EPF response to ESMA consultation: Guidelines on sound remuneration policies under the AIFMD

The European Property Federation (EPF; Commission Register of Interest Representatives identification number 36120303854-92) represents all aspects of property ownership and investment: residential landlords, housing companies, commercial property investment and development companies, shopping centres and the property interests of the institutional investors (banks, insurance companies, pension funds). Its members own property assets valued at € 1.5 trillion, providing and managing buildings for the residential or service and industry tenants that occupy them. Through its member the **European Union of Developers and House Builders (UEPC)**, it represents more than 30.000 developer and house building companies that annually build and develop several million m² of offices and shopping centres as well as more than 1.000.000 new homes. www.epf-fepi.com / www.uepc.org

We are grateful for the opportunity to comment on the proposed remuneration guidelines which ESMA has developed in the context of the AIFM Directive ('the Directive'). We set out below a brief summary of the comments made by our members; please refer to **Appendix 1** for responses to relevant consultation questions.

Key points

1. We welcome ESMA's clarification on the application of the proportionality principle in relation to different criteria. Given the huge diversity of the fund management industry it is vital that the remuneration requirements of the Directive can be applied in a proportionate way that recognises the unique characteristics of individual AIFMs. Member State regulators should have discretion to determine how best the proportionality principle should apply in individual cases and we would expect them to work closely with AIFMs to develop reasonable remuneration policies.

2. We also believe that it is for Member State regulators to provide any additional guidance that may be necessary on the interpretation of 'significant' in the context of determining whether the scale, structure or nature of activities of an AIFM are such that it must establish a Remuneration Committee ('RemCo').

3. We agree that compensation structures which successfully align the interests of AIFM staff with those of investors (chiefly, carried interest) should be outside the scope of the remuneration requirements. However, we do not believe that the definition of carried interest in Article 4(1)(d) of the Directive adequately reflects how such structures operate in practice. We also believe that the structure proposed in paragraph 192 of the guidelines is not necessarily the only way in which the interests of AIFM staff and investors can be aligned, and encourage ESMA to clarify that that is the case.

4. The deferred remuneration provisions could in certain circumstances (notably in the case of partnership investment structures) give rise to tax difficulties for AIFM staff which are tax resident in member states which impose tax on earned income even if it has not been actually received. We would welcome clarification from ESMA that where tax charges arise on the vesting of upfront and deferred instruments, the retention period would apply in such a way as to allow staff to realise sufficient funds to cover those tax charges.

5. We have seen the representations submitted by the European Venture Capital Association (EVCA) and are generally supportive of the comments made in that submission.

We would be delighted to discuss the contents of this submission with you in more detail, should you have any questions. Please contact Ion Fletcher at the British Property Federation (ionfletcher@bpf.org.uk) in the first instance.

Appendix 1 – detailed answers to consultation questions

Question 5: Notwithstanding the fact that the provisions of the AIFMD seem to limit the scope of the principles of remuneration to those payments made by the AIFM or the AIF to the benefit of certain categories of staff of the AIFM, do you consider that the AIFMD remuneration principles (and, therefore, these Guidelines) should also apply to any payment made by the AIFM or the AIF to any entity to whom an activity has been delegated by the AIFM (e.g. to the remuneration of a delegated investment manager)?
No. The Directive clearly contemplates that each AIF must have only one AIFM, and that the remuneration provisions of the Directive should apply only to the AIFM. Accordingly, where an AIFM delegates activities to another party (and assuming that the AIFM does not become a letterbox entity), the staff of the delegated entity should fall outside the scope of the AIFMD, unless the delegated entity is also authorised as an AIFM in its own right. Similarly, staff of other entities providing services to the AIFM should not be subject to the remuneration requirements. We therefore consider that it would be entirely inappropriate for ESMA to seek to extend the intended scope of the AIFMD through its guidelines. Doing so would give rise to anomalies, such as staff of delegated entities potentially becoming subject to the remuneration provisions even though the entities employing them are not otherwise within the scope of the Directive.
Question 9: Do you agree with the clarifications proposed above for the application of the proportionality principle in relation to the different criteria (i.e. size, internal organisation and nature, scope and complexity of activities)? If not, please state the reasons for your answer and also suggest an alternative approach.
Given the enormous variety of business models employed by different AIFMs carrying out different investment strategies, it is vital that there is scope for the remuneration requirements of the Directive to be implemented in a proportionate way that takes account of the individual characteristics of each AIFM. We therefore welcome the confirmation provided by the proposed ESMA guidelines that the size, internal organisation and nature, scope and complexity of activities of an AIFM should collectively be taken into account in determining how the remuneration provisions apply to it. We also consider that Member State regulators should be provided with discretion to assess how best to apply the proportionality principle in relation to the remuneration policies of the AIFMs in their jurisdiction. We would expect AIFMs to work closely with their regulators as necessary to develop reasonable internal remuneration policies based on the nature of their business and their mandated risk profile.
Question 19: Do you agree with the criteria above for determining whether or not a RemCo has to be set up? If not, please provide explanations and alternative criteria.
We agree that the proportionality factors mentioned in Section V of the consultation paper must collectively be taken into account in determining whether an AIFM should set up a RemCo. We also consider that it would be disproportionate in terms of cost for 'non-significant' AIFMs to be required to establish a RemCo. ESMA's statement that setting up a RemCo constitutes best practice for such AIFMs is in our view unhelpful as it adds uncertainty to the assessment of whether an AIFM requires it. Whilst proportionality should mean that only significant AIFMs need set up a RemCo, it is unclear

