CAPOLINO-PERLINGIERI & LEONE
STUDIO LEGALE

VIA ELECTRONIC DELIVERY

September 27, 2012

European Securities and Market Authority
103 Rue de Grenelle
75007 Paris
France

Re: Consultation on Guidelines on Sound Remuneration Policies under the AIFMD

Ladies and Gentlemen:

You will find attached our comments to the draft Guidelines on sound remuneration policies under the AIFMD.

We represent a number of alternative investment fund sponsors and investors in alternative investment funds, active in many different European jurisdictions, and we would like to thank ESMA for this opportunity to submit our answers and other comments. We hope that you will find them helpful in your continued efforts to craft detailed rules for the application of the AIFMD.

Please do not hesitate to contact us - at +39 02 8905 0320 or dleone@cp-dl.com - should you have any questions or wish to discuss any matters in connection with our submission.

Very truly yours,

Dante Leone

MEMORANDUM

to: European Securities and Market Authority

from: Dante Leone, Barbara Braghiroli, Nicola Rapaccini

date: September 27, 2012

<u>Our Comments to Draft Guidelines on Sound Remuneration Policies under the AIFMD</u>

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.**

We agree with your general approach. In particular, we share your view that, whereas in the banking world remuneration policies are meant to avoid excessive risk-taking potentially affecting the banks, in the asset management world remuneration policies should fundamentally pursue the alignment of interests between clients/investors and funds managers.

The alternative fund industry is populated by highly sophisticated investors, which have always worked hard to attain such alignment of interests. In fact, a very typical structure for the compensation of alternative fund managers – monetary investment in the AIF by the AIF managers themselves; carried interest calculated on other investors' profits – constitutes the perfect fulfilment of this goal of aligning interests of investors and managers.

At the same time, we believe that due consideration should be given to the fact that risk-taking (often, extreme risk-taking) is an inherent component of AIFs. Indeed, AIFs are almost invariably – and most likely should, where they are not – offered as very risky products. As a result, we do not believe that investors in AIFs need to be protected against excessive risk-taking. Furthermore, we do not believe that risk-taking may damage the AIF but not the manager, as the typical structure of compensation is such that - at least for the vast majority of small-to-mid-sized AIFMs - compensation arising from fixed management fees covers little more than their operating costs. Consequently, risks that do not produce profits significantly impact the actual profits of the AIFMs (and their ability to attract and retain key personnel), in addition to the value of investments in the AIF made by AIFM principals.

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.**

> We agree with your clarifications, to which we would add that, in order to calculate the maximum portion of the return on investments by staff members which should not be subject to the Guidelines, management fees and carried interest on such investments should be deemed waived by the AIFM (as they typically are).

- **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.**

> Yes, to the extent that quantitative threshold would allow AIFMs to reserve slightly better investment terms for their staff members. An extra 20% of annual return over standard investors' returns (net of management fees and carried interest, as pointed out in our answer under Q2) would seem appropriate for this purpose.

- **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?**

> Yes, we agree.

- **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)?**

We would suggest staying true to the principles set forth in article 13 of the AIFMD. If the delegated function is such that it requires authorization or registration of the delegated entity, of course such delegated entity will be subject to the rules set forth in the Guidelines, to the extent that it qualifies as an AIFM.

- **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)?**

No, indeed it is the distribution or allocation of those proceeds among AIFM staff that should be subject to the Guidelines. (Similarly, banking fees are not subject to the CEBS Guidelines, whereas compensation paid by banks to bank staff is.)

- **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.**

In principle yes, although we would note that, in a very large portion of AIFMs, members of the governing body of the AIFMs also serve as senior management and/or there may be senior management that are also owners of the AIFMs and do not serve as members of the governing body. Moreover, given the significant differences in numbers and structure of staff within the various AIFMs, it is paramount that the Guidelines allow the appropriate flexibility in order to configure remuneration policies in a way that is most appropriate based on the specific AIFM's organization.

