European Securities and Markets Authority

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Jeroen Dijsselbloem, President of the Economic and Financial Affairs Council, Council of the European Union

Ref: Proportionality principle and remuneration rules in the financial sector

Dear Commissioner Hill, dear Mr. Gualtieri, dear Mr. Dijsselbloem,

Article 14a(4) of Directive 2009/65/EC ("UCITS Directive"), as amended by Directive 2014/91/EU ("UCITS V Directive") provides that ESMA shall issue guidelines addressed to competent authorities or financial market participants concerning the application of the remuneration principles set out under Article 14b of the UCITS Directive ("UCITS Remuneration Guidelines").

The UCITS V Directive further provides that ESMA shall cooperate closely with the EBA in the development of the guidelines in order to ensure consistency with requirements developed for other financial services sectors, and that the guidelines should, where appropriate, be aligned to the extent possible with the equivalent guidelines under the Directive 2011/61/EC ("AIFMD"). The latter ("AIFMD Remuneration Guidelines") were issued

by ESMA on 3 July 2013[1] following the requirement under Article 13(2) of the AIFMD for ESMA to develop guidelines on sound remuneration policies which comply with the remuneration rules set out in Annex II of the AIFMD. In developing these guidelines as well, ESMA closely cooperated with the EBA, in line with the mandate under Article 13(2) of the AIFMD, and in order to ensure as much as possible a cross-sectoral alignment of the remuneration rules in the financial sector, the content of the AIFMD Remuneration Guidelines was in turn largely aligned to the content of the Guidelines on Remuneration Policies and Practices issued by CEBS in December 2010 for the banking sector ("CEBS Guidelines")[2].

Article 14(b)(1) of the UCITS Directive (as amended by the UCITS V Directive) provides that "*When establishing and applying the remuneration policies referred to in Article 14a, management companies shall comply with the following principles in a way and to the extent that is appropriate to their size, internal organisation and the nature, scale and complexity of their activities*". Therefore, a key element of the UCITS Remuneration Guidelines (as well as the other aforementioned guidelines) relates to proportionality and, in particular, whether proportionality can lead to a situation in which the specific requirements on the pay-out process (i.e. the requirements on variable remuneration in instruments, retention, deferral and ex-post incorporation of risk for variable remuneration)[3] set out in the Directives may not have to be applied.

- The ESMA consultation on the UCITS Remuneration Guidelines

On 23 July 2015 ESMA published a consultation paper ("CP") on draft UCITS Remuneration Guidelines[4]. The consultation closed on 23 October 2015.

The CP proposed a reading of the provisions on proportionality under the UCITS V Directive[5] which was also in line with that of the CEBS Guidelines (i.e. the disapplication of the abovementioned requirements on the pay-out process set out at Level 1 can be allowed in certain circumstances on an exceptional basis) and the AIFMD Remuneration Guidelines, but different from that of the EBA consultation paper on guidelines on sound remuneration policies under Directive 2013/36/EU ("CRD IV") of 4 March 2015[6] and the final version of the EBA guidelines, published on 21 December 2015[7] (see below). This approach was based on a certain reading of the provisions on proportionality in the UCITS V Directive and supported by the consideration that the alternative reading followed by the EBA in the context of the CRD IV related to a different sector of the financial services industry. For the purposes of the consultation ESMA considered that the different nature of UCITS compared to credit

[1] ESMA/2013/232
[2] Available at https://www.eba.europa.eu/documents/10180/106961/Guidelines.pdf.
[3] Article 14b(1)(m), (n) and (o) of the UCITS Directive and Annex II, paragraph 1, letters (m), (n) and (o) of the AIFMD.
[4] 2015/ESMA/1172
[5] Proportionality is also foreseen in the UCITS V Directive via recital (3): "*Provided that management companies of UCITS and investment companies apply all the principles governing remuneration policies, they should be able to apply those policies in different ways according to their size, the size of the UCITS that they manage, their internal organisation, and the nature, scope and complexity of their activities*".
[6] EBA/CP/2015/03
[7] EBA/GL/2015/22

institutions, and the relatively diverse nature of the UCITS sector, could justify a different approach to proportionality which is in line with the AIFMD Remuneration Guidelines.

To form its final views on this matter, ESMA also included a question (Q1) in its CP aimed at assessing the impact from a general perspective, and more precisely in terms of costs and administrative burden, that a general prohibition to disapply any of the remuneration requirements based on proportionality would have on management companies.

ESMA received 37 responses to its CP, 27 of which were non-confidential and published on the ESMA's website. The overwhelming majority of respondents supported the approach on proportionality proposed in the CP.

- The EBA consultation and its guidelines on sound remuneration policies under CRD IV

The EBA was mandated under Articles 74 and 75 of the CRD IV to issue guidelines on sound remuneration policies with respect to the remuneration requirements contained in the CRD IV.