as to what 'significant' actually means in the context of the Directive and trying to define it raises a number of difficult questions. For instance, at what point do the scale, organisational structure and complexity of activities of an AIFM become 'significant'? Against what benchmark should AIFMs measure themselves to determine whether or not they are significant? Should benchmarks be absolute or relative (i.e. comparison against other AIFMs)?

Whilst setting absolute thresholds such as AUM or number of employees is a simple and often helpful way of determining significance, the thresholds would inevitably be arbitrary and would likely lead to many inappropriate or unfair outcomes. It would also be difficult to set objective measures on the complexity of an AIFM's activities or its organisational structure.

We believe that Member State regulators are best placed to judge whether an AIFM for which they have oversight is significant enough to require a RemCo and that they should be given the necessary discretion to apply their judgement in their jurisdictions. Our view is that only the largest, multi strategy investment management groups should be considered significant.

Question 20 :Do you agree that in assessing whether or not an AIFM is significant, consideration should be given to the cumulative presence of a significant size, internal organisation and nature, scope and complexity of the AIFM's activities? If not, please provide explanations and alternative criteria.

Yes, and we expect that Member State regulators will be in a good position to assess how these different considerations influence whether an AIFM should be considered 'significant'.

Question 22 :Do you see merits in adding further examples of AIFMs which should not be required to set up a RemCo? If yes, please provide details on these additional examples.

Yes, but we believe this is a task best left to Member State regulators; it is sufficient for ESMA to set out the high level considerations which AIFMs need to take into account in assessing whether they are significant.

As a general matter and as noted above, despite their arbitrary nature we appreciate that absolute thresholds (such as the €250 AUM 'safe harbour') can be a simple and helpful indicator of the significance of an AIFM. However, we do not think setting significance at such a low level can be justified, given that many AIFMs with AUM of under €500m will not even be subject to the full requirements of the Directive. If a meaningful absolute value is to be attached to the "significant" concept, , we would recommend that the threshold be raised to at least €1bn.

Question 28: Do you agree with the above criteria on the remuneration of the control functions? If not, please provide explanations.

In the real estate context, risk management is bound up with proper performance of the portfolio management function and cannot easily be separated; indeed it would be counterproductive to do so. In this context risk management does not lend itself to separation in a way that, for example, the trading decisions of a hedge fund portfolio manager are subject to quantitative risk limits imposed and monitored by a specialist professional. When a real estate fund manager considers whether to make a further investment into an existing asset to fund repairs, improvements or sustainability enhancements to the fabric of a building it will take into account risks relating specifically to the asset, to its financing and also to alternative uses of its resources and market conditions generally.

Decisions on such crucial questions are explicitly entrusted by investors to the key executives of the AIFM on the basis of their experience, expertise, due diligence, intimate knowledge of the relevant asset and of the property market, and judgment, subject to the relevant defined investment policy. There is no investor protection rationale for employing a professional risk manager (or indeed other 'control function' staff) who would inevitably be less expert in real estate and would find it difficult to pass judgement in any meaningful way on the decisions made by the investment manager. Nor is there any group of sufficiently expert professionals from which such independent risk managers could realistically be recruited.

With the above in mind, we would appreciate acknowledgement that, provided controls are put in place to avoid conflicts, it may remain appropriate for those in control functions (whose exercise of proper risk assessments is part and parcel of the investment process) to continue to participate in carried interest structures where those structures are designed to comply with the AIFMD remuneration principles, and do not inappropriately reward short term performance. We are concerned that if such a position is not taken there will be significant disincentives for those most qualified to make appropriate risk assessments from occupying control functions.

