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Submitted via Online Form

27 September 2012

Dear Sirs

Re: ESMA Consultation Paper: Guidelines on sound remuneration policies under the AIFMD (28 June 2012, ESMA/2012/406) (the "CP")

The City of London Law Society ("**CLLS**") represents approximately 14,000 City lawyers through individual and corporate membership, including some of the largest international law firms in the world.

This paper has been prepared by the CLLS Regulatory Law Committee (the "**Committee**"). Members of the Committee advise a wide range of firms in the financial markets, including alternative investment fund managers specialising in numerous strategies and asset classes such as hedge, private equity, real estate, listed equities and fixed income, as well as service providers such as depositaries/custodians, prime brokers and fund administrators.

The CLLS is registered on the European Commission's Transparency Register, and its registration number is **24418535037-82**.

We are grateful for the opportunity to comment on the proposed remuneration guidelines which ESMA has developed in the CP. We have set out below responses to certain of the specific questions raised in the CP. We have also raised two general issues relating to the interpretation and application of the relevant parts of the Alternative Investment Fund Managers Directive ("**AIFMD**") on which ESMA did not invite responses but which are relevant to these issues.

A. General Comments

1. **Proportionality in general (pages 17 and 18 of the CP and paragraphs 22-25 of the Guidelines).**

   (a) We agree with ESMA's statement that the proportionality principle may lead to a tailored application of some requirements in Annex II of the AIFMD, in the circumstances which ESMA has identified. We would question, however, the meaning of, and the legal basis for, the following words in paragraph 23 of the Guidelines:

   "..... nor should tailored application be understood as allowing an AIFM to disregard any of the requirements of Annex II of the AIFMD."

   The words might be read to mean that, unlike the corresponding CEBS/EBA Guidelines under the Capital Requirements Directive (2006/48/EC), AIFMs will not be permitted to "neutralise" any provision in Annex II, even if that may be justified in accordance with the criteria stated by ESMA. If this is the conclusion which ESMA intends should be drawn, we do not agree, for the following reasons:-

   (i) there is no difference between the respective texts of the CRD and the AIFMD which justifies the harsher treatment for AIFMs which the Guidelines propose. Each directive uses similar wording requiring firms to "*comply with the following principles in a way and to the extent that it is appropriate....*" We recognise that the European Parliament in recitals to the amending CRD specifically noted that certain aspects of the CRD might be inappropriate for "limited licence' firms, including asset management firms, and that the AIFMD contains no equivalent note, notwithstanding the fact that all external AIFMs would be limited licence firms if they were subject to the CRD. We do not believe that justifies a fundamentally different treatment of similar risks and activities in a situation where the proportionality wording in the main text of the two Directives is substantially the same; and

   (ii) in paragraph 12 of the CP, ESMA confirms its intention to develop the AIFMD Guidelines on the basis of the structure used in the CEBS/EBA Guidelines, subject to the adaptations referred to in that paragraph. In our view, there is nothing in the "*specificity of the asset management sector*" which requires the different approach to proportionality reflected in paragraph 23 of the Guidelines. Moreover appropriate adaptation for the specificities of the asset management sector as opposed to the banking sector would argue for treating AIFM, as far as possible within the constraints of the relevant Directives. An AIFM should, in principle, be entitled to "neutralise" a specific requirement if it is able to justify that step on the basis of the criteria stated and its own situation. It is important to note in this respect that the universe of AIFMs falling within the scope of the Directive is extremely broad and that, therefore, it is quite possible that "neutralisation" of particular provisions may be

justified on objective grounds, without offending against the principles on which Annex II is based. Indeed the level of detail of some of the provisions of Annex II will in some cases be impossible to meet by reason of the specific characteristics of a particular AIF or AIFM or investor requirements. In other cases, a good example being the carried interest structure described by ESMA in paragraph 150, the objectives of risk management and investor alignment may be achieved and accordingly the requirements of Annex II met in a structure which does not follow precisely every line of every paragraph in Annex II.

(iii) Although in our comments above we have adopted the term "neutralise" because it is used in the CEBS/EBA Guidelines this is not intended to involve simply ignoring any of the provisions of Annex II to the AIFMD but rather to involve a reasoned consideration of whether, in the particular circumstances of the AIFM and staff concerned, the overriding objectives of risk management and investor alignment of interests are appropriately addressed by the policy adopted, even when it is considered disproportionate to apply some specific detail of, for instance, the pay out process. We would not expect that ESMA's brief comment prohibiting a "disregard" for any of the provisions of Annex II when applying a tailored approach is intended to prevent such a reasoned and proportionate approach which appears to us to be supported by the remainder of ESMA's paper. But it would be helpful to make this clear.