EBA consulted from March to June 2015 on draft guidelines on remuneration under the CRD IV. The consultation paper set out the EBA's legal interpretation, confirmed by the European Commission, that the wording of Article 92(2) of the CRD IV does not permit exemptions or waivers to the application of the remuneration principles. The feedback from this consultation, as well as information provided to the EBA by national competent authorities, evidenced that "*there are different legal interpretations of the proportionality clause as established in Article 92(2) of* [the CRD IV]*, which have led to different applications of the remuneration principle at national level*"[8].

The final EBA guidelines on remuneration are silent on the possibility to disapply any of the CRD IV remuneration requirements. Together with the guidelines, the EBA issued an Opinion[9] under Article 34 of the EBA Regulation addressed to the Commission, European Parliament and Council suggesting changes in the CRD to make clear that certain provisions on variable remuneration do not apply to certain firms and/or their staff. The Opinion is accompanied by a report on Member States' implementation of the principle of proportionality in the area of the CRD IV remuneration provisions.

- The finalisation of the UCITS Remuneration Guidelines

While finalising its UCITS Remuneration Guidelines ESMA had to balance the co-legislators' steer to ensure alignment with the AIFMD Remuneration Guidelines[10] and the obligation to

[8] See paragraph 13 of the EBA opinion on the application of the principles of proportionality to the remuneration provisions in Directive 2013/36/EU (EBAOp/2015/25) issued together with the EBA guidelines on 21 December 2015.
[9] EBA/Op/2015/25
[10] Recital 9 of the UCITS V Directive.

closely cooperate with the EBA "*in order to ensure consistency with requirements developed for other financial services sectors, in particular credit institutions and investment firms*"[11].

Against this background, and mindful of the information gathered from national competent authorities on different legal interpretations of the proportionality clause established in the sectoral asset management legislation, ESMA decided to follow an approach which is similar to that adopted by the EBA and did not include in its final UCITS Remuneration Guidelines[12] any guidance on the possibility not to apply certain specific requirements on the pay-out process set out in the UCITS Directive and as specified above.

- ESMA's stance on proportionality and call for further clarity and cross-sectoral alignment

Both the AIFMD and UCITS Directive prescribe that proportionality shall apply to the full set of remuneration principles set out under these Directives. This is made clear by the language in both Directives stating that management companies and AIFMs "*shall comply with the* [remuneration] *principles in a way and to the extent that is appropriate to their size, internal organisation and the nature, scope and complexity of their activities*". ESMA considers, therefore, that proportionality applies to the full set of requirements under Article 14b(1)(a) to (r) of the UCITS Directive and letters (a) to (r) of paragraph 1 of Annex II of the AIFMD. Proportionality is also a key element that had to be taken into account by ESMA when elaborating guidelines under both the AIFMD and UCITS Directive[13].

Recent work and legal analysis have called into question the existing understanding that the aforementioned proportionality provisions as set out under the UCITS Directive and AIFMD may lead to a result:

a) where – under specific circumstances – the requirements on the pay-out process (i.e. the requirements on variable remuneration in instruments, retention, deferral and ex post incorporation of risk for variable remuneration) are not applied; or

b) where it is possible to apply lower thresholds whenever minimum quantitative thresholds are set for the pay-out requirements (e.g. the requirement to defer at least 40% of variable remuneration).

ESMA considers that the scenarios under a) and b) should remain possible in certain situations and further legal clarity on this possibility could be beneficial to all the interested parties (market participants, investors and regulators).

This is true, in particular, in light of the specificities of the fund management sector. Fund managers operate according to an agency model and do not accept deposits nor deal on

[11] Article 14a(4) of the UCITS Directive, as amended by the UCITS V Directive.
[12] ESMA/2016/411
[13] Both Article 14a(4) of the UCITS Directive and Article 13(2) of the AIFMD state that ESMA shall issue guidelines on the remuneration principles taking into account "*the size of the* [AIFMs/management company] *and the size of* [AIFs/the UCITS that] *they manage, their internal organisation and the nature, the scope and the complexity of their activities*".

their own account. As a consequence, fund managers, unlike credit institutions, do not issue liabilities to fund investors. Fund investors have a claim on the investment portfolio which is ring-fenced from the fund manager. Fund managers manage a portfolio of securities on behalf of a fund, in the interest of the investors in such fund, under an investment mandate. Their discretion on how to dispose of the assets in the relevant portfolio is constrained by the investment objectives and specific limits and restrictions set out in the investment management mandate and in specific product regulation (e.g. UCITS concentration limits). ESMA recalls that remuneration rules under the UCITS Directive and AIFMD are aimed to align the interests of, including the risks taken by, the fund managers with those of the investors of the funds that they manage.

Given the nature of activities of fund managers, and the variety of funds they manage and strategies they implement for those funds, it is appropriate to recognise the possibility to tailor the rules on the pay-out process of variable remuneration when these do not, in the specific circumstances, achieve the goal of aligning the interests of the fund manager's staff with those of the investors in the funds. For example:

- *Small and non-complex fund managers and small amounts of variable remuneration*: small and non-complex fund managers have a relatively high number of identified staff, compared to larger fund managers, to whom the remuneration requirements could apply (even though this number is low in absolute terms). For these fund managers, the application of the pay-out process rules needs to be proportionate so as not result in significant one-off and on-going administrative and systems costs which could put them at a competitive disadvantage against larger fund managers.[14]

  Similarly, certain staff only receive small amounts of variable remuneration. The pay-out process rules are only effective in aligning long-term interests when the amount of variable remuneration is meaningful enough to be spread over a multi-year horizon.

