



European Securities and  
Markets Authority

## **Consultation paper**

Guidelines on sound remuneration policies under the AIFMD





## **Responding to this consultation paper**

ESMA invites comments on all matters in this paper and in particular on the specific questions summarised in Annex V. Comments are most helpful if they:

- indicate the specific question to which the comment relates and respond to the question stated;
- contain a clear rationale, clearly stating the costs and benefits; and
- describe any alternatives ESMA should consider.

ESMA will consider all comments received by 27 September 2012.

All contributions should be submitted online at [www.esma.europa.eu](http://www.esma.europa.eu) under the heading 'Your input - Consultations'.

### **Publication of responses**

All contributions received will be published following the close of the consultation, unless you request otherwise. Please clearly and prominently indicate in your submission any part you do not wish to be publically disclosed. A standard confidentiality statement in an email message will not be treated as a request for non-disclosure. A confidential response may be requested from us in accordance with ESMA's rules on access to documents. We may consult you if we receive such a request. Any decision we make not to disclose the response is reviewable by ESMA's Board of Appeal and the European Ombudsman.

### **Data protection**

Information on data protection can be found at [www.esma.europa.eu](http://www.esma.europa.eu) under the heading 'Legal Notice'.

### **Who should read this paper?**

This document will be of interest to asset management companies and trade associations of asset management companies managing funds falling in the scope of the Alternative Investment Fund Managers Directive and investors investing into such funds.

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## Acronyms

AIF	Alternative Investment Fund
AIFM	Alternative Investment Fund Manager
AIFMD	Directive 2011/61/EC of the European Parliament and of the Council of 8 June 2011 on Alternative Investment Fund Managers and amending Directives 2003/41/EC and 2009/65/EC and Regulations (EC) No 1060/2009 and (EU) No 1095/2010 <sup>1</sup>
EBA	European Banking Authority
ESMA	European Securities and Markets Authority
UCITS	Undertakings for Collective Investment in Transferable Securities
UCITS Directive	Directive 2009/65/EC of the European Parliament and of the Council of 13 July 2009 on the coordination of laws, regulations and administrative provisions relating to undertakings for collective investment in transferable securities (UCITS) (recast) <sup>2</sup>

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<sup>1</sup> <http://eur-lex.europa.eu/LexUriServ/LexUriServ.do?uri=OJ:L:2011:174:0001:0073:EN:PDF>.

<sup>2</sup> <http://eur-lex.europa.eu/LexUriServ/LexUriServ.do?uri=OJ:L:2009:302:0032:0096:EN:PDF>

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## **I. Executive Summary**

### **Reasons for publication**

Annex II of the AIFMD establishes a set of rules (largely inspired from the provisions of Directive 2006/48/EC, the “CRD”) with which AIFMs have to comply when establishing and applying the remuneration policies for certain categories of their staff. Article 13(2) of the AIFMD requires ESMA to develop guidelines on sound remuneration policies which comply with Annex II of the AIFMD. This consultation paper represents the first step in the elaboration of the guidelines on remuneration policies required by the AIFMD and sets out ESMA’s formal proposals for these guidelines.

### **Contents**

Section II explains the background to our proposals, while Section III explains the structure of the guidelines.

Section IV sets out the proposed scope of the guidelines and timing of their entry into force.

Section V describes the proposed guidance on the application of the proportionality principle as regards remuneration policies.

Section VI sets out our proposals on the treatment of AIFMs that are part of a group.

Section VII contains our guidance on the consideration to be given to the financial situation of the AIFM when establishing the remuneration policies.

Section VIII introduces our proposals on the governance of remuneration.

Section IX covers the general requirements on risk alignment.

Section X describes our proposals on the specific requirements on risk alignment.

Section XI sets out our proposals on the remuneration disclosure requirements.

Annex I provides definitions of certain concepts used in this paper.

Annex II provides for a mapping of the remuneration principles included in the AIFMD.

Annex III gives a schematic overview of some deferral mechanisms.

Annex IV contains a correlation table between the provisions of Recommendation 2009/384/EC and those of Annex II of the AIFMD.

Annex V sets out the list of questions contained in this paper.

Annex VI contains the full text of the draft guidelines.

### **Next steps**

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Responses to this consultation paper will be taken into account by ESMA in finalising the guidelines on sound remuneration policies under the AIFMD. In finalising the guidelines, ESMA will also take into account the development of its work on the separate set of guidelines, which will be complementary to the CEBS Guidelines, focused on remuneration policies of investment firms from an investor protection point of view, for which a separate consultation paper will be published at the end of Q3 2012.

ESMA aims to adopt the final text of the guidelines on sound remuneration policies under the AIFMD in Q4 2012.

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## II. Background

1. Article 13(1) of the AIFMD introduces a basic principle for the remuneration policies and practices of certain categories of staff of the AIFMs insofar as it provides that “*Member States shall require AIFMs to have remuneration policies and practices for those categories of staff, including senior management, risk takers, control functions, and any employees receiving total remuneration that takes them into the same remuneration bracket as senior management and risk takers, whose professional activities have a material impact on the risk profiles of the AIFMs or of the AIFs they manage, that are consistent with and promote sound and effective risk management and do not encourage risk-taking which is inconsistent with the risk profiles, rules or instruments of incorporation of the AIFs they manage*”.
2. Annex II of the AIFMD sets out further details on the principles that AIFMs have to comply with when establishing and applying the total remuneration policies for certain categories of their staff.
3. Article 22(2)(e) and (f) of the AIFMD also provides for some specific minimum disclosures on remuneration in the annual report of the AIF and Box 107 of ESMA's technical advice to the European Commission on possible implementing measures of the AIFMD (“AIFMD advice”) clarified the content and format of the remuneration disclosure.<sup>3</sup>
4. Article 13(2) of the AIFMD requires ESMA to issue guidelines on sound remuneration policies (“Guidelines”) which shall comply with Annex II of the AIFMD. This article provides for some specific requirements when elaborating the Guidelines:
  - ESMA shall take into account the principles on sound remuneration policies set out in Recommendation 2009/384/EC (“Recommendation”);
  - ESMA shall take into account the proportionality principle; and
  - ESMA shall cooperate closely with EBA.<sup>4</sup>
5. The Recommendation sets out general principles applicable to remuneration policy in the financial sector and applies to all financial undertakings operating in the financial services industry. It provides under its Section II for some general principles on the remuneration policy and some principles on the structure of the remuneration policy, performance measurement and governance which are broadly reflected under Annex II of the AIFMD and, therefore, covered in the sections of these Guidelines relating to the governance requirements and the general and specific requirements on risk alignment.<sup>5</sup> Furthermore, it provides for rules on disclosure (Section III), which are not reflected in the AIFMD, but are developed under Section XI (Disclosure) of these Guidelines, and for some principles applying to competent authorities (Section IV).
6. Further principles on remuneration have been set out in some specific sectoral legislation. In particular, Article 22 of the CRD, as amended by Directive 2010/76/EU, laid down the fundamental principle

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<sup>3</sup> ESMA's technical advice to the European Commission on possible implementing measures of the AIFMD is available at: [http://www.esma.europa.eu/system/files/2011\\_379.pdf](http://www.esma.europa.eu/system/files/2011_379.pdf).

<sup>4</sup> In developing this consultation paper, the close cooperation with EBA has been ensured first at working level between ESMA staff and EBA staff and then at the level of EBA's representative within ESMA's Board of Supervisors.

<sup>5</sup> See Section VIII (Governance of remuneration), Section IX (General requirements on risk alignment) and Section X (Specific requirements on risk alignment).

for credit institutions (applicable also to investment firms) to ensure that their remuneration policies and practices are consistent with and promote sound and effective risk management. The further remuneration requirements of the CRD are included in Annex V, Section 11 and Annex XII, Part 2, point 15 of the CRD. These requirements may be divided into three categories: governance (Annex V), risk alignment (Annex V) and transparency (Annex XII). The principles on governance and risk alignment set out in Annex V of the CRD are substantially equivalent (with the exception of some adaptations) to those set out under Annex II of the AIFMD.

7. On the basis of these provisions, EBA's predecessor issued the CEBS Guidelines on Remuneration Policies and Practices on 10 December 2010 ("CEBS Guidelines"). ESMA has placed particular focus on the CEBS Guidelines since the principles on remuneration set out in the CRD are substantially equivalent to those set out in the AIFMD and the latter explicitly requires ESMA to ensure cooperation with EBA when developing the Guidelines.
8. Furthermore, EBA issued Guidelines on Internal Governance (GL 44) on 27 September 2011 ("Guidelines on Internal Governance").<sup>6</sup> Internal governance for credit institutions is covered by the above-mentioned Article 22 of the CRD, which requires that *"every credit institution has robust governance arrangements, which include a clear organisational structure with well defined, transparent and consistent lines of responsibility, effective processes to identify, manage, monitor and report the risks it is or might be exposed to, adequate internal control mechanisms, including sound administrative and accounting procedures, and remuneration policies and practices that are consistent with and promote sound and effective risk management"*. EBA has consolidated the majority of its guidelines regarding general internal governance issues<sup>7</sup> in the Guidelines on Internal Governance. These provide, inter alia, the general framework applicable to the governance of the remuneration policy and to the alignment of remuneration with risk profile, whereas specific aspects of remuneration are treated in the CEBS Guidelines.
9. The Commission Directive proposal amending the CRD (2011/0203 (COD)) ("CRD IV") provides under its Title VII (Prudential supervision), Chapter 2 (Review Processes), Section II (Arrangements, processes and mechanisms of institutions), Sub-Section 3 (Governance) for revised rules on remuneration which are substantially similar to the corresponding CRD provisions. According to Article 90(2) of the CRD IV, EBA shall develop draft regulatory technical standards (i) on the criteria to determine the appropriate ratios between the fixed and the variable component of the total remuneration of certain categories of staff of credit institutions and investment firms and (ii) to specify the classes of instruments that reflect the credit quality of credit institutions and investment firms as a going concern and shall be included in the balance of instruments that shall consist a substantial portion, and in any event at least 50%, of any variable remuneration.
10. According to the Commission's proposal, the topics to be covered by the abovementioned draft regulatory technical standards to be elaborated by EBA are identical to the ones already covered by the CEBS

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<sup>6</sup> [http://www.esma.europa.eu/cebs/media/Publications/Standards%20and%20Guidelines/2011/EBA-BS-2011-116-final-\(EBA-Guidelines-on-Internal-Governance\)-\(2\)\\_1.pdf](http://www.esma.europa.eu/cebs/media/Publications/Standards%20and%20Guidelines/2011/EBA-BS-2011-116-final-(EBA-Guidelines-on-Internal-Governance)-(2)_1.pdf)

<sup>7</sup> i.e. the CEBS High Level Principles on Remuneration published in April 2009 (available at: <http://www.esma.europa.eu/getdoc/34beb2e0-bdff-4b8e-979a-5115a482a7ba/High-level-principles-for-remuneration-policies.aspx>) and the CEBS High Level Principles on Risk Management published in February 2010 (available at: <http://www.esma.europa.eu/documents/Publications/Standards---Guidelines/2010/Risk-management/HighLevelprinciplesonriskmanagement.aspx>).

Guidelines, in compliance with the requirements of Article 22(4)(a) and (b) of the CRD.<sup>8</sup> There is no equivalent empowerment for ESMA to develop draft regulatory technical standards on remuneration under the AIFMD.

11. Finally, ESMA is also working to develop guidelines on remuneration complementary to the CEBS Guidelines and focused on remuneration policies of investment firms from an investor protection point of view (“MiFID remuneration guidelines”). These MiFID remuneration guidelines, for which a separate consultation paper will be published at the end of Q3 2012 by ESMA, will be based on the MiFID requirements for conflicts of interests and best interests of the client.
12. Given the broad alignment between the provisions of Annex V of the CRD and Annex II of the AIFMD and the need to ensure cooperation with EBA, ESMA sees merit in developing the present Guidelines on the basis of the structure used in the CEBS Guidelines, with due adaptations for the specificities of the asset management sector as compared to the banking sector, on one side, and the differences between the text of the CRD and AIFMD, on the other. Indeed, the specificity of the asset management sector (where assets are managed on behalf of clients/investors) has to be taken into account. In the banking universe, remuneration policies are predominantly directed to address alignment of interests between market operators and their bank employer for financial stability reasons (i.e. to avoid excessive risk taking which could threaten the bank and, subsequently, the financial system). In the asset management universe, remuneration policies should principally address alignment of interests between clients/investors (and so the funds) and portfolio managers who make investment decisions on behalf of the funds. Indeed, in the asset management universe, excessive risk taking may be damaging for the AIF’s investors before there is any impact on the AIFM itself.

**Q1: Do you agree with the approach suggested above for developing the present Guidelines? If not, please state the reasons for your answer and also suggest an alternative approach.**

### III. Structure of the Guidelines

13. Annex II of the AIFMD sets out the remuneration requirements applicable to AIFMs which are divisible into two parts: governance and risk alignment. A third set of remuneration requirements aimed at strengthening transparency is set out in Article 22(2)(e) and (f) of the AIFMD and in Box 107 of the AIFMD advice.<sup>9</sup> Furthermore, transparency requirements are also included in Section III (Disclosure)

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<sup>8</sup> Article 22(4)(a) and (b) of the CRD provide that “The Committee of European Banking Supervisors shall, *inter alia*, ensure the existence of guidelines to: (a) set specific criteria to determine the appropriate ratios between the fixed and the variable component of the total remuneration within the meaning of point 23(l) of Annex V; (b) specify instruments that can be eligible as instruments within the meaning of point 23(o)(ii) of Annex V that adequately reflect the credit quality of credit institutions within the meaning of point 23(o) of that Annex”.

<sup>9</sup> Par. 25 of the explanatory text under Box 107 of the AIFMD advice mentioned the following in relation with this disclosure: “Further context may be provided by disclosure of the total variable remuneration funded by the AIF through payment by it of performance fees or carried interest, as the case may be. ESMA believes that in addition of remuneration disclosure, it may be appropriate for AIFM to provide information relating to the financial and non-financial criteria of the remuneration policies and practices for relevant categories of staff to enable investors to assess incentives created. In this context, guidance may be provided by ESMA when developing guidelines on remuneration policies as provided by Article 13(2). In addition, the Directive requires disclosure of the aggregate amount of remuneration broken down by senior management and members of staff of the AIFM whose actions have a material impact on the risk profile of the AIF. ESMA suggests that account should be taken of the work undertaken as part of the EBA’s guidelines in relation to the identification and categories of ‘staff whose actions have a material impact on the risk profile’ to ensure consistency in approach, and proportionality. However, ESMA believes that additional tailoring would be required to reflect the specifics of the asset management industry in line with the flexibility needed for the diverse AIF population, an approach already applied in relation to Article 22(4), 23 (6) and elsewhere in the Directive”.

of the Recommendation that ESMA has to take into account when drafting the AIFMD Guidelines. Proportionality, as explained further in these Guidelines (Section V below), is relevant for all three parts.

14. In order to comply with the AIFMD remuneration policies and practices, AIFMs will, in many cases, have to apply requirements included in the AIFMD on an AIFM-wide basis. This is particularly true for those principles regarding governance and transparency. Indeed, the governance requirements are by nature directed to the AIFM as a whole and, in order to apply the transparency requirements on an AIFM-wide basis, AIFMs will need to disclose general information on their overall remuneration policies and practices under Article 22(2)(e) and (f) of the AIFMD.
15. In addition to the governance and transparency requirements, an AIFM-wide application is further required only for some of the principles that fall under the "risk alignment" part. For the other principles in this part, AIFMs must identify the staff members to whom the specific requirements will apply. Both Article 13 and Annex II of the AIFMD contain a reference to the categories of staff "whose professional activities have a material impact on the risk profile" of the AIFMs or of the AIFs they manage (hereafter the "Identified Staff").
16. Therefore, the part on risk alignment is broken down into two types of requirement:
  - the general requirements, that should apply to AIFMs and their staff as a whole (i.e. Principles under par. 1(a), (b) and (p)<sup>10</sup> of Annex II, and 1(i), (k) and (q)<sup>11</sup> of Annex II of the AIFMD that ESMA considers as essential correlates of (a), (b) and (p); these requirements are discussed in Section IX (General requirements on risk alignment) of these Guidelines);
  - the specific requirements, that AIFMs have to apply only to the individual remuneration packages of the Identified Staff<sup>12</sup> (these requirements are treated in Section X (Specific requirements on risk alignment) of these Guidelines).
17. In order to comply with the general requirements on risk alignment, AIFMs may always consider an AIFM-wide application (or, at least, a "broader-than-strictly-necessary" application) of all or some of the specific requirements. Annex II to these Guidelines indicates the specific requirements for which this voluntary AIFM-wide application is strongly recommended.

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<sup>10</sup> "(a) the remuneration policy is consistent with and promotes sound and effective risk management and does not encourage risk-taking which is inconsistent with the risk profiles, rules or instruments of incorporation of the AIFs they manage; (b) the remuneration policy is in line with the business strategy, objectives, values and interests of the AIFM and the AIFs it manages or the investors of such AIFs, and includes measures to avoid conflicts of interest; [...] (p) the pension policy is in line with the business strategy, objectives, values and long-term interests of the AIFM and the AIFs it manages. If the employee leaves the AIFM before retirement, discretionary pension benefits shall be held by the AIFM for a period of 5 years in the form of instruments defined in point (m). In the case of an employee reaching retirement, discretionary pension benefits shall be paid to the employee in the form of instruments defined in point (m), subject to a 5 year retention period;"

<sup>11</sup> "(i) guaranteed variable remuneration is exceptional, occurs only in the context of hiring new staff and is limited to the first year; [...] (k) payments related to the early termination of a contract reflect performance achieved over time and are designed in a way that does not reward failure; [...] (q) staff are required to undertake not to use personal hedging strategies or remuneration- and liability-related insurance to undermine the risk alignment effects embedded in their remuneration arrangements;"

<sup>12</sup> In Annex II, a list of the general and specific risk alignment principles inter alia is included.

#### **IV. Scope of the Guidelines**

18. Paragraph (2) of Annex II of the AIFMD provides for the scope of application of the remuneration principles and reads as follows:

*The principles set out in paragraph 1 shall apply to remuneration of any type paid by the AIFM, to any amount paid directly by the AIF itself, including carried interest, and to any transfer of units or shares of the AIF, made to the benefits of those categories of staff, including senior management, risk takers, control functions and any employee receiving total remuneration that takes them into the same remuneration bracket as senior management and risk takers, whose professional activities have a material impact on their risk profile or the risk profiles of the AIF that they manage.*

##### **IV.I. Which remuneration?**

19. For the purposes of the Guidelines, remuneration consists of all forms of payment or benefit paid by the AIFM, of any amount paid by the AIF itself, including carried interest, and of any transfer of units or shares of the AIF, in exchange for professional services rendered by the AIFM staff. All remuneration can be divided into either fixed remuneration (payments or benefits without consideration of any performance criteria) or variable remuneration (additional payments or benefits depending on performance or, in certain cases, other contractual criteria). Both components of remuneration (fixed and variable) may include monetary payments or benefits (such as cash, shares, options, cancellation of loans to staff members at dismissal, pension contributions, remuneration by AIFs e.g. through carried interest models, subject to the specificities set out in paragraph 20 below) or non (directly) monetary benefits (such as discounts, fringe benefits or special allowances for car, mobile phone etc.). Ancillary payments or benefits that are part of a general, non-discretionary, AIFM-wide policy and pose no incentive effects in terms of risk assumption can be excluded from this definition of remuneration for the purposes of the AIFMD-specific risk alignment remuneration requirements.
20. According to Article 4(1)(d) of the AIFMD, “carried interest” shall be understood as a share in the profits of the AIF accrued to the AIFM as compensation for the management of the AIF, but it shall not include any share in the profits of the AIF accrued to the AIFM as a return on any investment by the AIFM into the AIF. Therefore, ESMA considers that any payment made directly by the AIF to the benefit of those categories of staff mentioned under Annex II, paragraph (2) of the AIFMD which consists of a pro-rata return on any investment made by those staff members into the AIF does not represent a remuneration within the meaning of the AIFMD and, therefore, is not subject to any of the remuneration requirements set out in the AIFMD and these Guidelines. Indeed, this is consistent with the fact that a key purpose of the remuneration requirements is to align the interests of the AIFM’s staff members with those of the AIFM and the AIFs it manages and that in this case the alignment of the interests of the staff members with those of the AIFM and the AIFs it manages is facilitated by the fact that these staff members invest into the AIFs and, therefore, no additional safeguards seem necessary to ensure the alignment of interests. However, ESMA considers that in order for a return on an investment made by the staff member into the AIF to be considered exempt from the remuneration provisions, the investment needs to consist in an actual disbursement made by the staff member (i.e. loans granted by the AIFM to the staff member in order to allow a co-investment into the AIF should not be considered as an investment for the purposes of the exemption if the loan has not been reimbursed by the staff member by the time the return is paid).
21. AIFMs should be able to clearly identify and make the relevant distinctions in the treatment of:

- (i) the portion of the payment made by the AIF to the above-mentioned categories of staff members which exceeds the pro-rata investment return for the investment made by the relevant staff members and represents carried interest i.e. a share in the profits of the AIF accrued to the staff members as compensation for the management of the AIF (which is subject to the remuneration requirements of the AIFMD and these Guidelines<sup>13</sup>); and
- (ii) the portion of the payment made by the AIF to the same categories of staff members which represents a share in the profits of the AIF accrued to the staff members as a pro-rata return on any investment by the staff members into the AIF (which is not subject to the remuneration requirements of the AIFMD and these Guidelines).
22. A "retention bonus" is a form of variable remuneration and can only be allowed to the extent that risk alignment requirements are properly applied.
23. According to Annex II, paragraph (1)(r) of the AIFMD, AIFMs should ensure that variable remuneration is not paid through vehicles or methods which aim at artificially evading the requirements of the AIFMD. The governing body of each AIFM has the primary responsibility for ensuring that the ultimate goal of having sound and prudent remuneration policies and structures is not improperly circumvented. Circumstances and situations that may pose a greater risk from this perspective may be: the conversion of parts of the variable remuneration into benefits that normally pose no incentive effect in respect of risk positions; the use of tied agents or other persons not considered "employees" from a legal point of view; transactions between the AIFMs and third parties in which the risk takers have material interests; the setting up of structures or methods through which remuneration is paid in the form of dividends or similar pay outs (e.g. improper use of performance fees) and non-monetary material benefits awarded as incentive mechanisms linked to the performance.
24. The so called 'carried interest vehicles' are typically limited partnerships (or other kinds of vehicle) being themselves limited partners in the AIF together with third party investors and are used by senior executives of an AIF either to regulate the executives' entitlements to carried interest among themselves as a consequence of a modest capital contribution or to commit capital which is more than merely nominal – i.e. co-investments – in transactions along with the AIF. Payments made by the AIF to the relevant staff members through these carried interest vehicles should be subject to the same treatment described above in paragraphs 20 and 21. Therefore, if such payments fall under the definition of carried interest, they should be subject to the remuneration requirements of the AIFMD and these Guidelines, whereas if they represent a pro-rata return on any investment by the staff members (through the carried interest vehicle) into the AIF, they should not be subject to such requirements.
25. Notwithstanding the above, in line with the principle expressed in Section 1.5 of the Recommendation, the AIFMD remuneration principles do not apply to fees and commissions received by intermediaries and external service providers in case of outsourced activities.

**Q2: Do you agree with the above considerations on the scope of the Guidelines? In particular, do you agree with the clarifications on what should be considered as a remuneration falling into scope and what should be considered an ancillary payment or benefit falling outside the scope of the Guidelines? If not, please state the reasons for your answer and also suggest an alternative approach.**

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<sup>13</sup> See however Section X.V (Compliance of certain remuneration structures with the requirements on risk alignment of variable remuneration, award and pay-out process) for some specific provisions which may apply to certain remuneration structures.

**Q3: Do you see any benefit in setting a quantitative or qualitative threshold at which the portion of the payment made by the AIF exceeding the pro-rata investment return for the investment made by the relevant staff members is transformed into carried interest? If yes, please make suggestions on the threshold to be used.**

**Q4: 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?**

**Q5: 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)?**

**Q6: 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 categories of staff of the AIFM and, therefore, fall under the scope of the AIFMD remuneration rules (and, therefore, of these Guidelines)?**

#### **IV.II. Which entities and which staff to be identified?**

26. The AIFMD remuneration requirements apply to all AIFMs which are within the scope of the AIFMD. These are:
- (a) EU AIFMs which manage one or more AIFs irrespective of whether such AIFs are EU AIFs or non-EU AIFs;
  - (b) non-EU AIFMs which manage one or more EU AIFs; and
  - (c) non-EU AIFMs which market one or more AIFs in the Union irrespective of whether such AIFs are EU AIFs or non-EU AIFs.

However, as long as the national regimes referred to in Article 42 of the AIFMD continue to be in force, non-EU AIFMs which market to professional investors units or shares of AIFs in Member States without a passport will not be subject to the AIFMD remuneration requirements set out in Article 13 and Annex II of the AIFMD and only the rules on remuneration disclosure set out in Article 22(2)(e) and (f) of the AIFMD and in Box 107 of the AIFMD advice will apply to them. Indeed, Article 42(1)(a) of the AIFMD does not mention Article 13 of the AIFMD within the Articles of the AIFMD with which these non-EU AIFMs shall comply. ESMA notes that even these non-EU AIFMs will be subject to the full set of remuneration requirements (i.e. those of Article 13 and Annex II of the AIFMD and of the present Guidelines) as from the date when the national regimes referred to in Article 42 of the AIFMD will be terminated and the passport regime provided for in Articles 37 to 41 of the AIFMD will become the sole and mandatory regime applicable in all Member States, as determined by the Commission's delegated act referred to in Article 68(6) of the AIFMD.

Moreover, ESMA notes that non-EU AIFMs which market to professional investors units or shares of AIFs in Member States without a passport will be subject to the national regimes applicable in those Member States. Therefore, it may be that the national regime applicable in one Member State sets out remuneration requirements for non-EU AIFMs marketing AIFs in this Member State that are equivalent to the ones set out in the AIFMD and in the present Guidelines.

27. AIFMs which can benefit from the exclusions and exemptions foreseen in Articles 2 or 3 of the AIFMD are not AIFMs subject to that Directive and thus are not currently covered by the AIFMD.
28. In accordance with Article 5 of the AIFMD, for the purposes of the Guidelines, the AIFMs to which the remuneration principles apply shall be either an external manager or, where the legal form of the AIF permits internal management and where the AIF's governing body chooses not to appoint an external AIFM, the AIF itself. AIFs which are not internally managed and have appointed an external AIFM are not subject to the remuneration principles established in the AIFMD as well as the Guidelines. However, the remuneration principles set out in the Recommendation are relevant to those AIFs, as well as the AIFMs which can benefit from the exclusions and exemptions foreseen in Articles 2 or 3 of the AIFMD, to the extent that they fall within the definition of 'financial undertaking' provided in paragraph 2.1 of the Recommendation.<sup>14</sup> See Annex IV of the Guidelines for a correlation table highlighting those principles of the Recommendation which are reflected in the AIFMD.
29. AIFMs providing the services of individual portfolio management and non-core services mentioned under Article 6(4) of the AIFMD are subject to Articles 13 (Organisational requirements) and 19 (Conduct of business obligations when providing investment services to clients) of MiFID for the provision of these services. Therefore, the aforementioned AIFMs will also be subject to the principles relating to Articles 13 and 19 of MiFID in the separate guidelines focused on remuneration policies of MiFID investment firms from an investor protection point of view on which ESMA will consult at the end of Q3 2012.<sup>15</sup> AIFMs which do not provide the services of individual portfolio management and non-core services mentioned under Article 6(4) of the AIFMD are only subject to the principles set out in these Guidelines.<sup>16</sup> ESMA will seek to ensure an alignment of the principles in these Guidelines with the relevant principles of the MiFID remuneration guidelines; this is likely to be particularly appropriate for AIFMs that perform marketing activities according to paragraph 2(b) of Annex II of the AIFMD.
30. It is primarily the responsibility of AIFMs to identify the members of staff whose professional activities have a material impact on the AIFM's risk profile or the risk profiles of the AIF that it manages and to whom the specific requirements of these Guidelines will apply, according to these Guidelines and any other guidance or criteria provided by competent authorities. AIFMs should be able to demonstrate to competent authorities how they have assessed and selected Identified Staff.
31. ESMA considers that the following categories of staff, unless it is demonstrated that they have no material impact on the AIFM's risk profile, must be included as the Identified Staff:

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<sup>14</sup> Paragraph 2.1 of the Recommendation reads as follows: "*Financial undertaking*" means any undertaking, irrespective of its legal status, whether regulated or not, which performs any of the following activities on a professional basis : (a) It accepts deposits and other repayable funds; (b) It provides investment services and/or performs investment activities within the meaning of Directive 2004/39/EC; (c) It is involved in insurance or reinsurance business; (d) It performs business activities similar to those set out in points (a), (b) or (c). A financial undertaking includes, but is not limited to, credit institutions, investment firms, insurance and reinsurance undertakings, pension funds and collective investment schemes".

