Addressing EU Restrictions on Remuneration – Part II

AIFMD Remuneration Code Implementation Planning

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Introduction

- AIFMD Remuneration Rules: Not going away
- Are there any ways I could avoid this altogether?
- If not, could I partially avoid it or minimise its effect?
- When do I need to worry about this?
- What are the Pay-Out Process rules?
- A typical scenario
- Deferral/retention/performance adjustment/use of equity and equity-linked instruments – possible structures and tax and other technical considerations of these (Fletcher Rogers)
- Current remuneration structures and ways to reward appropriate risk taking (Carnell/Wood)

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Introduction

- Project planning – panel discussion
- Conclusions

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AIFMD Remuneration Rules: not going away

- AIFMD effective in 12 EU Member States on 22 July 2013 (now 15) subject to one year transitional period in most: so 22 July 2014 is the real deadline for many
- ESMA Guidelines on sound remuneration policies under the AIFMD – final report published 3 July 2013
- The UK has confirmed it will comply with the ESMA Guidelines
- AIFMD Remuneration Code is in SYSC19B
- CP 13/9, Chapter 14 – Draft FCA Guidance on SYSC19B; Consultation closes 6 November 2013; Handbook and non-Handbook guidance (NB limited guidance only on key issues)

Are there any ways I could avoid this altogether?

- Avoid being subject to AIFMD – no EU AIFM; no marketing into the EU; no portfolio or risk management as delegate of EU AIFM (NB: can be delegate of non-EU AIFM)
- Move more substance outside the EU?
- Delegate of EU AIFM – NB FCA would generally consider the CRD and MiFID remuneration regimes to be equally as effective as AIFMD; still a problem for non-EU delegates which could be mitigated by limiting risks able to be taken by delegate
- Do not avoid by only managing non-EU funds

If not, could I partially avoid it or minimise its effect?

- Proportionality concept interpreted relatively benignly in draft FCA guidance
- AIFMs to comply “in a way and to an extent that is appropriate to their size, internal organisation and the nature, scope and complexity of their activities”
- Ultimately, an AIFM decision as to how to apply proportionality. FCA “expects the firm to be able to justify its rationale behind any application of the proportionality principle”. In all cases AIFM “to develop and implement remuneration policies and practices which appropriately align the risks faced and provide adequate and effective incentives to its staff”
- AIFM must be able to explain its approach to FCA, particularly where any rules disapplied
- Proposed presumption as to whether or not certain remuneration requirements may be disapplied based on net AIF assets under management. NB: only presumption, “never automatic”, and only certain rules (the Pay-Out Process rules)

If not, could I partially avoid it or minimise its effect?

- Higher AUM disapplication threshold for AIFMs managing closed-end funds - £4-6 billion currently proposed
- Open-ended funds – threshold proposed at £0.5-1.5 billion AUM
- In relation to an individual (i) whose variable remuneration is no more than 33% of total remuneration, <u>and</u> (ii) whose total remuneration is less than £500,000, FCA “does not generally consider” that either (a) the Pay-Out Process rules, or (ii) the rule restricting guaranteed bonuses to exceptional one-year deals, need be applied
- Other factors FCA think relevant to proportionality analysis: whether AIFM listed/ traded on regulated market, nature of a delegation arrangement; the nature of certain fee structures – e.g. carried interest

If not, could I partially avoid it or minimise its effect?

- If AIFM listed/traded, this factor favours application of Pay-Out Process rules to align the interests of AIFM with those of external investors
- May be able to disapply re senior management who own, say, a majority stake in the business as their interests are already aligned with those of the firm
- More complex firm; more strategies, funds etc – less likely to be able to disapply; conversely more likely if strict risk parameters, or low level of risk taken
- Fee structure may ensue alignment of intersts with investors – example given of typical private equity carried interest structure with escrow and clawback
- With regard to dividends, remuneration may be apportioned between for example MiFID, UCITs and AIFMD–related activity
- Flexibility as to how to do this

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When do I need to worry about this?

- Based on when firms become subject to AIFMD obligations under UK law – for most, 22 July 2014; but some may be able to put off becoming an authorised AIFM
- AIFMD remuneration regime to apply to new awards of variable remuneration to relevant staff for performance periods following that is which the firm becomes authorised – i.e. for most, calendar 2015, but beware if you may become an authorised AIFM before 31 December 2013
- Will not apply to remuneration payments earned, allocated or otherwise awarded in performance period prior to authorisation as a AIFM

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What are the Pay-out Process rules?

