

Remuneration policy of management companies under UCITS V

On 15 April 2014, the European Parliament in a plenary session gave its final approval to the UCITS V Directive. Once it enters into force, Member States will have 18 months.

UCITS V focuses mainly on three areas: the legal regime of the depositaries, the sanctions regime and lastly, the remuneration policy of management companies which is analysed in this note.

In the same vein as Directive 2011/61 on Managers of Alternative Investment Funds (**AIFMD**), UCITS V regulates in detail the remuneration policy of UCITS' management companies. At this time, and as expected, we inform you that both remuneration policies (applicable to alternative investment funds -AIFs- and to UCITS) are almost identical except for small differences that we will point out in this note.

To close the remuneration regime it must be recalled that when a management company provides investment services (portfolio management, investment advice and ancillary services such as safekeeping and administration of units and shares of collective investment schemes) the Guidelines published by ESMA/2013/606 on remuneration policies and practices (MiFID), applicable from 1 February 2014, will also apply to them.

We focus below on the new remuneration policy of management companies under UCITS V.

The guiding principles of the new legal regime are the following:

UCITS management companies shall establish remuneration policies and practices that:

- (i) are consistent with and promote sound and effective risk management;
- (ii) do not encourage risk-taking which is inconsistent with the risk profiles, rules or instruments of incorporation of the UCITS they manage;
- (iii) do not impair compliance with the management company's duty to act in the best interest of the UCITS;
- (iv) are in line with the business strategy, objectives, values and interests of the management company and the UCITS it manages and the investors of such UCITS; and
- (v) include measures to avoid conflicts of interest.

Proportionality principle: when setting the remuneration policy it shall be taken into account the size, internal organisation and the nature, scope and complexity of the

activities of the management company, and therefore, in certain circumstances, will be possible to waive particular requirements of the remuneration policy.

To which entities does this apply?

The remuneration policy applies to management companies of UCITS and to self-managed SICAVS UCITS. Unlike the AIFMD, in which the remuneration policy applies to third parties in whom certain functions are delegated and/or advisors, the agreed text of UCITS V is unclear at this respect.

What employees are affected?: Identified Staff

The remuneration policies and practices shall apply to all those categories of staff of the management company and specifically, to the identified staff, which includes the following categories of employees: (i) members of the management body (ii) senior management; (iii) risk takers; (iv) employees engaged in control functions; and (v) any employee receiving total remuneration that falls within the remuneration bracket of senior management and risk takers whose professional activities have a material

impact on the risk profiles of the management companies

To which remunerations if this applicable?

It shall apply to any benefit of any type paid by the management company or to any amount paid directly by the UCITS itself as consideration for the professional services rendered by the identified staff including, among others: (i) salaries (fixed and variable components), (ii) discretionary pension benefits, and (iii) any transfer of units or shares of the UCITS, made to the benefits of those categories of staff.

Management Body

The management body of the management company shall adopt the remuneration policy and shall review, at least annually, the general principles of the remuneration policy and shall be responsible for and oversee its implementation.

The implementation of the remuneration policy should be, at least annually, subject to central and independent internal review for compliance with policies and procedures for remuneration adopted by the management body.

Staff engaged in control functions shall be compensated in accordance with the achievement of the objectives linked to their functions, independent of the performance of the business areas they control.

The remuneration of the senior officers in the risk management and compliance functions shall be directly overseen by the remuneration committee, in case such committee exists.

Establishment of a remuneration committee

Management companies that are significant in terms of their size or the size of the UCITS 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 management company or the UCITS concerned and which are to be taken by the management body. The remuneration committee shall be chaired by a member of the management body who does

or of the UCITS they manage.

not perform any executive functions in the management company concerned. The members of the remuneration committee shall be members of the management body who do not perform any executive functions in the management company concerned. If employee representation on the management body is provided for by national law, the remuneration committee shall include one or more employee representatives. When preparing its decisions, the remuneration committee shall take into account the long-term interest of investors and other stakeholders and the public interest.

General requirements for risk alignment

The remuneration policies and practices shall include all aspects of the remuneration, including fixed and variable components, discretionary pension benefits and other similar specific benefits.

Payments related to the early termination of a contract shall reflect performance achieved over time and shall be designed in a way that does not reward failure. In this sense, we understand that “Golden parachute” arrangements for staff members who are leaving the management company and which generate large payouts without any performance and risk adjustment should be considered inconsistent with this principle.

The pension policy shall be in line with the business strategy, objectives, values and long-term interests of the management company and the UCITS it manages.

If the employee leaves the management company before retirement, discretionary pension benefits shall be held by the management company for a period of 5 years in the form of instruments. In the case of an employee reaching retirement, discretionary pension benefits shall be paid to the employee in the form of instruments, subject to a 5 year retention period.