<sup>15</sup> See paragraph 11 above.

<sup>16</sup> However, AIFMs being part of a group should refer to the guidance in Section VI (AIFMs being part of a group) below.

- Members of the governing body of the AIFM, depending on the local legal structure of the AIFM, such as: directors, the chief executive officer and partners. For the purposes of these Guidelines and in line with the AIFMD advice<sup>17</sup>, the governing body of an AIFM (also referred to as the ‘management body’ throughout these Guidelines) refers to the component of the governance structure with ultimate jurisdiction and power of direction. In corporate structures this is usually the board of directors but in other structures may be an equivalent body. The governing body is distinct from senior management, whom it directs, but some or all members of senior management may comprise the governing body which may also contain non-executive members.
- Senior management, i.e. the person or persons who effectively conduct the business of an AIFM in accordance with Article 8(1)(c) of the AIFMD.
- Control functions which include staff (other than senior management) responsible for risk management, compliance, internal audit and similar functions (e.g. the CFO to the extent that he/she is responsible for the preparation of the financial statements) within an AIFM.
- Staff responsible for heading the portfolio management, administration, marketing, human resources. These staff members will have remuneration requirements that are specific to their category of staff.
- Other risk takers such as: staff members, whose professional activities – either individually or collectively, as members of a group (e.g. a unit or part of a department) – can exert material influence on the AIFM’s risk profile or on an AIF it manages, including persons capable of entering into contracts/positions and taking decisions that materially affect the risk positions of the AIFM or of an AIF it manages. Such staff can include, for instance, sales persons, individual traders and specific trading desks.

When assessing the materiality of influence on an AIFM’s risk profile or on an AIF it manages, AIFMs must define what constitutes materiality within the context of their AIFMs and the AIFs they manage. Criteria that AIFMs may follow to check whether they are capturing the correct staff members include an assessment of staff members or a group, whose activities could potentially have a significant impact on the AIFM’s results and/or balance sheet and/or on the performance of the AIFs they manage.

An analysis of job functions and responsibilities at the AIFM should be undertaken for a proper assessment of those roles that could materially affect the risk profile of the AIFM or of the AIFs it manages. There could be cases where a staff member does not earn a high amount of total remuneration but could have a material impact on the risk profile of the AIFM or of the AIFs it manages given the individual’s particular job function or responsibilities.

32. Additionally, if they have a material impact on the risk profile of the AIFM or of the AIFs it manages, other employees/persons, whose total remuneration takes them into the same remuneration bracket as senior managers and risk takers must be included as the Identified Staff, such as: high-earning staff members who are not already in the above categories and who have a material impact on the risk profile of the AIFM or of the AIFs it manages. ‘Remuneration bracket’ refers to the range of the total re-

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<sup>17</sup> See paragraph 11 of the explanatory text under Box 25 of the AIFMD advice.

muneration of each of the staff members in the senior manager and risk taker categories – from the highest paid to the lowest paid in these categories. Any staff member, whose total remuneration would fall within that range, should be assessed. It is likely that in some cases, those staff members whose remuneration is as high as or higher than senior executives and risk takers will be exerting material influence in some way on the risk profile of the AIFM or of the AIFs it manages. In other AIFMs, this may not be the case.

33. The examples mentioned in paragraphs 31 and 32 are not conclusive. The greater the assumption that there may be risk-takers in certain business units, the more in-depth the risk analysis must be to assess whether a person is to be considered a material risk-taker or not.

**Q7: Do you agree with the categories of staff identified above which should be subject to the remuneration principles set out in the Guidelines? If not, please state the reasons for your answer and also suggest an alternative approach.**

#### **IV.III. Timing of entry into force of these Guidelines**

34. These Guidelines shall enter into force on 22 July 2013 (i.e. the deadline for the transposition of the AIFMD in the Member States).

**Q8: Please provide qualitative and quantitative data on the costs and benefits that the rules proposed in this Section IV (Scope of the Guidelines) would imply.**

### **V. Proportionality principle**

#### **V.I. Proportionality in general**

35. The proportionality principle aims to consistently match the remuneration policies and practices with the individual risk profile, risk appetite and the strategy of the AIFM and of the AIFs it manages, so that the objectives of the principles are more effectively achieved. The proportionality principle applies to the general as well as to the specific remuneration requirements of the AIFMD. The effect of the proportionality principle is that not all AIFMs have to give substance to the remuneration requirements in the same way and to the same extent. Proportionality operates both ways: some AIFMs will need to apply more sophisticated policies or practices in fulfilling the requirements; other AIFMs can meet the requirements of the AIFMD in a simpler or less burdensome way.
36. Notwithstanding the fact that the remuneration principles in Annex II of the AIFMD are applicable to all AIFMs, the proportionality principle may lead to a tailored application of some requirements if this is reconcilable with the risk profile, risk appetite and the strategy of the AIFM and the AIFs it manages. These Guidelines set the limits on which requirements can potentially be applied in a tailored manner insofar as such tailoring should not be understood as allowing an AIFM to disregard any of the requirements of Annex II of the AIFMD. If AIFMs deem a tailored application for these requirements appropriate for their type of AIFM or Identified Staff, they should be able to explain the rationale for every single requirement that is applied in a tailored manner. Tailored application is never automatically triggered on the basis of these Guidelines alone.
37. The following are examples of requirements that may be applied in a tailored manner:

- the requirements on the pay-out process, discussed under Section X.IV. (Payout process). This kind of tailored application can be based on either "proportionality between AIFMs" (as explained in Section V.II. (Proportionality with respect to the different characteristics of AIFMs) below) or "proportionality between categories of staff" (as explained in Section V.III. (Proportionality with respect of the different categories of staff) below). This means that some AIFMs, either for the total of their Identified Staff or for some categories within their Identified Staff, can tailor the requirements on
  - variable remuneration in instruments;
  - retention;
  - deferral;
  - ex post incorporation of risk for variable remuneration;
- the requirements relating to the remuneration of the management and supervisory function, and to annual review of the implementation of the remuneration policy, as discussed in Sections VIII.I.B and D of these Guidelines;
- the requirement to have a fully flexible policy on variable remuneration, as discussed in Section X.I. of these Guidelines.

38. 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 its staff.

39. Whilst each AIFM has the duty to properly assess its own risk profile, risk appetite and other characteristics (taking into account the AIFs that it manages) in the design and implementation of the remuneration policy, competent authorities should ensure that the application of the proportionality approach by AIFMs does not prejudice the achievement of the objectives of the remuneration principles and the need to preserve a level playing field among different AIFMs and jurisdictions. From this perspective, competent authorities should review the ways AIFMs actually implement the proportionality principle, thereby taking into account the achievement of regulatory objectives.

40. With specific regard to the remuneration requirements, ESMA recognises that a distinction should be made between two dimensions of proportionality: proportionality among different types of AIFMs and proportionality among an AIFM's different categories of staff whose professional activities have a material impact on its risk profile (Identified Staff). The first form of proportionality is relevant for both the general and specific requirements on remuneration. The latter form of proportionality is only relevant for the specific requirements on risk alignment.

## **V.II. Proportionality with respect to the different characteristics of AIFMs**

41. The different risk profiles and characteristics among AIFMs (e.g. complex AIFMs and/or AIFMs carrying out cross-border activities and/or AIFMs managing complex AIFs on the one hand and less complex AIFMs and/or local AIFMs and/or AIFMs managing less complex AIFs on the other hand) justify a proportionate implementation of the remuneration principles. According to the AIFMD, criteria ad-

addressing the application of the proportionality principle among AIFMs are their size or the size of the AIFs they manage, their internal organization and the nature, scope and complexity of their activities.

- a) Size: the size criterion can relate to the value of the AIFM capital and to the value of the assets under management (including any assets acquired through the use of leverage) of the AIFs that the AIFM manages; liabilities or risks exposure of the AIFM and of the AIFs that it manages; as well as the number of staff, branches or subsidiaries of an AIFM. The size of an AIFM and of the AIFs it manages is not to be considered in isolation when applying the proportionality principle. An AIFM might be considered “small” in terms of number of staff or subsidiaries, but be engaged in a high level of risk taking. Strict adherence to the specific requirements shall also be required where the aggregate set of AIFs that an AIFM manages - each of them considered “small” - becomes a potentially systemically important (e.g. in terms of total assets under management).

As already mentioned, the general obligation to have sound remuneration policies and practices applies to all AIFMs, regardless of their size or systemic importance.

- b) Internal organization: this can relate to the legal structure of the AIFM or the AIFs it manages, the complexity of the internal governance structure of the AIFM or the listing on regulated markets of the AIFM or the AIFs it manages.

ESMA considers that this criterion should be assessed having regard to the entire organisation of the AIFM including all the AIFs it manages, meaning that for instance the listing of one AIF should not by itself be sufficient for considering the AIFM as having a complex internal organisation.

- c) Nature, scope and complexity of the activities: in considering this criterion, the underlying risk profiles of the business activities that are carried out, must be taken into account. Relevant elements can be: the type of authorized activity (investment management functions listed in point 1 of Annex I of the AIFMD only or also the additional functions listed in point 2 of Annex I of the AIFMD and/or the additional services listed in Article 6(4) of the AIFMD); the type of investment policies and strategies of the AIFs the AIFM manages; the national or cross-border nature of the business activities (AIFM managing and/or marketing AIFs in one or more EU or non-EU jurisdictions); the additional management of UCITS subject to authorisation under the UCITS Directive.

42. In assessing what is proportionate, the focus should be on the combination of all the mentioned criteria (size, internal organization and the nature, scope and complexity of the activities) and, as this is not an exhaustive list, of any other relevant criteria. For instance, an AIFM’s business may well be small-scale but could still include complex risk-profiles because of the nature of its activities or the complexity of the managed AIFs. Also, an AIFM may have a small size, but manage big AIFs or a series of small AIFs leading to a large amount of assets under management and/or complex investment management activities.

**Q9: 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.**

### **V.III. Proportionality with respect of the different categories of staff**

43. The proportionality principle also operates within an AIFM for some of the specific requirements. The categories of staff whose professional activities have a material impact on their risk profile should comply with specific requirements which aim to manage the risks their activities entail. The same criteria of size, internal organisation and the nature, scope and complexity of the activities apply. In addition to the elements mentioned above, the following elements could be taken into account:

- The size of the obligations into which a risk taker may enter on behalf of the AIFM;
- The size of the group of persons, who have only collectively (see supra the fifth bullet point in paragraph 31) a material impact on the risk profile of the AIFM;
- The structure of the remuneration of the staff members (e.g. fixed salary with a variable remuneration vs. profit sharing arrangements).

**Q10: Do you agree with the clarifications proposed above for the application of the proportionality principle to the AIFM's categories of staff? If not, please state the reasons for your answer and also suggest an alternative approach.**

**Q11: Please provide qualitative and quantitative data on the costs and benefits that the rules proposed in this Section V (Proportionality principle) would imply.**

## **VI. AIFMs being part of a group**

44. ESMA considers that there should be no exception to the application to any of the AIFMs which are subsidiaries of a credit institution of the sector-specific remuneration principles set out in the AIFMD and in the present Guidelines.

45. ESMA recognises that the CRD provides for remuneration principles which apply not only to the credit institutions which are within the scope of the CRD, but also to entities which are part of a banking group. Indeed, Annex V, Section 11, point 23, last paragraph of the CRD provides that the remuneration principles set out by the CRD shall be applied by credit institutions at group, parent company and subsidiary levels, including those established in offshore financial centres.

46. However, ESMA considers that the application of the remuneration principles set out in the AIFMD and in the present Guidelines by AIFMs which belong to banking (or insurance or financial) groups is equivalent to the respect by such a group of the principles regarding remuneration applicable to the group. The application to AIFMs which are subsidiaries of a credit institution of the remuneration requirements of the AIFMD and these Guidelines should ensure that risk-taking that exceeds the level of tolerated risk of the credit institution is avoided not only at the level of the parent credit institution to which the CRD principles apply, but also at a group level. In particular, this may be facilitated by the principle in paragraph 1(a) of Annex II of the AIFMD according to which an AIFM shall ensure that its *« remuneration policy is consistent with and promotes sound and effective risk management and does not encourage risk-taking which is inconsistent with the risk profiles, rules or instruments of incorporation of the AIFs they manage »*.

47. Furthermore, the CEBS Guidelines explicitly recognise that: *“Where groups carry on activities that fall outside the scope of the CRD, consideration should be given to any applicable sectoral remuneration requirements that might apply to determine how these are to be reconciled with the group-wide remuneration policy. For example, where a group contains sectors regulated under different direc-*

*tives (e.g. insurance and banking), appropriate requirements should be taken into account when applying remuneration policies and practices for each type of sector. The group parent institution should oversee the remuneration policies, practices and procedures for each type of sector within its group and should ensure that each sectoral institution complies with its particular set of regulation”.*<sup>18</sup>

**Q12: Do you agree that there is a need for consistency in the potential application of different requirements for AIFMs which belong to a group subject to other principles?**

**Q13: Do you agree that the proposed alignment of the CRD and AIFMD remuneration provisions will reduce the existence of any conflicting remuneration requirements at group level for AIFMs whose parent companies are credit institutions subject to the CRD? If not, please state the reasons for your answer and provide quantitative details on any additional costs implied by the proposed approach.**

**Q14: Please provide qualitative and quantitative data on the costs and benefits that the rules proposed in this Section VI (AIFMs being part of a group) would imply.**

## **VII. Financial situation of the AIFM (Annex II, paragraph 1(o) of the AIFMD)**

48. The AIFMD contains several requirements aimed at ensuring the sound financial situation of the AIFM. Those requirements relate to the following:

- the minimum initial capital of the AIFM (Article 9(1) and (2) of the AIFMD);
- the additional amount of own funds that AIFMs shall provide when the value of the portfolios of AIFs managed by the AIFM exceeds EUR 250 million (Article 9(3) of the AIFMD);
- the own funds equivalent to one quarter of their preceding year's fixed overheads that AIFMs shall hold, notwithstanding the requirements of Article 9(3) (Article 9(5) of the AIFMD); and
- the additional own funds or the professional indemnity insurance that AIFMs shall hold to cover professional liability risks resulting from their activities pursuant to the AIFMD (Article 9(7) of the AIFMD).

49. In order to guarantee ongoing compliance with these requirements, AIFMs should ensure that a prudent balance between sound financial situation and the award, pay out or vesting of variable remuneration is maintained.

50. The award, pay-out or vesting of variable remuneration can be detrimental for the AIFM when the effect would be that its financial situation would no longer be sound. Therefore, the AIFM should ensure that its financial situation will not be adversely affected by:

- 1) the overall pool of variable remuneration that will be awarded for that year; and

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<sup>18</sup> Par. 30 of the CEBS Guidelines.

2) the amount of variable remuneration that will be paid or vested in that year.

51. The fact that an AIFM is or risks becoming unable to maintain a sound financial situation should be a trigger for, inter alia: a) reducing the variable remuneration pool for that year and b) the application of performance adjustment measures (i.e. malus or clawback) in that financial year<sup>19</sup>. Instead of awarding, paying out the variable remuneration or allowing it to vest, the net profit of the AIFM for that year and potentially for subsequent years should be used to strengthen its financial situation. The AIFM should not compensate for this at a later date by awarding, paying out or vesting a greater amount of variable remuneration than it otherwise would have done, unless it becomes evident in subsequent years that the AIFM's financial results justify such actions.

**Q15: Do you agree with the above principle aimed at preserving the soundness of the AIFM's financial situation? If not, please state the reasons for your answer and also suggest an alternative approach.**

**Q16: Please provide qualitative and quantitative data on the costs and benefits that the rules proposed in this Section VII (Financial situation of the AIFM) would imply.**

## VIII. Governance of remuneration

### VIII.I. Management body (Annex II, paragraph (1)(b), (c) and (d) of the AIFMD)

52. Annex II, paragraph (1) of the AIFMD provides for the following principles related to the role of the management body of an AIFM in relation with the remuneration policy:

*(b) the remuneration policy [...] includes measures to avoid conflicts of interest;*

*(c) the management body of the AIFM, in its supervisory function, adopts and periodically reviews the general principles of the remuneration policy and is responsible for its implementation;*

*(d) the implementation of the remuneration policy is, at least annually, subject to central and independent internal review for compliance with policies and procedures for remuneration adopted by the management body in its supervisory function;*

53. ESMA proposes to set out the guidelines below in relation with the abovementioned AIFMD Level 1 provisions.

#### A. Design, approval and oversight of the remuneration policy

54. For the purposes of the present Guidelines, the management body of the AIFM (also referred to as the 'governing body') shall be understood as the component of the governance structure with ultimate jurisdiction and power of direction. In corporate structures this is usually the board of directors but in other structures may be an equivalent body. The management body is distinct from senior management, whom it directs, but some or all members of senior management may comprise the management body which may also contain non-executive members.

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<sup>19</sup> See also Section X.IV.C. (Ex post incorporation of risk for variable remuneration) below.

55. To properly perform its tasks on remuneration stated below, the management body in its supervisory function (the ‘supervisory function’), if any, should include non-executive members that collectively have sufficient knowledge of remuneration policies and structures. For the purposes of these Guidelines, ‘supervisory function’ should have the same meaning provided under the definitions in Section IV (General operating conditions) of the AIFMD advice, i.e. the relevant persons or body or bodies responsible for the supervision of the AIFM’s senior management and for the assessment and periodical review of the adequacy and effectiveness of the risk management process and of the policies, arrangements and procedures put in place to comply with the obligations under the AIFMD. For those AIFMs that given their size, internal organisation and the nature, scope and complexity of their activities do not have a separate supervisory function, the tasks on remuneration that according to the paragraphs below in this sub-section A and in following sub-sections B, C and D should be performed by the supervisory function, should be performed by the person or persons in charge of the management body and the references to the supervisory function should be read as references to the person or persons in charge of the management body.
56. An AIFM’s remuneration policy should encourage the alignment of the risks taken by its staff with those of the AIFs it manages, the investors of such AIFs and the AIFM itself; in particular, the remuneration policy should duly take into consideration the need to align risks in terms of risk management and exposure to risk.
57. The supervisory function is responsible for approving and maintaining the remuneration policy of the AIFM, and overseeing its implementation. The remuneration policy should not primarily be controlled by executive members of the *supervisory function*. The supervisory function should also approve any subsequent material exemptions or changes to the remuneration policy and carefully consider and monitor their effects. Procedures to determine remuneration should be clear, well-documented and internally transparent. For example, proper documentation should be provided on the decision-making process, the determination of the Identified Staff, the measures used to avoid conflicts of interest, the risk-adjustment mechanisms used etc.
58. In the design and oversight of the AIFM’s remuneration policies, the supervisory function should take into account the inputs provided by all competent corporate functions (i.e. risk management, compliance, human resources, strategic planning, etc.). As a result, those functions should be properly involved in the design of the remuneration policy of the AIFM.
59. Ultimately, the supervisory function should ensure that an AIFM’s remuneration policy is consistent with and promotes sound and effective risk management. The remuneration policy should:
- be in line with the business strategy, objectives, values and interests of the AIFM,
  - not encourage excessive risk taking as compared to the investment policy of the AIFs the AIFM manages, and
  - enable the AIFM to align the interests of the AIFs and their investors with those of the Identified Staff that manages such AIFs, and to achieve and maintain a sound financial situation.
60. The supervisory function should ensure that the AIFM’s overall corporate governance principles and structures, as well as their interactions with the remuneration system are considered within the design and implementation of an AIFM’s remuneration policies and practices (i.e. the clear distinction be-

tween operating and control functions; the skills and independence requirements of members of the management body; the role performed by internal committees, including the RemCo; the safeguards for preventing conflicts of interests; the internal reporting system and the related parties' transactions rules).

## **B. Remuneration of members of the management and supervisory function**

61. The remuneration of the members of the management body in its management function (hereafter 'management function') should be consistent with their powers, tasks, expertise and responsibilities.
62. Where appropriate considering the size of the AIFM, its internal organisation and the nature, scope and complexity of its activities, the management function should not determine its own remuneration. The supervisory function should determine and oversee the remuneration of the members of the management function. To the extent compatible with national law, the supervisory function should also specifically approve and oversee the remuneration of senior executives and staff members who receive the highest amounts of total remuneration within the AIFM.
63. For AIFMs which have a separate supervisory function, in order to properly address conflicts of interests, it may be more appropriate for members of the supervisory function to be compensated only with fixed remuneration. When incentive-based mechanisms are in place, they must be strictly tailored to the assigned monitoring and control tasks, reflecting the individual's capabilities and the achieved results. If instruments are granted, appropriate measures should be taken, such as retention periods until the end of the mandate, in order to preserve the independence of judgment of those members of the management body. For those AIFMs that given their size, internal organisation and the nature, scope and complexity of their activities do not have a separate supervisory function, the principle according to which members of the supervisory function may more appropriately be compensated only with fixed remuneration does not apply to the person or persons in charge of the management body that perform the tasks of the supervisory function.
64. The above principles are in line with and without prejudice to the general requirement established in Boxes 21 and 22, paragraph 1(c) of the AIFMD advice according to which the conflicts of interest policy of an AIFM shall include procedures to be followed and measures to be adopted in order to manage such conflicts and these procedures shall include, where necessary, "*the removal of any direct link between the remuneration of relevant persons principally engaged in one activity and the remuneration of, or revenues generated by, different relevant persons principally engaged in another activity, where a conflict of interest may arise in relation to those activities;*".

**Q17: Do you agree with the proposed split of competences between the members of the management function and those of the supervisory function? If not, please provide explanations.**

## **C. Shareholders' involvement**

65. The approval of an AIFM's remuneration policy and decisions relating to the remuneration of members of the management body, may be assigned to the meeting of the shareholders of the AIFM, depending on the AIFM's characteristics or on the national rules in the jurisdiction in which the AIFM is established. The shareholders' vote may be either consultative or binding. To this end, shareholders should be provided with adequate information in order that they can make informed decisions.

66. The supervisory function remains responsible for the proposals submitted to the meeting of the shareholders of the AIFM, as well as for the actual implementation and oversight of any changes to the remuneration policies and practices.

**Q18: Do you agree with the guidelines above on the shareholders' involvement in the remuneration of the AIFM?**

**D. Review of the implementation of the remuneration policy**

67. The supervisory function should ensure that the implementation of the remuneration policy of the AIFM will be reviewed on an annual basis at a minimum. Such central and independent reviews should assess whether the overall remuneration system:
- operates as intended (in particular, that all agreed plans/programs are being covered; that the remuneration payouts are appropriate, and that the risk profile, long-term objectives and goals of the AIFM are adequately reflected); and
  - is compliant with national and international regulations, principles and standards.
68. The relevant internal control functions (i.e. internal audit, risk management, compliance functions, etc.) as well as other key supervisory function committees (i.e. audit, risk, and nominations committees) should be closely involved in reviewing the remuneration system of the AIFM.
69. Where periodic reviews reveal that the remuneration system does not operate as intended or prescribed, the supervisory function should ensure that a timely remedial plan is put in place.
70. The periodic review of the implementation of the remuneration policies and practices may be, partially or totally, externally commissioned when appropriate according to the proportionality principle. Larger and more complex AIFMs are expected to have sufficient resources to conduct the review internally, though external consultants may complement and support the AIFM in carrying out such tasks. In line with the proportionality principle, smaller and less complex AIFMs may decide to outsource the entire review, by performing the review less frequently than annually or carrying out at least annually an internal assessment not amounting to a full independent review. In all cases, the supervisory function should remain responsible for the review of remuneration policies and practices and for ensuring that the results of the review are followed up; moreover, the relevant control functions should be closely involved in line with paragraph 68.

**VIII.II. Remuneration Committee (Annex II, paragraph (3) of the AIFMD)**

71. Annex II, paragraph (3) of the AIFMD provides for the following principles related to the necessity for certain AIFMs to set up a RemCo:

*AIFMs that are significant in terms of their size or the size of the AIFs they manage, their internal organisation and the nature, the scope and the complexity of their activities shall establish a remuneration committee. The remuneration committee shall be constituted in a way that enables it to exercise competent and independent judgment on remuneration policies and practices and the incentives created for managing risk.*

*The remuneration committee shall be responsible for the preparation of decisions regarding remuneration, including those which have implications for the risk and risk management of the AIFM or*

*the AIF concerned and which are to be taken by the management body in its supervisory function. The remuneration committee shall be chaired by a member of the management body who does not perform any executive functions in the AIFM concerned. The members of the remuneration committee shall be members of the management body who do not perform any executive functions in the AIFM concerned.*

ESMA proposes to set out the guidelines below in relation with the abovementioned AIFMD Level 1 provisions.

### **A. Setting up a remuneration committee**

72. AIFMs that are significant in terms of their size or the size of the AIFs they manage, internal organisation and the nature, scope and complexity of their activities should establish a RemCo. It follows from this principle that AIFMs which are not significant are not required to set up a RemCo. Nevertheless, also for these AIFMs it can be considered as a good practice.
73. In order to identify whether a RemCo is expected to be set up, the factors mentioned in Section V. (Proportionality principle) need to be considered. When assessing whether or not an AIFM is significant, consideration should be given to the cumulative presence of all the three factors (i.e. size, internal organisation and nature, scope and complexity of the activities). For example, an AIFM which is significant in size, but is not significant in terms of its internal organisation and/or nature, scope and complexity of its activities should not be required to set up a RemCo.
74. ESMA considers that it is not possible to provide an exhaustive list of what constitutes AIFMs that are significant in terms of their size or the size of the AIFs they manages, internal organisation and the nature, scope and complexity of their activities. However, the following are examples of AIFMs which need not establish a RemCo:
  - AIFMs for which the value of the portfolios of AIFs that they manage does not exceed EUR 250 million;
  - AIFMs which are a subsidiary of a credit institution which is obliged to set up a RemCo which performs its tasks and duties for the whole group.

**Q19: 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.**

**Q20: 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.**

**Q21: Please provide quantitative data on the costs and benefits that the proposed criteria to determine whether a RemCo has to be set up would imply.**

**Q22: 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.**

### **B. Composition**

75. In order to operate independently from senior executives, the RemCo should comprise members of the supervisory function who do not perform executive functions, at least the majority of whom qualify as independent.
76. The chairperson of the RemCo should be an independent, non-executive member.
77. An appropriate number of the members of the RemCo should have sufficient expertise and professional experience concerning risk management and control activities, namely with regard to the mechanism for aligning the remuneration structure to AIFMs' risk and capital profiles.
78. The RemCo should be encouraged to seek expert advice internally (e.g. from risk management) and externally. The chief executive officer should not take part in the RemCo meetings which discuss and decide on his/her remuneration.

**Q23: Do you agree with the principles relating to the composition of the RemCo? Please provide quantitative data on the costs and benefits that the proposed principles on the composition of the RemCo would imply.**

**Q24: Do you see any need for setting out additional rules on the composition of the RemCo?**

### **C. Role**

79. The RemCo should:

- be responsible for the preparation of recommendations to the supervisory function, regarding the remuneration of the members of the management body as well as of the highest paid staff members in the AIFM;
- provide its support and advice to the supervisory function on the design of the AIFM's overall remuneration policy;
- have access to advice, internal and external, that is independent of advice provided by or to senior management;
- review the appointment of external remuneration consultants that the supervisory function, may decide to engage for advice or support;
- support the supervisory function in overseeing the remuneration system's design and operation on behalf of the supervisory function;
- devote specific attention to the assessment of the mechanisms adopted to ensure that:
  - the remuneration system properly takes into account all types of risks and liquidity and assets under management levels, and
  - the overall remuneration policy is consistent with the business strategy, objectives, values and interests of the AIFM and the AIFs it manages and the investors of such AIFs; and

- formally review a number of possible scenarios to test how the remuneration system will react to future external and internal events, and back test it as well.