- **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.**

Please see the qualitative remarks set forth in our answers under Q2-Q7.

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.

We agree and would add an additional criteria: the level of principal investment in the AIF (in absolute terms as well as in terms relative to the size of the AIF) by the AIFM and its members/managers/staff. Moreover, with respect to size and nature, we would clarify that due consideration should also be given to the type of AIFs managed, such as, for example, closed funds with a limited term during which to draw down commitments or so-called "evergreen vehicles".

- **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.**

Yes, we agree.

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

Please see the qualitative remarks set forth in our answer under Q9.

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?**

Yes, we very much agree. This currently is a matter of serious concern for groups comprising banking or investment firms as well as AIFMs.

- **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.**

In principle, yes. To such end, we would clarify that AIFMs which (*i*) are part of groups subject to CRD and (*ii*) comply with the proposed Guidelines, are not bound to comply with additional remuneration policies pursuant to the CEBS Guidelines.

- **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.**

Please see the qualitative remarks set forth in our answers under Q12-Q13.

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.**

Yes, we agree to the extent that payment of variable remuneration would affect the soundness of the accounts of the AIFM. After all, even if the variable remuneration is not paid in a year, the fixed remuneration should be able to cover the living standards of the persons otherwise entitled to receive the variable remuneration (see Annex II, paragraph (1)(j) of the AIFMD and §117 of your consultation paper).

- **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.**

Please see the qualitative remarks set forth in our answer under Q15.

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.**

Yes, we agree. With specific regard to the difference in remuneration, we suggest that the variable compensation of the members of the supervisory function should be limited, in relative terms, compared to their fixed compensation.

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

Yes, we agree with the proposed Guidelines. However, we suggest clarifying that – subject to standard legal requirements of the various national jurisdictions – the decision on whether shareholders may be asked to approve an AIFM's remuneration policy and whether such shareholders' vote is consultative or binding should be left to the AIFM itself.

- **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.**

We believe that the threshold of Euro 250 million of value for portfolios managed by AIFMs is much too low and we suggest that Euro 1 billion would be a more appropriate threshold (to the extent that internal organization and nature, scope and complexity would not otherwise make the AIFM significant). Also, AIFMs with less than 20 permanent staff or no more than 3 AIFs under management may be added as examples of AIFMs that are not significant for the purposes of establishing a RemCo.

- **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.**

Yes, we agree.

- **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.**

We do not believe that applying the proposed criteria to determine whether a RemCo should be set up would entail very significant costs.

- **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.**

Please see our answer under Q19.

- **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.**

Yes, we agree. We would also add that no member of the supervisory function should attend RemCo meetings which discuss and decide on his/her remuneration.

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

No.

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

We are not sure about the meaning of "*...independent of advice provided to senior management...*" under §79 of your consultation paper. Indeed, external consultants may consult for both the RemCo and the senior management, and this would not necessarily translate into a conflict of interest. Perhaps the sentence should read "*…advice, internal and external, <u>including advice</u> that is independent of advice provided to senior management…*".

- **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.**

Yes, although we would stress the importance of general reporting by the RemCo to the AIFM's shareholders' meeting.

- **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.**

Yes, we believe that reporting to the AIFs' shareholders' meeting would be beneficial. We do not think that this would translate in a significant cost for the RemCo. Conversely, we believe that it might serve to build additional trust between the AIFM and the AIFs' investors.

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

Yes, we agree, but we would suggest:

- in §89 of your consultation paper, to clarify that the variable remuneration of staff in control functions should not be determined by the financial performance of any business areas (rather than the financial performance of the business area they monitor), in order to avoid potential indirect conflicts of interests; and
- in §92 of your consultation paper, for AIFMs that are not required to have a RemCo, to allow for supervision on the remuneration of the control functions, not only by the person or persons in charge of the management body, but also by the shareholders' meeting.

