

Finalised guidance

General guidance on the AIFM Remuneration Code (SYSC 19B)

January 2014

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1 Introduction and interpretation

Status of guidance statement

1. This statement is general *guidance* given under section 139A(1) of the Financial Services and Markets Act (FSMA). It relates to the *AIFM Remuneration Code (SYSC 19B)* of the *Handbook* and the *Guidelines* (defined in table 1 below).
2. We intend to keep the *guidance* set out here under review, and may revise it once we have received more data on the number, size, organisation, and activities of *full-scope UK AIFMs*.

Interpretation

3. This *guidance* statement is to be interpreted as if it were an Annex to SYSC 19B.1. Consequently *GEN 2* (interpreting the Handbook) applies to the interpretation of this *guidance* statement.
4. In particular, an expression in italics which is defined in the *Glossary* has the meaning given there (*GEN 2.2.7R*). Where an expression in italics is not defined in the *Glossary*, it has the meaning given by the following table:

Table 1: Glossary of terms defined in this guidance statement

Defined Expression	Definition
<i>AIFM remuneration proportionality rule</i>	The <i>rule</i> in SYSC 19B.1.4R(1)
<i>AuM</i>	Net assets under management in <i>AIFs</i> managed by the relevant <i>AIFM</i>
<i>Guidelines</i>	ESMA guidelines on sound remuneration policies under the AIFMD (ESMA/2013/232) (available at http://www.esma.europa.eu/system/files/2013-232_AIFMD_guidelines_on_remuneration_-_en.pdf)
<i>Partner</i>	A partner of a partnership or a member of a limited liability partnership (LLP)
<i>Pay-out Process Rules</i>	The following <i>rules</i> : i. Retained units, shares or other instruments

	(SYSC 19B.1.17R), ii. Deferral (SYSC 19B.1.18R), and iii. Performance adjustment (SYSC 19B.1.19R & SYSC 19B.1.20G).
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2 When the AIFM Remuneration Code takes effect, to which remuneration payments the AIFM Remuneration Code will first apply, and the scope of the AIFM Remuneration Code

1. This *guidance* statement has effect from 31 January 2014 and is directed to *firms* authorised as *full-scope UK AIFMs*.
2. Once a *firm* becomes *authorised* as a *full-scope UK AIFM*, it becomes subject to the *AIFM Remuneration Code* and the *Guidelines*. We expect *firms* to implement the *AIFMD* remuneration regime for new awards of variable remuneration to relevant staff for performance periods following that in which the *firm* becomes *authorised*. So the *AIFMD* remuneration regime will apply only to full performance periods and will first apply to the first full performance period after the *firm* becomes *authorised*. The *AIFM Remuneration Code* will not apply to any remuneration payments earned, allocated or otherwise awarded in respect of performance periods prior to the first full performance period after the *firm's authorisation*, including any remuneration previously awarded in the form of instruments that have not yet vested at the time of the *firm's authorisation* or which vest in subsequent performance periods.
3. Remuneration disclosure must be contained in the relevant *AIF's* annual report.¹ The annual report must be made available no later than 6 months following the end of the *AIF's* financial year.² We recognise that remuneration disclosure requires, amongst other things, splitting remuneration into fixed and variable remuneration (as those terms are used in the *AIFMD*) and breaking down remuneration for those whose actions have a material impact on the risk profile of the (relevant) *AIF* (i.e., the identification of the relevant staff of the *AIFM* in respect of each *AIF* it manages). It follows that the annual report for some *AIFs* may be required to be made available before the *AIFM* has completed or possibly

¹ FUND 3.3.5R (5) & (6)

² FUND 3.3.3R

even commenced its first full performance period after becoming authorised (and thus covering a period during which the *AIFM* was not required to determine, e.g., the elements comprising variable remuneration or allocating the remuneration of the relevant staff of the *AIFM* in respect of each *AIF* it manages).

4. It is therefore possible that the items of information relating to remuneration are not available to the *AIFM* in respect of the relevant reporting period in the required form, or that the information that is available to the *AIFM* will not provide materially relevant, reliable, comparable and clear information to investors about the remuneration policy of the *AIFM* as it affects the particular *AIF*. The difficulty in providing accurate and meaningful remuneration disclosure is limited to the period during which an *AIFM* implements its remuneration policy. Where an *AIFM* determines that it lacks the relevant information and/or that it believes such information as is available would not be materially relevant, reliable, or provide a proper basis for comparison, it could consider omitting such disclosure while noting or explaining the basis for that omission. *AIFMs* should ensure that the disclosure in the annual report complies with the general principles in Article 103 of the Commission Delegated Regulation (EU) No 231/2013.³

Small AIFMs

5. The *Guidelines* contain some references to smaller *AIFMs*, and state that the Commission Recommendation 2009/384/EC of 30 April 2009 (on remuneration policies in the financial services sector)⁴ should be considered by smaller *AIFMs*. However, the *AIFMD UK regulation*⁵ does not apply the *AIFM Remuneration Code* to *small authorised UK AIFMs, small registered UK AIFMs, non-EEA AIFMs* or *small non-EEA AIFMs*. Although these *firms* may nevertheless elect to implement some or all of these remuneration *rules*, it is not required to comply with the *AIFM Remuneration Code* nor the *Guidelines*.