80. The RemCo itself may be in charge of overseeing the central and independent review of the implementation of the remuneration policies and practices.

**Q25: Do you agree with the role for the AIFM's RemCo outlined above? If not, please provide explanations.**

#### **D. Process and reporting lines**

81. The RemCo should:

- have unfettered access to all data and information concerning the decision-making process of the supervisory function, on the remuneration system's design and implementation;
- have unfettered access to all information and data from risk management and control functions. Such access should not hinder the AIFM's ordinary activities;
- ensure the proper involvement of the internal control and other competent functions (e.g. human resources and strategic planning). The RemCo should collaborate with other board committees whose activities may have an impact on the design and proper functioning of remuneration policy and practices (e.g. risk audit, and nomination committees); and
- provide adequate information to the supervisory function, and, where appropriate, to the AIFM's shareholders' meeting about the activities performed.

**Q26: Do you agree with the principles above on the process and reporting lines to be followed by the RemCo? If not, please provide explanations.**

**Q27: Do you consider that the AIFM's RemCo should provide adequate information about the activities performed not only to the AIFM's shareholders' meeting, but also to the AIFs' shareholders' meetings? When providing your answer, please also provide quantitative details on the additional costs involved by such requirement.**

#### **VIII.III. Control functions (Annex II, paragraph (1)(e) and (f) of the AIFMD)**

82. Annex II, paragraph (1) of the AIFMD provides for the following principles related to the role of the control functions of an AIFM in relation with the remuneration policy:

- (e) staff engaged in control functions are compensated in accordance with the achievement of the objectives linked to their functions, independent of the performance of the business areas they control;*
- (f) the remuneration of the senior officers in the risk management and compliance functions is directly overseen by the remuneration committee;*

ESMA proposes to set out the guidelines below in relation with the abovementioned AIFMD Level 1 provisions.

#### **A. Roles of control functions**

83. AIFMs must provide for an active participation of control functions in the design, ongoing oversight and review of the remuneration policies for other business areas.
84. Working closely with the RemCo and the supervisory and management functions, the control functions should assist in determining the overall remuneration strategy applicable to the AIFM, having regard to the promotion of effective risk management.
85. The risk management function should assess how the variable remuneration structure affects the risk profile of the AIFM. It is good practice for the risk management function to validate and assess risk adjustment data, and to attend a meeting of the RemCo for this purpose.
86. The compliance function should analyse how the remuneration structure affects the AIFM's compliance with legislation, regulations and internal policies.
87. The internal audit function should periodically carry out an independent audit of the design, implementation and effects of the AIFM's remuneration policies.

#### **B. Remuneration of control functions**

88. The remuneration level of staff in the control functions should allow the AIFM to employ qualified and experienced personnel in these functions.
89. If staff in control functions receives variable remuneration, it should be based on function-specific objectives and should not be determined by the individual financial performance of the business area they monitor.
90. In line with the views already expressed in the AIFMD advice<sup>20</sup>, ESMA considers that the remuneration structure of control function personnel should not compromise their independence or create conflicts of interest in their advisory role to the RemCo, supervisory and/or management functions. If remuneration of the control functions includes a component based on AIFM-wide performance criteria, the risk of conflicts of interest increases and, therefore, should be properly addressed.
91. For AIFMs which are required to have a RemCo, the remuneration of the senior staff responsible for heading the control functions should not be solely left to the supervisory function, but should be directly overseen by the RemCo<sup>21</sup>. The remuneration of those staff members in compliance and risk management functions must be designed in a way that avoids conflict of interests related to the business unit they are overseeing and, therefore, should be appraised and determined independently. The

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<sup>20</sup> Box 49, paragraph (3)(d) of the AIFMD advice stated that “*the method of determining the remuneration of the relevant persons involved in the compliance function must not compromise their objectivity and must not be likely to do so*”.

<sup>21</sup> This is consistent with the provisions of Box 30, paragraph 1(d) of the AIFMD advice which provided that “*The remuneration of the senior officers in the risk management functions is directly overseen by the remuneration committee, where the AIFM is sufficiently significant in terms of its size or the size of the AIF it manages, its internal organisation and the nature, the scope and the complexity of its activities to have established such a committee;*”.

RemCo should make recommendations to the management body on the remuneration to be paid to the senior officers in the risk management and compliance functions.

92. For AIFMs which are not required to have a RemCo, the remuneration of the senior staff responsible for heading the control functions should be overseen by the management body in its supervisory function or, if the latter does not exist, by the person or persons in charge of the management body.
93. Conflicts of interest which might arise if other business areas had undue influence over the remuneration of staff within control functions should be adequately managed. The need to avoid undue influence is particularly important where staff members from the control functions are embedded in other business areas. However, the views of other business areas should be sought as an appropriate part of the assessment process.
94. Control function personnel should not be placed in a position where, for example, approving a transaction, making decisions or giving advice on risk and financial control matters could be directly linked to an increase or decrease in their performance-based remuneration.

**Q28: Do you agree with the above criteria on the remuneration of the control functions? If not, please provide explanations.**

**Q29: Please provide qualitative and quantitative data on the costs and benefits that the rules proposed in this Section VIII (Governance of remuneration) would imply.**

## **IX. General requirements on risk alignment**

### **IX.I. The basic principle of risk alignment (Annex II, paragraph (1)(a), (b) and (p) of the AIFMD)**

95. Annex II, paragraph (1) of the AIFMD provides for the following basic principles on risk alignment to be followed by AIFMs in relation with the remuneration policy:

*(a) the remuneration policy is consistent with and promotes sound and effective risk management and does not encourage risk-taking which is inconsistent with the risk profiles, rules or instruments of incorporation of the AIFs they manage;*

*(b) the remuneration policy is in line with the business strategy, objectives, values and interests of the AIFM and the AIFs it manages or the investors of such AIFs [...];*

*(p) the pension policy is in line with the business strategy, objectives, values and long-term interests of the AIFM and the AIFs it manages.*

*If the employee leaves the AIFM before retirement, discretionary pension benefits shall be held by the AIFM for a period of 5 years in the form of instruments defined in point (m). In the case of an employee reaching retirement, discretionary pension benefits shall be paid to the employee in the form of instruments defined in point (m), subject to a 5 year retention period;*

ESMA proposes to set out the guidelines below in relation with the abovementioned AIFMD Level 1 provisions.

### **A. The general remuneration policy, including the pension policy**

96. The above principles are aimed at the alignment of remuneration with prudent risk taking. The long-term strategy of the AIFM should include the overall business strategy and quantified risk tolerance levels with a multi-year horizon, as well as other corporate values such as compliance culture, ethics, behaviour towards investors of the AIFs it manages, measures to mitigate conflicts of interest etc. The design of the remuneration systems should be consistent with the risk profiles, rules or instruments of incorporation of the AIFs the AIFM manages and with the objectives set out in the strategies of the AIFM and the AIFs it manages and changes that could be decided in the strategies must be taken into account. AIFMs should, therefore, ensure that their remuneration systems are well designed and implemented. This includes, in particular, a proper balance of variable to fixed remuneration, the measurement of performance as well as the structure and, where appropriate, the risk-adjustment of the variable remuneration. Even a smaller or less sophisticated AIFM should ensure it makes the best possible attempt to align its remuneration policy with its interests and the interests of the AIFs it manages and their investors.
97. When developing their remuneration policy, AIFMs should give due consideration to how remuneration contributes to the prevention of excessive risk-taking, the efficiency of the AIFM and the AIFs it manages and the consistency of the remuneration policy with effective risk management.
98. Remuneration has a direct or indirect influence on people's behaviour. Variable remuneration may encourage staff to take undesirable or irresponsible risks in the hope of generating more turnover or making more profit and thus increasing his/her variable remuneration. Furthermore, staff members may be tempted to 'play' with or manipulate information with a view to making their (measured) performance look better. E.g. if the variable part of the remuneration consists predominantly of instruments that are paid out immediately, without any deferral or ex post risk adjustment mechanisms (malus or clawback), and/or are based on a formula that links variable remuneration to current year revenues rather than risk-adjusted profit, there are strong incentives for managers to shy away from conservative valuation policies, strong incentives to ignore concentration risks and strong incentives to ignore risk factors, such as liquidity risk and concentration risk, that could place the AIFs that the AIFM manages under stress at some point in the future.
99. By connecting risk management elements to the remuneration policy, the dangers mentioned can be counterbalanced. Indeed, when properly structured and implemented, variable remuneration can be an efficient tool to align the staff's interests with the interests of the AIFs that the AIFM manages. Having regard to the nature, scale and complexity of an AIFM, alternative approaches exist for connecting risk management elements to a remuneration policy.

### **B. Discretionary pension benefits**

100. Remuneration policy should cover all aspects of remuneration including fixed components, variable components, pension terms and other similar specific benefits. The pension policy (the fixed as well as the variable pension payments) should be aligned with the long term interests of the AIFM and the AIFs it manages.
101. In case of discretionary pension benefits, as part of the variable remuneration, a staff member should not retire or leave the AIFM with such benefits vested, with no consideration of the economic situation of the AIFs that the AIFM manages or risks that have been taken by the staff member in the long term.

102. In order to align this specific kind of pension benefits with the economic situation of the AIFs that the AIFM manages, discretionary pension benefits, where legally possible according to the relevant pension legislation, should be paid in the form of units or shares of the AIF concerned, or equivalent ownership interests, or share-linked instruments or equivalent non-cash instruments (see further the description of 'instruments' in Section X.IV.B.a. (Types of instruments)).

103. In the context of a retirement, the discretionary pension benefits vested to the staff member should be subject to a five years retention period (see the definition of 'retention' in Annex I).

104. In the context of the termination of a job, when the staff member leaves the AIFM before retirement, the discretionary pension benefits should not be vested before a period of five years and should be subject to performance assessment and ex post risk adjustment before pay out.

**Q30: Do you agree with the principles related to the treatment of discretionary pension benefits? If not, please provide explanations.**

**IX.II. General prohibitions**

**A. Severance pay (Annex II, paragraph (1)(k), of the AIFMD)**

105. Annex II, paragraph (1)(k) of the AIFMD provides for the following principle:

*(k) payments related to the early termination of a contract reflect performance achieved over time and are designed in a way that does not reward failure;*

106. "Golden parachute" arrangements for staff members who are leaving the AIFM and which generate large payouts without any performance and risk adjustment are inconsistent with the principle in Annex II, paragraph (1)(k) of the AIFMD. Such arrangements create a "heads I win, tails I still win" approach to risk, which encourages more risk-taking than would likely be preferred by the AIF's shareholders or creditors and by those of the AIFM. Any such payments should be related to performance achieved over time and designed in a way that does not reward failure. This should not preclude termination payments in situations such as early termination of the contract due to changes in the strategy of the AIFM or of the AIFs it manages, or in merger and/or takeover situations.

107. Without prejudice to employment law or contract law, severance payments are meant to provide a safety net for a staff member in cases of early termination of the contract. Severance payments may include payments related to the duration of a notice period, redundancy remuneration for loss of office, and may also include a non-competition clause in the contract.

108. AIFMs should set up a framework in which severance pay is determined and approved, in line with the AIFM's general governance structures for employment. The framework should ensure that there is no reward for failure.

109. AIFMs should be able to explain to competent authorities the criteria they use to determine the amount of severance pay. It is good practice to defer any outstanding variable payments or long-term incentive plans and for these to mirror the original deferral schemes.

**Q31: Do you consider appropriate to add any further guidance on the payments related to the early termination of a contract? If yes, please provide suggestions.**

## **B. Personal hedging (Annex II, paragraph (1)(q), of the AIFMD)**

110. Annex II, paragraph (1)(q) of the AIFMD provides for the following principle:

*(q) staff are required to undertake not to use personal hedging strategies or remuneration- and liability-related insurance to undermine the risk alignment effects embedded in their remuneration arrangements;*

111. An appropriate remuneration policy which is aligned with risks will, if sufficiently effective, occasionally result in a downward adjustment to the amount of variable remuneration awarded to staff. This will be the case explicitly, for example, if performance adjustment measures such as malus are implemented, or implicitly, if the value of deferred instruments is reduced.

112. The effectiveness of risk alignment will be significantly weakened if staff members are able to transfer the downside risks to another party through hedging or certain types of insurance.

113. Staff could be considered to have hedged away the risk of a downward adjustment in remuneration if the staff member enters into a contract with a third party which requires the third party to make payments directly or indirectly to the staff member that are linked to or commensurate with the amounts by which the staff member's variable remuneration has been reduced. The contract could for instance take the form of an option or any other derivative contract or other form of contract which provides any type of hedging for the staff member's variable remuneration.

114. The effectiveness of risk alignment would also be undermined if staff members were to buy an insurance contract which compensates them in the event of a downward adjustment in remuneration. As a general rule, however, this would not prohibit insurance designed to cover personal payments such as healthcare and mortgage instalments (provided that the mortgage coverage concerns health-related circumstances that would render the staff member unable to work in an equivalent position), although each case should be judged on its merits.

115. The requirement not to use personal hedging strategies or insurance to undermine the risk alignment effects embedded in their remuneration arrangements should apply to deferred and retained variable remuneration. AIFMs should maintain effective arrangements to ensure that the staff member complies with this requirement.

**Q32: Do you consider that the above guidance is sufficiently broad to cover any kind of hedging strategies that may be pursued by a member of the staff of an AIFM? If not, please provide details on how the scope of the guidance should be enlarged.**

**Q33: Please provide qualitative and quantitative data on the costs and benefits that the rules proposed in this Section IX (General requirements on risk alignment) would imply.**

## **X. Specific requirements on risk alignment**

### **X.I. Fully flexible policy on variable remuneration (Annex II, paragraph 1(j) of the AIFMD)**

116. Annex II, paragraph (1)(j) of the AIFMD provides for the following principle:

*(j) [...] the fixed component represents a sufficiently high proportion of the total remuneration to allow the operation of a fully flexible policy, on variable remuneration components, including the possibility to pay no variable remuneration component;*

117. Having a fully-flexible policy on variable remuneration implies not only that variable remuneration should decrease as a result of negative performance but also, that it can go down to zero in some cases. For its practical implementation, it also implies that the fixed remuneration should be sufficiently high to remunerate the professional services rendered, in line with the level of education, the degree of seniority, the level of expertise and skills required, the constraints and job experience, the relevant business sector and region. These Guidelines are not directly concerned with setting certain numerical levels of fixed remuneration for individual staff members, recognizing that the fixed remuneration is primarily the result of negotiations between a staff member and the AIFM and that it is up to AIFMs to decide how to best align remuneration structures to meet the remuneration requirements laid down in the AIFMD. Individual levels of fixed remuneration should, however, be indirectly impacted by the basic principle on risk alignment.

118. Meeting the requirement of a fully flexible variable remuneration policy implies as a prerequisite the accomplishment of several mechanisms that are dealt with in subsequent sections of these Guidelines, including proper performance measurement and associated risk adjustments, i.e. adjustments that ensure that variable remuneration can be reduced in a flexible manner, not imposing a floor on the adjustment, applied to both non-deferred and deferred variable remuneration.

## **X.II. Risk alignment of variable remuneration**

### **A. Risk alignment process (Annex II, paragraph 1(g), (h) and (l) of the AIFMD)**

119. Annex II, paragraph (1) of the AIFMD provides for the following principles related to the risk alignment process in relation with the remuneration policy:

*(g) where remuneration is performance related, the total amount of remuneration is based on a combination of the assessment of the performance of the individual and of the business unit or AIF concerned and of the overall results of the AIFM [...];*

*(h) the assessment of performance is set in a multi-year framework appropriate to the life-cycle of the AIFs managed by the AIFM in order to ensure that the assessment process is based on longer term performance and that the actual payment of performance-based components of remuneration is spread over a period which takes account of the redemption policy of the AIFs it manages and their investment risks;*

*(l) the measurement of performance used to calculate variable remuneration components or pools of variable remuneration components includes a comprehensive adjustment mechanism to integrate all relevant types of current and future risks;*

120. To limit excessive risk taking, variable remuneration should be performance-based and risk adjusted. To achieve this aim, an AIFM should ensure that incentives to take risks are constrained by incentives to manage risk. A remuneration system should be consistent with effective risk management and governance processes within the AIFM.

121. Risk alignment includes the performance and risk measurement process, the award process and the payout process.

## **1. Performance and risk measurement process**

Setting up a remuneration system should start by defining the objectives of the AIFM, the unit, as well the staff and the investment strategy of the AIFs concerned. These objectives should be derived from the business plan of the AIFM, if any<sup>22</sup>, and should be in line with the risk appetite of the AIFM and the investment strategy of the AIFs concerned. The performance criteria, which should be used to assess the staff member's achievement of his/her objectives during the accrual period, can be directly derived from these objectives. If properly designed, the performance assessment links the remuneration with the achievement of the investment strategy of the AIFs concerned and the business plan, if any, or the objectives of the AIFM. On the contrary, performance criteria which are badly designed, can be an incentive for taking too much risk. When assessing performance, only the effective results should be taken into account. Risk alignment during performance measurement can be achieved by using risk adjusted performance criteria or by adjusting performance measures for risk afterwards. The risk adjustment may differ according to the activity of the staff member and the business line or AIF concerned.

## **2. Award process**

After the accrual period, the AIFM should use a specified award process in order to translate performance assessment into the variable remuneration component for each staff member. This should usually be carried out through so-called "pools" of variable remuneration that are first determined and later on allocated. As not all performance and risk measures are suitable to be applied at the level of the AIFM, the business unit and the staff member, the AIFM should identify the risks at each level and ensure that a risk correction adequately captures the magnitude and the duration of the risk at each level. This so-called "ex-ante risk adjustment" should adjust remuneration for potential adverse developments in the future. Because of their upfront application, ex-ante risk adjustments have an immediate effect on risk taking behaviour. But the consequence of this is also that not all risk and performance outcomes can be fully taken into account.

## **3. Payout process**

In order to align the actual payment of remuneration to the life-cycle and redemption policy of the AIFs managed by the AIFM and their investment risks, the variable remuneration should partly be paid upfront (short-term) and partly deferred (long-term). The short-term component should be paid directly after the award and rewards staff for performance delivered in the accrual period. The long-term component should be awarded to staff during and after the deferral period. It should reward staff for the sustainability of the performance in the long term, which is the result of decisions taken in the past. Before paying out the deferred part, a reassessment of the performance and, if necessary, a risk adjustment should be required in order to align variable remuneration to risks and errors in the performance and risk assessments that have appeared since the staff members were awarded their variable remuneration component. This so-called ex post risk adjustment should always be necessary, because at the time remuneration is awarded, the ultimate performance cannot be assessed with certainty.

122. The performance and risk measurement process underpins both the award process and the payout process. Guidelines on performance and risk measurement are given in Sections X.II.C. (Risk meas-

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<sup>22</sup> Box 11, paragraph (4)(a) of the AIFMD advice requires that "Where applicable to the type of asset, the AIFM should [...] set out and update a business plan consistent with the duration of the AIF and market conditions;"

urement) and X.II.D. (Performance measurement). The award process and pay-out process are discussed in Sections X.III. (Award process) and X.IV. (Pay-out process). For the whole risk alignment process, there are some common requirements. These are discussed in Section B below.

## **B. Common requirements for the risk alignment process**

### **a. Time horizon**

123. AIFMs, when assessing risk and performance, should take into account both current and future risks that are taken by the staff member, the business unit, the AIF concerned or the AIFM as a whole. For this exercise, AIFMs should examine what the impact of the staff member's activities could be on the AIFs they manage and AIFM's short and long term success. To be able to do so, the AIFM should align the horizon of risk and performance measurement with the life-cycle and redemption policy of the AIFs managed by the AIFM and their investment risks. The requirement of an AIFM to assess the performance of its staff in a multi-year framework appropriate to the life-cycle of the AIFs managed by the AIFM implies the accrual period and the payout period for short-term and long-term remuneration covering an appropriate period in total. There is a link between these periods.
124. The right balance between accrual and payout periods should depend on the type of AIFs managed by the AIFM and on the type of business and activity developed by the staff member. However, the use of multi-year accrual periods is more prudent since the assessment of the performance can take into account with certainty more risks that have materialized since the beginning of the accrual period.

### **b. Levels of risk and performance measurement**

125. To avoid excesses due to over-individualistic behaviour, performance-related remuneration should include parameters linked to the risks and performance of the AIF concerned and of the business unit of the AIFM in addition to the risks and performance of the individual activities. Thus, the amount of variable remuneration a staff member is eligible for should be determined by his/her individual performance, the performance of his/her business line or the AIF concerned and the performance of the AIFM. The relative importance of each level of the performance criteria should be determined beforehand and adequately balanced to take into account the position or responsibilities held by the staff member.
126. To have the greatest impact on staff behaviour, the variables used to measure risk and performance should be linked as closely as possible to the level of the decisions made by the staff member that is subject to the risk adjustment. Performance criteria should include achievable objectives and measures on which the staff member has some direct influence. For example, for senior executives, AIFMs may design the remuneration policies to include financial measures based on the performance of all the AIFs managed by the AIFM or the entire AIFM, or for performance and risks of units, or decisions that were determined by senior executive strategy. In contrast, variables for the manager of a business unit ideally would be for performance and risk of that unit.

### **c. Quantitative and qualitative measures**

127. The risk alignment process should use a mix of quantitative and qualitative approaches (e.g. measurement of performance or risk; setting of the pool and adjustment to risks).
128. Quantitative measures may have some advantages in terms of transparency if they are pre-defined. They can, therefore, influence the behaviour of staff more directly. However, quantitative measures or

criteria are not sufficient to measure all risk or performance or to risk adjust remuneration. To complete the measurement and adjustment of risk or performance, AIFMs should also rely on qualitative approaches.

#### **d. Judgemental measures**

129. Quantitative measures (e.g. the formulae used for setting the pool) may themselves (partly) rely on judgemental inputs, the derivation of which may lack transparency. Qualitative measures generally require a higher use of judgement than quantitative measures. There are inherent risks in relying on judgement, including lack of transparency in decision-making from staff and other stakeholder's perspectives, and poor judgement being made. To offset these risks it is important that whenever judgement is used for a risk and performance measurement or risk adjustment, there should be:

- a clearly written policy outlining parameters and key considerations on which the judgement will be based;
- clear and complete documentation of the final decision regarding risk and performance measurement or risk adjustment;
- involvement of relevant control functions experts; and
- appropriate levels of approval obtained, e.g. of the management body or supervisory function, or of the RemCo; and
- consideration of the personal incentives of the manager making the judgement, e.g. by using scorecards.

130. For both kind of measures, AIFMs should be prepared to disclose and reproduce any judgmental elements incorporated into their risk alignment process. AIFMs should also provide detailed information to the competent authority if the final outcome after applying judgmental measures is significantly different from the initial outcome using pre-defined measures.

**Q34: Do you consider these common requirements for the risk alignment process appropriate? If not, please provide explanations and alternative requirements.**

#### **C. Risk measurement**

131. AIFMs should take into account all risks, whether on or off balance sheet, differentiating amongst risks affecting the AIFM, the AIFs it manages, business units and individuals. Though AIFMs usually bear all types of risk at AIFM-wide level (meaning at a level which includes the AIFs managed by the AIFM), at the level of (the measurement of the performance of) the individual staff members or business units, only some types of risk may be relevant. Risk identification and quantification at the AIF level can be found in the risk management policy that the AIFM shall establish, implement and maintain and shall identify all the relevant risks to which the AIFs they manage are or might be exposed to.<sup>23</sup> AIFMs should also determine whether measures they are utilizing for risk adjustment include 'difficult-to-measure' risks, such as reputational and operational risk.

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<sup>23</sup> See Box 26 of the AIFMD advice.

132. In order to take into account all material risks, AIFMs should use the same risk measurement methods as used in the risk management policy established for the AIFs managed by the AIFM. Furthermore, AIFMs should also take into account (i) the risks arising from the additional management of UCITS and from the services provided under Article 6(4) of the AIFMD and (ii) the potential professional liability risks that AIFMs have to cover through either additional own funds or professional indemnity insurance according to Article 9(7) of the AIFMD.
133. Taking the proportionality principle into account, the risk management calculations should be transparent and the AIFMs should be able to demonstrate how the risk calculations can be broken down by AIFs and related to the AIFM's business units and different types of risk positions throughout the organisation. The quality of methods and models used should influence the extent to which an AIFM should implement a more sophisticated variable remuneration policy based on performance measurements.

**Q35: Do you agree with the proposed criteria on risk measurement? If not, please provide explanations and alternative criteria.**

**Q36: Do you agree that in order to take into account all material risks AIFMs should also take into account the risks arising from the additional management of UCITS and from the services provided under Article 6(4) of the AIFMD?**

#### **D. Performance measurement (Annex II, paragraph 1(g) of the AIFMD)**

134. Annex II, paragraph (1)(g) of the AIFMD provides that:

*(g) [...] when assessing individual performance, financial as well as non-financial criteria are taken into account;*

##### **a. Qualitative/Quantitative measures**

135. AIFMs should use both quantitative (financial) as well as qualitative (non-financial) criteria for assessing individual performance. Usually, quantitative criteria are more frequently available at an AIFM-wide level while qualitative factors are usually assessed at the individual level, where they are more relevant. However, qualitative criteria can also be relevant at an AIFM-wide level or business level (such as the achievement of results, compliance with strategy within the risk appetite and compliance track record).
136. The appropriate mix of quantitative and qualitative criteria should also depend on the tasks and responsibilities of the staff member. In all cases, the quantitative and qualitative criteria and the balance between them should be specified and clearly documented for each level and category of staff.
137. Quantitative measures should cover a period which is long enough to properly capture the risk of the staff member's actions. Examples of quantitative performance measures used in the asset management sector which fulfil the abovementioned requirements are the internal rate of return (IRR), earnings before interest, taxes, depreciation and amortization (EBITDA), Alpha Ratio, absolute and relative returns, Sharpe Ratio and assets raised.
138. In addition to quantitative performance measures, variable remuneration awards should also be sensitive to the staff's performance with respect to qualitative (non-financial) measures. Examples are the achievement of strategic targets, investor satisfaction, adherence to risk management policy,

compliance with internal and external rules, leadership, management, team work, creativity, motivation and cooperation with others business units and with control functions. Such determined qualitative criteria could rely on compliance with risk control measures such as limits and audit results. Negative non-financial performance, in particular unethical or non-compliant behaviour, should override any good financial performance generated by a staff member and should diminish the staff member's variable remuneration.

**Q37: Do you agree with the proposed guidance for the financial and non-financial criteria to be taken into account when assessing individual performance? If not, please provide explanations and alternative guidance.**

**b. Relative/absolute and internal/external measures**

139. Absolute performance measures are measures set by the AIFM on the basis of its own strategy, which includes the risk profile and risk appetite of the AIFM and of the AIFs it manages, as further developed down through the chain of business levels. Such measures help to minimize the risk that remuneration is awarded that is not justifiable by the AIFM's or AIFs' performance. They also tend to create long term incentives. However, it may be difficult to calibrate absolute performance measures, especially for new entrants or for new kinds of financial activities (with difficult-to-measure risks) linked to the management of AIFs.
140. Relative performance measures are measures that compare performance with peers, either 'internal' peers (i.e. within the organization) or 'external' (similar AIFMs). Relative performance measures are easier to set because the benchmark is readily available. However, such measures pose the risk that variable remuneration that is not supported by long-term success of the business unit or the AIFM or the AIFs it manages will be paid out anyway. In a period of sector wide positive financial performances, it could lead to 'raising the bid' and/or 'herd' mentality, providing incentives to take on excessive risk. In a downturn economic cycle where most AIFMs and AIFs may perform poorly, relative measures may nonetheless lead to positive outcomes (and thus to an insufficient contraction of the AIFM's total variable remuneration) even if absolute performance has deteriorated compared to previous periods.
141. Similarly, internal (e.g. profits) and external (e.g. share price) variables come with both advantages and disadvantages that should be balanced carefully. Internal performance measures are able to generate more involvement of the staff members if they can influence the outcome by their own behaviour. This is especially true if the performance measures are fixed at the level of the business unit (rather than on the AIFM-wide level). Furthermore, it is easier to introduce risk adjustment features for internal measures, because the link with in-house risk management techniques is more readily available. On the other hand, such measures can be manipulated and can create distorted outcomes on a short-term basis. External performance measures are less subject to this danger of manipulation, although attempts to artificially increase the stock price (probably only relevant for top executives) may still occur.

