: "covered financial institutions" with consolidated assets in excess of $1B
  - "Covered Financial Institutions":
    - Certain banking organizations
    - Registered brokers or dealers
    - Investment advisors
    - Fannie Mae and Freddie Mac
    - Any other financial institution that the appropriate federal regulators jointly by rule determine should be treated as a covered financial institution.
  - Investment Adviser "consolidated assets" defined as *balance sheet assets* rather than AUM.
    - *Result* - Stand-alone IAs are not subject to the remuneration requirements

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Alternative Investment Fund Managers Directive (AIFMD)

- Adopted as the “Proposal for a Directive of the European Parliament and of the Council on Alternative Investment Fund Managers, on Nov. 11, 2010.
- Contain remuneration requirements that are substantively similar to the FSB guidelines (Article 13 and Annex II of AIFMD)
- Remuneration provisions are designed to ensure that the AIFM’s remuneration policies “are consistent with and promote sound and effective risk management”.

Alternative Investment Fund Managers Directive (AIFMD)

- Specific Requirements for a Remuneration Policy (Annex II):
  - Guaranteed bonuses are exceptional and only granted in the context of hiring new staff and in first year of employment,
  - At least 40% (60% for larger bonuses) must be deferred and must vest no faster than on a pro-rated basis,
  - At least 50% of any variable component should be paid in units or shares in the AIF or equivalent investments,
  - Performance related remuneration subject to clawback/malus,
  - There must be an appropriate balance between fixed and variable pay,
  - Severance payments should reflect performance over time and ensure failure is not rewarded, and
  - The AIFM's annual report must disclose its remuneration policies.

AIFMD Application

- Applies to:
  - Managers with a registered office in the EU
  - All other managers that manage and/or market alternatives funds in the EU
- Excludes:
  - AIFM whose ***AUM*** do not exceed either (i) €100m, including any assets financed through leverage; or (ii) €500m when the portfolio is leveraged and redemption rights are only exercisable five years or more after the date of the initial investment
    - Remuneration regulation is based on AUM, in contrast to the US joint agency proposal.
  - UCITS**.** Only applies to managers of *alternatives funds:* hedge funds, private equity funds, real estate funds, infrastructure funds, ***US domiciled mutual funds,*** and all other collective investment schemes ***other than UCITS***.

AIFMD Application to Sub-Advisers

- AIFMD remuneration requirements only apply to the following ***staff*** of an AIFM *whose professional activities have a material impact on the risk profiles of the AIFMs or of the AIFs they manage*
  - *senior management*
  - *risk takers*
  - *control functions*
  - *any employees receiving total remuneration that takes them into the same remuneration bracket as senior management and risk takers*
- ESMA Guidance on Third-Country Delegation (Aug. 23, 2011)
  - Would have imposed an "equivalency principle" when delegating to third country undertakings
    - *Result* – US manager of an EU fund would be subject to remuneration guidelines
- ESMA Final Report (Nov. 16, 2011)
  - Abandons "equivalency principal"; delegates must be "authorized for the purposes of asset management" and "effectively supervised"
    - *Result* – AIFMD remuneration requirements may not impact US managers sub-advising EU funds
    - ***Will likely depend on transposition at the member state level***

UCITS V

- Expected to subject UCITS managers to remuneration policies and procedures based on the FSB Implementation Principles (UCITS carved out of AIFMD).
- Reportedly, “leaked” draft of UCITS V:
  - Remuneration requirements directly replicating those contained in AIFMD
  - Remuneration requirements *will not apply to delegates carrying out an investment management function*

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Client Planning

- Remuneration affects firm culture; therefore legal departments will be tasked to "design to mitigate".
- UCITS ManCos are all EU based. All US RIAs therefore act as delegates.
  - All UCITS delegates are expected to be excluded from remuneration regulation.
- AIF ManCos will be either EU based (starting no later than July 2013) or US based (starting no earlier than July 2015).
  - US AIFMs will be subject to remuneration regulation <u>if</u> they passport/seek EU authorization.
  - US delegated advisers will <u>not</u> be subject to remuneration regulation if they do not passport/seek EU authorization.
    - Argues for an EU based ManCo that delegates investment advice to an investment adviser .
- In US, RIAs will keep assets below $1 billion.

Questions?