- Retained units, shares or other instruments (SYSC19B.1.17R)
  - At least 50% (or less if management of AIFs accounts for less than 50% of total portfolio managed) of any variable remuneration shall consist of units or shares of the AIF concerned, or share-linked instruments,etc
- Deferral (SYSC 19B.1.18R)
  - A substantial proportion being over 40% of variable remuneration component must be deferred for at least 3 to 5 years (or shorter if life cycle of AIF shorter); vesting no faster than pro-rata; 60% required to be deferred in the case of large bonuses (NB FCA draft guidance > £500,000 but firms should also consider whether a lesser amount should be considered large)

Pay-out Process Rules

- Performance adjustment (SYSC 19B.1.19R & SYSC 19B.1.2 OR)
  - Variable remuneration must only be paid or vest if it is sustainable according to the AIFM’s then financial situation and justified according to the performance of the AIF, the business unit and the individual concerned – ‘malus’, clawback arrangements necessary

A typical scenario

- English LLP
- Hedge fund or private equity manager
- Members including founder members taking annual profit shares
- Employees also, with variable bonuses, typically cash; may be some element of deferral
- NB – Benefits for members of LLPs under attack: tax and regulatory
- Under AIFMD may be necessary to apportion member profit share between (i) remuneration (in AIFMD remuneration rules) and (ii) return on equity (outside AIFMD remuneration rules). E.g. discretionary profit share paid to members based on performance likely to be variable remuneration. Drawings taken in advance may be fixed remuneration
- Possible use of benchmarks – expected return on capital; expected remuneration

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Jonathan Fletcher Rogers – Abbiss Cadres, Partner

About Abbiss Cadres

Abbiss Cadres LLP is a multi-disciplinary professional services firm focussed on helping clients make the most of their people. With professionals from legal, tax and consulting backgrounds, we are able to offer a complete HR service covering employment law, compensation and benefits, tax, global mobility, communications, business immigration and other complimentary areas.

Summary

- Steps to determining Code application
- The deferral period
- The retention period
- Payment in shares/units
- Tax issues
- Example

Steps to determining Code application

- Determine whether pay-out process rules can be disapplied on proportionality grounds
- Identify Code staff and how Code applies to each member of staff
  - Different treatment for control function staff
  - Proportionate application of Code may be possible for some staff (e.g. those which significant proportion of non-AIF work)
- Categorise the different elements received by each staff member
- Apply the pay-out process rules