³ <http://eur-lex.europa.eu/LexUriServ/LexUriServ.do?uri=OJ:L:2013:083:0001:0095:EN:PDF>

⁴ <http://eur-lex.europa.eu/LexUriServ/LexUriServ.do?uri=OJ:L:2009:120:0022:0027:EN:PDF>

⁵ See Part 3, *AIFMD UK Regulation* (available at <http://www.legislation.gov.uk/ukdsi/2013/9780111540206/contents>)

3 Applying proportionality to AIFMs, delegates of the AIFM, AIFM Remuneration Code staff at an AIFM performing permitted business not involving the management of AIFs, and remuneration committees

1. The *AIFM Remuneration Code* requires, among other things, a *firm* to apply requirements in SYSC 19B.1 to *AIFM Remuneration Code staff*. The *AIFM remuneration proportionality rule* requires a *firm*, when establishing and applying the total remuneration policies for *AIFM Remuneration Code staff*, to comply with SYSC19B.1 in a way and to the extent that is appropriate to its size, internal organisation and the nature, scope and complexity of its activities. Further *guidance* on proportionality is provided in paragraphs 23-31 of the *Guidelines*.
2. This guidance statement provides the FCA's view on when it may be appropriate for firms to be able to apply the *AIFM remuneration proportionality rule*. The process by which firms determine whether the *AIFM remuneration proportionality rule* applies is provided below (see page 6). This process is also used as the basis for the separate proportionality test which applies in relation to remuneration committees (see page 11).
3. We also consider proportionality applicable to the payment of remuneration in shares, units or other instruments below (see page 15).
4. Although this *guidance* gives the FCA's view of how certain provisions in the *AIFM Remuneration Code* could be applied in light of the principle of proportionality, it is 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.⁶ *AIFMs* should, if requested, be able to explain to the FCA the rationale for how they apply the *AIFM remuneration proportionality rule*, particularly where they have concluded that it is appropriate for certain *rules* to be disapplied.⁷

⁶ See paragraph 28 of the *Guidelines*.

⁷ See paragraph 25 of the *Guidelines*.

Proportionality with respect to the different characteristics of AIFMs - Process

5. This section provides guidance as to how proportionality should be taken into account by a *full-scope UK AIFM* in determining the *firm's* remuneration policy. Considerations of proportionality may result in the disapplication of the following *rules*:
 - a. Retained units, shares or other instruments (*SYSC 19B.1.17R*);
 - b. Deferral (*SYSC 19B.1.18R*); and
 - c. Performance adjustment (*SYSC 19B.1.19R & SYSC 19B.1.20G*).
6. For convenience, these *rules* are together referred to in this *guidance* as the *Pay-out Process Rules*. Disapplication of the *Pay-out Process Rules* is never automatic; *AIFMs* should perform an assessment for each of the *rules* that may be disappplied based on the application of the principle of proportionality. The *Guidelines* provide some detail on the proportionality elements that must be considered: size, internal organisation and the nature, scope and complexity of the *firm's* activities. We provide further *guidance* on each of these elements and suggest additional elements where appropriate.
7. If an *AIFM* is able to completely disapply the *Pay-out Process Rules*, that *AIFM* in its discretion may nevertheless apply all or part of the *Pay-out Process Rules* to the remuneration of its staff. Where an *AIFM* is not able to disapply the *Pay-out Process Rules* in their entirety, the specific numerical criteria in the *Pay-out Process Rules* should be adhered to.⁸

Size – AuM thresholds

8. Size includes factors such as capitalisation and assets under management. As a first step, we would expect an *AIFM* to calculate the value of its *AuM* in the *AIFs* that it manages. The *AIFM* should calculate its *AuM* by reference to the value of the portfolios of *AIFs* (i.e. net asset value of *AIFs*) that it manages on the most recent valuation date for the *AIFs*. However, portfolios of *AIFs* that the *AIFM* is managing under delegation should be excluded from the calculation.
9. The value of *AuM* provides a useful working presumption (to be confirmed or disconfirmed by considering other factors) as to how considerations of proportionality should be reflected in the *AIFM's* remuneration policy. For these purposes we think it is reasonable to use the *AuM* thresholds specified in the table below. If an *AIFM's* *AuM* is above the relevant *AuM* threshold, we would expect it to review the other criteria to determine whether there are other characteristics of the firm or its *AIFs* that,

⁸ See paragraph 27 of the *Guidelines*.

notwithstanding its size, merit disapplication of all or some of the *Pay-out Process Rules* on the grounds of proportionality. Similarly, if an *AIFM's AuM* is below the relevant *AuM* threshold, we would presume that it may disapply the *Pay-out Process Rules* on the grounds of proportionality. However, we would still expect it to review the other criteria to determine whether there are other characteristics of the firm or its *AIFs* that merit full application of all or some of the *Pay-out Process Rules*.