**Q38: Do you agree with the proposal to distinguish between absolute and relative performance measures on one side and between internal and external performance measures on the other? If not, please provide explanations.**

**X.III. Award process**

## **A. Setting and allocation of pools**

142. During the award process, the individual variable remuneration is determined. A key challenge of the award process is translating performance measures into actual remuneration awards and defining at what level performance can be accurately assessed and risk adjustment can be applied.
143. AIFMs should adopt a documented policy for the award process and ensure that records of the determination of the overall variable remuneration pool are maintained.

**Q39: Do you agree with the requirement set out above to document the policy for the award process and ensure that records of the determination of the overall variable remuneration pool are maintained? If not, please provide explanations and an alternative procedure.**

## **B. The risk adjustment in the award process (Annex II, paragraph 1(l) and(o) of the AIFMD)**

144. Annex II, paragraph (1) of the AIFMD provides for the following basic principles on risk adjustment in the award process to be followed by AIFMs:

- (l) the measurement of performance used to calculate variable remuneration components or pools of variable remuneration components includes a comprehensive adjustment mechanism to integrate all relevant types of current and future risks;*
- (o) the variable remuneration [...] is paid or vests only if it is sustainable according to the financial situation of the AIFM as a whole, and justified according to the performance of the business unit, the AIF and the individual concerned.*

*The total variable remuneration shall generally be considerably contracted where subdued or negative financial performance of the AIFM or of the AIF concerned occurs, taking into account both current compensation and reductions in payouts of amounts previously earned, including through malus or clawback arrangements;*

ESMA proposes to set out the guidelines below in relation with the implementation of ex-ante risk adjustment in the award process and the types of and techniques for ex-ante risk adjustment.

145. In determining remuneration pools or individual awards, AIFMs should consider the full range of current and potential (unexpected) risks associated with the activities undertaken. Performance measures used in setting the remuneration pool may not fully or adequately capture risks undertaken, thus, ex-ante adjustments should be applied to ensure that the variable remuneration is fully aligned with the risks undertaken. AIFMs should establish whether the risk adjustment criteria they are using take into consideration severe risks or stressed conditions.
146. AIFMs should determine to what level they are able to risk adjust their variable remuneration calculations quantitatively – whether to the business unit level or further down the line such as to a trading desk level, if any, or even to an individual level. AIFMs should determine the level of granularity that is suitable for each level.

### **a. Quantitative ex ante risk adjustment**

147. In order to have a sound and effective remuneration scheme, AIFMs should use a number of different quantitative measures for their risk adjustment process. Normally, these measures should be based on an overarching risk adjustment framework.
148. When measuring the profitability of the AIFM and its business units as well as the AIFs it manages, the measurement should be based on net revenue where all direct and indirect costs related to the activity are included. AIFMs should not exclude IT costs, research costs, legal fees, marketing costs, and costs for outsourced activities. AIFMs should make sure that remuneration pools are not being “back-fitted” to meet remuneration demands.
149. The quantitative ex-ante risk adjustments made by AIFMs should largely rely on existing measures within the AIFMs, generally used for other risk management purposes. As a result, the limitations and potential issues related to these measures should also be relevant for the remuneration process. The risk adjustments used should benefit from the experience gained when dealing with these risks in other contexts and should be challenged like any other component of the risk management process.

#### **b. Qualitative measures for ex-ante risk adjustment**

150. It is important that qualitative risk elements are considered. These ex-ante adjustments could take place while setting AIFM-wide and business unit remuneration pools or when determining or allocating individuals’ remuneration. Qualitative ex-ante risk adjustments are common at pool and individual levels, contrary to quantitative adjustments which tend to be mostly observed only at the pool level.
151. AIFMs make qualitative risk adjustments when allocating/determining individuals’ remuneration through assessments that may explicitly include risk and control considerations such as compliance breaches, risk limit breaches and internal control breakdowns (e.g. based on internal audit results).

**Q40: Do you agree with the proposal according to which AIFMs should use both quantitative and qualitative measure for the ex-ante risk adjustment? If not, please provide explanations and an alternative proposal.**

#### **X.IV. Pay-out process**

##### **A. Non-deferred and deferred remuneration (Annex II, paragraph 1(h) and (n) of the AIFMD)**

152. Annex II, paragraph (1) of the AIFMD provides for the following principles on the pay-out process to be followed by AIFMs:

- (h) [...] the actual payment of performance-based components of remuneration is spread over a period which takes account of the redemption policy of the AIFs it manages and their investment risks;*
- (n) a substantial portion, and in any event at least 40 %, of the variable remuneration component, is deferred over a period which is appropriate in view of the life cycle and redemption policy of the AIF concerned and is correctly aligned with the nature of the risks of the AIF in question.*

*The period referred to in this point shall be at least three to 5 years unless the life cycle of the AIF concerned is shorter; remuneration payable under deferral arrangements vests no faster than*

*on a pro-rata basis; in the case of a variable remuneration component of a particularly high amount, at least 60 % of the amount is deferred;*

ESMA proposes to set out the guidelines below in relation with the abovementioned AIFMD Level 1 provisions.

153. A deferral schedule is key to improving risk alignment effects in a remuneration package, since it allows for part of the remuneration to be adjusted for risk outcomes over time through ex-post risk adjustments. Although remuneration is aligned through ex-ante risk adjustments, due to uncertainty, ex-post risk adjustments are needed to keep incentives fully aligned. This can only be done if part of the remuneration has been deferred.
154. A deferral schedule is defined by different components: (a) the time horizon of the deferral, (b) the proportion of the variable remuneration that is being deferred, (c) the speed at which the deferred remuneration vests (vesting point) and (d) the time span from accrual until the payment of the first deferred amount; another related issue is the form of the deferred variable remuneration (although it is not specific to deferral - see Section B. below). AIFMs can differentiate their deferral schedules by varying these five components. A stricter than necessary application for one component may influence the supervisory scrutiny for another component. In any case, the way in which an AIFM combines these components should lead to a meaningful deferral schedule, in which the long-term risk alignment incentives are clear.

#### **a. Time horizon and vesting**

155. The deferral period always starts at the moment the upfront part of the variable remuneration is paid out and can be coupled either to cash variable remuneration or variable remuneration in instruments. It ends when the last variable remuneration has vested. The minimum deferral period is three to five years, unless the AIFM can demonstrate that the life cycle of the AIF concerned is shorter; this means that if the life cycle of the AIF concerned is, for instance, one year, the minimum deferral period may be one year. AIFMs should set the deferral period which should be calculated on the basis of the life cycle and redemption policy of the AIF concerned and depending on the potential impact of the staff on the risk profile of the AIF. The actual deferral period should be further tailored to the responsibilities and tasks performed by the staff and expected fluctuations in the value of the assets of the AIF, which in many cases will imply longer time horizons. The AIFM should consider longer deferral periods for at least members of the *management body*.

#### **b. Vesting point**

156. Pro rata vesting (or payment) means that for a deferral period of, for example, three years one-third of the deferred remuneration vests at the end of each of the years  $n+1$ ,  $n+2$  and  $n+3$ , , where 'n' is the moment at which performance is measured to determine the variable remuneration. Annex III to these Guidelines includes a diagram showing an example of a pro rata spreading for a deferral scheme in which 60% of the variable remuneration is deferred (first diagram).
157. In any case, vesting should not take place more frequently than on a yearly basis (e.g. not every six months) since higher frequencies do not allow for a proper assessment of risks and thus, an ex-post adjustment of remuneration.

#### **c. Proportion to be deferred**

158. The proportion of the variable remuneration that should be deferred ranges from 40 to 60 %, depending on the impact the staff member (or category of staff) can have on the risk profile of the AIFs managed by the AIFM and the responsibilities and tasks performed, and depending on the amount of variable remuneration. If AIFMs decide to determine the proportion that is being deferred by a cascade of absolute amounts (rather than percentages of the total variable remuneration - e.g. part between 0 and 100: 100% upfront, part between 100 and 200: 50% upfront and rest is deferred, part above 200: 25% upfront and rest is deferred ...), on an average weighted basis, such AIFMs should respect the 40 to 60 % threshold.

#### **d. Time span between end of accrual and vesting of deferred amount**

159. In order to ensure a proper assessment of the performance outcome and, thus, to undertake a proper ex-post risk adjustment, the first deferred portion should not be paid out too soon after the accrual period. For the deferral to be really effective with regard to the staff's incentives, the first amount should not vest sooner than 12 months after the accrual. See also the first diagram in Annex III on pro rata spreading.

**Q41: Do you agree with the guidance on the different components to be considered in relation with the deferral schedule for the variable remuneration? If not, please provide explanations and alternative guidance.**

#### **B. Cash vs. instruments (Annex II, paragraph 1(m) of the AIFMD)**

160. Annex II, paragraph (1)(m) of the AIFMD provides for the following principle to be followed by AIFMs on the split between cash and types of instruments which may constitute the variable remuneration:

*(m) subject to the legal structure of the AIF and its rules or instruments of incorporation, a substantial portion, and in any event at least 50 % of any variable remuneration consists of units or shares of the AIF concerned, or equivalent ownership interests, or share-linked instruments or equivalent non-cash instruments, unless the management of AIFs accounts for less than 50 % of the total portfolio managed by the AIFM, in which case the minimum of 50 % does not apply.*

*The instruments referred to in this point shall be subject to an appropriate retention policy designed to align incentives with the interests of the AIFM and the AIFs it manages and the investors of such AIFs. Member States or their competent authorities may place restrictions on the types and designs of those instruments or ban certain instruments as appropriate. This point shall be applied to both the portion of the variable remuneration component deferred in line with point (n) and the portion of the variable remuneration component not deferred;*

ESMA proposes to set out the guidelines below in relation with the abovementioned AIFMD Level 1 provisions.

#### **a. Types of instruments**

161. For the purposes of these Guidelines (and as set out in Annex II of the AIFMD), instruments can be understood as instruments being units or shares of the AIFs managed by the AIFM or equivalent ownership interests, subject to the legal structure of the AIFs concerned and their rules or instruments of incorporation, or share-linked instruments or equivalent non-cash instruments.

162. One of the basic purposes for remunerating staff in instruments is to put the staff into an owner-like position in order to align the staff's interests with those of the stakeholders of the AIFs managed by the AIFM. The owner-like position incentivises the staff to increase the AIF's value. This added value will then be reflected in the instruments' value. However, staff should only be remunerated using instruments if it does not trigger interest misalignment or encourage risk-taking which is inconsistent with the risk profiles, rules or instruments of incorporation of the relevant AIF(s).
163. For AIFMs managing several AIFs, in order to align the interests of the Identified Staff with those of the relevant AIF(s), the Identified Staff should receive instruments related only to the AIF(s) in relation to which they perform their activities. E.g. if one member of the staff of an AIFM which manages three AIFs (x, y and z) performs his/her activities for AIF x only, that member of the staff should receive instruments related to AIF x only.
164. The availability of instruments is dependent on the legal structure of the AIFs concerned and their rules or instruments of incorporation. For AIFs in the legal form of a corporate fund, shares or share-linked instruments should be able to align the interests of the shareholders and staff. Share-linked instruments are those whose value is based on a market value appreciation of the stock and that have the share price as a reference point, e.g. stock appreciation rights, types of synthetic shares.
165. For many AIFs which are common funds, share-linked instruments are not an option due to their legal form. Even for unlisted corporate funds it may be difficult to determine a share price that represents the AIF's net asset value between two (at least annual) net asset value calculations. In these cases alternative instruments, may be used that reflect the AIF's value and have the same intended effect as share-linked instruments.
166. Neither dividends nor interest should be paid on these types of instruments before vesting.

**Q42: Do you agree with the types of instruments composing the variable remuneration which have been identified by ESMA? If not, please provide explanations.**

**Q43: Do you consider that additional safeguards should be introduced in these Guidelines in order to ensure that the payment of the Identified Staff with instruments does not entail/facilitate any excessive risk-taking by the relevant staff in order to make short-term gains via the instruments received? If yes, please provide details.**

#### **b. Retention policy**

167. To obtain the necessary risk alignment for instruments, a retention policy should be determined by the AIFM in the remuneration policy. The AIFM should be able to explain how the retention policy relates to other risk alignment measures in the total remuneration policy and should explain whether and how they differentiate between instruments paid upfront and deferred instruments.
168. Retention periods, as the most important element of the retention policy, are coupled with the vesting of instruments.
169. In the case of upfront instruments, retention periods are the only mechanism available to emphasize the difference between cash paid upfront and instruments awarded upfront in order to align incentives with the longer-term interests of the AIFM and the AIFs it manages and the investors of such AIFs.

170. In the case of deferred instruments, the retention periods come after every vested portion (see also the concepts in Annex I and the second diagram in Annex III that illustrate these concepts). Competent authorities may determine whether the retention periods proposed by the AIFM are sufficient and appropriate.
171. The minimum retention period should be sufficient to align incentives with the longer term interests of the AIFM, of the AIFs it manages and of their investors. Different factors may tend to suggest that this period could be longer or shorter. Longer retention periods should be applied for staff with the most material impact on the risk profile of the AIFM and the AIFs it manages.
172. It is possible that a retention period lasts for a shorter period than the deferral period applied to the instruments that are not paid up front. However, as an example of proportionality, for their most senior staff, large and complex AIFMs should consider the use of a retention period for upfront paid instruments that goes beyond the deferral period for the deferred instruments.
173. Instruments should be valued on the date of the award (at the end of the accrual period) of these instruments as the contrary would run against the long term interests of the AIFM and the AIFs it manages and the investors of such AIFs. This value is the basis for the determination of the initial number of instruments and for later ex-post adjustments to the number of instruments.
174. It is important to highlight that the upfront payment of instruments, even with a minimum retention period of, for example, three years, is not equivalent to deferred instruments. Instruments paid upfront belong to the staff member (they are vested rights) which imply that no malus clauses can be applied to them. Although the staff member cannot sell the instruments for a 3-year period, the AIFM cannot change the number of instruments it has awarded. On the contrary, deferred instruments are subject to an ex-post risk adjustment due to the back-testing of the underlying performance, possibly leading to a reduction in the number of instruments that will eventually be paid out (see below Section X.IV.C.a (Explicit ex-post risk adjustments)). This difference is illustrated in the second diagram in Annex III.

**Q44: 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.**

**c. Minimum portion of instruments and their distribution over time**

175. According to the abovementioned paragraph (1)(m) of Annex II to the AIFMD, at least 50% of any variable remuneration shall consist of equity-linked instruments related to the AIF concerned. However, if the management of AIFs accounts for less than 50% of the total portfolio managed by the AIFM, the minimum of 50% does not apply.
176. A requirement is included to apply the minimum of 50% (where applicable) to both the portion of the variable remuneration component that is deferred and the portion of the variable remuneration component not deferred. This means that the 50% minimum threshold for instruments must be applied equally to the non-deferred and the deferred part; in other words, AIFMs must apply the same chosen ratio between instruments and cash for their total variable remuneration to both the upfront and deferred part.

Examples:

- Correct practice: For a certain category within its Identified Staff, an AIFM establishes a 50 instruments / 50 cash ratio for the variable remuneration, combined with a 60% deferral schedule (that is, 40% is non-deferred variable remuneration). This results in an upfront payment in instruments of 20 (i.e. 50% of 40) and 20 in cash. The deferred part consists of 30 in instruments and 30 in cash.
- Correct practice: For a certain category within its Identified Staff, an AIFM establishes a 70 instruments / 30 cash ratio for the variable remuneration, combined with a 40% deferral schedule (that is, 60% is non-deferred variable remuneration). This results in an upfront payment in instruments of 42 (i.e. 70% of 60) and 18 in cash. The deferred part consists of 28 in instruments and 12 in cash.
- Incorrect practice: If for a certain category within its Identified Staff, an AIFM were to establish a 50 instruments / 50 cash ratio for the variable remuneration, combined with a 40 % deferral scheme, the AIFM cannot decide to pay 50 in cash upfront and 10 in instruments, leading to a deferred pay out of 40 in instruments.
- Incorrect practice: If for a certain category within its Identified Staff, an AIFM were to establish a 70 instruments / 30 cash ratio for the variable remuneration, combined with a 50% deferral scheme, the AIFM cannot decide to pay 50 upfront in instruments and 0 in cash, leading to a deferred pay out of 20 in instruments and 30 in cash.

177. In Annex III, an example of this equal distribution of instruments over the non-deferred and deferred parts of remuneration is provided (second diagram).

### **C. Ex post incorporation of risk for variable remuneration (Annex II, paragraph 1(o) of the AIFMD)**

178. Annex II, paragraph (1)(o) of the AIFMD provides for the following principle to be followed by AIFMs on the ex post incorporation of risk for variable remuneration:

*(o) the variable remuneration, including the deferred portion, is paid or vests only if it is sustainable according to the financial situation of the AIFM as a whole, and justified according to the performance of the business unit, the AIF and the individual concerned.*

*The total variable remuneration shall generally be considerably contracted where subdued or negative financial performance of the AIFM or of the AIF concerned occurs, taking into account [...] reductions in payouts of amounts previously earned, including through malus or clawback arrangements;*

ESMA proposes to set out the guidelines below in relation with the abovementioned AIFMD Level 1 provisions.

#### **a. Explicit ex-post risk adjustments**

179. Once an initial variable remuneration component has been awarded to the staff member, and an upfront part has already been paid, the AIFM still will be able to adjust, by way of a reduction, the variable remuneration as time goes by and the outcomes of the staff member's actions materialize. This is

the “ex-post risk adjustment”, an element absolutely necessary to improve full alignment of the remuneration policy with risk taking.

180. An ex-post risk adjustment is an explicit risk alignment mechanism through which the AIFM itself adjusts remuneration of the staff member by means of malus arrangement or clawback clauses (e.g. by lowering cash remuneration or by awarding a lower number of instruments). Ex-post risk adjustment should always be performance-related: techniques that are, for example, based on the amount of dividends or the evolution of the share price are not sufficient because the link to the performance of a staff member is not sufficiently direct. Therefore, ex-post risk adjustments are frequently also called “performance adjustments” because they are a response to the actual risk outcomes of the staff member’s actions. Performance measures taken at this stage will allow the AIFM to perform an analysis (similar to back testing) as to whether its initial ex-ante risk adjustment was correct. AIFMs should ensure there is a link between the initial performance measurement and the back-testing. Thus, the extent to which an ex-post risk adjustment is needed depends on the quality (accuracy) of the ex-ante risk adjustment.

181. Malus is a method for the implementation of risk adjustment and reducing the value of a part of the deferred remuneration, taking into account risk outcomes of the underlying performances of the AIFM as a whole, the business unit, the AIF and, where possible, the staff member. The effect of this kind of ex-post risk adjustment cannot be inflated by paying out artificially high interest (above market rates) on the cash deferred parts to the staff member. Maluses operate by affecting the vesting point and cannot operate after the end of the deferral period. Furthermore, clawback can be a method for achieving an ex-post risk adjustment on variable remuneration (see also the concepts in Annex I).

182. AIFMs may utilize specific criteria whereby malus (to both the cash portion and the instruments portion of deferred remuneration) and clawbacks would apply. Such criteria should, for example, include:

- a. evidence of misbehaviour or serious error by the staff member (e.g. breach of code of conduct, if any, and other internal rules, especially concerning risks);
- b. whether the AIF and/or the AIFM and/or the business unit subsequently suffers a significant downturn in its financial performance (specific indicators are to be used);
- c. whether the AIF and/or the AIFM and/or the business unit in which the staff member works suffers a significant failure of risk management;
- d. significant changes in the AIFM’s overall financial situation.

183. A clawback typically operates in the case of established fraud or misleading information. Where applicable, AIFMs should include clawback clauses in addition to the two cases mentioned before e.g. for remuneration received in breach of the AIFMD and these Guidelines.

184. Similar to ex-ante risk adjustment, ex-post risk adjustment could be based on both quantitative measures and informed judgment. The benefit of judgmental approaches is that they can take into account circumstances that are difficult to capture in a formulaic approach.

185. To have the greatest impact on staff’s incentives, the variables should measure outcomes as close as possible to the level of the decisions made by the staff member that is subject to the ex-post explicit adjustment. For example, variables for senior executives probably should be for outcomes for the

AIFM as a whole, or for outcomes of units or decisions that were determined by senior executive strategy. In contrast, variables for the head responsible for a business unit ideally would reflect outcomes of that unit.

### **b. Implicit adjustments**

186. When the variable remuneration takes the form of instruments, the final payout to the staff member will depend partly on market prices due to fluctuations during the deferral or retention period. This implicit adjustment of remuneration is not related to any explicit decision of the AIFM, but is inherent to the form that is used for paying out. Under no circumstances should the evolution of the net asset value of the AIF or, for listed AIF, the evolution of the share price be considered sufficient as a form of ex-post risk adjustment. There should always be a form of explicit risk adjustment on the initiative of the AIFM. This is because price movements may respond to many factors other than the risk outcomes of performance of staff members. For non-senior staff in particular, there may be no direct relation between their decisions and the value of the AIF.
187. Retention periods affect the risk-taking incentives of staff members only by extending the period during which implicit adjustments can take place. Therefore, a retention period on its own can never be sufficient to design an ex-post risk adjustment for instruments. A retention period is not a substitute for a longer deferral period.

### **c. Possibility of upward revisions**

188. Symmetry between remuneration and risk outcomes has two important dimensions. First, variable remuneration must be flexible enough to be able to go to zero if results turn out to be unexpectedly negative (see above). On the other hand, there is the question as to whether they should be allowed to increase, above the amount that was initially awarded, if the results are unexpectedly good.
189. The answer is straightforward for instruments, since their market price can go up, so implicitly they will be subject to movements in their value in both directions.
190. The question turns more complicated with regard to explicit ex-post risk adjustments (both for cash and instruments). As a general rule, malus arrangements/clawback clauses will normally result in a reduction of the variable remuneration. Under no circumstances should the ex-post risk adjustment lead to an increase of the deferred part. When the staff member is exposed to both the positive and the negative part of the outcomes distribution, he/she will be given incentives to take more risk than that which can be considered prudent from a supervisory point of view.

**Q45: 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.**

### **X.V. Compliance of certain remuneration structures with the requirements on risk alignment of variable remuneration, award and pay-out process**

191. ESMA considers that the policy objectives of the requirements on risk alignment of variable remuneration, the requirements on the award process and on the pay-out process set out under Sections X.II to X.IV above, may be more naturally met by certain remuneration structures which are structured in a very specific way with the aim of ensuring the alignment of the interests of the Identified Staff with those of the investors of the AIFs the AIFM manages.

192. Indeed, ESMA is of the view that the risk alignment requirements in relation with the variable remuneration (as detailed under Sections X.II to X.IV above) may be met where, having regards to all circumstances:

- a) an AIFM must first return all capital contributed by the investors of the AIF it manages and an amount of profits at a previously agreed hurdle rate (if any) to the investors of the AIF, before the Identified Staff of the AIFM may receive any compensation for the management of the relevant AIF; and
- b) the compensation received by the Identified Staff of the AIFM is subject to clawback arrangements until the liquidation of the relevant AIF.

193. Indeed, ESMA considers that the aforementioned remuneration structures could have a built-in adjustment mechanism integrating all types of current and future risks, in accordance with Annex II, paragraph (1)(l) of the AIFMD. Furthermore, the carry clawback and the hurdle rate mechanism could operate in a manner which satisfies both the retention, deferral and vesting requirements set out in Annex II, paragraph (1)(m) and (n) and the requirement that variable remuneration be paid or vest only if it is sustainable and justified. The structure could also allow the remuneration to be considerably contracted where subdued or negative performance occurs, in accordance with Annex II, paragraph (1)(o) of the AIFMD.

**Q46: Do you agree with the analysis on certain remuneration structures which comply with the criteria set out above? If not, please provide explanations.**

**Q47: Do you consider that there is a need for submitting to an equivalent/similar treatment any other form of remuneration? If yes, please provide details of the remuneration structure(s) and of the specific treatment that you consider appropriate.**

**Q48: Please provide qualitative and quantitative data on the costs and benefits that the rules proposed in this Section X (Specific requirements on risk alignment) would imply.**

## **XI. Disclosure**

### **XI.I. External disclosure**

194. Article 22(2)(e) and (f) of the AIFMD provides for the following specific minimum disclosure on remuneration in the annual report of the AIF:

- (e) the total amount of remuneration for the financial year, split into fixed and variable remuneration, paid by the AIFM to its staff, and number of beneficiaries, and, where relevant, carried interest paid by the AIF;*
- (f) the aggregate amount of remuneration broken down by senior management and members of staff of the AIFM whose actions have a material impact on the risk profile of the AIF.*

Box 107 (Content and Format of Remuneration Disclosure) of the AIFMD advice provides for some implementing rules relating to the requirements of Article 22(2)(e) and (f) of the AIFMD.<sup>24</sup>

Section III (Disclosure) of the Recommendation, which is relevant to both AIFMs and AIFs, provides for the following:

7. *Without prejudice to confidentiality and data protection provisions, relevant information on the remuneration policy referred to in section 2 and any updates in case of policy changes should be disclosed by the financial undertaking in a clear and easily understandable way to relevant stakeholders. Such disclosure may take the form of an independent remuneration policy statement, a periodic disclosure in annual financial statements or any other form.*
8. *The following information should be disclosed :*
  - (a) *information concerning the decision-making process used for determining the remuneration policy, including if applicable, information about the composition and the mandate of a remuneration committee, the name of the external consultant whose services have been used for the determination of the remuneration policy and the role of the relevant stakeholders;*
  - (b) *information on linkage between pay and performance;*
  - (c) *information on the criteria used for performance measurement and the risk adjustment;*
  - (d) *information on the performance criteria on which the entitlement to shares, options or variable components of remuneration is based;*
  - (e) *the main parameters and rationale for any annual bonus scheme and any other non-cash benefits.*
9. *When determining the level of the information which should be disclosed, Member States should take into account the nature, the size as well as the specific scope of activities of the financial undertakings concerned.*

ESMA proposes to set out the guidelines below in relation with the abovementioned provisions.

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<sup>24</sup> Box 107 of the AIFMD advice reads as follows:

“1. In accordance with Article 22(2) (e) of the AIFMD, AIFM shall made available for each EU AIF it manages and each AIF it markets in the Union an annual report that should contain information on the total amount of remuneration for the financial year, split into fixed and variable components.

2. In this annual report, it shall be specified whether the total remuneration disclosed in the AIF’s Annual Report relates to:

(a) the total remuneration of the entire staff of the AIFM and indicate the number of beneficiaries; or

(b) the total remuneration of those staff of the AIFM who in part or in full are involved in the activities of the AIF and indicate the number of beneficiaries; or

(c) the proportion of the total remuneration of the staff of the AIFM attributable to the AIF and indicate the number of beneficiaries.

3. Where relevant, the total remuneration for the financial year should also mention the carried interest paid by the AIF.

4. Where this information is disclosed at the level of the AIFM, an allocation or breakdown should be provided in relation to each AIF, insofar as this information exists or is readily available. As part of this disclosure, a description of how the allocation or breakdown has been provided should be included.

5. In relation to the requirements of Article 22 (2) (f) of Directive 2011/61/EU aggregated amounts broken down by senior management and those members of staff whose professional activities have a material impact on the risk profile of the AIF shall be disclosed unless any such disclosure would breach the requirements of Directive 95/46/EC or other applicable legislation”.

## **A. Specific and general requirements on disclosure**

195. The AIFMD provides that AIFMs should disclose the information mentioned in Article 22(2)(e) and (f) of the AIFMD in the AIF's annual report. Paragraph (8) of the Recommendation provides for an additional disclosure on remuneration that AIFMs should consider, to the extent that the Recommendation may also be relevant to them. As for the information to be disclosed, the Recommendation does not specify where information should be disclosed and gives the flexibility to disclose through an independent remuneration policy statement, a periodic disclosure in the annual report or any other form. In all cases, however, the AIFM should ensure that the disclosure is clear and easily understandable and accessible.
196. Without prejudice to confidentiality and applicable data protection legislation, AIFMs should publicly disclose detailed information regarding their remuneration policies and practices for members of staff whose professional activities have a material impact on the risk profile of the AIFs the AIFM manages. AIFMs should also provide general information about the basic characteristics of their AIFM-wide remuneration policies and practices.
197. The Recommendation's remuneration disclosures may be made on a proportionate basis and the overall remuneration proportionality principle will apply to the type and amount of information disclosed. Small or non-complex AIFMs/AIFs will only be expected to provide some qualitative information and very basic quantitative information where appropriate. In practice, this could mean that such AIFMs/AIFs are not expected to provide all the information under paragraph (8) of the Recommendation. AIFMs should disclose how they have applied the proportionality principle.
198. The disclosure should be published on, at least, an annual basis and as soon as practicable after the information becomes available.