Key issues for firms subject to the full application of the AIFM Code

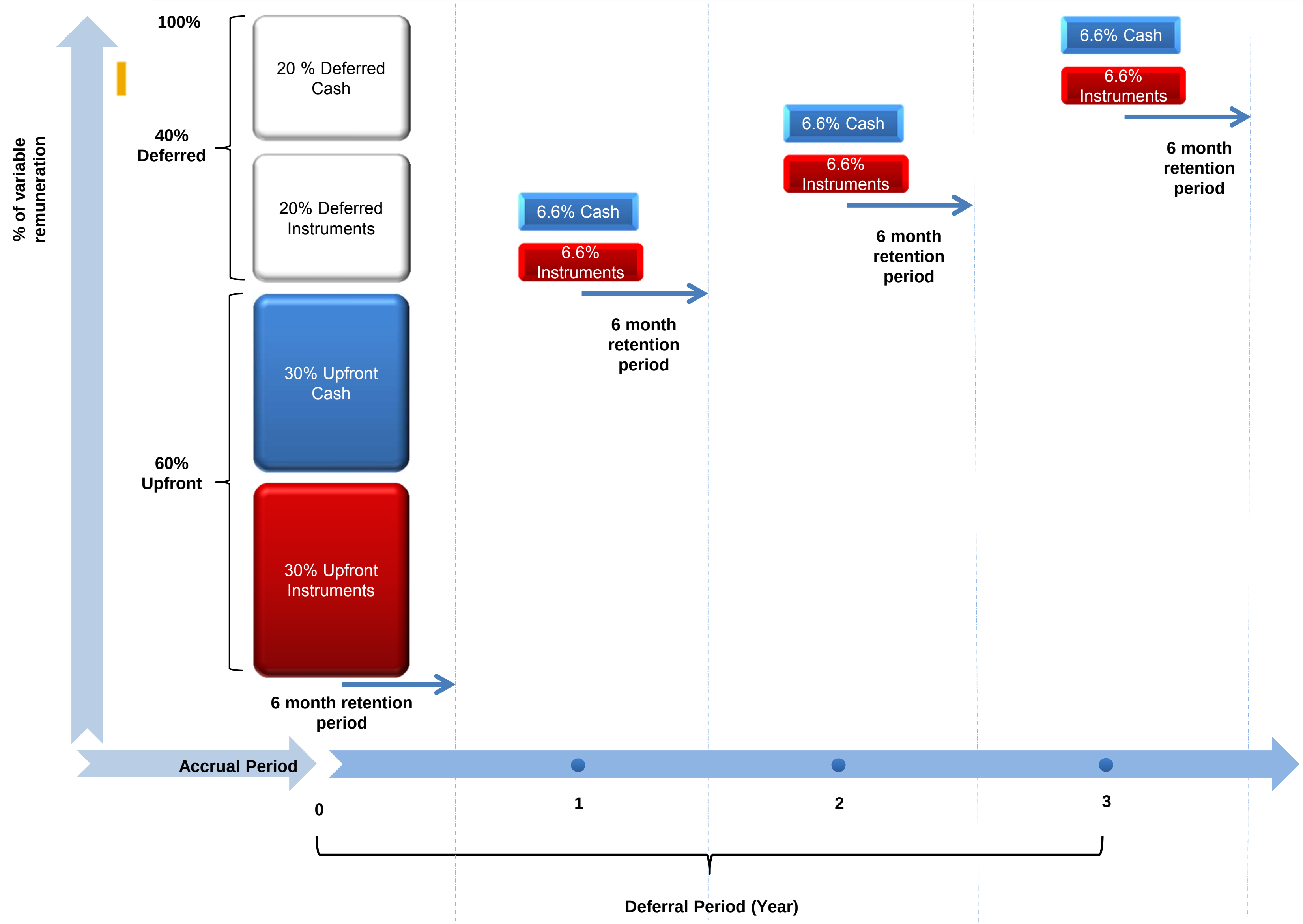
- What are the deferral and retention periods?
- What instruments will be delivered?
- How will the deferral of instruments be structured?
- How will retention periods be enforced?
- How to ensure no unfunded tax charge?

The deferral period

- What is the proportion deferred (40% to 60%)?
- What is the deferral period (the ‘time horizon’)?
  - 3-5 year deferral unless shorter can be justified by reference to the life cycle of the fund (minimum 1 year)
  - longer for management body members
- What is the vesting schedule – cliff vesting or pro rata?
  - If pro rata, first payment no earlier than 12 months, and no more frequently than annually

The retention period

- Purpose of a retention period is to align incentives with long-term interests of AIFM, the AIFs and the AIF investor
- Retention period should be set with that purpose in mind, but 6 months should be sufficient (FCA guidance)
- Different purpose to deferral period, so no forfeiture during the retention period


% of variable remuneration
100%
40% Deferred
60% Upfront
20 % Deferred Cash
20% Deferred Instruments
30% Upfront Cash
30% Upfront Instruments
6 month retention period
6.6% Cash
6.6% Instruments
6 month retention period
6.6% Cash
6.6% Instruments
6 month retention period
6.6% Cash
6.6% Instruments
6 month retention period
Accrual Period
0
1
2
3
Deferral Period (Year)

Payment in shares/units

- General principle – the value receivable should become linked to unit/share value from the payment date
- FCA guidance provides quite a lot of flexibility
- 50% of both deferred and non-deferred variable remuneration must consists of units or shares of the AIF concerned, or equivalent ownership interests, or share-linked instruments or equivalent non cash instruments
- Can be disapplied where ‘impractical’ (e.g. close ended fund), or disproportionate (e.g. numerous AIFs)
- If disapplied, FCA recommend payment in shares/units of the AIFM or parent

Payment in shares/units – what does this mean in practice?