(b) We note that the CEBS/EBA Guidelines at paragraph 17 recognise the position of those who are owners of businesses as well as working in them (specifically those who are partners, since many AIFMs are not structured as companies with shareholders) and say that "*Dividends that partners receive as owners of an institution are not covered by these guidelines (unless they represent a vehicle or method for circumvention); however any imprudent extraction of capital out of the institution through pay outs of dividends would be covered by normal capital adequacy rules.*" We believe that the ESMA Guidelines should also expressly recognise that profit shares received as owners of AIFMs should not be regarded as remuneration covered by the guidelines, just as the profits of investment in AIFs are not regarded as remuneration.

(c) In view of the wide range of AIFMs falling within the Directive's scope, and the differences which exist between the markets in each member state, we believe that competent authorities will play a vital role in interpreting and applying the proportionality principle in practice. We believe that this may require clarificatory guidelines to be published in individual member states; this possibility may usefully be highlighted in paragraph 26 of the Guidelines by inserting additional words at the end of the second sentence, such as:

"... and may publish supervisory guidelines clarifying the application of the principle to AIFMs having different characteristics."

2. **AIFMD and MiFID (Article 6(4) AIFMD; paragraph 29 of the CP)**

We note ESMA's policy intention set out in paragraph 29 of the CP that the MiFID remuneration guidelines, on which ESMA is consulting separately (ESMA/2012/570), will apply to AIFMs which provide the services of individual portfolio management and non-core services mentioned under Article 6(4) AIFMD, in respect of those services (while the AIFMD Guidelines will apply to AIFM services). We have three concerns in relation to the approach stated:

(a) it is not clear that this bifurcated approach will be practicable in some cases. For example, some AIFMs will operate a single bonus pool under which employees will share remuneration derived from a mixture of fees earned from (respectively) AIFs and segregated investment portfolios. Alternatively, variable remuneration may be earned by employees on a fund-by-fund basis, but, in the case of any particular AIF, some investors' participations may be structured as segregated investment mandates rather than being pooled as part of the AIF's assets. Accordingly, ESMA may in such cases, in our view, wish to consider a "default" position under which (for example) either the MiFID or the AIFM Guidelines will apply to the exclusion of the other if the majority of a firm's assets under management are represented by segregated investment mandates or (as the case may be) AIFs; or, alternatively, given that the respective Guidelines are intended to be aligned, a firm might be permitted to choose which set of Guidelines it will adopt. We would observe, however, that any solution will only deliver a proper outcome if the approaches to proportionality under AIFMD and MiFID are aligned. ESMA's consultation paper on the MiFID Guidelines is silent in relation to the application of proportionality, while (as noted above) there are important differences between the draft AIFMD Guidelines and the CRD Guidelines currently applying to investment firms;

(b) the MiFID Guidelines are strongly focused upon remuneration earned from sales and marketing activities. If ESMA intends that these guidelines will apply to AIFMs providing portfolio management services, we consider that they will need to be drafted in a more balanced way. In addition, in relation to ESMA's reference in paragraph 29 to "*marketing activities according to paragraph 2(b) of Annex II of the AIFMD*", we consider that the AIFMD Guidelines (and not the MiFID Guidelines) should ordinarily apply to remuneration derived from such activities. The services of investment advice and/or receipt and transmission of orders may be carried on in connection with such marketing, but in many cases will not be. If such services are provided, and remuneration is earned specifically in that connection, the MiFID Guidelines should apply (subject to our comments above in relation to overlap between the respective sets of Guidelines); and

(c) in the case of a branch established under AIFMD, where the branch provides Article 6(4) services as well as fund management services, it is

unclear which competent authority (home or host state) would supervise compliance with remuneration guidelines.

B. Responses to ESMA's questions

We have set out our responses to certain questions in the Appendix to this letter.

The Committee would be delighted to discuss with ESMA any of the responses and observations set out in this letter. In the first instance, please contact Margaret Chamberlain of Travers Smith (+44 (0)20 7295 3000, margaret.chamberlain@traverssmith.com) or James Perry of Ashurst LLP (+44 (0)20 7859 1214, james.perry@ashurst.com).

Yours faithfully

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Margaret Chamberlain

Chair, Regulatory Law Committee

CLLS

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APPENDIX – Responses to Questions

Question 4 Do you agree that the AIFMD remuneration principles should not apply to fees and commissions received by intermediaries and external service providers in case of outsourced activities?

We do. The scope of Article 13 and Annex II is clearly limited to payments to staff of the AIFM.

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 scope of Article 13 and Annex II is clearly limited to the remuneration policies of AIFMs. In our view, the treatment in this respect of a delegated investment manager should be no different to that of intermediaries and other service providers (see Question 4). We do not believe that this conclusion is problematic in principle, because:

(a) delegated investment managers in the EEA and other significant jurisdictions will be subject to remuneration requirements under other directives and laws (including CRD and MiFID); and

(b) paragraph (r) of Annex II contains an appropriate provision which prohibits abusive structures or practices designed to avoid the requirements of Annex II. So, for example, a structure under which an AIFM arranges for fees to be paid directly to a delegate in a lightly regulated jurisdiction to evade remuneration restrictions would probably breach paragraph (r) (as well as possibly offending against the restriction relating to letter-box entities).