Question 44: Do you agree with the proposed guidance for the retention policy relating to the instruments being a consistent part of the variable remuneration? If not, please provide explanations and alternative guidance.

We agree that the length of a deferral period should be such as to align the interests of staff and investors. We also support the view that, in respect of upfront instruments, a retention period may, therefore, be shorter than the deferral period. However, a retention period following a sufficient deferral period may not bring any significant alignment benefits.

We note that in certain circumstances (notably in the case of partnership investment structures) the tax rules of certain member states can require tax to be paid on income earned in a year, even if it is not received in cash by the taxpayer. In these circumstances, it would be helpful if the guidelines indicated that it will be acceptable to structure variable remuneration using alternative instruments or cash-based schemes where the employee receives their eventual variable remuneration in cash rather than units, but the amount received corresponds to the return which would have been realised had the employee been awarded the units directly. Paragraph 127 of the guidelines anticipates that such arrangements are acceptable in other circumstances and it would be helpful if this could be extended to where a 'dry' tax charge would otherwise arise.

Question 45: Do you agree with the proposed guidance for the ex-post risk adjustments to be followed by AIFMs? If not, please provide explanations and alternative guidance.

We support the criteria suggested by ESMA in determining when 'malus' provisions should apply to deferred remuneration, and supports the view that, in order to provide certainty to AIFM staff, the ex-post risk adjustment provisions should apply only in very limited circumstances.

It should also be clarified that where remuneration is vested in fund units, a significant downturn in the financial performance of an AIF should not, of itself, be grounds for malus, especially as the total remuneration that could crystallise would be decreased anyway as a function of such poor performance. Rather, malus should only be applied where the poor performance of the AIF is linked to negligence or recklessness on the part of the relevant staff member. In cases where the staff member has simply made an investment decision that did not pay off but has not inappropriately breached a risk threshold, it should be sufficient that his remuneration is vested in

units of the poorly performing AIF.

We would also welcome clarification from ESMA that, where tax charges have arisen, such amounts would be excluded from malus and ex-post risk adjustment requirements.

Question 46: Do you agree with the analysis on certain remuneration structures which comply with the criteria set out above? If not, please provide explanations.

We welcome ESMA's proposals that certain remuneration structures, as outlined in paragraphs 191 to 193, should be considered to meet the policy objectives of aligning the interests of the participants in those structures with the AIF investors, and in particular the proposals in relation to the treatment of carried interest. However, we note that carried interest is generally understood to be a return payable to the individual staff member or a special purpose vehicle that receives the carry (and itself subsequently distributes to the individual staff members), rather than to the AIF or the entity that serves as the AIFM. ESMA's description of a carried interest structure does not appear to reflect that understanding.

We agree that the risk alignment requirements in relation to variable remuneration may be met where both paragraphs 192 a) and 192 b) of the proposed guidelines are complied with. However, we believe that an AIF complying with either of these subparagraphs (but not necessarily both) may also meet the risk alignment requirements in relation with variable remuneration. Therefore, we would urge ESMA to change "and" at the end of sub-paragraph 192 a) to "or".

Carried interest is typically paid out on either a 'whole fund' (i.e. following the return of each investor's entire capital contribution, plus a return) or deal by deal basis (i.e. paid out in parts following each realisation of an asset and the return of capital contributions attributable to that asset, plus a return on that asset). It appears to be an implicit assumption in ESMA's guidance that only the 'whole fund' model achieves alignment of interests between AIFM staff and investors. Whilst the 'whole fund' model is clearly a very effective way of achieving alignment, we believe that a 'deal by deal' approach can achieve very similar strength of alignment by using measures such as clawback, escrow accounts and true-ups.

We would also question ESMA's proposal that all capital contributed by investors plus an agreed hurdle must be repaid before any payments are made to Identified Staff in order for the carried interest arrangement to be deemed to successfully align AIFM staff and investor interests.Often, the order of payments would see a return to investors of the bulk of their contributions (the element taking the form of loan capital plus agreed hurdle), with a carried interest payment being made in priority to the return to investors of their pure equity investment (usually a very small proportion of their total contribution) usually This structure would in our view be sufficient for the carried interest to be treated as being in compliance with the AIFMD remuneration principles (even though technically some carried interests payments are made before all money is repaid to investors).

As mentioned above, we also believe that a carried interest arrangement which allows for payments to be made to AIFM staff to the extent necessary to meet tax charged on carried interest earned should be acceptable. A carried interest arrangement must be considered in the round and not solely by applying a mechanical test such as whether all amounts have been repaid to investors before payments are made to AIFM staff.