## **B. Policy and practices**

199. The disclosure report should set out the decision-making process used to determine the remuneration policy for the individuals to which it applies. This may include the governance procedure relating to the development of the remuneration policy and should include information about the bodies (including their composition and mandate), such as the RemCo or external consultants, which played a significant role in the development of the remuneration policy. AIFMs should outline the role of all relevant stakeholders involved in the determination of the remuneration policy. Additionally, the disclosure should include a description of the regional scope of the AIFM's remuneration policy, the types of staff considered as material risk takers and the criteria used to determine such staff.
200. The report should include information on how pay and performance are linked. Such information should include a description of the main performance metrics used for: the AIFM, top-level business lines, and for individuals (i.e. scorecards). AIFMs should disclose information relating to the design and structure of remuneration processes, such as the key features and objectives of the remuneration policy and how the AIFM ensures that staff members in control functions are remunerated independently of the businesses they oversee. The report should also include a description of the different forms of variable remuneration used (i.e. cash, equity, options, other capital instruments, and long-term incentive plans) and should include the rationale for using these different forms and for allocating them to different categories of staff. Additionally, the report should include a discussion of the parameters used to allocate deferred and non-deferred remuneration for different staff categories.

201. Disclosure reports should describe how the AIFM takes into account current and future risks to which they are exposed when implementing remuneration methodologies and what these risks are. Also, AIFMs should describe the measures used to take account of these risks and the ways in which these measures affect remuneration. In addition, AIFMs should disclose the ways in which they seek to adjust remuneration to take account of longer-term performance - as in the AIFM's policy on deferral, vesting and performance adjustment.
202. The quantitative (financial) as well as qualitative (non-financial) criteria used by AIFMs for assessing individual performance which are relevant for determining the remuneration policies and practices and are described under Section X.II.D.a (Qualitative/Quantitative measures) should also be disclosed in the disclosure reports.
203. The disclosure should be produced and owned by the management body that has the ultimate sign-off on remuneration decisions.

#### **XI.II. Internal disclosure**

204. The remuneration policy of an AIFM should be accessible to all staff members of that AIFM. AIFMs should ensure that the information regarding the remuneration policy disclosed internally reveals at least the details which are disclosed externally. Therefore, according to the size, internal organisation and the nature, scope and complexity of the activities of the AIFM, the information provided to staff members might contain some of the elements listed in Section III (Disclosure) of the Recommendation. The staff members should know in advance the criteria that will be used to determine their remuneration. The appraisal process should be properly documented and should be transparent to the member of staff concerned. Confidential quantitative aspects of the remuneration of staff members should not be subject to internal disclosure.

**Q49: Do you consider appropriate to require AIFMs to apply the same level of internal disclosure of remuneration as they apply to their external disclosure? Please state the reasons of your answer.**

**Q50: Please provide qualitative and quantitative data on the costs and benefits that the rules proposed in this Section XI (Disclosure) would imply.**

## Annex I

### Concepts

The meaning of the specific terminology related to the time horizon of deferral schedules, as used for the purposes of these Guidelines, is outlined here.

**Accrual period:** Period during which the performance of the staff member is assessed and measured for the purposes of determining its remuneration. The right to receive the variable remuneration is earned (“awarded”) at the end of the period or during the period. The accrual period is at least one year, but it may be longer. In some cases different accrual periods may overlap.

**Vesting point:** An amount of remuneration vests when the staff member receives payment and becomes the legal owner of the remuneration. Once the remuneration vests, no explicit ex-post adjustments can occur apart from clawback clauses.

**Deferral period:** Variable remuneration payment can be made immediately after the accrual period (“upfront payments”) or later on. The deferral period is the period during which variable remuneration is withheld following the end of the accrual period. A deferral period should not be less than three to five years, unless the AIFM can demonstrate that the life cycle of the AIF concerned is shorter. Deferred remuneration meets two essential conditions: it is unvested and it is subject to ex-post risk adjustments such as malus. Deferred remuneration pay-out can be a once-only event at the end of the deferral period or may be spread out over several payments in the course of the deferral period, according to a pro-rata vesting scheme.

**Instruments:** see Section X.IV.B.a. (Types of instruments) of the Guidelines.

**Retention period:** period of time during which variable remuneration that has been already vested and paid out in the form of instruments cannot be sold. The retention period is independent from the deferral period. This means that, in order to meet the requirement of a minimum deferral period of three to five years (where applicable), the retention period counts for nothing. The retention period can last for a shorter or longer period than the deferral period applied to the instruments that are not paid upfront.

**Malus:** arrangement that permits the AIFM to prevent vesting of all or part of the amount of a deferred remuneration award in relation to risk outcomes or performances. Malus is a form of ex-post risk adjustment.

**Clawback:** contractual agreement in which the staff member agrees to return ownership of an amount of remuneration to the AIFM under certain circumstances. This can be applied to both upfront and deferred variable remuneration. When related to risk outcomes, clawback is a form of ex-post risk adjustment.

## Annex II

### Mapping of the remuneration principles included in the AIFMD

AIFMD requirements - Annex II		Paragraphs of these Guidelines relating to the relevant requirement	Scope
Par. 1 (a)	the remuneration policy is consistent with and promotes sound and effective risk management and does not encourage risk-taking which is inconsistent with the risk profiles, rules or instruments of incorporation of the AIFs they manage;	96-99	AIFM-wide obligatory
Par. 1 (b)	the remuneration policy is in line with the business strategy, objectives, values and interests of the AIFM and the AIFs it manages or the investors of such AIFs, and includes measures to avoid conflicts of interest;	96 – 99 54 – 70	AIFM-wide obligatory
Par. 1 (c)	the management body of the AIFM, in its supervisory function, adopts and periodically reviews the general principles of the remuneration policy and is responsible for its implementation;	54 – 70	AIFM-wide obligatory
Par. 1 (d)	the implementation of the remuneration policy is, at least annually, subject to central and independent internal review for compliance with policies and procedures for remuneration adopted by the management body in its supervisory function;	67 – 70	AIFM-wide obligatory
Par. 1 (e)	staff engaged in control functions are compensated in accordance with the achievement of the objectives linked to their functions, independent of the performance of the business areas they control;	88 – 94	AIFM-wide obligatory
Par. 1 (f)	the remuneration of the senior officers in the risk management and compliance functions is	88 – 94	AIFM-wide obligatory

	directly overseen by the remuneration committee;		
Par. 1 (g)	where remuneration is performance related, the total amount of remuneration is based on a combination of the assessment of the performance of the individual and of the business unit or AIF concerned and of the overall results of the AIFM, and when assessing individual performance, financial as well as non-financial criteria are taken into account;	125 – 130 135 – 138	Only to the Identified Staff, but AIFM-wide strongly recommended
Par. 1 (h)	the assessment of performance is set in a multi-year framework appropriate to the life-cycle of the AIFs managed by the AIFM in order to ensure that the assessment process is based on longer term performance and that the actual payment of performance-based components of remuneration is spread over a period which takes account of the redemption policy of the AIFs it manages and their investment risks;	123 – 124 155 – 159	Only to the Identified Staff, but voluntary AIFM-wide application is always possible
Par. 1 (i)	guaranteed variable remuneration is exceptional, occurs only in the context of hiring new staff and is limited to the first year;	None	AIFM-wide obligatory
Par. 1 (j)	fixed and variable components of total remuneration are appropriately balanced and the fixed component represents a sufficiently high proportion of the total remuneration to allow the operation of a fully flexible policy, on variable remuneration components, including the possibility to pay no variable remuneration component;	117 – 118	Only to the Identified Staff, but AIFM-wide strongly recommended
Par. 1 (k)	payments related to the early termination of a contract reflect performance achieved over time and are designed in a way that does not reward failure;	106 – 109	AIFM-wide obligatory
Par. 1 (l)	the measurement of performance used to calculate variable remuneration components or pools of variable remuneration components includes a	131 – 133 145 – 151	Only to the Identified Staff, but AIFM-wide

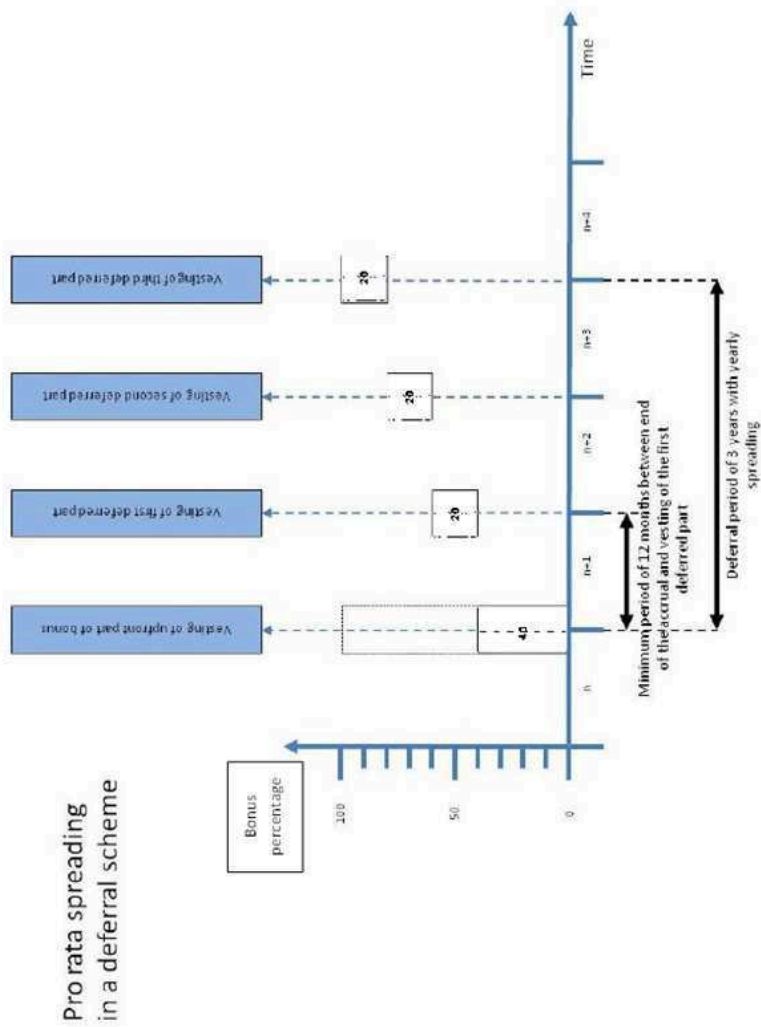
	comprehensive adjustment mechanism to integrate all relevant types of current and future risks;		strongly recommended
Par. 1 (m)	<p>subject to the legal structure of the AIF and its rules or instruments of incorporation, a substantial portion, and in any event at least 50 % of any variable remuneration consists of units or shares of the AIF concerned, or equivalent ownership interests, or share-linked instruments or equivalent non-cash instruments, unless the management of AIFs accounts for less than 50 % of the total portfolio managed by the AIFM, in which case the minimum of 50 % does not apply.</p> <p>The instruments referred to in this point shall be subject to an appropriate retention policy designed to align incentives with the interests of the AIFM and the AIFs it manages and the investors of such AIFs. Member States or their competent authorities may place restrictions on the types and designs of those instruments or ban certain instruments as appropriate. This point shall be applied to both the portion of the variable remuneration component deferred in line with point (n) and the portion of the variable remuneration component not deferred;</p>	145 – 151	Only to the Identified Staff, but voluntary AIFM-wide application is always possible
Par. 1 (n)	<p>a substantial portion, and in any event at least 40 %, of the variable remuneration component, is deferred over a period which is appropriate in view of the life cycle and redemption policy of the AIF concerned and is correctly aligned with the nature of the risks of the AIF in question.</p> <p>The period referred to in this point shall be at least three to 5 years unless the life cycle of the AIF concerned is shorter; remuneration payable under deferral arrangements vests no faster than on a pro-rata basis; in the case of a variable remuneration component of a particularly high amount, at least 60 % of the amount is deferred;</p>	153 – 159	Only to the Identified Staff, but voluntary AIFM-wide application is always possible

Par. 1 (o)	<p>the variable remuneration, including the deferred portion, is paid or vests only if it is sustainable according to the financial situation of the AIFM as a whole, and justified according to the performance of the business unit, the AIF and the individual concerned.</p> <p>The total variable remuneration shall generally be considerably contracted where subdued or negative financial performance of the AIFM or of the AIF concerned occurs, taking into account both current compensation and reductions in payouts of amounts previously earned, including through malus or clawback arrangements;</p>	<p>48 – 51</p> <p>145 – 151</p> <p>179 – 190</p>	<p>Only to the Identified Staff, but voluntary AIFM-wide application is always possible</p>
Par. 1 (p)	<p>the pension policy is in line with the business strategy, objectives, values and long-term interests of the AIFM and the AIFs it manages.</p> <p>If the employee leaves the AIFM before retirement, discretionary pension benefits shall be held by the AIFM for a period of 5 years in the form of instruments defined in point (m). In the case of an employee reaching retirement, discretionary pension benefits shall be paid to the employee in the form of instruments defined in point (m), subject to a 5 year retention period;</p>	<p>96 – 104</p>	<p>AIFM-wide obligatory</p>
Par. 1 (q)	<p>staff are required to undertake not to use personal hedging strategies or remuneration- and liability-related insurance to undermine the risk alignment effects embedded in their remuneration arrangements;</p>	<p>111 – 115</p>	<p>AIFM-wide obligatory</p>
Par. 1 (r)	<p>variable remuneration is not paid through vehicles or methods that facilitate the avoidance of the requirements of this Directive.</p>	<p>23 – 24</p>	<p>AIFM-wide obligatory</p>
Par. 2	<p>The principles set out in paragraph 1 shall apply to remuneration of any type paid by the AIFM, to any amount paid directly by the AIF itself, including carried interest, and to any transfer of units or shares of the AIF, made to the benefits</p>	<p>19 – 33</p>	<p>AIFM-wide obligatory</p>

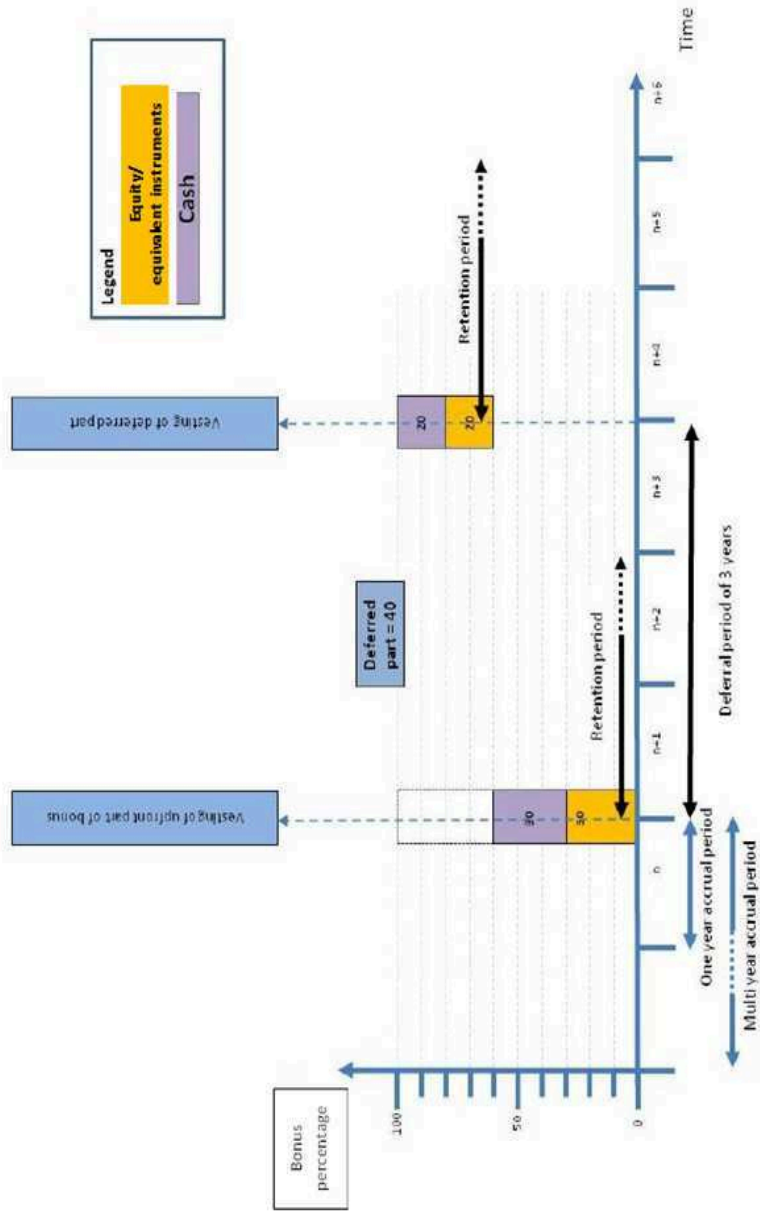
	<p>of those categories of staff, including senior management, risk takers, control functions and any employee receiving total remuneration that takes them into the same remuneration bracket as senior management and risk takers, whose professional activities have a material impact on their risk profile or the risk profiles of the AIF that they manage.</p>		
Par. 3	<p>AIFMs that are significant in terms of their size or the size of the AIFs they manage, their internal organisation and the nature, the scope and the complexity of their activities shall establish a remuneration committee. The remuneration committee shall be constituted in a way that enables it to exercise competent and independent judgment on remuneration policies and practices and the incentives created for managing risk.</p> <p>The remuneration committee shall be responsible for the preparation of decisions regarding remuneration, including those which have implications for the risk and risk management of the AIFM or the AIF concerned and which are to be taken by the management body in its supervisory function. The remuneration committee shall be chaired by a member of the management body who does not perform any executive functions in the AIFM concerned. The members of the remuneration committee shall be members of the management body who do not perform any executive functions in the AIFM concerned.</p>	72 – 81	AIFM-wide obligatory

## Annex III

### Schematic overview of some deferral mechanisms



### Accrual vs. deferral vs. retention



## Annex IV

### Correlation table Recommendation/AIFMD

	<b>Recommendation</b>	<b>AIFMD</b>
1.	Section II, par. 3.1.	Annex II, par. 1(a)
2.	Section II, par. 3.2. and 6.1.	Annex II, par. 1(b)
3.	Section II, par. 6.2.	Annex II, par. 1(c)
4.	Section II, par. 6.5.	Annex II, par. 1(d)
5.	Section II, par. 6.6.	Annex II, par. 1(e)
6.	Section II, par. 5.1. and 5.4.	Annex II, par. 1(g)
7.	Section II, par. 5.2.	Annex II, par. 1(h)
8.	Section II, par. 4.1. and 4.2.	Annex II, par. 1(j)
9.	Section II, par. 4.5.	Annex II, par. 1(k)
10.	Section II, par. 5.3.	Annex II, par. 1(l)
11.	Section II, par. 4.4.	Annex II, par. 1(m)
12.	Section II, par. 4.3.	Annex II, par. 1(n)
13.	Section II, par. 6.4.	Annex II, par. 3

## **Annex V**

### **List of questions**

#### **II. Background**

**Q1: Do you agree with the approach suggested above for developing the present Guidelines? If not, please state the reasons for your answer and also suggest an alternative approach.**

#### **IV. Scope of the Guidelines**

**Q2: Do you agree with the above considerations on the scope of the Guidelines? In particular, do you agree with the clarifications on what should be considered as a remuneration falling into scope and what should be considered an ancillary payment or benefit falling outside the scope of the Guidelines? If not, please state the reasons for your answer and also suggest an alternative approach.**

**Q3: Do you see any benefit in setting a quantitative or qualitative threshold at which the portion of the payment made by the AIF exceeding the pro-rata investment return for the investment made by the relevant staff members is transformed into carried interest? If yes, please make suggestions on the threshold to be used.**

**Q4: 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?**

**Q5: 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)?**

**Q6: 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 categories of staff of the AIFM and, therefore, fall under the scope of the AIFMD remuneration rules (and, therefore, of these Guidelines)?**

**Q7: Do you agree with the categories of staff identified above which should be subject to the remuneration principles set out in the Guidelines? If not, please state the reasons for your answer and also suggest an alternative approach.**

**Q8: Please provide qualitative and quantitative data on the costs and benefits that the rules proposed in this Section IV (Scope of the Guidelines) would imply.**

#### **V. Proportionality principle**

**Q9: 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.**

**Q10: Do you agree with the clarifications proposed above for the application of the proportionality principle to the AIFM's categories of staff? If not, please state the reasons for your answer and also suggest an alternative approach.**

**Q11: Please provide qualitative and quantitative data on the costs and benefits that the rules proposed in this Section V (Proportionality principle) would imply.**

#### **VI. AIFMs being part of a group**

**Q12: Do you agree that there is a need for consistency in the potential application of different requirements for AIFMs which belong to a group subject to other principles?**

**Q13: Do you agree that the proposed alignment of the CRD and AIFMD remuneration provisions will reduce the existence of any conflicting remuneration requirements at group level for AIFMs whose parent companies are credit institutions subject to the CRD? If not, please state the reasons for your answer and provide quantitative details on any additional costs implied by the proposed approach.**

**Q14: Please provide qualitative and quantitative data on the costs and benefits that the rules proposed in this Section VI (AIFMs being part of a group) would imply.**

#### **VII. Financial situation of the AIFM (Annex II, paragraph 1(o) of the AIFMD)**

**Q15: Do you agree with the above principle aimed at preserving the soundness of the AIFM's financial situation? If not, please state the reasons for your answer and also suggest an alternative approach.**

**Q16: Please provide qualitative and quantitative data on the costs and benefits that the rules proposed in this Section VII (Financial situation of the AIFM) would imply.**

#### **VIII. Governance of remuneration**

**Q17: Do you agree with the proposed split of competences between the members of the management function and those of the supervisory function? If not, please provide explanations.**

**Q18: Do you agree with the guidelines above on the shareholders' involvement in the remuneration of the AIFM?**

**Q19: 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.**

**Q20:** 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.

**Q21:** Please provide quantitative data on the costs and benefits that the proposed criteria to determine whether a RemCo has to be set up would imply.

**Q22:** 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.

**Q23:** Do you agree with the principles relating to the composition of the RemCo? Please provide quantitative data on the costs and benefits that the proposed principles on the composition of the RemCo would imply.

**Q24:** Do you see any need for setting out additional rules on the composition of the RemCo?

**Q25:** Do you agree with the role for the AIFM's RemCo outlined above? If not, please provide explanations.

**Q26:** Do you agree with the principles above on the process and reporting lines to be followed by the RemCo? If not, please provide explanations.

**Q27:** Do you consider that the AIFM's RemCo should provide adequate information about the activities performed not only to the AIFM's shareholders' meeting, but also to the AIFs' shareholders' meetings? When providing your answer, please also provide quantitative details on the additional costs involved by such requirement.

**Q28:** Do you agree with the above criteria on the remuneration of the control functions? If not, please provide explanations.

**Q29:** Please provide qualitative and quantitative data on the costs and benefits that the rules proposed in this Section VIII (Governance of remuneration) would imply.

## **IX. General requirements on risk alignment**

**Q30:** Do you agree with the principles related to the treatment of discretionary pension benefits? If not, please provide explanations.

**Q31:** Do you consider appropriate to add any further guidance on the payments related to the early termination of a contract? If yes, please provide suggestions.

**Q32:** Do you consider that the above guidance is sufficiently broad to cover any kind of hedging strategies that may be pursued by a member of the staff of an AIFM? If not, please provide details on how the scope of the guidance should be enlarged.

**Q33:** Please provide qualitative and quantitative data on the costs and benefits that the rules proposed in this Section IX (General requirements on risk alignment) would imply.

**X. Specific requirements on risk alignment**

**Q34:** Do you consider these common requirements for the risk alignment process appropriate? If not, please provide explanations and alternative requirements.

**Q35:** Do you agree with the proposed criteria on risk measurement? If not, please provide explanations and alternative criteria.

**Q36:** Do you agree that in order to take into account all material risks AIFMs should also take into account the risks arising from the additional management of UCITS and from the services provided under Article 6(4) of the AIFMD?

**Q37:** Do you agree with the proposed guidance for the financial and non-financial criteria to be taken into account when assessing individual performance? If not, please provide explanations and alternative guidance.

**Q38:** Do you agree with the proposal to distinguish between absolute and relative performance measures on one side and between internal and external performance measures on the other? If not, please provide explanations.

**Q39:** Do you agree with the requirement set out above to document the policy for the award process and ensure that records of the determination of the overall variable remuneration pool are maintained? If not, please provide explanations and an alternative procedure.

**Q40:** Do you agree with the proposal according to which AIFMs should use both quantitative and qualitative measure for the ex-ante risk adjustment? If not, please provide explanations and an alternative proposal.

**Q41:** Do you agree with the guidance on the different components to be considered in relation with the deferral schedule for the variable remuneration? If not, please provide explanations and alternative guidance.

**Q42:** Do you agree with the types of instruments composing the variable remuneration which have been identified by ESMA? If not, please provide explanations.

**Q43:** Do you consider that additional safeguards should be introduced in these Guidelines in order to ensure that the payment of the Identified Staff with instruments does not entail/facilitate any excessive risk-taking by the relevant staff in order to make short-term gains via the instruments received? If yes, please provide details.

**Q44:** 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.

**Q45: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.**

**Q46:Do you agree with the analysis on certain remuneration structures which comply with the criteria set out above? If not, please provide explanations.**

**Q47:Do you consider that there is a need for submitting to an equivalent/similar treatment any other form of remuneration? If yes, please provide details of the remuneration structure(s) and of the specific treatment that you consider appropriate.**

**Q48:Please provide qualitative and quantitative data on the costs and benefits that the rules proposed in this Section X (Specific requirements on risk alignment) would imply.**

## **XI. Disclosure**

**Q49:Do you consider appropriate to require AIFMs to apply the same level of internal disclosure of remuneration as they apply to their external disclosure? Please state the reasons of your answer.**

**Q50:Please provide qualitative and quantitative data on the costs and benefits that the rules proposed in this Section XI (Disclosure) would imply.**

## Annex VI

### Cost-benefit analysis

#### 1. Introduction

1. Pursuant to Article 16 of the Regulation establishing ESMA<sup>25</sup>, ESMA is empowered to issues guidelines and recommendations addressed to competent authorities or financial market participants with a view to establishing consistent, efficient and effective supervisory practices within the European System of Financial Supervision, and to ensuring the common, uniform and consistent application of Union law. The same article obliges ESMA to analyse the related potential costs and benefits, where appropriate. Such consultations and analyses shall be proportionate in relation to the scope, nature and impact of the guidelines or recommendations.
2. Pursuant to Article 13 of the AIFMD, ESMA is required to ensure the existence of guidelines on sound remuneration policies which comply with Annex II of the Directive. The guidelines shall take into account the principles on sound remuneration policies set out in Recommendation 2009/384/EC, the size of the AIFMs and the size of AIFs they manage, their internal organisation and the nature, the scope and the complexity of their activities. ESMA is required to cooperate closely with the European Banking Authority.

#### 2. Procedural issues and consultation process

3. ESMA is seeking feedback from stakeholders on its proposals via this consultation paper. For these guidelines, ESMA did not consider it necessary to publish a discussion paper, taking into account the significant amount of material already in place with respect to remuneration (e.g. the aforementioned Commission Recommendation of 2009 and the guidelines developed by the Committee of European Banking Supervisors Guidelines on Remuneration Policies and Practices of 10 December 2010), the fact that the remuneration principles are already clearly stated at Level 1 by the AIFMD (which implies limited room for policy choices at the level of guidelines) and the desirability of having the guidelines in place well in advance of the transposition deadline of the Directive of 22 July 2013.
4. This cost-benefit analysis assesses the (qualitative) costs and benefits that will potentially arise from the different policy options identified by ESMA. Stakeholders' views are sought on these costs and benefits; quantitative data would be particularly useful in helping ESMA reach a final decision on the best approach.

