Securities and Markets Stakeholder Group

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ADVICE TO ESMA

Advice on ESMA's Consultation paper – Guidelines on sound remuneration policies under the AIFMD

I. Executive summary

The Securities and Markets Stakeholder Group has reviewed ESMA's Consultation paper regarding Guidelines on sound remuneration policies under the AIFMD. In our analysis of the draft ESMA guidelines, we have focused on how they contribute to achieving the main purposes of the AIFM Directive: anticipate and control systemic risk and provide the appropriate level of investor protection. The Stakeholder Group has considered if these objectives are achieved in a fit for purpose manner, while also allowing the right level of tailoring and proportionality for the fundamental diversity and divergence in nature, scale and complexity of the different product offerings to the investors concerned.

In this perspective, the Securities and Markets Stakeholder Group acknowledges the highly valuable work of ESMA. The Group supports the overall approach of these Guidelines – to align managers' and their relevant staff's interests with those of their investors through promoting sound remuneration policies under the AIFMD. However the Securities and Markets Stakeholder Group also calls for a consideration of a number of specific elements in the draft ESMA Guidelines. Consideration by ESMA of these elements should lead to a better balance between market stability and investor protections on the one hand and the tailoring of the remuneration and alignment of interest policies when applied to the wide range of managers with different business models on the other hand. The Securities and Markets Stakeholder Group has chosen to focus its advice around the following four high level elements: (i) need for consistency, (ii) need for proportionality, (iii) use of neutralization and (iv) how existing remuneration and incentive practices that align the interests of the investors and managers can be assessed in context of compliance with the Guidelines.

II. INTRODUCTION

1. The Securities and Markets Stakeholder Group ("SMSG") welcomes this opportunity to comment on ESMA's Consultation paper Guidelines on sound remuneration policies under the AIFMD published on 28 June 2012 (ESMA/2011/209) ("the Guidelines").

2. It is important that ESMA's final Guidelines provide a balance between serving as guidance to industry participants and competent authorities which is as concrete and practical as possible, while staying within the perimeters of the Level 1 text.

3. In its analysis of the ESMA draft Guidelines, the Stakeholder Group has taken the perspective that its advice to ESMA should focus on the balance between market stability and investor protections on the

one hand and the tailoring of the remuneration and alignment of interest policies when applied to the wide range of managers with different business models on the other hand, rather than focussing on more technical responses to the draft Guidelines which can be expected to be provided by the different respondents to the Consultation. Four elements have been identified by the SMSG which could potentially impact this balance:

(i) Need for consistency – while recognizing diversity

4. A large number of traditional investment management firms in Europe are currently and in the future likely to have activities falling under the AIFMD, the UCITS Directive and/or MiFID. Furthermore a number of these traditional investment management firms are also part of financial institutions like banks and insurance companies and therefore the CRD articles applicable to these financial institutions will also impact some of their activities, including remuneration.

5. Within many of these investment management firms, the same personnel is on a daily basis conducting activities and working on different product lines which fall under the different directives. Compliance officers will for example be responsible for the compliance in the entire firm and not only compliance related to the activity under the one or the other of the directives.

6. These more traditional investment managers need to manage investments for investors regardless of the directive by which these investments are regulated. The staff employed by these managers has one remuneration package despite perhaps working for different types of investors, covered under different regulatory regimes. It will therefore in practice be very difficult, if not impossible, to distinguish between which parts of the remuneration that would be falling under which rule.

7. Therefore, the SMSG proposes that, in these cases, ESMA should provide high-level guidance to avoid the creation of a patch-work of remuneration principles across a single company falling into that category. At the same time ESMA should continue to reflect in the Guidelines the differences between the non-bank asset management sector and the banking sector, as reflected in the texts of AIFMD and CRD III.

(ii) Need for proportionality

8. The SMSG echoes the statement made by ESMA that it is primarily the responsibility of the AIFM to assess its own characteristics and to develop and implement remuneration policies and practices which appropriately align the risks faced and provide adequate and effective incentives to staff.

9. While the SMSG also acknowledges that the proportionality principle does not imply that AIFM can disregard any of the guidelines, sufficient flexibility must be provided to allow for tailoring when applied to individual sectors and individual firms. The very different business models of financial institutions like banks and insurance companies, different types of investment firms and asset managers must be sufficiently taken into account. Proportionality is therefore a key concern.

10. Managers covered by the AIFMD should be able to apply the guiding principles in different ways according to their size and strategy pursued as well as, where relevant, the size of the funds they manage, their internal organization and the nature, scope and complexity of their activities and their products.

11. As the universe of managers and their funds covered by the AIFMD is very broad it is critical to include the following differentiating factors into the proportionality assessment:

- whether funds are closed-ended or open-ended (noting also the different redemption policies applied by the latter)
- whether fees are fixed or can be influenced through trading activity
- whether incentives and incomes are based upon actual cash returns or valuations
- whether investment decisions are taken by committees or "autonomous traders"
- whether management companies are partner owned, parts of larger groups and/or listed; and
- whether or not there is consistent sharing of investment risk between managers and investors.

(iii) Use of neutralization

12. Given the very wide variety in size, internal organization and the nature, scope and complexity of activities of different fund managers, the SMSG recommends that the remuneration guidelines include an express recognition that the application of the proportionality principle may lead to neutralization of some requirements, if this is reconcilable with the risk profile, risk appetite and strategy of the relevant AIFMs and of the AIFs they manage. Furthermore, neutralization is also crucial to allow for consistency with other regulatory frameworks applicable to the asset managers.

13. The CEBS remuneration guidelines specifically provide for 'neutralisation' of certain requirements if this is reconcilable with the risk profile, risk appetite and the strategy of the firm. This ability was specifically extended to firms which fall under Article 20(2) of Directive 2006/49/EC. This should equally be reflected under the guidelines issued by ESMA for MiFID firms, AIFM and UCITS Management Companies, especially as the scope for neutralization provided at Level 1 does not seem to differ.

(iv) Assessment of existing risk-sharing models for compliance with the Guidelines

14. Within the alternative investment management sector there exist different incentive models - negotiated and agreed between investors and managers –which are based on a sharing of the investment risk and which – to a certain or larger extent – integrate the risk adjustment, deferral and retention requirements, as stated in Annex 2 of the AIFMD

15. The SMSG recommends that the option should be considered to neutralize the relevant articles of the Guidelines where the variable component of such risk sharing remuneration and incentive models only vests after the fund first returns to the investors all the capital contributed by such investors or – in case any portion of such remuneration or return is paid out prior to final payments to investors – where such pay-outs are subject to appropriate claw-back or escrow arrangements, protecting the investors. As such risk sharing remuneration and incentive models protecting the investors also imply a high degree of conditionality and irregularity in the actual payment of the variable component of the remuneration, the SMSG further recommends to consider the option to take into consideration the payments made over the whole life of the relevant fund - rather than on an annual basis – when assessing the relevance of such structures in the total variable remuneration arrangements of these managers.

This advice will be published on the Securities and Markets Stakeholder Group section of ESMA's website.

Adopted on 27 September 2012

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