- *Application of the deferral rules*: Article 14b(1)(n) of the UCITS Directive requires a substantial portion, and in any case at least 40%, of the variable remuneration component to be deferred over a period which is appropriate in view of the holding period recommended to the investors of the UCITS and is correctly aligned with the nature of the risks of the UCITS in question. The same article then goes on to clarify that the deferral period should be at least three years.

  Certain types of funds may have an investor's holding period which is significantly shorter than three years. Because of this, it can be argued that the application of the deferral rules is unlikely to align the interests of the management company's staff with those of the investors in the UCITS and the risks of the UCITS in question.

[14] This would particularly be the case for UCITS management companies, This is because in the UCITS Directive there is no equivalent provision to Article 3 of the AIFMD exempting asset managers with lower amounts of assets under management from the scope of the AIFMD.

- *Application of the payments in instruments rules*: Article 14b(1)(m) requires that a substantial portion of any variable remuneration component consists of units of the UCITS concerned, equivalent ownership interests, or share-linked instruments or equivalent non-cash instruments.

  The payment of variable remuneration in shares or UCITS or equivalent non-cash instruments might not achieve an effective alignment of interests for certain staff of the management company who have no direct involvement in the management of UCITS, for example the head of the compliance or internal audit function. In such cases, it could be desirable to include other types of instruments in the remuneration packages of those staff such as, for example, shares in the management company.

- *Application of payout process rules to delegates*: the UCITS remuneration guidelines, as well as the AIFMD remuneration guidelines clarify that the remuneration requirements apply to delegates of the management company. This is the case even when the delegate's contract with the management company sets out strict investment guidelines or it only covers a small portion of the UCITS portfolio. As a consequence, the delegate would have little or no discretion to affect the risk profile of the UCITS.

  In light of the above, there might be cases where the application of the payout process rules to the staff of the delegate would not be proportionate and would not achieve the outcome of aligning the delegates' staff interests with those of the investors in the UCITS. There is also a risk that the unwillingness of delegates outside of the EEA to be subject to some requirements they consider disproportionate, could prevent access of EU management companies to certain investment strategies.

- *Application of pay-out process rules to portfolio managers who do not manage only portfolios of UCITS:* certain portfolio managers employed by the management company do not manage the UCITS as a whole. For example, they may have responsibilities for managing an asset class / strategy in which they have a very specific expertise. These portfolio managers would apply this expertise across the various products managed by the management company, which could be UCITS, alternative investment funds or segregated mandates, but they might only affect the risk of a small proportion of the relevant portfolio.

  As a consequence, the application of the pay-out process rules, for example the payment of a portion of variable remuneration in shares of the UCITS, could be disproportionate and may impose an excessive burden on certain portfolio managers which may ultimately reduce the level of diversification and choice available to the funds' investors.

It is also important to note that the fund manager's decision not to apply certain remuneration requirements should never be automatic. In applying proportionality, it is the responsibility of the fund manager to review how each remuneration principle should apply to it in a way that it aligns the interests of its staff with those of the underlying investors and having taken into account its size, internal organisation and the nature, scope and complexity of its activities. Fund managers must document this process and be able to demonstrate at any time, with the support of objective evidence, to their national competent authorities the way in which they have applied the relevant remuneration principles.

Given, inter alia, these specificities, it would be inappropriate to impose the payout requirements where their implementation would not achieve the intended policy outcome. Moreover, to achieve an effective alignment of interests between the fund managers' staff and the investors, ESMA believes that it would be inappropriate for the following fund managers to be subject in all circumstances to the requirements on the pay-out process:

i) smaller fund managers (in terms of balance sheet or size of assets under management),

ii) fund managers with simpler internal organisation or nature of activities, or

iii) fund managers whose scope and complexity of activities is more limited.

ESMA also considers that it would be disproportionate to apply the requirements to relatively small amounts of variable remuneration and to apply certain requirements to certain staff when this would not result in an effective alignment of interests between the staff and the investors in the funds.

ESMA is of the view that legislative changes in the relevant asset management legislation could be one way to further clarify the applicable regulatory framework and ensure consistent application of the remuneration requirements in the asset management sector. These could further clarify the requirements in order to allow for the scenarios outlined in (a) and (b) above.

ESMA stands ready to provide further input to the institutions if that were considered useful.

Yours sincerely,

Steven Maijoor

cc: Věra Jourová, Commissioner for Justice, Consumers and Gender Equality, European Commission

Olivier Guersent, Director-General, DG Financial Stability, Financial Services and Capital Markets Union, European Commission

Tiina Astola, Director-General, DG Justice and Consumers, European Commission

Sven Giegold, MEP, member of the Committee on Economic and Monetary Affairs and rapporteur for Directive 2014/91/EU, European Parliament

Jeppe Tranholm-Mikkelsen, Secretary-General of the Council of the European Union