#### 3. Problem definition

5. As noted above, ESMA is obliged to develop guidelines with respect to remuneration of AIFMs. The aim of these guidelines should be consistent with that of the provisions in the Level 1 Directive, namely to ensure that AIFMs apply remuneration policies and practices that are consistent with and promote sound and effective risk management and do not encourage risk-taking which is inconsistent with the

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<sup>25</sup> Regulation (EU) No 1095/2010 of the European Parliament and of the Council of 24 November 2010.

risk profiles, rules or instruments of incorporation of the AIFs they manage. The problems that should be tackled were already described extensively in the impact assessment that accompanied the Commission Recommendation.<sup>26</sup> In particular, the situation was summarised as follows: ‘Remuneration schemes in the financial services industry favoured excessive risk-taking in financial institutions at the expense of their long-term performance.’

6. The baseline scenario for this cost-benefit analysis would be the application of the requirements in the Level 1 Directive (i.e. the provisions in Article 13 and Annex II). This would in effect be more of a principles-based approach, leaving discretion to AIFMs to determine how best to apply the high-level requirements to their businesses. This could lead to a lack of harmonisation in the application of the provisions of the Level 1 Directive across the alternative investment industry.

#### **4. Objectives of the guidelines**

7. The guidelines aim to promote the objectives of the Level 1 Directive and, by extension, those of the Commission Recommendation of 2009. They also aim to clarify how the requirements should be applied taking into account the different remuneration structures that exist in the AIF sector. They should contribute to the creation of a level playing field across Member States, which will help ensure that the risks tackled by the guidelines are done so in a harmonised way and there is reduced scope for regulatory arbitrage (e.g. an AIFM choosing to move its activities to a jurisdiction with a more flexible approach) which could hamper the key objectives of the Level 1 Directive such as the alignment of the interests of the AIFM’s staff with those of the AIFM and the AIFs it manages or the investors of such AIFs.

#### **5. Policy options**

8. It is worth noting at the outset that ESMA has taken as a starting point for these guidelines the aforementioned CEBS guidelines of 2010.

##### Scope of the guidelines

9. Clarification of scope issues is crucial in determining the potential overall impact of the guidelines. In this context, it is important to state clearly which types of remuneration are covered, which entities and staff will be subject to the guidelines and the timing of the entry into force of the guidelines.
10. Regarding the types of remuneration covered, the text of Level 1 is already clear and leaves limited room for interpretation or development of different policy options. ESMA has therefore followed the same approach in its draft guidelines, which does not create any costs beyond those of the Level 1 text. The position is similar with respect to the determination of the entities and staff that will be subject to the guidelines.

#### **6. The likely economic impacts**

11. This section sets out the incremental economic costs and benefits associated with the proposed guidelines, taking as a baseline scenario the existence of Article 13 and Annex II of the AIFMD only (i.e. without complementary guidelines).

##### Direct costs and benefits for regulators

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<sup>26</sup> [http://ec.europa.eu/internal\\_market/company/docs/directors-remun/impact\\_assessment\\_en.pdf](http://ec.europa.eu/internal_market/company/docs/directors-remun/impact_assessment_en.pdf).

12. The guidelines are likely to lead to some additional costs for regulators to the extent that competent authorities (CAs) will be required to incorporate them into their supervisory practices. This implies that CAs may need to hire additional staff or provide training to existing staff. Depending on the supervisory approach taken to the alternative investment fund management sector by each CA, the costs may arise from the need to spend more time when carrying out supervisory visits at AIFMs or through the broadening of the scope of a thematic review into AIFMs in a particular jurisdiction.
13. There are likely to be benefits from the guidelines to the extent that they provide CAs with a clear framework against which to assess AIFMs' compliance with the requirements in Article 13 and Annex II. In the absence of the guidelines, CAs would need to clarify on their own how the high-level requirements of the Directive should be applied in practice by AIFMs. Indeed, it is likely that AIFMs themselves would seek such clarification from CAs. The guidelines should therefore help reduce the need for both one-off and ongoing requests for further guidance and clarification from external stakeholders.

#### Compliance costs for firms

14. The AIFMD framework as a whole will lead to increased compliance costs for firms. The Impact Assessment carried out by the European Commission discusses this extensively. As set out in that document, these costs should be balanced by benefits in terms of greater financial stability, investor protection etc. With respect to the remuneration guidelines in particular, compliance costs will arise principally via the time needed for existing personnel (mainly, but not exclusively, the compliance function) to familiarise themselves with the guidelines and to put the necessary structures in place. For some AIFMs, it may be necessary to hire additional personnel although this will depend very much on the extent to which the AIFM in question is already applying similar procedures or not. For AIFMs that are part of a group that is already subject to the Capital Requirements Directive (CRD) and the corresponding CEBS guidelines, for example, the costs of adjustment should be less since these guidelines have been inspired by the CEBS guidelines.

#### Indirect costs

15. Indirect costs are inherently difficult to identify and assess. The aim of the guidelines is, inter alia, to ensure alignment of interests between the AIFM and investors in the AIF. Assuming that this aim is achieved, the indirect costs that may arise should be outweighed by the benefits of the broader policy objective. However, it cannot be excluded that the stricter requirements resulting from the guidelines may lead to indirect costs to the extent that they may reduce incentives for new entities to enter the market. Similarly, if the guidelines oblige existing AIFMs to modify their remuneration policies and practices, those AIFMs may have a reduced incentive to continue or expand their activities.

#### Benefits

16. As mentioned above, the guidelines aim to ensure alignment of interests between the AIFM and investors in the AIF. They also seek to ensure that remuneration policies and practices for Identified Staff are consistent with and promote sound and effective risk management and do not encourage risk-taking which is inconsistent with the risk profiles, rules or instruments of incorporation of the AIFs they manage. These objectives are clearly a beneficial step for AIF investors, particularly the alignment of interests, while the focus on reducing excessive risk-taking should be beneficial to the market as a whole by helping avoid potential sources of systemic risk.

17. In addition to the above, and while noting that is not a benefit per se, regard should also be had to level playing field issues. Taking into account the Commission's objective, as set out at the time of its 2009 Recommendation, to have a harmonised approach on a cross-sectoral basis, it is important to ensure that the alternative investment fund sector is subject to a consistent set of requirements as for other areas of financial services.

#### Impacts on third countries

18. The general principle underpinning the AIFMD with respect to non-EU entities is that of 'same rights, same obligations'. Therefore, non-EU AIFMs should in general be subject to the same requirements as EU AIFMs when operating in the EU. Taking into account the benefits that this access to the EU market provides, it seems reasonable to expect the non-EU AIFMs to comply with the same obligations as their EU counterparts. Indeed, applying a more lenient approach to entities from 3<sup>rd</sup> countries would place EU entities at a competitive disadvantage, potentially leading to loss of key personnel due to the highly competitive and global nature of the AIF sector.
19. Furthermore, as regards remuneration rules, the principles expressed in the AIFMD and these draft guidelines are broadly inspired by the Financial Stability Forum's Principles for Sound Compensation Practices and their Implementation Standards that were endorsed by the G20 Leaders at their Summits in London in April 2009 and Pittsburgh in September 2009. As mentioned in the Peer Review Report '2011 Thematic Review on Compensation' published by the Financial Stability Board (FSB) on 7 October 2011<sup>27</sup>, FSB members have made good progress toward implementing the aforementioned principles and standards since the first thematic review was completed in March 2010, especially in some emerging market jurisdictions. Therefore, at least for those third countries which are FSB member jurisdictions, it may be the case that principles similar to those included in the draft guidelines already apply to alternative investment fund managers.

#### Impact on small and medium-sized enterprises

20. The principles in Annex II of the AIFMD must be applied 'in a way and to the extent that it is appropriate to their size, internal organisation and the nature, scope and complexity of their activities'. ESMA's draft guidelines have been developed in light of this general proportionality principle (see in particular Section V) with the aim of allowing appropriate tailoring for smaller, less complex AIFMs. As set out in the guidelines, the concepts of 'size', 'internal organisation' and 'nature, scope and complexity of the activities' must be assessed taking into account a range of factors. In this context, it should be noted that the fact that an AIFM is small in terms of number of staff does not necessarily mean that it is managing only a small amount of assets or that it is not pursuing relatively risky investment strategies. The guidelines should therefore be applied in a way that takes into account the AIFM's features as a whole.

#### Impacts by region of the EU

21. Although the market for some types of AIFM is more heavily concentrated in certain jurisdictions, the broad range of entities covered by the Directive means that its impact – and that of the guidelines – will be felt throughout the EU.

### **7. Comparing the options**

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<sup>27</sup> [http://www.financialstabilityboard.org/publications/r\\_111011a.pdf](http://www.financialstabilityboard.org/publications/r_111011a.pdf).

22. This section compares the options that ESMA has identified for the different elements of the guidelines, taking into account the overall costs and benefits.

#### Section I – Scope

##### Issue – application of guidelines to CAs and/or AIFMs

23. In line with the options available under Article 16 of the ESMA Regulation, ESMA has considered whether to apply the guidelines to CAs only, to AIFMs only, or to both. On the basis of the Directive, it seems clear that the guidelines should apply directly at least to AIFMs since they target AIFMs' remuneration policies and practices. ESMA is of the view that in order to achieve the most effective implementation of the guidelines, they should also apply to CAs. This will oblige CAs to take into account the guidelines in their day-to-day supervisory practices.

#### Section V – Guidelines on the proportionality principle

##### Issue – quantitative versus qualitative approach to criteria with respect to the different characteristics of AIFMs

24. The principles in Annex II are to be applied taking into account the size, internal organisation and the nature, scope and complexity of the AIFM's activities. ESMA has considered whether to develop a quantitative approach to these concepts or rely on a more qualitative approach. For the 'size' criterion, for example, it could be envisaged that the guidelines would specify thresholds of assets under management and that the precise requirements to be applied would depend on the category into which an AIFM fell. Alternatively, regard could be had to the number of staff employed by the AIFM. Similar approaches could be considered for the complexity of the AIFM's activities e.g. applying a particular set of requirements to AIFMs pursuing a specific type of investment strategy. One benefit of such an approach could be greater certainty for AIFMs when applying the guidelines to their remuneration policies and practices (and for CAs when monitoring that compliance via their supervisory activities). However, any quantitative approach would limit the extent to which flexibility could be used and a case by case approach taken in determining how the proportionality principle should be applied. Since ESMA considers that flexibility is the key element when dealing with the proportionality principle, it decided to prefer the qualitative to the quantitative approach.

##### Issue – application of proportionality at an AIFM-wide basis only or also considering the different categories of staff

25. The remuneration principles should apply to the different AIFMs taking into account their size, internal organisation and the nature, scope and complexity of their activities. This means that not all AIFMs should have to give substance to the remuneration requirements in the same way and to the same extent and, therefore, the relevant principles should be applied in a different manner to different AIFMs having regard to each AIFM as a whole. Notwithstanding the fact that Level 1 requires the remuneration rules to be applied to all categories of staff whose activities have an impact on the risk profile of the AIFMs or of AIFs they manage, ESMA has considered whether within all these categories of staff specific consideration should also be given to the individual categories of staff of the AIFM for applying to them the requirements in a tailored manner. The advantage of this option would be the possibility to graduate the obligations of the relevant staff member depending on his or her impact on the risk profile of the AIFM: persons having a more limited impact would be subject to less strict requirements, whereas people having a bigger impact would be subject to more stringent requirements. ESMA believes that this approach is in line with the objectives of the requirements at Level 1 and would not imply specific costs for AIFMs while ensuring the aforementioned benefits. The alternative

option of applying all the requirements in a blanket manner to all the categories of staff within the same AIFM would not be in line with the proportionality principle, which implies the adoption of a more graduated approach depending on each specific situation.

#### Section VI – Guidelines for AIFMs being part of a group

26. The CRD, which applies to credit institutions and investment firms, provides for specific remuneration requirements which are broadly in line with the ones set out in the AIFMD. Since AIFMs may be part of a group the parent company of which may be a credit institution subject to the CRD (and the relevant CEBS guidelines), the issue of the interaction between the rules applicable in the banking sector and the ones applicable in the alternative investment management sector needs to be considered. ESMA believes that, given the broad alignment between the provisions of the CRD and the AIFMD on remuneration, the risk of conflicting rules is in principle limited. Such a risk should be even reduced by the fact that the draft guidelines under the AIFMD are largely inspired by the CEBS guidelines on remuneration and that, therefore, there should be no contradictions between these two texts.
27. AIFMs belonging to a group which has a parent credit institution should however be able to assess how to comply with the relevant remuneration requirements applying at the group level. Indeed, the CRD provides that its remuneration principles should apply not only to the credit institutions which are within its scope, but also to entities which are part of a banking group. AIFMs could then have to double check whether they comply with the CRD remuneration rules or not. Alternatively, they could consider that the compliance with the remuneration rules under the AIFMD and these draft guidelines ensures the compliance with the CRD rules at a group level, without having to perform any specific check and leaving to the parent credit institution the oversight of the remuneration policies and practices applied at a group level. In ESMA's views, the latter approach is more in line with the views expressed by CEBS in its guidelines (where the role of the sectoral remuneration requirements is explicitly recognised) and avoids imposing to AIFMs excessively burdensome requirements such as double-checking whether a given practice/policy is in line with both the ESMA remuneration guidelines and the CEBS remuneration guidelines.

#### Section VII – Guidelines on the financial situation of the AIFM

28. The payment of variable remuneration to its staff may put (or risk to put) the AIFM in a situation where it is no longer able to comply with the requirements on its financial situation stemming from the Level 1 provisions. In order to avoid such an outcome, Level 1 provides that AIFMs should pay or vest variable remuneration only if it is sustainable according to the financial situation of the AIFM. There may be alternative solutions to determine what should be done by AIFMs when they become or risk becoming unable to maintain a sound financial situation. One solution could be that AIFMs should refrain from paying or vesting variable remuneration only for the affected financial year. An alternative solution would be to impose to the AIFM not only to avoid paying variable remuneration for the affected financial year, but to also require a more proactive role of the AIFM and impose some performance adjustment measures (i.e. malus or clawback) in that financial year and in principle not compensate for this at a later date. This second approach may entail some additional costs for AIFMs to the extent that it may make it more difficult to attract new staff or retain existing personnel. However, ESMA considers that it is preferable since it has the advantage of being more in line with the spirit of the remuneration requirements set out at Level 1 (in particular, those requiring adjustment mechanisms for the variable remuneration).

#### Section VIII – Guidelines on governance of remuneration

29. Most of the provisions on the governance of remuneration provide clarifications on the requirements stemming from the Level 1 provisions and do not impose any additional requirement to AIFMs. However, as for the clarifications on the remuneration committee, ESMA faced two options for setting up the relevant policy proposal.

#### Issue – remuneration committee

30. AIFMs which are ‘significant’ in terms of their size, or the size of the AIF they manage, their internal organisation and the nature, the scope and the complexity of their activities are required to set up a remuneration committee. ESMA considered that two options were available for providing clarifications on what should be considered ‘significant’ for the purposes of the requirement to set up a remuneration committee. The first option was to propose one or several tests that AIFM have to pass for each of the relevant criteria (i.e. size, internal organisation and nature, scope and complexity of the activities) in order to determine whether or not an AIFM is ‘significant’. The test could be quantitative and/or qualitative. The second option was not to set a list of tests to be passed by AIFMs, but to only provide some indications of what can be taken into account for determining whether or not an AIFM is ‘significant’. The advantage of the first option is that it could offer more certainty for AIFMs as to when they are obliged to establish a remuneration committee (and for CAs when monitoring the compliance with this requirement via their supervisory activities); however, the list of tests would certainly not be exhaustive and thus would risk not covering certain elements that may be relevant when having to determine whether or not an ‘AIFM’ is significant in terms of the elements to be taken into account. Ultimately, this approach could potentially lead to the unintended consequence of not taking into account certain elements that in fact be key in establishing an AIFM as ‘significant’, but that are not included in the list of tests. For this reason, ESMA preferred the second option and chose to only provide examples of AIFMs which are entitled not to establish a remuneration committee.

#### Section IX – Guidelines on the general requirements on risk alignment

31. The provisions on the general requirements on risk alignment provide clarifications on the requirements stemming from the Level 1 provisions and do not impose any additional requirement on AIFMs.

#### Section X – Guidelines on the specific requirements on risk alignment

32. Most of the provisions on the specific requirements on risk alignment provide clarifications on the requirements stemming from the Level 1 provisions and do not impose any additional requirement on AIFMs.

#### Issue – treatment of certain remuneration structures

33. Given the different specificities of the asset managers’ population that is covered by the AIFMD and the specific remuneration practices put in place by some of them, ESMA analysed whether or not some of these practices merited a specific consideration within the remuneration guidelines. Indeed, ESMA is aware that certain types of AIFM have remuneration structures which are set up in a way which aims to align the interests of their staff with those of the investors of the AIFs the AIFM manages, which is ultimately the aim of the AIFMD remuneration requirements. These structures may more naturally meet the policy objectives of the requirements on risk alignment of variable remuneration, the requirements on the award process and on the pay-out process set out. Starting from these considerations, several options could be envisaged in relation to these remuneration structures.

34. One option would be to totally exempt them from the specific requirements on risk alignment, provided that their structure complies with certain conditions (i.e. the AIFM must first return all capital contributed by the investors of the AIF it manages and an amount of profits at a previously agreed hurdle rate, if any, to the investors of the AIF, before the relevant staff of the AIFM may receive any compensation and such a compensation is subject to clawback arrangements). This option would entail a relevant compliance benefit for those AIFMs which would not have to check the respect of the full set of requirements of the AIFMD on risk alignment. However, the disadvantage of this option is that these structures, even if formally complying with the relevant conditions for being exempted, might not be fully in line with the risk alignment objectives of the AIFMD and, therefore, an unconditional exemption could lower the investor protection objectives underlying the risk alignment rules.
35. Another option would be not to take into consideration the specificities of these remuneration structures and to subject them to the full set of the risk alignment rules of the AIFMD. The outcome of this approach would be to subject the AIFMs which make use of these remuneration structures to potentially material compliance costs which might not be necessary from an investor protection point of view, to the extent that it is ensured that the relevant remuneration structures effectively achieve the risk alignment objectives.
36. A third option would be to take an intermediate approach and recognise that these remuneration structures exist and may ensure an alignment of interests, but to leave to the AIFM and the CAs to assess on a case-by-case basis whether or not the said structures (through their functioning mechanism) guarantee that the relevant requirements are fully respected. This may happen because, for instance a built-in adjustment mechanism ensures that all types of current and future risk are integrated in the remuneration structure, the carry clawback and the hurdle rate mechanism operate in a manner which satisfies both the retention, deferral and vesting requirements or the structure allows the remuneration to be considerably contracted where subdued or negative performance occurs. ESMA considers that this approach ensures the right balance between the advantages and disadvantages of the two aforementioned options.

#### Section XI – Guidelines on disclosure

##### Issue – application of the disclosure requirements of the Commission Recommendation of 2009 to AIFMs

37. The section on disclosure does not impose any additional requirements on AIFMs in relation to the provisions on disclosure of the Level 1 Directive, which provides clear rules on the content of the AIF's annual report disclosure on remuneration.
38. However, ESMA considered whether it would be appropriate to add to the Level 1 provisions on disclosure the supplemental disclosure requirements which are mentioned in the Commission Recommendation of 2009. The costs for AIFMs implied by this approach should be limited considering that the disclosure could be done through alternative methods (an independent remuneration policy statement, a periodic disclosure in the annual report or any other form) and, to the extent that an AIFM may decide to disclose through the AIF's annual report, it should not incur any substantial additional costs. Furthermore, the proportionality principle would ensure that the costs are limited, since the type and amount of information disclosed would be in line with the size and complexity of the AIFMs/AIFs. This additional disclosure would generate benefits for the investors of the AIFs the AIFM manages since it would increase transparency and the quality of information provided to them. This approach is also supported by the fact that it would be in line with the requirement of Level 1 accord-



ing to which in its guidelines ESMA should take into account the principles on sound remuneration of the Commission Recommendation of 2009.

## Annex VII

### Draft guidelines on sound remuneration principles under the AIFMD

#### I. Scope

##### Who?

1. These guidelines apply to AIFMs and competent authorities.

As long as the national regimes referred to in Article 42 of the AIFMD will continue to be in force, non-EU AIFMs which market to professional investors units or shares of AIFs in Member States without a passport will only be subject to Section XIII (Guidelines on disclosure) of these guidelines. These non-EU AIFMs will be subject to the full set of remuneration requirements in these guidelines as from the date when the national regimes referred to in Article 42 of the AIFMD will be terminated and the passport regime provided for in Articles 37 to 41 of the AIFMD will become the sole and mandatory regime applicable in all Member States, as determined by the Commission's delegated act referred to in Article 68(6) of the AIFMD.

2. In accordance with Article 5 of the AIFMD, for the purposes of these guidelines, the AIFMs to which the remuneration principles apply shall be either an external manager or, where the legal form of the AIF permits internal management and where the AIF's *governing body* chooses not to appoint an external AIFM, the AIF itself. AIFs which are not internally managed and have appointed an external AIFM are not subject to the remuneration principles established in the AIFMD as well as these guidelines. However, the remuneration principles set out in the *Recommendation* are relevant to those AIFs, as well as the AIFMs which can benefit from the exclusions and exemptions foreseen in Articles 2 or 3 of the AIFMD, to the extent that they fall within the definition of 'financial undertaking' provided in paragraph 2.1 of the *Recommendation*. Annex I<sup>28</sup> of these guidelines provides for a correlation table highlighting those principles of the *Recommendation* which are reflected in the AIFMD.

##### What?

3. These guidelines apply in relation to the remuneration policies and practices for *identified staff*.

##### When?

4. These guidelines apply from 22 July 2013.

#### II. Definitions

Unless otherwise specified, terms used in the Directive 2011/61/EC of the European Parliament and of the Council of 8 June 2011 on Alternative Investment Fund Managers and amending Directives

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<sup>28</sup> Annex IV of the CP

2003/41/EC and 2009/65/EC and Regulations (EC) No 1060/2009 and (EU) No 1095/2010<sup>29</sup> (AIFMD) have the same meaning in these guidelines. In addition, the following definitions apply:

<i>governing body</i>	the <i>management body</i> of an AIFM.
<i>Recommendation</i>	Commission Recommendation 2009/384/EC of 30 April 2009 on remuneration policies in the financial services sector. <sup>30</sup>
<i>identified staff</i>	categories of staff, including <i>senior management</i> , risk takers, <i>control functions</i> and any employee receiving total remuneration that takes them into the same <i>remuneration bracket</i> as <i>senior management</i> and risk takers, whose professional activities have a material impact on the AIFM's risk profile or the risk profiles of the AIF that it manages.
<i>senior management</i>	the person or persons who effectively conduct the business of an AIFM in accordance with Article 8(1)(c) of the AIFMD.
<i>control functions</i>	staff (other than <i>senior management</i> ) responsible for risk management, compliance, internal audit and similar functions within an AIFM (e.g. the CFO to the extent that he/she is responsible for the preparation of the financial statements).
<i>remuneration bracket</i>	the range of the total remuneration of each of the staff members in the senior manager and risk taker categories – from the highest paid to the lowest paid in these categories.
<i>instruments</i>	units or shares of the AIFs managed by the AIFM or equivalent ownership interests, subject to the legal structure of the AIFs concerned and their rules or instruments of incorporation, or share-linked instruments or equivalent non-cash instruments
<i>malus</i>	arrangement that permits the AIFM to prevent vesting of all or part of the amount of a deferred remuneration award in relation to risk outcomes or performances of the AIFM as a whole, the business unit, the AIF and, where possible, the staff member. Malus is a form of ex-post risk adjustment.
<i>clawback</i>	contractual agreement in which the staff member agrees to return ownership of an amount of remuneration to the AIFM under certain circumstances. This can be applied to both upfront and deferred variable remuneration. When related to risk outcomes, clawback is a form of ex-post risk adjustment.
<i>supervisory function</i>	the relevant persons or body or bodies responsible for the supervision of the AIFM's <i>senior management</i> and for the assessment and periodical review of the adequacy and effectiveness of the risk management process and of the policies, arrangements and procedures put in place to comply with the obligations under the AIFMD. For those AIFMs that given their size, internal organisation and the nature, scope and complexity of their activities do not have a separate superviso-

<sup>29</sup> <http://eur-lex.europa.eu/LexUriServ/LexUriServ.do?uri=OJ:L:2011:174:0001:0073:EN:PDF>.

<sup>30</sup> <http://eur-lex.europa.eu/LexUriServ/LexUriServ.do?uri=OJ:L:2009:120:0022:0027:EN:PDF>.

ry function, the supervisory function should be understood as the person or persons in charge of the *management body*.

<i>management body</i>	the component of the governance structure with ultimate jurisdiction and power of direction. In corporate structures this is usually the board of directors but in other structures may be an equivalent body. The governing body is distinct from <i>senior management</i> , whom it directs, but some or all members of <i>senior management</i> may comprise the management body which may also contain non-executive members.
<i>retention period</i>	period of time during which variable remuneration that has been already vested and paid out in the form of <i>instruments</i> cannot be sold.
<i>accrual period</i>	period during which the performance of the staff member is assessed and measured for the purposes of determining its remuneration.
<i>deferral period</i>	the deferral period is the period during which variable remuneration is withheld following the end of the <i>accrual period</i> .
<i>vesting point</i>	an amount of remuneration vests when the staff member receives payment and becomes the legal owner of the remuneration. Once the remuneration vests, no explicit ex-post adjustments can occur apart from <i>clawback</i> clauses.

### III. Purpose

5. The purpose of these guidelines is to ensure common, uniform and consistent application of the provisions on remuneration in Articles 13 and 22(2)(e) and (f) of, and Annex II to, the AIFMD.

### IV. Compliance and reporting obligations

#### Status of the guidelines

6. This document contains guidelines issued under Article 16 of the ESMA Regulation<sup>31</sup>. In accordance with Article 16(3) of the ESMA Regulation competent authorities and financial market participants must make every effort to comply with guidelines and recommendations.
7. Competent authorities to whom the guidelines apply should comply by incorporating them into their supervisory practices, including where particular guidelines within the document are directed primarily at financial market participants.

#### Reporting requirements

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<sup>31</sup> Regulation (EU) No 1095/2010 of the European Parliament and of the Council of 24 November 2010 establishing a European Supervisory Authority (European Securities and Markets Authority), amending Decision No 716/2009/EC and repealing Commission Decision 2009/77/EC.

8. Competent authorities to which these guidelines apply must notify ESMA whether they comply or intend to comply with the guidelines, with reasons for non-compliance, within two months of the date of publication by ESMA to [email address]. In the absence of a response by this deadline, competent authorities will be considered as non-compliant. A template for notifications is available from the ESMA website.
9. AIFMs are not required to report whether they comply with these guidelines.

## **V. Guidelines on which remuneration is covered by these guidelines**

10. For the purposes of the guidelines, remuneration consists of all forms of payments or benefits paid by the AIFM, of any amount paid by the AIF itself, including carried interest, and of any transfer of units or shares of the AIF, in exchange for professional services rendered by the AIFM staff.
11. All remuneration can be divided into either fixed remuneration (payments or benefits without consideration of any performance criteria) or variable remuneration (additional payments or benefits depending on performance or, in certain cases, other contractual criteria). Both components of remuneration (fixed and variable) may include monetary payments or benefits (such as cash, shares, options, cancellation of loans to staff members at dismissal, pension contributions, remuneration by AIFs e.g. through carried interest models) or non (directly) monetary benefits (such as, discounts, fringe benefits or special allowances for car, mobile phone, etc.). Ancillary payments or benefits that are part of a general, non-discretionary, AIFM-wide policy and pose no incentive effects in terms of risk assumption can be excluded from this definition of remuneration for the purposes of the AIFMD specific risk alignment remuneration requirements.
12. Any payment made directly by the AIF to the benefit of those categories of staff mentioned under Annex II, paragraph (2) of the AIFMD which consists of a pro-rata return on any investment made by those staff members into the AIF should not be subject to any of the remuneration requirements set out in these guidelines. In order for a return on an investment made by the staff member into the AIF to be considered as exempted from the remuneration provisions, the investment needs to consist in an actual disbursement made by the staff member (i.e. loans granted by the AIFM to the staff member in order to allow a co-investment into the AIF should not be considered as an investment for the purposes of the exemption if the loan has not been reimbursed by the staff member by the time the return is paid).
13. AIFMs should be able to clearly identify and make the relevant distinctions in the treatment of:
  - (i) the portion of the payment made by the AIF to the above mentioned categories of staff members which exceeds the pro-rata investment return for the investment made by the relevant staff members and represents carried interest, i.e. a share in the profits of the AIF accrued to the staff members as compensation for the management of the AIF (which is subject to the remuneration requirements of these guidelines)<sup>32</sup>; and
  - (ii) the portion of the payment made by the AIF to the same categories of staff members which represents a share in the profits of the AIF accrued to the staff members as a pro-rata return on any in-

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<sup>32</sup> See however Section XII (Guidelines on the specific requirements on risk alignment) for some specific provisions which may apply to certain remuneration structures.

vestment by the staff members into the AIF (which is not subject to the remuneration requirements of these guidelines).