10. The following table shows the *AuM* thresholds for the two types of *full-scope UK AIFMs*. If an *AIFM* manages (i) only unleveraged open-ended *AIFs* or (ii) a combination of leveraged and unleveraged *AIFs*, we would characterise that *firm* in the second category, i.e. as an *AIFM* managing portfolios of *AIFs* in other cases.⁹ We would expect a *firm* corresponding to the description given in the first and second columns to commence its analysis of its remuneration policy by using the working presumption listed in the third column.

Table 2: Proportionality – AuM thresholds

	Type of firm	AuM threshold	Presumption
1	<i>AIFMs</i> which manage portfolios of <i>AIFs</i> that are unleveraged and have no redemption rights exercisable during a period of 5 years following the date of initial investment in each <i>AIF</i>	Less than £5 billion	it is appropriate to disapply <i>Pay-out Process Rules</i>
		Greater than £5 billion	it is not appropriate to disapply <i>Pay-out Process Rules</i>
2	<i>AIFMs</i> which manage portfolios of <i>AIFs</i> in other cases, including any assets acquired through the use of leverage	Less than £1 billion	it is appropriate to disapply <i>Pay-out Process Rules</i>
		Greater than £1 billion	it is not appropriate to disapply <i>Pay-out Process Rules</i>

Other proportionality elements

11. Based on the presumption derived from the *AuM* threshold, we would expect *firms* then to consider other proportionality elements against the characteristics of the *firm* and its business. To this end, we would encourage comparisons to a *firm's* peers and competitors in the *UK* or *EEA* market where relevant and where available. Where such information is not available, reference to other objective risk measures and the *firm's* *FCA* impact score (if known) will be sufficient.

⁹ This categorisation mirrors the categories of firms outlined in regulation 9 of the *AIFMD UK Regulation*. However the thresholds provided here serve a different purpose and are different than those used in regulation 9.

12. We note in the table below additional non-exhaustive factors that *firms* should take into account when determining whether the presumption created by the *AuM* threshold should apply to them. We have illustrated this process in a number of examples in the Appendix.

Table 3 – Proportionality – other elements

Proportionality element	Specific factor	Comments
Size	Number of the <i>AIFM's</i> partners, members, employees and consultants performing services for the <i>AIFM</i>	This factor may be taken into account in comparison to peers or in considering the type of staff performing services, ie. the number of <i>AIFM Remuneration Code</i> staff.
Internal Organisation	Whether the <i>AIFM</i> is listed and traded on a <i>regulated market</i>	If so, this factor favours application of the <i>Pay-out Process Rules</i> because compliance is likely to align the interests of the <i>AIFM's</i> staff with external investors in the <i>AIFM's</i> equity.
	Ownership structure - whether a significant portion of the <i>firm's</i> equity or such other appropriate legal and/or economic interests is held by investors not working in the business	To the extent that the senior management of the <i>firm</i> own a majority stake in the <i>firm</i> , this would favour the disapplication of some or all of the <i>Pay-out Process Rules</i> on the grounds of proportionality in respect of the senior management, such as the requirement on ex-post incorporation of risk.
Nature, scope and complexity of activities	Number of investment strategies / styles and number of <i>AIFs</i>	To the extent a <i>firm</i> manages a large number of <i>AIFs</i> which implement a wide range of strategies, this is likely to indicate increasing complexity. A <i>firm</i> may consider its activities as non-complex where regulation limits the <i>AIF</i> strategies carried out or scope of investment in such a way so that investor risk is mitigated.
	Risk management and monitoring	Where the discretion of the <i>AIFM</i> or its delegated portfolio manager (and thus its risk-taking) is strictly controlled within certain pre-defined narrow parameters and/or investment decisions are rules-based (such as where there is a mandate to track an index), this favours disapplications of the

Proportionality element	Specific factor	Comments
		deferral and retention requirements.
	Level of risk	We categorise <i>firms</i> internally using our conduct and prudential supervision categories (C1-C4, P1-P4 respectively) and if a <i>firm</i> is aware of its impact score, this can be used to measure its risk profile. Alternatively, <i>firms</i> should use their own indicators of risk, such as a VaR measure (where applicable) or other appropriate methods, to determine the level of risks linked to their <i>AIFs</i> ' activities. If an <i>AIFM</i> is associated with a low level of risk or an <i>AIFM</i> falls within the lowest-risk FCA impact score, this favours the disapplication of the <i>Pay-out Process Rules</i> .
	The nature of any delegation arrangement between the <i>AIFM</i> and its delegate	This factor should be taken into account when an <i>AIFM</i> delegates the function of portfolio or risk management to a third-party delegate. See below and examples 5 and 6 in the Appendix.
	The nature of certain fee structures such as performance fees or <i>carried interest</i>	This factor may be considered where fee structures satisfy the objectives of alignment of interest with investors and avoid incentives for inappropriate risk-taking, but perhaps do not meet the requirements of the <i>Guidelines</i> . ¹⁰ See example 7 in the Appendix.