- Upfront instruments
  - Arguably impractical to use any unit/share the value of which cannot be easily realised at the end of the retention period?
  - If impractical to hold units/shares in AIF, then payment can be in:
    - instrument linked to the value of the AIF, or
    - units/shares in the AIFM/parent company (or linked instrument)

Payment in shares/units – what does this mean in practice?

- Deferred instruments
  - If longer deferral period, may be easier to use units/shares in the AIF (but may still be impractical)
  - Subject to malus (forfeiture) during deferral period
  - If deferred instruments held by third party (e.g. trust or SPV):
    - easier to apply malus provisions
    - may be preferable if minimum investment requirements
    - may be easier to sell/realise value from units
  - Retention period following deferral period

Payment in shares/units – example of cash-based fund-linked incentive plan

- Operated through a trust/SPV
- Trust acquires units in fund
- The ‘instrument’ involves entitlement to a cash payment linked to the value of a specified number of units
- During deferral period, entitlement subject to forfeiture
- At end of deferral period, no longer subject to forfeiture, but will not pay out until end of retention period
- Trust pays out through selling underlying units
- Possible to operate over multiple funds

Tax issues on deferral/retention – LLP members

- LLP members taxed on share of LLP profits in year they arise
- Common deferral mechanism through use of corporate member
- Significant tax issue for LLPs due to HMRC LLP consultation
- Under HMRC proposals payment through corporate member may result in upfront tax charge
- Possible recovery of tax paid if remuneration subsequently forfeited

Tax issues on deferral/retention – LLP members

- HMRC and FCA discussions on 'statutory tax mechanism'
- Not clear what this will involve but indication it will involve deferral on net of tax basis (with immediate tax payment) rather than deferral of tax charge
- Given the number of firms potentially affected, it is hoped that a workable solution is found
- Further guidance expected December 2013

Tax issues on deferral/retention – employees

- In general, employees would only be taxable on receipt of cash or units/shares
- However, if trust involved which holds units/shares during deferral period – disguised remuneration issue
- Exemption for certain types of deferral schemes, but strict conditions
- Retention of units/shares/instruments can be on a net of tax basis
- Need to consider how the tax charge is paid – ‘net settlement’ mechanism likely to be easiest

Example - facts

- The AIFM is an LLP and is subject to the full application of the Code
- An LLP member who manages an AIF is entitled to the following amounts in a year:
  - Base salary/fixed drawings - £200,000
  - Performance bonus - £400,000
  - Carried interest return - ???
  - Returns from co-investment - £400,000
- Fixed remuneration = £200,000
- Variable remuneration = £400,000 plus carried interest?
- Profit on investments = £400,000

Example – application of pay-out process rules

- Need to apply the 'Pay-out Process rules' to variable remuneration BUT
- Not in the case of the carried interest return
- Not clear from guidance whether carried interest included in variable remuneration for the purposes of:
  - determining whether 40% or 60% must be deferred
  - determining how the 40%/60% is calculated
- Example assumes that carried interest not included in variable remuneration
- Variable remuneration subject to pay-out process rules is £400,000, so 40% to be deferred
- £188,000 tax due (45% income tax and 2% NICs)

Example - deferral on gross basis (LLP member)

- £240,000 upfront (60%)
  - £120,000 paid in instruments subject to retention period
  - Remaining £120,000 in immediate cash
  - All of cash and £68,000 worth of instruments required to pay tax
  - If 60% deferral, member is out of pocket
- £160,000 deferred (40%)
  - £80,000 paid in instruments subject to retention period following vesting
  - £80,000 paid in cash

Example – deferral on net basis (LLP member)

- If 'statutory tax mechanism' involves net of tax deferral, variable remuneration to be deferred is £212,000
- £127,200 upfront
  - £63,600 paid in instruments subject to retention period
  - Remaining £63,600 in immediate cash
- £84,800 deferred
  - £42,400 paid in instruments subject to retention period following vesting
  - £42,400 paid in cash at end of deferral period
- Replicates position for an employee

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- Jonathan is a Compensation and Benefits Partner and advises on all aspects of equity incentives and remuneration. His practice focuses primarily on the design and operation of incentive plans, both in the UK and on a global basis, including the tax, regulatory and corporate governance aspects. Jonathan also has considerable experience advising on the incentive aspects of a wide range of corporate transactions such as flotations, mergers and acquisitions. Jonathan also advises on employment tax more generally as well as the tax and social security issues affecting employees on international assignment.
- Jonathan joined Abbiss Cadres as a Partner in July 2013 having been at Allen & Overy for over 11 years. He is recognised as a leader in his field by Chambers and Partners independent legal directory and is a regular speaker at industry conferences.