14. A "retention bonus" is a form of variable remuneration and can only be allowed to the extent that risk alignment requirements are properly applied.
15. The *governing body* of each AIFM has the primary responsibility for ensuring that the ultimate goal of having sound and prudent remuneration policies and structures is not improperly circumvented. Circumstances and situations that may pose a greater risk under this perspective may be: the conversion of parts of the variable remuneration into benefits that normally pose no incentive effect in respect of risk positions; the use of tied agents or other persons not considered "employees" from a legal point of view; transactions between the AIFMs and third parties in which the risk takers have material interests; the setting up of structures or methods through which remuneration is paid in the form of dividends or similar pay outs (e.g. improper use of performance fees) and non-monetary material benefits awarded as incentive mechanisms linked to the performance.
16. The so called 'carried interest vehicles' are typically limited partnerships (or other kinds of vehicle) being themselves limited partners in the AIF together with third party investors and are used by senior executives of an AIF either to regulate the executives' entitlements to carried interest among themselves as a consequence of a modest capital contribution or to commit capital which is more than merely nominal – i.e. co-investments – in transactions along with the AIF. If payments made by the AIF to the relevant staff members through these carried interest vehicles fall under the definition of carried interest, they should be subject to the remuneration requirements of these guidelines, whereas if they represent a pro-rata return on any investment by the staff members (through the carried interest vehicle) into the AIF, they should not be subject to such requirements.
17. These guidelines do not apply to fees and commissions received by intermediaries and external service providers in case of outsourced activities.

## **VI. Guidelines on how to identify the categories of staff covered by these guidelines**

18. AIFMs should identify the *identified staff*, according to these guidelines and any other guidance or criteria provided by competent authorities. AIFMs should be able to demonstrate to competent authorities how they have assessed and selected *identified staff*.
19. The following categories of staff, unless it is demonstrated that they have no material impact on the AIFM's risk profile, should be included as the *identified staff*:
  - Members of the *governing body* of the AIFM, depending on the local legal structure of the AIFM, such as: directors, the chief executive officer and partners.
  - *Senior management*
  - *Control functions*
  - Staff responsible for heading the portfolio management, administration, marketing, human resources.

- Other risk takers such as: staff members, whose professional activities – either individually or collectively, as members of a group (e.g. a unit or part of a department) – can exert material influence on the AIFM’s risk profile or on an AIF it manages, including persons capable of entering into contracts/positions and taking decisions that materially affect the risk positions of the AIFM or of an AIF it manages. Such staff can include, for instance, sales persons, individual traders and specific trading desks.

When assessing the materiality of influence on an AIFM’s risk profile or on an AIF it manages, AIFMs should define what constitutes materiality within the context of their AIFMs and the AIFs they manage. Criteria that AIFMs may follow to check whether they are capturing the correct staff members include an assessment of staff members or a group, whose activities could potentially have a significant impact on the AIFM’s results and/or balance sheet and/or on the performance of the AIFs they manage.

An analysis of job functions and responsibilities at the AIFM should be undertaken for a proper assessment of those roles that could materially affect the risk profile of the AIFM or of the AIFs it manages. There could be cases where a staff member does not earn a high amount of total remuneration but could have a material impact on the risk profile of the AIFM or of the AIFs it manages given the individual’s particular job function or responsibilities.

20. Additionally, if they have a material impact on the risk profile of the AIFM or of the AIFs it manages, other employees/persons, whose total remuneration takes them into the same *remuneration bracket* as senior managers and risk takers should be included as the *identified staff*, such as: high-earning staff members who are not already in the above categories and who have a material impact on the risk profile of the AIFM or of the AIFs it manages. It is likely that in some cases, those staff members whose remuneration is as high as or higher than senior executives and risk takers will be exerting material influence in some way on the risk profile of the AIFM or of the AIFs it manages. In other AIFMs, this may not be the case.
21. The examples mentioned in paragraphs 19 and 20 above are not conclusive. The greater the assumption that there may be risk-takers in certain business units, the more in-depth the risk analysis must be to assess whether a person is to be considered a material risk-taker or not.

## **VII.Guidelines on the proportionality principle**

### **Proportionality in general**

22. Not all AIFMs should have to give substance to the remuneration requirements in the same way and to the same extent. Proportionality should operate both ways: some AIFMs will need to apply more sophisticated policies or practices in fulfilling the requirements; other AIFMs can meet the requirements of the AIFMD in a simpler or less burdensome way.
23. Although the remuneration principles in Annex II of the AIFMD are applicable to all AIFMs, the proportionality principle may lead to a tailored application of some requirements if this is reconcilable with the risk profile, risk appetite and the strategy of the AIFM and the AIFs it manages. If AIFMs deem a tailored application for these requirements appropriate for their type of AIFM or *identified staff*, they should be able to explain the rationale for every single requirement that is applied in a tailored manner. Tailored application should never be automatically triggered on the basis of these

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

24. The following are examples of requirements that may be applied in a tailored manner:

- the requirements on the pay-out process for which guidelines are given below under the heading “Payout process” in Section XII (Guidelines on the specific requirements on risk alignment). This means that some AIFMs, either for the total of their *identified staff* or for some categories within their *identified staff*, can tailor the requirements on
  - variable remuneration in *instruments*;
  - retention;
  - deferral;
  - ex post incorporation of risk for variable remuneration;
- the requirement to have a fully flexible policy on variable remuneration, for which guidelines are given below under the heading “Fully flexible policy on variable remuneration” in Section XII (Guidelines on the specific requirements on risk alignment).

25. 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 its staff. Competent authorities should review the ways AIFMs actually implement the proportionality principle, taking into account the achievement of regulatory objectives and the need to preserve a level playing field among different AIFMs and jurisdictions.

### **Proportionality with respect to the different characteristics of AIFMs**

26. The different risk profiles and characteristics among AIFMs justify a proportionate implementation of the remuneration principles. Criteria relevant to the application of the proportionality principle are the size of the AIFM and of the AIFs it manages, its internal organization and the nature, scope and complexity of its activities.

- a) **Size:** the size criterion can relate to the value of the AIFM capital and to the value of the assets under management (including any assets acquired through the use of leverage) of the AIFs that the AIFM manages; liabilities or risks exposure of the AIFM and of the AIFs that it manages; as well as the number of staff, branches or subsidiaries of an AIFM. The size of an AIFM and of the AIFs it manages should not be considered in isolation when applying the proportionality principle. An AIFM might be considered “small” in terms of number of staff or subsidiaries, but be engaged in a high level of risk taking. An AIFM should adhere strictly to the remuneration principles where the aggregate set of AIFs that it manages - each of them considered “small” - becomes a potentially systemically important (e.g. in terms of total assets under management) or leads to complex investment management activities.

The general obligation to have sound remuneration policies and practices applies to all AIFMs, regardless of their size or systemic importance.

- b) **Internal organization:** this can relate to the legal structure of the AIFM or the AIFs it manages, the complexity of the internal governance structure of the AIFM, the listing on regulated markets of the AIFM or the AIFs it manages.

This criterion should be assessed having regard to the entire organisation of the AIFM including all the AIFs it manages, meaning that for instance the listing of one AIF should not by itself be sufficient for considering the AIFM as having a complex internal organisation.

- c) **Nature, scope and complexity of the activities:** in considering this criterion, the underlying risk profiles of the business activities that are carried out, should be taken into account. Relevant elements can be:

- the type of authorized activity (investment management functions listed in point 1 of Annex I of the AIFMD only or also the additional functions listed in point 2 of Annex I of the AIFMD and/or the additional services listed in Article 6(4) of the AIFMD);
- the type of investment policies and strategies of the AIFs the AIFM manages;
- the national or cross-border nature of the business activities (AIFM managing and/or marketing AIFs in one or more EU or non-EU jurisdictions); and
- the additional management of UCITS.

27. In assessing what is proportionate, the focus should be on the combination of all the mentioned criteria (size, internal organization and the nature, scope and complexity of the activities) and, as this is not an exhaustive list, of any other relevant criteria. For instance, an AIFM's business may well be small-scale but could still include complex risk-profiles because of the nature of its activities or the complexity of the managed AIFs.

#### **Proportionality with respect of the different categories of staff**

28. The proportionality principle should also operate within an AIFM for some of the specific requirements. The categories of staff whose professional activities have a material impact on their risk profile should comply with specific requirements which aim to manage the risks their activities entail. The same criteria of size, internal organisation and the nature, scope and complexity of the activities should apply. In addition, the following elements should be taken into account, where relevant:

- The size of the obligations into which a risk taker may enter on behalf of the AIFM;
- The size of the group of persons, who have only collectively a material impact on the risk profile of the AIFM;
- The structure of the remuneration of the staff members (e.g. fixed salary with a variable remuneration vs. profit sharing arrangements).

## VIII. Guidelines for AIFMs being part of a group

29. There should be no exception to the application to any of the AIFMs which are subsidiaries of a credit institution of the sector-specific remuneration principles set out in the AIFMD and in the present guidelines.

The application of these remuneration principles by AIFMs which belong to banking (or insurance or financial) groups should be considered equivalent to the respect by such a group of the principles regarding remuneration applicable to the group.

## IX. Guidelines on the financial situation of the AIFM

30. In order to guarantee ongoing compliance with the requirements of Article 9(1) to (3), 9(5) and 9(7) of the AIFMD, AIFMs should ensure that they maintain a prudent balance between sound financial situation and the award, pay out or vesting of variable remuneration.
31. The AIFM should ensure that its financial situation will not be adversely affected by:
- 1) the overall pool of variable remuneration that will be awarded for that year; and
  - 2) the amount of variable remuneration that will be paid or vested in that year.
32. The fact that an AIFM is or risks becoming unable to maintain a sound financial situation, should be a trigger for, inter alia: a) reducing the variable remuneration pool for that year and b) the application of performance adjustment measures (i.e. *malus* or *clawback*) in that financial year<sup>33</sup>. Instead of awarding, paying out the variable remuneration or allowing it to vest, the net profit of the AIFM for that year and potentially for subsequent years should be used to strengthen its financial situation. The AIFM should not compensate for this at a later date by awarding, paying out or vesting a greater amount of variable remuneration than it otherwise would have done, unless it becomes evident in subsequent years that the AIFM's financial results justify such actions.

## X. Guidelines on governance of remuneration

### Design, approval and oversight of the remuneration policy

33. An AIFM's remuneration policy should encourage the alignment of the risks taken by its staff with those of the AIFs it manages, the investors of such AIFs and the AIFM itself; in particular, the remuneration policy should duly take into consideration the need to align risks in terms of risk management and exposure to risk.
34. The *supervisory function* should be responsible for approving and maintaining the remuneration policy of the AIFM, and overseeing its implementation. The remuneration policy should not primarily be controlled by executive members of the *supervisory function*. The *supervisory function* should also approve any subsequent material exemptions or changes to the remuneration policy and carefully consider and monitor their effects. Procedures to determine remuneration should be clear, well-documented and internally transparent. For example, proper documentation should be provided on

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<sup>33</sup> See also Section XII (Guidelines on the specific requirements on risk alignment).

the decision-making process, the determination of the *identified staff*, the measures used to avoid conflicts of interest, the risk-adjustment mechanisms used etc.

35. In the design and oversight of the AIFM's remuneration policies, the *supervisory function* should take into account the inputs provided by all competent corporate functions (i.e. risk management, compliance, human resources, strategic planning, etc.). As a result, those functions should be properly involved in the design of the remuneration policy of the AIFM.
36. Ultimately, the *supervisory function* should ensure that an AIFM's remuneration policy is consistent with and promotes sound and effective risk management. The remuneration policy should:
  - be in line with the business strategy, objectives, values and interests of the AIFM,
  - not encourage excessive risk taking as compared to the investment policy of the AIFs the AIFM manages, and
  - enable the AIFM to align the interests of the AIFs and their investors with those of the *identified staff* that manages such AIFs, and to achieve and maintain a sound financial situation.
37. The *supervisory function* should ensure that the AIFM's overall corporate governance principles and structures, as well as their interactions with the remuneration system are considered within the design and implementation of an AIFM's remuneration policies and practices. The *supervisory function* should ensure that the following elements are taken into account: the clear distinction between operating and *control functions*, the skills and independence requirements of members of the *management body*, the role performed by internal committees, including the remuneration committee, the safeguards for preventing conflicts of interests and the internal reporting system and the related parties' transactions rules).

### **Remuneration of members of the management body and supervisory function**

38. The remuneration of the members of the *management body* should be consistent with their powers, tasks, expertise and responsibilities.
39. Where appropriate considering the size of the AIFM, its internal organisation and the nature, scope and complexity of its activities, the *management body* should not determine its own remuneration. The *supervisory function* should determine and oversee the remuneration of the members of the *management body*. To the extent compatible with national law, the *supervisory function* should also specifically approve and oversee the remuneration of senior executives and staff members who receive the highest amounts of total remuneration within the AIFM.
40. For AIFMs which have a separate *supervisory function*, in order to properly address conflicts of interests, it may be more appropriate for members of the *supervisory function* to be compensated only with fixed remuneration. When incentive-based mechanisms are in place, they should be strictly tailored to the assigned monitoring and control tasks, reflecting the individual's capabilities and the achieved results. If *instruments* are granted, appropriate measures should be taken, such as *retention periods* until the end of the mandate, in order to preserve the independence of judgment of those members of the *management body*. For those AIFMs that given their size, internal organisation and the nature, scope and complexity of their activities do not have a separate *supervisory function*, the principle according to which members of the *supervisory function* may more appropriately be com-

pensated only with fixed remuneration should not apply to the person or persons in charge of the *management body* that perform the tasks of the *supervisory function*.

### **Shareholders' involvement**

41. The approval of an AIFM's remuneration policy and decisions relating to the remuneration of members of the *management body*, may be assigned to the meeting of the shareholders of the AIFM, depending on the AIFM's characteristics or on the national rules in the jurisdiction in which the AIFM is established. The shareholders' vote may be either consultative or binding. To this end, shareholders should be provided with adequate information in order that they can make informed decisions.
42. The *supervisory function* remains responsible for the proposals submitted to the meeting of the shareholders of the AIFM, as well as for the actual implementation and oversight of any changes to the remuneration policies and practices.

### **Review of the implementation of the remuneration policy**

43. The *supervisory function* should ensure that the implementation of the remuneration policy of the AIFM will be reviewed on an annual basis at a minimum. Such central and independent reviews should assess whether the overall remuneration system:
  - operates as intended (in particular, that all agreed plans/programs are being covered; that the remuneration payouts are appropriate, and that the risk profile, long-term objectives and goals of the AIFM are adequately reflected); and
  - is compliant with national and international regulations, principles and standards.
44. The relevant internal *control functions* (i.e. internal audit, risk management, compliance functions, etc.) as well as other key *supervisory function* committees (i.e. audit, risk, and nominations committees) should be closely involved in reviewing the remuneration system of the AIFM.
45. Where periodic reviews reveal that the remuneration system does not operate as intended or prescribed, the *supervisory function* should ensure that a timely remedial plan is put in place.
46. The periodic review of the implementation of the remuneration policies and practices may be, partially or totally, externally commissioned when appropriate according to the proportionality principle. Larger and more complex AIFMs should have sufficient resources to conduct the review internally, though external consultants may complement and support the AIFM in carrying out such tasks where appropriate. In line with the proportionality principle, smaller and less complex AIFMs may decide to outsource the entire review, by performing the review less frequently than annually or carrying out at least annually an internal assessment not amounting to a full independent review. In all cases, the *supervisory function* should remain responsible for the review of remuneration policies and practices and for ensuring that the results of the review are followed up; moreover, the relevant *control functions* should be closely involved.

### **Setting up a remuneration committee**

47. The setting up of a remuneration committee should be considered as a good practice even for those AIFMs that are not obliged to set up such a committee under paragraph (3) of Annex II to the AIFMD.

48. In order to identify whether a remuneration committee is expected to be set up, the factors mentioned in Section VII (Guidelines on the proportionality principle) need to be considered. When assessing whether or not an AIFM is significant, consideration should be given to the cumulative presence of all the three factors (i.e. size, internal organisation and nature, scope and complexity of the activities). For example, an AIFM which is significant in size, but is not significant in terms of its internal organisation and/or nature, scope and complexity of its activities should not be required to set up a remuneration committee.
49. The following are examples of AIFMs which need not establish a remuneration committee:
- AIFMs for which the value of the portfolios of AIFs that they manage does not exceed EUR 250 million;
  - AIFMs which are a subsidiary of a credit institution which is obliged to set up a remuneration committee which performs its tasks and duties for the whole group.

#### **Composition of the remuneration committee**

50. In order to operate independently from senior executives, the remuneration committee should comprise members of the *supervisory function* who do not perform executive functions, at least the majority of whom qualify as independent.
51. The chairperson of the remuneration committee should be an independent, non-executive member.
52. An appropriate number of the members of the remuneration committee should have sufficient expertise and professional experience concerning risk management and control activities, namely with regard to the mechanism for aligning the remuneration structure to AIFMs' risk and capital profiles.
53. The remuneration committee should be encouraged to seek expert advice internally (e.g. from risk management) and externally. The chief executive officer should not take part in the remuneration committee meetings which discuss and decide on his/her remuneration.

#### **Role of the remuneration committee**

54. The remuneration committee should:
- be responsible for the preparation of recommendations to the *supervisory function*, regarding the remuneration of the members of the *management body* as well as of the highest paid staff members in the AIFM;
  - provide its support and advice to the *supervisory function* on the design of the AIFM's overall remuneration policy;
  - have access to advice, internal and external, that is independent of advice provided by or to *senior management*;
  - review the appointment of external remuneration consultants that the *supervisory function*, may decide to engage for advice or support;

- support the *supervisory function* in overseeing the remuneration system’s design and operation on behalf of the *supervisory function*;
- devote specific attention to the assessment of the mechanisms adopted to ensure that:
  - the remuneration system properly takes into account all types of risks and liquidity and assets under management levels, and
  - the overall remuneration policy is consistent with the business strategy, objectives, values and interests of the AIFM and the AIFs it manages and the investors of such AIFs; and
- formally review a number of possible scenarios to test how the remuneration system will react to future external and internal events, and back test it as well.

55. The remuneration committee itself may be in charge of overseeing the central and independent review of the implementation of the remuneration policies and practices.

#### **Process and reporting lines of the remuneration committee**

56. The remuneration committee should:

- have unfettered access to all data and information concerning the decision-making process of the *supervisory function*, on the remuneration system’s design and implementation;
- have unfettered access to all information and data from risk management and *control functions*. Such access should not hinder the AIFM’s ordinary activities;
- ensure the proper involvement of the internal control and other competent functions (e.g. human resources and strategic planning). The remuneration committee should collaborate with other board committees whose activities may have an impact on the design and proper functioning of remuneration policy and practices (e.g. risk audit, and nomination committees); and
- provide adequate information to the *supervisory function*, and, where appropriate, to the AIFM’s shareholders’ meeting about the activities performed.

#### **Roles of control functions**

57. AIFMs should ensure that *control functions* have an active role in the design, ongoing oversight and review of the remuneration policies for other business areas.
58. Working closely with the remuneration committee and the *supervisory function* and *management body*, the *control functions* should assist in determining the overall remuneration strategy applicable to the AIFM, having regard to the promotion of effective risk management.
59. The risk management function should assess how the variable remuneration structure affects the risk profile of the AIFM. It is good practice for the risk management function to validate and assess risk adjustment data, and to attend a meeting of the remuneration committee for this purpose.

60. The compliance function should analyse how the remuneration structure affects the AIFM's compliance with legislation, regulations and internal policies.
61. The internal audit function should periodically carry out an independent audit of the design, implementation and effects of the AIFM's remuneration policies.

### **Remuneration of control functions**

62. The remuneration level of staff in the *control functions* should allow the AIFM to employ qualified and experienced personnel in these functions.
63. If staff in *control functions* receives variable remuneration, it should be based on function-specific objectives and should not be determined by the individual financial performance of the business area they monitor.
64. The remuneration structure of *control functions* personnel should not compromise their independence or create conflicts of interest in their advisory role to the remuneration committee, *supervisory function* and/or *management body*. If remuneration of the *control functions* includes a component based on AIFM-wide performance criteria, the risk of conflicts of interest increases and, therefore, should be properly addressed.
65. For AIFMs which are required to have a remuneration committee, the remuneration of the senior staff responsible for heading the *control functions* should not be solely left to the *supervisory function*, but should be directly overseen by the remuneration committee. The remuneration of those staff members in compliance and risk management functions must be designed in a way that avoids conflict of interests related to the business unit they are overseeing and, therefore, should be appraised and determined independently. The remuneration committee should make recommendations to the *management body* on the remuneration to be paid to the senior officers in the risk management and compliance functions.
66. For AIFMs which are not required to have a remuneration committee, the remuneration of the senior staff responsible for heading the *control functions* should be overseen by the *supervisory function*.
67. Conflicts of interest which might arise if other business areas had undue influence over the remuneration of staff within *control functions* should be adequately managed. The need to avoid undue influence is particularly important where staff members from the *control functions* are embedded in other business areas. However, the views of other business areas should be sought as an appropriate part of the assessment process.
68. Control function personnel should not be placed in a position where, for example, approving a transaction, making decisions or giving advice on risk and financial control matters could be directly linked to an increase or decrease in their performance-based remuneration.

## **XI. Guidelines on the general requirements on risk alignment**

69. The general requirements on risk alignment should apply to AIFMs and their staff as a whole.

### **The general remuneration policy, including the pension policy**

70. The long-term strategy of the AIFM should include the overall business strategy and quantified risk tolerance levels with a multi-year horizon, as well as other corporate values such as compliance culture, ethics, behaviour towards investors of the AIFs it manages, measures to mitigate conflicts of interest etc. The design of the remuneration systems should be consistent with the risk profiles, rules or instruments of incorporation of the AIFs the AIFM manages and with the objectives set out in the strategies of the AIFM and the AIFs it manages and changes that could be decided in the strategies must be taken into account. AIFMs should, therefore, ensure that their remuneration systems are well designed and implemented. This includes, in particular, a proper balance of variable to fixed remuneration, the measurement of performance as well as the structure and, where appropriate, the risk-adjustment of the variable remuneration. Even a smaller or less sophisticated AIFM should ensure it makes the best possible attempt to align its remuneration policy with its interests and the interests of the AIFs it manages and their investors.
71. When developing their remuneration policy, AIFMs should give due consideration to how remuneration contributes to the prevention of excessive risk-taking, the efficiency of the AIFM and the AIFs it manages and the consistency of the remuneration policy with effective risk management.
72. Managers should consider conservative valuation policies and should not ignore concentration risks and risk factors, such as liquidity risk and concentration risk that could place the AIFs that the AIFM manages under stress at some point in the future. There are strong incentives not to follow such obligations if the variable part of the remuneration consists predominantly of *instruments* that are paid out immediately, without any deferral or ex post risk adjustment mechanisms (*malus* or *clawback*), and/or are based on a formula that links variable remuneration to current year revenues rather than risk-adjusted profit.
73. In order to counterbalance the dangers mentioned, risk management elements should be connected to the remuneration policy. When properly structured and implemented, variable remuneration can be an efficient tool to align the staff's interests with the interests of the AIFs that the AIFM manages. Having regard to the nature, scale and complexity of an AIFM, alternative approaches exist for connecting risk management elements to a remuneration policy.

#### **Discretionary pension benefits**

74. Remuneration policy should cover all aspects of remuneration including fixed components, variable components, pension terms and other similar specific benefits. The pension policy (the fixed as well as the variable pension payments) should be aligned with the long term interests of the AIFM and the AIFs it manages.
75. In case of discretionary pension benefits, as part of the variable remuneration, a staff member should not retire or leave the AIFM with such benefits vested, with no consideration of the economic situation of the AIFs that the AIFM manages or risks that have been taken by the staff member in the long term.
76. In order to align this specific kind of pension benefits with the economic situation of the AIFs that the AIFM manages, discretionary pension benefits, where legally possible according to the relevant pension legislation, should be paid in the form of *instruments*.
77. In the context of a retirement, the discretionary pension benefits vested to the staff member should be subject to a five years *retention period*.

78. Where a staff member leaves the AIFM before retirement, the discretionary pension benefits should not be vested before a period of five years and should be subject to performance assessment and ex post risk adjustment before pay out.

#### **General prohibitions – severance pay**

79. “Golden parachute” arrangements for staff members who are leaving the AIFM and which generate large payouts without any performance and risk adjustment should be considered inconsistent with the principle in Annex II, paragraph (1)(k) of the AIFMD. Any such payments should be related to performance achieved over time and designed in a way that does not reward failure. This should not preclude termination payments in situations such as early termination of the contract due to changes in the strategy of the AIFM or of the AIFs it manages, or in merger and/or takeover situations.
80. AIFMs should set up a framework in which severance pay is determined and approved, in line with the AIFM’s general governance structures for employment. The framework should ensure that there is no reward for failure.
81. AIFMs should be able to explain to competent authorities the criteria they use to determine the amount of severance pay. It is good practice to defer any outstanding variable payments or long-term incentive plans and for these to mirror the original deferral schemes.

#### **General prohibitions – personal hedging**

82. Staff could be considered to have hedged away the risk of a downward adjustment in remuneration if the staff member enters into a contract with a third party which requires the third party to make payments directly or indirectly to the staff member that are linked to or commensurate with the amounts by which the staff member’s variable remuneration has been reduced. The contract could for instance take the form of an option or any other derivative contract or other form of contract which provides any type of hedging for the staff member’s variable remuneration.
83. In order to ensure the effectiveness of risk alignment, staff members should not buy an insurance contract which compensates them in the event of a downward adjustment in remuneration. As a general rule, however, this would not prohibit insurance designed to cover personal payments such as healthcare and mortgage instalments (provided that the mortgage coverage concerns health-related circumstances that would render the staff member unable to work in an equivalent position), although each case should be judged on its merits.
84. The requirement not to use personal hedging strategies or insurance to undermine the risk alignment effects embedded in their remuneration arrangements should apply to deferred and retained variable remuneration. AIFMs should maintain effective arrangements to ensure that the staff member complies with this requirement.

## **XII. Guidelines on the specific requirements on risk alignment**

85. The specific requirements on risk alignment should be applied by AIFMs only to the individual remuneration packages of the *identified staff*, but AIFMs may always consider an AIFM-wide application (or, at least, a “broader than strictly necessary” application) of all or some of the specific requirements. [Annex II] indicates the specific requirements for which this voluntary AIFM-wide application is strongly recommended.

### **Fully flexible policy on variable remuneration**

86. Having a fully-flexible policy on variable remuneration implies not only that variable remuneration should decrease as a result of negative performance but also, that it can go down to zero in some cases. For its practical implementation, it also implies that the fixed remuneration should be sufficiently high to remunerate the professional services rendered, in line with the level of education, the degree of seniority, the level of expertise and skills required, the constraints and job experience, the relevant business sector and region. Individual levels of fixed remuneration should be indirectly impacted by the basic principle on risk alignment.

### **Risk alignment of variable remuneration**

#### **Risk alignment process**

87. To limit excessive risk taking, variable remuneration should be performance-based and risk adjusted. To achieve this aim, an AIFM should ensure that incentives to take risks are constrained by incentives to manage risk. A remuneration system should be consistent with effective risk management and governance processes within the AIFM.

#### **Performance and risk measurement process**

88. Setting up a remuneration system should start by defining the objectives of the AIFM, the unit, as well as the staff and the investment strategy of the AIFs concerned. These objectives should be derived from the business plan of the AIFM, if any, and should be in line with the risk appetite of the AIFM and the investment strategy of the AIFs concerned. The performance criteria, which should be used to assess the staff member's achievement of his/her objectives during the accrual period, can be directly derived from these objectives. The right to receive the variable remuneration is earned ("awarded") at the end of the accrual period or during the accrual period, which should be at least one year, but it may be longer. In some cases different accrual periods may overlap. If properly designed, the performance assessment links the remuneration with the achievement of the investment strategy of the AIFs concerned and the business plan, if any, or the objectives of the AIFM. On the contrary, performance criteria which are badly designed can be an incentive for taking too much risk. When assessing performance, only the effective results should be taken into account. Risk alignment during performance measurement can be achieved by using risk adjusted performance criteria or by adjusting performance measures for risk afterwards. The risk adjustment may differ according to the activity of the staff member and the business line or AIF concerned.