Proportionality – delegation of portfolio or risk management

13. Where an *AIFM* is delegating portfolio or risk management, the *Guidelines*¹¹ say that either:

- a. the delegate is subject to regulatory requirements on remuneration that are equally as effective as those applicable under the *Guidelines*; or

¹⁰ See paragraph 159 of the *Guidelines* which specifies certain remuneration structures that comply with the requirements on risk alignment of variable remuneration, award and pay-out process.

¹¹ See paragraph 18 of the *Guidelines*.

- b. appropriate contractual arrangements are put in place with the delegate in order to ensure that there is no circumvention of the remuneration rules set out in the *Guidelines*.

Interpretation of remuneration requirements that are 'equally as effective'

14. An AIFM's assessment of which remuneration regulatory requirements are equally as effective as the requirements of the *AIFMD* should include a comparison of the objectives of those regulatory requirements, and does not require equivalence between regimes. As a result, we would consider the *CRD* and *MiFID* remuneration regimes to be equally as effective as the requirements of the *AIFMD* where a delegate¹² is subject to such requirements, because the *AIFMD* objectives are likely to be achieved.
15. Where EEA member states have not applied the full *CRD* remuneration regime to a type of investment firm, a delegate falling within this type should also be considered as subject to regulatory requirements on remuneration that are equally as effective. This is because we would normally expect it to be appropriate for the *firm* to receive similar treatment under the *AIFMD*.

Other proportionality considerations

16. The requirements on *AIFMs* when delegating portfolio or risk management may be subject to proportionality. As noted above, the nature of delegation arrangement should be considered, for example, the contractual terms and conditions, including the requirements of the investment mandate, agreed between the *AIFM* and delegate. We have illustrated some cases in examples 5 and 6 in the Appendix, where a delegate is subject to a group remuneration policy equivalent to *CRD* or where the delegate performing portfolio management has limited investment discretion.

Appropriate contractual arrangements with delegate

17. Where it would be appropriate for the *AIFM* to put in place contractual arrangements with the delegate, we expect the *AIFM* to tailor these arrangements so that it applies the *AIFM Remuneration Code* to the remuneration of the delegate's relevant staff resulting from the delegation. For example, the *AIFM* need only put arrangements in place with respect to those staff of the delegate who have a material impact on the risk profiles of the relevant *AIFs*, and in respect of remuneration that is connected with the delegated activities.

¹² In the UK, a delegate performing investment business would likely be subject to SYSC 19A or SYSC 19C.

Proportionality – Staff at an AIFM performing permitted business not involving the management of AIFs

18. The *AIFM Remuneration Code* applies to all staff whose professional activities have a material impact on the risk profiles of the *AIFM* or of the *AIFs* the *AIFM* manages (*AIFM Remuneration Code staff*). *AIFMs* are permitted to manage other *funds*, such as *UCITS*, and are permitted to carry out certain *MiFID* investment activities as listed in *FUND 1.4.3R*. To the extent that *AIFM Remuneration Code staff* are not involved in the management of *AIFs*, this can be considered in any proportionality analysis of such staff, and may justify disapplication of the *Pay-out Process Rules* in respect of those staff. We would also expect that some staff performing non-*AIFMD* business (e.g. under the *UCITS Directive* or *MiFID*) would not be considered *AIFM Remuneration Code staff* because of their limited impact on the risk profiles of the *AIFM* or of the *AIFs* it manages.
19. For a member of staff whose work is a mixture of *AIFMD* and non-*AIFMD* business, a *firm* could apportion his or her remuneration according to the type of business performed, and treat such portions under the relevant remuneration regime after taking into consideration the need to align risks in terms of risk management and exposure to risk. A *firm* may apportion an individual's remuneration based on time, funds under management or another benchmark taking into account any conflicts or risks created in each case.
20. Because of additional regulatory changes, remuneration received by an individual in respect of non-*AIFMD* activities may fall within the scope of other Directives such as the *CRD* and subject to their respective proportionality frameworks, if applicable.

Remuneration committees

General

21. *SYSC 19B.1.9R(1)* provides that a *firm* that is significant in terms of its size, internal organisation and the nature, the scope and the complexity of its activities must establish a remuneration committee. Although at least some of the same factors are considered as for general proportionality, the *Guidelines* explain that only significant *AIFMs* should be required to establish a remuneration committee. That means an analysis of each of the proportionality elements should show that the relevant firm is significant. Paragraphs 52-57 in the *Guidelines* provide further information regarding which *firms* should establish a remuneration committee.

22. *Firms* may set up a remuneration committee even if they are not a significant firm under the proportionality framework. In so doing, there is no requirement for that remuneration committee to be fully compliant with the requirements for a remuneration committee under *AIFMD*, although the firm should take account of general principles. We confirm this because the *Guidelines* may not be completely clear in this respect.

Proportionality elements

23. The guidance provided in Tables 2 and 3 above should also be used when analysing the proportionality elements. Without prejudice to the criteria outlined in paragraph 55 of the *Guidelines*, we would also have regard to the *AuM* thresholds specified above and, if a *firm* is above the relevant *AuM* threshold, that would provide a working presumption of significance in terms of size. Similarly, if a *firm* is listed and its equity is traded on a regulated market, that *firm* is likely to be significant in terms of internal organisation. As for the rest of the proportionality analysis for these purposes, comparisons with its peer group may be done to assist in determining whether a *firm* is significant.