Staff shall be 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.

Specific requirements for risk alignment

In the total remuneration, fixed and variable components shall be appropriately balanced; the fixed component shall represent 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.

Variable Remuneration (VR)

- ✓ Guaranteed VR shall be exceptional and shall occur only in the context of hiring new staff and shall be limited to the first year.
- ✓ At least 50% of any VR shall consist of units of the UCITS concerned, or equivalent ownership interests, or share-linked instruments or equivalent non-cash instruments with equally effective incentives as any of the above, unless the management of UCITS accounts for less than 50% of the total portfolio managed by the management company, in which case the minimum of 50% shall not apply. VR shall not be paid through vehicles or methods that facilitate the avoidance of the requirements of UCITS V.
- ✓ The instruments shall be subject to an appropriate retention policy designed to align incentives with the interests of the management company and the UCITS it manages and the investors of such UCITS. 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 and not deferred.
- ✓ A substantial portion, and in any event at least 40% of the VR component (or at least 60% in the case of a VR component of a particularly high amount), shall be deferred over a period which is appropriate and for at least 3 years in view of the holding period recommended to the investors of the UCITS concerned and shall be correctly aligned with the nature of the risks of the UCITS in question. Under the AIFMD deferment period is of at least 3 to 5 years.
- ✓ The VR, including the deferred portion, shall be paid or vest only if it is sustainable according to the financial situation of the management company as a whole, and justified according to the performance of the business unit, the UCITS and the individual concerned.
- ✓ In the same way, the total VR shall generally be considerably contracted where subdued or negative financial performance of the management company or of the UCITS concerned occurs, taking into account both current compensation and reductions in payouts of amounts previously earned, including

through malus or clawback arrangements, as described in the following section.

Where remuneration is performance related:

- ✓ The total amount of remuneration shall be based on a combination of the assessment of the performance of the individual and of the business unit or UCITS concerned and their risks and of the overall results of the management company, and when assessing individual performance, financial as well as non-financial criteria shall be taken into account.
- ✓ The assessment of performance shall be set in a multi-year framework appropriate to the holding period recommended to the investors of the UCITS managed by the management company in order to ensure that the assessment process is based on longer term performance of the UCITS and its investment risks and that the actual payment of performance-based components of remuneration is spread over the same period.
- ✓ The measurement of performance used to calculate variable remuneration components or pools of variable remuneration components shall include a comprehensive adjustment mechanism to integrate all relevant types of current and future risks.
- ✓ Existence of an adjustment mechanism to integrate current and future risks such as malus or clawback arrangements:
 - **Malus** is understood as the arrangement that permits the management company to prevent vesting of all or part of the amount of a deferred remuneration award in relation to risk outcomes or performances of the management company as a whole, the business unit, the UCITS and, where possible, the staff member. Malus is a form of ex-post risk adjustment.
 - Clawback** is understood as the contractual agreement in which the staff member agrees to return ownership of an amount of remuneration to the management company 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.

Transparency Requirements

UCITS V also requires new transparency requirements in relation to the disclosure of information to investors and regulators that go beyond what is required under the AIFMD.

Information to be included in the Prospectus and the KIID

The Prospectus shall include either (i) details of the up to date remuneration policy, including but not limited to a description of how remuneration and benefits are calculated, the identities of persons responsible for awarding the remuneration and benefits including the composition of the remuneration committee, in case such committee exists; or (ii) a summary of the remuneration policy and a statement that the details of the up to date remuneration policy aforementioned are available by means of a website (including a reference to that website) and that a paper copy will be made available free of charge upon request.

The KIID shall also include a statement in the same terms described above regarding the details of the up to date remuneration policy.

Information to be included in the Annual Report

The annual report shall include, among other issues, the following:

- ✓ The total amount of remuneration for the financial year, split into fixed and variable remuneration paid by the management company to its staff, and the number of beneficiaries, and where relevant, any amount paid directly by the UCITS itself, including performance fee.
- ✓ The aggregate amount of remuneration broken down by categories of employees or other members of staff whose professional activities have a material impact on the risk profiles of the management companies or of the UCITS they manage.
- ✓ A description of how the remuneration and benefits have been calculated.
- ✓ Outcomes of the annual reviews of the remuneration policy and its implementation, including any irregularities that occurred.
- ✓ Material changes to the adopted remuneration policy.

Contact

Clifford Chance Madrid

Paseo de la Castellana, 110
28046 – Madrid
Tel.: +34 91 590 75 00

Natalia López Condado

Counsel, Banking & Finance
natalia.lopez@cliffordchance.com

Cristina Armada

Lawyer, Banking & Finance
cristina.armada@cliffordchance.com

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Clifford Chance, Paseo de la Castellana 110, 28046 Madrid, Spain
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