#### **Award process**

89. After the accrual period, the AIFM should use a specified award process in order to translate performance assessment into the variable remuneration component for each staff member. This should usually be carried out through so-called "pools" of variable remuneration that are first determined and later on allocated. As not all performance and risk measures are suitable to be applied at the level of the AIFM, the business unit and the staff member, the AIFM should identify the risks at each level and ensure that a risk correction adequately captures the magnitude and the duration of the risk at each level. This so-called "ex-ante risk adjustment" should adjust remuneration for potential adverse developments in the future.

#### **Payout process**

90. In order to align the actual payment of remuneration to the life-cycle and redemption policy of the AIFs managed by the AIFM and their investment risks, the variable remuneration should partly be paid upfront (short-term) and partly deferred (long-term). The short-term component should be paid directly after the award and rewards staff for performance delivered in the accrual period. The long-term component should be awarded to staff during and after the deferral period. It should reward staff for the sustainability of the performance in the long term, which is the result of decisions taken in the past. Before paying out the deferred part, a reassessment of the performance and, if necessary, a risk adjustment should be required in order to align variable remuneration to risks and errors in the performance and risk assessments that have appeared since the staff members were awarded their variable remuneration component. This so-called *ex post* risk adjustment should always be necessary, because at the time remuneration is awarded, the ultimate performance cannot be assessed with certainty.

### **Common requirements for the risk alignment process**

#### **Time horizon**

91. AIFMs, when assessing risk and performance, should take into account both current and future risks that are taken by the staff member, the business unit, the AIF concerned or the AIFM as a whole. For this exercise, AIFMs should examine what the impact of the staff member's activities could be on the AIFs they manage and AIFM's short and long term success. To be able to do so, the AIFM should align the horizon of risk and performance measurement with the life-cycle and redemption policy of the AIFs managed by the AIFM and their investment risks. The requirement of an AIFM to assess the performance of its staff in a multi-year framework appropriate to the life-cycle of the AIFs managed by the AIFM implies the *accrual period* and the payout period for short-term and long-term remuneration covering an appropriate period in total.
92. The right balance between accrual and payout periods should depend on the type of AIFs managed by the AIFM and on the type of business and activity developed by the staff member. However, the use of multi-year *accrual periods* is more prudent since the assessment of the performance can take into account with certainty more risks that have materialized since the beginning of the *accrual period*.

#### **Levels of risk and performance measurement**

93. To avoid excesses due to over-individualistic behaviour, performance-related remuneration should include parameters linked to the risks and performance of the AIF concerned and of the business unit of the AIFM in addition to the risks and performance of the individual activities. Thus, the amount of variable remuneration a staff member is eligible for should be determined by his/her individual performance, the performance of his/her business line or the AIF concerned and the performance of the AIFM. The relative importance of each level of the performance criteria should be determined beforehand and adequately balanced to take into account the position or responsibilities held by the staff member.
94. To have the greatest impact on staff behaviour, the variables used to measure risk and performance should be linked as closely as possible to the level of the decisions made by the staff member that is subject to the risk adjustment. Performance criteria should include achievable objectives and measures on which the staff member has some direct influence. For example, for senior executives, AIFMs may design the remuneration policies to include financial measures based on the performance of all the AIFs managed by the AIFM or the entire AIFM, or for performance and risks of units, or de-

cisions that were determined by senior executive strategy. In contrast, variables for the manager of a business unit ideally would be for performance and risk of that unit.

### **Quantitative and qualitative measures**

95. The risk alignment process should use a mix of quantitative and qualitative approaches (e.g. measurement of performance or risk; setting of the pool and adjustment to risks).
96. Quantitative measures may have some advantages in terms of transparency if they are pre-defined. They can, therefore, influence the behaviour of staff more directly. However, quantitative measures or criteria are not sufficient to measure all risk or performance or to risk adjust remuneration. To complete the measurement and adjustment of risk or performance, AIFMs should also rely on qualitative approaches.

### **Judgemental measures**

97. Whenever judgement is used for a risk and performance measurement or risk adjustment, there should be:
  - a clearly written policy outlining parameters and key considerations on which the judgement will be based;
  - clear and complete documentation of the final decision regarding risk and performance measurement or risk adjustment;
  - involvement of relevant *control functions* experts;
  - appropriate levels of approval obtained, e.g. of the *management body* or *supervisory function*, or of the remuneration committee; and
  - consideration of the personal incentives of the manager making the judgement, e.g. by using scorecards.
98. For both quantitative and qualitative measures, AIFMs should be prepared to disclose and reproduce any judgmental elements incorporated into their risk alignment process. AIFMs should also provide detailed information to the competent authority if the final outcome after applying judgmental measures is significantly different from the initial outcome using pre-defined measures.

### **Risk measurement**

99. AIFMs should take into account all risks, whether on or off balance sheet, differentiating amongst risks affecting the AIFM, the AIFs it manages, business units and individuals. Risk identification and quantification at the AIF level can be found in the risk management policy that the AIFM is required to establish, implement and maintain and which identifies all the relevant risks to which the AIFs they manage are or might be exposed to. AIFMs should also determine whether measures they are using for risk adjustment include 'difficult-to-measure' risks, such as reputational and operational risk.
100. In order to take into account all material risks, AIFMs should use the same risk measurement methods as used in the risk management policy established for the AIFs managed by the AIFM. Fur-

thermore, AIFMs should also take into account (i) the risks arising from the additional management of UCITS and from the services provided under Article 6(4) of the AIFMD and (ii) the potential professional liability risks that AIFMs have to cover through either additional own funds or professional indemnity insurance according to Article 9(7) of the AIFMD.

101. Taking the proportionality principle into account, the risk management calculations should be transparent and the AIFMs should be able to demonstrate how the risk calculations can be broken down by AIFs and related to the AIFM's business units and different types of risk positions throughout the organisation. The quality of methods and models used should influence the extent to which an AIFM should implement a more sophisticated variable remuneration policy based on performance measurements.

### **Performance measurement**

#### **Qualitative/Quantitative measures**

102. AIFMs should use both quantitative (financial) as well as qualitative (non-financial) criteria for assessing individual performance.
103. The appropriate mix of quantitative and qualitative criteria should depend on the tasks and responsibilities of the staff member. In all cases, the quantitative and qualitative criteria and the balance between them should be specified and clearly documented for each level and category of staff.
104. Quantitative measures should cover a period which is long enough to properly capture the risk of the staff member's actions. Examples of quantitative performance measures used in the asset management sector which fulfil the abovementioned requirements are the internal rate of return (IRR), earnings before interest, taxes, depreciation and amortization (EBITDA), Alpha Ratio, absolute and relative returns, Sharpe Ratio and assets raised.
105. In addition to quantitative performance measures, variable remuneration awards should also be sensitive to the staff's performance with respect to qualitative (non-financial) measures. Examples are the achievement of strategic targets, investor satisfaction, adherence to risk management policy, compliance with internal and external rules, leadership, management, team work, creativity, motivation and cooperation with others business units and with *control functions*. Such determined qualitative criteria could rely on compliance with risk control measures such as limits and audit results. Negative non-financial performance, in particular unethical or non-compliant behaviour, should override any good financial performance generated by a staff member and should diminish the staff member's variable remuneration.

#### **Relative/absolute and internal/external measures**

106. Absolute performance measures are measures set by the AIFM on the basis of its own strategy, which includes the risk profile and risk appetite of the AIFM and of the AIFs it manages, as further developed down through the chain of business levels. Such measures help to minimize the risk that remuneration is awarded that is not justifiable by the AIFM's or AIFs' performance. They also tend to create long term incentives. However, it may be difficult to calibrate absolute performance measures, especially for new entrants or for new kinds of financial activities (with difficult-to-measure risks) linked to the management of AIFs.

107. Relative performance measures are measures that compare performance with peers, either 'internal' peers (i.e. within the organization) or 'external' (similar AIFMs). Relative performance measures are easier to set because the benchmark is readily available. However, such measures pose the risk that variable remuneration that is not supported by long-term success of the business unit or the AIFM or the AIFs it manages will be paid out anyway. In a period of sector wide positive financial performances, it could lead to 'raising the bid' and/or 'herd' mentality, providing incentives to take on excessive risk. In a downturn economic cycle where most AIFMs and AIFs may perform poorly, relative measures may nonetheless lead to positive outcomes (and thus to an insufficient contraction of the AIFM's total variable remuneration) even if absolute performance has deteriorated compared to previous periods.
108. Internal (e.g. profits) and external (e.g. share price) variables come with both advantages and disadvantages that should be balanced carefully. Internal performance measures are able to generate more involvement of the staff members if they can influence the outcome by their own behaviour. This is especially true if the performance measures are fixed at the level of the business unit (rather than on the AIFM-wide level). Furthermore, it is easier to introduce risk adjustment features for internal measures, because the link with in-house risk management techniques is more readily available. On the other hand, such measures can be manipulated and can create distorted outcomes on a short-term basis. External performance measures are less subject to this danger of manipulation, although attempts to artificially increase the stock price (probably only relevant for top executives) may still occur.

### **Award process**

109. AIFMs should adopt a documented policy for the award process and ensure that records of the determination of the overall variable remuneration pool are maintained.

### **The risk adjustment in the award process**

110. In determining remuneration pools or individual awards, AIFMs should consider the full range of current and potential (unexpected) risks associated with the activities undertaken. Performance measures used in setting the remuneration pool may not fully or adequately capture risks undertaken, thus, ex-ante adjustments should be applied to ensure that the variable remuneration is fully aligned with the risks undertaken. AIFMs should establish whether the risk adjustment criteria they are using take into consideration severe risks or stressed conditions.
111. AIFMs should determine to what level they are able to risk adjust their variable remuneration calculations quantitatively – whether to the business unit level or further down the line such as to a trading desk level, if any, or even to an individual level. AIFMs should determine the level of granularity that is suitable for each level.

### **Quantitative ex ante risk adjustment**

112. In order to have a sound and effective remuneration scheme, AIFMs should use a number of different quantitative measures for their risk adjustment process. Normally, these measures should be based on an overarching risk adjustment framework.
113. When measuring the profitability of the AIFM and its business units as well as the AIFs it manages, the measurement should be based on net revenue where all direct and indirect costs related to the activity are included. AIFMs should not exclude IT costs, research costs, legal fees, marketing costs, and costs

for outsourced activities. AIFMs should make sure that remuneration pools are not being “back-fitted” to meet remuneration demands.

114. The quantitative ex-ante risk adjustments made by AIFMs should largely rely on existing measures within the AIFMs, generally used for other risk management purposes. As a result, the limitations and potential issues related to these measures should also be relevant for the remuneration process. The risk adjustments used should benefit from the experience gained when dealing with these risks in other contexts and should be challenged like any other component of the risk management process.

### **Qualitative measures for ex-ante risk adjustment**

115. Qualitative risk elements should be considered by AIFMs. Qualitative ex-ante adjustments could take place while setting AIFM-wide and business unit remuneration pools or when determining or allocating individuals’ remuneration. Qualitative ex-ante risk adjustments are common at pool and individual levels, contrary to quantitative adjustments which tend to be mostly observed only at the pool level.
116. AIFMs make qualitative risk adjustments when allocating/determining individuals’ remuneration through assessments that may explicitly include risk and control considerations such as compliance breaches, risk limit breaches and internal control breakdowns (e.g. based on internal audit results).

### **Pay-out process**

#### **Non-deferred and deferred remuneration**

117. Although remuneration is aligned through ex-ante risk adjustments, due to uncertainty, ex-post risk adjustments should be put in place to keep incentives fully aligned. This can only be done if part of the remuneration has been deferred.
118. A deferral schedule is defined by different components: (a) the time horizon of the deferral, (b) the proportion of the variable remuneration that is being deferred, (c) the speed at which the deferred remuneration vests (*vesting point*), (d) the time span from accrual until the payment of the first deferred amount and (e) the form of the deferred variable remuneration. AIFMs can differentiate their deferral schedules by varying these five components. A stricter than necessary application for one component may influence the supervisory scrutiny for another component. In any case, the way in which an AIFM combines these components should lead to a meaningful deferral schedule, in which the long-term risk alignment incentives are clear.

#### **Time horizon and vesting**

119. The *deferral period* always starts at the moment the upfront part of the variable remuneration is paid out and can be coupled either to cash variable remuneration or variable remuneration in *instruments*. It ends when the last variable remuneration has vested. The minimum *deferral period* is three to five years, unless the AIFM can demonstrate that the life cycle of the AIF concerned is shorter; this means that if the life cycle of the AIF concerned is, for instance, one year, the minimum *deferral period* may be one year. AIFMs should set the *deferral period* which should be calculated on the basis of the life cycle and redemption policy of the AIF concerned and depending on the potential impact of the staff on the risk profile of the AIF. The actual *deferral period* should be further tailored to the responsibilities and tasks performed by the staff and expected fluctuations in the value of the assets of the AIF, which in many cases will imply longer time horizons. The AIFM should consider longer *deferral periods* for at least members of the *management body*.

### **Vesting point**

120. Pro rata vesting (or payment) means that for a *deferral period* of, for example, three years one-third of the deferred remuneration vests at the end of each of the years  $n+1$ ,  $n+2$  and  $n+3$ , where 'n' is the moment at which performance is measured to determine the variable remuneration. [Annex III] includes a diagram showing an example of a pro rata spreading for a deferral scheme in which 60% of the variable remuneration is deferred (first diagram).
121. In any case, vesting should not take place more frequently than on a yearly basis (e.g. not every six months).

### **Proportion to be deferred**

122. The proportion of the variable remuneration that should be deferred ranges from 40 to 60 %, depending on the impact the staff member (or category of staff) can have on the risk profile of the AIFs managed by the AIFM and the responsibilities and tasks performed, and depending on the amount of variable remuneration. If AIFMs decide to determine the proportion that is being deferred by a cascade of absolute amounts (rather than percentages of the total variable remuneration - e.g. part between 0 and 100: 100% upfront, part between 100 and 200: 50% upfront and rest is deferred, part above 200: 25% upfront and rest is deferred ...), on an average weighted basis, such AIFMs should respect the 40 to 60 % threshold.

### **Time span between end of accrual and vesting of deferred amount**

123. In order to ensure a proper assessment of the performance outcome and, thus, to undertake a proper ex-post risk adjustment, the first deferred portion should not be paid out too soon after the *accrual period*. For the deferral to be really effective with regard to the staff's incentives, the first amount should not vest sooner than 12 months after the accrual.

### **Cash vs. instruments**

#### **Types of instruments**

124. Staff should only be remunerated using *instruments* if it does not trigger interest misalignment or encourage risk-taking which is inconsistent with the risk profiles, rules or instruments of incorporation of the relevant AIF(s).
125. For AIFMs managing several AIFs, in order to align the interests of the *identified staff* with those of the relevant AIF(s), the *identified staff* should receive *instruments* related only to the AIF(s) in relation to which they perform their activities. E.g. if one member of the staff of an AIFM which manages three AIFs (x, y and z) performs his/her activities for AIF x only, that member of the staff should receive *instruments* related to AIF x only.
126. The availability of *instruments* is dependent on the legal structure of the AIFs concerned and their rules or instruments of incorporation. For AIFs in the legal form of a corporate fund, shares or share-linked instruments should be able to align the interests of the shareholders and staff. Share-linked instruments are those whose value is based on a market value appreciation of the stock and that have the share price as a reference point, e.g. stock appreciation rights, types of synthetic shares.

127. For many AIFs which are common funds, share-linked instruments are not an option due to their legal form. Even for unlisted corporate funds it may be difficult to determine a share price that represents the AIF's net asset value between two (at least annual) net asset value calculations. In these cases alternative instruments, may be used that reflect the AIF's value and have the same intended effect as share-linked instruments.

128. Neither dividends nor interest should be paid on *instruments* before vesting.

### **Retention policy**

129. A retention policy should be determined by the AIFM in the remuneration policy. The AIFM should be able to explain how the retention policy relates to other risk alignment measures in the total remuneration policy and should explain whether and how they differentiate between *instruments* paid upfront and deferred *instruments*.

130. *Retention periods*, as the most important element of the retention policy, should be coupled with the vesting of *instruments*. The *retention period* is independent from the *deferral period*. This means that, in order to meet the requirement of a minimum *deferral period* of three to five years (where applicable), the *retention period* counts for nothing. The *retention period* can last for a shorter or longer period than the *deferral period* applied to the instruments that are not paid upfront.

131. In the case of upfront *instruments*, *retention periods* are the only mechanism available to emphasize the difference between cash paid upfront and *instruments* awarded upfront in order to align incentives with the longer-term interests of the AIFM and the AIFs it manages and the investors of such AIFs.

132. In the case of deferred *instruments*, the *retention periods* come after every vested portion (the second diagram in [Annex III] illustrates these concepts). Competent authorities may determine whether the *retention periods* proposed by the AIFM are sufficient and appropriate.

133. The minimum *retention period* should be sufficient to align incentives with the longer term interests of the AIFM, of the AIFs it manages and of their investors. Different factors may tend to suggest that this period could be longer or shorter. Longer *retention periods* should be applied for staff with the most material impact on the risk profile of the AIFM and the AIFs it manages.

134. It is possible that a *retention period* lasts for a shorter period than the *deferral period* applied to the *instruments* that are not paid up front. However, as an example of proportionality, for their most senior staff, large and complex AIFMs should consider the use of a *retention period* for upfront paid *instruments* that goes beyond the *deferral period* for the deferred *instruments*.

135. *Instruments* should be valued on the date of the award (at the end of the *accrual period*) of these *instruments*. This value is the basis for the determination of the initial number of *instruments* and for later ex-post adjustments to the number of *instruments*.

136. The upfront payment of *instruments*, even with a minimum *retention period* of, for example, three years, is not equivalent to deferred *instruments*. Deferred *instruments* are subject to an ex-post risk adjustment due to the back-testing of the underlying performance, possibly leading to a reduction in the number of *instruments* that will eventually be paid out (second diagram in [Annex III]).

### **Minimum portion of instruments and their distribution over time**

137. The requirement in paragraph (1)(m) of Annex II to the AIFMD to apply the minimum of 50% (where applicable) to both the portion of the variable remuneration component that is deferred and the portion of the variable remuneration component not deferred means that the 50% minimum threshold for *instruments* should be applied equally to the non-deferred and the deferred part; in other words, AIFMs should apply the same chosen ratio between *instruments* and cash for their total variable remuneration to both the upfront and deferred part.

Examples:

- Correct practice: For a certain category within its *identified staff*, an AIFM establishes a 50 *instruments* / 50 cash ratio for the variable remuneration, combined with a 60% deferral schedule (that is, 40% is non-deferred variable remuneration). This results in an upfront payment in *instruments* of 20 (i.e. 50% of 40) and 20 in cash. The deferred part consists of 30 in *instruments* and 30 in cash.
- Correct practice: For a certain category within its *identified staff*, an AIFM establishes a 70 *instruments* / 30 cash ratio for the variable remuneration, combined with a 40% deferral schedule (that is, 60% is non-deferred variable remuneration). This results in an upfront payment in *instruments* of 42 (i.e. 70% of 60) and 18 in cash. The deferred part consists of 28 in *instruments* and 12 in cash.
- Incorrect practice: If for a certain category within its *identified staff*, an AIFM were to establish a 50 *instruments* / 50 cash ratio for the variable remuneration, combined with a 40 % deferral scheme, the AIFM cannot decide to pay 50 in cash upfront and 10 in *instruments*, leading to a deferred pay out of 40 in *instruments*.
- Incorrect practice: If for a certain category within its *identified staff*, an AIFM were to establish a 70 *instruments* / 30 cash ratio for the variable remuneration, combined with a 50% deferral scheme, the AIFM cannot decide to pay 50 upfront in *instruments* and 0 in cash, leading to a deferred pay out of 20 in *instruments* and 30 in cash.

138. The second diagram in [Annex III] provides an example of this equal distribution of *instruments* over the non-deferred and deferred parts of remuneration.

## **Ex post incorporation of risk for variable remuneration**

### **Explicit ex-post risk adjustments**

139. An “ex-post risk adjustment” should imply that once an initial variable remuneration component has been awarded to the staff member, and an upfront part has already been paid, the AIFM is still able to adjust, by way of a reduction, the variable remuneration as time goes by and the outcomes of the staff member’s actions materialize.

140. An ex-post risk adjustment is an explicit risk alignment mechanism through which the AIFM itself adjusts remuneration of the staff member by means of *malus* arrangement or *clawback* clauses (e.g. by lowering cash remuneration or by awarding a lower number of *instruments*). Ex-post risk adjustment should always be performance-related: techniques that are, for example, based on the amount of dividends or the evolution of the share price are not sufficient because the link to the performance of a staff member is not sufficiently direct. Therefore, ex-post risk adjustments are frequently also called

“performance adjustments” because they are a response to the actual risk outcomes of the staff member's actions. Performance measures taken at this stage should allow the AIFM to perform an analysis (similar to back testing) as to whether its initial ex-ante risk adjustment was correct. AIFMs should ensure there is a link between the initial performance measurement and the back-testing. Thus, the extent to which an ex-post risk adjustment is needed depends on the quality (accuracy) of the ex-ante risk adjustment.

141. The effect of *maluses* should not be inflated by paying out artificially high interest (above market rates) on the cash deferred parts to the staff member. *Maluses* operate by affecting the *vesting point* and cannot operate after the end of the *deferral period*. Furthermore, *clawback* can be a method for achieving an ex-post risk adjustment on variable remuneration.
142. AIFMs may utilize specific criteria whereby *malus* (to both the cash portion and the *instruments* portion of deferred remuneration) and *clawbacks* would apply. Such criteria should, for example, include:
- a. evidence of misbehaviour or serious error by the staff member (e.g. breach of code of conduct, if any, and other internal rules, especially concerning risks);
  - b. whether the AIF and/or the AIFM and/or the business unit subsequently suffers a significant downturn in its financial performance (specific indicators should be used);
  - c. whether the AIF and/or the AIFM and/or the business unit in which the staff member works suffers a significant failure of risk management;
  - d. significant changes in the AIFM's overall financial situation.
143. A *clawback* should typically operate in the case of established fraud or misleading information. Where applicable, AIFMs should include *clawback* clauses in addition to these cases e.g. for remuneration received in breach of the AIFMD and/or these guidelines.
144. Ex-post risk adjustment could be based on both quantitative measures and informed judgment.
145. To have the greatest impact on staff's incentives, the variables should measure outcomes as close as possible to the level of the decisions made by the staff member that is subject to the ex-post explicit adjustment. For example, variables for senior executives probably should be for outcomes for the AIFM as a whole, or for outcomes of units or decisions that were determined by senior executive strategy. In contrast, variables for the head responsible for a business unit ideally would reflect outcomes of that unit.

### **Implicit adjustments**

146. When the variable remuneration takes the form of *instruments*, the final payout to the staff member will depend partly on market prices due to fluctuations during the deferral or *retention period*. This implicit adjustment of remuneration is not related to any explicit decision of the AIFM, but is inherent to the form that is used for paying out. Under no circumstances should the evolution of the net asset value of the AIF or, for listed AIF, the evolution of the share price be considered sufficient as a form of ex-post risk adjustment. There should always be a form of explicit risk adjustment on the initiative of the AIFM. For non-senior staff in particular, there may be no direct relation between their decisions and the value of the AIF.

147. A *retention period* on its own can never be sufficient to design an ex-post risk adjustment for *instruments* and should not be a substitute for a longer *deferral period*.

#### **Possibility of upward revisions**

148. The market price of *instruments* can go up, so implicitly they are subject to movements in their value in both directions.

149. Under no circumstances should the explicit ex- post risk adjustment (both for cash and *instruments*) lead to an increase of the deferred part.

#### **Compliance of certain remuneration structures with the requirements on risk alignment of variable remuneration, award and pay-out process**

150. While it is necessary to have regard to all the relevant circumstances case-by-case, the guidelines under the headings “Risk alignment of variable remuneration”, “Award process” and “Pay-out process” of this Section may be met where :

- a) an AIFM must first return all capital contributed by the investors of the AIF it manages and an amount of profits at a previously agreed hurdle rate (if any) to the investors of the AIF, before the *identified staff* of the AIFM may receive any compensation for the management of the relevant AIF; and
- b) the compensation received by the *identified staff* of the AIFM is subject to *clawback* arrangements until the liquidation of the relevant AIF.

### **XIII. Guidelines on disclosure**

#### **External disclosure**

##### **Specific and general requirements on disclosure**

151. AIFMs should consider the additional disclosure on remuneration required under paragraph (8) of the *Recommendation*, to the extent that the latter may also be relevant to them. AIFMs should have the flexibility to disclose the information mentioned in the *Recommendation* through an independent remuneration policy statement, a periodic disclosure in the annual report or any other form. In all cases, however, the AIFM should ensure that the disclosure is clear and easily understandable and accessible.

152. Without prejudice to confidentiality and applicable data protection legislation, AIFMs should publicly disclose detailed information regarding their remuneration policies and practices for members of staff whose professional activities have a material impact on the risk profile of the AIFs the AIFM manages. AIFMs should also provide general information about the basic characteristics of their AIFM-wide remuneration policies and practices.

153. The *Recommendation's* remuneration disclosures may be made on a proportionate basis and the overall remuneration proportionality principle will apply to the type and amount of information disclosed. Small or non-complex AIFMs/AIFs should only be expected to provide some qualitative information and very basic quantitative information where appropriate. In practice, this could mean that

such AIFMs/AIFs are not expected to provide all the information under paragraph (8) of the *Recommendation*. AIFMs should disclose how they have applied the proportionality principle.

154. The disclosure should be published on at least an annual basis and as soon as practicable after the information becomes available.

### **Policy and practices**

155. The disclosure report should set out the decision-making process used to determine the remuneration policy for the individuals to which it applies. This may include the governance procedure relating to the development of the remuneration policy and should include information about the bodies (including their composition and mandate), such as the remuneration committee or external consultants, which played a significant role in the development of the remuneration policy. AIFMs should outline the role of all relevant stakeholders involved in the determination of the remuneration policy. Additionally, the disclosure should include a description of the regional scope of the AIFM's remuneration policy, the types of staff considered as material risk takers and the criteria used to determine such staff.
156. The report should include information on how pay and performance are linked. Such information should include a description of the main performance metrics used for: the AIFM, top-level business lines, and for individuals (i.e. scorecards). AIFMs should disclose information relating to the design and structure of remuneration processes, such as the key features and objectives of the remuneration policy and how the AIFM ensures that staff members in *control functions* are remunerated independently of the businesses they oversee. The report should also include a description of the different forms of variable remuneration used (i.e. cash, equity, options, other capital instruments, and long-term incentive plans) and should include the rationale for using these different forms and for allocating them to different categories of staff. Additionally, the report should include a discussion of the parameters used to allocate deferred and non-deferred remuneration for different staff categories.
157. Disclosure reports should describe how the AIFM takes into account current and future risks to which they are exposed when implementing remuneration methodologies and what these risks are. Also, AIFMs should describe the measures used to take account of these risks and the ways in which these measures affect remuneration. In addition, AIFMs should disclose the ways in which they seek to adjust remuneration to take account of longer-term performance - as in the AIFM's policy on deferral, vesting and performance adjustment.
158. The quantitative (financial) as well as qualitative (non-financial) criteria used by AIFMs for assessing individual performance which are relevant for determining the remuneration policies and practices and are described under the heading "Qualitative/Quantitative measures" in Section XII (Guidelines on the specific requirements on risk alignment) should also be disclosed in the disclosure reports.
159. The disclosure should be produced and owned by the *management body* that has the ultimate sign-off on remuneration decisions.

### **Internal disclosure**

160. The remuneration policy of an AIFM should be accessible to all staff members of that AIFM. AIFMs should ensure that the information regarding the remuneration policy disclosed internally reveals at least the details which are disclosed externally. Therefore, according to the size, internal organisation and the nature, scope and complexity of the activities of the AIFM, the information provided to staff

members might contain some of the elements listed in Section III (Disclosure) of the *Recommendation*. The staff members should know in advance the criteria that will be used to determine their remuneration. The appraisal process should be properly documented and should be transparent to the member of staff concerned. Confidential quantitative aspects of the remuneration of staff members should not be subject to internal disclosure.