4 How to treat payments to partners or members of an AIFM

1. This part of the *guidance* statement explains how *firms* should treat remuneration (as defined in the *Guidelines*) that is paid to partners or members (for ease, we use '*partners*' only below) of a *full-scope UK AIFM* set up as a partnership or limited liability partnership (LLP). The *Guidelines* define 'remuneration' broadly, and this includes 'all forms of payments or benefits paid by the AIFM ... in exchange for professional services rendered by the AIFM identified staff.'¹³ On the other hand, the *Guidelines* limit the scope of what should be considered remuneration by excluding '[d]ividends or similar distributions that partners receive as owners of an AIFM.'¹⁴ We use the terms 'profit share' or 'profit distribution' indistinguishably below.
2. We provide *guidance* on how remuneration for the purposes of the *AIFM Remuneration Code* should be calculated for *partners* of a *full-scope UK AIFM*, and where applicable, how deferral of the variable remuneration component can be operated.

¹³ See paragraph 10 of the *Guidelines*. The corresponding section in the Handbook is SYSC 19B.1.4R(3).

¹⁴ See paragraph 17 of the *Guidelines*.

Determination of a *partner's* remuneration – process

3. The *Guidelines* allow payments to *partners* as owners of an *AIFM*, such as dividends or distributions, to be excluded from the scope of the remuneration requirements.¹⁵ Many *AIFMs* in the *UK* are currently structured as partnerships or limited liability partnerships. Currently, payments from the *AIFM* to *partners* working in the business are classified as a profit share or distribution primarily for tax purposes, and no part is classified as a fixed remuneration or a variable remuneration. The requirements of the *AIFM Remuneration Code* primarily fall on the portion of a staff member's remuneration that is considered variable remuneration. So it is likely to be necessary to determine the portion of the payments to *partners* that is considered remuneration within *AIFMD* scope and the portion that is a return on equity in the relevant firm. We suggest the following analysis of a *partner's* remuneration for *AIFMD* regulatory purposes.

Allocating between profit share, fixed remuneration and variable remuneration under the *AIFMD*

4. Firstly, a *full-scope UK AIFM* which is a partnership must determine whether a *partner* should be considered as part of the *firm's AIFM Remuneration Code staff*.¹⁶ If the *partner* is part of the *firm's AIFM Remuneration Code staff*, his or her remuneration must comply with the *AIFM Remuneration Code*. Because these *rules* apply to the fixed and variable remuneration components of the *partner's* remuneration, it is then necessary to calculate these components from the payments or other benefits paid by the *AIFM* in exchange for professional services rendered by the *partner*.
5. This process of determining the fixed and variable remuneration for the purposes of *AIFMD* for a *partner* should depend on the circumstances of the *partner* and his or her relationship with the *AIFM*. We provide some approaches below. An *AIFM* may use a mixture of the approaches or change the approaches used as reasonable.

Approach based on existing payments to partners

6. For existing *firms*, a factor to consider is how the *partner* currently receives his or her profit share, and how the partnership or LLP pays its *partners*. An amount of additional profit share for senior or founding *partners* is likely to be considered as a profit distribution that is outside of the scope of the *AIFM Remuneration Code*, especially if structured as an automatic allocation with no adjustment for performance. An amount of

¹⁵ See paragraph 17 of the *Guidelines*.

¹⁶ See SYSC 19B.1.3R (defining *AIFM Remuneration Code staff*) and paragraphs 19-22 of the *Guidelines* (identifying the categories of staff covered by these guidelines).

discretionary profit share distributed to all *partners* may be considered a variable remuneration, especially if the amount will depend on performance. Finally, any drawings taken in advance may be considered a fixed remuneration.

Approach based on benchmarking

7. Another approach that may be possible is to use benchmarks such as
 - a. the remuneration structures of others performing similar tasks or working in similar businesses as the *partner* in question; and/or
 - b. where the *partner* has invested capital in the relevant *AIFM*, the return on equity or return on capital expected in a similar investment context to that of the *partner*.

General considerations

8. To the extent a *partner* works less than full-time in an executive position for the *AIFM*, a larger percentage of the *partner's* profit share should be considered as a profit distribution and not remuneration under the *AIFMD*. Conversely, where a *partner* devotes his or her full time and attention to the *AIFM*, we will expect a reasonable portion of the *partner's* profit share to be considered as remuneration under the *AIFMD*.
9. When allocating a *partner's* income to these regulatory categories under any approach, *firms* should take into account SYSC 19B.1.5R. The *AIFM* must ensure that the fixed and variable components 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.¹⁷
10. Finally, we draw the attention of affected *AIFMs* to SYSC 19B.1.24R (Avoidance of the remuneration code). For example, we would caution *AIFMs* not to allocate all payments to a certain *partner* as profit share without sound justification.