- **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.**

Please see the qualitative remarks set forth in our answers under Q17-Q28.

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.**

Yes, we agree.

- **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.**

We would add that it is a sound principle for the severance pay of AIF managers to take into account the performance of the AIF prior to their termination and/or any breach of obligations or other duties on the part of the AIF manager that may have had a detrimental effect on the AIF. Also, if termination by the AIF manager is voluntary, consideration should be given as to whether such termination triggers "key person" or other similar mechanisms at the level of the AIF, which may have an adverse effect on the AIFM.

- **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.**

Yes, we agree.

- **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.**

Please see the qualitative remarks set forth in our answers under Q30-Q32.

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.**

As mentioned above, we should bear in mind that AIF investors are purchasing interests in inherently risky products (or, at the very last, riskier than most other investment products), and that these products do not pose a systemic risk of any kind. Consequently, the goal of the proposed Guidelines is not, and should not, to create a disincentive for a manager to take risks in connection with its management of an AIF.

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

Yes, although see our answer under Q34 for a general discussion of the approach of the proposed Guidelines.

- **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?**

Yes, we agree.

- **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.**

Yes, we agree.

- **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.**

We are not sure that external variables should play any role in the definition of the remuneration policy of AIFMs. After all, the goal of the proposed Guidelines is aligning the interests of the AIFM's staff with those of the investors in the AIFs, rather than with those of the AIFM's owners or of other interested parties. As mentioned above (see our answer under Q1), this is the main difference between the proposed Guidelines and the CEBS Guidelines.

- **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.**

Yes, we agree and we would also specify that responsibility for keeping such records should be given to the RemCo, if any, or otherwise to the staff dedicated to supervisory functions.

- **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.**

Yes, we agree.

- **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.**

Yes, we agree.

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

Yes, we agree, although we would leave the flexibility of providing instruments that do not relate exclusively to AIFs in relation to which the relevant staff members perform their activities.

- **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.**

No. Once again, the goal is not to create a disincentive to risk-taking, but rather to structure compensation in order to align the interests of AIFs' investors with those of AIFs' managers.

- **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.**

We are not sure that retention policy in-and-of-itself (*i.e.*, as a function separate from deferral of compensation in order to allow ex-post adjustments) serves the goal of aligning the interests of AIFs' investors with those of AIFs' managers. Retaining key persons may be a benefit for the AIFM's senior management or owners, but it does not fall within the goals of the proposed Guidelines. Where investors believe that ensuring the continued availability of key persons is crucial to the results of the AIF, they will ask for appropriate protections in that respect.

- **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.**

Yes, we agree.

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

Yes, we agree, because risk alignment and time horizon discussions are irrelevant in the instances in which AIF managers receive performance fees only after all capital of the AIF's investors - as well as a preferred return on such capital, in the typical all-capital-back-first model adopted for private equity and venture capital funds - has been paid back.

- **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.**

Yes. Structures in which the payment of capital back to AIF investors is limited to capital used to acquire investments with respect to which a performance fee is paid to AIFM staff - so-called "deal-by-deal" model in private equity and venture capital funds, less common in Europe and more so in Asia and the U.S. - should also be deemed to have a built-in adjustment mechanism integrating all types of current and future risks, *provided* that there are clawback provisions (at times, accompanied by escrow or personal guarantees) which are meant to make the AIF's investors whole in the event that, due to weaker performance of the other investments of the AIF, the performance fees already paid should be returned in part or in full to the AIF's investors.

- **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.**

Please see the qualitative remarks set forth in our answers under Q34-Q47.

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.**

Yes, we agree.

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

We do not believe that disclosure would entail significant costs. Conversely, we believe that it would be conductive to building trust between the AIFM and the AIFs' investors.

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Once again, we hope that you will find our comments helpful in your continued efforts to craft detailed rules for the application of the AIFMD.

We are of course available to discuss any of the foregoing matters in further detail.