ESMA publishes final UCITS V remuneration Guidelines

7 April 2015

On Thursday, 31 March 2016, the European Securities and Markets Authority (ESMA) published its final report setting out Guidelines on sound remuneration policies under the fifth iteration of the Undertakings for Collective Investment in Transferrable Securities Directive (UCITS V) (the "Guidelines").

ESMA has amended its draft Guidelines and remains silent on the extent to which proportionality can lead to the disapplication of the "Pay-out process rules". In addition, it has addressed a letter to the European Commission setting out its position on proportionality, the rationale behind it and suggesting the provision of clarification.

In brief

Who?

ESMA

What?

Final Guidelines on sound remuneration policies under the UCITS V Directive and AIFMD

For whom?

UCITS Management Companies ("UCITS Managers") and Alternative Investment Fund Managers (AIFMs)

When?

To apply from 1 January 2017

Where?

Links to the final Guidelines and the letter to the European Commission can be found here : https://www.esma.europa.eu/press-news/esma-news/esma-publishes-ucits-remuneration-guidelines

In detail

ESMA has published its final Guidelines on sound remuneration policies under the UCITS V Directive, as well as some minor amendments to similar, existing guidelines with regards to AIFMD.

The Guidelines themselves apply directly to local regulators and are relevant to UCITS Managers and AIFMs. **Local regulators have two months from the publication of the translations of the guidelines to notify ESMA whether they will comply with all of the Guidelines, or explain the reasons for any non-compliance.**

The most significant changes to the final Guidelines concern the application of **proportionality**. Overall, the industry is likely to consider that the changes made by ESMA to the Guidelines from the draft version are unhelpful. **In particular, the changes give firms less clarification on how the rules will be expected to be applied in practice, with no clear view on when firms might expect such clarification.**

While ESMA is still of the view that proportionality should lead to the disapplication of some requirements in certain circumstances, the lack of specific detail creates more uncertainty at a time when firms are grappling with the practical implementation of the rules.

Approach to proportionality

ESMA chose to remain silent on the extent to which proportionality can lead to the disapplication of certain remuneration requirements of UCITS V, including **the payout process rules** (i.e. the rules relating to deferral, non-cash instruments and performance adjustment). These changes are a significant deviation from the approach initially set out in the draft Guidelines, which mirrored the equivalent guidelines for the application of AIFMD.

The final version is rather similar to the EBA approach on sound remuneration policies under CRD IV. To explain the rationale behind its decision, ESMA has cited the need to align its approach to the application of proportionality under AIFMD and its obligations to liaise with the EBA, to ensure consistency in the application of similar rules across the financial services sector.

In addition to its Guidelines, ESMA has also published a **letter addressed to the European Commission to further explain its position and express the need for further clarifications on how proportionality should apply.** In particular, it is clear that while ESMA has amended its Guidelines, they are still of the view that proportionality could lead to a scenario where either:

1. Proportionality can lead to the disapplication of remuneration requirements in certain circumstances (i.e. in line with AIFMD and draft UCITS Guidelines); or

2. Proportionality can lead to firms applying the remuneration requirements, but to a lesser extent than the rule provides for (e.g. an amount lower than 40% of variable remuneration could be subject to deferral).

The letter suggests that **legislative change** could be “one way” to clarify how firms should apply proportionality; however, ESMA has not gone so far as the EBA in setting out detailed recommendations for specific changes to either AIFMD or UCITS V.

While firms are likely to be concerned that ESMA has amended its Guidelines to align more closely to the EBA’s approach, the sentiment of its letter to the European Commission clearly suggests that ESMA are still of the view that proportionality could still lead to the disapplication of remuneration rules in certain circumstances.

Until clarification is provided on the issue of proportionality, ESMA has confirmed it will not look to make change to existing guidelines under AIFMD. This suggests that firms will not be expected to change their approach to complying with AIFMD at this time, which will be viewed positively by the industry.

Transitional provisions

ESMA had originally proposed that its Guidelines apply to UCITS Managers for the first full performance period starting on/after 18 March 2016, in line with the remuneration requirements of the Directive itself.

The final Guidelines will come into effect **on 1 January 2017**. Importantly, sections 12 and 13 of the Guidelines (the provisions on risk adjustment and the payout process rules) **will apply to the first**

full performance period starting on/after this date. ESMA states, however, that this is "without prejudice" to the Directive itself coming into effect as of 18 March 2016.

The Guidelines do not clarify how firms have to comply with the remuneration requirements of UCITS V in the interim period. This means that UCITS Managers who have a performance year starting between 18 March 2016 and 31 December 2016 will need to take steps to comply with the UCITS V requirements without specific guidance. Technically, the UCITS V remuneration requirements should apply to the performance year starting in this period, though ESMA implies that the Guidelines themselves would not apply until the following performance year. Given the lack of clarity on when the rules should apply, local regulators will likely have to address the issue of timing.

Identified Staff

The final provisions on Identified Staff have remained unchanged from the draft Guidelines and therefore broadly in line with the approach on AIFMD. ESMA has not provided any further guidance on either:

a) The types of roles that should be included as Identified Staff; or

b) The process for identifying the Identified Staff population.

Delegation

ESMA has not provided additional guidance on the treatment of entities to which either portfolio or risk management services have been delegated. In particular, the reference to the fact that CRD IV and AIFMD are the regulatory regimes that ESMA consider to be"equally as effective" as UCITS V remains.

Payment in non-cash instruments

UCITS V provides for firms to tailor their compliance with the non-cash instruments requirement where the management of UCITS constitutes less than 50% of the portfolio of the UCITS Manager.

In the calculation of the 50%, the draft Guidelines envisaged an approach whereby UCITS Managers would compare the AuM of each individual UCITS it manages and compare this to the aggregate AuM of the total UCITS portfolio managed by the UCITS Manager (i.e. excluding assets not managed under UCITS).

The final Guidelines have amended this approach to reflect a change in the Directive itself. Therefore, UCITS Managers will now need to compare the AuM of their UCITS portfolio to the AuM of the entire portfolio managed by the UCITS Manager.

ESMA states in its response to the consultation Q&A that where no single UCITS fund constitutes more than 50% of the total UCITS funds managed, a "substantial portion" of variable remuneration shall be delivered in non-cash instruments instead of the minimum 50%.

Conclusion

UCITS Managers in Europe will likely experience challenges in understanding the extent to which proportionality may apply, particularly in territories where local regulators would typically rely directly on ESMA's Guidelines without providing additional clarification or guidance.

It is likely that ***until the European Commission provides clarification on proportionality*** *UCITS Managers will be expected to adopt a reasoned and well-justified approach to compliance in the absence of further guidance.*

The PwC Reward Team remains at your disposal for further clarification.

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