Partner's deferred portion of variable remuneration – impact on retained units, shares or other instruments

11. SYSC 19B.1.17R requires at least 50% of any variable remuneration to consist of units, shares or other instruments of the *AIF* concerned (referred to as "*units*" for convenience), whether such a component is deferred or not. The deferral of any remuneration in cash or in units,

¹⁷ SYSC 19B.1.15R

shares or other instruments that are retained would give rise to a tax charge in the base year in accordance with partnership tax rules. This means that *partners* are taxed on all their profit shares when they arise in the base year even when these profits are not yet distributed or received by the *partners*, i.e. prior to that remuneration vesting with those individuals. Effectively this tax charge would not be funded in the base year as individual *partners* do not have immediate access to the deferred remuneration.

12. The Government proposes to set up a statutory tax mechanism to address the unfunded charge issue following consultation with us and industry representatives. It published draft Finance Bill 2014 legislation and tax guidance for this mechanism on 10 December 2013.¹⁸ Subject to Parliamentary approval for the legislation, references in SYSC 19B.1.18R to the portions of deferred variable remuneration referred to above should be read as being on a 'net-of-tax' basis and should be calculated on a 'net-of-tax' basis where the partnership (instead of the *partner*) will pay tax on deferred remuneration upfront by opting to use the proposed mechanism.
13. This 'net-of-tax' basis will only take into account income tax that arises on the deferred remuneration under the partnership tax rules. National insurance contributions will not be payable by the partnership upfront and the *partner* will instead be liable to it when the deferred remuneration is received.
14. Where the mechanism is not used, then deferral of remuneration should be on a gross of tax basis and national insurance contributions are also payable. This is because it would not be considered to be compliant with the *AIFMD* remuneration regime for *firms* to allow their members to have immediate access to part of the deferred remuneration on the assumption that this would be used to fund payment of tax.

5 Remuneration in the form of units, shares or other instruments

1. The *AIFM Remuneration Code* requires that 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.¹⁹ However, this *rule* is subject to:
 - a. the legal structure of the *AIF*;

¹⁸ <https://www.gov.uk/government/publications/finance-bill-2014-draft-legislation-overview-documents>

¹⁹ SYSC 19B.1.17R(1)

- b. the instrument constituting the *fund*; and
- c. whether the management of *AIFs* accounts for less than 50% of the total portfolio managed by the *AIFM*.

Legal structure of the *AIF* and the instrument constituting the *AIF*

2. We interpret this condition to permit taking into account the circumstances where the legal structure or instrument of the *AIF* makes the *rule's* application impracticable considering the objectives of the *AIFM Remuneration Code*. Some non-exhaustive considerations for judging impracticability in this context would be where:
 - a. an *AIF* is closed-ended and there are no *units* available to acquire;
 - b. the *AIF's* constituting instrument or rules prohibit investments by *AIFM Remuneration Code staff* or prescribe a large minimum investment amount that will not be met by staff investments;
 - c. the *AIF* may not be marketed to some or all *AIFM Remuneration Code staff* due to laws or regulations preventing distribution to investors for whom *units* in the *AIF* are not suitable;
 - d. legislation or regulation limits or prohibits the *AIFM* or an individual from holding *units* in an *AIF* or *AIFs*;
 - e. an investment by *AIFM Remuneration Code staff* in an *AIF* could result in adverse tax consequences for any third party investors in the *AIF*, or
 - f. because of the *AIF's* structure, the creation of equivalent ownership interests, share-linked instruments or equivalent non-cash instruments is unduly costly when weighed against any benefits gained from aligning interests between relevant staff and investors.
3. Where the *firm* decides to disapply this *rule*, there is no requirement in the *AIFM Remuneration Code* for payment in *units* linked to other entities. Nevertheless, in order to align the incentives of relevant staff with those of the relevant *AIFs*, the investors of such *AIFs* and the *AIFM* itself, a *firm* has the option to use the following forms of payment:
 - a. shares, interests, or instruments linked to the *AIFM* or its parent company where reasonable such as, e.g. if either is a listed entity or where the performance of the *AIFM* business is relevant to the parent company's valuation; or
 - b. shares or instruments linked to the performance of *AIFs* or other portfolios managed by the *AIFM* or its affiliates.

Proportionality considerations for payment in shares, units or other instruments

4. We recognise that for some *AIFMs* the effect of SYSC 19B.1.17R(1) may be disproportionate, due to the number of *AIFs* that it manages or for certain types of *AIFM Remuneration Code staff* such as senior management or compliance and audit functions. In such cases, *firms* may alternatively pay staff in:
 - a. shares, interests, or instruments linked to the *AIFM*, or its parent company; or
 - b. shares or instruments linked to the performance of a weighted average of the *AIFs* managed by the *AIFM*.
5. Any such alternative should be justified by showing that it aligns the risks taken by staff with those of the relevant *AIFs*, the investors in such *AIFs* and the *AIFM* itself, or, when staff (such as those in compliance and audit functions) are not risk-takers, that it does not represent a conflict of interest with their duty to perform their functions independently.