Question 6: Do you consider that payments made directly by the AIF to the AIFM as a whole (e.g. payment of a performance fee or carried interest) shall be considered as payments made to the benefit of the relevant staff of the AIFM and , therefore, fall under the scope of the AIFMD remuneration rule (and therefore of these Guidelines)

No. Article 13 relates to remuneration received by staff of the AIFM, not to the fees due to the AIFM.

Questions 20 and 22 – Setting up a Remuneration Committee

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.

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.

We agree with ESMA's comments in paragraphs 72 and 73 of the CP and with the considerations set out therein, except that whether or not it would be "good practice" for an AIFM which is not required to establish a committee to do so will, in our view, depend on the circumstances.

In relation to Question 22, further examples may be helpful, but the first existing example (value of portfolios of AIFs not exceeding EUR 250 million) needs to be re-considered. This threshold is far too low, and suggests that AIFMs which are relatively small or mid-sized may be considered "significant". If an example by reference to value of portfolios is to be included, the threshold(s) should be considerably higher and, in our view, calibrated by reference to different asset classes. For example, EUR5-10bn under management may be considered substantial in the case of managers of private equity portfolios, but probably would not in the case of managers of fixed income/government securities and cash. We expect that trade organisations will also have views on this issue.

Additional examples might include a threshold for annual payroll, or a minimum number of employees (in the latter case, the threshold for "large companies" under EU Companies legislation may be helpful).

We believe that the Annex II provisions relating to the composition of a remuneration committee (essentially requiring there to be a number of members of the management body which do not perform any executive functions) effectively mean that a remuneration committee should only be mandatory for AIFM which are very large and complex in nature. Other AIFM will rarely be in a position to have multiple non-executives.

Q 23 Do you agree with the principles relating to the composition of the RemCo?

As has been noted in other contexts many AIFM do not have a supervisory function separate from their senior management. Some will have no non-executives, or only one non-executive who may or may not have expertise in remuneration risk management. It is accordingly not clear to us how practicable it will be for any but the very largest and most complex AIFM to meet the proposed composition requirements.

Question 42: Do you agree with the types of instruments composing the variable remuneration which have been identified by ESMA? If not, please provide explanations.

We agree with the types of instruments potentially comprising part of the variable remuneration, although we are not aware of many, if any, AIFs which currently issue share-linked instruments or other non-cash instruments which are not interests in the AIF. More importantly, the extent to which this provision can be complied with, will vary depending on the nature of the AIF in question. This is recognised in paragraph (m) itself which is made subject to the legal structure of the AIF and its rules or instruments of incorporation. For example it may be relatively easy to issue units or shares in open

ended AIFs but in relation to certain closed ended products it may not be possible to issue interests depending on the life-cycle and structure of the fund and the willingness or otherwise of the investors to accept any dilution of their own returns.

Question 44 – Retention Policy

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 believe that certain trade organisations have pointed out that some member states may require income tax to be paid in respect of non-cash instruments awarded to an employee, and that it would be fair for any retention policy to accommodate this by permitting payments to be made in cash to the extent of such a charge to taxation (thereby resulting in a commensurate adjustment to the required proportions of cash and instruments). We endorse this view.

Question 46 – Carried Interest

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

We agree with ESMA's analysis. We have a few minor drafting comments on paragraph 150 of the Guidelines as follows:

(a) in sub-paragraph (a), we suggest that the words "or substantially all" are added between the words "all" and "capital", because technically structures of this kind normally involve a minor part of investors' capital (0.1% or 0.2%) being repaid at liquidation of the AIF;

(b) also in sub-paragraph (a), the word "variable" should be added before the word "compensation". Staff will receive fixed remuneration on a regular basis;

(c) we believe that the "and" at the end of paragraph (a) may be intended to be "or"; and

(d) at the end of sub-paragraph (b), the following words should be added:

"... or, if earlier, the time at which it is certain that investors will, in any event, have received a previously agreed minimum return even if the AIF's remaining investments are written off to zero."

A provision to this effect is commonly included, in our experience, in agreements establishing carried interest structures.

THE CITY OF LONDON LAW SOCIETY
REGULATORY LAW COMMITTEE

Individuals and firms represented on this Committee are as follows:

Margaret Chamberlain (Travers Smith LLP) (Chair)
Karen Anderson (Herbert Smith LLP)
Chris Bates (Clifford Chance LLP)
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Peter Bevan (Linklaters LLP)
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