AIFMD – Remuneration market issues

Presented by Damian Carnell

8 October 2013

Current AIF rem elements

AIFMD	Aim is to lower risk for shareholders and investors in AIF
Conventional reward and incentive structure	To increase alignment of interest between management and owners / investors
Changes needed	Depends on recent status of pay AND final regulation interpretation

Current AIF rem elements

- Base pay
- Bonus / annual
- Carry
  - Hurdle types
  - Pay out profile
  - Gain share %
- Co-invest
  - Various designs
- Pension and benefits

Comments: Base pay

- Keep ‘low’ is conventional wisdom
- In practice low is not ‘low’. In fact for big MBO funds it is ‘high’
- BUT > impact of any bonus cap (if CRD IV) may be ‘up’ fixed pay and hence ‘up’ fixed cost

Comments: Bonus

- Pool funding set on a variety of basis – rare to have pure % of pure-tax pre-bonus profit
- Bonus deferral (investment requirement currently rare but some co-invest seen into funds)
- What is the deferred requirement to become now, 60:40% for 5 years rateably?
- Flat fee 2% is a major source of PBT and hence of bonus funding

Comments: Carry

- In fact this is a ‘get rich slow’ plan
- Gains/losses offset within the fund so no ‘inappropriate risk’ problem to solve
- Most carry is ‘whole fund’ not deal by deal
- Deferral requirements if it does ‘hit’ carry may mean deal by deal becomes the norm – with clawback
- Hedge fund HWM annual carry may change to PE style, i.e. whole fund – big issue for ‘in-flight’ funds

Comments: Co-invest

- Again alignment good with investors BUT gains/losses DO NOT OFFSET
- Employer soft loan arrangements may be stopped / reorganised
- Bonus invest into equity will be hard
  - LLPs
  - 100% captives
- Use of phantom equity needed
  - Issues of equity valuation
  - And liquidity (closed market) or cash-out mechanic needed

Comments: Pension and Benefits

- Unlikely to change much
  BUT
- Beware base pay ‘flow through’ cost if base is raised
  - Acute problem for DB pension

Pay governance

- Most AIFMs do not have formal Remco
  - Decisions made by parent for captives
  - And by board or partners for independents
- New RemCos and Terms of Reference needed
- Investor visibility of pay, particularly carry and co-invest is already good – expect compliance will mean minor change for many

Key areas

- HF carry HWM annual pay out
  - Deferral and invest requirement
  - Risk taking due to HWM with no offset feature
- Carry with no ‘catch up’ feature (i.e. a ‘straight’ hurdle) may need lower % of gain, with ‘catch up’ to help reduce risk
- Carry may go from whole fund to deal by deal plus catch up
- Co-invest may go in favour of carry
- Bonus pool funding may change if currently based on % of Pre-bonus PBT
- Deferral into equity a problem – phantoms needed
- New governance protocols needed for many

Questions

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Project planning

- Start early; big time lag on implementation
- Establish scope of AIFMD/impact on firm
- Consider application of proportionality and prepare written justification for position
- Audit of existing remuneration structures
- Identify remuneration code staff (similar for delegates)
- Analyse incentives created by existing remuneration structures
- In relation to LLP members analyse which part of profit share might be considered remuneration
- Identify proportion of the roles of identified individuals that are in scope for AIFMD (similar for staff in delegates)

Project planning

- Consider benchmarking/advice regarding possible compliant alternatives to existing pay structures
- Assess impact (if any) on underlying funds
- Assess whether possible to give equity interests in underlying funds; if not, why not? Compliant alternatives?
- Assess tax and other technical implications of proposed adjusted pay structures
- Monitor legal developments on an ongoing basis – e.g. final FCA implementation

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Conclusion

- Everyone touched by AIFMD needs to do something
- Prompt attention recommended, given the timing
- Quite a few opportunities to mitigate effect
- Consider responses to consultation (we would be happy to help or consolidate your thoughts into a response given by us)

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