6 Minimum retention periods

1. This *guidance* relates to the appropriate retention policy under SYSC 19B.1.17R(2) (relating to Remuneration Principle 12(e): Remuneration structures: retained units, shares or other instruments). We would normally consider a retention period of 6 months to be sufficient, provided that other risk management techniques within the *firm* are operating to secure sound and effective risk management (including, in particular, those on performance adjustment and measurement of performance set out in SYSC 19B.1.19R to SYSC 19B.1.21G). The retention period should apply to all *units* forming part of a variable remuneration award, beginning from the date at which the *units* vest. Longer retention periods may also be appropriate in certain cases.²⁰
2. Similarly to how the Remuneration Code (19A) operates, the *rule* on retention may be applied on a 'net of tax' basis where all the tax owed is deducted at source (as is the case under the *UK's* PAYE system) or paid on a self-assessment basis using the proposed statutory tax mechanism for partnerships.²¹ Where a tax liability arises under the PAYE system on the vesting of a deferred portion of *units*, the tax owed may be deducted at source to facilitate the payment of tax owed, and the remainder of *units* forming part of the variable remuneration award should be subject to the retention period.

²⁰ See generally paragraphs 137 -144 of the *Guidelines*.

²¹ This guidance is closely aligned with our finalised guidance on retention periods in SYSC 19A, which is available here: http://www.fsa.gov.uk/pubs/guidance/fg11_11_retention_periods.pdf

3. We note that it is common for firms subject to SYSC 19A to fund the PAYE liability that arises from paying a bonus in shares, by selling shares to a third party and using the proceeds to pay that liability to facilitate the payment of tax owed. Firms subject to SYSC 19B may also consider adopting such an approach. There may be cases in certain jurisdictions where the tax rate on the shares is lower than the tax rate on cash. We will not consider it acceptable for firms to sell shares that are subject to retention to meet tax liabilities on the cash amount.

Annex - supplemental guidance on applying proportionality (examples)

The following non-exhaustive examples illustrate the operation of this *guidance*. It should be borne in mind that individual *guidance* could vary the outcome provided by the operation of this general *guidance*.

(a) Example 1 (Proportionality does not apply):

Firm A is a *full-scope UK AIFM* that manages many *AIFs* which implement a number of investment strategies, including equity, fixed income and alternatives. The *AIFs* that it manages are both open-ended and closed-ended, and several are leveraged. Its *AuM* is approximately £10 billion. Taking into account this *guidance*, Firm A presumes that it must comply with the full *AIFM Remuneration Code*. It considers its size on other benchmarks, such as its number of staff or subsidiaries being greater than most of its competitors in the UK market. It counts six offices worldwide, with a number of subsidiaries abroad. In terms of internal organisation, the *firm* itself is listed on a regulated market, as are several of its *AIFs*. With respect to its activities, the *firm* holds additional permissions in the *UK* to carry on the activities listed in *FUND 1.4.3R*. The *firm* manages various investment strategies which invest in several regions and industry sectors.

We would expect Firm A to conclude that it is appropriate for it to comply in full with the *AIFM Remuneration Code* because on assessment of the proportionality elements, there is little evidence to demonstrate that Firm A should be considered less complex or small-scale.

(b) Example 2 (Proportionality does apply):

Firm B is a *full-scope UK AIFM* that manages three *AIFs* investing in commercial and residential property in the UK. The *AIFs* are closed-ended and unleveraged, and the firm's *AuM* is approximately £750 million. Taking into account this *guidance*, Firm B presumes that it may disapply certain *Pay-out Process Rules*. Considering its size, it ascertains that it has fewer staff than most of its competitors, and it has no subsidiaries. Regarding its internal organisation, its internal governance structure is non-complex as it has not established a supervisory function. Neither it nor its *AIFs* are listed. It is owned by three of its *partners*, each of whom works full-time in the business. With respect to its activities, it does not carry out any of the additional services listed in *FUND 1.4.3R*. Its investment strategies are not considered complex.

Firm B could reasonably conclude that it is appropriate for it to disapply the *Pay-out Process Rules*, assessed on a case-by-case basis, because on assessment of the proportionality elements, there is sufficient evidence to demonstrate that Firm B should be considered less complex or small-scale.

(c) Example 3 (Small size presumption displaced by consideration of other proportionality factors):

Firm C is a *full-scope UK AIFM* that manages three *AIFs* investing in global macro strategies. The *AIFs* are open-ended and leveraged, and the firm's *AuM* is approximately £800 million. Taking this *guidance* into account, Firm C presumes that it may disapply certain *Pay-out Process Rules*. Upon further considering its size, it ascertains that it has fewer staff than some of its competitors, and it has no subsidiaries. Its internal organisation involves external shareholders as it is part of a medium-sized asset management group, which is listed. With respect to its activities, it carries out the additional service of individual portfolio management under *FUND 1.4.3R*. Its global macro strategies are complex and use significant human capital, such as experienced economists and computer programmers. It uses considerable leverage at most times in its management of its *AIFs*, which occasionally reaches ten times their net asset value calculated on a commitment method basis²². The returns of the *AIFs* are extremely volatile, and are intended for investors with a high risk appetite. The *AIFs* are passported widely in the *EEA*, and Firm C has passported its services to a number of countries on a branch basis.

We would expect Firm C to apply the *Pay-out Process Rules* despite the size presumption, because Firm C carries out complex activities, namely managing highly-leveraged, volatile *AIFs* on a cross-border basis and it is part of a listed asset management group which makes its internal organisation more complex.

(d) Example 4 (Large size presumption rebutted, proportionality does apply):

Firm D is a *full-scope UK AIFM* that manages several *AIFs* investing in equities, including investment trusts as well as open-ended structures. Its *AuM* is £2 billion. Taking this *guidance* into account, Firm D presumes that it must apply the *Pay-out Process Rules* because it manages some open-ended *AIFs*. Upon further considering its size, it determines that it has fewer staff than some of its competitors. Its internal organisation is straightforward as most of the owners work in the business, with only a few external shareholders who together comprise a minority. Firm D is not listed. In terms of its activities, it uses limited leverage for bridging purposes in its *AIFs*, not more than 1.5 times their net asset values. The portfolios are characterised by strict investment restrictions requiring considerable diversification, and the *firm* strives to limit the volatility of its portfolios. Its *AIFs* do not pay performance fees to the *firm*. However, the *AIFs* are marketed under the *Prospectus Directive* or passported under *AIFMD* in a number of markets in Europe. Firm D also manages several *UCITS* with aggregate net assets of approximately £250 million that implement conservative equity strategies.

Firm D could reasonably conclude that it is appropriate to disapply some or all of the *Pay-out Process Rules*, despite the size presumption, because Firm D carries out non-complex activities, namely conservative, low volatility strategies; it is not listed; and it does not have significant external ownership with respect to internal organisation.

²² See Commission Delegated Regulation (EU) No 231/2013, Article 8 (available at <http://eur-lex.europa.eu/LexUriServ/LexUriServ.do?uri=OJ:L:2013:083:0001:0095:EN:PDF>)

(e) Example 5 (Proportionality applies to delegate when it contracts to apply CRD remuneration requirements):

Firm E is a *full-scope UK AIFM* that delegates part of its portfolio management activity to Firm Y, a non-EEA firm which is part of the same group as Firm E. Firm E puts in place contractual arrangements which require Firm Y to implement *CRD* remuneration requirements for the making of remuneration payments to the staff of Firm Y who have an impact on the risk profiles of the relevant *AIFs*. The remuneration of Firm Y's identified staff is already subject to oversight in accordance with a remuneration policy set at group level that implements *CRD* remuneration requirements, and this policy achieves the Guidelines' objectives in relation to the particular *AIFs* and the *AIFM* in question.

We would consider these arrangements appropriate because the full implementation of the *AIFMD* remuneration regime would bring negligible additional benefit in terms of appropriate risk alignment relative to the additional costs that would be incurred for the *AIFM Remuneration Code* to be implemented in full.

(f) Example 6 (Proportionality applies to delegate when it has limited investment discretion):

Firm F is a *full-scope UK AIFM* managing an *EEA AIF*. It has delegated portfolio management to a US manager, Firm Z, under a contract with strict investment guidelines leaving limited investment discretion to Firm Z. In addition, Firm Z is required by the contract to implement the *Guidelines*, except the *Pay-out Process Rules*. Due to the limited discretion given to Firm Z, there is little or no scope for it to affect the risk profile of the *AIF*.

We would consider this factor to indicate to Firm F that it would be proportionate to disapply the *Pay-out Process Rules* in relation to Firm Z.

(g) Example 7 (Proportionality applies to certain fee structures that meet objectives of regime)

Firm G is a *full-scope UK AIFM* that manages a number of *AIFs* implementing various private equity strategies. The fee structure of each *AIF* is intensively negotiated with prospective investors. Each *AIF* pays Firm G an annual management fee. Additionally, the firm's senior management are awarded *carried interest* in each *AIF* subject to a number of conditions, which – if the *AIF* performs well – will result towards the end of the lifecycle of the *AIF* (or earlier if the target returns agreed with investors have been achieved and there are appropriate clawback or make-up arrangements in place) in a portion of the gain being paid to the senior management. The senior management also co-invests with third party investors in the *AIFs*.

Firm G may reasonably conclude that it may disapply the *Pay-out Process Rules* for the payment of such *carried interest* to senior management on the grounds of proportionality. This carried interest structure appears to satisfy the objectives of alignment of interest with investors, because it has been negotiated with prospective investors and avoids incentives for inappropriate risk-taking, such as by being paid towards the end of the lifecycle of the *AIF* (or earlier if the target returns agreed with investors have been achieved and there are appropriate clawback or make-up arrangements in place).

Awards of variable remuneration to the staff of Firm G may also be made annually from management fees received. How the *Pay-out Process Rules* apply to this portion of variable remuneration should depend on the proportionality analysis applicable to Firm G and the role of the staff receiving the award. Finally, any gain received by Firm G's senior management as a return on any co-investment is not subject to the *AIFM Remuneration Code*.